Fair Return

Rent control programs are constitutionally required to give landlords the opportunity to obtain a fair return on their property investment.

Courts have not required a particular methodology to determine if a landlord is receiving a fair return, generally leaving it to the rent programs.

Court Approval of MNOI

Courts have approved Maintenance of Net Operating Income (“MNOI”) as a valid methodology for determining fair return.

What is MNOI?

Maintenance of Net Operating Income compares income and expenses in a base year and a subsequent (“comparison”) year to determine if the Net Operating Income has kept up with expenses and inflation.

Pasadena uses MNOI as the standard for determining fair return.

Pasadena City Charter, Section 1813(b) Fair Return Standard

In Pasadena, all rent increases above the Annual General Adjustment (75% of the CPI) sought by a landlord must go through MNOI analysis.

Petition Required for MNOI Increase

Landlords must petition for an MNOI rent increase and the rent increase may be granted after a hearing if the landlord proves entitlement to the increase.

How is the Base Year determined?

The base year is generally the year before the rent control law was adopted. Before the adoption of rent control, it is presumed that a landlord could set rents at a rate that established a fair return. In Pasadena’s law, the base year is set at 2021.

What is the Comparison Year?

The Comparison Year is a year subsequent to the Base Year that a landlord uses to seek a rent increase based on a claimed lack of fair return.

What is Net Operating Income?

Net Operating Income is a rental property’s annual income minus the property’s annual operating expenses.

To maintain Net Operating Income, a Base Year’s Net Operating Income is compared to Comparison Year’s Net Operating Income, adding an inflation factor to the Net Operating Income. If the Comparison Year’s rental income is insufficient to cover the increased operating costs and inflation factor, rents may be increased to cover the difference.

What are operating expenses?

Operating expenses include:

- Maintenance.
- Operating.
- Utilities.
- Property taxes.
- License and registration fees.

Operating expenses continued:

- Landlord self-labor.
- Amortized cost of capital improvements.
- Interest allowance for amortized expenses.
- Legal expenses.

Items that are not operating expenses:

- Debt service on loans used to finance or refinance the property.
- Depreciation.
- Reimbursed expenses, e.g. insurance claims.
- Expenses resulting from unreasonable delay in maintenance.
    - E.g., a roof leak that causes other damage

Inflation factor for Net Operating Income

Cmparison Year Net Operating Income is adjusted by an inflation factor of 50% of the Consumer Price Index for each of the years between the Base and Comparison Years.

What if a landlord believes MNOI does not produce a fair return for their property?

Landlords are permitted to contend the MNOI calculation for their property does not produce a fair return. They must first go through the MNOI procedure. Then petition to present an alternate fair return analysis.

Other Proposed Fair Return Methodologies

- Return on property value
- Return on equity
- Very low rents in the base year (“Vega”) adjustments

Courts have approved MNOI and have not been receptive to other methodologies, except the extremely low base year rents (Vega).

Vega Low Base Year Rent Adjustments

Vega adjustments have only been allowed when rents were not raised over an extended period and are significantly below market. Rents just being below market are not sufficient.

Base Year Adjustments

Pasadena’s rent law permits adjustments to a landlord’s Base Year NOI in exceptional circumstances:

- Unusually high or low operating expenses.
- Disproportionately low gross income.