

---

*Fair Return  
and the California Courts*

**MICHAEL ST JOHN, Ph.D.**

**St. John & Associates  
2121 West Street  
Berkeley, California 94702**

---

## EXECUTIVE SUMMARY

### *This Report...*

#### **Defines fair return**

This report discusses the concept of “fair return” as it has been addressed by California appellate courts in rent control cases. Written by an economist about a legal principle, the report links legal and economic concepts, exploring the economic outcomes of differing legal interpretations of fair return.

#### **Clarifies the relationship between inflation and fair return**

This report breaks new ground by explaining thoroughly the link between inflation and fair return. Much confusion has been generated over the years about this connection. Municipalities across California have allowed themselves to be convinced that there is no need to allow rents to increase at the inflation rate. In fact, more than full inflation adjustments are often required, because operating and maintenance expenses may increase by more than the inflation rate. The report demonstrates that a fair return will be generated only if full inflation adjustments are allowed.

#### **Explains fair return methods**

This report catalogs and explains the fair return formulas that have been employed in California’s rent control jurisdictions. The report then demonstrates that—as courts have said repeatedly from a legal point of view—it matters little what formula is employed. If any of several fair return formulas is used correctly, the result will be approximately the same. The report also identifies the bottom line—the method most likely to serve as a “constitutional” fair return rule.

#### **Concludes that full indexing is required for true rent stabilization**

This report’s conclusions contrast sharply with conclusions reached by attorney Kenneth Baar, whose 1983 article has dominated the literature for more than a decade. While Baar questions the feasibility of making internally consistent fair return computations, the report makes it clear that consistent fair return computations are possible. While Baar believes that “partial indexing” for inflation is all that is required, the report demonstrates that full inflation indexing is mandatory. While Baar believes that it is permissible for municipalities to lower the real value of rents year after year, the report demonstrates that such a policy is confiscatory.

#### **Serves as a manual for fair return calculations**

This report can also serve as a manual for administrators and courts interested in sound application of the principles of fair return. Comprehensive, balanced, and thoroughly documented, the report spells out the calculations that will result in fair return rents—rents that will balance the interests of property owners and tenants and protect the economic viability of the controlled housing enterprises.

# Table of Contents

---

Acknowledgements.....	i
Conventions used in this document .....	i
Biographical note.....	ii
1. <i>INTRODUCTION</i> .....	1
1.1. The Fair Return Principle .....	1
1.2. The Fair Return Requirement in California Case Law.....	4
1.3. The Fair Return Requirement--Economic Content.....	12
1.4. Fair Return in Other Regulated Industries.....	15
2. <i>INFLATION AND FAIR RETURN</i> .....	17
2.1. Inflation and Free Market Rents .....	17
2.2. Inflation and Rent Control.....	25
2.3. The Debt Service Question.....	35
2.4. The Treatment of Inflation in California Case Law.....	46
2.5. Rent Control and Social Security.....	53
3. <i>THE STANDARDS</i> .....	55
3.1. True Fair Return Standards.....	57
3.1.1 <i>Fair Return on Value (FROV)</i> .....	57
3.1.2 <i>Fair Return on Equity (FROE)</i> .....	62
3.1.3 <i>Fair Return on Investment (FROI)</i> .....	64
3.1.4 <i>Internal Rate of Return (IRR)</i> .....	67
3.2. Approximation Standards.....	70
3.2.1 <i>Maintenance of Net Operating Income (MNOI)</i> .....	70
3.2.2 <i>NOI Ratio Standard</i> .....	77
3.2.3 <i>The CPI Standard</i> .....	80
3.3. Comparisons of Fair Return Standards .....	82
3.4. False Standards .....	86
4. <i>RELEVANT CASE LAW</i> .....	87
4.1. Debt Service.....	89
4.2. Fair Return Calculations.....	93
4.3. Cases Involving MNOI as a Fair Return System.....	100
4.4. Capital Improvements .....	107
5. <i>CONCLUSION</i> .....	110
5.1. Several Fair Return Systems--One Conclusion .....	110
5.2. Inflation and Fair Return: The Key to the Puzzle.....	111
5.3. Post-Modern Rent Control: True Stabilization.....	112

---

*Continued on next page*

## Table of Contents, Continued

APPENDICES .....	115
Appendix A: CPI and Rent Index, SF Bay Area, 1919-1996.....	116
Appendix B: CPI and Rent Index, US Cities, 1913-1982 .....	118
Appendix C: Hypothetical Index and Expense Calculations.....	120
Appendix D: Hypothetical Investment History with 5% Inflation and 100% Indexing....	124
Appendix E: Hypothetical Investment History with 5% Inflation and 50% Indexing .....	128
Appendix F: CPI and Social Security .....	131
FAIR RETURN CASE LIST .....	133
GLOSSARY .....	137
BIBLIOGRAPHY.....	141
INDEX OF CASE CITATIONS .....	145