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To the honorable Rent Control Board Members:

This is a follow up to my previous memo. It outlines a methodology for how you might approach evaluating a rate case for Mill Pond. This methodology is based on the rate justification process used by the Department of Public Utilities to set rates.

COST-BASED METHODOLOGY FOR SETTING RENTS

1. Carrying cost of the acquisition

It is my understanding the acquisition was made with some portion of the note held by the previous owners. You should ensure this was an arms-length transaction, and any seller-financed future sale is also arms-length. The concern here is that because such a large portion of the rate case is dependent upon this item, you should ensure it has not been inflated by a related parties' purchase price or some other consideration that inflates the price beyond fair market value for the property.

There are several determining factors, which I would suggest you require the applicant to share. First, you know the purchase price, as it is filed with the assessors. What is the annual interest on the note? What is the duration of the note? Is the note structured as a straight-line pay down or is there a balloon payment due at some point? On an acquisition such as this, I would assume financing is in the 15 to 30 year range. The applicant will argue for the shortest term possible, as this will increase the line item impact on the rate case. I might suggest you choose a reasonable mortgage length such as a minimum of 20 years, a reasonable interest rate such as 6% to 8%, and use a simple mortgage calculator to determine the portion of the rate base tied to the acquisition of the asset.

2. Capital purchases/improvements

Capital purchases/improvements should be depreciated over the expected lifetime of the investment. For example, if the applicant were buying a pick-up truck, a reasonable depreciation schedule would be five years; a new water line on the other hand might have an expected lifetime of 30 years or more. The longer the lifetime of the asset, the less the impact should be on the annual rate base. You should add an imputed cost of capital, which likely would be slightly higher than the mortgage rate, say in the



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range of 8% to 10%. In the case of a purchase of a pick-up truck, you would divide the purchase price by 5 and add in the annual finance charge. Once again, there are a number of on-line tools to develop a simple depreciation schedule and one should be created for each asset in question.

3. Operating expenses

Examples of operating expenses are mowing and plowing. The applicant has provided you with a schedule of operating expenses. These annualized expenses should be included at 100% in the rate case.

4. Owner's profit

Once you have computed categories one, two, and three, you should add a reasonable rate of return. In the example of a DPU filing, a reasonable rate of return is 8%. This final number gives you the aggregate revenue the rent should generate. For example, if there are 35 sites, you would divide this number by 35 and then by 12 to set the monthly rent.

Example rate case:

I have not taken the time to create an actual rate case for this applicant, as I am volunteering my time. Here is an example of how it might result. You will need to plug in the actual numbers for each line item category. I have specifically used round numbers to simplify the example.

1. Carrying cost	60,000
2. Capital purchases/improvements (annualized depreciation)	15,000
3. Operating expenses	25,000
Sub-Total	100,000
4. Owner's Profit calculated at 8%	8,000
Total rent revenue for determination of rent	108,000
Divided by 35 units (annual rent)	3,086
Divided by 12 (monthly rent)	\$ 257.14



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Due diligence requirement

I would strongly encourage you to require financial statements, signed by the applicant's Certified Public Accountant, that documents his actual income statement related to this property, and require him to submit any and all documentation you need to justify each line item in the income statement. These financials should be audited, not just reviewed, as audited financials include an expression by the CPA as to their accuracy.

In summary

I believe this to be a fair methodology that provides the owner with a reasonable rate of return while protecting the interests of the rent control tenants, whose interest you must weigh in your final determination as you set the rent for the units in question.

Respectfully submitted,

Patrick White