

Apartment Operating Cost Increases (March 2001-March 2002)

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The Annual General Rent Adjustment under Santa Monica's Rent Law

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This study was commissioned by the Santa Monica Rent Control Board in order to provide technical assistance in the preparation of its 2002 annual general adjustment regulations.

The opinions herein are those of the author and do not necessarily reflect the opinions of the Rent Control Board.

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I. Alternate Rent Increase Mechanisms Percentage v. Dollar Increases and other Issues

A Perspective on the Annual Rent Adjustment

A majority of apartment rent control ordinances tie the allowable annual rent increase to the percentage increase in the CPI and set the increase as a percentage of the current rent (as opposed to a uniform dollar amount for all units).

Annual Rent Increase Standards under California Apartment Rent Control Laws

<u>Jurisdiction</u>	<u>Annual Rent Adjustment</u>
Berkeley	Set by Rent Board
Beverly Hills	CPI
East Palo Alto	CPI (lower of all-items & rent residential index)
Hayward	5%
Los Angeles	CPI
Oakland	CPI (avg. all-items & less shelter)
San Francisco	60% of CPI
San Jose	8%
Santa Monica	Set by Rent Board
West Hollywood	66% of CPI

A Weighted Cost Index

Santa Monica's law directs the Rent Board to institute annual rent increases based on an analysis of changes in apartment operating costs.¹ Pursuant to that direction the Board has used a "weighted

¹ The Rent Control law states:

Section 1805. (b) ANNUAL GENERAL ADJUSTMENT: Each Year the Board shall generally adjust rents as follows:

- (1) Adjust rents upward by granting landlords a utility and tax increase adjustment for actual increases in the City of Santa Monica for taxes and utilities.
- (2) Adjust rents upward by granting landlords a maintenance increase adjustment for actual increases in the City of Santa Monica for maintenance expenses.
- (3) Adjust rents downward by landlords to decrease rents for any actual decreases in the City of Santa Monica for taxes. ...

(e) In making individual and general adjustments of the rent ceiling, the Board shall consider the purposes of this Article and the requirements of law.

operating cost index" in order to estimate apartment cost increases. This contrasts with the other rent ordinances which tie rent increases to the CPI, which reflects the general market basket of goods, rather than apartment expenses in particular.

In fact, in Santa Monica's annual general adjustment studies, the estimates of annual increases in a substantial majority of apartment costs are based on increases in the CPI. This approach is used because information on actual increases in these costs is not publicly available and is not determined by rates which are set by public agencies. For example, the measurement of increases in maintenance and insurance costs is CPI based. In addition, approximately half of apartment owners' rental income consists of net operating income (NOI) which covers cash flow and debt service rather than operating expenses. The cash flow portion is adjusted by a CPI factor. Overall, of the 82% of rental income that is adjusted each year,² approximately 66% is adjusted by a CPI index and approximately 16% is adjusted based on rate increases that are not tied to CPI. Approximately 18% of rental income, the portion attributed to debt service, is not adjusted. The annual general adjustment standard could be seen as a standard that provides for increases tied to a combination of two different CPI indexes, two types of rate increases, and increases in property taxes.

**CPI and Non-CPI Adjusted Cost Factors
in Operating Cost and Annual General Adjustment Determination**

Type of Cost	Operating Cost Weight ³	Measure of Cost Increase
Factors Adjusted by the CPI		
Water & Sewer	.028	Rates determined by CPI
Maintenance & Other	.145	CPI all-items less shelter
Insurance	.041	CPI all-items less shelter
Self-Labor	.069	CPI all-items
Cash Flow	.329	CPI all items
Management	.050	CPI all items
Total Weight Factors Adjusted by CPI	.662	
Factors <u>Not</u> Adjusted by CPI		
Gas	.049	Southern California Gas Rates
Electricity	.022	Southern California Electric Rates
Property Taxes	.068	2% per year or actual increases
Refuse	.019	Rate increases
Total Weight Factors <u>Not</u> Adjusted by CPI	.158	

² The portion of income that is attributable to base year levels of debt service is not adjusted.

³ These weights are calculated by this author by adjusting the 2000 "Component Ratio" set forth in last year's annual general adjustment report by its "Pct.Increase 4/00-4/01" (See AGA Report 2001/2002, p.10, Chart A), and then dividing that sum by the 4.2% annual general adjustment for 2001. Next year's weights will differ, however, the overall distribution among factors adjusted by the CPI and factors not adjusted by the CPI will not differ significantly.

Furthermore, it must be understood that the cost increases that can be measured and/or estimated can only be averages, when the reality is that ratios of each type of cost and its annual increase vary substantially among apartments.

In totality, Santa Monica's methodology is more sensitive to changes in apartment costs than the CPI standards used in other jurisdictions because it considers increases in water, sewer, refuse, gas, and electricity costs. But, there are substantial limits to what precision is possible.

In fact, since 1990, the rent increases permitted pursuant to the annual general adjustments have approximately equaled the percentage increase in the CPI - a 28.9% increase in rents versus a 31.0% increase in the CPI.⁴ The table on the following page summarizes the annual general adjustments since 1979.

From 1979 through 1989, rent increase allowances were always calculated as a percentage of the current rent. From 1990 through 1999 dollar floors (minimum allowable increases) were added to the percentage increase allowances. In the past four years, the annual general adjustments have included dollar ceilings on allowable rent increases.

⁴ From March 1990 through March 2001, the CPI all items for all urban consumers increased from 134.5 to 176.2.

Annual General Adjustments under Santa Monica Rent Controls

CPI Increase**		Pct. Rent Increase	Dollar Rent Increase	Ceiling	Utility Increase
8.8%	1979	7%			
18.4%	1980	6.5%			
9.1%	1981	5.5%			
8.8%	1982	5.5%			
0.3%	1983	4.5%			
4.7%	1984	4%			
4.6%	1985	3%			1% master metered gas 0.5% master metered elec.
4.3%	1986	2.5%			2% - master metered elec.
4.0%	1987	4%			
4.4%	1988	3%			
4.6%	1989	3%			
6.6%	1990	6%	or \$25		
3.9%	1991	3.5%			\$7.00 - master metered elec. \$11.00 - master metered g&e
4.2%	1992	3%	or \$16		
3.0%	1993	3%	or \$16		
1.8%	1994	2%	or \$11		
1.4%	1995	1.5%	or \$ 8		
1.7%	1996	1.6%	or \$ 9		
1.6%	1997	2%	or \$15		
1.0%	1998	1%	or \$ 4	\$ 9	
2.2%	1999	1%	or \$ 4	\$ 9	
3.5%	2000	3%	\$12 for units on properties w/o vac. inc.	\$28	
3.2%	2001	4.2%		\$40	\$10 master metered electric

* See Rent Board Regulations, Chapter 3, published on the Rent Board's internet web page.

** The change in the CPI all-items from March of the prior year to March of each year is used. (See table Appendix A)

The Use of a CPI Standard for Annual General Adjustments

As the foregoing discussion indicates, Santa Monica's methodology for setting annual general adjustments is heavily based on the CPI. In practice, the use of a CPI based standard would accomplish nearly the same results as the current methodology.

Under these circumstances, one option may be to adopt a CPI standard for future annual general adjustments. This approach would have the advantage of removing the annual disputes over rent increases that are an inevitable outcome of the use of a methodology (the annual general adjustment study) that requires discussion and debate in order to make public decisions over how to interpret sophisticated analysis. Furthermore, one major potential strength of the annual general adjustment studies, their possible sensitivity to very volatile changes in gas and electricity costs, has been offset by the lack of publicly available information on apartment owners' gas and electricity costs (see Section II.H of this report.)

Vacancy Decontrol

Until 1995, rent increases were limited to the amounts authorized by the annual general adjustments, except when apartment owners obtained additional adjustments pursuant to individual rent adjustment petitions.

From October 1995 through 1998, pursuant to the adoption of the Costa-Hawkins Act, apartment owners were permitted increases of up to 15% on vacancies.

Starting on January 1, 1999, apartment owners have been permitted unlimited increases when apartments become vacant.⁵ As a result, within the three year period of vacancy decontrols, 27% of the units in the City (7,507 out of 27,434 units) have been permitted to raise rents to market levels. As the table below demonstrates, the market rent levels are far above rent controlled levels.

⁵ The data on vacancy increases in this section is set forth in Santa Monica Rent Control Board, "The Impact of Market Rate Vacancy Increases - Three-Year Report January 1,1999-Dec.31,2001" (Feb 2002, report available on the Rent Board's web page).

Vacancy Increases 1/1/99-12/31/01 (7,507 units)⁶

<u>Number of Bedrooms</u>	<u>Pre-increase Median MARs</u>	<u>Post-Increase Median MARs</u>	<u>No. of units Obtaining Vacancy Increases</u>	<u>Dollar Amount</u>	<u>% Change</u>
0	\$572	\$861	1,012	\$289	51%
1	\$647	\$1,167	3,871	\$520	80%
2	\$828	\$1,600	2,284	\$772	93%
3	\$1,060	\$2,068	340	\$1,008	95%

In the units with vacancy increases, the overall rate of rent increases since the adoption of rent control in Santa Monica has far outpaced the rate of inflation.

**Rent Increases for Units with Vacancy Increases
Compared with the Increase in the CPI**

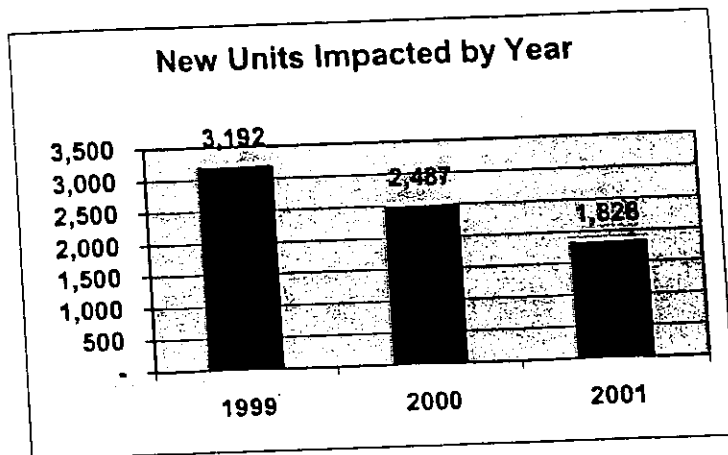
<u>Size of Unit</u>	<u>Median Rent 1978*</u>	<u>Median Rent with Vacancy Increase</u>	<u>Pct. Increase</u>	<u>CPI Pct. Increase</u>
Studio	\$200	\$ 861	331%	172% ⁷
1 br.	\$250	\$1,167	367%	↓
2 br.	\$350	\$1,600	357%	
3 br.	\$455	\$2,068	355%	

*Median rents for 7,507 units that have had vacancy increases.

⁶ Id , based on table on page 4 and data on p.5.

⁷ 1978 CPI all-items - annual average - 65.3; 2001 CPI all-items - annual average - 177.3.

Vacancies are occurring at the highest rate among units that have already become vacant and the number of units obtaining initial vacancy decontrol increases has been declining each year.



The vacancy increases have not been evenly spread among apartment owners. 27% of all units have had vacancy increases and there have already been vacancy increases in a majority of all buildings. 2,340 buildings with from four to ten units, which contain 14,330 apartment units constitute approximately half of the rental housing stock in Santa Monica. According to the registration records of the Rent Board, 1,579 buildings with 10,080 units have had at least one vacancy increase, while 761 buildings with 4,250 units have not yet had any vacancy increases.

**Distribution of Vacancy Increases Among Apartment Buildings (1999-2001)
Buildings with Four to Ten Units⁸**

Size of building (Apt. Units)	No. of bldgs. & (units)	Buildings with Number of Vacancy Increases								
		0	1	2	3	4	5	6	7+	
4	623/(2492)	269	169	124	49	12				
5	389/(1945)	145	101	69	49	20	5			
6	546/(3276)	181	119	108	80	36	15	7		
7	265/(1855)	71	49	57	37	25	16	7	3	
8	175/(1400)	32	35	46	22	23	6	6	5	
9	62/(558)	20	5	15	8	5	2	2	5	
10	280/(2800)	43	43	42	50	44	35	17	6	
Total	2340/(14,326)									

It is critical to note that the foregoing data on vacancy increases does not take into account the 15% vacancy increases that were permitted between 1995 and the end of 1998.

⁸ Source of data: print out supplied by Rent Board to author, summary of data compiled by the author.

Issues in Establishing a General Adjustment Methodology

As the above data clearly indicates, vacancy decontrol has resulted in what may be labeled as a "bifurcated" rent structure in the City, with an average difference of \$500 to \$1,000 between allowable rent levels for units with and without vacancy decontrol increases. Under these circumstances, the differences in outcome among the different rent increase methodologies for different units has become more substantial. In the case of percentage increases, if the average percentage increase is 3% a year, the difference in allowable rent increases for one bedroom units with median rents would be \$16 per month in the first year (\$192 per year) or \$64 per month (\$768 per year) within four years, depending on whether the unit had obtained a vacancy decontrol increase.

**Allowable Rent Increases Under Percentage Methodology
After Adoption of Vacancy Decontrol**

Pct. Annual General Adjustment

	Median Rent	2%	4%	6%
1 bedroom apt. without vacancy increase	\$629	\$12.58	\$25.16	\$37.74
1 bedroom apt. with vacancy increase	\$1,167	<u>\$23.34</u>	<u>\$46.68</u>	<u>\$70.02</u>
Difference		\$10.76	\$21.52	\$32.28

For two and three bedroom units, the differences in allowable rent increases in the first year would be approximately \$23 per month for two bedroom units and \$30 per month for three bedroom units and \$92 per month to \$120 per month in the fourth year. On an annual basis, the differences would be \$276 to \$360 in the first year and \$1,104 to \$1,440 in the fourth year.

Across-the-Board Dollar Rent Increases

As previously indicated the annual general adjustment analysis is mostly CPI driven and the available information does not indicate whether operating cost increases are greater for apartments with higher rents. In the case of Santa Monica, rent levels are largely determined by the circumstance of whether or not a unit has had a vacancy increase, rather than size of the unit. For example, the median rent for one bedroom units which have received vacancy increases (\$1,167) is higher than the median rent for two bedroom units (\$828) and three bedroom units (\$1,060) which have not received vacancy increases. The median rent for two and three bedroom units which have obtained vacancy decontrol increases is double the level for units which have not obtained such increases.

Under these circumstances, flat dollar annual general adjustments are recommended. This conclusion is based on the likelihood that cost increases are not significantly correlated with rent levels and that apartment owners with lower rents should not receive smaller rent increases. Conversely, units which have received the large vacancy increases do not have to receive larger rent increases, since on the average they have already obtained rent increases far exceeding the increase in the CPI and the amounts that have been estimated in the annual general adjustment studies as necessary to cover operating cost increases.

Alternative Rent Increase Mechanisms

Alternative types of annual rent adjustment standards include:

- 1) dollar floors and/or ceilings for allowable rent increases,
- 2) percentage floors and/or ceilings for allowable rent increases

These types of mechanisms accomplish some of the same results as across the board dollar increases; they insure certain levels of allowable rent increases for lower rent units and place a ceiling on rent increases for units with high rents. However, they are still based on the premise that rent increases should be tied to rent levels.

GA and CPI Comparison 1979 - 2003

	CPI Increase	GA Increase
1979	8.8%	7.0%
1980	18.4%	6.5%
1981	9.1%	5.5%
1982	8.8%	5.5%
1983	0.3%	4.5%
1984	4.7%	4.0%
1985	4.6%	3.0%
1986	4.3%	2.5%
1987	4.0%	4.0%
1988	4.4%	3.0%
1989	4.6%	3.0%
1990	6.6%	6.0%
1991	3.9%	3.5%
1992	4.2%	3.0%
1993	3.0%	3.0%
1994	1.8%	2.0%
1995	1.4%	1.5%
1996	1.7%	1.6%
1997	1.6%	2.0%
1998	1.0%	1.0%
1999	2.2%	1.0%
2000	3.5%	3.0%
2001	3.2%	4.2%
2002	2.8%	1.75%
2003	3.9%	3.00%
TOTAL	112.8%	85.1%
GA Percentage of CPI		75.40%