## SANTA MONICA RENT CONTROL BOARD ADMINISTRATION MEMORANDUM

DATE: May 17, 2001

TO: Santa Monica Rent Control Board

FROM: Mary Ann Yurkonis, Administrator

FOR MEETING OF: May 24, 2001

RE: Annual General Adjustment 2001/02

### SUMMARY

The Annual General Adjustment is calculated using the "component ratio to gross rent" or "pie" method. This is the same method that has been used over the last several years.

The 2000/2001 March-to-March increase in the Consumer Price Index for all urban consumers in the Los Angeles-Anaheim-Riverside area was 3.2%. The increase for urban consumers less shelter was 3.0%. The general adjustment calculation relies in large part on these figures. A general adjustment based on 100% of the CPI alone would be 3.5%.

The annual general adjustment is usually retrospective, looking back at changes in operating expenses of the prior year. However, when a change which affects the coming year is definite it is usually incorporated into the annual general adjustment. One such change is the significant increase in electricity rates authorized by the Public Utilities Commission on May 15, 2001. The commission authorized a new rate structure for residential and commercial consumers. The new rates will be retroactive to March 27, 2001 and are projected to increase the average monthly residential bill up to $71 or 37%. The commission also commented that additional rate increases may be necessary in the future to stay in line with rising wholesale electricity costs.

Rates for gas have also increased significantly in the past two years. Last year's general adjustment reflected a 21.2 percent increase in the gas component. This year, from April 2000 to April 2001, the average monthly gas bill has increased by 35.7%. In the past two years, gas rates have increased by 56.9%.

Water and refuse rates have also had some increase in rates but the increases are not as significant as the gas and electric rates. When the increases in all the utilities are considered, especially the electricity rates, operating costs have increased by 4.5%.

Staff recommends that the Board schedule a public hearing on June 7, 2001 to consider the recommended 2001/2002 general adjustment of 4.5% for all units and a ceiling, or maximum increase, of $43.

**Note**: Owners of units with a market rate increase implemented between September 1, 2000 and August 31, 2001 are presumed to have included operating cost increases when they established the rent on the unit. Therefore, these units are not eligible for the 2001 general adjustment.

## METHODOLOGY

The 2001/2002 General Adjustment was prepared by the staff of the Rent Control Board, using the methodology and survey data developed by Dr. Kenneth Baar. (See Appendix A for details of methodology.)

In this report, expenses cover the period April 1, 2000 to March 31, 2001. Staff collected data from Southern California Gas, Southern California Edison, the U.S. Bureau of Labor Statistics and the City of Santa Monica General Services and Finance departments to determine operating cost increases experienced by landlords of multi-family residential properties. Cost increases are discussed under the heading for each expense category.

## OPERATING EXPENSE CALCULATIONS

*(In the following discussion, to avoid confusion, the word "unit" is used to refer to quantities to which rates are applied, such as water units. Apartment units are referred to as apartments.)*

### I. Property Taxes

Under state law, property taxes are limited to 1% of assessed value. Increases in valuations are limited to 2% per year, except when a property is sold and reassessed.

The component is usually increased by 2% per year because most properties do not change hands in any given year. In 1989 and 1992 the general adjustment included a 6% increase to account for properties that had been sold in earlier years.

With the implementation of full vacancy decontrol/recontrol, property sales will likely be influenced by the anticipation of significantly higher earnings because of market rate rents. The increase in property tax resulting from a sale may be absorbed in those higher rents. Staff believes it is appropriate to continue to use the 2% factor.

| | Avg. Monthly Property Tax Bill |
|---|---|
| 1978 | $19.20 |
| 2000 | 43.86 |
| 2001 | 44.74 |

*2000 to 2001* -- 2% increase

### II. Gas

In more than two-thirds of all apartments, the landlord pays for hot water heating, but not heat for the apartment. On April 1, 2001 the gas rates increased. The daily service rate surcharge and the State Regulatory Fee did not change but there was a decrease in the low-income discount rate surcharge.

The methodology to determine an average consumption rate was established in a 1989 report, which estimated that 47% of consumption was at baseline and 53%, was at non-baseline rates. Average consumption level of 23.3 therms per month was used based on analysis of 1978 gas costs as reported in registration statements and 1978 rate schedules.

The following rates were in effect during the periods covered by this report:

| | **Baseline Avg. Bill** | **Non-Baseline** | **Rate-Based Charges** | | **Surcharges** |
|---|---|---|---|---|---|
| April 1978 | .13 | .14 | | | $3.47[1] |
| April 1999 | .45 | .61 | 13.79 | 5.67 | 19.47 |
| April 2000 | .61 | .78 | 17.92[2] | 5.67[3] | 23.59 |
| April 2001 | .94 | 1.12 | 26.51[4] | 5.49[5] | 32.00 |

*2000 to 2001* -- The average expenditure on gas increased from $23.59 in 2000 to $32.00 in April 2001, an increase of 35.7%. The increase from April 1999 to April 2000 was 21.2%. The cumulative increase in the past two years is 56.9%.

## III. Electricity

According to Southern California Edison, a rate freeze went into effect on June 1, 1996 and was to have remained until the year 2002. However, due to the recent energy crisis, the freeze was lifted in January 2001, and the Public Utilities Commission authorized a one cent/per kilowatt-hour increase on baseline and non-baseline rates. Subsequently, on May 15, 2001, the PUC authorized a new rate structure resulting in significant permanent increases, retroactive to March 27, 2001.

A 1983 Southern California Edison survey showed the consumption level for electricity in a 6-unit building to be 1638 kWh per month. Of the 1638 kWh, 1140 hours are billed at baseline rates (300 per building plus 840 hours credited above 300 hours at the rate of 190 baseline kWh per apartment), and 498 hours charged at non-baseline rates. In other words, 69.6% of use is billed at baseline and 30.4% at non-baseline rates.

1 Original average bill ($3.30) multiplied by 5% tax.

2 April 2000 cost - (.47 x 23.3 x .61182) + (.53 x 23.3 x .77671) = $16.29 + 10.0% tax = $17.92

3 Daily service rate (30 days x .16438) + State Regulatory Fee (23.3 therms x .00076) + Low Income Discount Rate Surcharge (23.3 therms x .00884) = $5.155 + 10% tax = $5.67.

4 April 2001 cost - (.47 x 23.3 x .93907) + (.53 x 23.3 x .1.11895) = $24.10 + 10.0% tax = $26.51

5 Daily service rate (30 days x .16438) + State Regulatory Fee (23.3 therms x .00076) + Low Income Discount Rate Surcharge (23.3 therms x .00186) = $4.992 + 10% tax = $5.49.

The calculations shown below for April 2001 are based on the consumption rates shown above and reflect the recent rate increase[6]. As in the computations for gas, the costs were then multiplied by the utility tax.

| | Baseline | Non-Baseline | Avg. Cost |
|---|---|---|---|
| April 1978 | 3.2 | 4.2 | $ 10.80[7] |
| June 1996 | 12.0 | 14.2 | 38.03[8] |
| April 2000 | 12.0 | 14.2 | 38.03 |
| April 2001-A | 13.0 | 19.66 | 45.14[9] |
| April 2001- Adjusted | | | 52.10 |

*2000 to 2001* --- The projected average expenditure on electricity using the new rates, would result in an increase of 18.71% over last year's average monthly bill. The restructured rate schedule utilizes a five-tier schedule instead of the two-tier schedule previously in effect. This significant change may affect the distribution of kWhs (kilowatt-hour) attributed to baseline and non-baseline rates. Therefore, staff believes the projected monthly expenditure of $45.14 (April 2001-A) does not accurately reflect the impact of the new rate schedule. Based on the PUC's estimate that the new rates could result in monthly increases of up to 37% for residential customers, staff has increased the monthly average cost to $52.10 by applying the estimated increase of 37% to the April 2000 cost of $38.03.

The average costs shown above are based on usage within apartments as well as common areas. These "average costs" are used to determine the rates of increase rather than common area increases alone because the larger figure provides a more stable basis for determination. The 2000 cost for common area consumption, was $10.68. Applying the estimated increase of 37% brings the 2001 cost for common areas to $14.63.

The new rate structure and changes in the distribution of kWh will probably require staff to consider a new method for calculating the monthly average cost for electricity. Therefore, staff recommends that before the next general adjustment the Board authorize an in-depth study by outside consultants of how the new rate structure affects the monthly electricity expense for individual units and common areas. The study should also review consumption rates and the distribution of kWh and what effect if any, the increased use of electronics has on consumption and/or the effect of any conservation efforts by individuals.

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6 Although the expenditures used in most components are April 1, 2000 through March 31, 2001, when a change is known to affect a large part of the coming year, it is usually used. In this case, the increase is retroactive to March 27, 2001, and is expected to be in effect all of the 2001/02 year. Therefore, the increase is used in the calculation.

7 Original bill of $10.29 + 5% tax = $10.80

8 1140 x .120/6 = $22.82 + 498 x .142/6 =$11.75
$22.82 + $11.75 =34.57 x 10.% tax = $38.03

9 1140 x .1301/6 = $24.72 + 498 x .1966/6 =$16.32
$24.72 + $16.32 =41.04 x 10.% tax = $45.14

Because there is not time for such a study for the present general adjustment and because the rates were just adopted, the actual impact cannot yet be determined. Staff modified the approach to the electricity component this year to ensure the general adjustment adequately compensates owners for the increased utility costs.

IV. Water and Sewer

The Water Department of the City of Santa Monica reports that there has been a rate increase for the 2nd tier of water usage rates and for the basic water service charge effective July 1, 2000. These rate changes result in a 2% increase in this component from April 2000.

The water consumption rate has declined substantially over time. The 1983 through 1988 general adjustments used 7.7 HCF (hundred cubic feet) as the average rate, based on a survey of owners. The rate was reduced to 7.3 in 1989 after a new study.

In 1992 staff began to monitor consumption rates and costs of water/sewer and refuse bills on the same 70 randomly selected properties each year. The study showed a reduced average consumption rate of 5.6 HCF, which was used in the 1993 through 1996 calculations. In 1996 the City adopted a new rate structure, and evidence from the consumption study supported another reduction of the consumption rate to 5.0 HCF, the rate that was in effect until 1999.

In 1997 staff established a second group of randomly selected properties for annual monitoring to serve as a validity check on the first selection. Both groups of properties have shown a consistent decrease in consumption. Last year, based on the consistent lower usage, the HCF was again reduced in the calculation, this time to 4.6. Staff will continue to monitor the consumption rate and track any changes.

Below are the findings from study of the two selections for the last several years, which support continued use of 4.6 HCF. Although the average HCF rate for 2001 for both selections is slightly higher than the 2000 rates, the combined average of both selections is slightly less than the 4.6 HCF base.

| Year | Avg. HCF --1st Selection | Avg. HCF -- 2nd Selection |
|---|---|---|
| 1997 | 4.83 | 4.56 |
| 1998 | 4.65 | 4.54 |
| 1999 | 4.66 | 4.51 |
| 2000 | 4.65 | 4.34 |
| 2001 | 4.77 | 4.42 |

The 4.6 HCF calculation using the current rates yields an average bill of $18.15. For 2000/2001, the actual average bill for the first selection was $17.42, and for the second selection it was $17.04.

As the average consumption rate has not changed significantly in the last year; there is no change in this component.

## MONTHLY WATER/SEWER CHARGES - APARTMENTS WITH AVERAGE CONSUMPTION

| | Water Chg/ Water Unit | Sewer Chg/ Water Unit | Water Chg Per Meter | Sewer Chg Per Meter | Total |
|---|---|---|---|---|---|
| 1978 | 2.70 | 1.39 | none | none | 4.09 |
| April 1999 | 6.36 | 5.42 | 1.91 | 4.11 | 17.80[10] |
| April 2000 | 6.36 | 5.42 | 1.91 | 4.11 | 17.80 |
| April 2001 | 6.53 | 5.42 | 2.09 | 4.11 | 18.15[11] |

2000 to 2001 -- 2% increase

V. Refuse

Refuse rates were restructured in 1999. The multi-family building charges per apartment were decreased from $12.08 to $6.00 per apartment bi-monthly while the cost of a bin was increased from $49.80 to $93 bi-monthly. Because the structure of the bill was changed, some properties pay less than they did previously for the same service, and some pay more.

The calculations below are based on both a 5-unit building and a 10-unit building to represent the "average" cost per apartment. The 2001 average reflects a 2% increase over the 2000 average cost.

Staff checked these calculations against actual refuse bills for two selections of properties. For the first selection, the average refuse bill decreased from $11.91 in 2000 to $11.41 in 2001, a decrease of 4.2%. For the second selection, the average refuse bill increased from $12.54 to $12.97, an increase of 3.4%.

**MONTHLY REFUSE COLLECTION CHARGES PER APARTMENT**

| | Per Apartment | Bin/Container Charge | Total Bill |
|---|---|---|---|
| 1978 | $1.75 | $.54 | $2.29 |
| April 1, 1996 | 6.04 | 4.98[12] | 11.02 |
| April 1, 2000 | 3.00 | 9.30[13] | 12.30 |
| April 1, 2001 | 3.00 | 9.55[14] | 12.55 |

10 The costs in the table include the 10% tax within each component of the bill.

11 The costs in the table include the 10% tax within each component of the bill.

12 In 1996 the calculation was derived from the calculated cost of a 5-unit building and a 10-unit building. The $49.80 bi-monthly charged was divided among 5 apartments to derive a $4.98 monthly charge. The 10-unit building assumed that there would be a bi-monthly charge of $99.60 divided among the 10 units, and derived the same $4.98 per apartment per month.

13 The calculation makes the same assumptions for year 2000 as were used in 1996 -- one bin per week for a 5-unit building and 2 bins for a 10-unit building.

14 The calculation makes the same assumptions for year 2001 as were used in 1996 -- one bin per week for a 5-unit building and 2 bins for a 10-unit building.

2000 to 2001 -- The increase in the bin/container charge has resulted in an overall increase of 2% for 5- and 10-unit properties.

VI. Maintenance and Other Operating Expenses

The Board adjusts this category by the change in the Consumer Price Index, less shelter.

The March 2000 to March 2001 increase for all urban consumers less shelter in the Los Angeles-Anaheim-Riverside area was 3.0%.

2000 to 2001 -- Maintenance and Other Operating Expenses was $92.03 in 2000. After increasing the component at the rate of the March to March CPI for all urban consumers less shelter, the 3.0% increase results in an average cost of $94.79.

VII. Insurance

Insurance costs are usually treated as one of many factors included within the category of Maintenance and Other Operating Expenses. There have been some years when there was a need to analyze insurance costs separately due to a real or perceived increase or decrease in insurance costs which did not match inflation. The insurance component was increased by 27.8% in 1997 and by 4.26% in 1998.

There is no evidence that insurance rose faster last year than other operating expenses as a whole. Therefore, the insurance component has been increased at the same rate as Maintenance and Other Operating Expenses -- 3.0%. This is the same result as if it had been placed back into the Maintenance component.

2000 to 2001 -- The average insurance cost was determined to be $26.22 in 2000. With an increase of 3.0%, the average cost would be $27.01 in 2001.

VIII. Self Labor

Because the Board increases Self Labor at the rate of the March to March CPI for all urban consumers, the 3.2% increase results in an average cost of $44.73.

IX. Net Operating Income

In the early history of the general adjustment, the NOI was adjusted on the basis of 40% of the CPI, except in the years when the general adjustment itself was 66% of the CPI. This methodology was originally based on the assumption founded on base year data that 60% of the NOI went to debt service and 40% to cash flow. The cash flow component was then increased at the rate of the CPI. The formula was created to accomplish this.

In recent years, NOI has been separated into its component parts, debt service and cash flow. The cash flow component was increased by the rate of CPI for all urban consumers for the March 2000 to March 2001 period. This rate was 3.2%.

Management costs are estimated to increase at the same rate as the Consumer Price Index. Per Regulation 4101(c)(1) this component is to be fixed at 5% of the rent dollar. The Consumer Price Index increased 3.2% from March 2000 to March 2001.

2000 to 2001 -- Using the 3.2% March to March increase in the CPI, the average monthly Management costs increased from $31.32 to $32.32.

A 4.5% general adjustment increases the rent dollar to $654.64. Management costs at 5% would be $32.73 rather than $32.32, changing the component year-to-year increase from 3.2% to 4.5% (See Charts A and B). The balance of the adjustment, which results from rounding, is reflected in the cash flow component.

## ALTERNATIVE GENERAL ADJUSTMENT APPROACHES

### Specified Floor

In most recent years, the Board has authorized a floor or minimum increase. The floor is typically calculated by applying the general adjustment calculation to the rent dollar. Last year the floor was based on the rent at the 15th percentile and a calculated general adjustment figure that did not include the percent increase attributed to the prospective gas rate increase.

This year staff is not recommending a floor. Vacancy increases have greatly reduced the number of apartments with low rents and greatly increased the number of higher rents. The recommended general adjustment of 4.5% is high enough to cover the increase in operating expenses at most rent levels. Even rents at the 15th percentile ($501 as of May 16, 2001) will receive an increase of $23, which is more than the total amount of increase of the "hard" expenses. ("Hard" expenses include all utility components and the property tax component.)

### Specified Ceiling

According to a report titled "Operating Expenses And General Adjustment Methods - 1998" by a Board consultant, Thomas D. Stringer, "(G)enerally, the operating expenses for properties with arbitrarily high rent levels should be similar to those of other apartment buildings with more typical rent levels." Arbitrarily high rent levels are those that are not based on luxury or special accommodations, but rather on high base rents in 1978, base rents set after 1978, large earthquake-related repair increases, and one or two Costa-Hawkins increases.

Therefore, staff recommends that the MAR at the 85th percentile be considered inclusive of most higher rent units (in fact only 15% of units are not included), and that the ceiling be determined by applying the general adjustment to that amount. The units in the selection should exclude those that have received a market rate increase, as that would completely distort the study.

The MAR at the 85th percentile on May 16, 2001 was $958. Applying the 4.5% rounded general adjustment provides an increase of $43. This report recommends a ceiling of $43 which would apply to all units with a MAR of $945 or higher.

## Mobile Homes

In most years since 1992, the Board has granted an annual general adjustment for mobile home units the same as that for all other units, but did not approve a specified dollar floor. This decision was based on expense analyses, which showed that the actual increase realized by the percentage increase was sufficient to cover the increases in operating costs.

Staff does not believe that it is necessary to update the analysis in order to make the recommendation that mobile home units again receive the same annual general adjustment, but not a specified dollar floor.

No 2001 General Adjustment for Units With Vacancy Increases between September 1, 2000 and August 31, 2001.

Owners of units with a market rate increase between September 1, 2000 and August 31, 2001 are presumed to have taken operating cost increases into account in establishing the rent on the unit. Therefore, these units are not eligible for any general adjustment until September 2002.

## RECOMMENDATION

The charts below detail the computed costs for the hypothetical average apartment and increases required to cover costs. The first part of Chart A shows the mathematical computation of the required increases, and the second part details the breakdown of expenses in dollars for the hypothetical average apartment.

- Chart A is the computation derived from the methodology -- 4.22%. Rounding would result in a general adjustment of 4.5%. This would provide an increase for the average unit of $29 per month. It is not appropriate for the general adjustment to be rounded down from the calculated amount, as a lower figure may not account for all increases in operating expenses.
- Chart B shows the changes that result from rounding to 4.5%.

**CHART A -- Based on calculations**

HYPOTHETICAL AVERAGE APARTMENT
RENT INCREASES TO COVER COST INCREASES (2000 to 2001)

| Operating Expense | 2000 Component Ratio To Gross Rent | Pct. Increase 4/00 - 4/01 | Pct. Rent Increase Over Prior Year Req'd to Cover Cost Increase |
|---|---|---|---|
| Property Taxes | 0.07001 | 2.0% | .14 |
| Water & Sewer | 0.02841 | 2.0 | .06 |
| Refuse | 0.01963 | 2.0 | .04 |
| Maintenance & Other | 0.14691 | 3.0 | .44 |
| Insurance | 0.04185 | 3.0 | .13 |
| Gas | 0.03766 | 35.7 | 1.34 |
| Electricity | 0.01705 | 37.0 | .63 |
| Self-Labor | 0.06918 | 3.2 | .22 |
| Debt Service | 0.18677 | 0.0 | .00 |
| Cash Flow | 0.33252 | 3.2 | 1.06 |
| Management | 0.05000 | 3.2 | .16 |
| **Total Rent Adjustment** | | | **4.22%** |

HYPOTHETICAL AVERAGE APARTMENT
RENT INCREASES REQUIRED TO COVER COST INCREASES 2000/2001
(MONTHLY TOTAL IN DOLLARS)

| | 2000 | 2001 |
|---|---|---|
| Property Taxes | 43.86 | 44.74 |
| Water & Sewer | 17.80 | 18.15 |
| Refuse | 12.30 | 12.55 |
| Maintenance & Other | | |
| Maintenance | 92.03 | 94.79 |
| Insurance | 26.22 | 27.01 |
| Gas | 23.59 | 32.00 |
| Electricity | 10.68 | 14.63 |
| Self-Labor | 43.34 | 44.73 |
| Debt Service | 117.00 | 117.00 |
| Cash Flow | 208.31 | 214.98 |
| Management | 31.32 | 32.32 |
| **Total Rent** | **$626.45** | **$652.89** |

**CHART B -- Based on calculations -- rounded to 4.5%**

HYPOTHETICAL AVERAGE APARTMENT
RENT INCREASES TO COVER COST INCREASES (2000 to 2001)

| Operating Expense | 2000 Component Ratio To Gross Rent | Pct. Increase 4/00 - 4/01 | Pct. Rent Increase Over Prior Year Req'd to Cover Cost Increase |
|---|---|---|---|
| Property Taxes | 0.07001 | 2.0% | .14 |
| Water & Sewer | 0.02841 | 2.0 | .06 |
| Refuse | 0.01963 | 2.0 | .04 |
| Maintenance & Other | 0.14691 | 3.0 | .44 |
| Insurance | 0.04185 | 3.0 | .13 |
| Gas | 0.03766 | 35.7 | 1.34 |
| Electricity | 0.01705 | 37.0 | .63 |
| Self-Labor | 0.06918 | 3.2 | .22 |
| Debt Service | 0.18677 | 0.0 | .00 |
| Cash Flow | 0.33252 | 3.8 | 1.28 |
| Management | 0.05000 | 4.5 | .22 |
| **Total Rent Adjustment** | | | **4.50%** |

HYPOTHETICAL AVERAGE APARTMENT
RENT INCREASES REQUIRED TO COVER COST INCREASES 2000/2001
(MONTHLY TOTAL IN DOLLARS)

| | 2000 | 2001 |
|---|---|---|
| Property Taxes | 43.86 | 44.74 |
| Water & Sewer | 17.80 | 18.15 |
| Refuse | 12.30 | 12.55 |
| Maintenance & Other | | |
| Maintenance | 92.03 | 94.79 |
| Insurance | 26.22 | 27.01 |
| Gas | 23.59 | 32.00 |
| Electricity | 10.68 | 14.63 |
| Self-Labor | 43.34 | 44.73 |
| Debt Service | 117.00 | 117.00 |
| Cash Flow | 208.31 | 216.31 |
| Management | 31.32 | 32.73 |
| **Total Rent** | **$626.45** | **$654.64** |

**APPENDIX A**

DETAILED METHODOLOGY

At the direction of the Board, Dr. Baar developed a methodology for calculating the annual General Adjustment which has the following features:

1. Division of the rent dollar into categories of expense, including "hard expenses" (taxes, utilities, City services), and "calculated expenses" (management, maintenance and other operating costs, and net operating income).

2. Identification of the "component ratio to gross rent" by dividing the dollar amount of each component of the 1997 rent dollar for the hypothetical average apartment by the total rent dollars. These ratios represent the percentage of the average rent dollar devoted to each expense category.

3. Survey of utility companies and government agencies to determine actual increases (or decreases) in costs to property owners in the last year. Last year, additional samples were taken from individual rent adjustment petitions and water/sewer and refuse bills.

Some modifications to this methodology were made in subsequent years such as fixing Management Expenses at 5%.