Rent Stabilization Board

M E M O R A N D U M

DATE: October 20, 2003

TO: Members of the Rent Stabilization Board

FROM: Jay Kelekian, Executive Director

SUBJECT: 2004 ANNUAL GENERAL ADJUSTMENT

Recommendation

That the Board authorize an Annual General Adjustment (AGA) of rent ceilings for 2004 at the conclusion of the October 20, 2003, scheduled public hearing. In approving the 2004 AGA, the Board is required to adopt a formula that is designed to permit an efficient landlord to pay all actual and reasonable expenses and receive a fair profit, while at the same time protecting the public interest in having affordable and properly maintained rental housing available to the citizens of the community.

Background

Section 11 of the Rent Stabilization Ordinance mandates that the Rent Board annually consider setting and adjusting the rent ceiling for all Berkeley rental units and/or particular categories of rental units. The Board is required to establish a formula or formulas of general application for rent ceiling adjustments based on a survey of changes in operating costs, other available information and public testimony. The law requires that the formula take into account increases and decreases in the landlord's operating expenses in the prior year and the impact of inflation on landlords' profits but does not dictate any particular method for determining the amount of the AGA. Thus, the Ordinance gives the Rent Board broad legislative discretion to annually adopt a formula after it has received and analyzed all relevant information. The Ordinance limits the amount of the AGA to no more than 45% of the increase in the Consumer Price Index ("CPI") unless six or more Commissioners vote for a larger adjustment. In setting the AGA, the Board acts within its lawful discretion if the amount of the proposed AGA is supported by the record and the net operating income for the median rental unit remains at or above the level that the Board has reasonably determined gives most landlords a fair return on their investment.

Last year, the Board determined that no general adjustment, either upward or downward, was warranted. This determination was based on proof that the relevant Consumer Price Index[1] had declined, that natural gas costs had decreased markedly from the prior year and that other operating expenses had generally remained flat. It also took into account evidence that the existing median rent in Berkeley generated net operating income in excess of that required under the Board's fair return standard, as a net cumulative result of all prior general rent adjustments.

In February 2003, the Rent Board agreed to settle the case of *Berkeley Property Owners Association v. Berkeley Rent Stabilization Board* (Case No.831986-1), in which the plaintiff property owners challenged the validity of the 1996-2002 AGAs and the Board's AGA methodology. The main component of the settlement was the placement on the November 2004 ballot of a measure to amend Section 11 of the Rent Ordinance so that all future AGAs would be set at 65% of the prior fiscal year's increase in the CPI. If the voters approve the measure in November 2004, the lawsuit will be dismissed. Because the ballot measure, if approved, will not be operative until the 2005 AGA, the Board is obligated to comply with existing Section 11, conduct a survey of changes in operating costs for the 2004 AGA and exercise its legislative discretion to authorize an AGA that is consistent with the evidence. Under the settlement agreement, however, the Board has agreed that it will adopt a 2004 AGA that is 65% of the increase in the CPI unless to do so would constitute a clear abuse of the Board's legislative discretion under existing Section 11. The CPI from June 2002 to June 2003 has increased by 1.6%. Thus, under the settlement with the BPOA, the Board is committed to pass an AGA of 1% (i.e., 65% of 1.6%), unless to do so would constitute an abuse of discretion.

The Rent Ordinance mandates that at least two public hearings be conducted prior to setting the AGA in order for the Board to discuss and receive public comment on the 2004 AGA. The first hearing was held on Thursday, October 2, 2003. Two members of the public addressed the Board during the public hearing. In addition, the 2004 AGA has been discussed at meetings of the IRA/AGA Committee held on September 16, 2003, and October 7, 2003. At the latter meeting, Michael Wilson, president of the Berkeley Property Owners Association, addressed the Committee on behalf of the BPOA. The Board has also received correspondence regarding the AGA from Theodore R. Edlin and David L. Howland. (Copies appended as Attachment 6.)

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1 Two separate consumer prices indexes are referred to in this report. The index that includes all consumer items is the Consumer Price Index, All Urban Consumers, San Francisco-Oakland-San Jose Metro Area. This index, which is used for determining when six votes are required and for future AGAs under the proposed ballot amendment, is referred to as the CPI. For purposes of indexing Net Operating Income, Rent Board Regulation 1264 uses the Consumer Price Index, All Urban Consumers, San Francisco-Oakland-San Jose Metro Area. less its shelter component. This index will be referred to as CPI, Less Shelter.

Methodology for Determining AGA

The gross rental income a landlord receives for a rental unit consists of two components: (1) revenue to pay for operating expenses and (2) net operating income (NOI), which covers the property's debt service and provides the owner a profit. In setting an AGA, the Board must examine both components and provide an adjustment that allows an owner to keep up with increases in operating costs and also receive a fair return from the property.

Operating Expense Component

For the past several years, the operating expense component of the AGA formula has consisted of twenty-seven separate categories of expenses. The basic methodology for determining the amount of an adjustment necessary to cover changes in operating costs is to estimate the ratio of each type of expense to gross rent and determine the rate of change in that expense for the 12-month period ending the prior June 30th. The change is incorporated into a formula that reflects the proportion each expense occupies in the total operating expense portion of the median rent in Berkeley. The total increase or decrease in operating expenses is ultimately expressed as a percentage increase or decrease.

This year the Board retained Dr. Kenneth K. Baar to complete the data collection and calculations pertaining to the above-described operating cost components of the AGA. Dr. Baar was the author or co-author of the 1983 through 1988 AGA reports and is widely regarded as one of the foremost experts on the operation of rent control systems. The methodology used by Dr. Baar in calculating the operating expense component for the 2004 AGA generally follows the same methodology used for prior AGAs. This year, however, for the first time Berkeley landlords have been required to incur certain new operating expenses related to implementation of the City of Berkeley's Rental Housing Safety Program. These costs have not previously been considered in the AGA operating cost studies. In addition, Dr. Baar reports that natural gas rates have increased dramatically, effectively offsetting the rate decreases reported last year. The report also takes account of the $12 increase in the Rent Board registration fee, the first increase in five years. Dr. Baar concludes that, if all these items are fully considered, a rent increase of 2.83% is necessary to cover the cumulative increase in operating costs for the median rental unit.

A preliminary draft of Dr. Baar's report was submitted to the IRA/AGA Committee on September 16, 2003, and October 7, 2003, and to the Board on October 2, 2003. Attachment 1 is the final version of Dr. Baar's report, dated October 2003.

Net Operating Income (NOI) Component

In addition to determining whether an adjustment is required to cover operating cost increases, the Board is required to consider whether an adjustment is necessary to protect the landlords' original investment profit from the adverse effects of inflation. The amount appropriate to protect profits from inflation is determined annually by the Board. (Regulation 1100.) By protecting profits from the effects of inflation, the Board seeks to assure that landlords generally are receiving the constitutionally mandated "fair return" from their rental properties. The Board has previously determined that allowing a property's base year NOI to increase at the rate of 65% of the cumulative increase in the CPI, Less Shelter, since June 1979 provides the necessary protection. (*See* Regulation 1264 and Memorandum to Board dated October 27, 1995, attached as Attachment 2.)

The first step in determining the amount, if any, by which NOI should be adjusted in a particular year is to calculate the portion of the median rent attributable to NOI. For purposes of determining the adjustment necessary to provide a fair return, the Board considers only the rental income for units that have been continuously regulated since the adoption of the Rent Ordinance in 1980. The increased income for units that have been deregulated under Costa-Hawkins vacancy decontrol is not considered. Thus, for AGA purposes, the median rent under consideration is not the median rent of all Berkeley units – it is the 1980 median rent increased by all general adjustments authorized by the Board since 1980. Thus, the estimated 2003 median rent is $611.88**.** (Baar 2004 AGA Report, p. 4.) Operating expenses as of June 2003 are estimated to be 52.31% of the median rent for individually metered buildings and 62.92% for master metered buildings. (Baar 2004 AGA Report, p. 22.) Because there are significantly more individually metered units, a weighted average is used to estimate the operating expenses for the median unit. The weighted average for operating expenses is 54.70% of gross rent, which means that the average operating expense for the median Berkeley rental unit in 2003 is $334.69. ($611.88 x 54.70% = $334.69.) By subtracting this amount from the 2003 median rent, the median unit's 2003 NOI is determined to be $277.19.

The Board's AGA process is intended to insure that general rent increases are set so as to generate NOI in an amount equal to the median rental unit's 1979 NOI, increased by 65% of the cumulative increase in the CPI, Less Shelter since June 1979. According to the Rent Board's records, the median rent in 1980 was $226. NOI is assumed to have been 60% of the gross 1980 rent. Therefore, the 1980 NOI for a rental unit at the median rent was $136. ($226 x 60%.)

In June 1979, the CPI, Less Shelter was 73.2, and in June 2003, it was 172.9, for an increase of 136%.[2] (172.9 minus 73.2 divided by 73.2.) Therefore, the indexing factor for 2004 fair return purposes is 88.4%, i.e., the 65% of the 136% CPI, Less Shelter increase. Increasing the 1979 NOI of $136 by 88.4% results in an adjusted NOI of $256.22. (1.884 x 136 = 256.22.) In other words, if the NOI portion of the base rent had increased at 65% of CPI, Less Shelter from 1979 to the present, the NOI portion of the median rent would be $256.22. In fact, however, the NOI portion of the median rent in 2003 is $277.19, a surplus of $20.97. Thus, for the median rental unit in Berkeley, a fair return is obtained in 2004 without any further adjustment of NOI.

2 *See* Printout of Consumer Price Index, All Urban Consumers, San Francisco-Oakland-San Jose Metro Area. All items less shelter, June 1979 to June 2003, from Bureau of Labor Statistics Web Site, 10/15/03 [Attachment 3].

Supermajority Limitation

The Ordinance provides that the adoption of an AGA based on a formula greater than forty-five percent of the increase in the CPI shall require the affirmative vote of six commissioners. From June 2002 to June 2003 the CPI has increased from 193.2 to 196.3, an increase of 1.6%.[3] (196.3 minus 190.9 divided by 190.9.) Thus, an AGA greater than .72% (i.e. .45 x 1.6) requires an affirmative vote of 6 commissioners.

Discussion

In setting each year's AGA, the Board must consider the increase or decrease in operating expenses for the preceding year and whether any adjustment is necessary to comply with the mandate that landlords generally receive an inflation-insulated fair return.

In determining whether the AGA should include an adjustment to reflect the effect of inflation on NOI, several factors deserve consideration. The Board has adopted the standard of 65% of CPI, Less Shelter on a cumulative basis from 1979 (i.e., the last year before rent control was implemented) as the benchmark of a fair return. From June 2002 to June 2003, the CPI, Less Shelter increased from 169.1 to 172.9, an increase of 2.2%. Thus, if 2003 rent ceilings were at the minimum necessary to generate a fair return, the NOI portion of the median rent for 2004 should be increased by 1.43% (i.e., 65% of 2.2%.) The Board's fair return standard, however, requires that that a unit's current NOI be compared to its base year NOI adjusted by on a cumulative basis at 65% of the increase in the CPI, Less Shelter from 1979 to the present, i.e., from the beginning of the rent control program. When measured against this index, the 2003 median rent is generating more gross income than is necessary to maintain the base year's NOI indexed for inflation. In other words, if NOI had been adjusted every year at 65% of the CPI, Less Shelter, the NOI for the median rent unit would be $256.22. But in fact the NOI for the median rental unit in Berkeley is $277.19. Thus, as previously noted, there is a monthly NOI surplus of $20.97. Consequently, no additional percentage increase in the AGA is necessary to protect landlords' NOI from the adverse effects of inflation.

Dr. Baar reports that operating costs for the unit with the median regulated rent have increased generally since June 2002 by 2.8%, an amount significantly higher than the increase in the CPI. The principal factors driving this year's increase that were not present last year are: (1) the inspection fee for the Rental Housing Safety Program; (2) the costs associated with demonstrating compliance with the Rental Housing Safety Program; (3) the increase in the Rent Board registration fee; and (4)

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3 *See* Printout of Consumer Price Index, All Urban Consumers (CPI), San Francisco-Oakland-San Jose Metro Area, June 1979 to June 2003, from Bureau of Labor Statistics Web Site, 10/16/03 [Attachment 4].

the increase in the cost of natural gas.[4] (Baar 2004 AGA Report, p. i.) Dr. Baar also reports that, since 1999, approximately half of all Berkeley rental units have become eligible for unlimited vacancy rent increases and that a high percentage of Berkeley rental properties have at least one unit that has taken advantage of vacancy decontrol to obtain a market level rent ceiling. (Baar 2004 AGA Report, p.4.) Units that have been eligible for unlimited vacancy increases are not exclusively dependant upon the AGA process to obtain profitable rent levels. As Dr. Baar points out, under vacancy decontrol, the annual turnover in tenancies, not the AGA process, is the primary determinant of the amount of profit returned to landlords from their rental property. (Baar 2004 AGA Report, p. 3, n.6.) The validity of this principle is reflected in the great disparity between the average rent for units that have had vacancies since 1999 ($1,220) and those that have never had a vacancy increase ($698).[5] (Baar 2004 AGA Report, p.4.)

Board legal staff believes that in view of the large number properties that have taken advantage of vacancy decontrol as well as the continued return of excess NOI for units that have remained regulated, it would be within the Board's legislative discretion to adopt an AGA of 1%, notwithstanding the documented increase of 2.8% in apartment operating costs. As noted below, however, due to the unanticipated cost increases for the Rental Housing Safety Program, I recommend that the Board exceed the minimum required by the BPOA settlement agreement and also directly pass through some, or all, of the unforeseen new costs.

In the past, the Board has considered various formulas to calculate the AGA: (1) a percentage of the current rent; (2) a flat dollar amount; (3) a percentage with a floor expressed as a flat dollar amount; and (4) a percentage with a ceiling expressed as a flat dollar amount. The Rent Ordinance allows the Board to consider different AGA formulas for particular categories of rental units. In fact, in prior years, the Board has adopted different formula for units where the landlord pays the gas and electricity than for individually metered units.

So far, two types of formulas have been put forth and discussed as reasonable means of addressing the unique situation facing the Board this year: (1) a percentage AGA plus an additional flat dollar amount; and (2) a bifurcated AGA that gives a higher amount to rental units that have not been eligible for vacancy decontrol since 1999.

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4 Under the AGA methodology traditionally followed by the Rent Board, changes in gas rates are determined by comparing the residential rates in June of the present year with the rates charged in June of the past year. Dr. Baar reports that gas rate tend to fluctuate widely during a calendar year and opines that the Board's method of comparing rates in effect on a specific date each year does not provide a representative comparison of changes in annual costs. (Baar 2004 AGA Report, p. 19.)

5 This $698 figure represents the ***average*** 2003 rent ceiling of units that have not had a vacancy increase since 1999 but includes units with Individual Rent Adjustments and units that were eligible for a 15% increase during the 1996-1998 phase-in of vacancy decontrol. The $611.88 figure referred to on page 4 is the 2003 rent ceiling of the rental unit with the ***median*** 1980 rent ceiling increased by all general adjustments granted by the Rent Board – it does not include any Individual Rent Adjustments or vacancy increases.

At the meeting of October 2, 2003, I suggested that, in addition to the percentage of CPI increase contemplated by the BPOA settlement as covering increases in the operating costs traditionally included in the AGA computation, the Board should consider allowing property owners an extra flat dollar amount to cover the unanticipated costs associated with the Rental Housing Safety Program. The suggested additional amount would be between $3 to $5 per month. The Board heard from Steve Barton, the Director of the City of Berkeley's Housing Department, who explained the importance and value to tenants and the community of the Rental Housing Safety Program and suggested that it was fair that tenants bear some of the costs of the program.

As discussed below, at its meeting of October 7, 2003, the IRA/AGA Committee discussed the possibility of a bifurcated, two-tier AGA by which all units would receive the percentage AGA required by the BPOA settlement plus a flat dollar pass-through of some or all of the Rental Housing Safety Program costs. In addition, those units that have not had a vacancy increase under the Costa-Hawkins law since 1999 would receive an additional amount.

IRA/AGA Committee Recommendation

The IRA/AGA Committee met to discuss the 2004 AGA on September 16, 2003, and October 7, 2003. Dr. Baar attended both meetings. After discussion at the October 7, 2003, meeting, the Committee, by a vote of 3-0, with Commissioner Siegel abstaining, adopted the following motion:

> To recommend that the Rent Board adopt a bifurcated 2004 AGA so that:
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> (1.) The lawful rent ceilings for rental units for which an Initial Rent was established between January 1, 1999, and December 31, 2002, be increased by 1% plus $2 or $3; and
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> (2.) The lawful rent ceilings for rental units for which no Initial Rent has been established since January 1, 1999, be increased by not less than 1.8% plus $2 and by not more than 2% plus $3. (M/S/C Evans/Spector.)

The Committee unanimously recognized that, even though a 1% AGA might be within the Board's discretion, the costs associated with the Rental Housing Safety Program were not within the contemplation of the parties when the settlement with the BPOA was negotiated and that, inasmuch as the program will be a significant benefit to Berkeley tenants and the community at large, it would be appropriate to pass some or all of these increased costs along to tenants in the AGA in addition to the 1%. Moreover, a clear majority of the Committee believed that, in view of the great and growing disparity in rent levels between those units that have established an initial rent under vacancy decontrol after January 1, 1999, and those units that have been continuously regulated, it would be appropriate to grant a larger AGA to those units that have not taken advantage of vacancy decontrol to better assure that the exceptional cost increases imposed this past year are recovered. Committee members noted that the bifurcated approach would allow both the average pre- vacancy decontrol unit and the average post-vacancy decontrol unit to come very close to recouping the actual dollar increases noted in the Baar report (see Addendum to Annual General Adjustment Study). Consequently, a majority of the Committee voted to have a bifurcated AGA that allows a greater increase for units that have not taken a vacancy increase since 1999.

The Committee, however, was unable to agree on the precise amount of the AGA. There was a minor disagreement regarding the appropriate amount of the percentage AGA for pre-Costa Hawkins units. In addition, the Committee could not agree on how to treat the costs associated with the Rental Housing Safety Program. According to Dr. Baar, the Rental Housing Safety Program has a direct per-unit fee of $17 per year or $1.42 per month. In addition, Dr. Baar reported that there will be additional per unit costs of compliance. While acknowledging the difficulty of making a precise assessment due to the various cost configurations associated with compliance, he estimates the average cost of compliance will be roughly $20 per year or $1.67 per month. Thus, according to Dr. Baar's report, the estimated total monthly cost of compliance is $3.09. At the Committee meeting, however, BPOA President Wilson asserted that Dr. Baar had significantly underestimated the cost of compliance for a significant number of property owners. The Committee members could not agree on how much of this amount should be passed on.

Beginning with the 2000 AGA, the Board has presumed that the market level rents that landlords have been allowed to obtain under Costa-Hawkins vacancy decontrol have covered operating cost increases in effect when the initial rent was established. Consequently, in each subsequent AGA order, the Board has not allowed the AGA to be implemented on rental units for which an initial rent was established during the preceding calendar year. Regardless of which formula the Board ultimately adopts this year, I recommend that the Board provide that the 2004 AGA not apply to any tenancy that began during calendar year 2003.

<u>Board Action Requested</u>

1. Determine and set an appropriate NOI-indexing formula for use in setting the AGA. This formula should protect the landlord charging median rent against erosion by inflation of the real value of the profit component as measured by 1980 NOI. It is advised that this be the same indexing formula that is set forth in Regulation 1264.

2. Set a formula or formulas for the 2004 AGA. The excess NOI identified and discussed above may be taken into account in setting the final 2004 AGA formula. An adjustment greater than 45% of the increase in the CPI (i.e., 0.72% or higher) must be approved by an affirmative vote of at least six Board members.

3. Adopt a 2004 AGA Order, enumerated Regulation 1126. (Copy included as Attachment 5.)

Documents Attached

1. Apartment Operating Cost Increases in Berkeley – Analysis for the 2004 Annual General Adjustment, Kenneth K. Baar, dated October 2003.
2. October 27, 1995 Staff Report on 1996 Annual General Adjustment.
3. U.S. Department of Labor, Consumer Price Index, All Urban Consumers (CPI), San Francisco-Oakland-San Jose, CA., All items less shelter, 1979-2003. (Taken from Bureau of Labor Statistics Web Site on 10/15/03.)
4. U.S. Department of Labor, Consumer Price Index, All Urban Consumers (CPI), San Francisco-Oakland-San Jose, CA., All items. (Taken from Bureau of Labor Statistics Web Site on 10/16/03.)
5. Draft 2004 Annual General Adjustment (AGA) Order.
6. Correspondence from Theodore R. Edlin and David L. Howland.