Rent Guidelines Board Submission Order 37

June 2005

Rent Stabilization Association

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Introduction

This year, the RGB must approve rent guidelines at the high end of the proposed range of increases, and certainly no lower than last year's guidelines, in order to meet its legal mandate and prevent further deterioration in housing economics.

This Submission will provide evidence to support the following propositions:

- This year's data shows housing economics in the worst conditions ever recorded.
- The deterioration of housing economics reflected in this year's data is not an aberration but part of a long-term trend which began after 1999.
- This year's Price Index, a relatively high 5.8% increase, would be even higher if new lead paint abatement costs and a more accurate reflection of real estate tax increases were included.
- This year's 5.8% increase in building operating costs, not substantially lower than last year's 6.9% increase, is part of a long term trend which is likely to continue.
- Recent RGB increases have fallen short of historical levels of rent adjustment and have failed to compensate owners adequately for operating cost increases.
- If the RGB fails to approve rent guidelines this year at least equal to last year's rent increases, the result will be a further deterioration of housing economics.

In the past two years, the RGB has approved rent increases substantially below the PIOC, and substantially below the historical levels of commensurate rent increase adjustments. These low guidelines may have been approved in the hope that cost increases would mitigate or in the belief that rental housing economics was strong enough to absorb cost increases usually passed on to tenants. The evidence now shows that any such hope or belief is unrealistic as the gap between rental income and operating expenses continues to narrow. Unless a series of significant guideline increases are approved by the RGB any remaining profitability in rental housing will soon evaporate.

Even without these considerations, this year's PIOC is not substantially lower than last year's PIOC and, in itself, justifies rent increases that are no lower than last year's rent guidelines.

Based on the evidence before the RGB, any increase less than last year's guidelines can only be seen as politically motivated in this election year. Another inadequate rent guideline will hurt property owners, but will also harm tenants as owners are unable to adequately maintain their buildings or sell their buildings for conversion to homeownership tenures.

The RGB is legally mandated to compensate property owners for increases in operating costs. This year's data, in light of the RGB's action over the last two years, provides no rational course of action other than to maintain at least last year's level of rent increase.

The Price Index and Commensurate Rent Increases

This year's Price Index calls for rent increases at least equal to last year's.

This year the PIOC measured a 5.8% increase in building operating costs, a small decline from last year's 6.9% increase. The commensurate rent adjustment is the methodology that translates the measured increase in the PIOC into possible one- and two-year guideline increases. Each year, the RGB staff calculates possible one- and two-year rent increases based on five different commensurate rent methodologies. For ease of comparison we have reprinted last year's and this year's commensurate rent increase numbers side by side. As is evident, this year's and last year's commensurate rent increases are largely the same. Therefore, in and of itself, this year's 5.8% PIOC should call for rent guidelines no lower than last year's guidelines. However, as we will see below, there are both quantitative and qualitative reasons for believing that this year's price index is under-estimated and should be adjusted upward.

In itself, the 5.8% PIOC calls for rent increases at least equal to last year's guidelines.

Commensurates - 2004

"Net Revenue" Commensurate Adjustment

1-Year Lease	2-Year Lease
5.5%	9.0%

"Net Revenue" Commensurate Adjustment with Vacancy Increase

1-Year Lease	2-Year Lease
2.5%	4.5%

"CPI-Adjusted NOI" Commensurate Adjustment

1-Year Lease	2-Year Lease
7.0%	11.5%

"CPI-Adjusted NOI" Commensurate Adjustment with Vacancy Increase

1-Year Lease	2-Year Lease
4.0%	7.0%

"Traditional" Commensurate Adjustment

1-Year Lease	2-Year Lease
4.3%	5.5%

Commensurates - 2005

"Net Revenue" Commensurate Adjustment

1-Year Lease	2-Year Lease
4.25%	8.0%

"Net Revenue" Commensurate Adjustment with Vacancy Increase

1-Year Lease	2-Year Lease
2.5%	4.5%

"CPI-Adjusted NOI" Commensurate Adjustment

1-Year Lease	2-Year Lease
6.5%	10.5%

"CPI-Adjusted NOI" Commensurate Adjustment with Vacancy Increase

1-Year Lease	2-Year Lease
4.0%	7.0%

"Traditional" Commensurate Adjustment

1-Year Lease	2-Year Lease
3.7%	6.0%

Just as every instrument of measurement is imperfect, the PIOC imperfectly captures operating cost increases. This year, the PIOC fails to capture the new operating costs imposed on property owners by Local Law 1 of 2004. This new law, which went into effect on August 1, 2004, establishes lead paint abatement and remediation standards that impose significant new costs on owners.

The Board heard extensive testimony from property owners and practitioners in this new field of lead abatement, as well as from HPD officials who testified about the dollars committed by the City to implement the new requirements. Without going into specifics, there can be no question that the routine costs of operating buildings have increased significantly.

Ordinary paint jobs have now doubled in price. Owners' costs for abating lead paint in vacant apartments can range up to $25,000. The cost of paperwork and administration alone adds a significant new operating burden.

There can be no doubt that the Price Index, with its focus on measuring a constant quantity and quality of goods and services, does not capture cost increases attributable to changes in the market basket of services that owners must provide.

Another change in law, affecting the Building Façade Inspection Program, also imposes significant new costs on owners. Under the new requirements, building owners must inspect and repair damage on all exterior building walls, not just the façade wall. And owners no longer have an option to place potentially dangerous conditions on a "watch and monitor" status; all deficiencies identified in a prior inspection cycle must be repaired in the current cycle.

The Price Index must be adjusted upward to account for new operating cost requirements including lead paint hazard reduction and building façade improvements.

This year, the peculiar methodology used to calculate the real estate tax component of the PIOC presents an inaccurate picture of the increased tax burden bourne by the majority of property owners.

The PIOC measures the change in real estate taxes in the aggregate, i.e., by adding together the change in taxes for each building and measuring the change from year to year in the total tax burden for all stabilized properties.

As an alternative to this calculation, we took the raw data provided to the RGB by the Department of Finance, calculated the change in real estate taxes for each building and then calculated the median change in taxes from year to year.

The median change in real estate taxes this year is 3.6%, or three times higher than the 1.2% aggregate change measured by the PIOC. In other words, half of all rent stabilized buildings had an increase in real estate tax bills more than three times as high as the increase measured by the Price Index.

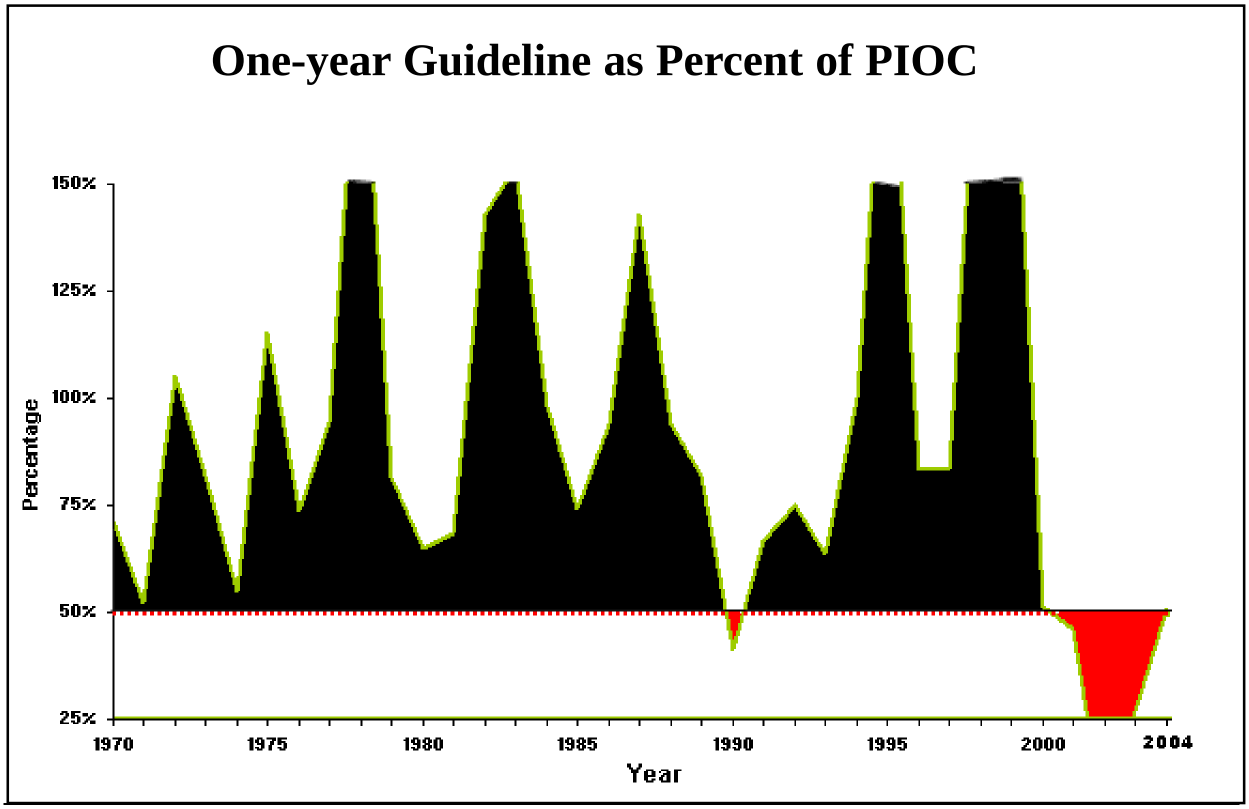
We suggest that the median increase is more representative of this year's increase in real estate tax bills than the aggregate increase measured by the Price Index. This view is supported by the fact that the average per building tax bill increase is 2.5%, or more than twice the increase measured by the PIOC. In other words, common measures of central tendency paint a picture of real estate tax increases substantially higher than the unusual aggregate measure used in the Price Index.

Although the increase in real estate taxes by any measure is moderate this year compared to prior years, even small differences in measured real estate increases can significantly alter the overall Price Index, since real estate taxes are such a large component of the overall index. This year, the difference between measuring the median and the aggregate change in real estate taxes results in nearly a one percentage point difference in the PIOC.

The Price Index must by adjusted upward by nearly one percentage point to account for an accurate measurement of increases in real estate taxes.

The precise level of the change in operating costs, however, is of no consequence if there is no relationship between the PIOC and the rent guidelines approved by the RGB. In the last several years, the guidelines have deviated significantly from the traditional, historical relationship between the guidelines and the PIOC. Historically, rent increases have averaged two-thirds of the PIOC, but since 2000 rent increases have averaged less than 50% of the PIOC.

From the perspective of commensurate rent increases, last year's guidelines were lower than all but one set of commensurate rent increases. (We believe that the commensurate adjustments involving the vacancy allowance are underestimated because they rely on the assumption that the vacancy allowance yields an increase of



18%, whereas our analysis of rent registration yields an average increase on vacancy closer to 10%.)

Similarly, this year, a guideline equal only to last year's guideline would be lower than all but one of the possible commensurate adjustments, which itself is suspect since it relies on an apparently erroneous assumption about the rent increases generated upon vacancies.

The RGB has been passing through smaller shares of the increase in operating costs at the very time that operating cost increases have risen significantly. For example, throughout the decade of the 1990's, operating costs increased by an average of only 3.5% per year, and the average one-year rent increase was 2.95% – an average increase equal to 84% of PIOC. However, in the first five years of the current decade, operating costs have increased at an annual pace of 7.7%, nearly double the rate of increase of the last decade. At the same time, the average one year increase rose to only 3.6%, or only 46% of the PIOC on average.

In other words, at the very time that operating cost increases for buildings were escalating steeply, the RGB was reducing the share of these increased costs to be passed on to tenants in the form of rent increases.

The recent failure of the RGB to provide adequate commensurate rent increases can be directly related to the deteriorating economic condition of the rental housing industry.

We ask that the RGB also bear in mind that the commensurate rent adjustment formulas underestimate the required level of rent increase. The commensurate rent methodology assumes that all increases, such as renewal guidelines or vacancy increases, are fully collectible. However, it should be clear from this year's data that, with actual rent collections running at 15% less than legal rents, owners are not always able to collect the full renewal rent increase.

The RSA's analysis of rent registration data shows that renewal guidelines generate approximately one percentage point less in rental revenue than estimated by the RGB's methodology. Similarly, our analysis of rent registration shows that vacancy leases do not generate an 18% increase in rents but an increase of approximately 10%.

The difference between actual revenue increases based on market conditions and the revenue projections based on the commensurate rent methodologies amounts to approximately one percentage point. Therefore, the RGB needs to aim higher in terms of the rent guidelines it enacts in order to hit the revenue target it has in mind.

It is only reasonable and realistic to take such market conditions into consideration. If the rent stabilization system intends to constrain rent increases when strong market conditions would allow higher rent levels, then it is equally reasonable to permit higher rent adjustments to compensate for weak market conditions which constrain available revenues.

Rent Guidelines must be adjusted upwards to compensate for the erroneous assumption that all legal rent increases are collectible.

The Deteriorating Economic Condition of Rental Housing

In recent years, the Rent Guidelines Board may have enacted inadequate rent guidelines in the hope that high operating cost increases were an aberration or in the belief that rental housing economics were strong enough to absorb cost increases usually passed on to tenants. The data available this year, however, makes it clear that building operating costs have been and are likely to continue to increase at a high rate while building profitability has declined steeply and is likely to decline further.

This year's data shows a marked deterioration in the economic condition of the rent stabilized housing stock.

The Preliminary Income and Expense Study presented to the RGB this year shows that building profitability, as reflected in the level of inflation-adjusted net operating income (NOI) has fallen to an all-time low. Net operating income now averages $293 per apartment per month, a decline of 9.1% since 1989, when this measure was first recorded (final data, not now available, will show a significant decline of some magnitude).

By a complementary measure, operating ratios have risen to an all-time high. The operating costs measured by the PIOC now account for 63% of every rent dollar. This is the highest level ever recorded. While a record high operating ratio is, in and of itself, bad news for the housing industry, the absolute level of operating ratios is also important. (We have argued in prior Submissions to the RGB that operating ratios as presented to the Board are underestimated because they are inappropriately adjusted downward based on audit results. Even the adjusted operating ratios are substantially higher than nation-wide operating ratios for rental housing and therefore place New York housing at a competitive disadvantage.)

These measures indicate that building owners, after paying for the costs of operating their properties, have fewer dollars left than ever before to cover their mortgage and other costs and to return a profit.

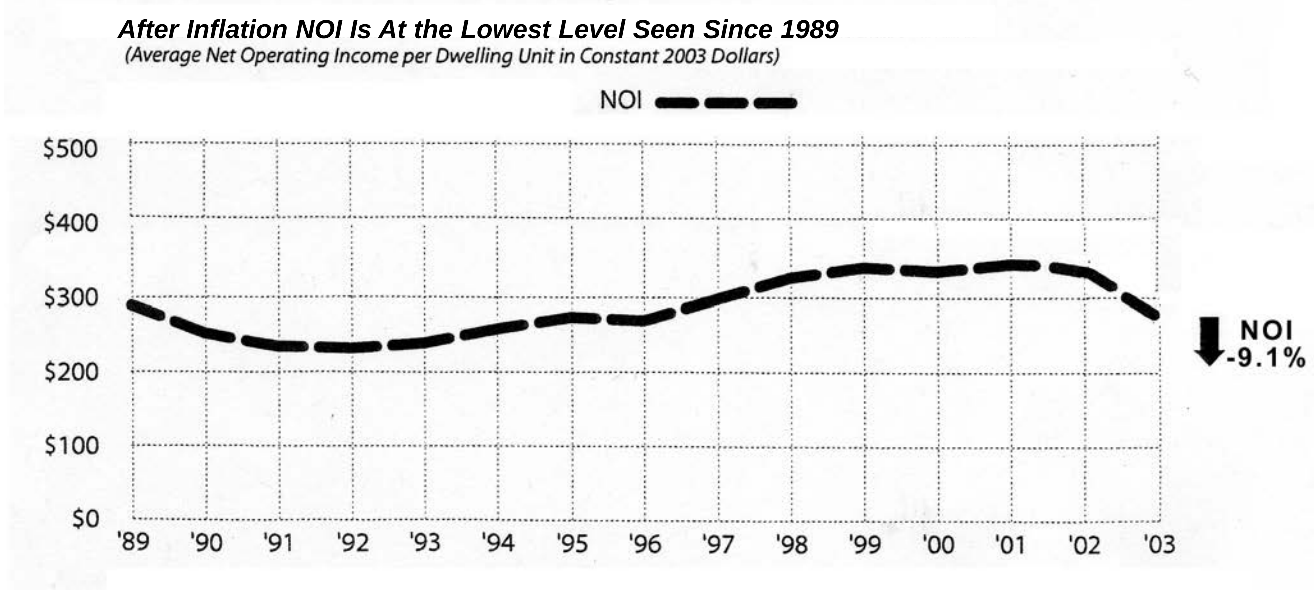
In fact, more owners than ever before are not even able to cover their operating costs, much less turn a profit. According to the Income and Expense Study, 11% of stabilized properties do not generate enough income to meet expenses and are therefore considered "distressed." Obviously, this means many more properties would be considered economically "marginal" because they do not generate enough income to service any debt or provide a profit.

A final measure of economic health contained in the Income and Expense Study is the percentage of legal rent that is actually collected by property owners. In 2003, owners were collecting only 89% of their rents, down from a high of 94.4% in 2001, and approaching the low of 85% rent collection in 1991.

The economic deterioration of rental housing is part of a continuing trend.

The negative indicators discussed above are not a one-time phenomenon but part of a trend which began after 1999 and has accelerated more recently. As the following chart indicates, inflation-adjusted net operating income remained virtually flat in every year since 1999 before declining precipitously in 2003.

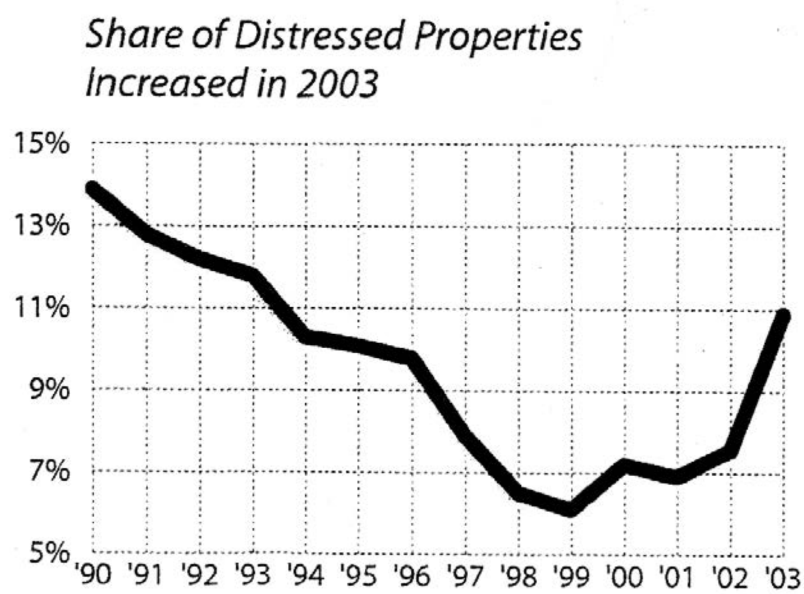
NOI After Inflation



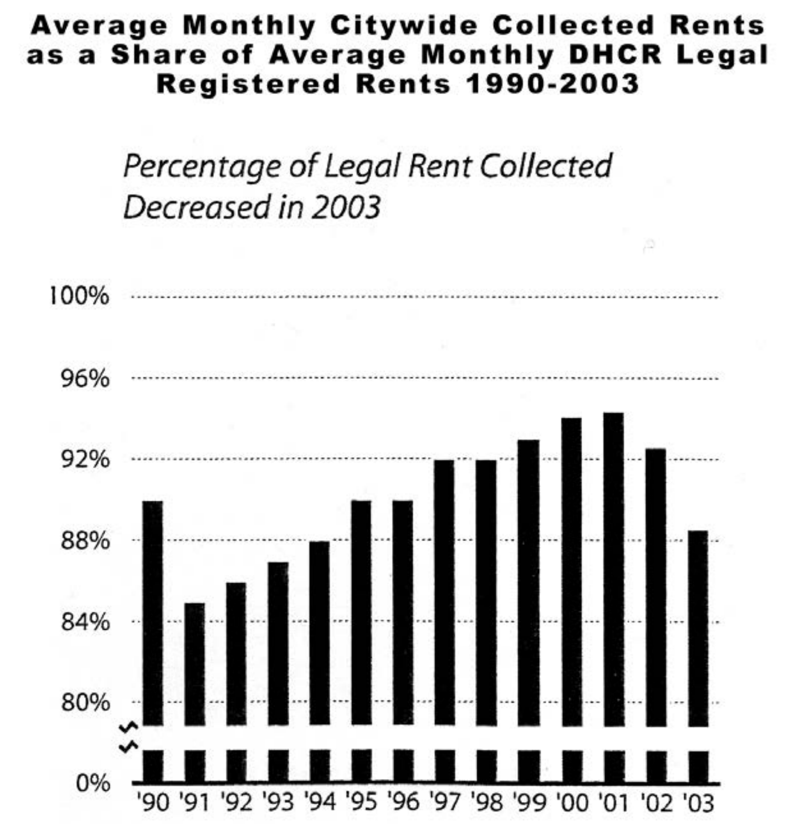
Source: RGB Preliminary Income & Expsense Study, 2005

Similarly, operating ratios declined in three of the last four measured years leading up to the dramatic increase in 2003. The percentage of distressed properties has risen steadily from a low in 1999, and rent collection began falling off after 2001.

Percent of Distressed Properties in Cross-Sectional Samples 1990-2003



Source: RGB Preliminary Income & Expense Study, 2005



Source: RGB Preliminary Income & Expense Study, 2005

Not coincidentally, the decline in the economic condition of stabilized housing mirrors the period since 1999 in which rent guideline increases fell to less than half the level of the price index. And again, not coincidentally, economic conditions for the stabilized stock improved markedly during the 1990's when the RGB rent adjustment averaged 84% of the price index.

The economic condition of the stabilized stock will decline further based on more current data.

The current, disastrous picture of the economic condition of the stabilized stock contained in the Income and Expense Study dates back to 2003, the last year for which income and expense data is currently available. But it is easy to see that the economic picture will become much cloudier before it improves.

Income and expense statements are generally filed on a calendar year basis. The 2003 expense data therefore includes only one-half of the 18% property tax rate increase which affected the City's fiscal year beginning in July, 2003. These statements also included only half of the 2003-2004 heating season, which saw dramatic increases in oil prices.

It is likely, therefore, that the 2004 income and expense filings will show another sharp jump in building operating costs, while rent increases, limited by RGB adjustments equal to just 25% of the price index, will not increase commensurately.

The continued operating cost pressures are indicated by last year's 6.9% PIOC and this year's 5.8% PIOC, while rent adjustment granted by the RGB were reduced even further. It will not be surprising to see further declines in net operating income and increases in building operating ratios for 2004 and 2005. And the 6.7% operating cost increase projected for next year will continue to place pressure on the potential profitability of rent stabilized housing through 2006.

Higher Rent Guidelines Are Reasonable

In light of the data provided above, higher rent guidelines this year are justified for a number of reasons:

- first, the commensurate rent adjustments for this year's guidelines are not significantly different than last year's commensurate adjustments. Therefore, last year's rent guidelines, which we believe were inadequately low, should be the floor for this year's guidelines.
- second, the commensurate rent adjustments are based on the false assumption that guideline increases are fully collectible and therefore the commensurate rent increases need to be adjusted upwards in order to generate the required revenue.
- third, this year's Price Index fails to accurately capture real estate tax increases and fails to capture in any way the added new costs of lead paint abatement and changes in façade repair requirements.
- fourth, property owners were not fully compensated for the very real 16.9% increase in costs two year ago, or for the 6.9% increase in costs last year, so that this year's guidelines need to contain some degree of catch-up for inadequate guidelines of the past.

- fifth, it should now be clear that building operating costs have entered a highly inflationary environment since 2000, one that will continue at least into next year with a projected PIOC of 6.7%, so that the RGB should apply the concept of smoothing the guidelines to avoid sharp guideline increases in the future.
- finally, it is the RGB's legal mandate to address the economic deterioration of stabilized housing since 2000 by enacting guidelines which will restore a reasonable level of profitability to rental housing.

For all these reasons we urge the RGB to enact rent guidelines of at least 6.5% for one-year leases and 10.5% for two-year leases. These are rational guidelines based on a commensurate rent adjustment that compensates owners for increased costs and provides for an inflation adjustment of net operating income.

We understand that the RGB is unlikely to come close to our proposal since the range of proposed increases does not exceed 4% and 7.5 % for one- and two-year leases. In light of the possibility that the final rent guidelines will be totally inadequate, we ask the RGB to consider a range of supplemental increases to ease the burden of increased operating costs, particularly for small owners of low-rent properties.

Enact a Fuel Surcharge

Heating oil costs have increased by approximately 100% over the last three years and show no signs of abating. OPEC target prices have increased to a range of $40-50 per barrel, current prices continue to hover around $50 per barrel without causing a world-wide recession, and a lack of world-wide refining capacity all indicate that oil prices are not likely to decline significantly. Yet, recent guideline increases have failed to adequately compensate owners for the increased heating costs.

We urge the Board to adopt a fuel surcharge in addition to any rent guideline increases in the amount of $15 per room per month with the following proviso: This surcharge shall become a part of the base rent as of October 1, 2006, unless the price of fuel as measured in next year's PIOC falls by more than 50%.

If such a surcharge is enacted, owners will be able to recoup some of the past, uncompensated increases in heating costs and will be able to maintain that increase in the likely event that the three-year increase in oil prices is a permanent situation.

Provide a Limited Long-Term Occupancy Adjustment

It is now five years since the last low rent adjustment was enacted, and low rents have resurfaced as a problem, although in a different context. The low rent adjustment last applied to rents of $500 or less. We note that operating costs averaged $613 per apartment per month in 2003 based on the current Income and Expense Study. Operating costs have obviously increased even more in the last two years, without accounting for capital improvement costs and debt service.

When property owners now complain about low rent apartments, they are talking about monthly rents of $600, $700 and $800 per month, which are now insufficient to carry the increased burden of property taxes, water and sewer charges, insurance, heating costs and the costs of maintenance and repair.

We suggest that the RGB provide an additional increase for apartments renting for less than $600, but only for those apartment that have been continuously occupied for ten years or more. Clearly, owners have an opportunity to raise rents upon vacancy, making it unlikely that apartments renting for less than $600 have been vacated since 1997. Rather, such low rent apartments are likely to be occupied by long-term occupants. Moreover, as we have demonstrated in prior RSA Submissions, there can be no assumption that occupants of low rent apartments are low-income or rent-burdened.

To make any future low rent adjustment more rational, we suggest that the adjustment be based on the size of the apartment. Clearly, there are very large apartments being rented at low rents disproportionate to the cost of heating such apartments and their proportionate share of building expenses. Specifically, we suggest that, for rents of $600 or less that have been continuously occupied by the same tenant for 10 years or more, the RGB enact an additional adjustment of $15 per room per month.