Rent Guidelines Board Submission For Order 40

June 2008

Who Is Going to Pay The Oil Bill?

RSA Rent Stabilization Association

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Summary

This is a critical year for affordable housing in New York City. This year's 7.8% increase in the Price Index, the largest increase in five years, continues a trend of skyrocketing building operating costs. Worse yet, the PIOC shows that a majority of stabilized buildings (those that heat with oil) experienced cost increases of 10%. And the real cost increase is even higher.

Despite historically high levels of operating cost increases, rent increases granted by the RGB have been inexplicably low. In the last six years, operating costs have increased by more than 40% (not including this year's increase), while the RGB has allowed rents to increase by no more than 20%. The recent pattern of rent guideline increases that average 50% of the price index stands in stark contrast to a history of guidelines that were 80%-85% of the price index.

The inadequacy of recent increases is reflected in the economic deterioration of stabilized housing. Building operating ratios have increased steadily since 1999. Over the same period, the number of properties operating at a loss have nearly doubled. This trend of economic deterioration will continue unless the RGB acts now to provide rent increases that are in line with rapidly increasing operating costs.

For the rent guidelines to be adequate, the RGB must recognize two basic principles. First, the guidelines must be within the range of commensurate adjustments calculated by RGB staff to produce the revenue needed to meet increased operating costs. This year, the range for a one-year lease falls between 4.75% and 7.5% while the two-year range falls between 8.1% and 13.25%.

Second, a percentage increase applied to a low rent generates less revenue than the same percentage applied to a high rent. But is costs as much to heat a low-rent apartment as a high-rent apartment. This year, the RGB must provide a minimum rent increase of $60 per apartment per month to generate the required revenue.

Adequate rent increases are essential if New York City is to maintain its large stock of affordable housing. There may well be households in New York with no income, or such low income, that they cannot afford a well-maintained apartment. That is a societal concern, the cost of which should be borne by all taxpayers, not just property owners. .

The RGB is required to provide the rent increases needed to preserve the City's rental housing industry. To do less would be a disservice to the City's tenants and owners alike.

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Typical Building Operating Costs Increased Even More Than the 7.8% Price Index

This year's 7.8% Price Index, on its face, represents an extraordinarily large increase in operating costs. This year's increase is the largest in the last five years and is 50% higher than last year's PIOC. However, even this relatively high average increase masks even higher increase for 75% of rent stabilized properties.

According to the RGB 2008 Price Index Study, stabilized buildings which heat with oil showed a 10% increase in operating costs. But oil-heated buildings represent the majority of stabilized properties. According to HVS, approximately 75% of stabilized units are heated with oil. In addition, the 2008 Price Index Study reports that pre-war buildings had a 9.1% increase in operating costs. Again, pre-war buildings are the majority of stabilized properties are pre-war buildings, with the HVS reflecting 75% of stabilized units in pre-1942 buildings.

Clearly, the majority of stabilized properties experienced operating cost increases exceeding the 7.8%, and these properties are primarily the providers of affordable housing outside of core Manhattan.

While this year's 7.8% increase in operating costs is large, large increases have, unfortunately, become the rule rather than the exception.

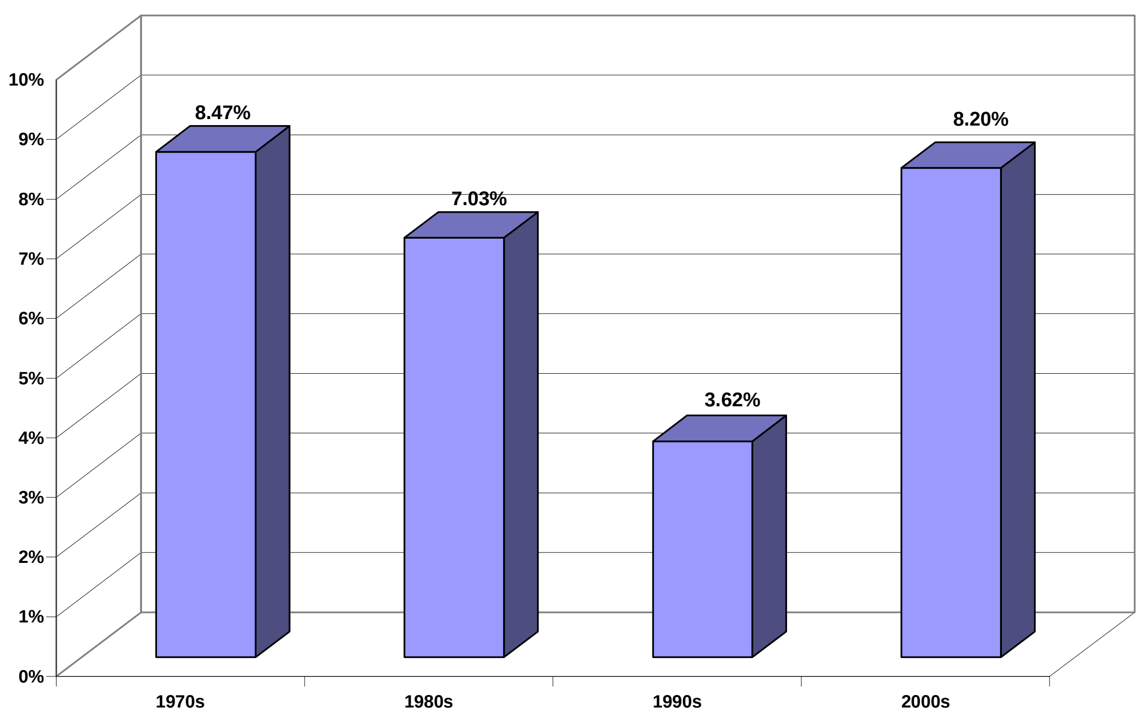
This past year continues an extraordinary period of increased inflation for building operating costs which has not been seen since the years after rent stabilization was first established. Building operating costs have increased by nearly 60% since 2000. The cost increase would be much higher if it were calculated cumulatively and included many additional cost increases not measured by the PIOC.

The increase in building operating costs stands in stark contrast to the relatively benign increase in the overall rate of consumer inflation in recent years. For example, the CPI for all urban consumers for 2007 increased by just 2.83% from the prior year, versus the 7.8% increase in the PIOC. In other words, the burden of inflationary pressures is falling much harder on landlords than on tenants.

The recent rate of increase in building operating costs is also extraordinarily high within the history or rent stabilization. For example, the 7.16% annual increase in operating costs since 2000 is nearly twice as high as the 3.62% rate of increase in the 1990's (*see chart below*).

Building Operating Cost Increases are Near Historic Highs

Average Annual Increase of PIOC



Source: NYC Rent Guidelines Reports 1970-2008.

The current rate of operating costs increases is only exceeded by the rate of increase which prevailed in the highly inflationary period of the 1970's – a period of wide-spread inflation which was responsible for the creation of the rent stabilization system.

In contrast to the 1970's, the current inflationary trends have largely held consumers harmless and have particularly affected rental properties. The rental industry has been hit hard not just by recent increases in heating costs, but by the continual increase in municipal levies such as real estate taxes and water and sewer charges, as well as increases in all other building operating costs including insurance, administration, contractor services and labor.

Nor are rising costs likely to abate any time soon. The Price Index for next year is projected to be 7.3%. Despite a proposal to freeze the tax rate, increases in assessments will still result in increased real estate bills. Water and sewer bills are projected to continue increasing at double digit rates for the remainder of this decade. There is no prospect of reduced heating oil prices any time soon, if ever. And utility costs will likely continue to rise in concert with the increase in oil prices.

These significant increased operating costs are only those measured by the PIOC. There are other substantial costs which are not included in the PIOC, such as the cost of lead paint abatement and building façade improvement costs. The cost of complying with these and other governmental mandates imposed since 1983, when the PIOC was last updated, are not included in the cost increases presented to the RGB.

Each year brings new costs to buildings owners. This year the RGB heard testimony about increased litigation costs that owner will bear as a result of recently enacted anti-harassment legislation and the increased administrative and other costs associated with the requirement that owners cannot refuse to accept subsidzed tenants. Such burdens, in terms of time and money, fall heaviest upon the small rental properties, the backbone of the City's affordable housing stock.

PIOC Underestimates Heating Costs

As high as this year's 37.4% increase in heating costs is, the RSA has provided the RGB with good reason to believe that the real cost increase is even higher. An analysis of the RGB fuel cost methodology by Energy Management and Research Associates (EMRA) reveals three major errors in basic assumptions. First, the RGB formula weights the heating cost using a 65 degree day standard. But New York City law requires buildings to be heated to 68 degrees. Using the correct heating degree standard would have showed increased consumption and increased cost over the past year.

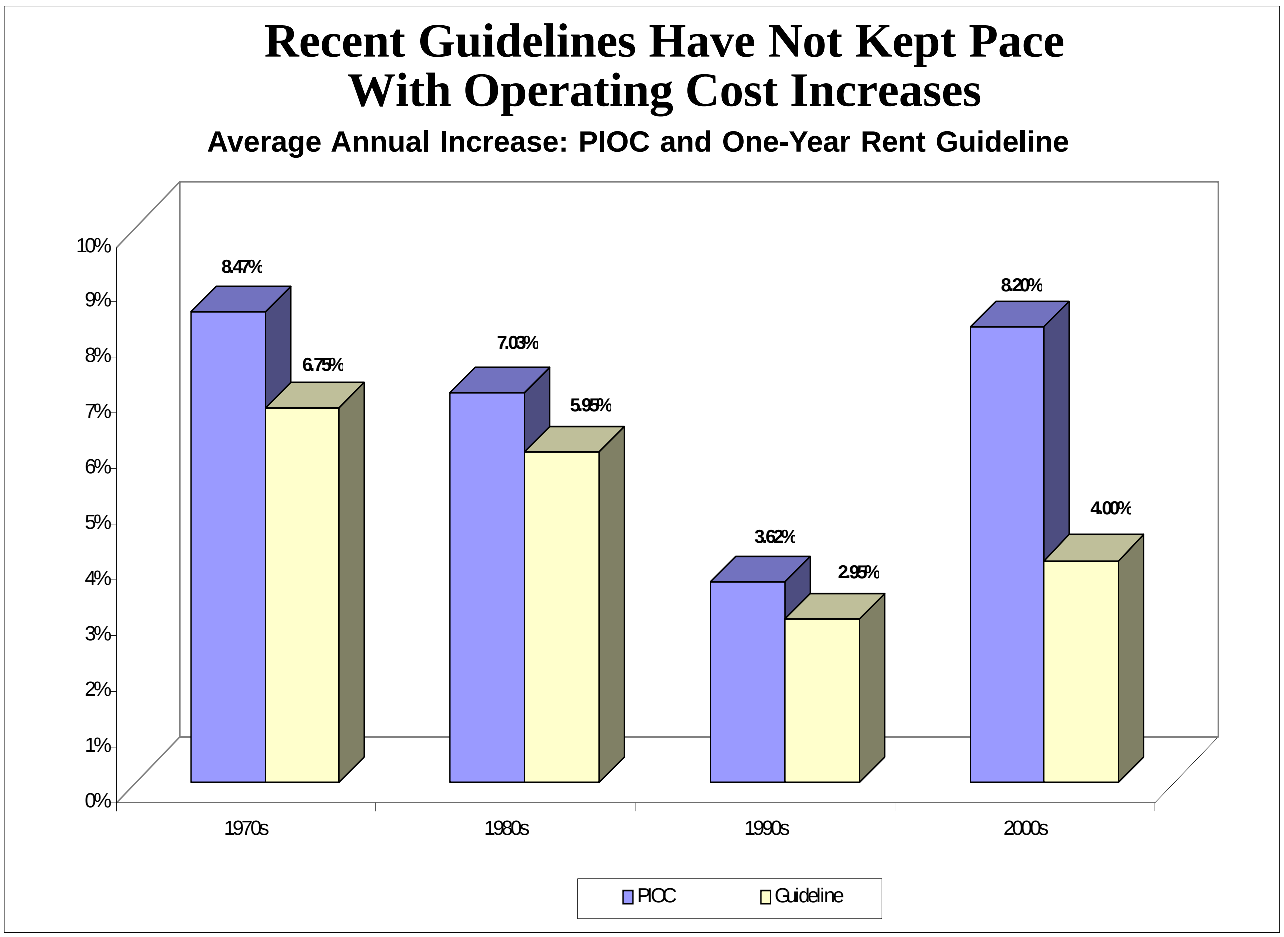
The RGB fuel formula also appears to under-estimate the portion of oil used to provide hot water rather than heat. Since domestic hot water use is fairly constant throughout the year, that portion of oil cost is directly influenced by price alone and is not moderating by a change in heating degree days.

Finally, the RGB formula appears to weight oil costs by applying heating degree days even in the summer months, when no heat is required and oil costs are totally determined by hot water use. This makes absolutely no sense.

As a result of the inadequacies of the measurement methodology, we believe that the real increase in fuel oil costs was 50% or greater, rather than the 37.4% measured by the RGB. The 7.8% Price Index is therefore underestimated, just based on the erroneous measurement of heating oil costs.

Rent Guideline Increases Have Fallen Far Behind Increased Building Operating Costs

While building operating costs have been soaring at historically high rates, rent increases granted by the RGB have fallen far behind. In recent years, the one-year rent guideline increase has amounted to only half of the increase in building operating costs. Specifically, the average increase in the one-year guideline since 2000 has been 4% compared to a 8.2% annual increase in the PIOC (*see chart below*).



Source: NYC Rent Guidelines Board Reports 1970-2008.

In other words, since 2000, building operating costs have increased by nearly 60% while property owners have, at best, collected increases of less than 30% based on the one-year rent guideline increase.

Not only have recent guidelines been low relative to the PIOC, they have also been low compared to historic levels of rent adjustment. The chart on the prior page also indicates that the only period in which rent guideline have been lower than in recent years (since 2000) was in the decade of the 1990's when inflation was very low both in terms of the CPI as well as the PIOC.

The recent pattern of rent increase adjustments also sharply contrasts with the historic norm in which the one-year guideline has equaled more than 80% of the PIO. As shown in the table below, prior to 2000, through periods of high inflation and low inflation, the one-year guideline has consistently provided rate increases equal to at least 80% of the PIOC. Only in the current decade have levels of rent adjustment fallen below their historic norms.

While there has been no explanation for the inadequacy of recent guidelines, the consequences of inadequate guidelines are readily apparent.

Recent Guidelines Are At Historic Lows

One-Year Guideline as a Percent of PIOC	
1970 - 1979	80%
1980 - 1989	85%
1990 - 1999	84%
2000 - 2007	50%

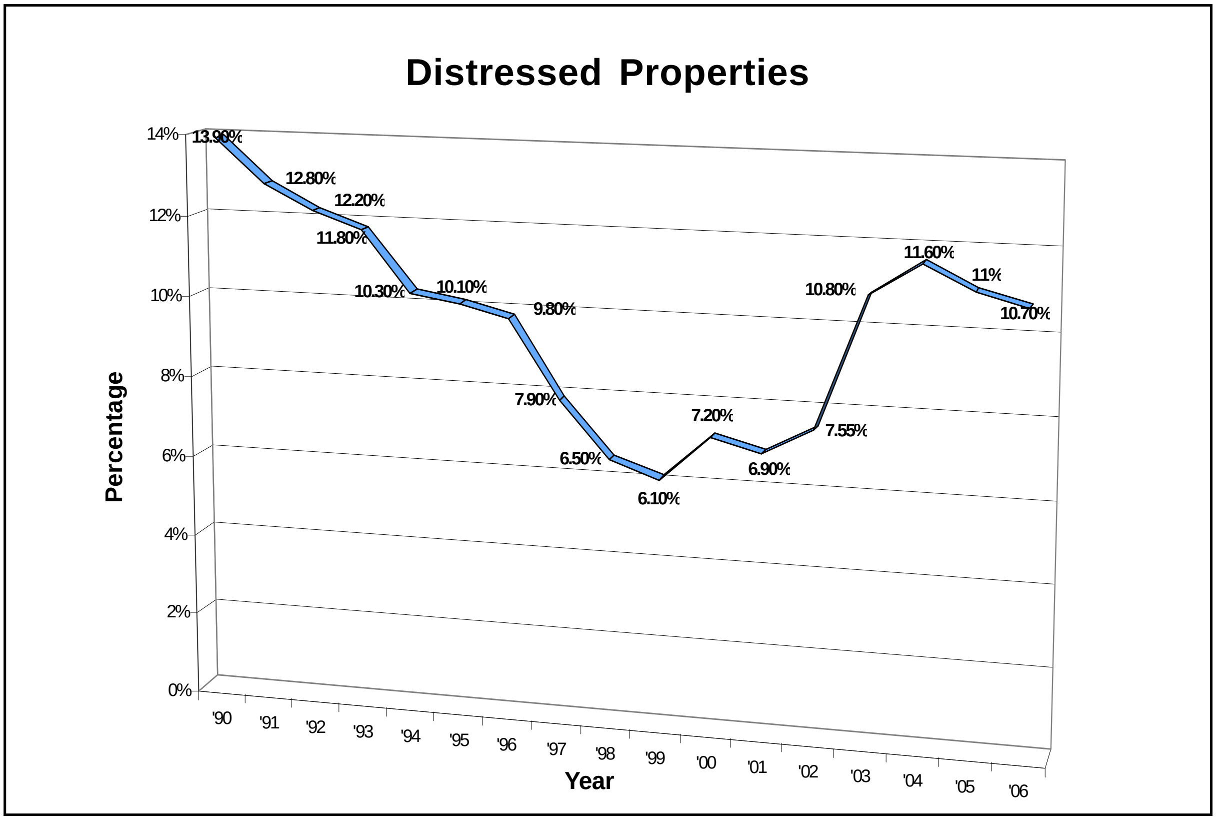
Source: NYC Rent Guidelines Reports 1970-2007

Inadequate Guideline Increases Have Resulted in Deteriorating Rental Housing Economics

The building economics data provided to the RGB makes it clear that rental housing economics has deteriorated as rent guidelines have failed to keep up with operating cost increases since 2000. The income and expense data filed with the City's Department of Finance and provided by staff to the RGB each year clearly highlight this economic deterioration.

From 1989, when such data was first available, until 1999 these indicators showed a gradual improvement in building economics. Beginning in 2000, however, these indicators began to trend downward. Based on the most recent report, which includes economic data from 2006, all indicators show that regulated housing is in its worst position since 1989.

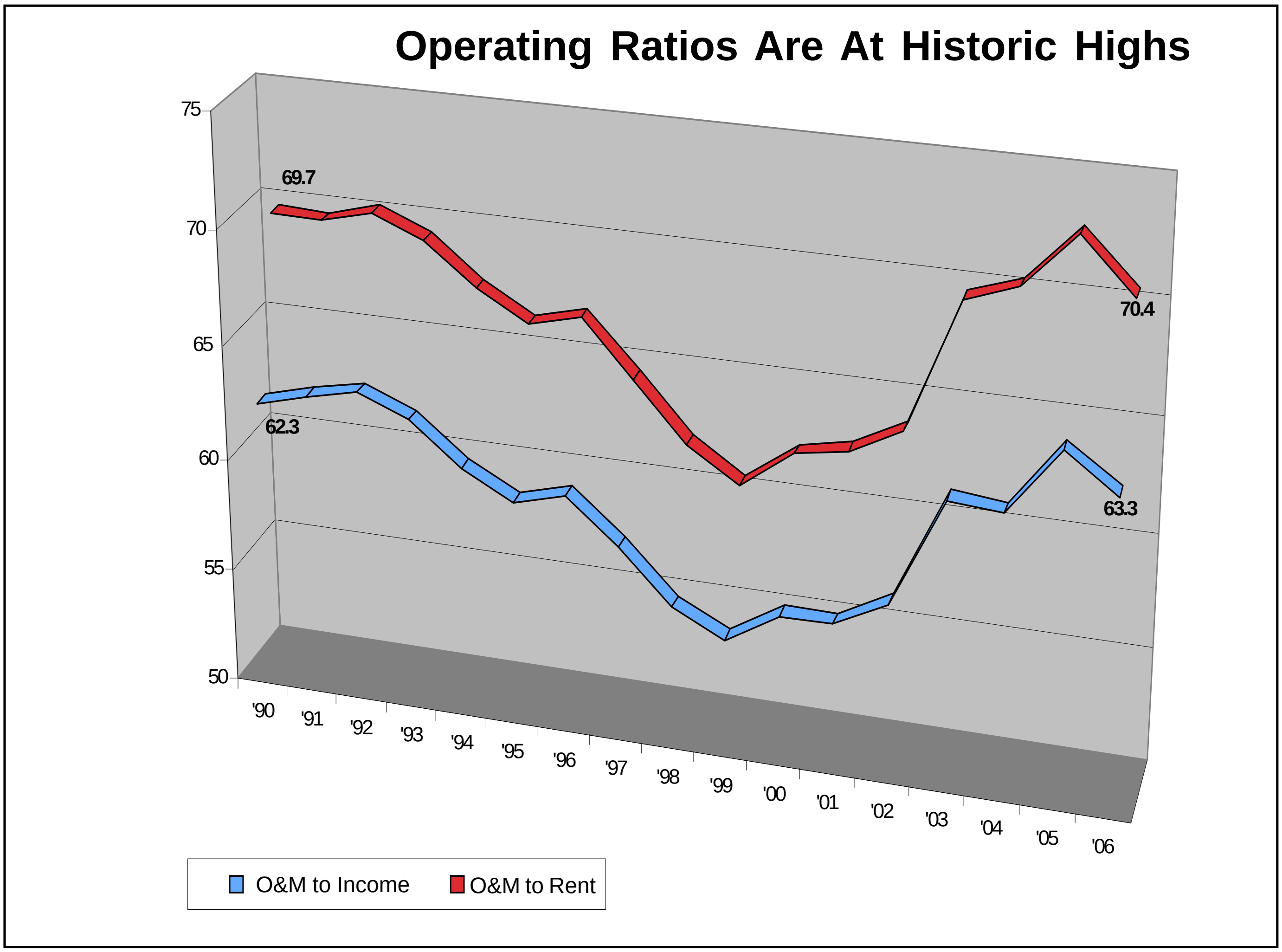
Despite a bit of improvement reflected in the 2006 data, the trend is clear. Operating costs are rising faster than income. As a result, operating margins are shrinking to the point that nearly 11% of stabilized buildings are operating in the red (see chart below). If this trend continues, it is only a matter of time before an increasing number of buildings fall into a state of disrepair.



Source: NYC Rent Guidelines Board, 2008

Take building operating ratios as an example. Operating ratios are expressed as a percentage of building income or rent consumed by the operating costs measured by the Price Index. The lower the ratio, the better because lower ratios mean there is more revenue available for profit, to finance a mortgage and to pay for building improvement.

As can be seen in the Chart below, building operating ratios generally improved from 1989 through 1999, falling to a low of 55%. Beginning in 2000, these ratios began to deteriorate, rising to 65% in 2005 before dipping slightly in 2006. Operating ratios are actually much higher as reflected by the 76.7% unaudited cost-to-rent ratio which is typical of apartment buildings without commercial income outside core Manhattan.



Source: NYC Rent Guidelines Board 2008 Income & Expense Report

In other words, the most recent income and expense data produced by the RGB staff shows that **operating ratios in 2006 are higher than the levels in 1989 and 1990** when such data was first collected and which, as acknowledged by staff reports at the time, was as a period of very dire housing economics.

Other economic indicators tell the same story. Net operating income (NOI) is the dollar amount left over to cover debt service, capital improvement costs and profit after paying for operating costs. Inflation-adjusted NOI, as calculated by RGB staff, fell in the early 1990's and then generally grew until 2000 when it leveled off and then began to decline. While the most recent RGB Income and Expense Report, shows an up tick in net operating income, the trend of declining NOI is clear.

The absolute dollar value of net operating income is critical to sustaining affordable housing. While the median net operating income in core Manhattan $561 month per apartment, the median NOI in the Bronx is only $171 per month per month. Such a small amount of net operating income, especially in smaller buildings, makes it extremely difficult to finance debt for improvements or pay for extraordinary repair costs when they occur. The stark difference between core Manhattan and the Bronx also highlights the fact that while Manhattan properties may appear to be profitable, there can be no question that the large stock of affordable housing outside the Manhattan core is barely hanging on.

The recent deterioration of regulated housing economics has coincided with and is directly related to the relatively low rent guidelines enacted since 2000.

It should be noted that the deteriorating condition of rent stabilized housing in recent years has occurred despite the availability of revenue, in addition to rent guideline increases, as a result of a State-mandated vacancy allowance of 20% and the ability to achieve de-regulation or market rents in certain circumstances. This indicates that the additional sources of income are insufficient to offset the losses imposed by the inadequate rent guideline increases of recent years.

Despite the obvious evidence of economic distress in the regulated housing sector, some have pointed to the high sales prices recently achieved for regulated properties as an indication that these regulated properties must be profitable. This is incorrect, for two reasons.

First, investors who are paying high prices for regulated properties may be working with unrealistic models (just as the models for securitized mortgage obligations turned out to be wrong). They must pursue all available means to significantly increase rental revenue and, in the end, they may have simply made a bad investment.

Second, although some owners with financial difficulties may have been driven to sell their properties, the majority of long-term owners must meet today's operating costs with today's rental income. While some owners have been forced to draw on their equity to finance current operations, other owners do not have enough cash flow to sustain any debt on their buildings.

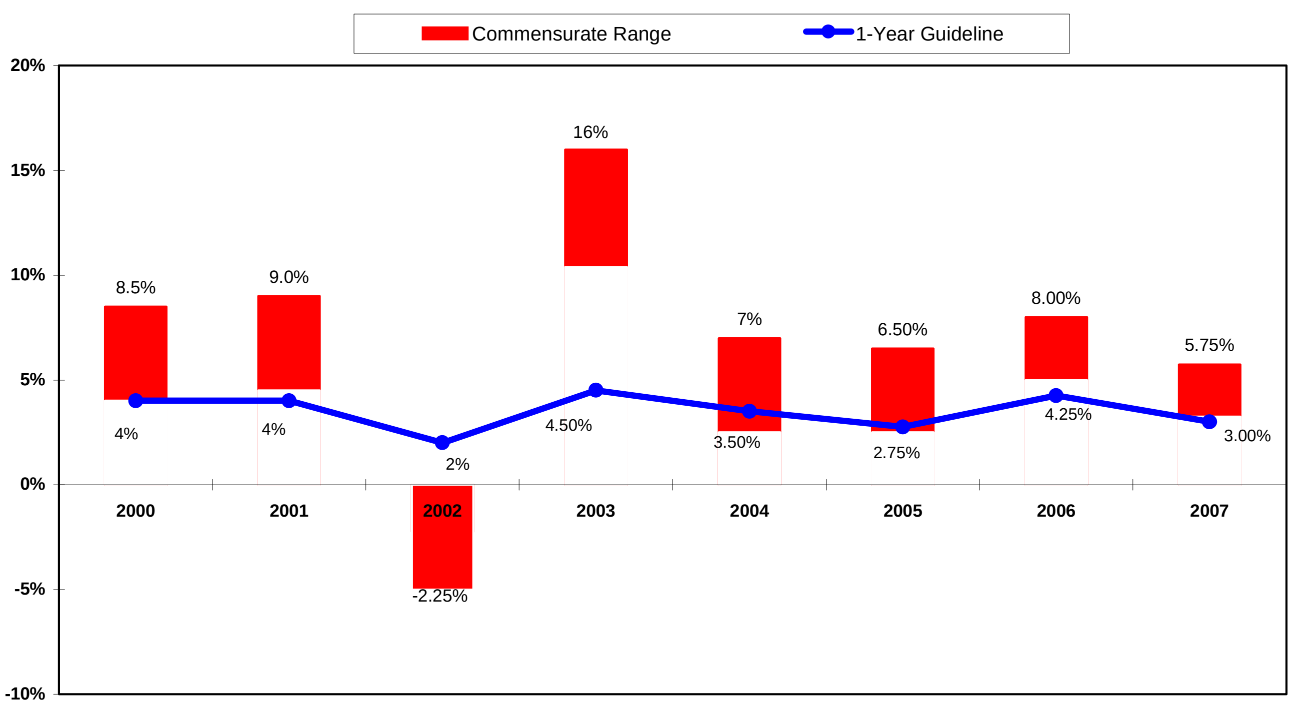
This year the RGB has a choice between providing long-term owners with the moderate rent increases they need to preserve affordable housing or forcing them to sell to speculators whose primary goal is to substantially increase rental income and value.

To Save Affordable Rental Housing the RGB Must Provide Double-Digit Rent Increases—Or a Low-Rent Adjustment

Another way to view the adequacy of recent rent guidelines is in relation to the range of commensurate rent adjustments provided each year by the RGB staff. The commensurate rent adjustment formulas indicate the level of rent guidelines needed to keep owners whole in the face of rising costs reflected in the Price Index. The commensurate adjustment formulas vary in their assumptions regarding whether or not net operating income is adjusted for inflation and whether or not the revenue from vacancy increases is factored into the formula.

In six of the last eight years, the one-year rent guideline has fallen below or at the very bottom of the range of possible commensurate rent adjustments (*see chart below*). In 2002, the 2% one-year guideline increase was actually above the commensurate range because the Price Index was zero. That "extra" increase was more than obliterated in the following year when the Price Index soared to nearly 17% and the one-year guideline was only 4.5%.

1-Year Guidelines Have Fallen Below or at the Bottom of Commensurate Range



Source: NYC Rent Guidelines Board, Price Index Reports 2000-2008.

In other words, recent rent guideline increases have not even come close to providing property owners with the revenue they need to meet increased operating costs.

This year, the commensurate rent adjustments based on the Price Index increase of 7.8% range from 4.75% to 7.5% for a one-year lease and from 8.1% to 13.25% for a two-year lease.

We have argued in this Submission that recent rent guidelines at the low end or below the commensurate rent adjustments have resulted in the economic deterioration of regulated housing, despite the availability of revenue from additional sources.

Since the commensurate rent adjustments are based on the 7.8% PIOC, this year the commensurate rent adjustments do not take into account the fact that the majority of stabilized buildings experienced cost increases of 10% or more.

The RSA has called for double digit rent increases this year based on the 10% cost increase for oil-heated buildings, the inadequacy of past guidelines and the high probability that large operating cost increases will continue in the future

For the 372,000 apartments renting for less than $723 per month outside of core Manhattan, a double digit rent increase is necessary to generate the revenue required just to pay for the increase in oil and water and sewer charges. For these low rent apartments, a one percent increase is required just to pay for last year's water and sewer rate increase.

However, a double digit rent increase may be an excessive on higher rent apartments. In the past, the RGB has dealt with this dilemma by adopted a more moderate percentage increase and complementing it with an additional dollar adjustment for low rent apartments.

Low-rent adjustments were a common feature of rent guidelines for many years and are justified by the fact that a percentage increase applied to a low-rent apartment yields less revenue than the same percentage applied to a high-rent apartment.

The lack of a low-rent adjustment since 2000, in conjunction with the availability of a State-mandated vacancy allowance, has exaggerated the rent skewing which is a hallmark of rent stabilization created by long-term occupancies. The rent stabilized market is now characterized by a Manhattan core which has high rents and rapid turnover and a much large universe of housing outside the Manhattan core with low rents constrained in a narrow range and low turnover.

While low rents are largely the result of long-term occupancies and while we have previously argued for long-term occupancy adjustment, we do not do so this year. Because low rents tend to be concentrated in certain neighborhoods and buildings, the low rent increase percentages of recent years have simply not yielded enough revenue to help owners, especially small property owners, meet increased operating costs. These buildings need to augment rental income substantially just to pay for the most basic of operating costs such as heating oil.

Linking the availability of a low-rent adjustment to a criteria of long-term tenure will overly complicate the guideline and result in the inability of owners to collect rent increases they need and deserve.

Therefore, this year we recommend that, in addition to any across the board guideline increase, the RGB adopt a minimum increase of $60 for a one-year lease and $90 for a two-year lease.

Higher Rent Increases This Year Cannot be Offset by Other Considerations

Despite what appears to be a clear case for substantially higher renewal guidelines increases this year, a number of RGB members have suggested that the need for such increases may be mitigated by other factors such as the availability of substantial rent increases upon vacancy. However, the economic deterioration of regulated housing since 2000 has occurred despite the availability of such increases.

The economic data upon which the RGB relies, derived from income and expense filings by property owners, includes all sources of building income including increased income available from vacancies as well as commercial and non-rental income. Yet, this inclusive economic data demonstrates that income from sources other than rent guideline increases has not been sufficient to offset the negative effect of inadequate rent guideline increases.

Vacancy increases also vary geographically. For instance, the RGB was presented with evidence that 84% of deregulated apartments occur in core Manhattan. Clearly, the economic benefits of deregulation do not benefit affordable housing outside Manhattan. We now also know that the turnover rate outside Manhattan is half that in core Manhattan.

The RGB staff analysis shows that the average rent increase upon vacancy city-wide was 9.8%, not the 20% increase available by State law. The average vacancy increase masks the fact that vacancy increases in core Manhattan are likely to be 20% or higher, but that vacancy increases outside Manhattan are likely to be less than 9.8% average.

Some RGB members have also suggested that higher guidelines may not be collectible because of the presence of preferential rents, which tend to reflect the average rent in a specific neighborhood. First, preferential rents comprise only a small portion of all stabilized apartments. Data provided by RGB staff demonstrates that only 15% of stabilized apartments have preferential rents.

Preferential rents can also be increased when warranted as operating costs rise. Preferential rents may, since 2003, be raised to the legal regulated rent upon renewal, though many preferential rents are locked in by the terms of the lease and are increased in tandem with the legal rent.

However, the existence of a small number of preferential and market rents does not mean that these rents cannot, are not and should not be increased.

Finally, many RGB members routinely cite the need to balance the need for increased rents against the ability of stabilized tenants to pay those rents. Even if there was a wide-spread crisis of housing affordability in New York City, the RGB must primarily weigh the ability of property owners to maintain their building in habitable condition against the rent increases needed to maintain habitable buildings.

The fact of the matter is that most rent stabilized housing provides bargain rents for households who can well afford their rents as well as required rent increases. As we can see in the Chart below, low-income households have a substantial rent burden. But these poverty level households can barely afford any rent without government assistance. It is certainly not the purpose of the rent stabilization system or the RGB to assume the role of a government income assistance program.

The majority of rent stabilized households, in contrast, have a median out-of-pocket rent-to-income ratio of only 22.3%, paying a median rent of only $865 per month. The rent burden for the typical stabilized renter is much lower than the median rent burden for renters nation-wide and can hardly be characterized as constituting an affordable housing crisis.

Typical Households Have Low Rent Burdens

	Median Income	**Median Out of Pocket Rent**	**Median Out of Pocket Rent as a Percentage of Income**	**Total Units**
Low Income *	$9,778	$579	57.4%	266,694
All Other	$45,000	$840	22.3%	732,618
Total	$34,000	$768	25.7%	999,312

**Low Income is defined as the 27% of stabilized households that have incomes lower than 125% of the 2004 Federal Poverty thresholds*

Source: Quantitative Analysis, Inc., NYC Housing & Vacancy Survey 2005.

Conclusion

- The economics of affordable rental housing is deteriorating even as the for-sale market is booming.

- Building operating costs are increasing faster than rents, forcing operating ratios to rise to historic highs. Operating costs are likely to continue to increase substantially.

- Deteriorating rental housing economics is the direct result of inadequate rent guideline increases.

- Higher rent guidelines and a minimum dollar amount rent increase are needed this year to compensate for past losses and current cost increases.

- Rent stabilized housing is the largest source of affordable housing.

- New York City cannot afford to lose its affordable housing for lack of adequate renewal rent increases.