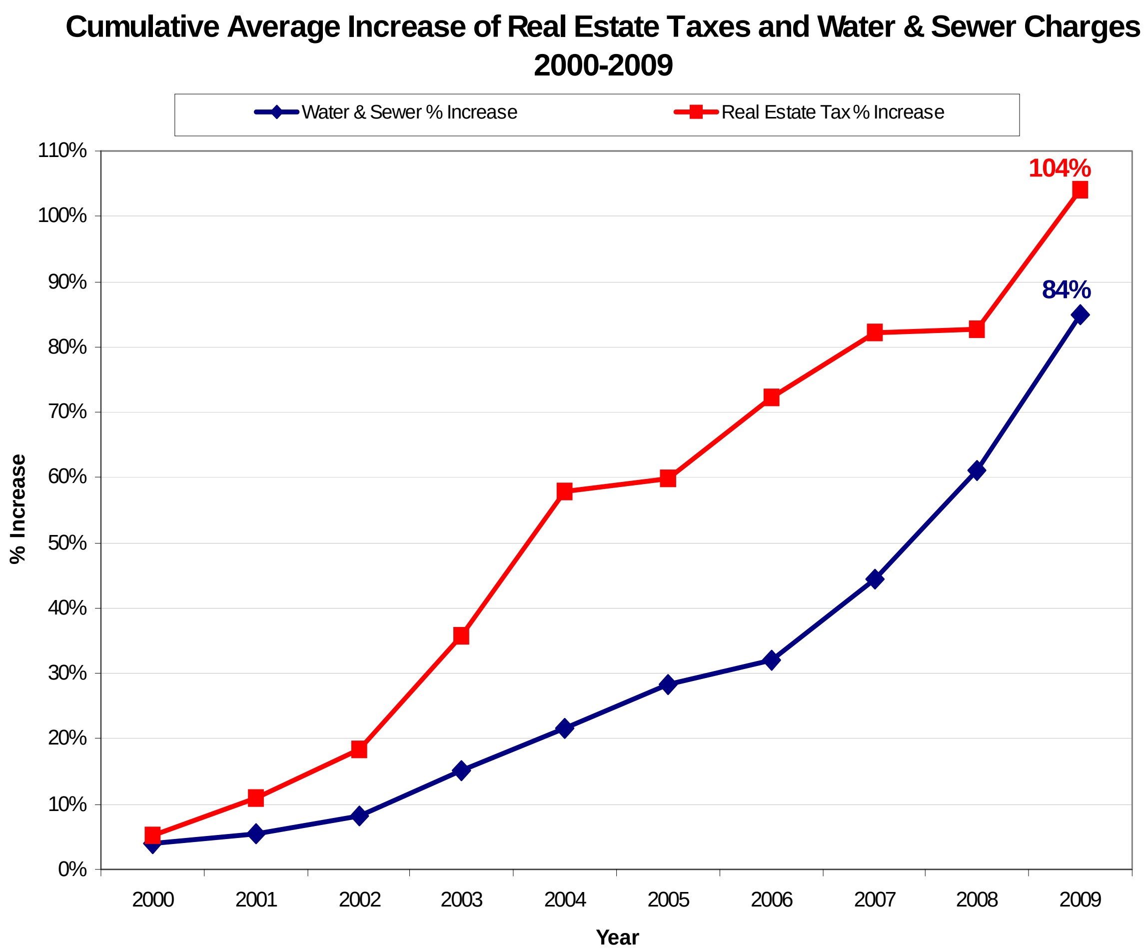
City Charges Increase Operating Cost



Source: The NYC Rent Guidelines Board: *2000-2009 Price Index of Operating Costs Reports*

Rent Guidelines Board Submission For Order 41

June 2009

RSA Rent Stabilization Association

Joseph Strasburg, President
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Summary

Years of inadequate rent guideline increases, capped by recession economics, have forced rent stabilized property owners into a position similar to that which marked the wave of housing deterioration and abandonment of the 1970's.

Over the last eight years, the RGB has granted rent guideline increases roughly equal to increases in the overall consumer price index. But, over the same period of time, building operating costs have increased at approximately twice the rate of overall inflation. In other words, for eight years, the RGB has established rent guidelines that cover only half the increase in building operating costs.

A strong housing market and some relaxation of the rent laws have allowed some owners to compensate for some of the shortfall. But now the weakened economy has dealt two blows to all property owners: they are paying substantially higher municipal levies to make up for City budget shortfalls at the same time that market pressures are reducing their rental income.

The current economics of increased costs and reduced income cannot be sustained. And the RGB can help by providing rent increases that are realistically related to the increase in operating costs. With a relatively modest measured increase in costs this year, the RGB can achieve its mandate by enacting rent increases above the 4% Price Index while still maintaining affordable rent increases for tenants.

The Price Index is not a precise measure and fails to capture many real cost increases as well as new costs that are imposed on owners. This Submission details the deficiencies of the PIOC this year.

Regardless of the level of rent increase this year, we urge the Board to continue the minimum rent adjustment instituted under the current guideline. This Submission details why the minimum rent adjustment is both necessary and equitable.

The owners of rent stabilized properties are the largest providers of affordable housing in New York City. But their ability to provide decent housing is threatened if the RGB again fails to provide adequate levels of rent increase. This Submission details why, this year, in this recessionary environment, the scales should be balanced in favor of owners rather than tenants.

RENT GUIDELINES BOARD
SUBMISSION ORDER 41

June 2009

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Rent Guideline Increases Must be Realistically Related to Increased Building Operating Costs

The RGB has a legal mandate to maintain the health of the housing industry. The RGB is required to consider a number of factors related to the health of the industry. While it was not contemplated and is not mentioned in the law, the Price Index of Operating Costs (PIOC or Price Index) has, almost from the inception of rent stabilization, been a major determinant of the Board's actions.

For more than thirty years, property owners could reliably count on a one-year guideline increase that was only slightly less than the increase in operating costs as measured by the PIOC. Since 2000, however, 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 3.6% compared to a 7.2% annual increase in the PIOC (*see Figure 1 below*).

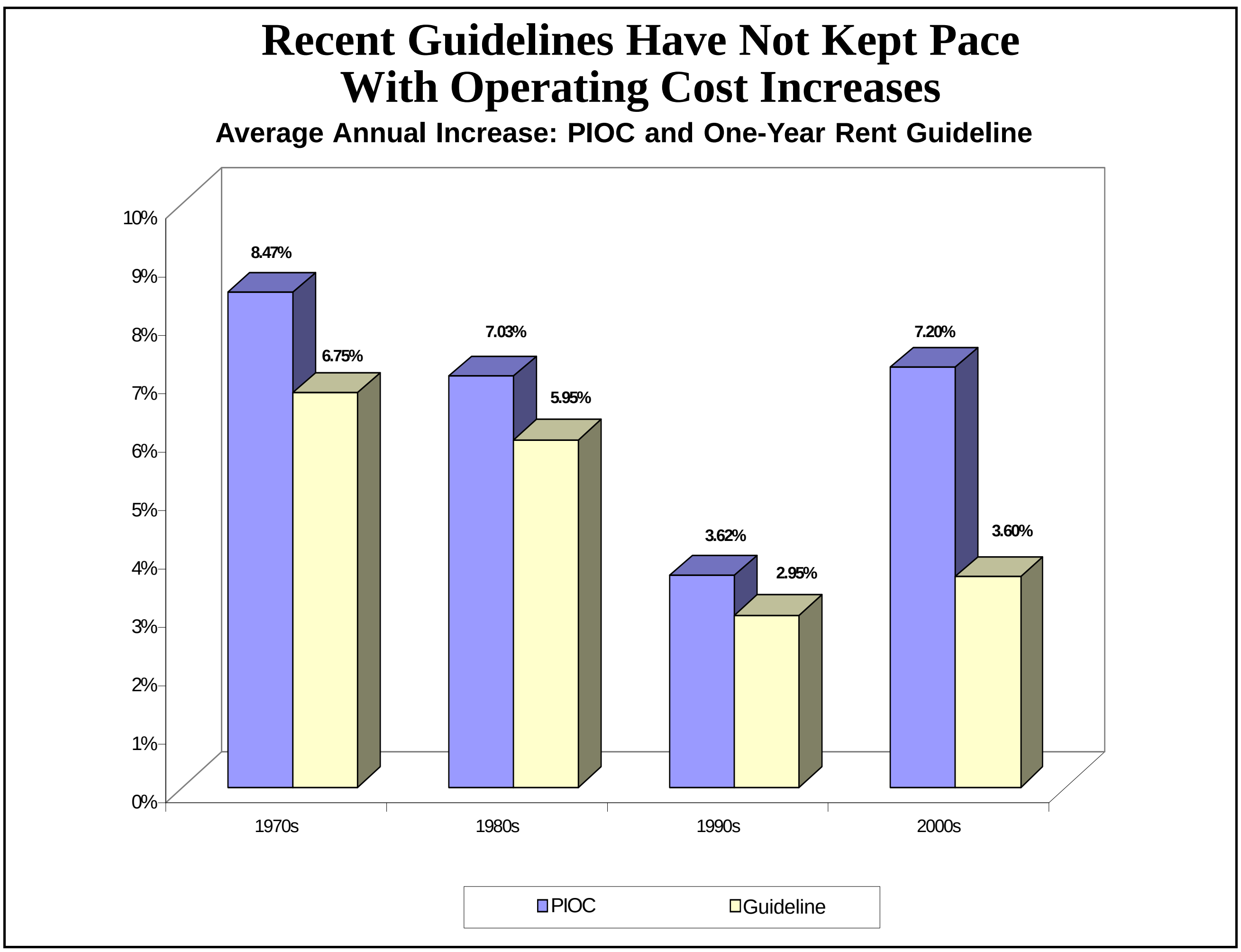

Figure 1
Source: NYC Rent Guidelines Board Reports 1970-2009.

In other words, since 2000, rent guideline increases have forced building owners into economic jeopardy by allowing them to recoup only half of the increase in building operating costs.

Figure 2 also highlights the fact that this decade has been a period of extraordinarily high operating cost increases comparable only to the high inflation period of the 1970's. Yet, the average one-year guideline during this high inflation period has been approximately half the level of increase in a comparable inflationary time. In fact, the current rate of rent adjustment is almost as low as during the 1990's when building operating costs were increasing at half the current rate.

To highlight the disparity in the recent level of rent adjustments, Figure 2 illustrates that from 2000 to 2008, the one year rent guideline averaged only 56% of the Price Index, while throughout the history of the rent stabilization system, the one-year guideline averaged 80% or more of the Price Index.

Recent Guidelines Are At Historic Lows

One-Year Guideline as a Percent of PIOC	
1970 - 1979	80%
1980 - 1989	85%
1990 - 1999	84%
2000 - 2008	56%

Figure 2
Source: NYC Rent Guidelines Reports 1970-2009

Not only have recent guidelines been low relative to the PIOC, they have also been low compared to historic levels of rent adjustment. Figure 1 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 Figure 2, 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.

This Year's Rent Guidelines Should be Based on the 6.5% Core Price Index

This year's relatively low 4% Price Index is purely the result of steep drop in oil prices and does not accurately reflect the true cost pressures faced by property owners. The core PIOC of 6.5%, which excludes volatile components like oil and electricity, is more consistent with past and projected building operating cost increases. The core PIOC is projected to increase by a staggering 9.1% next year.

The Board should also bear in mind that the PIOC is a stagnant market basket of goods and services which has not been updated since 1983. In the interim, government mandates have significantly increased building operating costs. Figure 3 below highlights just some of the costly requirements imposed on property owners since the PIOC was last updated.

The costs imposed by these government mandates are not incremental costs: they are 100% increases which add new costs to the bottom line and are not adequately reflected by the increase measured in the PIOC.

Each year witnesses new requirements not reflected in the Price Index. This year, for instance, as a result of new City requirements, the cost of mandated elevator inspection tripled.

In addition, as a result of Court rulings, property owners are now responsible for the eradication of bed bugs, which have become a plague throughout New York, even though tenants are responsible for creating the infestation. The cost of exterminating bedbugs is enormous; roughly double the cost of roach extermination. Yet, some Court rulings have held owners liable for rent reductions even after a finding that the owner diligently tried to cure the infestation.

Costs Not Included in The Price Index

- Building Facade Inspections
- Code Enforcement Re-inspection Fees
- Lead paint abatement costs
- DEP recycling regulation costs
- HPD annual building registration fees
- DEC oil tank registration fees
- DHCR/DOF annual rent stabilization fees
- Fire Department Fire Safety Compliance

Figure 3

Individually, these additional costs may seem minor, but they are not, and they add up. The cost of a bedbug extermination in one apartment in the Bronx is approximately double the average net operating income available from that apartment in one month.

A 4% increase in operating costs is not in itself insignificant. And we ask the Board to consider that actual operating costs have increased at a higher rate. In addition, operating costs are likely to continue increasing at rate significantly higher than the CPI, as they have in the past.

As is evident in Figure 4, real estate taxes and water and sewer charges have been escalating dramatically. These municipal charges now account for approximately one-third of all building operating costs and are all but certain to continue the steep increases of recent years. All other things being equal, building operating costs will likely continue to increase substantially above the rate of general inflation.

A relatively low Price Index this year should be viewed as an opportunity to compensate owners for inadequate past guidelines and to mitigate the need for even higher rent increases in the future.

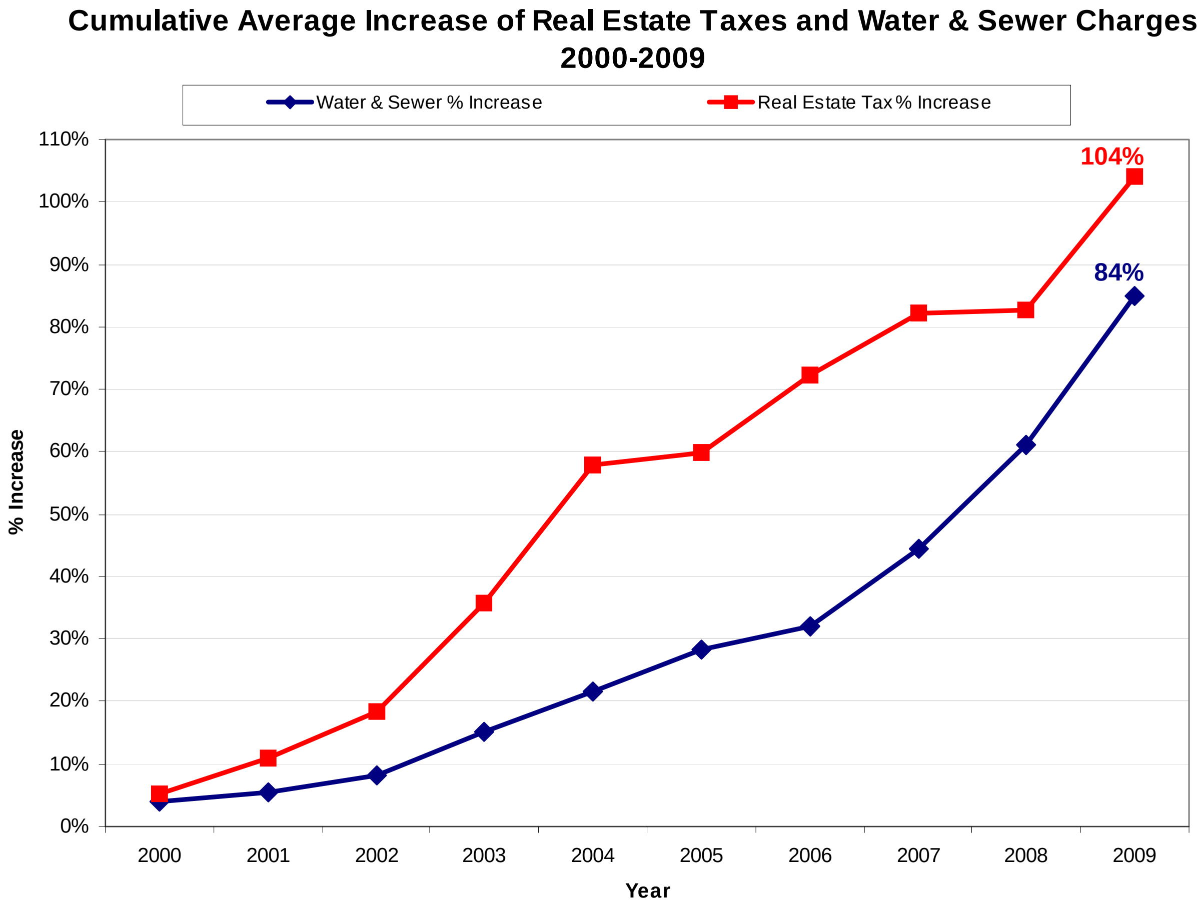

Figure 4
Source: The NYC Rent Guidelines Board: *2000-2009 Price Index of Operating Costs Reports*

Inadequate Guideline Increases Have Put Rental Housing Economics in Danger

The building economics data provided to the RGB makes it clear that rental housing economics have 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 (*please see Figure 5 below*). Beginning in 2000, however, these indicators turned negative, coinciding with the period of inadequate rent guideline increases.

Despite some improvement reflected in the 2006 and 2007 data, operating ratios in 2007 were approximately back to the levels in 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.

Further, it should be noted that rental housing economics deteriorated in 2008 and 2009, which should become evident when more recent data becomes available.

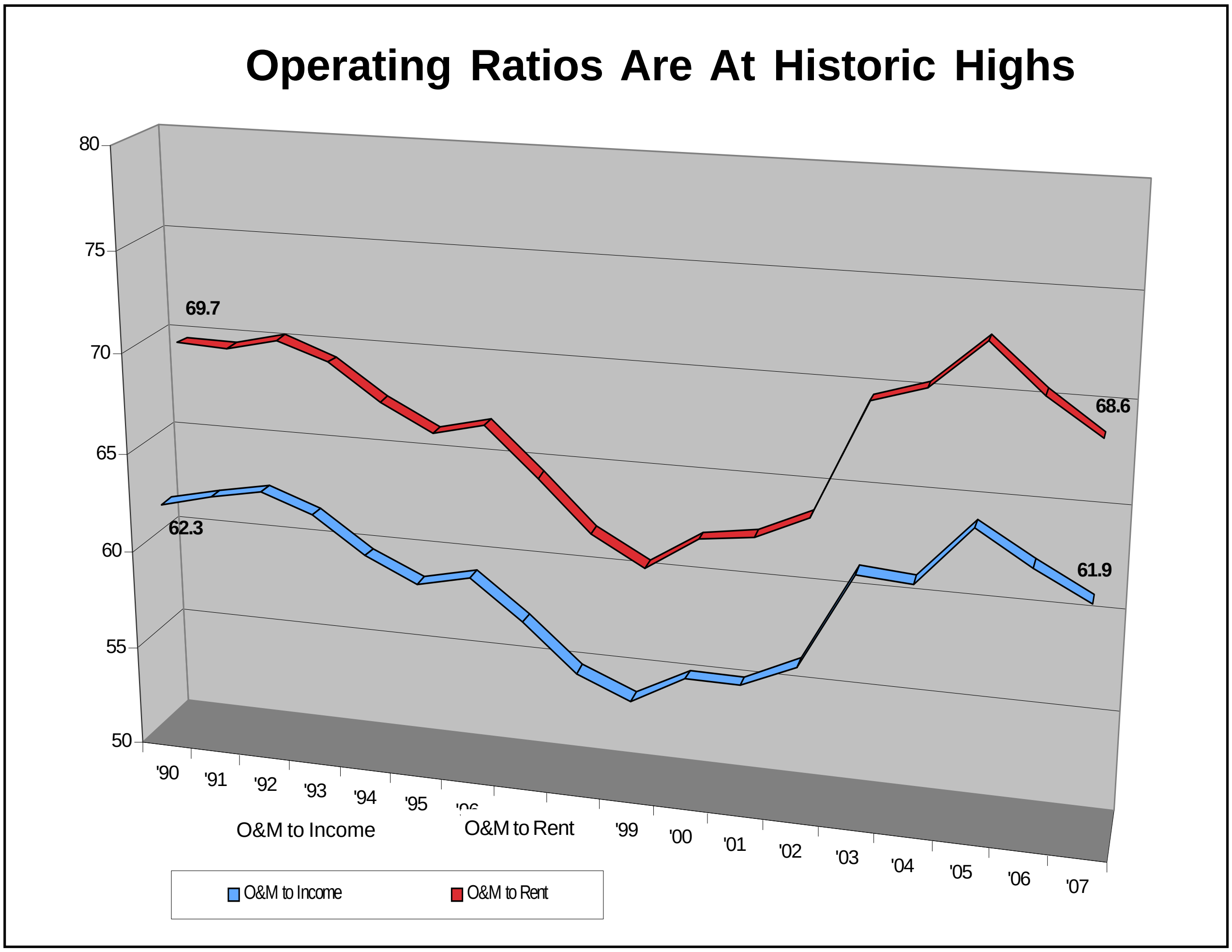

Figure 5
Source: NYC Rent Guidelines Board 2009 Income & Expense Report

Building operating ratios are one measure of the health of the housing. 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.

While the Chart above expresses operating costs based on "audited" expenses, absolute operating ratios are much higher (the RSA has consistently voiced its opposition to the use of adjusted numbers based on an audit that is now 15 years old and very likely to no longer be relevant). The unadjusted operating ratio based on the 2007 data is 67.9% compared to the audited ratio of 62.3%.

Even the un-audited numbers fail to reflect how precarious the state of the housing industry really is. Looking at the median, rather than the average, operating ratio, we find a median operating ratio of 72% compared to the average ratio of 68%. That means more than half the buildings in the City have extremely slim operating margin.

One way to view the significance of these high operating ratios is to compare the New York City numbers to national averages. Each year, the Institute of Real Estate Management (IREM) conducts a survey of multi-family rental properties which yields results that are quite similar to the data collected through RPIE statements. As indicated in Figure 6, the IREM survey shows that operating ratios across the country are significantly lower than in rent stabilized New York properties.

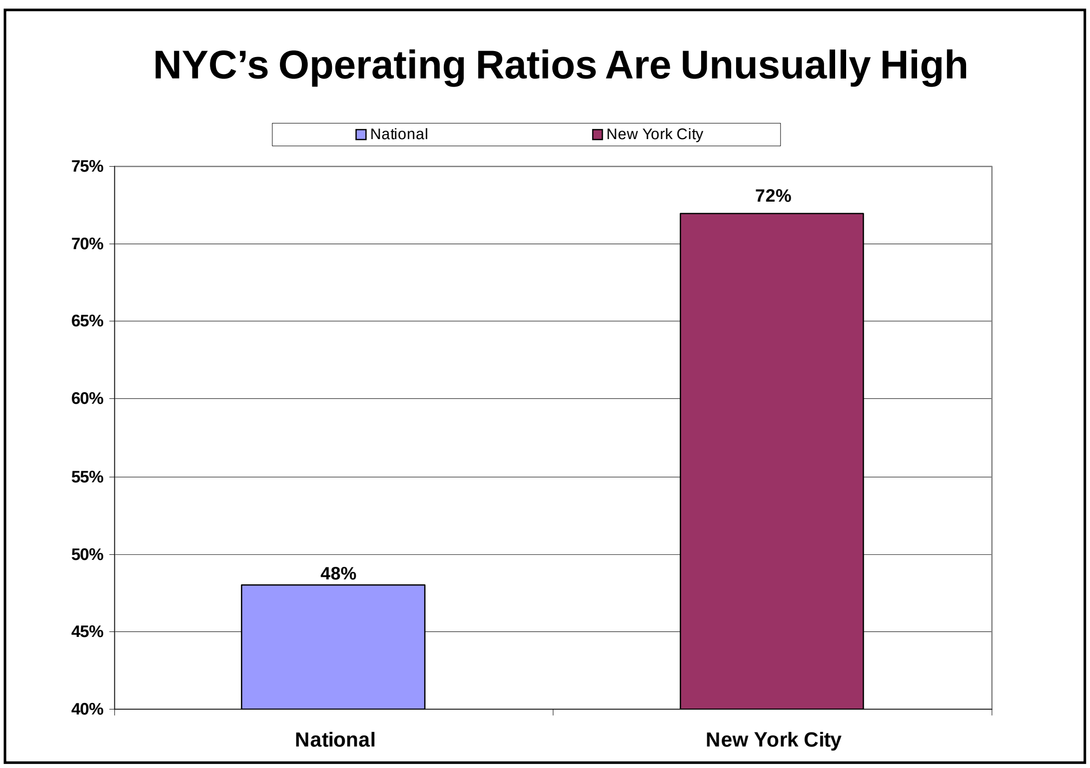

Figure 6
Source: Institute of Real Estate Management – *Income/Expense Analysis-Conventional Apartments Trend Report*
The NYC Rent Guidelines Board – *2009 Income and Expense Study*

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.

The absolute dollar value of net operating income is critical to sustaining affordable housing. While the average net operating income in core Manhattan $575 month per apartment, the average NOI in the Bronx is only $183 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 must 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.

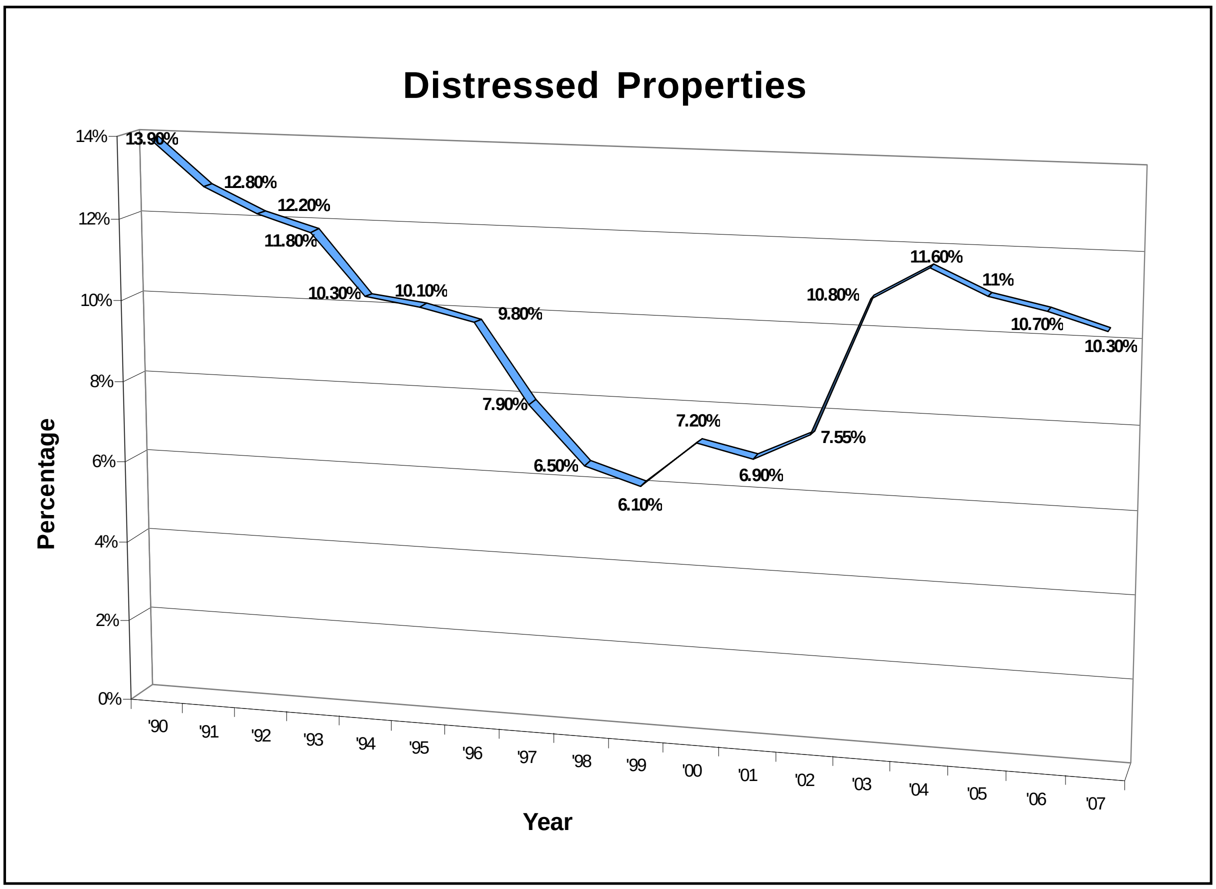

Figure 7
Source: NYC Rent Guidelines Board, 2009

While last year's drop in oil prices brought some relief to property owners, the long-term trend is clear. As reflected in the core PIOC, building operating costs will continue to increase at levels far above the overall increase in the consumer prices.

Operating costs are rising faster than income. As a result, approximately 10% of stabilized buildings were operating in the red as of 2007. With the more recent deterioration of housing economics, the number of distressed properties has certainly increased and it is only a matter of time before an increasing number of buildings fall into a state of disrepair and economic jeopardy.

It is not coincidental that the number of distressed properties, from a low of approximately 6% in 1999, increased to more than 11% in 2004 and remained above 10% in 2007 at the same time that the RGB enacted one inadequate rent guideline after another (*see Figure 7*).

This year's rent guidelines must be relatively higher than in recent years to acknowledge the precarious economic position of the providers of this city's affordable housing.

To Save Affordable Rental Housing the RGB Must Continue the Minimum Rent Adjustment and Provide Realistic Rent Increases

Another way to view the inadequacy 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, calculated by RGB staff, 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 seven of the last nine years, the one-year rent guideline has fallen below or at the very bottom of the range of possible commensurate rent adjustments (*see Figure 8 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%.

Guidelines Below PIOC and Commensurate Range

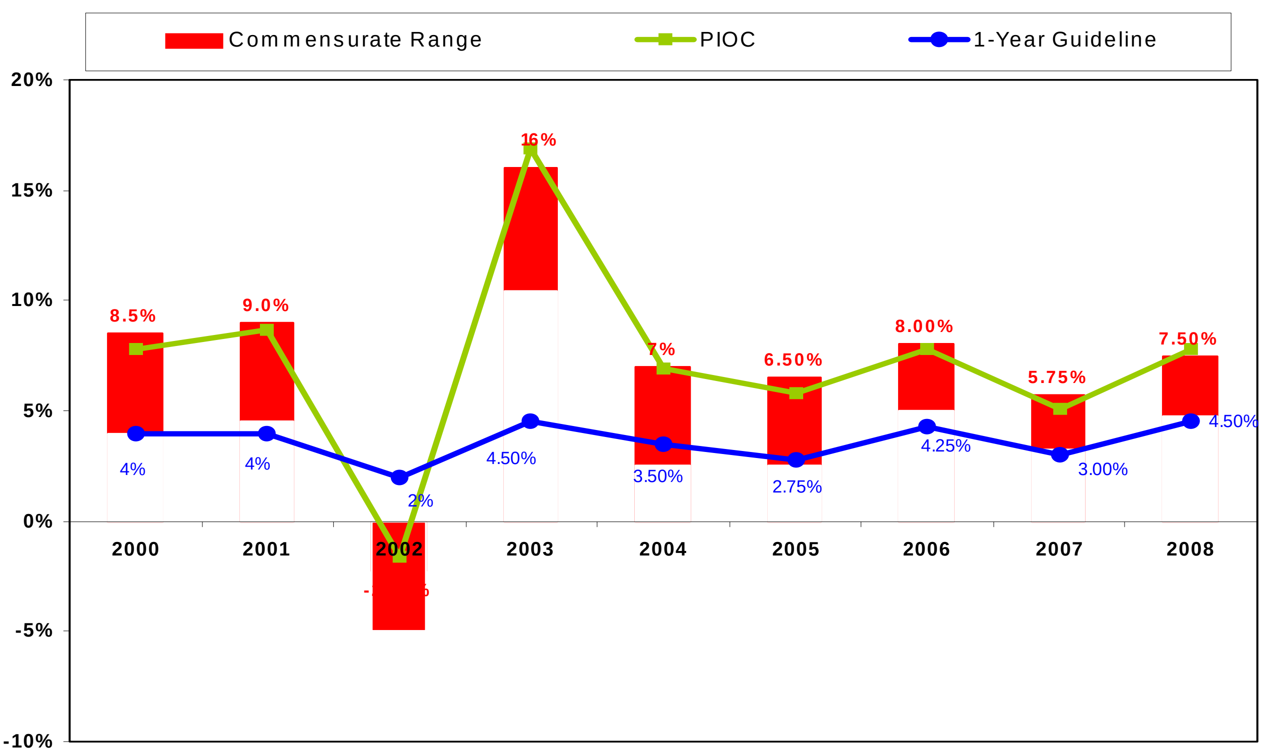

Figure 8
Source: *The NYC Rent Guidelines Board*

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 4% Price Index range from 1.75% to 5% for a one-year lease and from 2.5% to 8% 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.

It is critical that the RGB use this opportunity to make-up for the inadequacy of rent guidelines over the last nine years. There has long been a theory of RGB methodology which calls for "steering a more normal level of adjustment that indicated by the short term movements of the Price Index." Thus, in 2003, the RGB ignored a real spike of approximately 17% in the Price Index and approved a meager 4% one-year guideline. In 2002, the RGB ignored an apparently negative Price Index and approved an equally meager 2% one-year increase.

In the same sense, we ask the RGB to consider a history of inadequate guidelines, the near certainty of significant future cost increases and the current 6.5% core PIOC in determining that this year's rent guidelines should be 6.5% for a one-year lease and 9.5% for a two-year lease.

In addition, we ask that the RGB approve a minimum rent adjustment, as was done last, year, in the amount of $65 for a one-year lease and $95 for a two-year lease.

For the large universe of apartments renting for less than $762 per month outside of core Manhattan, a minimum rent increase is necessary to generate the revenue required to cover increased operating costs, because a percentage increase on a low rent does not generate as much income as the same percentage applied to a higher rent.

A minimum rent adjustment is also justified by the rent skewing which is a hallmark feature of rent stabilization and a result of long-term occupancies. While a minimum rent adjustment addresses long-term occupancies, we urge the Board not to limit the adjustment to long-term tenancies, as was done last year. This only over-complicates guideline calculations and creates opportunities for rent challenges and penalties based on hyper-technicalities.

A minimum rent adjustment without restrictions would address long-term tenancies but would not apply to recent move-ins because of market constraints. Therefore, we recommend that, in addition to any across the board guideline increase, the RGB adopt a minimum increase of $65 for a one-year lease and $95 for a two-year lease, without limitation.

Affordability Cannot Be a Consideration of the RGB

Despite the need for rent increases to meet ever increasing building operating costs, some RGB members routinely cite the need to balance the need for increased rents against the ability of stabilized tenants to pay those rents. The concept of balancing the need for rent increases against an ability to pay is wrong for several reasons.

First, housing affordability is by no means a critical issue for the majority of the renter population. Where affordability is an issue, it is not a problem of high rent, but low income. And the issue of affordability affects fewer households than commonly perceived. Even the Community Service Society, in testimony provided to this Board, concedes that a realistic analysis shows that the number of rent-burdened households is closer to 15% than the 25% figure commonly cited.

When the low –income, high rent burden households are removed, analysis shows that the vast majority of rent households have rent to income ratios substantially below the national and City averages. In other words, there simply is no “housing affordability crisis” for the typical middle income or moderate income renter. And to the extent that some renters do face a high rent burden, this is not a matter that the RGB can correct.

Second, the role of RGB is to maintain the health of the housing industry, not to provide affordable housing. These goals are mutually exclusive and cannot be addressed by the same agency. The RGB was established by the Legislature for only one reason: to provide rent increases to meet operating costs. There are many other agencies and programs whose purpose it is to address housing affordability.

Finally, posing the matters before this Board as a choice between owner and tenant interests adds to the acrimony of tenant/owner relationships and feeds the chaotic climate in which these deliberations take place. The RGB should unapologetically acknowledge the role it plays in the rent stabilization system: that of providing the rent increases necessary to help property owners provide decent housing.

Conclusion

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

- Building operating costs are increasing at historic highs and are likely to continue rising.

- Higher rent guidelines are needed this year to compensate for past losses and current cost increases.

- The minimum rent adjustment must be continued this year to provide adequate operating income for low-rent properties.

- 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.