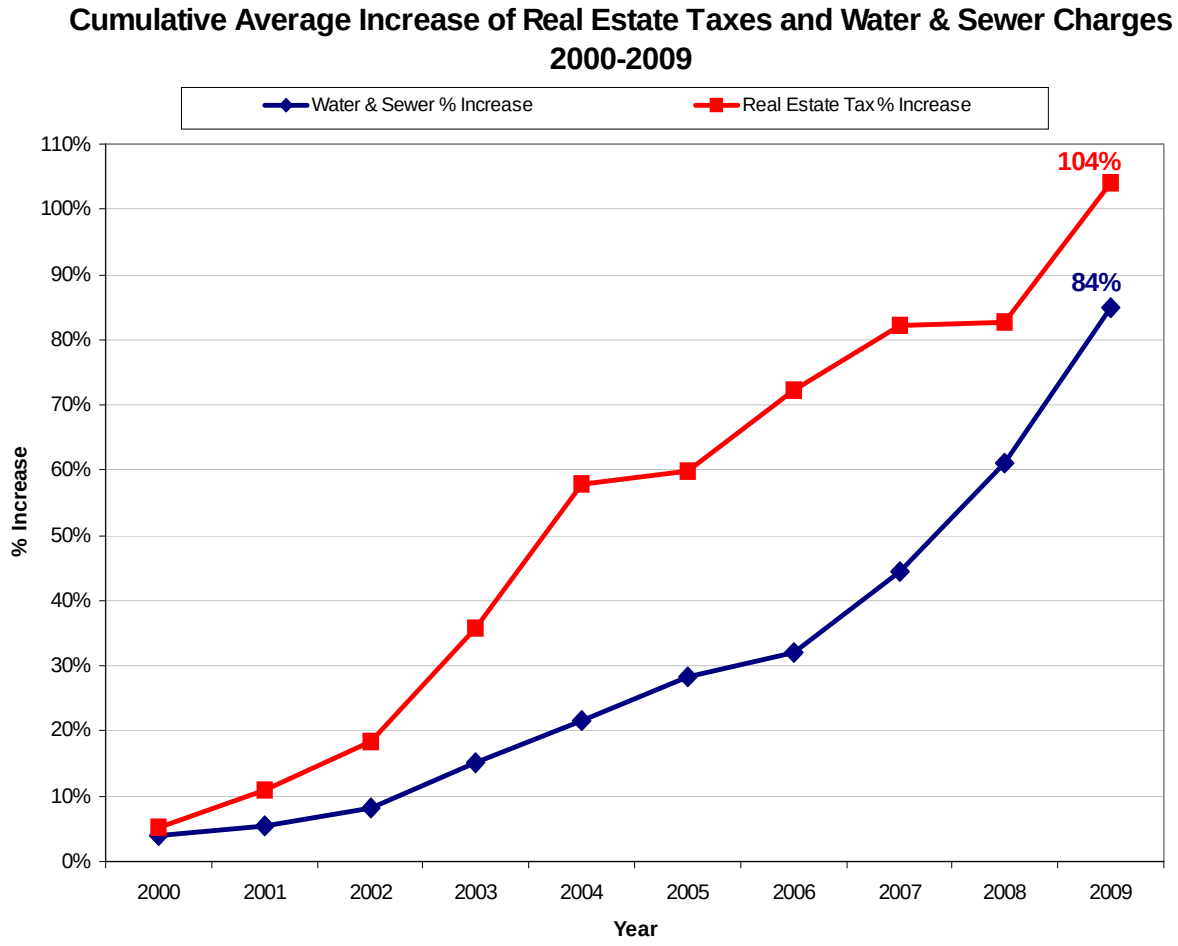
City Mandates Increase Operating Cost



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

Comments on the Preliminary Rent Guidelines For Order 42

June 2010

Rent Stabilization Association

Joseph Strasburg, President
Jack Freund, Executive Vice President

Summary

The Preliminary Rent Guidelines for Order #42 fail to include the minimum rent increases needed to keep owners whole. The RSA, in a concession to the recession which has affected both owners and tenants, calls for rent increases of 5% for a one-year lease and 9% for a two-year lease.

Minimal increases of 5% and 9% are needed just to cover last year's increased operating costs. This year's misleadingly low 3.4% Price Index masks double-digit increases in real estate taxes, water and sewer charges and heating oil. We will demonstrate that substantial portions of the housing stock are affected by a real increase in operating costs of up to 6.9%, double that reflected in the Price Index.

The requested rent increases will help owners meet these costs and help stem the tide of economic deterioration that has developed over the past ten decade. This year, all indicators point to a further deterioration in the economics of stabilized housing.

We will demonstrate that economic deterioration of stabilized housing is a direct result of guideline increases that have fallen below their historic norms and significantly below the price index over the past ten years.

The RGB now has an opportunity to reverse this course of deterioration by enacting guidelines higher than the price index, while still providing a moderate level of rent increase for tenants.

The private owners of stabilized housing continue to be the largest providers of affordable housing in New York – some 600,000 units throughout the City which rent for less than $1,000 per month. Sixty percent of this housing is more than 80 year old and requires significant repair and replacement costs. And the majority of this housing is owned and operated by small and mid-size property owners who have already been forced to absorb more cost increases than they can afford.

The RGB can and should encourage the long-term ownership and investment that has characterized stabilized housing for decades by enacting guidelines that reflect the intense cost pressures, primarily mandated by government, that owners are experiencing.

COMMENTS ON THE PRELIMINARY RENT GUIDELINES FOR ORDER 42

June 2010

Contents

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THE ROLE OF THE RGB IS TO RAISE RENTS

It may appear simplistic and unnecessary to clarify that the clear legislative mandate of the Rent Guidelines Board is to enact necessary levels of rent increase. But there has been testimony and commentary before the Board this year which sought to expand the role of the RGB to include all manner of other obligations and which needs to be addressed.

For instance, a former Executive Director of the RGB testified that the role of the RGB was to somehow "mimic" the free market. The point of this absurd notion was that, since some free market rents have seen downward pressure in these recessionary times, the RGB should eliminate rent increases or reduce rents to mirror market activity.

Of course, the role of the RGB is not to mimic the free market, a goal which could easily be accomplished by eliminating rent regulations and allowing a free market to reign.

This former Executive Director did not offer this year another theory that he authored which suggests that the role of the RGB is "to steer a more regular course of rent adjustment than is indicated by the short movements of the market". This theory more closely mirrors what the RGB has actually done historically, i.e., the Board has issued lower guidelines when operating cost increased dramatically and higher guidelines when operating costs have been inordinately low.

This concept of a 'more regular course of rent adjustment' would not be unreasonable if it were applied in a regular and consistent basis, but it does stand at odds with the way most rate-setting bodies operate.

The New York City Water Board apparently does not feel obliged to moderate the rate increases that its staff advises are necessary to maintain and operate the water and sewer system — even when these rates include double-digit increases stretching over several years. Other utility regulators do not blink when approving double-digit rate increases that

are deemed necessary by the regulated utilities. Nor does the City of New York hesitate to impose double-digit increases in real estate taxes to generate the revenue needed to provide essential City services.

This year, the Tenant Representatives of the RGB have also argued for a more expansive scope of the RGB's duties. They suggest that the Board should be responsible, not only for rate setting, but also for implementing the broad intent of the rent stabilization system as reflecting in the legislative preamble, including an obligation, for instance, to protect long-term tenancies.

However, as we sought to demonstrate during RSA's Invited Testimony before the Board, rent stabilized tenants are protected by a whole host of laws, regulations and City and State agencies which assure habitability standards, health and safety standards, rent protections and tenure rights, to name just a few.

The multitude of rules and agencies that regulate housing and protect tenants serve to circumscribe the role of RGB as a pure rate-setting body. As such, the simplest course of action for the Board would be to allow the rent guidelines to reflect the increase in operating costs. After all, Social Security and other welfare programs are adjusted in a straight-forward manner by the increase in the Consumer Price Index or some other objective measure. No adjustments to these measures are made and it could be argued that a 3.4% increase in building operating costs should result in a 3.4% increase in rents.

Of course, the matter is a little more complicated in the world of New York stabilized housing. Here, the RGB issues a level of rent adjustment that applies equally to apartments renting for $600 per month and those that rent for $16,000 per month.

At the extremes, it is difficult to see why high-rent apartments should require rent regulation or how it is possible that apartments rent for less than the cost needed to operate them. In between the extremes, we have regulated rents that are not significantly different than equivalent unregulated rents as well as apartments where the actual collected rent is less than the maximum legal rent.

The range of rents and market forces in the stabilized world limit the applicability of the rent adjustments established by the RGB. Wealthy tenants in high-rent apartments where the vacancy rate exceeds 5% should arguably not be the beneficiaries of rent protections. For another large segment of apartments, tenants receive greater protections from market forces than from rent guidelines.

Rent guidelines primarily affect low rent apartments. And the meager percentage increases which have become customary in recent years do not yield adequate revenue when applied to low rents. Therefore, the RGB this year must adopt guidelines higher than the price index in order to help owners maintain their properties.

THE PIOC UNDERESTIMATES REAL INCREASES IN COSTS

This year's 3.4% increase in the PIOC underestimates real increases in building operating costs for two reasons: first, increases and decreases in the various components of the PIOC offset each other and therefore do not reflect the real increase in costs for various sub-types of stabilized housing and, second, the PIOC does not reflect a number of mandated costs which are not included in the PIOC.

There are two major ways in which this year's PIOC fails to reflect real increases in costs for substantial portions of the housing stock. The most obvious is the case of heating oil, where double digit increases in the cost of #4 and #6 oil are offset by a decrease in the cost of #2 oil. When blended together, these oil price increases and decreases result in only a 0.5% increase in heating costs.

But buildings do not use a blend of oil types – they heat with one fuel or another. We know from the RGB Price Index Report that analyzing those buildings that heat with oil versus gas results in PIOC of 4.4% rather 3.4% for buildings that heat with oil. But the situation changes more dramatically when we look at those buildings that just use #4 or #6 oil. For buildings that use the heavier grades of fuel, the PIOC is actually 6.9% based on an analysis by RGB staff.

These higher heating costs affect a significant number of buildings. According to the weighting of the Price Index, approximately 40% of building use #4 or #6 oil. A recent analysis by the Mayor's Office of Sustainability confirms that a significant number of residential buildings use the heavier grades of oil.

As a second example, a double-digit increase in water and sewer charges is essentially negated by a decrease in the cost of gas for those buildings that use gas for heat. Obviously, all stabilized buildings paid a 12.9% increase for water and sewer charges, but relatively few buildings benefited from a decrease in the cost of gas. Yet, the overall PIOC is reduced by the decrease in gas prices, and the real increase in water and sewer charges is not adequately captured.

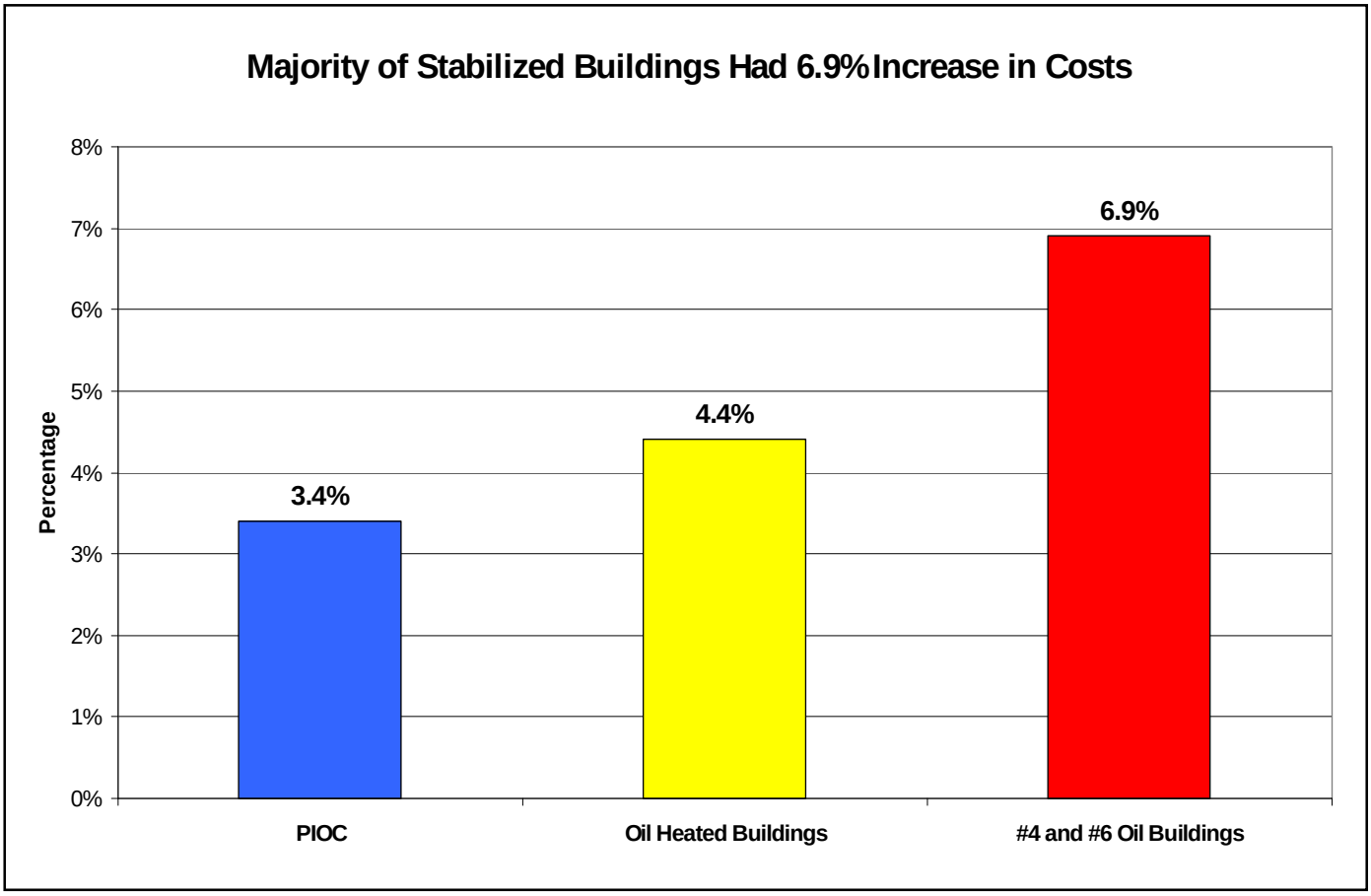

Figure 1
Source: *NYC Rent Guidelines Board 2010 Price Index of Operating Costs*

Under any analysis, a large portion if not the majority of rent stabilized properties experienced cost increases last year significantly in excess of the 3.4% increase reflected in the PIOC. The rent setting process this year must take into account the higher costs incurred by this significant segment of the stabilized housing stock.

The PIOC also under-estimates real increases in costs because it does not include a whole host of costs that have been imposed on property owners since the PIOC was last revised in 1983. While there is a lengthy list of such mandated costs dating back to 1983, consider just those costs which have been added in the last year.

In the last year, health and safety concerns have caused the City to increase inspectorial requirements which have added significant costs to elevator maintenance and façade improvements. In addition, a new level of Federal requirement for lead paint abatement has gone into effect which has resulted in increased costs for routine maintenance and repair work.

Unfunded Mandates: A Checklist

How much will unfunded mandates cost your building? "Different buildings will have different costs, based on their size, age, accessibility, and the condition of the building," says Greg Carlson, property manager at the Fairview co-op in Forest Hills, Queens. Carlson gave the following estimates of what the mandates will cost the Fairview, which has 425 units in a 14-story building, six elevators, and a total of 430,000 square feet:

- ☐ Third-party elevator inspections and new code compliance: $30,000
- ☐ Energy audit (for buildings over 50,000 square feet): $20,000-$40,000
- ☐ Standpipe sprinkler color coding: $5,000
- ☐ Site safety inspectors: $1,500
- ☐ Sight safety guards in elevators: $30,000
- ☐ Sustainability of such items as light bulbs, cleaning products, and appliances: will add 10 percent to upfront costs, but will probably save money in the long run.
- ☐ Push to eliminate No. 4 and 6 oil: natural gas and No. 2 oil will probably rise in price by 15 to 20 percent.
- ☐ "Benchmarking" estimate of energy usage: $2,000
- ☐ Workers must now have lead paint certifications: $300-$500 per worker

Figure 2
Source: *Habitat Magazine: June 2010*

Above, we reproduce a list of mandated costs prepared by the coop and condo community, which is equivalent to the types of buildings subject to the rent stabilization law.

It is sometimes argued that new, mandated costs not included in the PIOC are not relevant so long as the annual increase in the cost of these mandates is not significantly different from the overall increase in the PIOC. This argument is misguided.

The significance of new cost mandates is that they increase the operating cost basis. For example, if operating costs currently consume seventy cents of every dollar of income, a new mandate may increase the operating cost basis to seventy-five cents of every dollar of income.

New cost mandates are one reason we have witnessed an increase in operating ratios, especially in the last few years. With operating ratios now over 70% it is not inconceivable that operating ratios will eventually approach 100% of income and that net operating income will all but evaporate.

To prevent such an undesirable outcome, the RGB must qualitatively adjust the PIOC upwards to account for mandated costs not included in the PIOC and provide a more realistic base for rent adjustments.

We would like to remind the Board that the "core" PIOC, which excludes highly variable elements such as heating oil, stands at 6% this year and is more reflective of real cost increases incurred by owners than is the regular PIOC.

THE ECONOMIC CONDITION OF STABILIZED HOUSING HAS DETERIORATED

This year, every economic indicator available to the Board reflects deterioration in the economic condition of the stabilized housing stock. In brief:

- the number of distressed properties increased significantly to nearly 13% of the stabilized stock;
- rent collections decreased to their lowest level since 1991;
- increases in operating costs outstripped increases in income and rent;
- operating ratios increased significantly continuing a trend evident since 2000 and,
- net operating, measured cross-sectionally, fell continuing a six-year trend.

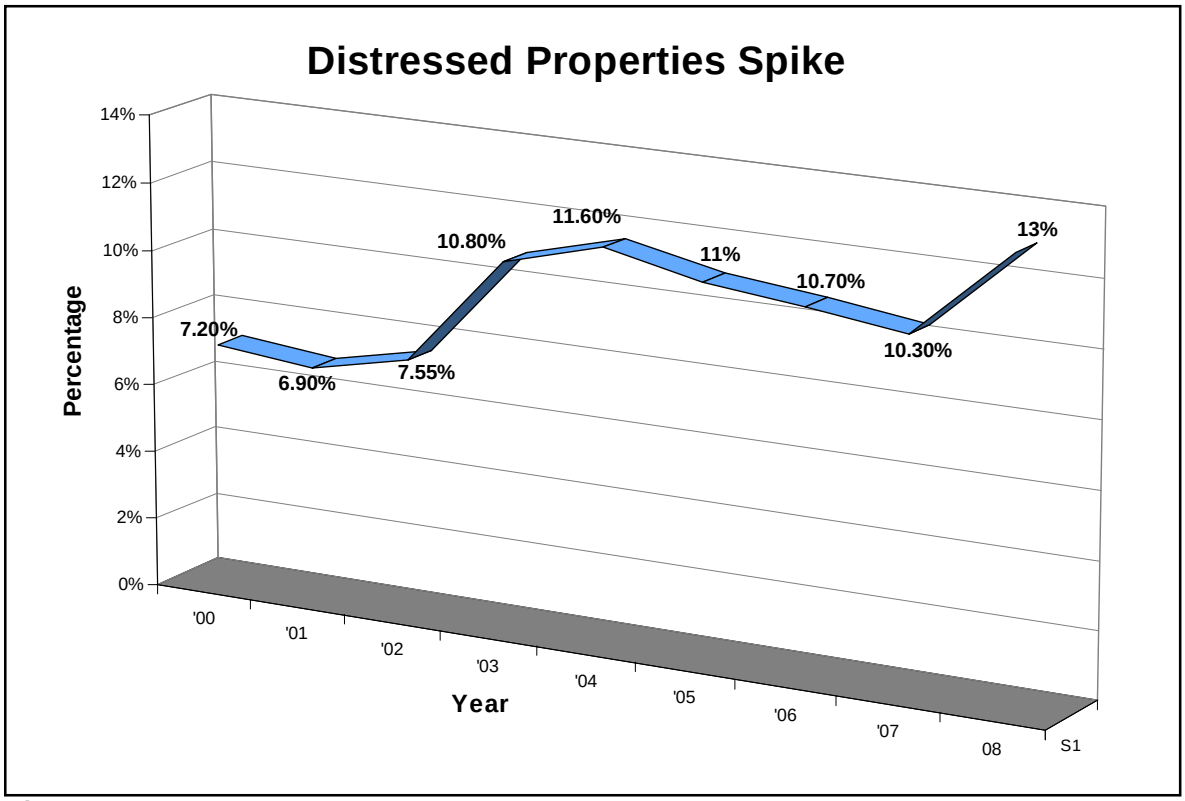

Figure 3
Source: *NYC Rent Guidelines Board 2010 Income and Expense Study*

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The only economic indicator which appears, at first blush, to be positive is an increase in net operating income (NOI) measured longitudinally. Net operating income can increase even when rent ratios are rising because even if operating costs and income rise by the same percentage, income, as the larger value will increase more and NOI will therefore grow.

But what is net operating income and what does it signify? Net operating is, of course, the dollar amount left over after the operating costs included in the PIOC are accounted for. And, of course, some portion of net operating income is used to finance the purchase of the property or to fund improvements to the property.

But net operating income is also used to pay for those costs not included in the Price Index including unexpected costs such as the repair of winter storm damage. These unincluded and unexpected costs are rising constantly as a result of government mandates and the aging of the housing stock.

We know that the Price Index measures a constant quantity of goods and services even though, as buildings age, they require an ever growing quantity of the goods and services measured by the Price Index. The cost of these additional goods and services- essentially comes out of net operating income.

As a result of these factors, net operating income in itself does not tell us very much about the profitability of stabilized housing. In many cases, all of a building's net operating income and more can be consumed by the cost of financing improvements and paying for items not in the Price Index.

In other cases, net operating income can be so minimal as to be inconsequential. In the Bronx, for example, NOI can be as low as $92 per apartment per month, so that a 10 unit building would throw off $11,040 annually in NOI assuming no debt service and no unusual expenses. In such a building, any major repair project such as a sidewalk or roof replacement would wipe out any net operating income.

Despite the nebulous nature of net operating income, much significance is placed on the fact that NOI appears to have increased this year. The RGB Income and Expense Report goes further to trace the evolution of NOI since 1990 and to conclude that inflation adjusted NOI has increased by 9.3% from 1990 through 2008 (never mind that this is reflects a meager increase of .05% annually over 18 years.)

TWO VIEWS OF THE SAME DATA…WHAT DOES IT ALL MEAN?

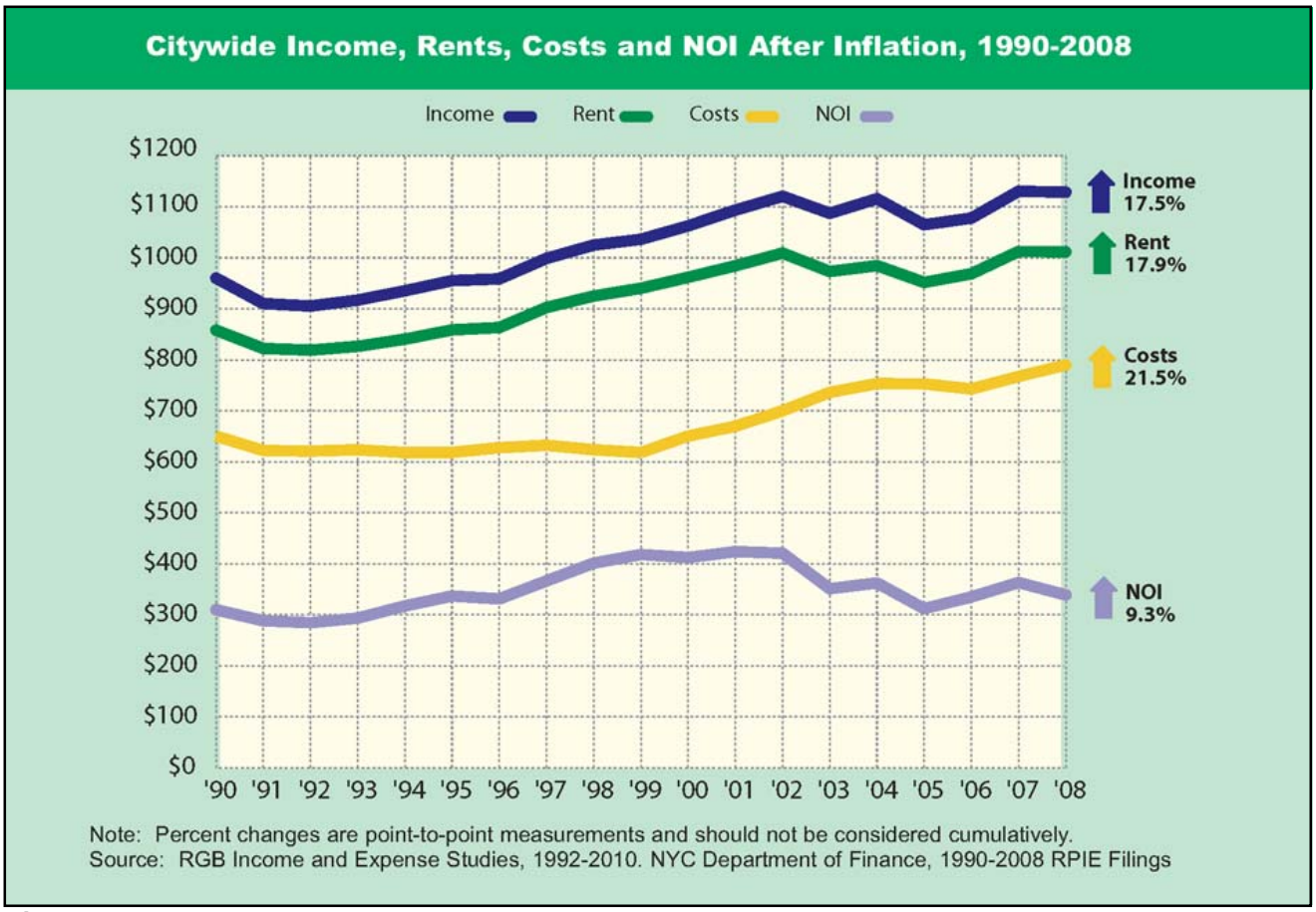

Figure 4
Source: *NYC Rent Guidelines Board 2010 Income and Expense Study*

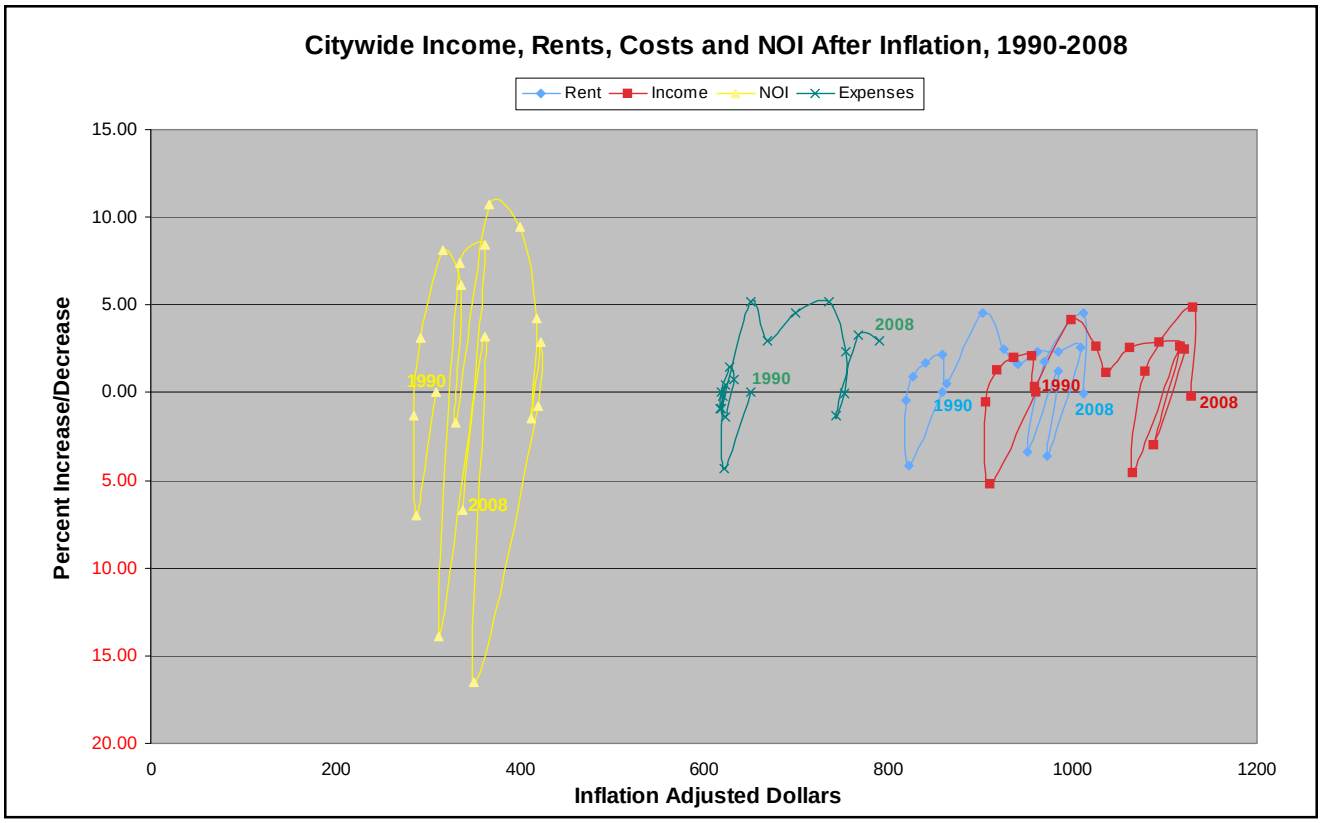

Figure 5
Source: *NYC Rent Guidelines Board 2010 Income and Expense Study*

To indicate the vaporous nature of the RGB analysis of longitudinal net operating income, we have taken the data points from **Figure 4** used by the RGB staff and replotted these data points to reflect the percentage change in NOI, rent, income and costs from year to year as well as the dollar value of these changes.

In **Figure 5**, on the previous page, when a line appears to double back on itself it means a decrease in dollar value for that component. When a line falls below the zero point horizontally in the middle of the chart, it means that the value of the component decreased in percentage terms from the prior year.

You can see that all elements show great variability from year to year in terms of both percentage change and dollar value, but none more so than Net Operating Income which is much more volatile then costs, rents or income over a much narrower dollar range.

In effect, this revised chart indicates that net operating income has experienced relatively large up and down moves over an eighteen year period but has barely budged in absolute dollar terms. Turning back to the RGB staff chart we can also see that net operating income, after rising through the 1990's, leveled off from 1999 to 2002 and then began to trend downward.

In short, to the extent that net operating income is a significant indicator, it also evidences a trend of economic deterioration.

ECONOMIC DETERIORATION IS THE RESULT OF INADEQUATE GUIDELINES

The deterioration of the economic condition of the City's stabilized housing stock is directly attributable to the inadequacy of rent guidelines over the past decade. An historical perspective highlights the degree to which recent guidelines have fallen below the prior pattern.

For the first three decades of the rent stabilization system, the one-year guideline was in the range of 80-85% of the PIOC (*see* **Figure 6**). In addition, throughout this period, the RGB authorized vacancy increases, supplementary low-rent increases and other adjustments which resulted in overall rent increases that approximately equaled the increase in operating costs as measured by the PIOC.

In sharp contrast, since 2000, the one-year guideline increase has fallen to approximately 50% of the PIOC. Over this period, there have been no supplemental adjustments except the minimum rent increases approved under Orders #40 & 41 which have now been revoked by the Courts. While there has been a State authorized 20% vacancy allowance in place during this period, its impact is not as broad or significant as one might imagine. RGB staff analysis demonstrates that, on average, the vacancy increase yields much less than the maximum allowed and, in many affordable housing neighborhoods, owners are hardly able to increase vacancy rents at all.

Recent Guidelines Are At Historic Lows

One-Year Guideline as a Percent of PIOC	
1970 - 1979	80%
1980 - 1989	85%
1990 - 1999	84%
2000 - 2009	53%

Figure 6
Source: *NYC Rent Guidelines Reports 1970-2010*

It is difficult to find any justification for rent increases that, at best, are equal to only half of the increase in operating costs. These paltry levels of rent increase are particularly egregious when increases in operating costs are near historic highs.

As indicated in **Figure 7**, on the next page, operating cost increases measured by the PIOC averaged nearly 8.5% during the high inflation years of the 1970's. Operating cost increases fell somewhat in the 1980's and then fell to 3.6% annually in the 1990's.

However, operating cost increases have surged since 2000, rising by nearly 7% per year, an increase largely driven by the rising costs of government mandates including real estate taxes and water and sewer charges.

There has been no explanation for why the current level of rent increases are so far below the increase in operating cost or why there has been such a dramatic break from the historic pattern of rent adjustment. But the effects of these actions are clear.

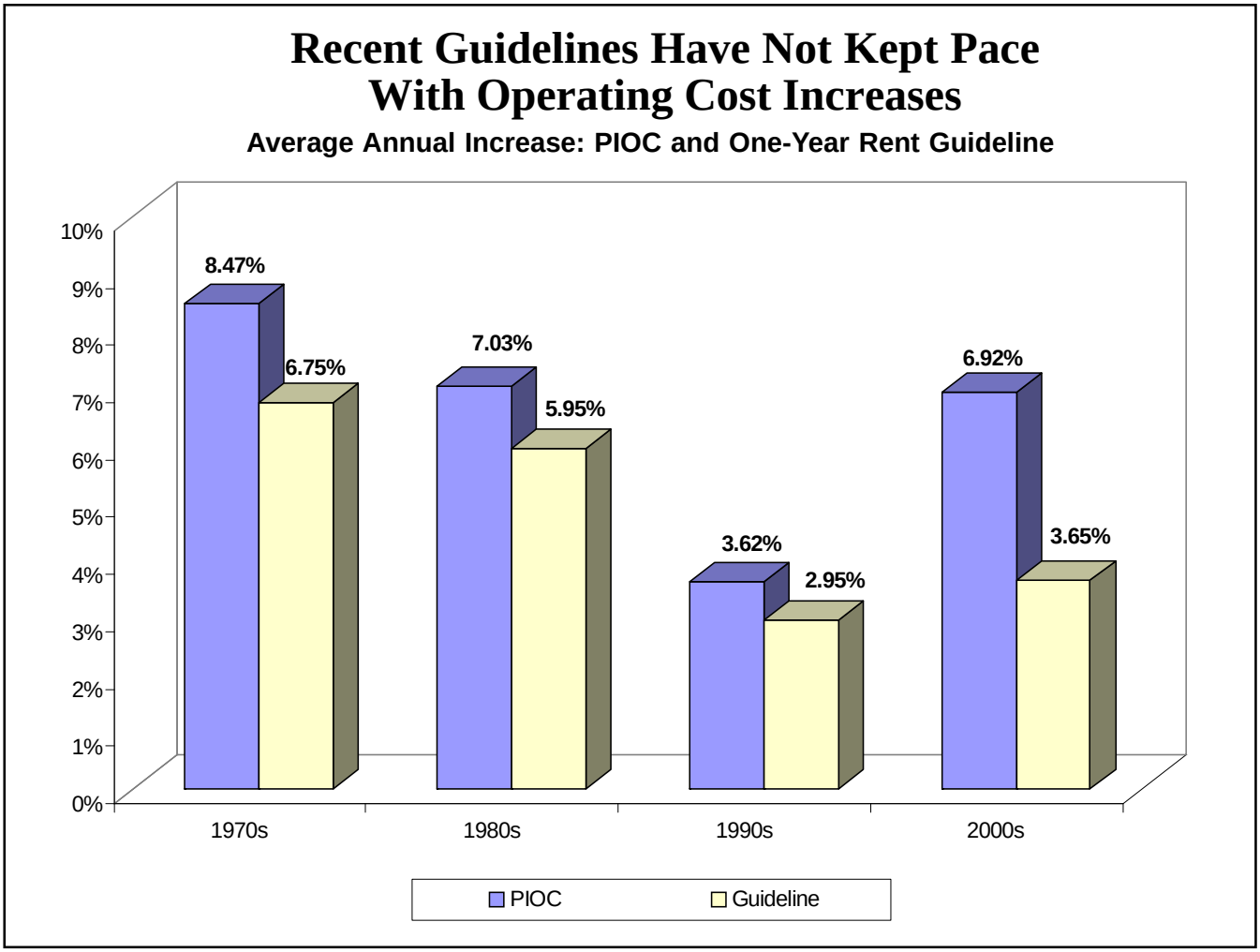

Figure 7
Source: *NYC Rent Guidelines Board Reports 1970-2010*

No business can survive for long when income declines and costs increase. During the current recession, we have seen that normal businesses react to declining income by reducing costs – laying off workers, reducing wages or benefits, and reducing inventory.

Property owners do not have the options available to normal businesses when their income fails to keep pace with rising expenses. They are not permitted to reduce the services they provide to their tenants. They must still pay ever increasing rents to the City in the form of municipal levies. They can no longer afford to fund improvements to their buildings even if those improvements would reduce their long-term operating costs.

In order to avert further deterioration of the City's affordable stabilized housing, the RGB must revert to a pattern of rent setting which has preserved the stabilized stock for decades. This year, the RGB must enact a one-year rent guideline increase higher than the 3.4% PIOC.

While these comments thus far have focused on the one-year rent guideline as a proxy for the reasonableness of RGB actions, it is also important to view the relationship between the one- and two-year guideline from a historic point of view.

In general, over the history of the rent guidelines, when the PIOC, and consequently the rent guidelines, are relatively low, the two-year guideline tends to be twice the rate of increase of the one-year guideline. When the PIOC and guidelines are relatively high, the two-year guideline tends to be somewhat less than twice the one-year guideline.

Since this year's preliminary guidelines indicate a relatively low level of rent adjustment, we urge the Board to ensure that the two-year guideline is at least twice the one-year guideline.

Most long-term stabilized tenants opt for the longest available lease term. Under the preliminary guideline range, most tenants this year will have an opportunity to lock in a relatively low two-year rate of increase, while the RGB staff predicts that next year's PIOC will be significantly higher, locking owners into a money losing position.

AFFORDABLE HOUSING REQUIRES REASONABLE RENT INCREASES

Despite the clear mandate and intent of the Rent Stabilization Law with regard to the RGB and its function, RGB deliberations inevitably degenerate into an owner versus tenant battle. In reality, both owners and tenants suffer when rent guidelines are inadequate and both owners and tenants benefit when guideline increases are reasonably related to increases in operating costs.

Housing affordability is a difficult concept to define, especially when the RGB regulates such a wide range of rents. Clearly, stabilized housing is generally affordable with most tenants carrying a rent burden that is no different than the national average.

Tenant advocates focus on the poorest of the poor when suggesting that rents should be frozen or kept low in order to ensure housing affordability. But for the poorest of tenants, even zero rent increases will not relieve their rent burdens. For these tenants, the problem is not high rents but low incomes. These are tenants who can only survive in the private market with the benefit of government subsidies.

For the majority of tenants, moderate levels of rent increase do not pose a substantial burden. Let's remember that cops, firemen and sanitation workers, those that some Board members cite as the reason for lower guidelines, continue to receive salary increases averaging 4% per year.

For the majority of property owners, moderate rent increases do not mean windfall profits but simply the ability to continue to maintain their affordable housing in a safe and decent condition while continuing to pay the taxes and fees that keep City services operating.

This year's Invited Tenant Testimony contained a remarkable admission. The chief operating officer of a non-profit mutual housing company acknowledged that her housing required at least a 2.5% rent increase this year to maintain operations. That's a 2.5% increase for housing that benefits from favorable real estate tax treatment, low cost financing and that has been recently renovated.

Private stabilized owners receive no favorable treatment for their provision of affordable housing. They pay the full cost of real estate taxes and water and sewer charges. They must repair and maintain an ever aging housing stock. They must pay the cost of an ever expanding range of government mandates that are not acknowledged by the PIOC. And most of the 600,000 units of affordable housing are provided by small and mid-size property owners who do not have the benefits of scale or the deep pockets to subsidize these costs for their tenants.

For the benefit of the majority of tenants and owners, the RGB can fulfill its obligations this year by enacting rent guidelines of 5% for a one-year lease and 9% for a two-year lease that will at least cover last year's increase in building operating costs.