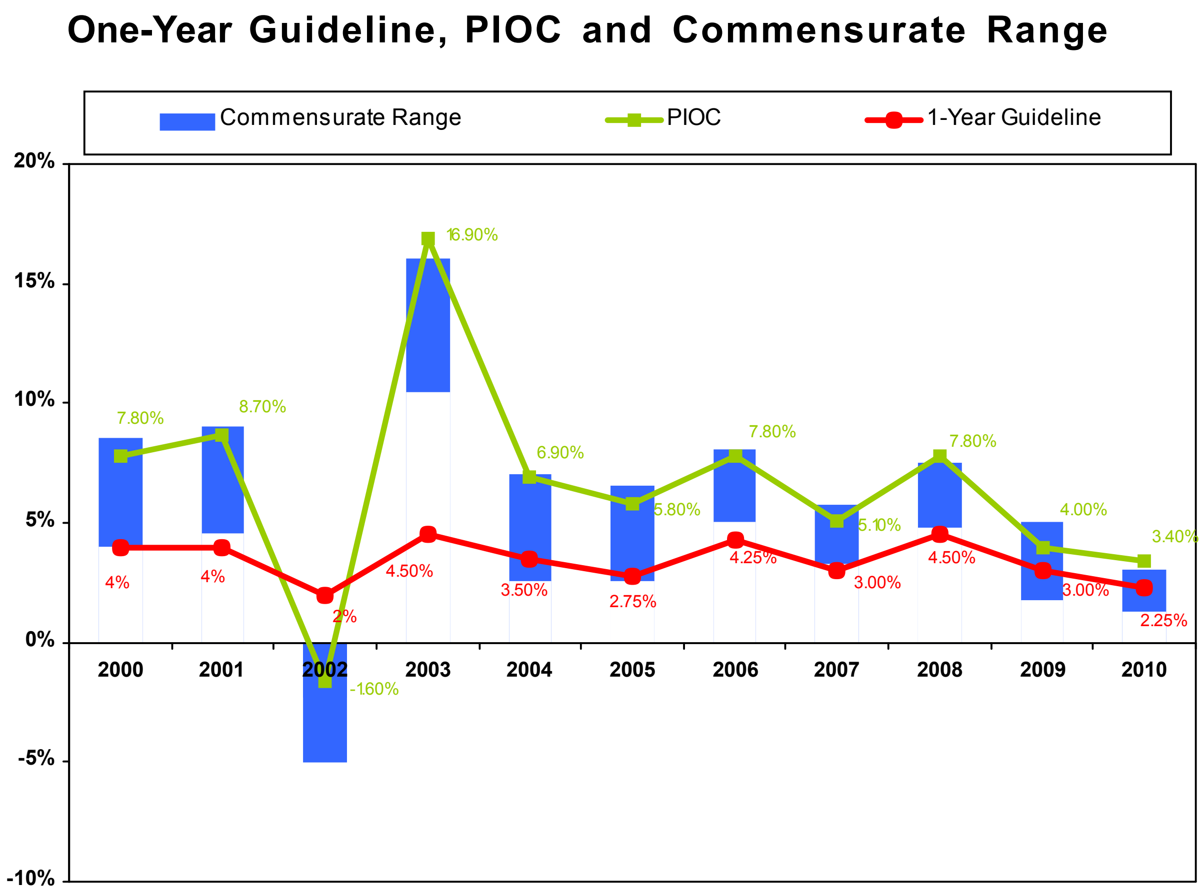
The RGB Must Aim Higher



Source: *The NYC Rent Guidelines Board*

Comments on the Preliminary Rent Guidelines For Order 43

June 2011

RSA Rent Stabilization Association

Joseph Strasburg, President
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Summary

The RGB faces more difficult choices than usual this year. Building operating costs continue to escalate at more than twice the rate of overall inflation. At the same time, the recession has affected everyone, tenants and owners alike.

Further complicating the picture, the preliminary guideline proposes a surcharge for oil-heated buildings but fails to propose a continuation of the minimum rent adjustment.

Unless the RGB aims for guidelines that are at least in line with increases in buildings operating costs as reflected in the 6.1% Price Index and in recent increases in coop maintenance costs, property owners will have a difficult time maintaining their buildings.

The preliminary guideline range already excludes the minimum 6% one-year guideline increase that the industry believes is necessary to cover just those costs counted in the Price Index. However, in the last two years, the RGB has moved the guidelines closer to the actual PIOC. We urge the RGB to at least reach the 6.1% PIOC target this year.

We urge the RGB, above all, to adopt guidelines that can be readily implemented and are clear to tenants, owners and government agencies. As we will make clear, a fuel surcharge is unnecessary and difficult to implement. Fuel costs should continue to be included in one generally applicable guideline.

As was the case in prior years, a minimum level of rent increase is both justifiable and necessary and its legitimacy is no longer in dispute after its recent endorsement by the State's highest Court. A continuation of the minimum rent increase is the single most effective way to help the significant portion of regulated housing stock that is seriously endangered.

The RGB's primary mandate is to sustain the health of the regulated rental housing sector. We will demonstrate that a significant portion of this housing stock is only marginally viable and requires realistic rent guidelines and that the overall stock is subject to long-term and comparatively high operating cost pressures.

We will demonstrate, on the other hand, that housing affordability is an issue for only a small segment of stabilized households and will argue that inadequate guidelines will not provide relief for impoverished households.

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BUILDING OPERATING COST INCREASES ARE BROAD-BASED AND LONG-TERM

Over the past decade, building operating costs have increased dramatically, rising by an average of 6.6% annually between 2000 and 2010 as measured by the PIOC. This year's 6.1% increase in the PIOC is consistent with this decade long trend.

This year's 'core' PIOC, which excludes volatile elements like oil, gas and electricity came in at 3.9%, lower than the overall PIOC but still higher than the rate of consumer inflation.

However, over the past decade, the 'core' PIOC increased almost at the same pace as the PIOC. With an average increase of 5.8% from 2000-2010, the core PIOC is less than one percentage point below the average 6.6% increase in the PIOC during the same period.

This substantial increase in the 'core' PIOC demonstrates that the increase in building operating costs is not primarily the result of increased fuel costs, but of increases in municipal levies, including increases in real estate taxes and water and sewer charges, as well as sharp increases in other building operating costs.

Municipal charges now account for 38% of the costs measured by the PIOC, and are the principal engine driving up building operating costs. Real estate taxes increased by 117% from 2000 to 2010 and water and sewer charges increased by 110% over the same period.

While this year's operating cost increase was driven substantially by increases in oil costs, the long-term trend is one of increases in the core PIOC that are close to increases in the overall PIOC with both measures more than twice as high as the increase in general consumer inflation.

As reflected in the chart below, average annual increases in the PIOC since 2000 are running at the highest level seen since the inflationary period of the 1970's. This year's 6.1% is not an aberration caused by a spike in oil prices, but part of long-term trend in which building operating costs have been increasing at more than twice the rate of overall consumer inflation.

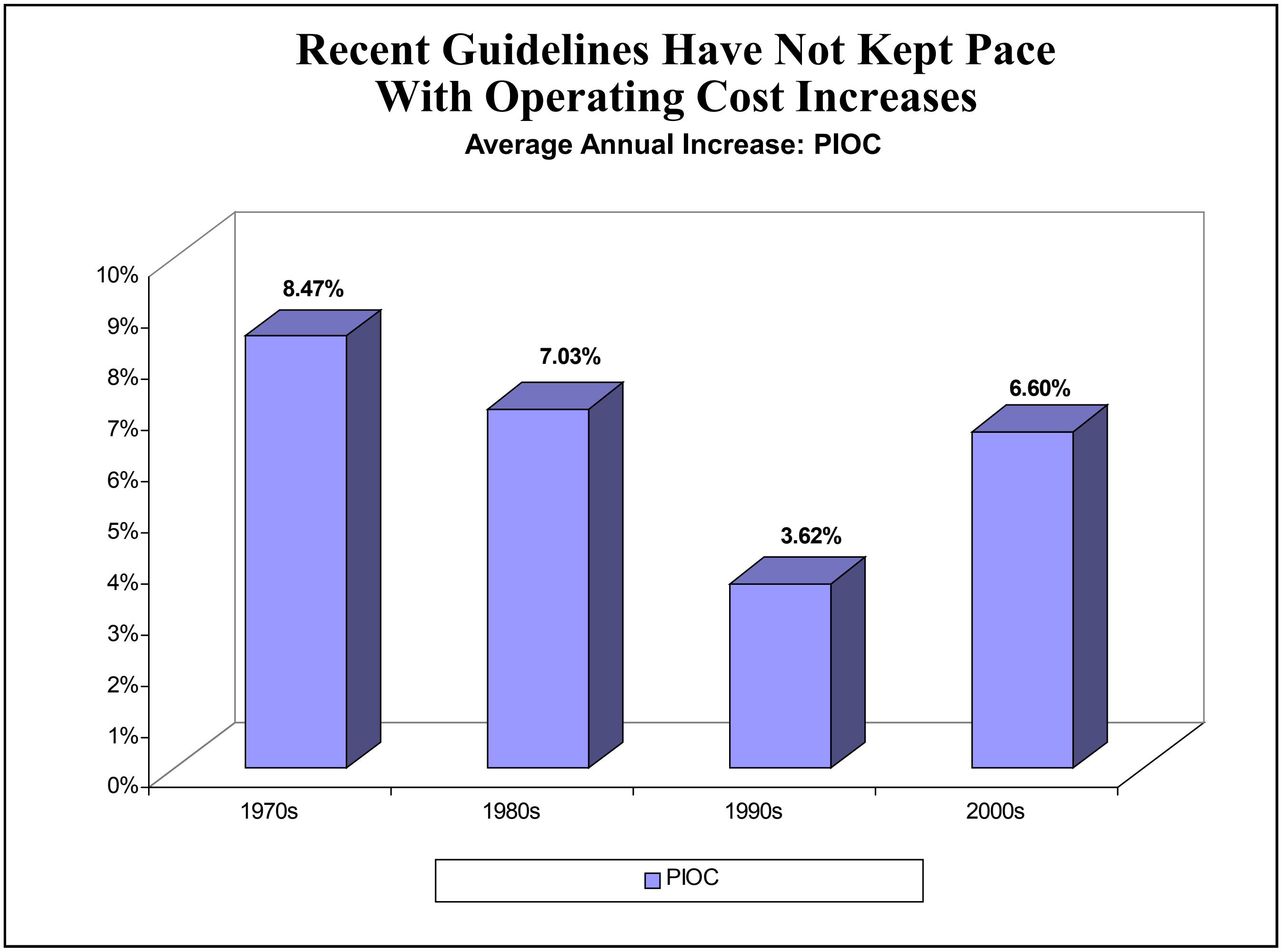

Figure 1
Source: *NYC Rent Guidelines Board Reports 1970-2011*

There is no question that these are real increases in operating costs. According to Miller Samuel, a Manhattan-based appraisal firm, co-op maintenance charges, increased an average of 19% in 2010 (SmartMoney 9/2/2010). According to Cooper Square Realty, a property management firm, co-op maintenance charges are set to increase by an average of between 5.5% to 7.5% in 2011 (*The Real Deal*, 11/01/2010).

Co-op buildings are similar to rent stabilized buildings and many still contain stabilized units. But co-ops tend to be in better condition than the rental stock, they do not have to account for profit and they have greater options for managing their operating cost increases than stabilized buildings. Co-ops often have reserve funds to call on, they can avail themselves of refinancing opportunities and many derive substantial income from commercial properties.

That co-op maintenance charges have been rising so much strongly suggests that the PIOC is seriously under-estimating the real increase in building operating costs.

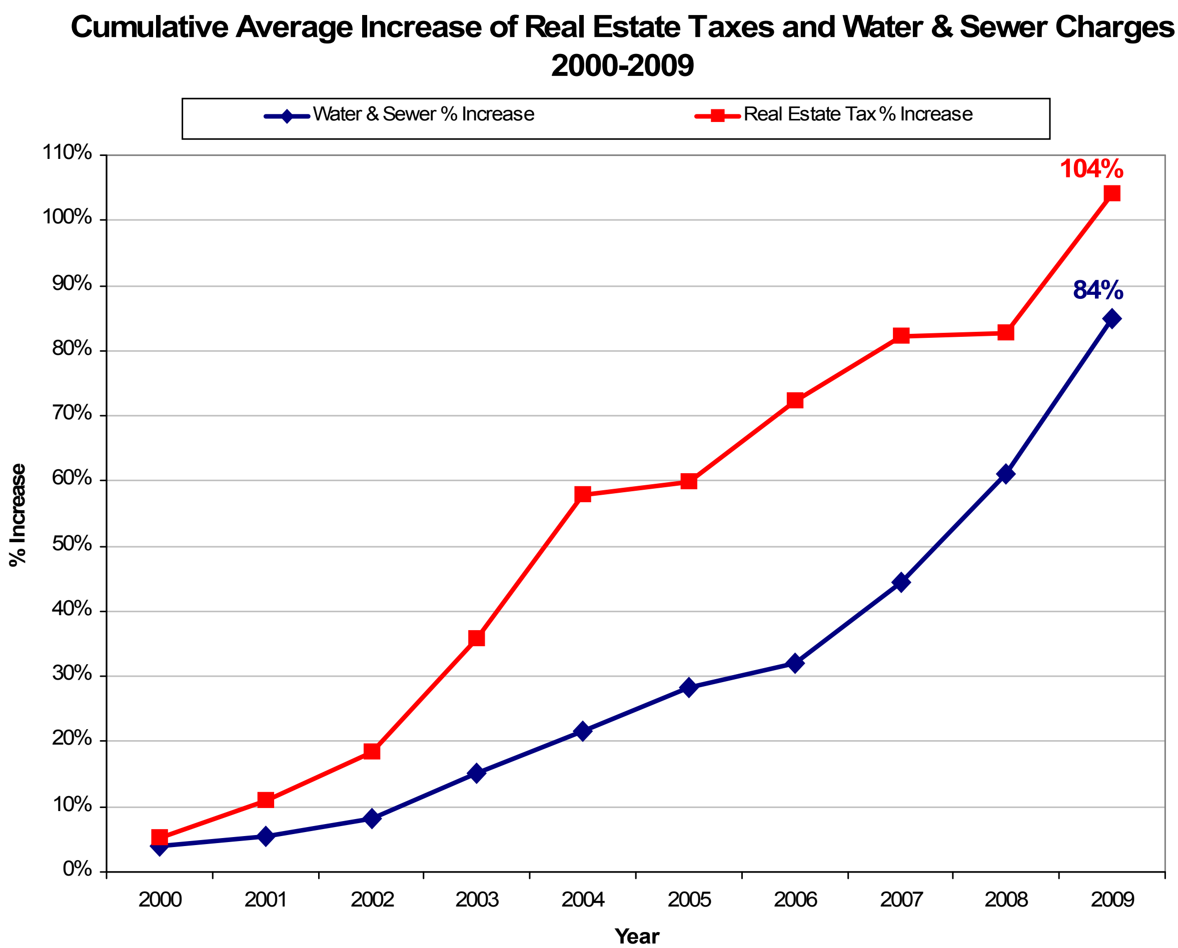

Figure 2
Source: *NYC Rent Guidelines Board - PIOC - 2000-2011*

A FUEL SURCHARGE IS NOT NECESSARY

The PIOC as formulated contains a measurement of fuel costs that is part of the 'rough justice' inherent in an across the board system of rent increases. This system clearly advantages or disadvantages various segments of the housing stock at any point in time but, hopefully, evens out in the long term.

In 2009, the PIOC came in at a relatively low 4% while the core PIOC measured 6.5%. The difference was purely the result of a sharp drop in oil prices. No one suggested in that year that buildings that did not heat with oil should have a higher rent guideline.

If the price of oil drops sharply in the coming year, that will be reflected in next year's PIOC as an offset to anticipated increases in real estate taxes and water and sewer charges. If the PIOC is lower next year, then the guidelines will also, presumably, be lower.

While the RSA believes conceptually that guidelines might be tailored to certain circumstances (e.g. distressed properties) or to specific segments of the housing stock (such as small building owners), this turns out to be difficult in practice.

A fuel surcharge is particularly problematic. If tenants refuse to pay the surcharge, as many may, it will cost owners more to initiate court proceedings than they are likely to collect in delinquent surcharges.

If a tenant files an overcharge complaint with DHCR believing their building is not oil-heated, DHCR will not know the building's heating source and owners will be burdened by the need to defend themselves in such cases. In addition, depending on how well articulated the guideline is in this regard, owners my face the risk of treble damages if they implement the surcharge erroneously.

Owners may also be subject to overcharge complaints if they innocently forget to remove a surcharge on a subsequent lease renewal.

And if fuel prices do not fall but remain high, will the RGB then extend the fuel surcharge or try to incorporate it into the base rent?

Will buildings that use interruptible gas be considered as oil or gas heated buildings?

Finally, the RGB should be aware that fuel surcharges have been challenged by tenant advocates in the past and may well be challenged in the future if a surcharge is approved.

In light of the potential problems created by a fuel surcharge, we urge the RGB to establish across the board guidelines, including minimum dollar increases, and not to implement a fuel surcharge.

PIOC DOES NOT TELL THE WHOLE STORY

Every year, we point out to the RGB members that the PIOC does not tell the whole story about property owners' increased costs. Each year there are new government mandates or increased enforcement of existing rules and regulations that increase operating costs for owners. Below is a short listing of some of new mandates that have been imposed over time. The cost of each of these mandates is a 100% increase in costs which is not reflected in the PIOC.

The traditional response to this issue is that it makes no difference if new costs are added so long as the rate of increase in those costs approximates the rate of increase in the overall PIOC. But this argument ignores the fact that, in the year in which new costs are imposed, those new costs represent a 100% increase to the property owner's cost base.

For instance, this year, owners required to do an 'energy benchmark' will have to pay ConEd $102.75 for a report of energy consumption by their tenants, in addition to any consultants' fees they will incur. While the $102.75 is not a large fee, it represents a 100% increase in an owner's costs and will result in a slight increase in the percentage of rental revenue dedicated to building operating costs. And this increase in operating costs will never be captured by the PIOC.

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 3
Source: *Habitat Magazine: June 2010*

This year, we have seen another slew of mandates, each with significant costs attached. The most obvious of these is the need for owners to pay for extremely costly exterminations of bed bugs. While an owner has no control over bed bugs, owners are responsible for eliminating bed bugs when they are brought in by a tenant. These exterminations are very costly and typically involve treating adjacent apartments as well as public areas and may require repeated exterminations to cure the problem.

Many owners have been subject this year to increased enforcement of a back-flow prevention device requirement. These devices prevent potentially toxic water from flowing back into the public water system and the requirement for such devices has long been on the books but seldom enforced.

With increased enforcement, it turns out that the installation of back-flow prevention devices is quite costly. The devices themselves and the associated plumbing costs can reach $10,000 in a larger building and the construction of over-flow containment vessels can add another $10,000 to the total cost.

While back-flow prevention devices are likely to be a one-time cost, they represent a 100% increase in costs which is not captured by the PIOC and must be funded out of the rental revenue of the building or be financed through the building's net operating income.

Another new mandate imposed this year requires owners of mid-sized and larger buildings to 'benchmark' their building's energy use and to do so annually going forward. While this is a task that is theoretically a "do it yourself" project, most owners' will undoubtedly hire a consultant at a cost of $3,000 and more to ensure that the work is done properly. Benchmarking will henceforth be another cost that will never be captured by the Price Index but will need to funded out of the building's rent roll.

Finally, and most significantly, City government has imposed a new and costly mandate that will require the phase-out of oil burners using #4 and #6 fuel oil. Effective as of May 23, 2011, owners will not be able to renew their #6 oil permits and will be required to shift to #4 oil and ultimately to #2 oil or gas.

This new mandate will require not only capital expenditures for the conversion costs but also permanent increases in operating costs for those owners who must switch to #2 oil because gas is not available for their building or they cannot afford the high cost of conversion to gas. In the short-term, buildings which use #6 oil are obligated to shift to #4 oil, necessitating costs of approximately $10,000 for the conversion in addition to the on-going cost of the higher price of #4 oil.

Certainly, the PIOC will never capture the capital costs involved in the longer-term mandate to transition to #2 oil or gas because it is not designed to capture such costs. But these will be real costs which must be funded out of net operating income and illustrate that net operating income must continue to grow if only to meet the rising costs of government mandates.

Costs which are not captured by the PIOC, whether these are operating costs or capital costs, demonstrate the need for the RGB to consider not only the factors which are quantified by the PIOC but also those unquantifiable factors, as illustrated above, which nevertheless constitute real increases in operating costs for property owners.

THE RENT GUIDELINES SHOULD BE HIGHER THAN THE COMMENSURATE RANGE

The Tenant Representatives on the RGB this year have raised the issue of which of the range of commensurate rent adjustments should be the basis for the rent guideline.

It is not at all clear that the RGB's final guidelines in prior years are the result of an agreement to base the guidelines on a particular commensurate rent adjustment formula rather than the result of a consensus built around disparate views.

Nevertheless, the commensurate rent adjustments do provide a basis for arguments about the direction of the final rent guidelines.

The Tenant Representatives argue this year that the appropriate guide for RGB action this year is what is know as the 'net revenue with vacancy increase' formula. They argue that, while guidelines for most of the 2000's were in line with this model, the two most recent guidelines exceeded this formula.

We argue that the 'net revenue' formula is deficient as a basis for the rent guideline and that through most of the 2000's the rent guidelines failed to reach even this inadequate level of commensurate rent increases.

In fact, when we look at the history of the rent guidelines relative to the PIOC increases decade by decade, it becomes apparent that the decade of the 2000's was the exception rather than the rule.

The chart below reflects that, for most of the history of the rent guidelines, the rent guidelines equaled 80% or more of the PIOC while in the 2000's the rent guidelines were just over 50% of the PIOC.

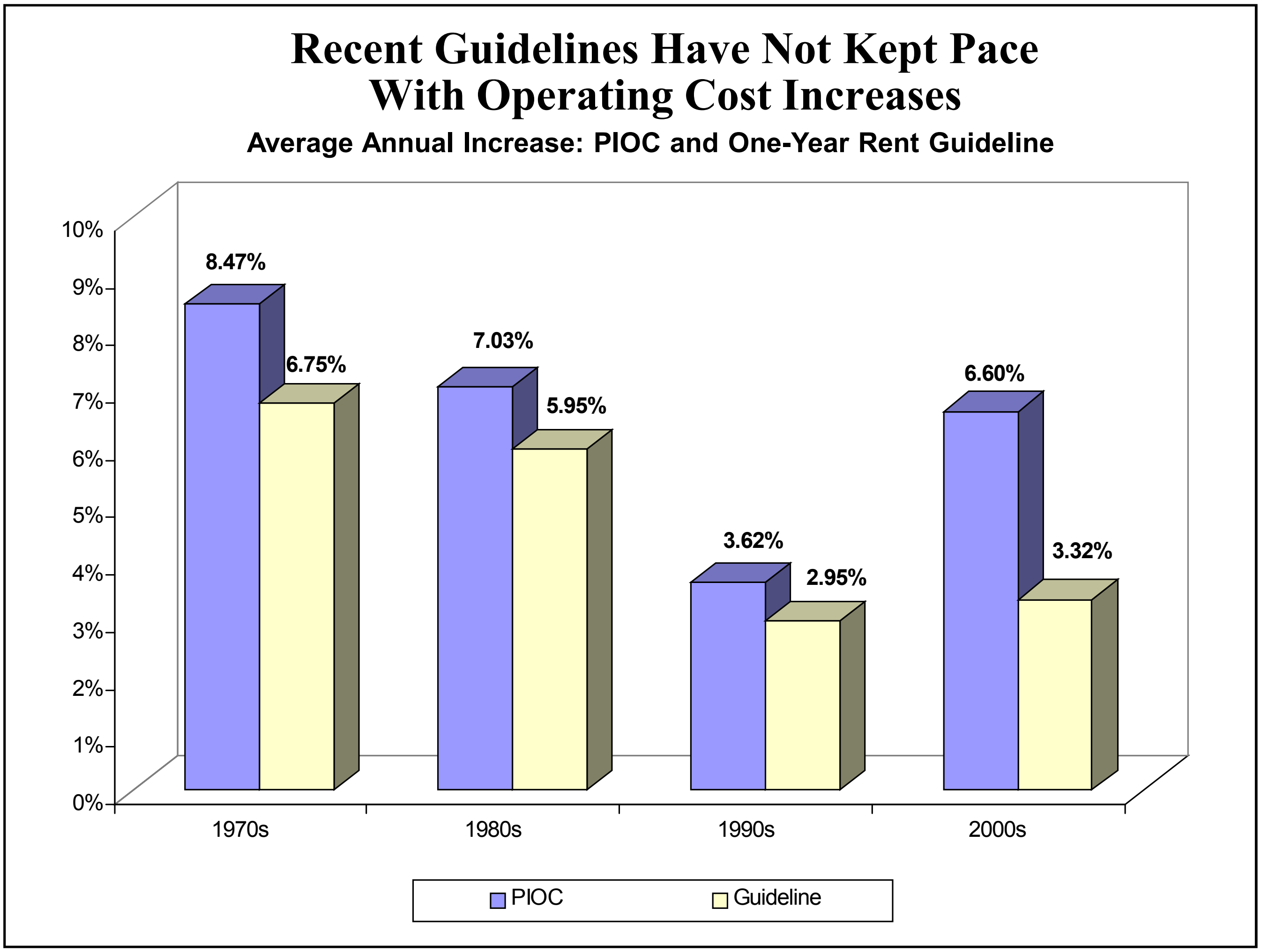

Figure 4
Source: *NYC Rent Guidelines Board Reports 1970-2011*

Not only were the rent guidelines during the 2000's substantially below the PIOC, they were at the bottom of or below the range of commensurate rent increases (*see chart below*) in seven of eleven years.

The guidelines in the last two years have moved in the right direction but nearly far enough.

There is ample justification for a rent guideline that is at least equal to the PIOC: it is the only guideline that will truly keep owners whole.

The 'net revenue' commensurate model fails the test because it does not adjust net operating income for inflation. In other words, if there were a nickel profit on every rent dollar in 1969, there would still be a nickel profit in 2011 even though that nickel is worth a lot less today than in 1969.

Guidelines Below PIOC and Commensurate Range

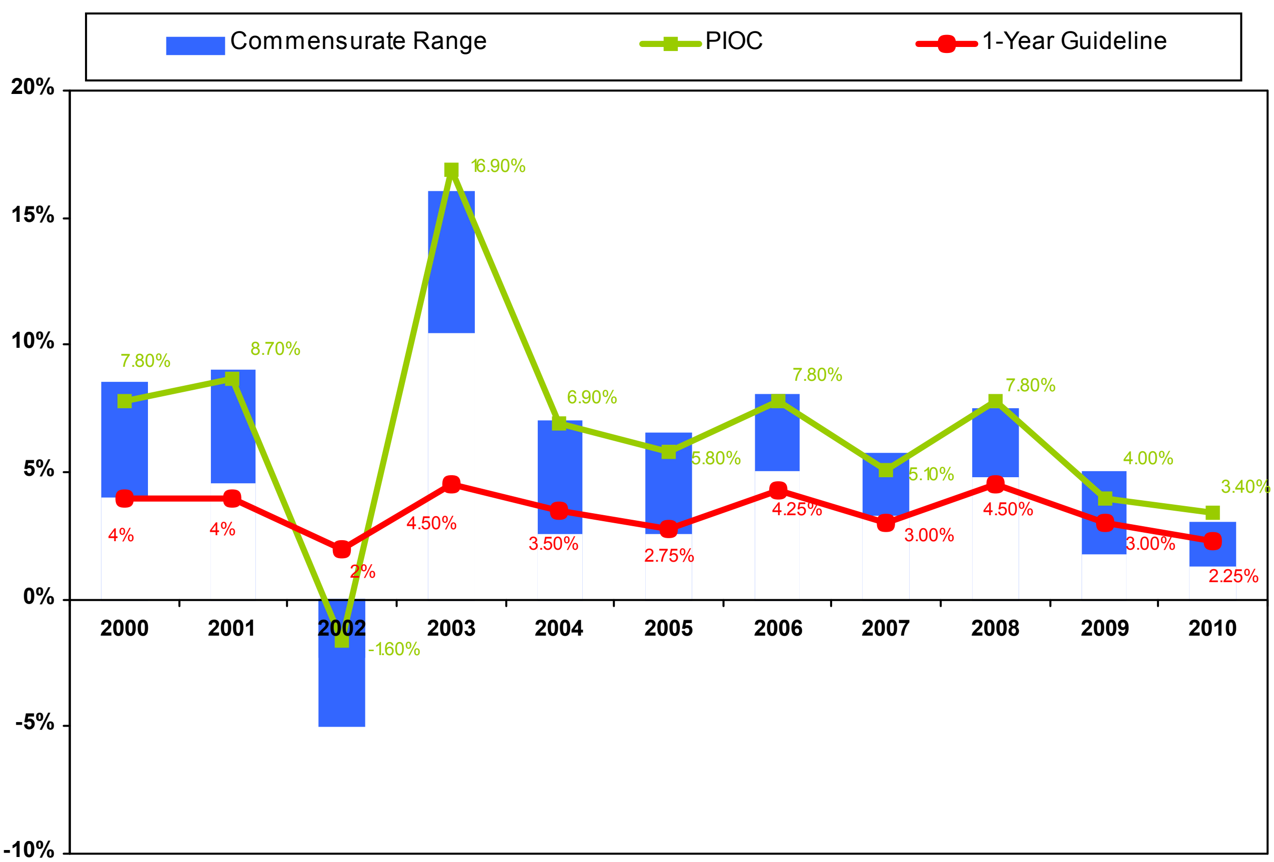

Figure 5
Source: *NYC Rent Guidelines Board*

In addition, net operating income must increase at least at the rate of general inflation in order to fund the cost of capital improvements, government mandates and other items not included in the PIOC.

The ‘CPI-adjusted NOI’ formula comes closer to the mark exactly because it adjusts net operating income. In fact, this year, the ‘CPI-adjusted NOI’ formula would dictate increases of 6% on a one-year lease and 10% on a two-year lease. We would argue that the guidelines should be even higher to account for the costs and mandates not included in the PIOC.

The RGB has neglected to keep owners whole in terms of their net operating income for far too long and the consequences of this neglect can be grave. The number of distressed properties (those with operating costs in excess of income) remains high. Nearly 12% of stabilized properties were distressed in 2009 according to the RGB’s 2011 Income and Expense Study. We estimate, based on prior years’ income and expense data, that more than 35% of additional properties are economically marginal, by which we mean these properties have operating expenses totaling 80%-100% of revenues.

The reported growth of net operating income ignores the fact that many properties have very low dollar values of net operating income. For example, a typical Bronx building with only rental income had a median net operating income of $113 per apartment per month in 2009. A 5.8% increase (the average increase for all stabilized properties) on that net operating income amounts to $6.50 per month or $78 per apartment per year. That increase in net operating income does not even come close to covering the cost of one bed bug extermination case, much less the other extraordinary costs outlined above which are not included in the PIOC but which are mandated by government and must be funded out of net operating income.

One further note on the commensurate rent adjustment formulas: two of these formulas take into account the revenue stream from vacancy increases, including the ‘CPI-adjusted NOI with vacancy increase” which would indicate rent increases of 4% for one-year and 7.5% for two-year leases.

These vacancy increase models assume that every turnover results in a 20% vacancy increase, but this is far from the case. In reality, once an apartment reaches a market rent level, it becomes difficult to take a renewal rent increase much less a vacancy rent increase. And since higher rent apartments turn over much more frequently than lower rent apartments, the opportunity for vacancy increases is much more limited than the potential number of turnovers.

Therefore, to the extent that the RGB looks to the commensurate rent adjustment formulas for guidance in the rent setting process, we would argue that the appropriate model would be the ‘CPI-adjusted NOI’ formula without consideration of vacancy increases, resulting in a base for this year’s rent guidelines of 6% for one-year leases and 10% for two-year leases.

HIGHER INCREASES FOR LOW RENTS ARE NECESSARY

While recent rent guidelines have been inadequate, the one bright light has been the minimum increases for rents under $1,000 which were enacted under RGB Orders #40 and #41. Unfortunately, the impact of these minimum adjustments was largely negated by the legal challenges brought by tenant advocates.

The vindication of the RGB's actions by the State's highest court brought little relief to property owners. Many, if not most, owners refunded minimum rent increases under Order #40 and most of the increases under Order #41 were never implemented as a result of adverse lower court decisions.

While property owners are now legally entitled to retroactively collect the minimum rent increases, as a practical matter, retroactive collection of rent is extremely difficult.

Additional rent increases for low rent apartments can be justified on several grounds. First, the same percentage rent increase applied across the board results in inadequate dollar increases when applied to relatively low rents.

Second, where low rents are not the result of market conditions, they are generally the result of rent skewing, a process by which rents are kept artificially low as the result of long-term tenancies which have benefited from a succession of two-year lease renewals.

Finally, in buildings where some stabilized rents have reached market levels, artificially low rents provide perhaps the only opportunity for owners to increase rent revenue in order to meet rising operating costs.

We appreciate the fact that the dust has barely settled on the recent Court of Appeals decision and that the RGB has not had the opportunity to update its data regarding the prevalence and impact of low rent adjustments. However, even without updated data, we believe there is ample justification to reinstate minimum rent adjustments this year.

The 2011 Housing and Vacancy Survey is likely to reveal that there are still substantial number of apartments renting for less than $1,000 per month. If we take the 2008 median rent of $925 and assume rent growth of 3% per year, the median rent in 2011 would be approximately $1010 per month. In other words, nearly half of all stabilized are still likely to rent for less than $1,000 per month today.

And there is no reason to believe that the occupants of such low rent apartments are any more rent burdened than they were in 2008. Nor would a minimum rent increase this year be likely to substantially increase the rent burden of such occupants.

Re-enactment of a minimum rent adjustment, short of an adequate rent increase, is the single most important action the RGB can take this year. We strongly urge the RGB to enact minimum rent increases and to do so without the unnecessary complication of the longevity restriction.

Low rents are low rents and by definition are rents which cannot support the cost of maintenance and operation for that unit. If such rents are low because of market conditions rather than longevity, then owners will simply not be able collect the increase.

KEEPING RENT INCREASES LOW DOES NOT ASSURE AFFORDABLE HOUSING

Every year, at least some Public Members of the RGB discuss the need to balance the interests of tenants and owner. Owners understand these comments to mean that the rent increases otherwise necessary to meet increases in building operating costs are being reduced in order to ensure that rents remain affordable to tenants.

The concept of balancing the interests of owners and tenants through the rent guideline process is deficient in two ways. First, this notion misconceives the mandate of the RGB, which is to provide property owners with the rent increases necessary to maintain and preserve the stabilized housing stock.

The protection provided to tenants under the legislative scheme is that tenants will be subject to only those increases necessary to maintain the housing stock and not to the potentially much larger increases that would be available to owners under free market conditions.

Second, the concept of balancing interests is predicated on the notion that a large number of tenants are overly rent burdened and that limitations on rent increases will alleviate these burdens. These notions are fatally flawed.

Several analyses have concluded that the New York City Housing and Vacancy Survey (HVS) raw income data overstates the number of rent burdened households. For example, every HVS reports that approximately 10% of stabilized households spend more than 100% of their income on rent. Clearly, households cannot spend more than all of their income on rent over a sustained period of time.

An analysis by the Citizens Housing and Planning Council (CHPC) in 2003 pointed out that the HVS does not include public subsidies as income. Therefore, some households which receive Section 8 subsidies or live in City or Federally subsidized housing are reported to have rent to income ratios in excess of 50% even though that cannot be true.

Similarly, the Community Service Society ("Housing Hardship and Rent Burdens Among Poor New Yorkers" April 12, 2005), acknowledged the inadequacies of the HVS income data and analyzed the data simply by eliminating extreme income data at both the high and low ends of the range. That analysis found that that the percentage of stabilized households with rent burdens in excess of 50% dropped from 23% to 12%.

We also find that the approximate 30% rent burden of the typical stabilized is also exaggerated when the data is realistically analyzed. When the RSA analyzed the 2002 HVS, we found that the contract rent-to-income ratio fell from 27% to 20% when the high rent burden households were excluded (this data was confirmed by RGB staff-RGB Memorandum, May 24, 2004).

We do not mean to minimize the problems of high rent burden households, even if the percentage of such households is much smaller than commonly reported. However, the CHPC analysis found that high rent burdens are largely a transitory phenomenon and that high rent burden households pay the same rent as non-burdened households. What distinguishes high rent burden households is their very low household income. In other words, the problem of rent burdened households is not high rents, but low incomes.

The RGB cannot assist those households which have such low incomes that they cannot afford any reasonable rent level whatsoever. However, more than 100,000 of these households living in stabilizaed apartments are protected from any rent increase by virtue of receiving Section 8, SCRIE or DRIE assistance. And the vast majority of stabilized renters have a very reasonable rent burden. Therefore, the RGB can feel free, in good conscience, to enact the rent increases that are necessary to maintain and preserve the existing rent stabilized housing stock.