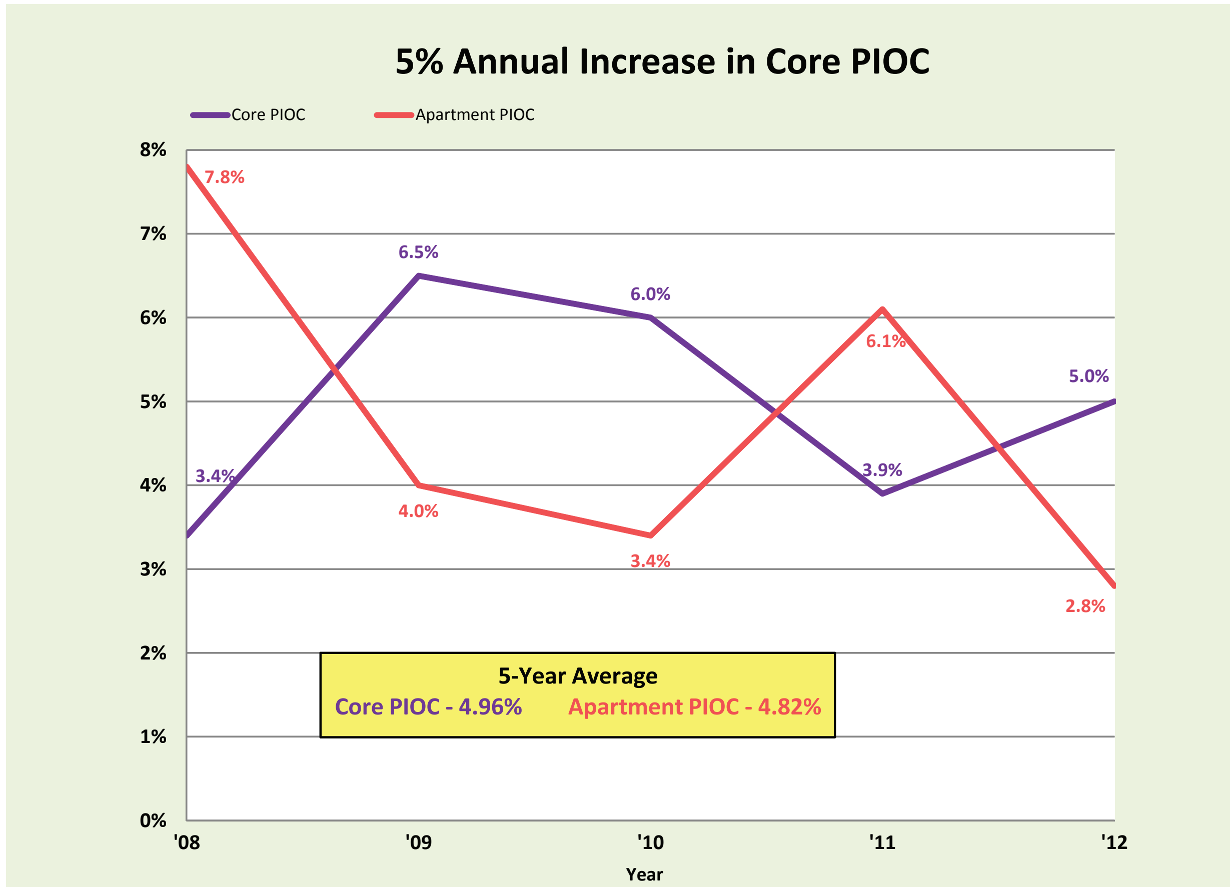
A Steady Course of Rent Increase: Vote the Core Price Index



Source: *RGB PIOC Reports 2008-2012*

Comments on the Preliminary Rent Guidelines for Order 44

June 2012

Joseph Strasburg, President
Jack Freund, Executive Vice President

“The practice of ‘smoothing’ out year-to-year adjustments to obtain a steady pattern of rent increases…, has been a consistent feature of past RGB orders.”

– *An Introduction to the NYC Rent Guidelines Board*,
by Timothy L. Collins, pg 70,
last revised Oct 2011 by RGB staff

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Summary

This year's 2.8% Price Index is deceptively low, driven down by an unusually warm winter and sharp drops in the price of gas and electricity.

The core Price Index, at an average of 5% over the last five years, is more representative of the level of cost increases propelled principally by large increases in real estate taxes and water and sewer charges.

Unfunded government mandates are a growing cost for owners and should be accounted for by the RGB as factors not included in the Price Index.

Operating margins are slim for a large percentage of the affordable housing stock outside of Manhattan with owners unable to absorb cost increases that are not passed on to tenants.

The majority of middle-income stabilized tenants have reasonable rent burdens and can sustain moderate rent increases without affecting affordability.

These considerations justify rent guidelines higher than the preliminary proposals.

Any rent guideline should contain minimum dollar increases, legitimized by the Court of Appeals decision in *Casado v. Markus*, and necessary to provide low-rent apartments with the rent increases needed to meet increases in operating costs.

Introduction

The rent setting actions of the RGB are limited by historical precedent and the year-to-year movements of the Price Index. Generally speaking, rent guidelines are, questionably, set at a level below the increase in costs measured by the Price Index. When the Price Index declines from the prior year, the rent guidelines will also be lower. However, when the Price Index is aberrationally low, the Board has historically enacted guidelines higher than the Price Index on the theory that rent adjustments should steer a more level course of adjustment than indicated by the short-term movements of the Price Index.

We suggest that this year's Price Index is an aberration, not reflective of the longer term trends in building operating costs that are more accurately represented by the core PIOC, which is 5% this year and has averaged 5% over the last five years. We therefore propose rent guidelines of 5% for one-year leases and 9% for two-year leases.

In addition, we propose that the RGB re-institute the minimum dollar increases that were approved under Orders # 40 and 41 but which were largely negated by the lengthy and ultimately unsuccessful legal challenge in *Casado v. Markus*. Regardless of the level of rent adjustment, it remains true that a percentage increase applied to a low rent will yield less than the same percentage applied to a higher rent. Combined with market limitation on rent increases for higher rent apartments, it is unlikely that the RGB's revenue targets for a specific set of guidelines will be met unless a minimum dollar rent increase is authorized.

Unfunded mandates are only one indication that many cost factors incurred by property owners are not included in the Price Index. While the Price Index measures the increase in costs for a constant market basket of goods and services, an aging housing stock requires ever greater expenditures for maintenance and repair costs. We ask the RGB to look beyond the Price Index this year.

We will also demonstrate that property owners cannot absorb the continuing increase in operating costs in their operating margins. A substantial portion of stabilized buildings are economically marginal. And operating margins on average are not sufficiently competitive to attract the capital needed to maintain and improve the aging stock.

We will also demonstrate that concerns about housing affordability have been over-stated and do not present a bar to the rent increases required to keep owners whole.

A Level Course of Adjustment

Throughout its history, the RGB has responded to peaks and valleys in the measurement of the Price Index by moderating the level of rent increase to insulate both tenants and owners from drastic changes in rents and revenue.

A prime example of this course of action occurred in 2002 when the Price Index measured a 1.6% decrease in owner's costs and the RGB approved increases of 2% for one-year leases and 4% for two-year leases. The following year, on the other hand, when the Price Index measured an increase of 16.9%(primarily the result of huge increase in real estate taxes) the RGB approved increases of only 4.5% for one-year leases and 7.5% for two-year leases (creating a deficiency which was never recouped).

As the graph on the next page indicates (**Figure 1**), the Price Index does produce sharp movements up and down whereas the core Price Index, which excludes volatile components such as fuel and electricity, moves in a more moderate manner without sharp peaks and valleys. For example, this year, with the Price Index at 2.8%, the core Price Index is 5%. On the other hand, the projections for next year show the Price Index rising to 7% while the core Price Index is expected to decrease to 4.6%.

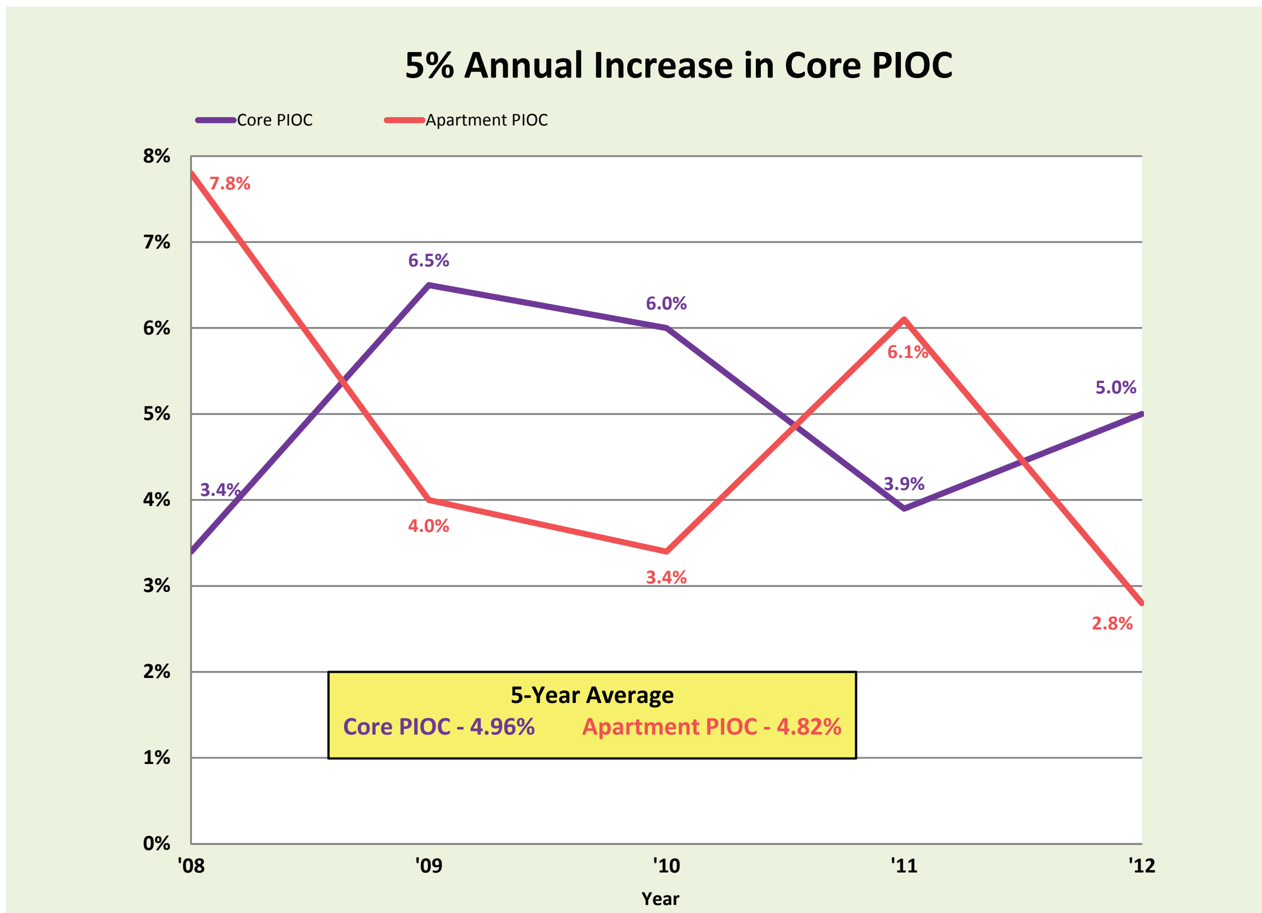

Figure 1
Source: *RGB PIOC Reports 2008-2012*

It is often the case that the Price Index and the core Price Index move in opposite directions. However, over the long term, the increases in each index average out to roughly the same number. As indicated in the chart above, over the last five years, both the Price Index and the core Price Index have increased at annual rate of approximately 5% per year.

The core PIOC may therefore be viewed as a better long-term indicator of the increase in building operating costs. For this reason, we urge the RGB to base its guidelines this year on the 5% core Price Index.

Costs Not Included in Price Index

Each year, we present the RGB with a new set of government mandates that impose costs which are not measured by the Price Index. In the past, these mandates have included items such as administrative fees, elevator inspection costs, lead paint and asbestos abatement costs, and building facade inspection and repair costs, to name just a few.

Historically, the RGB has recognized the distinction between quantitative considerations such as those measured by the Price Index and qualitative considerations which are not measured by the Price Index. As indicated in the chart on the next page (**Figure 2**), when such distinctions were actively considered, the rent guidelines tended to represent a larger percentage of the Price Index. However, even as government mandates continue to escalate, there appears to be less consideration of these additional costs as reflected by recent rent guidelines which fall increasingly short of the Price Index.

This has been a banner year for new government mandates and the RGB must consider these newly imposed costs in its guideline deliberations. Newly mandated costs are not included in the Price Index, which was last revised in 1983, and are generally not compensable through other mechanisms.

For example, the energy benchmarking requirements which became effective in September, 2011 impose definite costs on property owners, generally through the hiring of consultants to conduct the required surveys and submissions or through

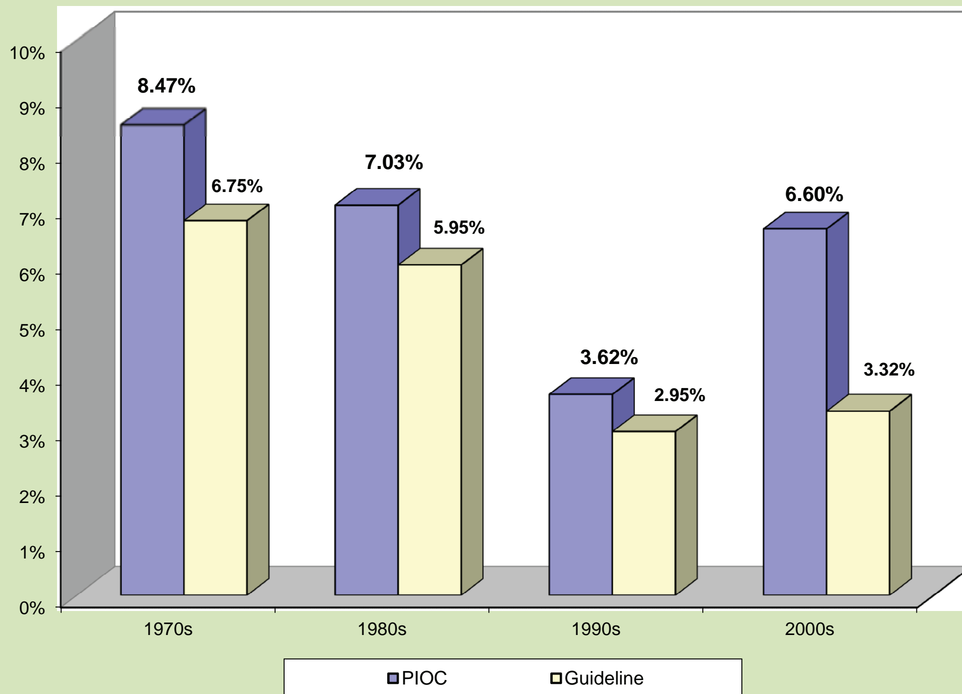

Figure 2
Source: *NYC Rent Guideline Board Reports 1970-2011*

administrative cost commitments coupled with required fees. There is no immediate pay-back or cost saving associated with these benchmarking surveys and the costs of the surveys are not compensable through any source other than their inclusion in guideline considerations.

While energy benchmarking requirements involve a relatively small cost of several hundred dollars, this and numerous other mandated costs quickly add up to impose a substantial cumulative burden on property owners.

Other government mandates, however, such as those requiring the installation of back-flow prevention devices, impose substantial monetary burdens on owners without any hope of compensation or pay-back. For large apartment buildings, these back-flow devices may cost as much as $80,000 and even an $8,000 cost for a small building represents a substantial burden.

The Economic Condition of the Housing Industry

The RGB has limited resources to gauge the health of the housing industry, even though its legislative mandate is to preserve the regulated housing stock. Net operating income (NOI) as reflected in the staff's annual Income and Expense Report is taken to be a proxy for profitability. But we know it is a bad proxy because it does not account for net profitability after mortgage expenses and the other costs not included in the Price Index.

Yet, even with a poor measure of profitability, it is apparent that regulated multi-family housing is a marginal business. Understanding that there is a vast difference between NOI in the Manhattan core and NOI for the majority of affordable rent stabilized units in the outer boroughs, it is important to note that the majority of stabilized buildings have minimal NOI even before the payment of any mortgage costs. As indicated in **Figure 3**, while average NOI in core Manhattan is $739 per month, NOI in the other boroughs ranges from $239 in the Bronx to $354 in Queens. So, for example, a sixteen-unit building in the Bronx would have an annual NOI of $45,888 before the payment of mortgage costs.

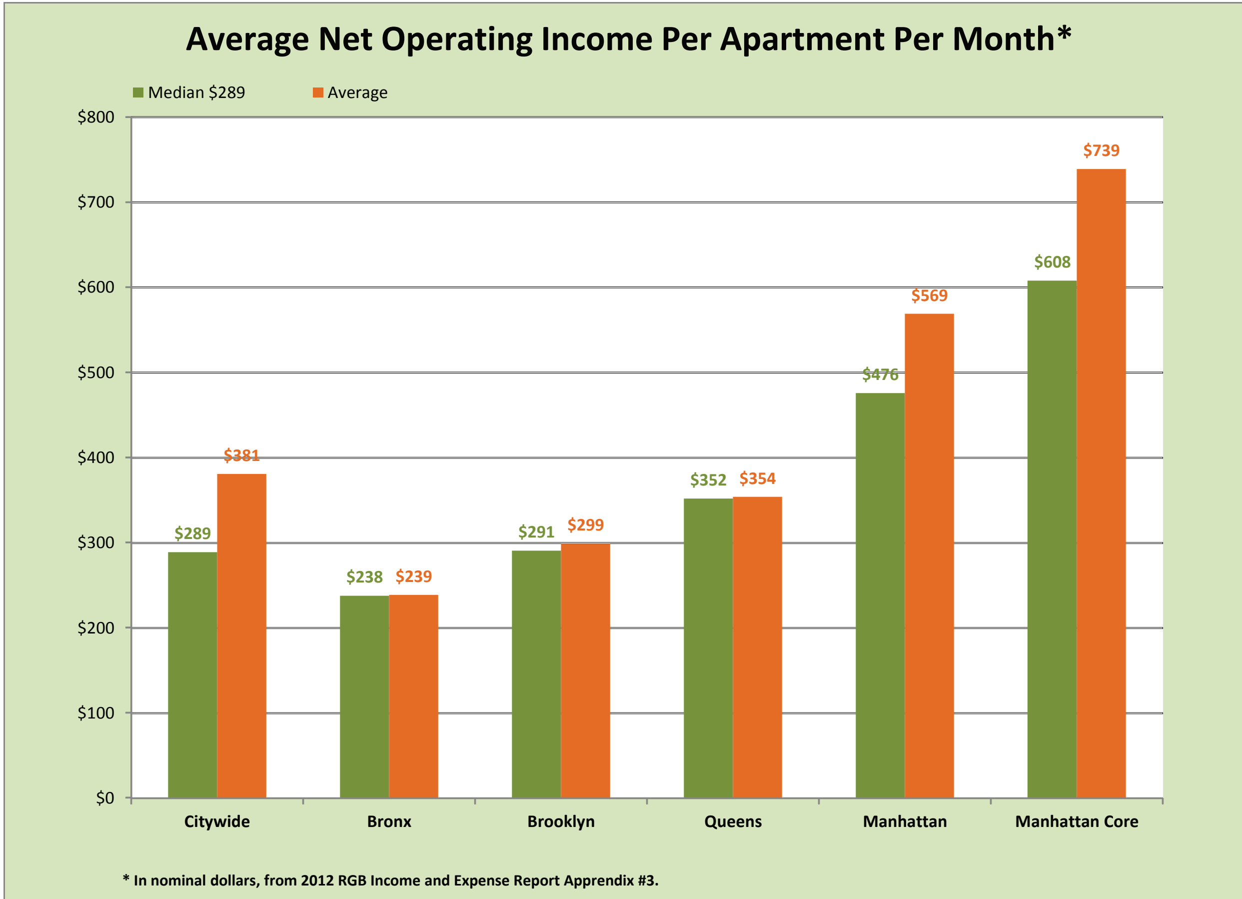

Figure 3
Source: *NYC Rent Guideline Board Reports 1970-2012*

To conflate these distinctions by constructing a hypothetical average building City-wide, as is done in the Income and Expense Report, with an annual NOI of $203,000 is a disservice to the impartial interests of the RGB.

Similarly, to represent the inflation-adjusted increase in NOI as a 22% increase over a two-decade period is a further obfuscation of the health of the housing industry. If we represent this same figure as a year-over-year change as in the graph in **Figure 4**, we can see that the 1.1% annual increase in NOI reflects an industry that has flat-lined economically. If we further compare the increase in NOI to the 20% and 30% increase in profitability for many large U.S. corporations, we can easily see that housing investments are simply not competitive with other investment options.

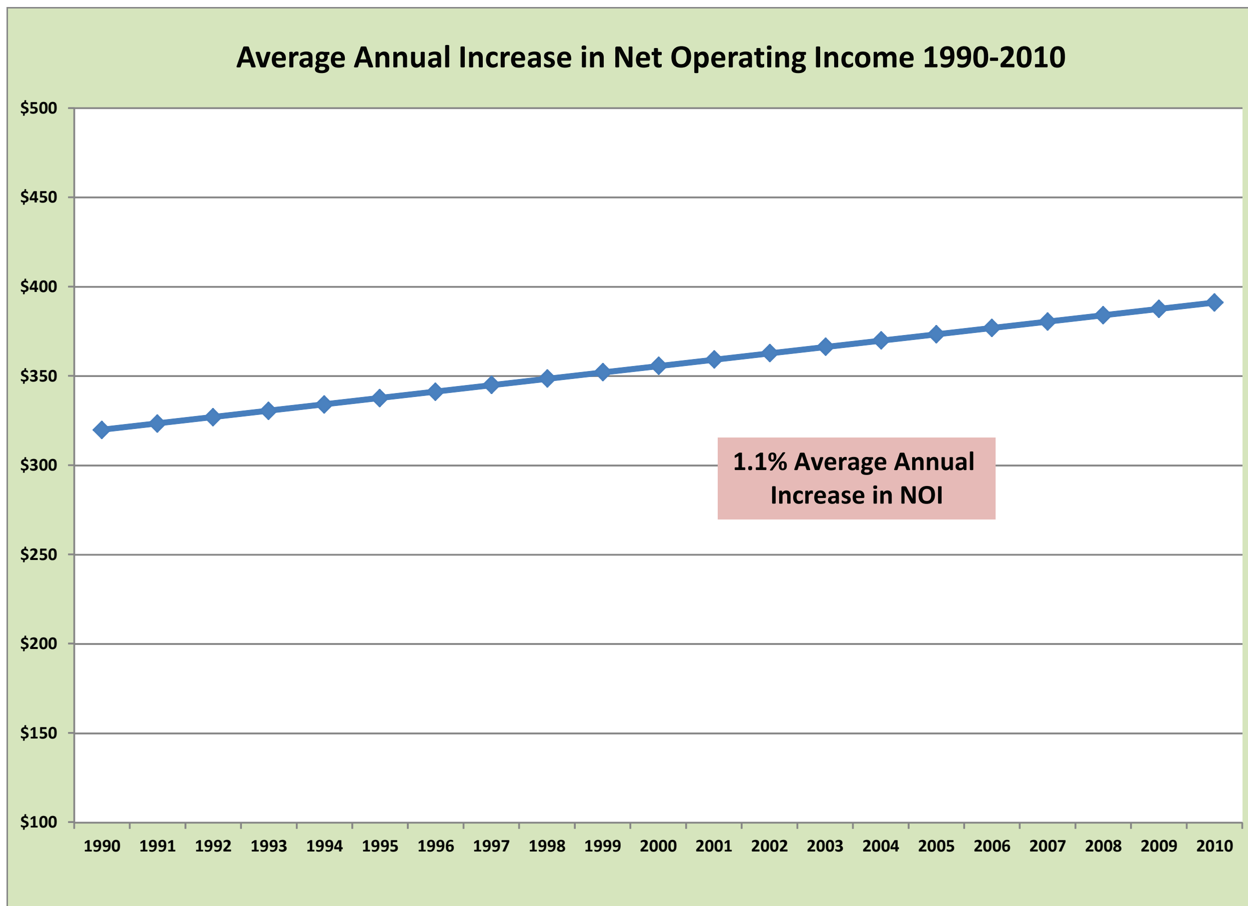

Figure 4
Source: *NYC Rent Guideline Board Reports 1970-2012*

And while data available this year indicates that the percentage of distressed property (those buildings where operating costs exceed revenue) has fallen to 6%, additional data available this year shows that many more buildings are operating at the margins. This data indicates that a 10% of buildings have operating costs in excess of 95% of income and another 10% of buildings have operating costs in excess of 84% of income.[1] The fact that 20% of rent stabilized buildings have no NOI or negligible NOI should be viewed in the context of national figures which indicate that buildings outside of New York operate with ratios of costs to income hovering around 50%.

[1]RGB Staff Memo dated April 19, 2012: data from Department of Finance, RPIE Statements

The Economic Condition of Rent Stabilized Tenants

RGB members have often professed the need to balance the interests of tenants and owners in the course of the annual rent setting process. A strong case can be made that the very act of limiting rent increases, not the precise level of rent increase, is the protection afforded to tenants under the Rent Stabilization Law, while the mandate of the RGB in the overall scheme of the RSL is to ensure the economic viability of the housing stock. This reasonable interpretation of the law suggests that balancing of the equities is not the function of the RGB, and if the RGB does balance the scale, it should be tilted towards higher rent guidelines. The evidence suggests, however, that the rent-setting scale has been balanced in favor of tenants in recent years.

Despite the annual protestations about the increasing rent burdens of rent stabilized tenants, the most recent evidence suggests that stabilized tenants have lower rent burdens than renters nationally as well as lower rent burdens than non-regulated renters in New York City.

The usual litany heard at this time of year from tenant advocates is that 50% of tenants pay more than 30% of their income for rent and that 25% of tenants pay more than 50% of their income for rent. It requires a bit of historical and methodological background to understand that these statements are totally meaningless.

First, it is important to note that most statements about rent burdens are based on gross rents (which include utility costs such as electricity and gas) rather than contract rent (the rent actually paid to the property owner). We believe that the RGB should only concern itself with contract rent since the RGB has no control over utility costs and property owners derive no benefit from a tenant's increased cost of utilities.

Second, we must note that the 30% of income standard for rent is an evolving standard. Housing costs as a percentage of income have risen steadily nationwide for both renters and homeowners over the past several decades, according to a 2008 report by the Center for Housing Policy. The rise in housing costs is largely explained by rapidly rising expenses for multifamily property owners. However, the rising cost of housing does not in itself place burdens on households to the extent that the cost of other necessities, such as food, for example, have decreased in price relative to income.

Third, those households which have a severe rent burden of 50% or more of income pay rents which are generally comparable to those households which are not rent-burdened. For these households, the high rent burdens are the result of very low incomes, not unusually high rents. It is commonly acknowledged that severely rent burdened households have such low incomes that they cannot function in the private housing market without rent subsidies. Fortunately, according to the Furman Center's 2011 State of NYC Housing Report, New York City has more subsidized housing than the next four largest American cities combined.

Finally, it is extremely important to note that the way in which housing burdens are measured tends to greatly exaggerate the incidence of extreme housing burdens, especially in New York where there are so many housing subsidies. On this matter, we must give great credit to the RGB staff for finally taking note of the difference between contract rents and out-of-pocket rents, a difference which is captured in the NYC Housing and Vacancy Survey. While rent burdens are usually characterized as contract rent to income ratios, it is the out-of-pocket rent to income ratio which more accurately measures the true rent burden for households which receive rent subsidies.

When we use out-of-pocket rents as a gauge of rent burden we find that, for all rent stabilized renters, the median rent burden falls from 32% to 27%, and the out-of-pocket rent-to-ratio for stabilized tenants with Section 8 subsidies is 20.9%[2.] So, while stabilized rent burdens in New York City are significantly lower than rent burdens nationally, nearly one out of ten poor tenants in stabilized housing have an even lower rent burden.

But even these numbers over-estimate the rent burden of the typical middle-class stabilized tenant: the cop, fireman or sanitation worker who, it is often erroneously said, cannot afford to live where they work. Since it is valid to distinguish stabilized Section 8 recipients, it is also valid to distinguish households who are Section 8 eligible but not receiving Section 8 assistance. When Section 8 recipients and Section 8 eligible household are excluded from the stabilized universe, the remaining stabilized households have a median contract rent to income ratio of approximately 21%, one-third lower than the median rent burden nationwide.[3]

It should be clear from this analysis that years of inadequately low rent guidelines increases have inured greatly to the benefit of what is often characterized as a typical rent stabilized middle class working tenant, and it should be equally clear from the foregoing that the economic pressures on the owners of stabilized properties have become enormous.

[2]**Data from RGB Staff Memorandum, April 19, 2012**

[3]**2011 HVS data compiled independently by Analysis & Inference, Inc.**

Guideline Proposals

This year, we are asking the members of the RGB to ignore the short-term movements of the Price Index and focus on the longer term trend in which operating costs have increased in excess of 5% per year over the last five years. In light of the projections for a 7% Price Index and a 4.6% core Price Index next year, there is every reason to believe that long-term price pressures on property owners will not abate. Therefore, we are asking the RGB to enact guidelines above the range of preliminary proposals this year in order to steer a more steady course of rent adjustment than is indicated by the short-term movements of the price index. Specifically we ask for:

- one year renewal guideline of 5% or $50, whichever is greater
- two-year renewal guideline of 9% or $90, whichever is greater
- a 10% sublet allowance
- an additional 1% increase for one- and two-year lease renewals where a property is heated exclusively with oil
- a pass-through of costs for the installation of backflow prevention devices or heating oil conversions mandated by government agencies based on the model for Major Capital Improvements(MCI's) unless such pass-throughs are otherwise authorized by other government entities
- the special guideline for apartments for vacated rent controlled apartments initially stabilized rents shall be 100% of MBR plus fuel cost adjustments or the HUD Fair Market Rent as adjusted for utility costs, whichever is greater.

The Need for a Minimum Rent Increase

It is always the case that a percentage increase in rent will result in a smaller dollar amount for a low rent and for a higher rent. This problem becomes compounded because tenants in low-rent apartments tend to maintain their tenure for longer than tenants in higher rent apartments. As a result of the application of percentage increases and long-term occupancies, low-rent apartments tend to fall further and further below the average rent.

By proposing a minimum dollar rent increase, we intend to target low rents, not long-term tenancies. Incredibly, according to the 2011 HVS, there are still 94,463 stabilized apartments renting for less than $700 per month and 166,689 units renting for less than $800 per month. With 17% of apartments renting at break-even levels, it is not surprising that 20% of buildings (***see page 25***) are economically marginal.

Property owners value good tenants who remain in place for a long time. But property owners cannot sustain rents which do not cover operating costs.

Justification for Additional Increases for Oil-Heated Buildings

This year's Price Index measured an overall operating cost increase of 2.8% but a significantly higher increase of 3.9% for oil-heated buildings. The increase in costs for oil-heated buildings would have been even higher except for the unusually warm weather conditions during this past winter. There is no reason to expect a repeat of last season's warm winter and every reason to believe that oil prices will continue their long-term upward trend. Properties that heat with oil did not benefit from the lower gas prices that drove the overall Price Index down significantly this year and will have difficulty paying next year's oil bills unless the RGB provides adequate compensation for the continued high cost of oil.