Appendix J

The City of New York

Rent Guidelines Board
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April 27, 1993

To: Members of the Board
From: D. Hillstrom
Subject: Commensurate Rent Increase

The commensurate rent increase is a formula which the RGB has used throughout its history. The commensurate rent increase has been explained as the percentage rent increase needed to maintain landlords' current dollar net operating income (NOI) at a constant level. The commensurate rent increase for this year is[1]:

One Year Lease	Two year Lease
3.3%	4.0%

As a means of compensating landlords for cost increases, the commensurate rent increase formula has two major drawbacks. First, although the formula is supposed to keep landlords' current dollar income at a fixed level, the formula doesn't consider the mix of one and two year lease renewals. Since only two-thirds of leases are renewed in any given year, and a preponderance of leases are for two years, the formula does not necessarily accurately estimate the amount of income needed to compensate landlords for past O&M increases.

A second possible flaw of the commensurate formula is that it does not consider the erosion of landlords' income by inflation. By maintaining current dollar net operating income at a constant level, adherence to the formula may cause profitability to decline over time, although this is not an inevitable consequence of using the

[1] The accuracy of the PIOC is assumed as is the collectability of legally authorized increases. Calculating the Commensurate Rent Increase requires an assumption about next year's PIOC. In this case we use 1.8%, staff's PIOC projection for 1994.

commensurate.[2] Of course other factors (e.g. individual apartment improvement and MCI increases) may mitigate these impacts.

An alternative to the commensurate rent increase would consider the mix of lease terms and sources of landlord revenue allowed by the RGB other than lease renewals (e.g. vacancy renewals). We will call this the "Net Revenue" rent increase. This formula takes into consideration the mix of leases actually signed by tenants but does NOT adjust NOI for inflation. Depending on whether revenue from a 5% vacancy allowance is included in these calculations, the **"Net Revenue"** increase is[3]::

One Year Lease	Two year Lease
3%	5.5% (Vacancy allowance income included)
4%	6 % (Vacancy allowance income NOT included)

An alternative to this "Net Revenue" formula would be to consider lease terms and to adjust NOI upward to reflect inflation so that BOTH O&M and NOI remain constant. We will call this the "Adjusted NOI" increase, which would result in the following figures[4]:

One Year Lease	Two year Lease
4%	7.5% (Vacancy allowance income included)
5.5%	8% (Vacancy allowance income NOT included)

2 Whether profits will actually decline depends on the level of inflation, the composition of net operating income (i.e. how much is debt service and how much is profit), changes in tax laws, and interest rates.

3 The following assumptions were used in the computations: (1) The required increase in landlord revenue is 3.3%, or 70% of the 1993 PIOC increase of 4.72%; (2) These lease terms are only illustrative. Other combinations of one and two year lease increases could also result in a 3.3% revenue increase. (3) Lease terms were derived from the 1991 NYC Housing and Vacancy Survey. According to the HVS, 24.9% of all tenants have a one-year lease and the remainder have two-year leases. As a result, 62.5% of tenants renew their leases in a given year. The increase in landlords' revenue reflects this lease distribution. (4) The 1991 HVS showed a turnover rate of 9.7%. As a result of turnover, landlords can expect an increase in revenue of about one-half percent, given the 5% vacancy allowance. This assumes that the vacancy allowance is collectible in all cases.

4 NOI was adjusted upward by the most recent yearly increase in the Consumer Price Index, March 1992 to March 1993. This figure was 3.4%.

These “Adjusted NOI” figures have a major drawback - we are adjusting the debt service portion of NOI UPWARD by the inflation rate when in fact, interest rates have been falling in recent years.[5]

All of these methods have their limitations. The commensurate increase is artificial and doesn't consider the impact of lease terms or inflation on landlords' income. The “Net Revenue” formula does not attempt to adjust NOI based on changes in interest rates or deflation of landlord profits. The “Adjusted NOI” formula inflates the debt service portion of NOI, even though interest rates have been falling, rather than rising. Finally, none of the formulas consider the impact of the MCI program or individual apartment improvement increases on landlord profitability.

Each of these formulas may be best thought of as a starting point for deliberations. The staff's other research (e.g. the mortgage survey or the I&E study) and testimony to the board can be used to modify the various estimates depending on these other considerations.

[5] An alternative would be to adjust only the portion of NOI which is “profit” upwards. In fact, we do not know what average “profits” are, but if we assume a figure of 10% of rent, the respective lease adjustments would be 4% for a one year lease and 5.75% for a two year lease if vacancy allowance income is included.