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The Honorable Walter F. Mondale
United States Senate

MAY 24 1976



Dear Senator Mondale:

In accordance with your request of October 30, 1975, and subsequent agreements reached with your office, we examined the recent rent increase at ~~Oak Grove Towers~~, a Department of Housing and Urban Development HUD supported housing project in Minneapolis, Minnesota. We confined our review to identifying reasons for the increases in operating costs that resulted in the most recent request for higher rents and to verifying the validity of the cost increases.

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We held discussions with officials of the Department's area office in St. Paul, Minnesota, and the Landtech Management Corporation, the firm managing Oak Grove Towers. Our review of Landtech's cost records included an examination of invoices and supporting documentation for all 1974 and 1975 recorded expenses to insure that the expenses were legitimate.

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The increased operating costs, which resulted in the rental increase at the project effective March 1, 1976, were caused primarily by increases in the cost of electricity, gas and fuel, protective services, decorating expenses, and real estate taxes. We found also that the cost increases were generally valid.

We believe the monthly maximum basic rents approved by the Department for the project were excessive by an average of \$3.43 for each apartment because certain project income was not considered by the Department in its rent computation and actual operating expenses were less than anticipated. Although the rents currently charged project tenants are less than the Department-approved maximum basic rents, these maximum rents should be reduced to prevent unwarranted future rent increases since Landtech could increase rents charged up to the limits approved by the Department. Reducing the maximum basic rents by an average \$3.43 would not affect rents charged project tenants unless more than \$2.83 of the \$3.43 reduction was allocated to one-bedroom units.

We brought these matters to the attention of Department officials who agreed to consider them and take appropriate corrective actions.

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Background

Oak Grove Towers is a 228-unit, 20-story apartment building in Minneapolis, Minnesota. It contains 152 one-bedroom apartments and 76 two-bedroom apartments.

The project was completed in August 1973 at a cost of about \$4.3 million; however, tenants were admitted as early as May 1973. The building is owned by a partnership consisting of several limited partners and two general partners. Landtech, one of the general partners, is the managing agent.

The Oak Grove Towers mortgage is insured by the Department under section 236 of the National Housing Act (12 U.S.C. 1715z-1). This section of the act authorizes a program to insure privately financed mortgage loans for constructing or rehabilitating multifamily housing projects for low- and moderate-income families and to pay, on behalf of the mortgagors, the mortgage insurance premiums and the interest on the mortgage loans over 1 percent. Because the Department makes these payments--called interest-reduction payments--a basic monthly rent for each housing unit is established at a lower rate than would apply if the project received no Federal assistance. Interest-reduction payments made by the Department for this project totaled about \$190,500 and \$190,400 in calendar years 1974 and 1975, respectively.

Section 236 provides that a tenant pay either the basic rent or 25 percent of adjusted family monthly income, whichever is greater, and that a tenant's rent payment not exceed the rent which would apply if the project had to bear the cost of the full mortgage interest.

Incentives to invest in federally subsidized multifamily housing have been provided by the law covering section 236 projects which permits owners to receive a 6-percent return on their investment and tax shelters--such as accelerated depreciation--that may reduce Federal income tax liability. However, no return on investment has been realized from the Oak Grove Towers project by the owners since the project's inception. Losses reported in certified financial statements for calendar year 1974 amounted to about \$275,000. Certified financial statements for 1975 were not available as of April 30, 1976.

Section 212 of the Housing and Community Development Act of 1974 authorizes the Department to make subsidy payments to owners of section 236 projects to offset increases in local property taxes and utility costs. These subsidies would reduce the amount of rental increases that normally

would have to be paid by the tenants. The Department has not deemed it necessary to implement this provision for subsidy payments of section 236 projects. A suit is pending before the U. S. District Court of Minnesota, brought by members of a tenants' group, including some tenants at Oak Grove Towers, to force the Department to make subsidy payments to the owners of Oak Grove Tower, and three other section 236 projects managed by Landtech. If the plaintiffs are successful in this suit, many of the Oak Grove Towers residents would benefit through a reduction in their rent payments.

Validity of the Reasons
for the Project's
Rental Increase

The cognizant Department area office must approve proposed rental increases made by owners of section 236 projects. The Department approves requests for rental increases when project operating costs have risen or when it has been demonstrated with reasonable certainty that utility rates, real estate taxes, or contracted services costs will rise in the future. The Department reviews the proposed increase and computes a maximum monthly rental income for the project. Within this limit, the Department then sets the maximum basic rents for each size of apartment.

The project owners use the maximum basic rents as the basis for their revised rental schedule. In this way, projects, at a specified percentage of occupancy, are assumed to continue to generate the income required for (1) payment of operating costs, including an allowable management fee, (2) mortgage amortization plus interest and mortgage insurance payments, and (3) owners' return on investment.

The average monthly basic rental rate for each apartment at Oak Grove Towers was \$132.33 when tenants were first accepted in May 1973. There have been two rental increases since: one effective July 1, 1975, which raised the average rental rate to \$151.63 and one effective March 1, 1976, which raised the average rental rate to \$161.

Rental increase - 1975

This rental increase was based on actual costs incurred by the project during calendar year 1974. The increases averaged \$19.30 a month for each apartment--\$23.52 for a one-bedroom apartment and \$10.86 for a two-bedroom apartment.

The Department found that the expenses, taxes, and reserves chargeable to the project totaled \$226,512 and would justify an average basic rental rate of \$155.63. On the basis of this analysis, the Department approved the lower average monthly rental rate of \$151.63 requested by Landtech.

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Rental increase - 1976

Upon reviewing Landtech's October 1975 rental increase request, the Department approved an increase in the maximum basic rents to an average \$167.30--\$152.83 for one-bedroom and \$196.24 for two-bedroom apartments. This rental increase was justified on the basis of estimated costs incurred by the project during calendar year 1975 and projected operating costs for calendar year 1976.

On March 1, 1976, Landtech increased the basic rents to an average \$161--\$6.30 less than approved by the Department. The increased rent of \$150 for one-bedroom and \$183 for two-bedroom apartments averaged \$9.37 a month for each apartment--\$11.48 for a one-bedroom and \$5.14 for a two-bedroom. Since Landtech increased the rents to an amount less than the Department-approved maximum, it has the authority to further increase them to the Department-established maximum limits, after proper notification to the tenants and to the Department.

The increase in the Department-approved basic rents effective March 1, 1976, over those approved by the Department effective July 1, 1975, was attributable to a net increase in the following operating costs:

Electricity	\$ 8,197
Gas and fuel	6,333
Protective services	6,872
Decorating expenses	3,319
Real estate taxes	3,098
Miscellaneous	<u>144</u>
Total	<u>\$27,963</u>

Our examination of actual calendar year 1975 expenses, taxes, and reserves chargeable to the project (totaling about \$258,250) showed that these expense items represented valid charges. Also, the projections made for 1976 costs and included in the rental increase appeared reasonable.

However, our examination showed that an average maximum basic rent of only \$163.87 was justified rather than the \$167.30 approved by the Department. The \$3.43 difference is attributable to the following:

- The Department's rent calculation underestimated certain project income. The Department's estimate of laundry and vending machine income was made in early 1973, before the building was occupied. Increases in this income occurred

in 1974 and 1975. Also, tenants are charged additional amounts for electricity if they have air-conditioning units. In evaluating Landtech's proposed rent, the Department overlooked these items which amounted to a total of about \$5,100 in 1975. These items of income account for a reduction of \$1.74.

--The project's operating expenses as of December 31, 1975, which represented more recent data than that available to the Department, showed that actual calendar year 1975 operating expenses were less than the Department anticipated. This affected the Department's projections for calendar year 1976 costs. Our projections for calendar year 1976 costs, based on the more recent data, are lower than the Department's and result in a further net reduction of \$1.69.

Reducing the computed average maximum basic rent of \$167.30 by \$3.43 would not likely reduce the rents charged project tenants. The monthly rental rates currently charged are \$150 for one-bedroom apartments and \$183 for two-bedroom apartments, while the rents approved by the Department for these units are \$152.83 and \$196.24 respectively. The maximum basic rents could be reduced by an average \$3.43 without affecting the rents currently charged, depending on how the reduction is allocated to one-bedroom and two-bedroom apartments. Any rental reductions will depend on a recomputation of the maximum basic rents by the Department.

Conclusions and Recommendations

The latest monthly rental increase approved by the Department for Oak Grove Towers was necessitated primarily by increases in operating expenses such as electricity, gas and fuel, protective services, decorating, and real estate taxes. These increases in expenses were generally valid; however, we determined that the Department-approved maximum basic rent was too high because it omitted certain project income and overstated certain operating expenses. Any adjustments to the maximum basic rents to reflect these items will have little or no effect on the rents currently charged tenants but could result in unwarranted future rent increases by Landtech.

To insure that Oak Grove Towers tenants are not charged excessive rents in the future, we recommend that the Secretary of Housing and Urban Development require the St. Paul Area Office to:

--Determine the proper maximum basic rent which should be established for Oak Grove Towers as of March 1, 1976. The Office should consider the current levels of income from

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laundry and vending machines and electricity charges for air-conditioning units, as well as recent data available on the project's operating expenses and its effect on projections made for calendar year 1976 costs.

--Adjust the maximum approved basic rent if it is excessive.

We brought our findings to the attention of the Department's St. Paul Area Office officials who agreed to consider these matters and take appropriate corrective actions.

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As your office requested, we did not give the Department or the other parties mentioned an opportunity to formally comment on matters contained in this report. However, we have discussed these matters with Department officials.

As agreed with your office, we are sending copies of this report to the Senate and House Committees on Government Operations and on Appropriations; to the Director, Office of Management and Budget; and to the Secretary of Housing and Urban Development.

Sincerely yours,

James B. Stacks

Comptroller General
of the United States

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