

aged upon owner's return on investment.

Cost Reasonableness Basis for Evaluation of Project Proposals

The proposed rule also includes changes related to evaluating the cost reasonableness of project proposals. Under current regulations, the agency has applied a policy of cost containment when evaluating whether the costs of the proposed design for new projects are reasonable. While this policy has effectively held down construction costs for new projects, agency field staff and borrowers report that lower-cost project design features are not always cost-effective over the long term. They report that while certain design features reduce initial construction costs, they actually cost more over the life of the project because the components used require higher levels of maintenance and more frequent replacement.

Projects with these design features experience higher routine maintenance costs, higher expenditures of project reserves, and a greater need for subsequent financing for rehabilitation. The result is an upward pressure on project rents and increased use of rental assistance payment assistance. To the extent a project cannot support the rent increases needed to cover these costs, the project faces an increased risk of financial failure or compliance violations due to physical deficiencies.

Currently, RHS has no process for conducting life cycle analyses. The proposed requirement for a life cycle cost analysis will be used for new and existing facilities. The requirement is intended to assure quality construction as well as long-term viability of complexes. Reserve levels would be set based on life cycle costs to provide necessary resources when needed to replace essential building components. Existing loan agreements are to be modified as needed by an addendum properly executed by the borrower. Under the proposed rule, the agency would change its policy for evaluating project proposals to consider the life cycle costs of proposed project designs. Under this policy, the agency may approve a proposed project design that is not the lowest cost if a life cycle cost analysis prepared by the project architect reveals that the design achieves the lowest overall cost over the life of the project. Industry standards will be used for the analysis. To assure that new projects are affordable and appropriate to the local housing market, the proposed rule restricts the agency from approving project designs that would cause rents to exceed the market standard (except in exceptional

circumstances where such costs are determined to be in the best interest of the Government and the tenants). Examples of two design features that may cost more initially but decrease operating expenses over the life of the project are brick exteriors and increased thermal standards. In the past, many projects were built using a popular exterior plywood siding. These buildings are now requiring replacement of the original siding. Similar buildings that utilized brick as an exterior finish or partial finish are not having similar expenses, therefore, decreasing demands on the reserve accounts. Thermal standards in RHS financed projects often exceed local codes. By building RHS projects more energy efficient, tenant and owner utility expenses are kept lower, thereby, decreasing the need for rent increases or tenant utility allowance increases. By avoiding the additional rent and utility allowance increases, tenant rent overburden is avoided, as is additional drain on scarce rental assistance resources.

Because this change will allow for more costly designs, the agency expects the size of initial loans and initial rents to grow slightly. However, higher up-front costs would be offset by lower long-term costs. The agency expects that new projects receiving funding under this policy will have lower maintenance and rehabilitation needs, leading to lower project rents and lower use of agency rental assistance over the life of the project. Lower maintenance expenses, resulting in rents essentially the same as projects built under cost containment guidelines, would offset the increased debt service due to higher construction costs. This change will also lower demand for subsequent loans from the agency in a time when additional loan funds are increasingly scarce.

Management Certification

Under current regulations, RHS must approve the management agreement between the borrower and the management entity for a project. This approval is designed to ensure that the management agent is also accountable for meeting program requirements. However, the agency has found that this policy results in a time-consuming approval process because these agreements frequently include complex contractual language that is difficult to evaluate. Further, OIG has found that many management agreements and plans lack the specificity to accurately describe how project and management agency costs are prorated between

expenses paid by the project and those that are paid by the management fee.

The proposed rule eliminates agency approval of management agreements and requires borrowers to submit a management certification in an agency-approved format. In submitting this document, borrowers certify that their agreement with the management entity for the project obligates that entity to comply with program requirements, establishes sanctions for failure to comply with these requirements, including termination of the agent, and specifies penalties for false certifications. This change eliminates the administrative burden on RHS for approving management agreements, while strengthening the agency's ability to hold borrowers and their agents accountable for their management responsibilities. In addition, revisions to management fee policy, discussed below, allow for a more definitive method to differentiate between project and management agent expenses.

Management Plan

Under current regulations, borrowers are also required to obtain RHS' approval of the management plans for their projects. The purpose of this policy is to provide the agency assurance that the borrower and management entities have adequate systems in place to comply with program requirements. However, experience has shown that these plans are time consuming to process. The requirement to obtain agency approval for updates only adds to the burden for agency staff and borrowers. This policy also leaves the agency in an awkward position when borrowers with sound projects have changed their operations, but not updated their management plan. OIG has reported audit findings where borrowers and management agents have not been operating the properties in conformance with the executed management plan. While this is true, when examined, it has been found that the practice the agent and owner have engaged in is not improper, just not documented correctly in the management plan. The OIG has agreed that had the practice been correctly disclosed in the management plan, the practice would not have been listed as an audit finding. OIG has worked with the RHS during the stakeholder process and subsequently to eliminate this particular area of confusion. The result of the change will be that RHS will not be required to micromanage borrower and management agent business practices when the practice is one that is beneficial to the tenants and the project. Additionally, fewer OIG