

## **Cost Control and Safe Harbor Standards for Rental Mixed-Finance Development**

**Revised: April 9, 2003**

In order to expedite the mixed-finance review process and control costs, HUD is instituting safe harbor and maximum fee ranges for a number of costs. In addition, HUD has provided guidance on several development issues. Unless otherwise noted, the cost controls and safe harbors apply to those phases for which a mixed-finance proposal is submitted after January 1, 2000. Any terms previously approved by HUD through approval of a pre-development agreement, development agreement, or program manager contract will not be reviewed again. This guidance is specific to rental developments, and does not apply to homeownership phases.

These policies were developed in consultation with housing authorities, HUD staff, and industry representatives, over the course of more than a year. Once drafted, they were circulated for public review, and the final cost controls included here reflect the many valuable comments received. HUD will continue to review the policies, based on experiences reported by housing authorities and other program participants, and may make alterations to the standards in the future.

Changes from the revised Cost Control and Safe Harbor Standards (January 2, 2002) are italicized in this alert and include the following:

- HOPE VI or other public housing funds may be used, on a case-by-case basis, to pay for up to 15% of the total developer fee/overhead amount to the developer prior to closing. A loan is not required.
- Operating subsidy and tenant rents used to fund a reserve must be used for eligible operating subsidy expenses.
- The property management fee for the public housing units may be calculated as 6% of imputed tax credit rents.

HUD's cost controls and safe harbors are contained in the following chart. The chart provides a brief definition of each term, lists the safe harbor and maximum allowable fees, and briefly describes the risk factors or circumstances that may result in a fee above the safe harbor standards. These guidelines should be used by housing authorities, developers, and consultants when negotiating terms and drafting documents for HUD review.

HUD will review the project terms when receiving Predevelopment and Development Agreements, Program Manager contracts, mixed-finance proposals, and/or other documents that contain negotiated terms. If a project is at or below a safe harbor standard, no further review will be required by HUD. If a project is above a safe harbor standard, additional review by HUD will be necessary. In order to approve terms above the safe harbor, the housing authority must demonstrate to HUD in writing that the negotiated terms are appropriate for the level of risk involved in the project, the scope of work, any specific circumstances of the development, and the local or national market for the services provided.

## Cost Control and Safe Harbor Standards

Item	Defining Criteria	Safe Harbor	Maximum
<p>Net Developer Fee for Rental Mixed-Finance Developments</p> <p>(Developer Fee and Overhead)</p>	<p>The safe harbor and maximum standards apply to the net developer fee, i.e., the portion of the developer fee received by the developer to cover overhead and profit.*</p> <p>Net developer fee is expressed as a percentage of the project costs. Project costs are defined as all hard and soft costs of constructing a particular component with the <b>exclusion</b> of the following:</p> <ul style="list-style-type: none"> <li>• Third-party costs paid by the PHA under contracts entered into directly by PHA and third parties, which will not be reimbursed to PHA at a mixed-finance closing (e.g., where the PHA contracts separately for demolition services);</li> <li>• The developer fee itself;</li> <li>• All costs related to family self-sufficiency and resident relocation activities; and,</li> <li>• All reserve accounts regardless of how characterized, including start-up reserves, operating deficit reserves, capital improvement reserves, initial operating period reserve, etc.</li> </ul> <p>Payments to developers such as “deferred developer fee” are considered part of the fee/overhead amount.</p> <p>Developers may receive up to a 1% additional fee (with a cap of 12% developer fee) if cost savings are realized. This 1% incentive fee must be paid from non-public housing funds.</p>	<p>9% or less of the project costs (profit and overhead); projects that do not have both LIHTC and public housing financing should have fees well below 9%.</p>	<p>12% of the project costs (profit and overhead).</p> <p>Fees above 12% will be considered only if allowed by the State Housing Finance Agency <b>and</b> with significant justification from the PHA and developer demonstrating the increased risk.</p>

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\* The safe harbor and maximum guidelines assume the net developer fee excludes any portion of the fee received by the developer or co-developer (including a PHA) that is returned to the project to fund operating reserves or to cover project costs.

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	<p>Developers with fees above the safe harbor standard should meet most or all of the following risk factors:</p> <ul style="list-style-type: none"> <li>• Developer guarantees are for large dollar amounts in proportion to project size and/or long terms;</li> <li>• Developer independently obtains financing, including tax credits (fee increases with both amount of financing and number of sources);</li> <li>• Developer obtains site control from an entity other than a PHA or PHA affiliate (fee increases with number of sites);</li> <li>• Project is small (i.e., 50 units or less);</li> <li>• Project is complex (e.g., in financial, legal, environmental, and/or political terms);</li> <li>• Project contains units without operating subsidy (i.e., market-rate or LIHTC-only units);</li> <li>• Developer bears more than 25% of the predevelopment costs (until reimbursement at closing); and/or</li> <li>• The Developer Fee is deferred (paid out of positive cash flow from market-rate units).</li> </ul> <p>All criteria apply to both for-profit and non-profit developers.</p> <p>PHAs or PHA affiliates that act as developer can only receive fees if they are first returned to the project and, to the extent that funds are remaining, subsequently classified as program income and used for low-income housing purposes.</p>		

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<p>Pay-Out Schedule for Developer Fee/Overhead</p>	<p>Public housing funds may not be used for payment of developer fee/overhead. HUD recommends the following limit on the pay-out schedule, to the extent that non-public housing funds are available, by phase:</p> <ul style="list-style-type: none"> <li>• Closing: Not to exceed 50% of the fee/overhead amount.</li> <li>• Construction Completion: 25% of the fee/overhead amount.</li> <li>• Stabilized Occupancy: 25% of the fee/overhead amount.</li> </ul> <p>A portion of the fee can be further deferred.</p> <p><i>On a case-by-case basis, HUD will consider advancing the developer funds where there is an extended predevelopment period caused by such external factors as environmental remediation, consent orders, etc. If HUD determines such an advance is warranted, HUD will advance up to 15% of the total developer fee/overhead amount to the developer prior to closing using HOPE VI or other public housing funds.</i></p>	<p>Within recommended pay-out schedule.</p>	<p>Payments of greater than 50% at closing or less than 25% at stabilized occupancy will be closely scrutinized.</p>
<p>Contractor Fee</p>	<ul style="list-style-type: none"> <li>• Percentages are based on hard construction cost.</li> <li>• General Conditions includes the bond premium.</li> </ul>	<p>Overhead: 2% Profit: 6% General Conditions: 6%</p>	<p>14% is the maximum for these combined costs provided that the PHA justifies why the 2/6/6 percentages for the individual costs cannot be met.</p>

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PHA Administrative/ Consultant Costs	<ul style="list-style-type: none"> <li>• Costs should reflect only actual documented expenditure of time and overhead cost (supplies, equipment, telephone, etc.)</li> <li>• Such costs include both in-house staff time and outside consultants (program manager, development advisors, relocation specialists, etc.), but <b>exclude</b> outside legal and community and supportive services costs. On the HUD budgets, these costs may be captured under multiple BLIs.</li> <li>• This cap applies to HOPE VI grantees awarded funds in 1998 or later, as well as to any non-HOPE VI mixed-finance projects with proposals submitted after January 1, 2000; HUD will evaluate earlier grants on a case-by-case basis. HUD will continue to evaluate whether this cap provides helpful guidance and controls costs without hampering the PHA's ability to implement the grant.</li> </ul>	3% of the total project budget (basis includes all hard and soft development costs <b>excluding</b> CSS expenses).	6% of the total project budget
Sharing of Third-party Pre-development Costs	<p>HUD recommends the following cost-sharing schedule:</p> <ul style="list-style-type: none"> <li>• PHA and Developer split third-party costs 75/25.</li> <li>• Developer's share of third-party costs (25%) will be reimbursed at closing out of available sources.</li> </ul> <p>Costs to be shared are all third-party costs under the developer's scope of work (e.g., A/E, market study, financing fees, etc.) incurred during the predevelopment period. Public housing funds may not be used to reimburse developer legal counsel prior to closing, and developer legal costs do not contribute to the developer's share of third-party costs.</p> <p>Exceptions to the schedule may be made for small, local, non-profit, and/or minority/disadvantaged firms on a case-by-case basis.</p>	Costs are shared up to 75% by the PHA and at least 25% by the Developer.	N/A
Equity Raise and Pay-In Schedule	HUD will not adopt a safe harbor equity raise or standard pay-in schedule, as these are highly competitive, market-driven numbers.	Current market standard.	N/A

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Identity of Interest Parties	<ul style="list-style-type: none"> <li>• Identity of interest parties are those that share an ownership interest. Identity of interest relationships are most common between a developer/owner and construction management, general contractor (GC), private management firm, and/or investor.</li> <li>• PHAs are required to ensure cost competitiveness to the extent possible.</li> <li>• Where a developer and GC have an identity of interest, the PHA needs to show the GC was the lowest bidder in response to a public request for bids or request a waiver from HUD under 24 C.F.R. 941.606(n)(1)(ii)(B).</li> <li>• While the use of related or preferred entities as investors is permitted, HUD encourages PHAs to have their procured developer “shop around” to ensure they are getting a competitive yield.</li> </ul>	N/A	N/A

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Property Management Fees	<ul style="list-style-type: none"> <li>• Can be defined on a percentage of gross income or per-unit per month (PUM) basis.</li> <li>• If using the PUM basis for fee, fees should drop for vacant units.</li> <li>• PHAs and PHA Affiliates cannot earn a fee for property management of public housing units, but can cover their associated administrative expenses.</li> <li>• Fees may increase with higher-risk projects.</li> <li>• Different types of risk are associated both with mixed-income and solely public housing projects.</li> </ul>	<p>a) 6% effective gross income or,</p> <p>b) a flat PUM fee for occupied units that is supported by the local project-based Section 8 program in the area (use Field Office guidelines) or,</p> <p><i>c) 6% of imputed tax credit rent for the public housing units (assume public housing units are tax credit units, charge up to maximum tax credit rent, and take 6% of that amount).</i></p>	Proposals above the safe harbor will be closely scrutinized; higher fees will require significant justification and market support.
Price for Program Management Services	<ul style="list-style-type: none"> <li>• Typically a fixed-price contract.</li> <li>• Contracts must be performance-based with payments fixed to milestones (or monthly if tied to milestones).</li> <li>• Size of fee should be related to the specific scope and role PM is expected to play.</li> <li>• Costs for program management (either a full team or independently procured consultants) must be included in the PHA's Administrative Cost Cap.</li> <li>• PHAs must comply with the provision of the procurement regulations that requires a PHA to prepare a cost estimate for procured services prior to receipt of bids.</li> </ul>	N/A; the fee must be contained within the PHA's overall Administrative Cost Cap. Use checklist of responsibilities and clearly defined scope to limit costs.	N/A

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Legal Fees	<ul style="list-style-type: none"> <li>• Largely independent of the size of the phase.</li> <li>• Attorneys should be used for legal functions.</li> <li>• Legal fees should be tied to a scope of work, which should be monitored. HUD will review PHA legal costs when reviewing HOPE VI development budgets.</li> <li>• In order to reduce costs and provide an incentive to reach closing, public housing funds may not be used to pay developer legal costs prior to closing.</li> <li>• HUD intends to produce further guidance on how PHAs should utilize their attorneys.</li> <li>• The procurement regulations state that for any RFP, the PHA must undertake a cost or price analysis prior to receipt of proposals.</li> </ul>	No express limit; public housing funds may not be used to reimburse developer legal counsel prior to closing. All legal costs will be reviewed by HUD.	N/A
Operating Deficit Reserve and Operating Subsidy Reserve	<ul style="list-style-type: none"> <li>• HUD is not establishing maximum or minimum levels of reserves to be maintained, as appropriate reserve levels depend upon the specific project and investor requirements.</li> <li>• Both reserves must be established with non-public housing funds, but may be replenished with public housing funds (i.e., operating subsidy or tenant rents from PHA-assisted units).</li> <li>• <i>If public housing funds are contributed to a reserve at any time, those funds in the reserve must be dedicated to the project or returned to the PHA to be used for eligible purposes.</i></li> <li>• <i>The portion of the reserve funded with public housing funds may not be used to pay for partnership exit taxes, debt repayment, or any other expense that is not an eligible use of public housing funds.</i></li> </ul>	N/A	N/A