The Rental Assistance Demonstration (RAD) and Energy Performance Contracts (EPCs)

Guidance for Public Housing Agencies (PHAs), Public Housing Field Offices, and Financial and Energy Partners

Overview: HUD is committed to providing PHAs with the tools they need to recapitalize and preserve public housing, reduce their utility cost burden, and enhance the sustainability and livability of the built environment. For over twenty years, PHAs have used EPCs to finance energy-efficient improvements by leveraging the savings generated. RAD offers an additional tool to PHAs to make capital improvements, including energy conservation measures.

This document provides guidance for PHAs that are converting public housing properties covered under an EPC as well as to PHAs and their partners that are weighing the options available to them to recapitalize and green public housing with EPC or RAD.

General Questions For PHAs considering undertaking energy conservation

Q1: What are the advantages of performing energy conservation work under an EPC?

A1: The EPC program provides PHAs a variety of incentives through the public housing Operating Fund that facilitate the financing of energy conservation measures. EPC lenders have been willing to underwrite up to 100% of a Energy Service Company's (ESCo) guaranteed anticipated energy savings when sizing their loans. Multifamily affordable housing lenders typically have varied experience and practice in underwriting to anticipated energy savings, which may impact mortgage sizing under RAD if pro forma cash flow is partially dependent on energy savings. On the other hand, the savings are used to cover costs associated with the EPC. HUD strongly recommends that, for any PHA entering into a new EPC that is considering RAD for the future, the PHA negotiate agreements that can be unwound with minimum complexity. For example, PHAs should avoid financing that does not allow for prepayment. It would also be prudent for the PHA to have a more granular understanding of the costs and savings of the EPC. While for an Energy Center approval the costs and savings are all rolled up to the entire project an understanding of the total costs and the savings associated with each AMP as it relates to that total will ease transitioning an AMP to RAD.

Q2: What are the advantages of performing energy and conservation work under RAD?

A2: Completing energy and water efficiency work under RAD produces benefits to the project's cash flow in two main ways. When properties convert under RAD, they convert with initial Section 8 contract rents based at funding levels based on their "RAD rent base year:" All properties awarded under the original 60,000 unit cap have initial contract rents based on FY 2012 funding levels ("FY 12 RAD rent base year") and all properties awarded above HUD's original 60,000 unit cap but subject to the increased 185,000 have initial contract rents based on FY 2014 funding levels ("FY 14 RAD rent base year"). (See the RAD Notice for further detail).

Following conversion, contract rents increase annually by HUD's Operating Cost Adjustment Factor (OCAF) and are unadjusted if operating expenses decrease. As a result, any decrease in energy or water expenses creates more cash flow for the property, which can be used to support greater debt. Further, when conversion will result in the reduction of one or more utility components (e.g. gas, water & sewer, electric) used to establish the Utility Allowance, HUD will permit the RAD contract rent to be increased by a portion of the utility savings, which similarly creates additional cash flow for the property.[1]

Further, as many properties converting under RAD use Low-Income Housing Tax Credits, including energy and water conservation improvements as part of tax-credit financing increases the "basis" on which the tax credit equity is calculated, helping to finance a greater level of repairs.

HUD strongly encourages PHAs to undertake energy conservation measures in the scope of work developed as part of a RAD transaction. The RAD Physical Conditions Assessment provides PHAs with a range of repair and replacement options and estimates the cost-effectiveness of each option. RAD requires that if systems and appliances are being replaced, at a minimum PHAs must complete replacements with Energy Star®, WaterSense® or Federal Energy Management Program (FEMP)-designated products and appliances.[2] Additionally, PHAs must utilize the most energy- and water-efficient options that are financially feasible and that are found to be cost-effective by the PCA.
Following conversion, HUD encourages all PHAs and owners to use utility management software such as EPA's Energy Star Portfolio Manager Benchmarking tool to monitor and better understand their energy consumption.

<u>Questions for PHAs converting properties under RAD that are covered under an EPC</u>

Q3: Can I convert a property that is covered under an EPC to RAD?

A3: Yes. PHAs may convert some or all of the public housing properties covered under an EPC. PHAs doing so should become familiar with how existing EPC incentives have or have not been included in their contract rents, the required submission requirements, and other considerations, which are covered in the questions below.

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[1] This provision is available as-of-right for PBRA conversion. For PBV, a PHA must first secure a waiver of PBV regulation from PIH to permit the use of site-based utility allowances before this provision can be applied in the context of a RAD conversion.

[2] For Energy Star®, see http://www.energystar.gov/. For WaterSense®, see http://www.epa.gov/watersense/. For FEMP, see http://www1.eere.energy.gov/femp/.

Q4: Are the existing EPC incentives maintained under the new RAD Section 8 rent?

A4: Yes. The RAD rents for each public housing project incorporate any existing Frozen Rolling Base (FRB), Add-On Subsidy (AOS), and Rate Reduction Incentive associated with an existing EPC that were in place at the time of each project's "RAD rent base year" – FY 2012 for properties awarded under the original 60,000 unit cap or FY 2014 for properties awarded as a result of the increase of the cap to 185,000 units.[3] The methodology for calculating RAD rents includes the Operating Subsidy Utility Expense Level (UEL) and Energy Add-on so that projects retain the value of existing EPC incentives when they convert through RAD. The PHA should consider the impact of essentially switching from the AOS to the Frozen Rolling Base incentive as part of its RAD conversion.

However, due to incomplete administrative data, HUD did not incorporate the Resident Paid Utility Incentive (RPU) into the rent levels posted in the RAD Application and Tool. As a result, for projects proposed for RAD conversion with an existing EPC using the RPU, HUD will allow an amendment to the posted RAD rent to add the Per Unit Month (PUM) EPC Resident Paid Utility Incentive. If the PHA has the RPU incentive, they should notify their Transaction Manager who will work with PIH to determine an accurate incentive amount.

For additional details on the specific line items utilized in calculating the posted RAD rents, see Attachment 1C in PIH Notice 2012-32 REV 2.

Q5: What if, for the project I was awarded a CHAP, my EPC add-on incentives became effective after my base year. Will my RAD rents be amended?

A5: No. For example, projects that were awarded CHAPs under HUD's original 60,000 unit cap have RAD rents that are based on FY 2012 funding levels. These amounts do not incorporate any EPC add-on incentives that began in 2013 or later. However, this structure is similar to a Frozen Rolling Base incentive, since the RAD rents are based on the Utility Expense Level (UEL) from 2012. Projects would continue to benefit from the real value of any reductions below the utility expense level from 2012.

Under this example, a PHA finishes construction in 2014 on an all Add-On Subsidy (AOS) EPC that reduces utility costs by $100,000 from a 2012 level of $500,000, down to $400,000. Since the AOS is the lesser of AOS costs or AOS savings, it will always be equal to or lower than realized utility savings. The PHA is set to receive an add-on in 2014 for $80,000, but has been awarded a RAD CHAP. The RAD formula will not recognize the $80,000 add-on scheduled to begin in 2014. However, the RAD formula recognizes the 2012 baseline of $500,000, instead of the lower 2014 level of $400,000. The effect is equivalent to the PHA freezing its base in 2012 instead of receiving an AOS.

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[3] 2014 RAD rents are available on the RAD web site (www.hud.gov/rad).

Q6: If I have a RAD award and my project is covered under an existing EPC, what are the options available in terms of satisfying that EPC obligation?

A6: Essentially, there are two basic options:

1) Pay off the EPC debt, either with proceeds from the RAD conversion (say, mortgage proceeds or tax credit equity) or through other eligible uses, e.g., existing Operating or Capital Fund accounts. Some EPC contracts require EPC lender approval to pay off (or pay down) any debt.
2) Assume the debt and continue to make the EPC debt payments post-conversion with project or other proceeds. If the converting project will assume the debt, the lender will have to agree to subordinate all interests to the RAD Use Agreement. Further, if, in addition to assuming the EPC debt, you plan on taking on new debt as part of the RAD conversion, the EPC lender and the non-EPC lender will need to negotiate over which position each will take, which often pushes the PHA towards paying off the EPC debt. Sometimes, a PHA will assume the obligation of the existing EPC debt but with non-program and non-project funds, depending on the existing EPC contractual provisions.

   Either of these options must be reflected in a PHA's Financing Plan submission. Where the debt will be paid down or paid off, the debt would be included in the development budget. Where the debt will be assumed, HUD will underwrite the transaction to ensure there is adequate cash flow to continue debt service payments.

HUD recommends a PHA consult with legal and financial advisors, the EPC lender and the new first mortgage lender (if applicable), to determine which approach will work best for the PHA and the project. HUD also encourages PHAs to work with ESCos early in the process to develop options and reach out to the OFO Energy Center at OFOEnergyCenter@hud.gov for comment.

Q7: What do I need to submit to HUD if I am converting a property covered under an EPC?

A7: Where the PHA will pay-off or assume all of the EPC debt as part of the conversion, the PHA will need to notify of its intent. The PHA will draft a letter from the Executive Director to the Field Office (copying the Transaction Manager and Energy Center) formally requesting HUD to end the EPC incentives at the time of conversion and describing the PHA plan to address EPC debt (i.e. Pay off or assume). After conversion, the Field Office will finalize the cessation of EPC incentives through a letter to the PHA Executive Director. However, where a portion of the EPC will remain following the conversion, HUD will need to amend the EPC approval letter. To do this the PHA must propose the amount to be paid off or assumed so as to ensure that the project's conversion does not increase the risk of default on the remaining EPC loan and, for partial AMP conversions, determine the appropriate updates to the project's Operating Subsidy forms (HUD 52722, 52723). This information will be submitted to the Energy Center, in the format requested, along with the supporting documents delineated in Appendix A, the PHA is highly encouraged to engage their ESCo in developing this submission. The Energy Center will review the submission and if it determines the PHA proposal to be accurate, the Energy Center will create a draft approval letter, which PHAs must submit with their Financing Plan. After closing, HUD will finalize the amendment to the EPC approval letter.

Q8: What if there is a security interest (HUD Section 30) associated with my EPC, does anything need to be done before the RAD conversion?

A8: When there are EPC Section 30 security interests, they are recorded as second liens against the property and HUD also enters into an EPC Section 30 ACC Amendment. Both of these need to be addressed. Where the debt will be paid off and the EPC terminated, the lender will release the security interest and HUD will remove the EPC Section 30 ACC Amendment. Where the debt will be assumed, the PHA and lender must determine whether to retain the security interest on the RAD project subordinate to the new RAD Use Agreement and possibly a new first mortgage lien or to release the security interest. In either case, HUD will terminate the EPC ACC Amendment as part of closing. Where a RAD project assumes EPC debt, the EPC security interest security interest in public housing will need to be removed so the remaining public housing units are not at risk of any adverse action should the converting units default on payments.

Q9: Where I am converting a project that is part of a larger EPC, and I am proposing to pay down the project's EPC debt, how will I determine the proportionate amount that must be addressed as part of the conversion?

A9: HUD's primary interest is to ensure that a converting property addresses, at a minimum, the debt proportionate with the amount of savings the project had been projected to achieve in the original EPC approval so that once the property is converted and removed from the public housing inventory, the PHA's remaining EPC remains financially viable. Accordingly, the information that PHAs must submit must clearly show the savings that were projected for the converting project, especially when it is not adequately presented in the EPC approval letter. HUD reserves the right to require additional debt treatment in the event that the remaining EPC would fail to meet the EPC statutory and regulatory standards.

Note that the EPC lender is likely to also evaluate the debt that should be addressed as part of the conversion and may require a different amount than HUD calculates. Notwithstanding the requirements of an EPC lender, PHAs must comply with HUD's requirements.

Q10: What special considerations are there if I am converting a portion of an AMP?

A10: Where a portion of an AMP is converting and a portion of the AMP will remain as public housing as part of amending the HUD approval letter, HUD will need information from the PHA in order to provide a new baseline utility consumption for the part of the AMP that will remain in public housing and continue to receive EPC incentives.

Q11: How long will it take to process the amended approval letter?

A11: The length of time depends on what kind of conversion the PHA is envisioning and over what timeframe. HUD anticipates that, once a PHA has provided complete documentation, the Energy Center will generally need between 30 and 45 business days depending on the complexity of the conversion. PHAs should begin preparing their submission as soon as a CHAP is awarded.

Q12: If I am converting multiple properties over time, do I need an amended approval letter?

A12: Each conversion to RAD necessitates an amended approval letter. However, for properties that will convert together (i.e. within the same month), a PHA may request that HUD calculate the amount of debt that must be addressed for the bundle of properties and perform a single amended approval letter that reflects all bundled units. Further, for PHAs that will convert multiple properties over time, HUD strongly recommends that the PHA submit the documents outlined in Appendix A for all of the properties. HUD will perform a single consolidated approval and produce a schedule of the amounts that must be addressed as part of each individual conversion. As each property converts, HUD will amend the approval letter in accordance with that schedule.

Where a PHA is planning to address all of the debt associated with an EPC, there is no need for an amended approval letter. (The purpose of the amended approval letter is to allow the PHA to continue to receive public housing EPC incentives in the public housing program.) A PHA may decide it makes business sense to lower risk by foregoing the complex EPC amendment process and focus on the RAD transactions. However, in doing so, the PHA would forego any future EPC incentives following the payoff of the debt. The EPC benefits would still be part of the RAD rents provided that the funding year for which the calculation was based on still had an active EPC.

Q13: Will Measurement & Verification (M&V) services still be required once a property has converted?

A13: M&V services will only be required for properties covered under an EPC that remain in the public housing program. (As part of the close-out process, however, the PHA shall prepare a report covering the final period – for example, if the project converts six months into the reporting year, then the report shall cover those six months before conversion. Although M&V reports for converted units will no longer be required to be submitted to HUD, PHAs may choose to continue receiving M&V reports from their ESCo for the converted units. For public housing units, the PHA should clearly identify within their annual submission what units are still operated as public housing and the costs and savings attributed to those units if they receive one combined M&V report.

Q14: How is the ESCo guarantee impacted when an EPC is amended as a result of a conversion of a portion of units covered under an EPC?

A14: Any changes to an ESCo guarantee are to be determined between the PHA and their ESCo. ESCo guarantees are not required for an EPC so if changes to it do occur they do not affect the conversion process.

HUD is committed to providing PHAs with ongoing assistance in understanding RAD's intersection with green and energy efficiency objectives. As additional best practices, success stories, and helpful decision frameworks are identified, HUD will maintain those resources on the RAD web site for interested parties. HUD also strongly encourages PHAs and partners to discuss creative ideas around maximizing energy and water efficient improvements through RAD. We look forward to continued dialogue with partners around this and other related issues.

For any questions or additional feedback, please contact us at the RAD mailbox at RAD@hud.gov, or the EPC Policy mailbox at PIH_EPC_Policy@hud.gov.

Appendix A – List of Documentation Needed for Energy Center Analysis

***Note: Where the PHA is paying off or assuming all of the EPC debt as part of the conversion, no submission to the Energy Center is needed. Instead, PHA will submit a letter to the Field Office as described above.**

Where following the conversion the PHA will have public housing properties that will continue to be covered under the EPC, the Energy Center requires documentation to update the EPC approval letter, much of which may be readily available from the existing HUD approval documentation. The PHA can expect to receive a clear list of needed documentation relevant to their circumstances following initial discussions with the Energy Center. Each RAD transaction and EPC may include circumstances where additional documentation is necessary to complete the analysis but generally the required documentation will include the following:

a. Original HUD EPC Approval letter and all attachments (including all separate Phase approval letters).

b. original HUD cost summary sheet

c. Revised HUD cost summary sheet to include:
   i. Original projected (not M&V based) savings –based on approved rates (not current rates)
   ii. Pro-rated installation, overhead, and profit costs-pro-rated based on the remaining term of the EPC- i.e., if the EPC was a 20 year approved EPC and there is 14 years left, then the installation, O&P would be prorated at 70% of those shown in the original HUD cost summary. The total remaining installation costs and O&P should be equivalent to the remaining loan balance; amortization schedule to confirm.

d. PIC spreadsheet that is provided in the HUD format that lists unit data for each project included in the original contract and a revised PIC spreadsheet that is provided in the HUD format that lists unit data for each project that will be remaining in the contract after the first RAD conversion.

e. A summary of the project costs noting in detail those project costs being removed from financing over the remaining term of the EPC for those units converting to RAD Project costs include:
   i. prorated installation, O&P for units converting to RAD;
   ii. M&V costs for those units converting to RAD; # of years, annual amounts.
   iii. Equipment replacement costs for those units converting to RAD; # of years, annual amounts.

iv. Any other project costs that were approved by HUD (as shown in HUDs approval letter cash flow or the signed Energy Service Agreement (ESA).

f. For the PH units remaining in the EPC after RAD conversion, a summary of equipment replacement costs remaining over the revised term of the EPC broken out by HUD incentive. We need to calculate the percentage of replacement costs per HUD incentive (i.e. 30% Frozen Rolling Base, 25% Resident Paid Utility incentive, and 45% Add on subsidy).

g. Original HUD approved cash flow and revised cash flow-

   i. Original HUD approved cash flow from the HUD original HUD approval letter. If not contained in the HUD approval letter, than the cash flow from the signed ESA.

   ii. Revised cash flow to include only those term years remaining in the EPC for those units remaining in PH. Savings to mirror the savings projected from the revised HUD cost summary form trued up for the approved inflation factor.

h. Proposed or approved inflation factors used in the cash flow with BLS backup documentation to support same;

i. original approved baselines on an AMP basis (or site basis if select sites from an AMP are measured using Option C M&V) and revised baselines for any savings measured using M&V option C-including a written narrative explaining all baseline adjustments from RAD sites being removed from the EPC. Must include backup (52722 or historical utility data from the baselines years) that supports the adjustments to the baselines since the original EPC was approved.

j. Original and Revised pre and post utility allowance consumption and cost savings spreadsheet that supports the savings from RPU sites noted in the original and revised HUD cost summary sheet.

k. Current year's M&V report.

l. HUDs field offices validation of the M&V results reported by the PHA.

m. Final signed Energy Service Agreement with all attachments and schedules in searchable PDF format.