



## **M2M Green Initiative**

### ***The Greening of the M2M Portfolio***

**[July 20, 2007]**

#### **INTRODUCTION**

HUD today introduces its Green Initiative, a nationwide pilot initiative to encourage owners and purchasers of affordable, multifamily properties to rehabilitate and operate their properties using sustainable Green Building principles. These principles comprise sustainability, energy efficiency, recycling, and indoor air quality, and incorporate the “Healthy Housing” approach pioneered by HUD (*see* <http://www.hud.gov/offices/lead/hhi/index.cfm>).

The Green Initiative will focus on properties within HUD’s Section 8 portfolio, specifically properties in the Mark to Market (M2M) Program administered by the Office of Affordable Housing Preservation (OAHP).

**What is Green Building?** The real estate industry, including the housing industry (and more particularly the affordable housing industry), is undergoing a fundamental shift toward Green Building principles. Green Building is an approach to sustainable development that is designed to result in a property that reduces its impact on the environment, costs less to operate, and improves the residents’ quality of life. Green building considerations start with site selection and include building placement and design, materials and techniques used in construction, and all the systems, appliances, and fixtures within the building. Wikipedia provides a good working definition for the OAHP Green Initiative:

*Green building is the practice of increasing the efficiency with which buildings and their sites use and harvest energy, water, and materials, and reducing building impacts on human health and the environment, through better siting, design, construction, operation, maintenance, and removal — the complete building life cycle. (Wikipedia, [http://en.wikipedia.org/wiki/Green\\_building](http://en.wikipedia.org/wiki/Green_building))*

To date, the focus of green initiatives nationally has been primarily on new construction rather than on rehab, particularly the moderate level of rehab that is typically associated with M2M properties. There are fewer opportunities to Go Green in rehab, but the opportunities are nonetheless significant and worth pursuing, particularly when viewed in the context of the M2M standard 20-year schedule of property repairs and replacements.

Green rehab practices should result in lower utility costs that benefit HUD as well as residents. They should also result in other benefits, generally in the form of lower environmental impact. When rehab is performed in a manner that meets both Green and Healthy Housing principles, residents will benefit from lower utility costs (to the extent the cost savings are shared by the owner and residents), improved indoor air quality, lower risk of pest infestations, lower levels of allergens, and reduced risk of mold-related illness.

**Why apply Green principles in the M2M Program?** The M2M Program offers a unique platform for establishing a Green Initiative in the HUD affordable housing portfolio because it can be implemented within existing statutes, regulations, and authorities. M2M affords the opportunity to implement Green Building principles in a representative sample of M2M restructurings involving properties that are already undergoing rehabilitation, from within the larger HUD portfolio. As HUD’s primary housing preservation tool since its creation in 1997, OAHP has restructured more than 1,600 projects nationwide through the M2M program. These projects are privately owned, HUD-subsidized (through Section 8), multifamily properties, with approx 100 units each, on average. In addition to rehabilitating properties, M2M also resizes and restructures property debt to account for market rent levels, to pay for rehabilitation and 20 years’ of estimated repairs and replacements, and to establish a financially viable project for the long term.

M2M provides an opportunity to test the impact of Green and Healthy Housing principles in the existing HUD-subsidized multifamily inventory by providing modest incentives to owners and purchasers to perform needed rehab and maintenance using Green alternatives, and to collect ongoing data to validate impacts on utility consumption and indoor air quality.

In developing the Green Initiative, OAHP has consulted with several industry experts, and their participation has been invaluable in the development of this outline. By launching the Green Initiative through M2M, HUD has the opportunity to continue to work with industry leaders to shape both the future of HUD’s efforts and of the Greening of affordable housing in this country.

## **PROGRAM OUTLINE**

**1. Overview:** OAHP’s Green Initiative is designed to incorporate Green principles into the property rehabilitation required in conjunction with M2M restructuring as well as into the repairs and replacements that are scheduled to occur over the next 20 years of the project’s life.

Each property undergoing a M2M restructuring is subject to a Physical Condition Assessment (PCA), a detailed inspection used to identify rehabilitation needs and estimate repair and replacement needs. For projects in the Green Initiative, the PCA scope will be expanded to explore Greening opportunities. OAHP will include as many Green alternatives as the property owner advocates, as the transaction can accommodate, as are appropriate for a specific property, and as OAHP determines are within its statutory authority.

OAHP will not stipulate what elements must be included in any given property, but will rely on its contractor/underwriters (the Participating Administrative Entities or PAEs) and the owner to highlight the opportunities, costs, and benefits of Green alternatives on each subject property.

As an incentive to property owners to “Go Green”, OAHP may determine the Green replacements to be Significant Additions as that term is defined statutorily, thus reducing the owner’s required financial contribution to the rehabilitation costs from the traditional 20 percent to as little as 3 percent of total costs. Upon the owner’s assurance that the property management company has a Leadership in Energy and Environmental Design (LEED) Accredited Professional, OAHP may also increase the Incentive Performance Fee (IPF) to support the owner’s ongoing maintenance of the

Green property.

**2. Eligibility:** Owner participation in the Green Initiative is voluntary. Effective immediately, OAHP will offer the Green Initiative to all owners currently engaged in M2M who have not yet executed a Restructuring Commitment, and to all owners entering M2M during the life of the Green Initiative. OAHP may consider a case-specific waiver request if an owner with a Restructuring Commitment wants to participate in the initiative. Owners may choose to undergo a traditional M2M restructuring, but will not be eligible for Green Initiative incentives.

**3. Due Diligence:** The traditional M2M due diligence will be supplemented with revisions to the Physical Condition Assessment (PCA) scope of work designed to capture more opportunities for Green alternatives, and with an energy audit. OAHP is also expanding the qualifications for its contracted PCA inspectors.

- A. **Green PCA Report:** OAHP is expanding the existing PCA scope of work to include an energy audit and a review of all possible opportunities to Green the property. The report will provide a cost comparison between traditional and Green alternatives and a discussion of the benefits of the Green alternatives (financial and otherwise) for the subject property.
- B. **Inspector Qualifications:** OAHP plans to continue to use the existing network of PCA contractors who have serviced the M2M Program since its formation, but will also be expanding the areas of PCA services for contractors having Green qualifications over time and is encouraging the network to expand and incorporate more Green industry representatives. OAHP expects to see all PCA contractors become LEED Accredited, for example, and OAHP plans to make a continuing education component (particularly focused on the Green industry) a standard of the qualifications.

**4. Expanded Due Diligence:** Owners are incentivized to pursue all available grants from federal, state, and local sources, utility companies, appliance manufacturers, etc., that may be available to support the funding of the Greening of the property undergoing M2M restructuring. OAHP will allow those funds to be incorporated into the restructuring (much as in an Additional Funds transaction). In exchange, HUD may allow a transaction cost of up to ten percent of the amount of the grant, up to a maximum dollar amount, payable to the owner and/or the PAE for securing the available grants.

**5. Underwriting Considerations:** OAHP is establishing threshold Green building principles for property owners that desire to participate in this Green Initiative. Beyond these threshold principles, OAHP will not stipulate what elements must be included in any given Green property, but will rely on its contractor/underwriters (the PAEs) and the property owner, informed by the Green PCA Report, to highlight the opportunities, costs, and benefits to pursuing the Green alternatives at each property.

- A. **Principle Components of Green Initiative:** A key component of the Green Initiative will be the owner’s commitment to maintain the Green property beyond the 20-year schedule of repairs and replacements, and at least as long as the extended term of the Use Agreement (generally 30 years, although it is 50 years in some instances). The Green Initiative also includes the preparation of a Green Operating & Maintenance (O&M) Plan that includes

these principal components:

- (i) Resident Involvement, Outreach, and Incentive Plan – The benefits of the Green elements are achieved through daily operations; the Plan addresses resident participation, education, and incentives.
  - (ii) Integrated Pest Management Plan (IPM) – The IPM generally addresses the item(s) attracting the pests and takes steps to remove or contain them rather than focusing on eliminating the pests, which typically requires toxic pesticides.
  - (iii) Baseline Green Requirements for Ongoing Operations – In addition to the Green rehab completed as part of the M2M restructuring, the Baseline addresses how the repairs and replacements will be greened throughout the 20-year schedule.
  - (iv) Monitoring Plan Development – The M2M restructuring may require electronic monitoring and remote data collection of energy use, water consumption, and certain environmental conditions. HUD intends to gather property performance data and make it widely available (respecting privacy concerns) in the hope that the academic community will join with industry and use this data to learn more about the correlation between Green alternatives and cost savings or other benefits. The owner must agree to cooperate with all monitoring, data gathering, reporting, and evaluation activities.
- B. Owner Contribution: OAHP will review the recommendations of its PAEs and the subject property owner with regard to Green elements that are not in the local code but that provide a significant benefit to the property. For these items, OAHP will reduce the required owner contribution from 20 percent to 3 percent, provided that this can be done without jeopardizing a viable restructuring plan. OAHP may also increase the owner’s required contribution to certain rehabilitation items beyond 3 percent, when it is necessary to do so in order to develop a viable restructuring plan, or when there are only marginal benefits to the proposed Green approach.
- C. Subject Property Benefits: OAHP will allow the owner to include only those Green elements that address the needs of the subject property.
- D. Property Location: OAHP expects that the Green PCA report will consider what is most appropriate for the subject property after considering its location. Furthermore, OAHP and its PAEs will consider the context in which each property is operating and will be guided accordingly with regard to the Green Initiative. (For example, a SEER 16 air conditioner will not be as advantageous to a property in Northeast Maine as it would be to one in Southern Alabama). M2M Program standards are not changing. the PAE must still determine what improvements are necessary to make the subject property market-standard, and then determine whether those improvements can be Greened.
- E. Exception Rents: OAHP has the flexibility to allow the owner to include reasonable Green elements in a M2M restructuring that can be structured with market rents. Within statutory limits, OAHP has authority to utilize above-market rents (Exception Rents), if warranted by preservation need and by property finances, but owners must make a detailed and case if

they wish to introduce Green elements using Exception Rents. When a restructuring requires Exception Rents and when Green elements are planned, OAHP will examine the incremental cost of the Green elements (if any), the potential cost savings and other benefits to the property, and the time period for recovering the cost of the investment. OAHP may trim its funding contribution or disallow certain Green elements in order to reduce or eliminate the need for Exception Rents. An owner can structure a transaction with part Green/ part non-Green rehabilitation to reduce the level of rents needed for a viable transaction.

F. Incentive Performance Fee (IPF): An owner is eligible for an increased IPF if the owner takes full advantage of all Green opportunities identified in the Green PCA report, meets the threshold Green principles, and provides evidence that its onsite property management company has at least one LEED-Accredited Professional actively involved in the management of the subject property.

G. Rehabilitation Escrow Set-up: The OAHP rehabilitation escrow is a reimbursement account. The owner completes required repairs and improvements, an inspector certifies the repairs were completed in accordance with the requirements, and the rehabilitation escrow administrator (generally the PAE or the mortgage lender) reimburses the owner. OAHP will require a modified Rehabilitation Escrow Deposit Agreement (REDA) for Green Initiative transactions that have repairs to be completed in the first year after M2M restructuring. The Green REDA will differ from the standard rehabilitation escrow in that it allows the owner to choose a more traditional alternative if a selected Green material or product is not available. The owner is strongly encouraged to engage a contractor and obtain current actual cost estimates for a Green rehab plan rather than relying on industry estimates. The PAE must ensure that the Exhibit A description of repairs and improvements is sufficiently detailed to guide the rehabilitation escrow administrator and inspector in overseeing and inspecting the improvements.

H. A “Reasonable” Standard: OAHP and its PAEs will implement the Green Initiative in a common-sense, cost-effective manner and, in so doing, may limit plans to use Green alternatives, especially when doing so requires Exception Rents.

**6. Post-Closing Considerations:** OAHP will continue to monitor all Green M2M properties after closing.

A. Rehabilitation Escrow Completion: As with all other M2M restructurings, OAHP’s New York office will oversee the rehabilitation escrow administrator and the work to be completed in the M2M restructuring.

B. Reserve for Replacements (R4R) Reimbursement Requests and Green O&M Plan Monitoring: HUD’s Real Estate Management System (REMS) will contain a designation noting the Green R4R accounts. HUD expects the effective monitoring of the account to occur through a combination of field-office project manager monitoring and owner certifications. HUD will process the approved reimbursement request in the traditional manner.

**7. Contractual Issues:** OAHP will modify its contracts with PAEs participating in the Green Initiative to provide for an incentive fee (the amount to be determined) for processing a Green Initiative transaction. The PAE must agree to have one or more LEED-accredited professionals on staff (presumably from the ranks of existing personnel) by [date TBD], in order to earn the incentive fee. That representative must review all Green Initiative restructuring plans submitted to OAHP.

**8. Pilot Program Contacts:** Questions or comments regarding the M2M Green Initiative should be referred to Ted Toon, OAHP Deputy Assistant Secretary, and Carolyn Carpenter Porritt, OAHP Headquarters Financial Transaction Specialist.

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