Portland Housing Bureau
Mayor Ted Wheeler • Director Shannon Callahan

Portland's Housing Bond
Investing Together in Affordable Homes

Date: October 3, 2019

To: Bond Oversight Committee

From: Shannon Callahan, Director

Cc: Molly Rogers, Deputy Director
Jill Chen, HIPP Manager
Mike Johnson, Finance and Accounting Manager
Suzanne Zuniga, Senior Housing Construction Coordinator

Re: Information Request on Project Cost Monitoring

BACKGROUND & REQUEST:

At its July 18, 2019 meeting, the Bond Oversight Committee requested a better understanding of how PHB manages affordable housing construction projects with the selection of nine new projects funded by the PHB Housing Bond. Since passage of the constitutional amendment in 2018, PHB's strategic focus on the bond implementation has shifted from being an owner/operator, to that of a gap lender with a subsidy per unit focus due to the increased importance of leverage.

Development is a complex process that includes risks due to unknown conditions and assumptions and evaluating the Bond Opportunity Solicitation (BOS) proposals for feasibility at a very early stage involves many unknowns. This memo summarizes PHB's cost monitoring steps at each stage of the development process used to reduce the risks that PHB awards and subsidy/unit are exceeded.

PHB COST MONITORING:

Solicitation / Pre-Award: Prior to issuing the BOS, PHB reviewed projects in its portfolio and those in the pipeline to form benchmark estimates for reasonableness in construction costs, financing assumptions, contingencies and operating expenses. Through this analysis PHB determined that in order to meet all the BOS production goals for 30% Area Median Income, Permanent Supportive Housing and family-sized units, the maximum subsidy per unit for new construction need to be capped at $150,000 and for acquisition/rehab at $100,000. Also, key components of PHB's financing requirements were then included in the BOS Underwriting Metrics, Appendix C.

In addition to ensure consistency among projects' financials, PHB required all proposers to use an adapted Oregon Housing and Community Service (OHCS) pro forma template to include the same line items for uses/sources for capital costs and income/expenses spreadsheets to prompt proposers to consider leveraging noncompetitive 4% Low Income Housing Tax Credits (LIHTC) and Senior Debt. This process enables PHB to quickly compile and compare key metrics across all proposals, including subsidy/unit, costs/unit, costs/square foot, operating expense/unit, requested vouchers, and any funding gaps to gauge reasonableness which helped inform the technical and financing feasibility evaluation.

Finally, PHB pre-negotiated key conditions with short-listed development teams who were asked to:

a) correct for errors in the pro forma that did not meet BOS investment requirements,
b) use the appropriate level of wage rates (BOLI and/or Davis Bacon) for construction costs,
c) meet PHB maximums for developer fees,
d) contain all the minimum required construction hard costs, soft cost, estimating and escalation contingencies and disclosed these amounts; and
e) identify the full team roster including their costs.

If original proposals did not contain sufficient and inaccurate information, development teams were asked to provide an updated pro forma including any changes in the subsidy requested. In addition, all but one project out of the nine BOS awarded projects are fully funded, requiring no additional gap funding, thereby reducing uncertainty in the project schedule and decreasing the risk of price escalations.

Prior to announcement of awards, PHB communicated with each development team on key issues and each award letter include critical aspects: 1) any costs increase in the construction budget would have to be "made-up" through contingencies and/or developer fees and 2) financing plans must be agreed by all parties by a certain date.

Pre-Development: The biggest challenges in cost containment typically arise during predevelopment which is the time between the award date and financial close. As in previous solicitations, all proposers in the BOS are at the very early stage of their real estate development process. Some have only Letters of Intent to purchase the land, so have not started due diligence for environmental considerations and some do not have conceptual designs, so constructability and costs estimates have been based off generalized assumptions of costs per square foot. A few proposers were somewhat more advanced with construction cost estimates from contractors and letters of interests from financing institutions. However, none of the new construction projects have advanced schematic designs and of the rehab/acquisition projects, none of the costs were detailed.

Many affordable housing developers do not have substantial internal funds to pursue predevelopment, unless they know their project will have public backing. The cost of additional due diligence and design can become prohibitive to smaller developers. Once awarded, the proposers usually request a predevelopment loan from PHB to pay for due diligence costs (i.e. environmental and geotechnical reports), architectural designs, permitting and cost negotiations which can greatly impact the scope and scale of the project.

During predevelopment, senior commercial lenders and tax credit investors also refine their requirements and gaps may be caused by revisions in the financing assumptions. Such as in 2017 when uncertainty and changes in the federal tax codes devalued Low Income Housing Tax Credit (LIHTC) from over $1.00 to under $0.85 resulting in significant funding gaps and delays in closing.

Predevelopment loans are handled like many of the loans PHB processes. There is a promissory note with terms and a maturity date. The loan is recorded and tracked in the bureau's loan management system (HDS). Funds are disbursed through the City's accounting system (SAP). A Senior Construction Coordinator (SCC) reviews invoices and approves disbursements, which are then approved by the HIPP manager (disbursements over $3million are also approved by the Deputy Director). The Finance and Accounting staff ensures that sufficient funds are appropriated for the loan and disburses the funds in a manner that they can be tracked by project. The City Office of Management and Finance reviews the disbursement to verify that the correct party is paid.

To ensure the project is within budget and on time, PHB works very closely with the developer to problem solve and mitigate risks, including:

- During due diligence: PHB reviews surveys, geotechnical reports, environmental reports and other due diligence documents to identify potential risks/mitigants, additional costs, and appropriate contingencies;
- During design and the "early, Early Assist (EA)": PHB helps identify issues with other bureaus in particular related to land use and/or entitlements approvals, monitors the design and budget, and suggest possible revisions/value engineering;
- During permitting: Through the Bureau of Development Services (BDS) pre-app meetings, GATR[1] processes and established inter-agency relationships, PHB staff problem solve and facilitate the permitting processes to keep projects on schedule and within budget;
- During bidding: PHB works closely with the development team to review and approve the construction budget and final GMP contract; and
- In financing: PHB works with the development team to maximize leverage and create a mutually acceptable financing structure.

This financing usually involves the repayment of the predevelopment loan and the inclusion of that funding into the construction loan. The repayment occurs at closing of the construction loan– paying off the predevelopment loan and creating the construction loan. Finance and Accounting staff ensure that the repayment is credited to the proper account so funds can be rolled into the construction loan. The new loan is then recorded in HDS.

Once the financing plan and terms are agreed upon and documentation negotiated and executed, the construction phase starts where the risks of additional cost increases are limited as the developer has signed a hard cost construction contract with the general contractor (usually, immediately after financial close) and all soft costs have been contracted and/or paid.

Construction Phase: Cost increases and schedule delays during construction occur due to unforeseen and/or uncontrollable circumstances including additional inclement weather (i.e. snow days or poor air quality preventing crews from working), unforeseen environmental conditions (i.e. sink hole) or change in code during construction (i.e. fire protection). Impacted public agencies that provide key field construction support such as PGE and Pacific Power may also lead to unforeseen construction schedule delays. Additional costs for these expenses are generally covered under project contingencies.

To control costs, PHB SCC works closely with the developer in each stages of a project including design development, cost estimating, bidding, permitting, construction, and close out. To ensure a smooth transition from design to construction, PHB coordinates and/or actively attends preconstruction meetings to discuss a number of issues including: a) DMWESB-SDV reporting requirements, Davis Bacon prevailing wage and Section 3 workforce/apprentice training, b) Bureau of Development Services inspections, to coordinate processes for inspections, deferred submittals and revisions, c) the general contractor and subs to discuss safety, pay app, change order approvals and reporting, d) green building policies and e) funders' coordination.

During construction, PHB SCC attends, as needed, regular owner-architect-contractor (OAC) meetings to track the construction progress, monitor and problem solve issues, approve and track change orders and addbacks, review construction pay-apps and provide any early warnings if construction costs and/or completion schedule are not in-line with PHB approvals. The continuity of

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[1] Government Accountability Transparency Review

PHB oversight at OAC meetings over the course of the construction schedule (usually 12-20 months) allows PHB to perform an informed fiduciary review of disbursement requests and change order approvals.

Construction funds are disbursed in the same manner as the Predevelopment funds except Construction funds are from Portland's Housing Bond.

At the completion of construction, PHB reviews the reconciled soft and hard costs for the project and approve any cost saving determination. Any identified project cost savings at close out are split between PHB and the developer based on a pre-determined percentage documented in the project's promissory note. If a project experiences unforeseen cost escalation during construction which exceeds identified project contingencies for hard and soft construction, PHB is not required, nor does PHB provide any additional project funding beyond final approved amounts from City Council based on Housing Investment Committee recommendations and approvals. More recently, PHB's construction projects are seeing costs savings as the rapid rise of construction has abated somewhat since 2017. If the loan is curtailed due to these savings, Finance and Accounting ensures that the loan principal balance is adjusted accordingly in HDS, and that the unspent funds return to the proper account.

SUMMARY

The BOS process sought to minimize the risks that increasing costs would result in increased PHB subsidy throughout the development process. And as indicated process and protocols are in place to establish expectations with selected development teams, clearly defining the conditions of each award, and actively working with teams after the award on cost monitoring throughout the predevelopment and construction stage to ensure that PHB gap funded projects provide durable, quality affordable housing for Portland's citizens.