December 12, 2003

Internal Revenue Service
Susan Reaman
Branch Chief
Branch 5 (CC:PSI:B05)
1111 Constitution Avenue, NW
Washington, DC 20224

Dear Ms. Reaman:

This letter is submitted on behalf of the Council for Affordable and Rural Housing, the National Apartment Association, the National Affordable Housing Management Association, the National Association of Home Builders, the National Leased Housing Association and the National Multi Housing Council in support of a change to Internal Revenue Service regulations, §1.42-10, that establish the method for determining utility allowances for calculating gross rent under the Low Income Housing Tax Credit ("housing credit") program. We believe that the current methodology results in inaccurate utility allowances, an incorrect calculation of gross rent and ultimately endangers the financial feasibility of housing credit projects. We urge that the regulations be modified as described below to provide greater options in determining the appropriate utility allowance for a property.

Background. Under section 42(g)(2)(B)(ii) of the Internal Revenue Code, the gross rent with respect to rent-restricted units receiving housing credits includes a utility allowance as determined by the Secretary of the Treasury. The regulations in §1.42-10 set forth a mechanism for determining the applicable utility allowance for a particular building. The regulations provide in §1.42-10(b)(4)(ii) that if a housing credit property, or the tenants at the property, do not receive FmHA (now RHS) or HUD assistance, the appropriate utility allowance for the units is the applicable Public Housing Authority (PHA) utility allowance. Alternatively, if an estimate is obtained from a local utility company, that estimate becomes the appropriate utility allowance for all rent-restricted units of similar size and construction in the building. If at any time during the building's extended use period, the applicable utility allowance changes, the new utility allowance must be used to compute gross rent within 90 days.

Issues. We believe there are three fundamental problems with the regulations described above. First, the applicable PHA utility allowance, typically based on the cost of utilities in older PHA rental housing properties, often has little correlation with actual utility costs for newer, more energy efficient housing credit properties. Housing credit properties placed in service today utilize new, cost-effective technologies and materials that are designed to reduce energy consumption. Some examples are higher rated roofing and wall insulation, double paned "thermal" windows, and more efficient furnaces, air conditioners, and water heaters. As a result, the major utility costs associated with the heating and cooling of a new property are not comparable to such costs in older PHA properties. For that reason, it makes little sense for housing credit properties to utilize PHA utility cost estimates.

Our second concern is that the option to use estimates from local utility companies is not a meaningful alternative to PHA utility allowances because such estimates are rarely available as very few utility providers maintain data that can be used for this purpose. In either case, PHAs and utility companies do not have any incentive to provide more specific or detailed utility cost estimates for housing credit properties. Further, deregulation has created added complication to utility information. In many states, deregulation has resulted in multiple utility providers in any given local jurisdiction and, in some cases you can have combined utility provision and transmission. For example, for electricity, owners must combine data from the entity that provides the lines and infrastructure to transmit the utility (i.e. kilowatt usage) and the entity that generates the electricity itself (i.e. rate per kilowatt). Current regulations do not allow for the combining of two or more utility providers.

The regulation should allow other options for determining utility allowances. For example, many state housing credit agencies, which have an interest in establishing the most accurate utility cost estimates for use in underwriting and in helping to maintain housing credit properties, could provide the necessary data. They are especially cognizant of the need to protect the viability and financial soundness of their portfolio of affordable housing and are much more likely to have information about actual utility usage and costs for housing credit projects based on their role as allocators of the credit. Finally, state credit agencies have more direct information about the specific materials and systems utilized in particular housing credit properties to which they award credits.

We understand that the expertise, resources, and willingness to take on increased responsibilities will vary between housing credit agencies. Many agencies will likely resist any change in regulations that impose significantly greater responsibilities and require the expenditure of additional staff and assets. In addition, in some regions of the country, particularly those with lower utility costs, utilization of PHA utility cost estimates has not been as problematic for housing credit properties. For these reasons, we do not recommend eliminating the PHA or utility company option or requiring states to adopt their own utility cost estimate. Instead, we believe the regulations should be enhanced to provide for other options for determining the applicable utility allowance.

Our third and final concern has to do with changes in utility allowances during the stabilization period of these properties. A housing credit project is underwritten during the development stage with a specific utility allowance, however, when a PHA issues a new allowance before the project is stabilized, it can result in decreased rents that negatively impact cash flow and undermine the financial viability of the property. It is important for housing credit properties to achieve pro-forma income levels based on economic stabilization and to establish positive cash flow to fund operating and replacement reserves to ensure that the property can provide the complete range of services to its residents. Deferring rent adjustments due to utility increases until the property is stabilized allows the property to achieve this economic stabilization. A stabilized property is commonly defined as one that has achieved 90 percent occupancy for 90 consecutive days.

<u>Proposal</u>. Our first two concerns can be addressed by providing additional options for determining utility allowances. The regulations, §1.42-10(b)(4)(ii), should be amended to permit state housing credit agencies to determine an appropriate utility allowance for housing credit properties. Where the state agency has established a utility allowance for a property, it would be an additional option for housing credit properties in addition to the two options under the current rules. Where the housing credit agency has not determined an appropriate utility allowance, the existing options in the regulations – the applicable local PHA utility allowance or the utility company estimate, including combined rate charges from multiple utility companies due to deregulation – would be applicable.

In establishing an appropriate utility allowance, the state housing credit agencies should be required to take into account certain criteria that enable an accurate utility allowance estimate to be established for the specific property. At a minimum, state housing agencies should be required to include the following: local utility rate data, property type, climate and degree-day variables by region in the state, and taxes and fees on utility charges. These would be minimum requirements and states should be encouraged to utilize additional criteria in establishing an appropriate utility allowance such as property building materials and mechanical systems. State housing credit agencies should also be allowed to use actual utility data collected by an owner from a property's residents or approve a utility allowance for a specific property based on the submission of the required data by the owner.

The decision whether or not to establish their own appropriate utility allowance should be at the discretion of the state housing credit agencies. Further, as long as the minimum criteria described above are utilized, the regulations should not impose any Treasury approval process for the specific methods the state housing credit agency uses to establish the allowance.

With regard to our third concern, changes to the original utility allowance for a property should be deferred until a property has stabilized, that is, until it has achieved 90 percent occupancy for 90 consecutive days.

Thank you for your attention to these comments. We would welcome the opportunity to meet with you to further discuss this issue and craft a solution to this problem.

Council for Affordable and Rural Housing
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National Multi Housing Council

Cc: National Council of State Housing Agencies