Examination Into Selected Aspects Of The Administration Of The Public Facility Loans Program

B-153449

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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Dear Senator Tower:

This is our report on our examination into selected aspects of the administration of the Public Facility Loans program, Department of Housing and Urban Development, as requested in your letter dated January 28, 1969, and pursuant to subsequent discussions with your staff. The examination also included a review of the financial soundness of a loan made to the city of Huxley, Texas, for the construction of a natural gas distribution system.

We believe, and your Administrative Assistant has concurred, that, in view of our findings and recommendation, copies of the report should be furnished to the appropriate Senate and House legislative committees. Accordingly, pursuant to his request, additional copies are provided herewith for the Senate Committee on Banking and Currency and the House Committee on Banking and Currency.

Copies of this report are being sent to the Secretary of Housing and Urban Development.

Sincerely yours,

Comptroller General
of the United States

The Honorable John G. Tower
United States Senate

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ABBREVIATIONS

GAO General Accounting Office

HUD Department of Housing and Urban Development

LP liquified petroleum

PFL public facility loans

COMPTROLLER GENERAL'S REPORT TO THE HONORABLE JOHN G. TOWER UNITED STATES SENATE

EXAMINATION INTO SELECTED ASPECTS OF THE ADMINISTRATION OF THE PUBLIC FACILITY LOANS PROGRAM Department of Housing and Urban Development B-153449

D I G E S T

WHY THE REVIEW WAS MADE

In accordance with the request of Senator John G. Tower, the General Accounting Office (GAO) has examined into selected aspects of the administration of the Public Facility Loans program by the Department of Housing and Urban Development (HUD). The examination included review of

- --the legislative history of the program (see p. 6),
- --the policies and procedures established by HUD to implement the program (see p. 9),
- --the implementation of the policies and procedures at the HUD Region V office in Fort Worth, Texas (see p. 15), and
- --the financial soundness of a loan made to the city of Huxley, Texas, to construct a natural gas distribution system (see p. 21).

FINDINGS AND CONCLUSIONS

HUD is authorized by statute to make loans to finance the construction of certain essential public works or facilities. The law provides that, in processing applications for financial assistance, the Secretary give priority to applications by smaller communities (under 10,000 population) for financial assistance in the construction of basic public works (including works for the storage, treatment, purification, or distribution of water; sewer facilities; and gas distribution systems) for which there are urgent and vital public needs.

The law does not require that such needs for projects exist for communities to receive financial assistance; it provides that priority be given to applications for financial assistance by smaller communities having urgent and vital needs for projects.

The legislative history of the program does not define what constitutes an "essential public works" or an "urgent and vital need" nor

indicate the priority that should be given to applications for financial assistance by smaller communities. (See p. 7.)

HUD policies and procedures define essential public works as those for which a public purpose has been established. They also require that loan applications be rated to identify those warranting processing and that such applications be subjected to engineering, legal, and financial reviews. (See pp. 13 and 9.)

HUD has not, however, developed written procedures for (1) systematically determining whether urgent and vital public needs exist for proposed projects of smaller communities for the purpose of giving priority consideration to applications for loans by such communities and (2) establishing priorities for those smaller communities having such needs for basic public works. Also, in practice, HUD has made loans to large communities for projects at the same time that it has deferred loans to small communities because of program funding limitations. (See p. 13.)

Region V's loan application processing activities were carried out in a manner generally consistent with HUD's policies and procedures. (See p. 15.) In processing loan applications, however, Region V makes no distinction between applications for loans by small and large communities and does not establish whether there are urgent and vital needs for projects for the purpose of determining priorities for processing loan applications by smaller communities. (See p. 17.)

GAO believes that, to properly implement the statutory provision, procedures would have to be adopted providing that applications for loans by smaller communities having urgent and vital needs for projects be funded before applications by larger communities. (See p. 14.)

GAO believes that HUD's determination that the city of Huxley was eligible for a loan for a natural gas distribution system was consistent with its definition of essential public works and that financing was not otherwise available to the city on a reasonable basis. In the absence of a legislative definition, GAO could not determine whether the system satisfied the statutory requirement of "essential." (See p. 21.)

Also, although the city of Huxley is classified as a small community, GAO found no evidence that HUD had considered whether an urgent and vital need existed for the system for the purpose of giving priority to the processing of the loan application or that the application had been processed on a priority basis. (See p. 21.)

HUD determined that the loan to Huxley would be financially sound on the basis of a revenue-debt ratio (quotient) of 1.48, which was somewhat greater than HUD's requirement of 1.4. GAO believes that HUD's computation of the ratio on the basis of estimates of the debt

service requirements (principal and interest) and revenues was reasonable. Also GAO found no evidence that the estimated operating costs were unreasonable. (See p. 22.)

RECOMMENDATIONS OR SUGGESTIONS

GAO proposed to the Secretary of Housing and Urban Development that, to properly meet the priority requirements of the law, he adopt procedures whereby applications for loans by smaller communities having urgent and vital needs for projects would be funded before applications by larger communities. Also, such application processing would require the formulation of a definition of "urgent and vital need." (See p. 14.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

The Secretary agreed with GAO's summarization of HUD's basic program policies and procedures and with GAO's analysis of the considerations bearing on the Huxley loan. The Secretary did not agree with GAO's views as to what was required to implement the priority provision. The Secretary stated that HUD had construed the priority provision as establishing a relative, rather than an inflexible, order of precedence and that HUD's application of the rating system provided a high degree of priority to smaller communities and amply reflected the determination of "urgent and vital need." (See app. II.)

GAO continues to believe that the manner in which loan applications are processed does not adequately serve to give priority to loan applications by smaller communities having urgent and vital needs for basic public works. (See p. 26.)

In view of the manner in which the priority provision for smaller communities has been implemented, GAO is recommending that the Secretary require HUD to reexamine its interpretation of the priority provision of the law and its rating system giving careful consideration to the need for developing procedures for ensuring that smaller communities having urgent and vital needs for basic public works are being afforded the full benefit of the priority provisions. (See p. 26.)

CHAPTER 1

INTRODUCTION

The General Accounting Office has examined into the procedures and practices employed by the Department of Housing and Urban Development in administering the Public Facility Loans (PFLs) program to determine whether the activities met the provisions of law and were in accordance with the intended purposes of the program. We also examined into the loan made to the city of Huxley for a natural gas distribution system. The examination was made at the request of Senator Tower.

Under the PFL program, HUD makes long-term loans for periods up to 40 years and in amounts up to 100 percent of the costs of projects to assist communities in financing the construction of needed public works. Loans may be made to finance the construction of such public works as water and sewer facilities; gas distribution systems; street improvements; public buildings, except schools; and recreation facilities. With a few exceptions, recipients of loans must be local units of Government or State instrumentalities having populations of less than 50,000.

The Housing Amendments of 1955, as amended (42 U.S.C. 1491), authorized the Secretary of Housing and Urban Development to borrow up to $600 million from the Secretary of the Treasury to finance a revolving fund from which PFL loans are made. In addition to financing through borrowings from the Department of the Treasury, financing for the fund has been obtained from the sale of participation certificates. To obtain funds from the sale of participation certificates, bonds purchased from communities under the PFL program were assigned to a trustee who used these bonds and obligations of other agencies to establish a pool of obligations in which an interest was sold to private investors.

From inception of the PFL program in August 1955 through June 30, 1969, funds totaling $410.9 million had been made available to the fund, consisting of $220.5 million borrowed from the Secretary of the Treasury, $160 million obtained from the sale of participation certificates,

and approximately $30.4 million in loan repayments and interest. In recent years, the Bureau of the Budget has authorized a spending level of about $40 million annually.

From the inception of the PFL program in August 1955 through June 30, 1969, HUD made 1,276 loans for a total of about $515 million. The difference in the amount of the loans and the available funds is accounted for primarily by loans approved on the basis of borrowing authority for which funds have not been made available for disbursement purposes.

The following table shows the number of loans made for various types of facilities.

Facility type	Number of applications received	Loans				
		Number	Percent of applications	Percent of number of loans	Amount of loans (million)	Percent of amount of loans
Water	1,569	762	48.5	59.7	$230	44.6
Sewer	627	298	47.5	23.4	112	21.7
Gas	153	74	48.3	5.8	31	6.2
Health	127	73	57.4	5.7	63	12.2
Street	79	22	27.8	1.7	17	3.3
Other (note a)	143	47	32.8	3.7	62	12.0
	2,698	1,276	47.2	100.0	$515	100.0

[a]Includes harbor facilities, administration buildings, cultural centers, electrical systems, and recreational areas.

As shown above, 74 loans, amounting to about $31 million, were for gas systems. These loans constituted 6 percent of the total number of loans--1,276--and 6 percent of the total amount of the loans--$515 million--that had been approved up to June 30, 1969.

CHAPTER 2

LEGISLATIVE HISTORY AND STATUTORY REQUIREMENTS

The PFL program was authorized by the Housing Amendments of 1955 (42 U.S.C. 1491), approved August 11, 1955. The program was proposed in an original bill, "the Public Facilities Loan Bill of 1955" (S. 1524, 84th Cong. 1st sess.). Senate bill 1524 was not acted upon; however, the general provisions of the bill were subsequently incorporated into the Housing Amendments of 1955.

The legislative history indicates that the program was intended primarily to make more readily available financing for sanitary facilities for smaller communities. In testifying on Senate Bill 1524, a sponsor of the bill remarked that the need for this type of aid had been brought to his attention by a group of 40 mayors from his home State who urged that something be done to make more readily available financing for sanitary facilities for smaller municipalities. He said that a survey of his State had disclosed several hundred cases where there were no sewerage facilities and many cases where there were no water distribution facilities.

The PFL bill of 1955 included a provision that priority be given to applications of smaller municipalities having urgent and vital needs for public works. In regard to this provision, the sponsor stated, in part, that:

> "*** the priorities provided would for the most part guarantee that these [projects] would be sanitary facilities and essential public works, with the understanding that gas distribution could be considered."

Other than this statement, we found no mention of gas distribution systems in the legislative history.

The Housing Amendments of 1955 set forth the purpose of the PFL program as being the extension of credit to assist in the provision of certain essential public works or facilities where credit is not otherwise available on reasonable terms and conditions.

The law provided that loans be made for periods up to 40 years and at rates of interest determined by the Secretary of HUD in accordance with a statutory formula. The law provided also that loans be of sound value or so secured as reasonably to ensure their retirement or repayment. In addition, the law provided that:

> "*** in the processing of applications for financial assistance *** the Secretary shall give priority to applications of smaller municipalities (less than 10,000 population) for assistance in the construction of basic public works (including works for the storage, treatment, purification, or distribution of water; sewage, sewage treatment, and sewer facilities; and gas distribution systems) for which there is an urgent and vital public need."

The law does not require that such need exist for communities to receive financial assistance; it provides that priority be given to applications for financial assistance by smaller communities having urgent and vital needs for projects.

Our review did not disclose information as to why gas distribution systems were specifically mentioned in the legislation. Furthermore, the legislative history is silent regarding a definition of "essential public works" and of "urgent and vital public need" and the manner in which priority in processing should be given to applications of smaller municipalities for financial assistance.

The Housing Act of 1961 (42 U.S.C. 1492) provided that no financial assistance be extended to a municipality or other political subdivision having a population of 50,000 or more--150,000 or more in the case of a community situated in an area designated as a redevelopment area under section 5(a) of the Area Redevelopment Act (42 U.S.C. 3161) (later amended to also include communities designated under section 5(b) of the Area Redevelopment Act) or any act supplementary thereto.

Additional legislative changes in the years following 1961 removed from the population limitations (1) public

entities receiving grant funds under section 3 of the Public Works Acceleration Act (42 U.S.C. 2642), if the applicants would otherwise be eligible for the assistance, (2) communities in or near an area where research or development installations of the National Aeronautics and Space Administration are located, and (3) new communities approved under section 1004 of the National Housing Act (42 U.S.C. 3901). In addition, on two occasions amendments to the legislation were made authorizing loans under the program for urban mass transportation facilities and providing that the priority in processing provisions of the law not apply to specific projects for cultural centers.

CHAPTER 3

HUD POLICIES AND PROCEDURES

The PFL program is administered, for the most part, by the various HUD regional offices. The responsibilities of HUD's Central Office primarily involve (1) developing program policies, standards, and procedures for application by the regional offices, (2) controlling the allocation of program funds, and (3) granting final project approval on the basis of regional office recommendations. The overall administration of the program is the responsibility of the Assistant Secretary for Metropolitan Planning and Development.

The policies and procedures established by HUD for the administration of the PFL program are set forth in volume VI of its Field Service Manual. Amendments to the Field Service Manual are contained in various circulars to the regional offices. The more important policies and procedures are discussed below.

RATING OF APPLICATIONS

Each application for a loan is rated by nine characteristics under a numeric rating system which was formally implemented in July 1967. These characteristics and the range of points that can be assigned are shown in the following table.

Project characteristics	Point value
Consistency with areawide planning	0 to 5
Project type	4 to 20
Population class	0 to 10
Need for Federal credit	0 to 20
Average family income	0 to 10
Physical need	0 to 10
Project size	0 to 5
Relationship to other projects	0 to 5
Program need (points assigned by Regional Administrator)	0 to 15
Total	100

As indicated by the preceding table, the structuring of the rating system provides for recognition of project characteristics. For example, project type has a maximum weight of 20 points representing 20 percent of the maximum point value attainable. Only those projects which involve domestic water or sewer facilities, however, are eligible for the maximum points. Other project types receive a lesser number of points--health facilities (15 points), gas facilities (10 points), cultural facilities (five points), public buildings (four points).

ENGINEERING, LEGAL, AND FINANCIAL REVIEWS

For those projects selected for further processing, HUD's procedures provide for additional and more detailed analyses through three technical reviews--engineering, legal, and financial--for the purpose of determining the overall feasibility of the proposed projects and the financial soundness of the loans.

The engineering review is limited to information included in the loan application. The primary determinations to be made are whether (1) the proposed project is practicable and follows acceptable design practice and (2) the cost estimates appear to be reasonable.

The legal review is limited to determining (1) whether the legal name of the applicant is correctly given and whether the applicant and the project are eligible for a loan under the program, (2) whether the resolution of the governing body of the applicant and the certification of the recording officer have been correctly executed, (3) whether the applicant has sufficient legal authority to construct the project as proposed and to undertake the loan and issue the bonds evidencing the loan, (4) whether the special conditions proposed by other reviews are legally sufficient, and (5) whether the information submitted indicates any legal obstacle which would adversely affect the proposed project or loan.

With respect to a financial review of the loan application, HUD procedures provide that the financial analysis include (1) an assessment of the applicant's overall financial condition and (2) a determination as to whether the

estimates of revenues and expenses for the proposed project are realistic and whether it can reasonably be anticipated that the revenues needed to repay the loan will materialize.

The first phase of the financial analysis involves an assessment of the applicant's economic and fiscal resources and the financial operations of existing revenue-producing facilities. The economic analysis includes, when appropriate, an evaluation of the applicant's prospect for growth and development during the term of the loan. A detailed fiscal analysis of the applicant--including an examination of the tax revenue potential, tax levies and collections, current budgetary operations and debt burden per capita--is required when the applicant proposes to finance the project with general obligation bonds. When revenue bonds are to be issued in connection with a proposed loan and the applicant has existing revenue-producing facilities, a general review of the operation of these facilities is required.

The second phase of the financial analysis is carried out if the overall financial condition of the applicant is found to be satisfactory. The type of review depends primarily on the type of bonds to be issued.

With regard to a revenue bond issue, HUD procedures provide that the analyst review the expected number of users and the rates to be charged to determine whether the needed revenues will be realized. The procedures provide that the analyst consider, after a review of the information included in the Engineering Review Report, whether:

1. The proposed users of the project are presently available.

2. The extent to which the attainment of the minimum number of users depends on the development of the community or on the growth of demand.

3. The proposed rates are comparable to the rates of nearby communities.

4. The proposed rates are reasonable in view of the economic situation of the community and the prospective users.

5. There is evidence, such as signed contracts, that the rates are satisfactory to the prospective users.

The procedures provide also that, if the loan is to be secured by project revenues, the estimated operation and maintenance expenses be reviewed and determined to be reasonable. In addition, the analyst must assure himself that the project will result in at least the minimum initial net revenue needed to support the loan. For loans made to finance gas distribution facilities, HUD currently requires that the estimated net revenues specifically pledged for loan repayment be 1.4 times the average annual debt service (principal and interest payments).

LOAN APPROVAL PROCEDURES

Semiannually each regional office makes a funding analysis of loan applications for the purpose of selecting those applications for which final approval and funding will be recommended to the Central Office. The applications considered during the funding analysis consist of those for which processing has been or is soon to be completed.

Several factors are considered in selecting the applications to be recommended for approval: the number of points assigned under the rating system; the findings of the engineering, legal, and financial reviews; the locations of the projects; and the amount of funds available.

Upon completion of the funding analysis, the regional offices submit to the Central Office a listing of projects for which approval and funding are recommended. The total amount of the loans recommended for final approval generally approximate the dollar limit established by the Central Office for each regional office for the particular funding period. The listing also includes projects for which regional office processing of loan applications has been or could be completed if the Central Office desires to act on these projects. Our review showed that, for the most part, the recommendations made by the regional offices were approved by the Central Office.

OBSERVATIONS ON HUD POLICIES AND PROCEDURES

HUD has established general guidelines which define essential projects as those for which public purposes have been clearly established. HUD has not, however, developed specific written criteria for (1) systematically determining whether urgent and vital public needs exist for proposed projects of smaller communities for the purpose of giving priority consideration to applications for loans by such communities and (2) establishing priorities for those smaller communities having urgent and vital needs for basic public works. In regard to the latter, HUD has made loans to large communities for projects at the same time that it has deferred loans to small communities because of program funding limitations.

With respect to limiting the program to essential projects, HUD officials informed us that, as a general practice, the facilities to be constructed with financial assistance under the program would be considered essential on the basis of the communities' desires for the facilities.

Although it is clear from the language of the Housing Amendments of 1955 that financial assistance was intended to be provided under the program for water and sewer, transportation, gas, cultural centers, and certain other facilities, the law does not define the conditions under which such facilities would be considered "essential" for the purpose of qualifying for financial assistance. In the absence of a definition, we could not determine whether HUD had provided financial assistance in accordance with the statutory requirements.

HUD officials told us that the local citizenry should have freedom of action to decide which types of public works are most urgently and vitally needed in their communities. A HUD official told us that, although he believed that the desire of a community to obtain a loan under the program was, in itself, evidence that an urgent and vital need existed, in administering the program it was a matter of individual judgment as to what constituted an urgent and vital need.

Concerning priorities, a HUD Central Office official informed us that HUD had not interpreted the priority provision to mean that smaller communities having urgent and vital needs would necessarily be provided with financial assistance before larger communities. He further informed us that he believed that the priority provisions included in the law were being met by means of the point values for population size and need included in the rating system.

Although we recognize that the needs of a community should be considered by HUD, it is the responsibility of HUD to administer its programs in accordance with statutory requirements. The law provides for priority treatment in processing applications of smaller municipalities (populations of less than 10,000) for financial assistance in the construction of basic public works for which there are urgent and vital public needs.

In our opinon, to properly meet this requirement, procedures would have to be adopted providing that applications for loans by smaller communities having urgent and vital needs for projects be processed and funded before applications by larger communities. Such processing would also require the formulation of a definition of "urgent and vital public need," which, as previously pointed out, has not been statutorily or administratively defined.

CHAPTER 4

REGION V'S IMPLEMENTATION OF HUD'S POLICIES AND PROCEDURES

Our review of Region V's practices in processing applications for public facility loans showed that the practices generally were carried out in a manner consistent with the policies and procedures established by the HUD Central Office.

With regard to revenue-producing facilities, the applications were rated as they were received and, if selected for further processing, were subjected to engineering, legal, and financial reviews. A regional official informed us that the extent of the engineering review was determined primarily on the basis of whether the applicant's consulting engineer's report showed that the facilities had been designed in accordance with American Standard Code design criteria and of HUD's prior experience with the particular consultant.

For the most part, the regional office's financial review was accomplished on the basis of the data contained in the consulting engineer's report. Regional officials advised us that all factors of revenue production, such as the estimated number of customers, the proposed rate to be charged, and the estimated average usage per customer, were evaluated on the basis of available criteria and their reasonableness and comparability to similar projects. A regional official informed us that, to gain insight into a proposed project, site visits were made by financial personnel in almost all cases. In addition, prior to the disbursement of loan funds, Region V requires a community receiving a loan to submit for review a listing of names of proposed customers, certified to by community officials.

A regional official also told us that, because of the region's limited staff, it would be impossible to undertake extensive verification of an applicant's consulting engineer's findings and that the regional office therefore relied heavily on the professionalism of the consulting engineer.

In processing applications for loans for construction of gas facility systems, the regional office appeared to follow review practices consistent with those followed in processing applications for other types of projects.

We reviewed 42 loan applications received by the regional office during the periods July 1 through December 31, 1967, and September 1, 1968, through February 28, 1969, for which processing action had been completed. These two periods were selected because of the changes in project approval procedures that had resulted from the implementation of semiannual funding analyses which had begun in fiscal year 1969. Of the 42 applications, 25 had been approved, 14 had been disapproved, and three had been transferred to another Federal agency for consideration.

The approved loan applications included three for gas facilities and 22 for other types of projects, including water, sewer, and health facilities. The approvals represented about 43 percent of the applications received for loans for gas facilities and about 63 percent of the applications received for loans for other types of facilities for which processing action had been completed.

The stated reasons for disapproval of the 14 applications (four gas and 10 other types) are shown below.

Reason for disapproval	Applications	Type
Low rating	4	Gas (3) Convalescent home (1)
Need to defer financing additions to newly installed gas distribution system pending evidence of good management	1	Gas
Not financially sound	6	Water and sanitation (3) Convalescent home (1) Recreational facilities (1) Hospital (1)

Reason for disapproval	Applications	Type
No need for additional convalescent homes in the area	1	Convalescent home
Low rating and not financially sound	1	Hospital
Contract award would be in violation of State statute	1	Hospital

The low ratings for the disapproved loan applications for gas systems were attributed, in part, to the lower maximum points allowed for gas systems compared with those allowed for water, sewer, or health facilities. As stated previously, whereas some types of projects can receive a maximum of 20 points in the category "project type," gas facility projects can receive a maximum of 10 points.

We also examined into 10 approved loans for natural gas distribution systems to determine how the regional office had established that the systems qualified for assistance under the program as essential public works. In six cases, the high cost of liquified petroleum (LP) gas for fuel was cited as justifying the need for natural gas. In the four remaining cases, the cited need was the communities' need for natural gas to replace LP gas, wood, or coal which was being used as the primary fuel supply. The available records for two projects for which the high cost of LP gas was cited as justification of the need for the projects showed that the estimated annual savings for average-size residential gas users would amount to about $30 for one of the projects and to about $61 for the other. The estimated annual savings for commercial customers of one of the projects ranged from about $214 for a small user to about $1,213 for a large user.

In processing loan applications, the regional office makes no distinction between applications of smaller communities and those of larger communities. The regional office had recommended to the Central Office that applications for loans for projects of large communities be

approved even though applications for loans for projects of small communities were not recommended for approval.

With regard to priorities, a regional office official informed us that, although no distinction was being made between applications for loans by small and large communities, priority in processing was being given to some applications. He stated, however, that in such cases priority in processing had been based on professional judgments as to the urgent and vital needs for the projects. As previously noted, a definition as to what would constitute urgent and vital needs for projects has not been established for the purpose of giving priorities to the processing of loan applications by smaller communities.

CHAPTER 5

LOAN DELINQUENCY EXPERIENCE

Our examination into HUD's experience with respect to delinquent public facility loans showed that as of June 16, 1969, 25 loans having balances outstanding totaling $8.8 million were considered by HUD to be delinquent.[1] The payments in arrears totaled $736,000--$393,000 in principal and about $343,000 in interest. The 25 delinquencies represent about 2 percent of the total loans.

Information furnished to us by HUD showed that the delinquency rates for the past several years had remained rather constant, ranging from 1.9 to 2.5 percent. Also, information furnished to us regarding loan refundings by borrowers and underwriters for the past several years showed that generally the refundings had not involved loans which were in a delinquent status and therefore would not appear to have materially affected the delinquency rate.

Of the 25 delinquent loans, six were for natural gas facilities--five made by the HUD Region III office, Atlanta, Georgia, and one made by the HUD Region V office, Ft. Worth.

The five loans made by the Region III office were relatively old loans which have been in a delinquent status for several years. These loans were made between February 1957 and May 1962 and became delinquent between March 1960 and April 1967. The sixth loan was made by the Region V office in May 1966 and became delinquent in November 1968.

Although the delinquency rate for gas system loans made prior to fiscal year 1963 is higher than the rate for loans for other type projects, only one of the 48 gas system loans made after fiscal year 1963 was in a delinquent status as of June 1969--a delinquency rate of 2.1 percent which is comparable with the overall delinquency rate of the past several years.

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[1] One or more months in arrears.

The one gas system loan referred to above was made by the Region V office. The pertinent loan records and discussions with Region V officials showed that the borrowing community was in financial distress due to (1) its inability to collect promised funds for the construction of a transmission line to another community for a private company and (2) the lack of initial management efforts to obtain the minimum number of customers.

With regard to all six delingent gas system loans, HUD's records indicated that the regional offices had taken active roles in working with the communities to help them resolve problems connected with the operations of the facilities and to place the facilities on a sound financial basis.

CHAPTER 6

SUMMARY OF OBSERVATIONS ON HUXLEY SYSTEM

We examined into selected aspects of the policies and procedures followed by HUD relative to a $1,330,000 loan to Huxley for the construction of a natural gas distribution system and into the financial soundness of the loan. The Texas LP Gas Association had protested the proposed loan to Huxley for the construction of a natural gas distribution system on the premise that there was no need for a natural gas system for a community adequately served by LP gas and that the proposed loan was financially unsound.

In regard to the system's being eligible for financial assistance under the program--that is, whether it was an essential public works--HUD has defined "essential" projects as being those for which public purposes have been clearly established. According to HUD officials, a project, as a general practice, would be considered essential on the basis of a community's desire for the facility. The Huxley natural gas system met HUD's definition of an "essential" public works because it was intended to satisfy a public purpose and the community had expressed a desire for the system and because financing was not otherwise available to Huxley on a reasonable basis. In the absence of legislative definition, we could not determine whether the project satisfied the statutory requirement of "essential."

As pointed out on page 7, the law provides that priority be given to applications of smaller communities for financial assistance in the construction of basic public works for which there are urgent and vital needs. Because Huxley is classified as a small community, its application for a loan to finance the construction of the gas system would have been eligible for priority if HUD had determined that there was an urgent and vital need for the system. The related records, however, contained no evidence that HUD had considered whether there was an urgent and vital need for the system for the purpose of giving priority to processing the loan application. Furthermore, we were advised by a Region V official that the Huxley application had not been given priority.

HUD determined that the loan to Huxley would be financially sound on the basis of an estimated annual revenue-debt service ratio of about 1.48, somewhat greater than HUD's requirement of 1.4.

The debt service ratio is based on the estimated annual revenues and operating costs of the system and on the average annual debt service (loan principal and interest payments). We found that the estimated annual revenues and average annual debt service used in computing the debt service ratio were reasonable.

In regard to operating costs, we found no evidence that estimated costs were unreasonable.

Further details on the loan to Huxley for construction of a natural gas distribution system are contained in appendix I.

CHAPTER 7

AGENCY COMMENTS AND OUR EVALUATION THEREOF

By letter dated January 19, 1970 (see app. II), the Secretary of Housing and Urban Development commented on our draft report. The Secretary agreed with our summarization of basic program policies and procedures and with our analysis of the considerations bearing on the approval of the Huxley loan. The Secretary, however, was not in agreement with our view (see p. 14) that, to properly implement the statutory provision, procedures would have to be adopted providing that applications for loans by smaller communities having urgent and vital needs for projects would be funded before applications by larger communities.

The Secretary agreed that the legislative history of the program does not define what constitutes an urgent and vital need and that there is no mention of what priority is to be given applications by smaller communities. The Secretary stated that, in the absence of such legislative definitions, HUD had construed the priority provision as establishing a relative, rather than an absolute and inflexible, order of precedence.

With regard to determining urgent and vital need, the Secretary stated that HUD believed that this was amply reflected in the application rating system which includes examination and assignment of numeric values for such items as the physical need for the proposed facilities, the need for Federal assistance, and the kind of project to be undertaken.

Although we agree that the rating system, as discussed on page 9, does take into consideration various project characteristics, and provides for each varying degrees of numerical importance, we doubt whether the method of assigning point values fully complies with the intent of the law. Even assuming that the method of assigning points could enable HUD to meet the statutory requirement that priority be given to applications by smaller communities, we noted that the numerical ratings derived had not always served to provide priority treatment to smaller communities.

As shown in the following examples, loan applications by larger communities were approved while applications by smaller communities were not approved even though the applications by the smaller communities had received higher numerical ratings.

1. The management control list submitted by Region V included the following information regarding loan approval for the last half of fiscal year 1969.

Project number	Project type	Population	Loan amount	Rating points	Approval recommended by regional office
TEX-241	Hospital	10,000 to 24,999	$500,000	74	Yes
TEX-239	Water	500 to 999	109,000	76	No

The loan application for project TEX-241 was approved by the Central Office during that period. As shown above, loans for these projects were not recommended for approval on the basis of their numerical ratings. Also, the loan for the smaller community was not approved by the Central Office ahead of the loan for the large community even though the smaller community's project had a higher rating.

2. Region VI's management control list for the last half of fiscal year 1969 showed:

Project number	Project type	Population	Loan amount	Rating points	Approval recommended by regional office
Calif-96	Drainage	28,600	$2,530,000	50	Yes
Calif-94	Sewer	2,500 to 4,999	1,000,000	69	Yes

Although the region recommended that loans for both projects be approved, the Central Office approved only the loan for the Calif-96 project to the community with the larger population and lower point rating and disapproved

the loan for the Calif-94 project to the community having the smaller population and the higher point rating.

The Secretary stated also that HUD believed that the loan application rating system properly implemented its interpretation of legislative intent--a relative, rather than an absolute and inflexible, order of precedence--and that program statistics, which showed that over 92 percent of the approved loans had been made to smaller communities, furnished persuasive evidence that loan applications from such communities had been given high priorities.

We agree that the majority of all loans have been made to smaller communities; however, we believe that the primary reason for the large percentage of loans having been made to the smaller communities was that the bulk of the loan applications had been by smaller communities and not that the application of the rating system resulted in high priorities being given to applications for loans by the smaller communities having urgent and vital needs for projects.

Our analysis of all loan applications received and approved in fiscal year 1969 showed that 85.5 percent of the applications were by communities with populations under 10,000 and that 14.5 percent were by larger communities. Although the bulk of the loan applications were by small communities, there was only a slight difference in the percentage of applications by small and large communities that were approved. Of those applications received, 58.5 percent of those by the smaller communities were approved and 50 percent of those by the larger communities were approved.

In addition, our analysis of the loan applications received and approved in Region V between July 1, 1967 (the rating system was formally initiated in July 1967), and June 30, 1969, showed that, of the applications received, 86.9 percent were by small communities and 13.1 percent were by large communities, that is, communities having populations of 10,000 or more. Of the loan applications received, 41.6 percent of those by the small communities were approved and 41.2 percent of those by the large communities were approved.

EVALUATION SUMMARY

We realize that, in the absence of legislative definitions, an administrative agency must use judgment in developing methods to carry out the requirements set forth in the law. We believe, however, that HUD's present numerical rating system does not adequately serve to give priority to loan applications by smaller communities having urgent and vital needs because some loan applications by smaller communities were not recommended for approval nor approved on the basis of point values assigned, not even when the smaller communities' projects were assigned higher ratings.

RECOMMENDATION

In view of the manner in which the priority provision for smaller communities has been implemented, we are recommending that the Secretary of Housing and Urban Development require HUD to reexamine its interpretation of the priority provision of the law and its rating system giving careful consideration to the need for developing procedures for ensuring that smaller communities having urgent and vital needs for basic public works are being afforded the full benefit of the priority provision.

CHAPTER 8

SCOPE OF REVIEW

Our examination was performed at HUD's Central Office in Washington, D.C., and at its regional office (Region V) in Fort Worth. We visited the city of Huxley and the offices of various individuals who were involved in activities concerning the public facility loan made to Huxley. At these locations we reviewed pertinent records and reports and interviewed various officials.

Our examination included reviews of (1) the legislative history of the program, (2) the criteria adopted by HUD to implement the program, (3) the procedures followed by the Central Office and Region V in administering the program, (4) HUD's delinquency experience with public facility loans, (5) the policy and procedures followed by HUD relative to the loan made to Huxley for construction of a natural gas distribution system, and (6) the financial soundness of the loan made to Huxley.

APPENDIXES

LOAN TO HUXLEY, TEXAS, FOR CONSTRUCTION OF A NATURAL GAS DISTRIBUTION SYSTEM

BACKGROUND

On July 21, 1967, the city of Huxley, Texas, population 225, submitted an application to HUD's Region V office for a loan of $1,326,000 to finance the construction of a natural gas distribution system to serve the residents of Huxley and surrounding communities.

On December 14, 1967, after a regional review of the application and supporting documentation and an onsite inspection by a regional official, the Project Summary, a document summarizing the pertinent facts about the project, was forwarded to the HUD Community Facilities Division in Washington with the recommendation that a 40-year loan of $1,326,000 at an interest rate of 4-1/2 percent be approved.

By letter to Region V, dated February 21, 1968, the Texas LP Gas Association (formerly the Texas Butane Dealers Association) protested the construction of the natural gas system. The protest charged that the proposed loan was financially unsound and asserted that the consulting engineer's report substantially overstated the estimated natural gas usage. The Association also questioned the need for the natural gas system, stating that the community was being adequately served by LP gas.

On February 23, 1968, the HUD Central Office in Washington deferred action on the project. On February 28 and 29, 1968, two HUD Region V representatives visited in and around Huxley to reappraise the earlier findings on which the recommendation for approval of the loan had been based. The two Region V representatives reported that they believed "that the allegations of the Texas Butane Dealers Association were hastily thrown together, ill prepared, and not supported by the facts." They recommended to Region V officials that the Huxley gas system loan application be given final approval by the Central Office. On March 5, 1968, the Assistant Regional Administrator, Metropolitan Development, forwarded the protest letter to the Community Facilities Division at the Central Office and recommended

that favorable action be taken on the loan application without further delay.

By letter dated April 9, 1968, a law firm representing the Texas LP Gas Association submitted another protest to Region V stating that the proposed Huxley loan was financially unsound. On April 23, 1968, the Assistant Regional Administrator forwarded the letter of protest to the Central Office and requested information regarding the status of the loan application and asked whether there was any intention of its being approved. By letter dated May 3, 1968, the Director, Community Facilities Division, informed the Assistant Regional Administrator that the relative priority of the Huxley project was such that there were no prospects for approval of the application within the foreseeable future.

On June 21 through 24, 1968, two regional officials visited the Huxley area to investigate the protests made by the Association on April 9, 1968. On the basis of their investigation, the officials concluded that it appeared that the statements and assumptions made by the Association were largely incorrect. They further concluded that it appeared that the estimates made by the consulting engineer and reviewed by the Region V office finance staff were quite conservative and that the system would definitely be economically feasible.

During July 1968, prior to the approval of the Huxley loan, HUD increased the interest rate to be charged on loans from 4-1/2 percent to 5 percent.

On September 25, 1968, the Central Office returned the Huxley Project Summary to Region V for updating. On October 14, 1968, the updated Project Summary, based on an interest rate of 5 percent, as prescribed by the Central Office, and on an increased number of potential customers of the system, was returned to the Central Office with the recommendation that a 40-year loan in the amount of $1,330,000 be approved. The increase in the amount of the loan covered revised amounts for capitalized interest, contingencies, and Government field expense.

By letter dated November 18, 1968, HUD informed the Mayor of Huxley that the loan application had been approved, and on November 25, 1968, HUD made a formal offer to the city of Huxley of a loan of $1,330,000 for financing the construction of the gas system. On December 3, 1968, the offer was accepted.

As a special condition to disbursement of any loan funds for gas systems, HUD requires the borrower to enter into a contract with a natural gas supplier for the provision of natural gas to the borrower's distribution system. Because the proposed supplier of natural gas to Huxley would be involved in interstate commerce, the proposed supplier was required to obtain a certificate of public convenience and necessity from the Federal Power Commission.

On January 2, 1969, the United Gas Pipe Line Company, a corporation having its principal place of business in Shreveport, Louisiana, filed an application with the Federal Power Commission for a certificate of public convenience and necessity to authorize the construction and operation of facilities to supply natural gas to the city of Huxley. The Association filed a memorandum of protest and an opposing petition to intervene with the Federal Power Commission stating that the Association members would be directly affected by the supplying of natural gas to Huxley replacing LP gas. The memorandum of protest also raised questions concerning the economic feasibility of the natural gas system. The Commission ruled that good cause existed to allow the petitioner to intervene in the proceeding, and public hearings were scheduled to be held in Washington on May 27, 1969.

By letter filed May 21, 1969, the Association withdrew its petition and, by order dated June 24, 1969, the Commission issued a certificate of public convenience and necessity to the United Gas Pipe Line Company.

To comply with HUD requirements that the financial assistance was not otherwise available on reasonable terms, the city of Huxley advertised an offer to sell $1,330,000 of natural gas system revenue bonds, series 1969, in The Daily Bond Buyer on February 20, 1969; the bids were to be

opened on March 10, 1969. The only bid submitted was by the Secretary of Housing and Urban Development.

On June 25, 1969, a contract was entered into between the city of Huxley and the Ellington Construction Company, Inc., Monroe, Louisiana, in the amount of $1,078,151 for construction of the gas system. The contract was concurred in by HUD on July 9, 1969, and construction of the system began on July 14, 1969. As of October 16, 1969, the amount of the construction contract had been increased to $1,080,648 by a change order in the amount of $2,497. At that date, the construction of the system was estimated to be about 58-percent complete and full operation of the system was expected by February 1, 1970.

PROJECT NEED

HUD's procedures require that each application for a loan for the construction of a project contain detailed comments as to why the project is needed. The need for the Huxley gas system was described as follows:

> "A natural gas distribution system is urgently needed to eliminate the excessive economic burden imposed upon the City and surrounding community by the present fuel supply. Individual liquified petroleum systems on the premises of the residential and commercial establishments in the community provide the existing fuel supply."

In addition to the above described need, a regional official stated that:

> "*** the *** project is urgently needed because of the high cost of the liquified petroleum systems now in existence, there are a large number of potential customers, the citizens are interested and highly cooperative and the project appears to be a very good one."

The city's consulting engineer claimed that the estimated savings to be derived through the use of natural gas would be about $37 a year for the average domestic user,

about $351 a year for the small commercial user, and about $972 a year for the large commercial user, representing a savings ranging from approximately 25 percent to 53 percent of the users' LP gas costs.

FINANCIAL SOUNDNESS OF THE HUXLEY SYSTEM

As stated on page 12, for loans made to finance the construction of gas distribution facilities, HUD requires that the estimated revenues specifically pledged for loan repayment be 1.4 times the average annual debt service (principal and interest payments).

On the basis of estimated revenue and operating cost data for the Huxley natural gas system, as furnished by Huxley's consulting engineer, and of the average annual debt service for a 40-year loan of $1,326,000 at an interest rate of 4-1/2 percent, a revenue-debt service ratio of 1.56 was computed, as shown below.

Average annual debt service		$ 72,021.84
Estimated annual average gross project revenues		$175,541.17
Less estimated annual average:		
Cost of gas	$41,258.98	
Operating costs	21,751.58	63,010.56
Estimated average net annual project revenues		$112,530.61
Annual revenue-debt service ratio ($112,530.61 ÷ $72,021.84)		1.56

Huxley's consulting engineer's preliminary report, submitted as part of the city's loan application, included estimates of (1) the number of customers to be served, (2) the average gas consumption per customer, and (3) the annual operating revenues and costs. On the basis of these estimates, the report concluded that the proposed Huxley natural gas distribution system should produce revenues sufficient to meet annual operating costs and the loan repayment, as required by HUD policy. We reviewed each of

these estimates, and the results of our review are discussed in the following subsections.

Number of customers

The consulting engineer's report proposed three rates for natural gas service: rate A for residential consumers, churches, and other small users and rates B and C for the larger commercial users.

The engineer estimated that, for the first year of operation of the natural gas system, there would be 500 customers at rate A, 140 customers at rate B, and 15 customers at rate C--a total of 655 customers. He estimated also that, during the second and third years of operation, all potential customers from the existing area residents would connect to the system and thereby increase the number of customers to 800, about a 22 percent increase. He estimated further that, beginning with the fourth year and continuing through the 10th year of operation, a growth rate of about 2 percent a year would occur and thereby increase the number of customers to 919 by the end of the 10th year. No further increase in the number of customers was projected for the 11th through the 40th years of operation.

A representative of the Association informed us that listings of customers of LP gas in the Huxley area during 1968 showed that there were about 900 possible users of natural gas. He contended that, of the LP gas customers on these listings, 233 would not convert to natural gas because they had used less than 400 gallons of LP gas in 1968--the point below which it is more economical to use LP gas than natural gas. Therefore the natural gas system would have a maximum of about 667 (900 less 233) customers.

All potential customers of the natural gas system were required to make deposits--$20 for rate A users and $50 for rate B and C users--and to sign applications agreeing to connect to the system within 30 days of its completion. As of May 13, 1969, 986 deposits had been made, 331 more than had been estimated by the consulting engineer for the first year of operation and 67 more than had been estimated by him by the end of the 10th year of operation. In addition, we were subsequently informed by the Mayor of Huxley

that 1,102 deposits had been made as of October 17, 1969. It is apparent, therefore, that the Huxley natural gas system should have more customers than was estimated by the representative of the Association.

In regard to the Association representative's contention that 233 LP gas customers would not connect to the Huxley natural gas system, we compared a listing of the 233 LP gas customers furnished to us by the Association with a listing of depositors who had signed connection agreements for the Huxley system as of May 13, 1969. This comparison showed that, of the 233 LP gas customers, 68 had made deposits and signed connection agreements with the Huxley system. These depositors made a total of 70 deposits. We also noted that there were 31 other Huxley system depositors with names almost identical to 31 of the names included in the Association's listing, which indicates that they also may be depositors of the Huxley gas system. These depositors made a total of 32 depositors.

The representative of the Association also furnished us with data regarding 87 deposits that indicated that (1) 28 deposits had been made for connections of the system to properties on which there were no structures, (2) 40 deposits had been made by persons residing beyond the boundaries of the proposed system, (3) four deposits had been made by persons who use all-electric facilities, and (4) 15 deposits had been made by persons who had connected to another natural gas system.

Information available as of May 13, 1969, regarding each of the above four types of deposits follows.

1. Thirty-two deposits had been made for connections of the Huxley system to properties on which there were no structures. The attorney for the city informed us that the deposits had been made to secure connections for various facilities--rental houses, trailers, and cabins--to be constructed in the future. The Mayor stated that the deposits had been made to ensure acquiring a meter for a nominal deposit rather than for the full costs, which would be the case after the 1,098 meters provided for in the construction contract have been applied for.

2. Of the 40 deposits indicated as having been made by persons residing outside the boundaries of the Huxley system, only three were by persons whose residence was not shown on the final engineering drawings as being within the boundaries of the system.

3. Huxley officials informed us that the four persons who use all-electric facilities intend to connect to the Huxley system because of the need for natural gas for such purposes as heating houses or brooders for raising broilers (chickens).

4. Of the 15 depositors stated as being connected to another natural gas system, 14 were being serviced by the Farmers Natural Gas Company, Shelbyville, Texas, after the latter part of 1968. It is doubtful that they will connect to the Huxley system, in view of the proposed rate which is higher than the Farmers rate.

In summary, we identified a maximum of 155 deposits by persons who, on the basis of the Association's contentions, may not become customers of the Huxley natural gas system.

To determine whether the Huxley gas system would meet HUD's revenue-debt service ratio of 1.4 if none of the 155 depositors become customers of the system, we computed a revenue-debt service ratio on the basis of 831 customers (986 depositors at May 13, 1969, less the 155 depositors). Our computation showed that, even with 831 customers, the system would meet the required ratio of 1.4, which indicates that the system would be financially sound on the basis of HUD's standards.

As pointed out on page 37, the Mayor of Huxley informed us that 1,102 deposits had been made as of October 17, 1969, 271 more than the 831 customers on which we based our computation of the annual revenue-debt service ratio.

On the basis of the foregoing, we concluded that (1) Huxley's consulting engineer had not overstated the estimated number of expected customers for the Huxley

natural gas system and (2) HUD had no reason for questioning the financial soundness of the system on the basis of the expected number of customers.

Average gas consumption per customer

Huxley's consulting engineer estimated that the average annual gas consumption by customers of the system would be as follows:

Type of customer	Estimated average annual consumption in MCF (note a)
Rate A	80
Rate B	410
Rate C	1,000

[a]MCF designates 1,000 cubic feet.

The consulting engineer informed us that the estimated gas consumption by rate A customers was based on usage statistics compiled by the Gas Utilities Division of the Railroad Commission of Texas. Our review of these statistics for the 3 years prior to the time of the engineer's preliminary report showed that the average annual domestic (rate A) consumption for 10 communities near the Huxley area ranged from about 74 MCF to about 141 MCF--an average annual consumption for all the communities of about 88 MCF. On this basis, the consulting engineer's estimate of 80 MCF was reasonable.

The consulting engineer's preliminary report and our discussions with the engineer showed that the estimates of the average gas consumption by commercial (rate B and C) customers had been based on the amount of gas required in the production of broilers (chickens) during a typical heating season, from October 1 through April 30. The consulting engineer estimated that the brooders (a device for providing heat for the broilers) would be operated 600 hours (3.6 weeks) for each batch of 10,000 broilers raised during the heating season and that each brooder would be operated on the basis of 35,000 BTUs input per hour, or 35 BTUs per

chick per hour, and that 1,000 BTUs equaled 1 cubic foot of natural gas.

On the basis of these factors, the consulting engineer computed that 210 MCF of natural gas would be required for each batch of 10,000 broilers raised during the heating season, as follows:

$$\frac{600 \text{ hours X } 35 \text{ BTUs X } 10{,}000 \text{ broilers}}{1{,}000 \text{ BTUs}} = 210 \text{ MCF}$$

The consulting engineer estimated that the rate B and C customers would raise about 15,000 and 45,000 broilers, respectively, during the heating season and that, on the basis of the foregoing factors, the customers average annual gas requirements for domestic and brooder heating would amount to about 410 and 1,000 MCF, respectively. Our examination into these factors is discussed below.

Brooder operating hours and heating season

On the basis of the brooder temperature requirements as recommended by the Texas A. & M. University, we estimated that the brooder operation time would be from 792 to 864 hours for each batch of broilers--somewhat more than the 600 hours estimated by the consulting engineer. Our examination of the climatic summary for the area showed that the typical heating season for brooders ranged from October through April, which is consistent with the consulting engineer's estimate.

The Association contended that, except for about 3 months during the coldest part of the winter season, the heating period would be only a few days after the baby chicks are placed in the brooder house. We noted that the broiler industry in the Huxley area follows a practice known as contract growing. Under this method, large feed companies (known as the producers) enter into contracts with individuals (growers) for raising broilers for the producers for a stipulated return. The producers furnish the baby chicks, feed, sanitation and medical supplies, and litter which is used for floor covering in the brooder houses. The growers furnish the brooder houses, fuel, water, and necessary surveillance of the growing

chicks. The producers pick up the chicks when they are mature.

In addition to proper nutrition, the requirements for growing broilers are essentially those of housing and temperature regulation. To determine what heating requirements are recommended by the producers, we questioned officials of two feed companies in the Huxley area and were advised that they recommend brooder operation during the period October through April of 5 to 6 weeks per batch of broilers--840 to 1,008 hours--substantially more than had been estimated by the consulting engineer or recommended by Texas A. & M. University.

Broiler production

Our analysis of 1968 broiler production by 87 depositors with the Huxley gas system showed that 51 were rate B users who produced an average 29,589 broilers during the 7-month heating season and 36 were rate C users who produced an average 63,330 broilers during the season, significantly more than had been estimated by the consulting engineer in each case. On this basis, the consulting engineer's estimates of average broiler production by commercial customers of the Huxley gas system were conservative.

Brooder BTU input

The consulting engineer's estimate of natural gas usage by commercial customers of the Huxley system was based on an assumed gas input of 35,000 BTUs per operating hour for brooders with a capacity of 1,000 chicks. A representative of the consulting engineer advised us that this factor was based on discussions with officials of a large feed company servicing the Huxley area concerning the company's requirements. According to the consulting engineer's representative, and as we subsequently confirmed by our review, that company requires from 30 to 40 BTUs per chick per hour (30,000 to 40,000 BTUs per 1,000 chicks per hour). Therefore 35,000 BTUs per 1,000 chicks per hour was selected as a compromise.

We were advised by a representative of the Association, however, that most of the brooders being used in the Huxley

area were of a type rated by the manufacturer as using significantly less than 35,000 BTUs per hour. He stated that the engineer's basing of his estimate on the use of 35,000 BTU brooders had resulted in his significantly overstating the amount of gas that would be used by commercial customers of the Huxley gas system.

The president of a company in the Huxley area that supplies brooders and other poultry equipment confirmed that the brooders used in the Huxley area had a capacity of less than 35,000 BTUs. He informed us that, although some of the brooders being used were of a type rated by the manufacturers at 28,000 to 32,000 BTUs, about 75 percent were of a type rated at 13,380 to 19,000 BTUs per hour.

We found that the broiler-growing practices in the Huxley area were such that brooder size was not the sole determinant of the amount of gas that a commercial customer would use. Officials of four feed companies in the Huxley area informed us that, in order to provide the required BTUs per chick during the cold months, the number of chicks per brooder was limited. For example, one company limits the use of 1,000 capacity brooders to 700 to 800 chicks per batch and thereby increases the BTU input per chick. An official of another company told us that it required 40 BTUs per chick per hour and that the number of broilers per brooder was limited to the number necessary to meet that requirement.

It is our understanding that approximately the same amount of gas would be required to provide each chick with 35 BTUs per hour in either a small brooder or a large brooder. Therefore it appears that, despite the use of brooders with a rating of less than 35,000 BTUs, the commercial customers of the Huxley natural gas system would use the amount of gas estimated by the consulting engineer if they (1) provide each chick with about 35 BTUs per hour--the amount estimated by the consulting engineer and (2) raise the total number of broilers estimated by the engineer. As stated above, the feed companies require their growers to provide chicks with 30 to 40 BTUs per chick per hour. Also as stated previously, depositors with the Huxley system were producing significantly more broilers than had been estimated by the consulting engineer.

Operating costs

The consulting engineer estimated that the operating costs for the Huxley gas system would be as follows:

	Year 1	Year 3	Year 6	Year 10 through 40
Wages	$10,000	$12,500	$13,500	$14,500
Repair and maintenance	1,100	1,900	2,100	2,300
Unaccounted for gas	1,600	1,800	1,800	2,000
Postage and printing	1,500	1,500	1,500	1,700
Insurance and miscellaneous	1,520	1,500	1,476	1,556
Total	$15,720	$19,200	$20,376	$22,056

The consulting engineer told us that he had estimated the operating costs on the basis of his experience with other municipal gas systems.

As stated on page 12, HUD's procedures provide that operation and maintenance expenses be reviewed and determined to be reasonable when a loan for the construction of a project is to be secured by project revenues. Accordingly, such a determination was required relative to the loan to Huxley for the construction of the natural gas system that is secured by the system's revenues. We were informed by a Region V official that operating and maintenance expenses for a project are evaluated by comparing the estimated expenses with those of other systems. In regard to the Huxley natural gas system, Region V's Financial Review Report contained the following statement:

> "These estimated costs were submitted by the Consulting Engineer in itemized detail. The totals average approximately $24.00 per connection, per year, which may be a bit high but are considered acceptable as a conservative estimate and have been utilized in the preparation of this review."

As stated on page 15, a regional office official told us that, because of the region's limited staff, it would be impossible to undertake extensive verification of an applicant's consulting engineer's findings and that, because of this, HUD relied heavily on the professionalism of the consulting engineer.

We compared the estimated operating costs for the Huxley natural gas system with the estimated and actual operating costs for five other municipal gas systems--the construction of which had been financed with loans under the PFL program--in an attempt to determine the reasonableness of the estimated operating costs for the Huxley system. The results of our comparison were inconclusive, however, because of differences in the types and sizes of the systems and in the numbers of customers; however, we found no evidence that the estimated operating costs for the Huxley system were unreasonable.

Cost of gas

In computing the revenue-debt service ratio for the Huxley natural gas system, the HUD analyst used $42,778 as the annual cost of gas for the system. This amount was based upon the consulting engineer's estimate of gas usage per customer, the estimated number of customers, and a unit cost of $0.2562 per 1,000 cubic feet of gas. As stated previously, we determined that the estimates of gas usage per customer and the number of customers were reasonable. The unit cost of gas used by the analyst was the gas supplier's price, as specified in the loan agreement between HUD and the city of Huxley.

Revision of revenue-debt service ratio

As stated on page 35, the HUD analyst originally computed an annual revenue-debt service ratio of 1.56 for the Huxley loan.

During July 1968, prior to approval of the loan, HUD increased the interest rate from 4-1/2 percent to 5 percent. In October 1968, Region V revised its Financial Review Report for the Huxley natural gas system and recomputed the revenue-debt service ratio based on a 40-year loan of

$1,330,000, an increased number of customers, and the 5 percent interest rate. The computation resulted in a reduction of the revenue-debt service ratio to 1.48, as shown below.

Average annual debt service		$ 79,453.95
Estimated annual average gross project revenues		$184,863.89
Less estimated annual average:		
Cost of gas	$42,778.66	
Operating costs	24,317.68	67,096.34
Estimated average net annual project revenues		$117,767.55
Annual revenue-debt service ratio ($117,767.55 ÷ $79,453.95)		1.48

THE SECRETARY OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D. C. 20410

JAN 19 1970

Mr. Max Hirschhorn
Associate Director
General Accounting Office
Washington, D. C. 20548

Dear Mr. Hirschhorn:

This is in reply to your letter of December 19, 1969, inviting our comments on the draft of your proposed report to Senator John G. Tower regarding selected aspects of the financing of public facilities under the Public Facility Loans Program.

The draft report questions two procedural points in HUD administration of the Public Facility Loans Program. Both are related to the statutory provision that in the processing of loan applications "the Secretary shall give priority to applications of smaller municipalities for assistance in the construction of basic public works (including works for the storage, treatment, purification, or distribution of water; sewage, sewage treatment, and sewer facilities; and gas distribution systems) for which there is an urgent and vital need."

The report contends that compliance with the foregoing priority provision would require:

1. Adoption of procedures whereby applications of smaller communities (those with populations of less than 10,000) involving projects for which there is an urgent and vital need would be funded ahead of applications submitted by larger communities, and

2. formulation of a definition of the term "urgent and vital need."

As noted in the report, the legislative history of the program does not define what constitutes an "urgent and vital need," and there is no mention of what degree of priority is to be given applications from smaller communities. In the absence of such legislative definitions we have proceeded on the basis of our interpretation of legislative intent. We have construed the priority provision as establishing a relative rather than an absolute and inflexible order of precedence. We believe the application rating system for the program properly implements this interpretation and that program statistics, which show that over 92 percent of the approved loans have been made to smaller

communities, furnish persuasive evidence that applications from such communities do in fact receive a high degree of priority.

With regard to determination of "urgent and vital need," we believe this consideration is amply reflected in the application rating system for the program, which includes examination and assignment of numeric values for such items as physical need for the proposed facilities, the need for Federal assistance, and the kind of project to be undertaken. About 84 percent of the approvals under the program have been for water and sewer projects.

We find the report draft an excellent summarization of basic program policies and procedures and a perceptive analysis of the considerations bearing on the approval of the Huxley loan. We appreciate this opportunity to review and comment on your findings.

Sincerely,

George Romney

Enclosures

APPENDIX III

PRINCIPAL OFFICIALS OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT RESPONSIBLE FOR THE ACTIVITIES OF THE PUBLIC FACILITY LOANS PROGRAM DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
SECRETARY OF HOUSING AND URBAN DEVELOPMENT:		
Robert C. Weaver	Jan. 1966	Dec. 1968
Robert C. Wood	Jan. 1969	Jan. 1969
George W. Romney	Jan. 1969	Present
ASSISTANT SECRETARY FOR ADMINISTRATION:		
Dwight A. Ink	Mar. 1966	Feb. 1969
Lewis E. Williams (acting)	Feb. 1969	Mar. 1969
Lester P. Condon	Mar. 1969	Present
ASSISTANT SECRETARY FOR METROPOLITAN PLANNING AND DEVELOPMENT:		
Charles Haar	July 1967	Jan. 1969
Samuel C. Jackson	Feb. 1969	Present
ASSISTANT REGIONAL ADMINISTRATOR FOR METROPOLITAN DEVELOPMENT FOR REGION V:		
Travis Miller	Dec. 1966	Present

U.S. GAO, Wash., D.C.