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REPORT TO THE CONGRESS 092048

Getting The New Communities Program Started: Progress And Problems B-170971

Department of Housing and Urban Development

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

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COMPTROLLER GENERAL OF THE UNITED STATES
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To the President pro tempore of the Senate
and the Speaker of the House of Representatives

This is our report on the progress and problems in getting the new communities program started. The program is administered by the Department of Housing and Urban Development.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the United States Housing Act of 1937, as amended (42 U.S.C. 1401).

We are sending copies of this report to the Director, Office of Management and Budget, and to the Secretary of Housing and Urban Development.

Elmer B. Staats

Comptroller General
of the United States

Contents

ABBREVIATIONS

DOT	Department of Transportation
FRAM	Financial Reporting and Monitoring
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
NCA	New Communities Administration
NUCOMS	New Community Simulation System

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

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D I G E S T

WHY THE REVIEW WAS MADE

The U.S. population is likely to increase by 75 million persons by 2000.

The Congress had determined that one solution to the problems associated with this growth is to develop new communities designed to:

--conserve land resources,

--minimize transportation problems,

--increase choices of housing, and

--promote economic development.

The Department of Housing and Urban Development (HUD) guarantees obligations of private and public developers which buy and develop land for residential, commercial, and industrial uses under the new communities program.

GAO reviewed 4 of the 10 new community projects HUD had approved for guarantee assistance as of January 1, 1974. They are: Jonathan, Minnesota; Park Forest South, Illinois; Flower Mound, Texas; and Riverton, New York.

FINDINGS AND CONCLUSIONS

HUD has made some progress in carrying out the new communities program.

From program inception in 1968 through January 1, 1974, HUD guaranteed obligations of about $222 million for 10 new community projects.

HUD is committed to guarantee $120.5 million for five other projects and has determined that two others are eligible for grant or loan assistance that, under the program, is available to State and local public bodies and agencies.

When completed in about 20 years, these 17 new communities will house almost one million people in 308,000 dwelling units. The average new community project is to cover about 5,500 acres:

--44 percent for residential development;

--17 percent for commercial and industrial development; and

--39 percent for open space. (See pp. 6 and 7.)

Certain types of new community projects are not being developed

The new communities legislation encourages the development of new communities in existing metropolitan areas, older central cities, smaller towns, and rural areas.

Of the 15 projects HUD has approved for guarantee assistance, 13 are on the outskirts of fast-growing metropolitan areas. New community projects are not being undertaken in central cities, smaller towns, and rural areas because unique problems in these areas increase costs of the projects and risks of the developers.

Planning and developing a new community within a central city is complicated by such problems as fragmented landholdings; high land acquisition costs; relocating residents and businesses; and planning complexities involving the existing community and local, State, and Federal Government jurisdictions.

For example, large-scale land acquisition is difficult without public condemnation powers. Only one State has established an agency with such power.

On the basis of prices paid for property acquired in one city's urban renewal areas, land acquisition costs for such projects would exceed the legislation's $50 million limit for federally guaranteed obligations for the developer's acquisition and development costs.

Developing new communities in rural areas and small towns presents different problems. Although large parcels of land are less expensive and much easier to buy than in the central city, the labor supply is uncertain and the network of highways, airports, and railroads is inadequate. (See pp. 8 to 12.)

Improvements needed in determining market feasibility

Before approving a new community project, HUD must determine whether the new community will be able to capture enough of the area's projected growth over the project's 20-year development period. This is known as market feasibility.

HUD determined that four projects had market feasibility and guaranteed $77 million in obligations after accepting market studies supplied by the developers. However, the studies for three of the four developers were in some respects either outdated or lacked the information HUD needed to make a proper determination.

Also HUD did not adequately evaluate market studies and other information supplied by three of the four developers.

For example, the developer of Jonathan applied to HUD for guarantee assistance in February 1969 and included a March 1966 study showing the project's market feasibility. HUD regulations provide that such studies not predate a developer's application by more than 12 months. (See pp. 14 to 23.)

Improvements needed in determining financial feasibility

Before approving a new community project, HUD also must determine whether the project land can be sold during the development period at prices that will cover the purchase price of the land and its development costs and also retire the federally guaranteed bonds. This is known as financial feasibility.

The financial projections the four developers submitted to HUD did not show that enough money would be generated to retire the guaranteed bonds nor did they contain all the information HUD needed to determine whether the projects were financially feasible.

--The developer of Jonathan provided HUD with financial projections for only one-half the development period.

--Park Forest South projections were not related to the development plan.

--The developer of Flower Mound based its projections on developing and selling over 2,000 acres of land it did not own and did not have an option to purchase.

--The Flower Mound and Riverton projections included major road and utility costs which were not supported by detailed site engineering studies or detailed site plans.

HUD did not fully evaluate the financial projections supplied by two of the developers.

For example, the developer of the Riverton project did not provide HUD with any support, nor could he provide GAO with any support, for his $6.2 million estimate for general administrative costs. (See pp. 24 to 29.)

The four projects generally were not meeting their forecasts of sales, revenues, and costs. (See pp. 22 and 23 and 29 to 31.)

Improvements needed in financial reporting

Because HUD did not require the developers to periodically revise their financial projections, it was not fully aware of the financial difficulties the developers of the four projects were encountering.

In addition, HUD did not require developers to submit enough information for it to determine their current financial condition. (See pp. 32 to 35.)

Collateral for the guaranteed obligations may be inadequate

The Federal Government may not be adequately protected from financial loss if the four developers default on the guaranteed bonds because HUD accepted as collateral (1) real property that was not properly valued and (2) items that would have little or no value.

HUD improperly increased the value of the real property pledged by the developers as collateral for HUD's guarantee.

For example, HUD increased, without an adequate basis, the value of certain real property in the Park Forest South project by $3.4 million. For other real property in the project, HUD accepted an appraisal which was not prepared according to HUD's instructions.

In the Riverton project, HUD, contrary to its regulations, added $840,000 to the value of the land pledged as collateral on the basis of anticipated zoning changes.

HUD allows developers to include as collateral for the federally guaranteed obligations costs incurred for general overhead expenses, interest expenses, and HUD fees and charges.

GAO believes these items should not be included because they would have little or no resale value to a prospective buyer or to a creditor if the project were liquidated. (See pp. 36 to 43.)

RECOMMENDATIONS

The Secretary of HUD should:

--Evaluate the current market and financial feasibility of each project HUD has approved.

HUD should (1) analyze the approved development plans in terms of present market conditions and revise them, if necessary, and (2) prepare a current financial plan to determine whether the projects appear able to generate enough revenue to meet the anticipated costs and to retire the federally guaranteed obligations. (See p. 50.)

--Require the New Communities Administration to periodically monitor the financial progress of the developers and affiliated companies and reevaluate the market and financial feasibility of each project when actual performance is much lower than projected. (See p. 50.)

--Require the New Communities Administration to establish guidelines for evaluating the proposed projects' market and financial feasibility, including how information supplied by the developer should be accepted or verified. (See p. 50.)

--Require that developers either own or control all project land before project agreements are signed. (See p. 50.)

--Review HUD's current policy pertaining to collateral so that only items which can be liquidated will be accepted as collateral for the federally guaranteed obligations and review each approved project's collateral to determine its current value. (See p. 50.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

HUD generally agreed with GAO's recommendations and outlined corrective actions underway or planned. (See p. 51.)

MATTERS FOR CONSIDERATION BY THE CONGRESS

If the Congress wishes to encourage the development of the wide range of new community projects contemplated by the legislation--particularly developments in central cities, small towns, and rural areas--it should change the legislation to provide additional incentives to encourage the development of such projects.

Among other alternatives, the Congress should consider

--increasing the $50 million guarantee limit, providing grants for land acquisition, and providing additional financial incentives to State and local governments for locating new community projects within central cities and

--providing additional tax incentives to encourage businesses and industries to locate in new community projects in small towns and rural areas. (See p. 13.)

CHAPTER 1

INTRODUCTION

Title IV of the Housing and Urban Development Act of 1968 (42 U.S.C. 3901, et seq.) and title VII of the Housing and Urban Development Act of 1970 (42 U.S.C. 4511, et seq.) established the new communities program in the Department of Housing and Urban Development (HUD). Under the program, HUD encourages new community development by providing financial assistance to private and public developers. For the developers to receive financial assistance, a new community must satisfy a broad range of economic, social, environmental, and governmental objectives. For example, a new community must:

--Provide the basic activities normally associated with a city or town--housing, education, cultural facilities, transportation, commerce, industry, and recreation--and combine these activities in an environment that is an attractive place to live, work, and shop.

--Have a favorable impact on the growth and development of its area by conserving land, minimizing transportation problems, increasing choices of housing, promoting economic development, and creating job opportunities.

--Be designed for people of different incomes; be open to members of all national, ethnic, and racial groups; and make substantial provisions for housing persons of low and moderate incomes.

During the past 25 years, at least 50 large planned communities have been constructed in the United States. Levittown, Long Island, New York, was an early example of a mass-housing development for the new, middle-class population leaving the central city. In recent years, the character of planned developments has been changing. The newer developments are starting with many more amenities--man-made lakes, open spaces, golf courses--and a wide range of public services and community facilities. Many developments have acquired light industry and other types of small businesses. A few have tried to diversify their population mix by building both federally subsidized housing and expensive residences.

The two most well known developments in the United States--Reston, Virginia, and Columbia, Maryland--were begun in the early 1960s. The financial problems of Reston and Columbia show how difficult the new community business is for private developers. Because of a tight money market, Reston's developer had to surrender its control to a private corporation 5 years after it began. The developer of Columbia enlisted the financial support of a large insurance company to start development.

FEDERAL ASSISTANCE

It was against this background that the Congress passed the Housing and Urban Development Acts of 1968 and 1970 which gave the Federal Government a role in the new community movement. In the 1970 act, the Congress said that the Nation was likely to experience a population increase of about 75 million persons by the end of this century. These persons must be provided with housing, employment, and recreation. The Congress expressed concern that, if the existing patterns of urban development continued, the Nation would experience a further deterioration in its physical and social environment because

--land resources would not be efficiently used;

--natural and recreational resources would be destroyed;

--public facilities and services would be costly and inefficient;

--residents of central cities would have difficulty finding employment and business opportunities; and

--distances would increase between where people live, where they work, and where they find recreation.

The Congress said that the development of new communities was one solution to a better pattern of urban development. It determined that new community development on a national scale had been prevented by difficulties in (1) obtaining adequate financing at moderate cost for enterprises which involve large initial capital investments, require extensive periods before investments can be returned, and provide irregular patterns of return, (2) assembling large sites in economically favorable locations at reasonable costs, and (3) coordinating arrangements among private and public organizations for promptly providing site and related improvements, such as streets, water and sewer facilities, and other public and community facilities.

In addition to establishing the new communities program, title IV of the Housing and Urban Development Act of 1968 provided for Federal guarantees of private new community developers' loans for buying and developing land. The guarantee was limited to $50 million for each project and borrowings outstanding at one time could not exceed $250 million. Title IV also established a program of supplemental grants to State and local public bodies associated with new communities for public facilities, such as water and sewer systems, under three Federal basic grant programs. Supplemental grants were limited to 20 percent of the basic grant, and the total grant amount was limited to 80 percent of the facilities' cost.

Title VII of the Housing and Urban Development Act of 1970 expanded the Federal Government's commitment to the new communities program. The act doubled the ceiling on loan guarantees to $500 million; made supplemental grants available to 10 other Federal grant programs; extended the guarantee program to public agencies, such as New York State's Urban Development Corporation; authorized grant programs for (1) special planning assistance, (2) certain public services during the first 3 years of development, and (3) compensating public developers for the loss of the exemption of interest from Federal taxation; authorized loans to meet interest payments for the first 15 years of the development period; authorized a program allowing the Federal Government to plan and carry out large projects demonstrating new community development; and provided for technical assistance to help new developers plan and carry out new community projects.

HUD's fiscal year 1972 budget request did not include funding for the new programs authorized by the legislation. Nevertheless, the Congress appropriated $5 million for the special planning assistance grant program for fiscal year

1972. The Office of Management and Budget, however, impounded the funds, and HUD has not requested appropriations for these programs since then. On June 30, 1973, HUD ended the supplemental grant program. Since that time HUD has offered developers the loan guarantee program as the only type of financial assistance available for developing new communities. Additional grant assistance may become available on January 1, 1975. The Housing and Community Development Act of 1974 provides that 2 percent of the funds appropriated for community development block grants must be set aside in a special discretionary fund for use by the Secretary in making grants on behalf of new communities and for five other purposes.

Public Law 93-117 of October 2, 1973, increased the ceiling for loan guarantees to $695.5 million. With the Federal Government guaranteeing their obligations, developers can borrow long-term private capital, through either private borrowings or public offerings of debentures, at considerably lower interest rates than would otherwise be possible.

A private developer can receive a Federal guarantee on borrowings up to 80 percent of the estimated value of the undeveloped real property acquired and 90 percent of the estimated land development cost. A public developer can receive a guarantee up to 100 percent of the estimated cost of land acquisition and development. Funds a developer receives from the federally guaranteed obligations can be used for land acquisition and for land development activities, such as clearing and grading; constructing water, sewer, and utility lines; and installing roads, streets, and sidewalks. However, these funds cannot be used to build residential, commercial, and industrial structures.

HUD can provide the other forms of financial assistance, if available, to developers not requesting guarantee assistance. These projects are required to meet the same standards HUD imposes for projects which are given guarantee assistance.

PROJECT APPROVAL

HUD's New Communities Administration (NCA) administers the new communities program. Various divisions within NCA review a developer's application for Federal assistance to determine whether the proposed new community project meets the goals of the legislation and conforms to HUD's regulations. For example, NCA's Market and Financial Analysis Division within the Office of Finance reviews and evaluates the market and financial studies the developer submits to HUD. These studies are requested to help demonstrate that the proposed new community has a strong economic base and will generate enough revenue to retire the federally guaranteed bonds. This Division also reviews the appraisals of the real property that secures the guaranteed obligations.

After these reviews, NCA reports its findings and recommendations to the New Community Development Corporation's board of directors. The board consists of the Secretary of HUD, five persons appointed by the Secretary, and a general manager appointed by the President of the United States. The general manager is NCA's Administrator. (See app. I for an organization chart of NCA.)

On the basis of its review of the developer's application and the NCA report, the board decides whether an "offer of commitment" should be made to the developer. When an offer is made, HUD issues a "letter of commitment" to the developer providing for a Federal guarantee of a specified amount of obligations if the developer meets certain conditions. For example, the developer must prepare plans for affording equal opportunity in housing and employment, for encouraging small builders to participate, and for developing the land. After the developer meets these conditions, HUD and the developer enter into a "project agreement" which identifies the amount of the Federal commitment and incorporates the previously mentioned conditions. HUD also requires the developer to enter into a "trust indenture" with a bank which acts as a trustee for the proceeds from the sale of the guaranteed obligations. The trust indenture and project agreement set forth the requirements and restrictions relating to the federally guaranteed obligations, the developer's general equity and financial reporting requirements, and the Government's rights and remedies in case the developer defaults on the obligations.

The obligations generally have a 20-year repayment period coinciding with the project development period. Developers pay HUD certain fees and charges for the guarantee assistance. These amounts are deposited in a revolving fund which is to be used to pay liabilities resulting from defaults on the guaranteed obligations and for such program expenditures as consultant contracts. As of March 31. 1974. the revolving fund amounted to $11.6 million.

STATUS OF THE NEW COMMUNITIES PROGRAM

The principal achievements of the new communities program from its inception in August 1968 through January 1, 1974, are summarized below.

--For 10 projects HUD guaranteed obligations of $221.9 million and agreed to guarantee additional obligations of $18.6 million for these projects.

--HUD offered to guarantee obligations of $120.5 million for five projects.

--HUD determined the eligibility of two projects for other forms of financial assistance. These projects did not request guarantee assistance.

--As of July 1973, HUD had awarded $73.8 million in basic grant funds to local public bodies for 12 new communities. Another $22.8 million in supplementary grants had been either reserved or approved for these communities.

--The 17 projects are located in 11 States, primarily on the eastern seaboard and in Texas. When completed in about 20 years, the projects will house 967,000 persons in 308,000 dwelling units. About 85,000 of the dwelling units will house persons of low or moderate incomes.

According to plans, the average new community project will be located on about 5,500 acres, with 44 percent of the land to be used for residential development; 17 percent for commercial and industrial development; and 39 percent for open space, such as lakes, walkways, and recreational areas.

Data on the 17 new communities is shown in appendix II.

SCOPE OF REVIEW

We reviewed the basic laws and legislative history pertaining to HUD's new communities program and HUD's policies, regulations, and instructions governing the program. We also reviewed 4 of the 10 projects HUD had approved for guarantee assistance as of January 1, 1974: Flower Mound, Texas; Jonathan, Minnesota; Park Forest South, Illinois; and Riverton, New York. HUD approved these projects during the period October 1970 through May 1972. We examined the project application material submitted by the project developers and the project agreements, trust indentures, and other related material.

We made our review at HUD's central office in Washington, D. C.; HUD's regional offices in Chicago, Dallas, and New York; and HUD's area offices in Buffalo, Chicago, Dallas, and St. Paul. We also visited the four projects, interviewed project officials, and examined various project documents and records. A description of the four projects we reviewed is provided in appendix III.

We also met with

--bank officials acting as trustees for project funds;

--marketing, financial, and engineering consultants;

--regional planning commissions;

--officials of residential and industrial projects near the new communities; and

--various State and local officials.

CHAPTER 2

CERTAIN TYPES OF NEW COMMUNITY PROJECTS

ARE NOT BEING DEVELOPED

One of the purposes of title VII of the HUD act of 1970 is to encourage development of new communities in existing metropolitan areas, older central cities, smaller towns, and rural areas. Of the 15 projects HUD has approved for guarantee assistance, 13 are on the outskirts of fast-growing metropolitan areas, 1 is in a central city, and 1 is in a rural area. HUD has not approved any projects in small towns. We believe new community projects are not being undertaken in central cities and nonmetropolitan areas because unique problems in these areas increase both the costs of the projects and the risks of the developers.

In its report (S. Rept. 91-1216, Sept. 21, 1970) on the bill which became the Housing and Urban Development Act of 1970, the Senate Committee on Banking and Currency envisioned four types of new communities.

1. Satellite new communities--economically balanced developments within or directly adjacent to large metropolitan areas, which will serve as alternatives to urban sprawl.

2. New-towns-in-town developments of significant size within or adjacent to existing central cities, which will help to revitalize existing urban centers.

3. Small-town growth centers--small cities or towns with growth potential, which may be expanded into larger urban centers to prevent economic decline and reduce migration to major metropolitan areas.

4. Free-standing new communities--self-sufficient towns considerable distances from existing urban areas, which would be built primarily to accommodate expected population growth.

From inception of the program through January 1, 1974, HUD approved guarantee assistance or offered to commit guarantee assistance to 15 new community projects, including 13 satellite projects. This trend of developers to locate new communities on the periphery of the fastest growing metropolitan areas--Dallas, Houston, Washington, D.C., and Minneapolis-St. Paul, for example--is understandable in view of such factors as access to transportation facilities, the availability of relatively low-priced land, the potential for population growth, and social and cultural opportunities. Developers of new communities can rely on large urban centers for labor and materials to carry out their projects. The urban centers are also the major outlets for the products of the major national firms which generally locate where market factors are most favorable.

We noted that, in contrast to satellite new communities, developing new-towns-in-town, small-town growth centers, and free-standing new communities presents developers with many difficult problems. For example, a number of unique problems are involved in planning and developing for a new-town-in-town: fragmented landholdings; high land acquisition costs; relocation of residents and businesses; and planning complexities involving the existing community, and local, State, and Federal government jurisdictions. Some specific problems are that:

--Large-scale land acquisition is difficult without public condemnation. Only the State of New York has established a State land development agency with such condemnation powers.

--Land costs are initially high and the costs of holding the land are a large part of development expense. We noted in a recent review that, for 11 residential properties and 35 commercial properties acquired in urban renewal areas in the District of Columbia, square-foot prices averaged $14.79 and $23.45, respectively. Since HUD generally requires that a new-town-in-town be located on at least 100 acres, land acquisition costs at the $14.79 a square-foot cost would amount to $64.4 million or well beyond the $50 million limit set by the legislation for federally guaranteed obligations for land acquisition and development costs.

In May 1973 the Secretary of HUD told the Subcommittee on Housing of the House Committee on Banking and Currency that new-towns-in-town seem to require considerable assistance beyond the Federal guarantee. He stated that several mechanisms had been suggested for dealing with the problems of planning and developing a new-town-in-town.

--State land development agencies could have both funding and land acquisition powers. State legislation would be required to create these agencies and it was uncertain whether State legislatures would grant adequate power and authority soon.

--The local general-purpose government might operate through local public agencies which had already been created under HUD's urban renewal program and which had condemnation powers. The local public agency would work jointly with a private developer by providing the public powers necessary for new-town-in-town development.

--Tax increment financing could be used which would involve reinvesting in the project through some public channel a part of the difference in real estate property taxes before and after development. Such tax increment funding would require authorizing State legislation.

Cedar-Riverside, Minnesota, was the only new-town-in-town project approved by HUD as of January 1, 1974. The new community will be about 12 blocks from downtown Minneapolis on a 100-acre tract primarily within the 336 acre Cedar-Riverside urban renewal area. The developer purchased or obtained control of most of the 100 acres during the early 1960s and plans to purchase the additional land from the local urban renewal agency. Before HUD ended the urban renewal program in June 1973, purchasing land through the urban renewal program was a possible approach to reducing the high land acquisition costs for new-town-in-town development.

Buying land is much easier in rural areas than in urban areas. Land is less expensive and it is easier to assemble in large parcels. However, small-town growth centers and free-standing new communities present other obstacles. Land development costs may be relatively higher because skilled labor and materials may not be available locally and may have to be transported to the site. Another problem is the uncertainty of available labor. To insure an ample labor supply, industry usually builds its plants where enough people already live. For a free-standing new community project, there is no available labor supply during the initial years because the new community which must generate the labor supply has not yet been constructed. Further, industry needs an adequate transportation network of highways, airports, and railroads to link the new community site with existing transportation facilities so it can market its products and services.

In May 1973 the Secretary of HUD told the Subcommittee on Housing that the problem with nonmetropolitan new communities was the uncertainty of a job base and that no satisfactory solution had been found for this problem. The then Deputy Assistant Secretary for Community Planning and Management told the subcommittee that it was a very complex job to insure a growing job base for a project the size of new communities. He also said that a number of proposed projects had not been approved solely because there was no assurance of a job base. A HUD official told us that most developers were interested in satellite new communities because they offered the best opportunity for profit at the lowest risk. On the other hand developers are not attracted to new communities in nonmetropolitan areas because of the high risks.

In 1972 the National Governor's Conference stated that nonmetropolitan new communities should be a major part of a national population growth policy. It noted that, since economic development was vital to such communities, there should be a national development policy to provide additional incentives to private business and to look for new ways of combining public and private interests to meet public needs. It suggested that the Congress adopt a system of tax incentives to encourage business and industry to locate in nonmetropolitan areas and also include financial incentive systems in rural job creation programs.

HUD has approved one free-standing new community project. In February 1974, HUD agreed to guarantee $14 million of the Soul City Company's obligations. Soul City is to be in Warren County, North Carolina, 45 miles north of Raleigh. Plans call for a city of 44,000 people by 2003. The project agreement between HUD and the developer of Soul City contains certain provisions which indicate some of the difficulties a developer must overcome in constructing a free-standing new community.

The project agreement provides that the developer may issue obligations guaranteed by HUD for $5 million during the first 3 years of the project. During this period, the developer is required to furnish evidence to the Secretary of HUD that (1) actual employment at the project site is at least 300, (2) sufficient funds are available to construct the water, sewer, and storm drainage systems for the project, (3) major roads and streets have been completed, and (4) certain industrial, residential, commercial, and institutional lands have been sold at certain prices. The project agreement also provides that, if these conditions are not met, HUD will not guarantee the remaining $9 million.

These provisions are considerably more stringent than the provisions for a satellite new community. For example, HUD generally allows the developer of a satellite new community to immediately issue the entire amount of the guaranteed obligations.

CONCLUSION

The new community legislation provides developers with rather limited financial assistance to help overcome the many problems associated with developing new-towns-in-town, small-town growth centers, and free-standing new communities. More developers might be attracted to the new communities program if the $50 million guarantee limitation were increased and if grant or loan assistance were available for acquiring land and for constructing transportation and industrial facilities.

MATTERS FOR CONSIDERATION BY THE CONGRESS

If the Congress wishes to encourage the development of the wide range of new community projects contemplated by the legislation--particularly developments in central cities, small towns, and rural areas--it should change the legislation to provide additional incentives to encourage the development of such projects.

Among other alternatives, the Congress should consider

--increasing the $50 million guarantee limit, providing grants for land acquisition, and providing additional financial incentives to State and local governments for locating new community projects within central cities and

--providing additional tax incentives to encourage businesses and industries to locate in new community projects in small towns and rural areas.

CHAPTER 3

IMPROVEMENTS NEEDED IN DETERMINING THE MARKET FEASIBILITY OF NEW COMMUNITY PROJECTS

Do economic indicators show continued growth of the area in which a new community is to be located? What percentage of the projected growth can the new community be expected to capture? Will demand for residential, commercial, and industrial land at the new community site continue for 20 years? Answers to these questions indicate to HUD the market feasibility of a proposed new community.

HUD determined that four projects had market feasibility and guaranteed $77 million in obligations after accepting market studies supplied by the developers. However, the studies were in some respects either outdated or lacked the information HUD needed to make a proper determination. Also HUD did not adequately evaluate market studies and other information supplied by three of the four developers.

Title IV of the Housing and Urban Development Act of 1968 and title VII of the Housing and Urban Development Act of 1970 prohibit the Secretary of HUD from guaranteeing obligations for land acquisition and land development unless the Secretary has determined that the proposed new community will be feasible in terms of its economic base or its potential for economic growth. HUD regulations require that information demonstrating market feasibility include

--current and projected economic and demographic growth patterns and demand for and supply of industrial, commercial, and residential properties for the region in which the project is to be located;

--the project's market area and the growth and demand trends projected within the market area; and

--the project's advantages relative to other developments, including its location, the managerial and marketing skills associated with it, and its capacity to sustain an employment base which will generate demand for housing and commercial facilities.

HUD issued additional instructions which specified information that a prospective developer must submit in its application for guarantee assistance. For example, regarding the projected supply and demand for residential properties, the instructions require the developer to submit information on the supply and demand for housing units for the regional area; for the market area; by the age of the dwelling; by the type of dwelling (single family, townhouse, garden apartment, mid-rise and high-rise apartments); and by the dwelling's price range or rental range.

This information is generally developed by an economic consulting firm hired by the prospective developer. The firm projects such items as the number of residential units to be sold, the industrial and commercial land to be sold, and the number and type of jobs within the new community. The firm then establishes a plan for the development period.

HUD evaluates the information in the consultant's report and other information the developer supplies to determine the proposed project's market feasibility.

MARKET STUDIES PROVIDED TO HUD WERE OUTDATED AND INCOMPLETE

Three of the four developers supplied HUD with market studies that were in some respects either outdated or lacked the information HUD regulations and instructions required. However, HUD used this data to support its conclusion that the proposed new community projects were feasible.

HUD regulations require that reports, studies, and supporting data reflect current conditions and not predate the developers' application by more than 12 months. For the Jonathan and Riverton projects, the market studies prepared by economic consulting firms predated the applications by 35 and 19 months, respectively.

--In March 1966, an economic consultant forecast that a new town could be developed at the present site of Jonathan. The developer began work on the project in 1967 but experienced difficulties obtaining additional needed capital. It applied to HUD for guarantee assistance in February 1969 and included the March 1966 study as the principal justification for the project's market feasibility.

--In April 1969 an economic consultant prepared a study that forecast the feasibility of developing a new town at the Riverton site. The study was 19 months old when the developer applied to HUD for guarantee assistance. Data in the study concerning the rates of employment and unemployment in the Rochester area covered the period 1960-68 and was almost 2 years old when the developer applied to HUD for guarantee assistance.

The market study for the Riverton project did not contain all the information HUD regulations and instructions required. The study did not contain such information as the supply of and demand for industrial land in the regional market, including the current inventory of available industrial land, the potential market for industrial land, and the current inventory of undeveloped industrial land owned by business concerns.

The consultant estimated that the developer could market 327 acres of industrial land in Riverton over a 13-year period, or about 25 acres a year. Subsequently, the developer increased the total land for the project from 1,510 to 2,335 acres. The developer then increased the industrial land that could be marketed to 400 acres over a 16-year period, or 25 acres a year. However, it did not prepare a market study to support this increase. A Riverton project official told us that, based on their judgment, he and a former Riverton official had decided to increase the industrial land. HUD approved the development plan containing 400 acres for industrial use.

The market study for the Flower Mound project estimated that the developer would be able to sell 371 acres for industrial use over the 20-year period. The market study, however, did not analyze the industrial demand and the employment potential for various sectors of the region, nor did it include adequate data on the anticipated growth for industrial development in the Dallas-Fort Worth area. A HUD reviewer noted that the study was not thorough and that the developer might have considerable difficulty in attracting industry to the project. He concluded, however, that the 371 acres for industrial use was modest in relation to the demand for industrial land in the Dallas-Fort Worth area, and he accepted the projection. He also concluded that the proposed project would have to include industrial land if it were to comply with HUD's regulations.

In October 1970 a consultant for the developer increased the projection for industrial land by 56 acres, to a total of 427 acres. The consultant did not provide documentation supporting the increased amount of land for industrial use but it stated the increase reflected an expected growing urbanization of the Flower Mound area and was based upon the experience of other industrial developers in the metropolitan area. HUD accepted the 427 acres without questioning the basis for the increase.

INADEQUATE EVALUATION OF MARKET STUDIES AND OTHER DATA

HUD approved the Park Forest South and Jonathan projects without fully considering market feasibility studies which indicated that the developers had greatly overestimated the expected rate of development. HUD also approved the Flower Mound project without fully verifying the status of a proposed freeway that, according to the developer's economic consultant, was a major factor in the successful project development.

HUD determined the Park Forest South project's market feasibility primarily on the basis of a consultant's 1969 study of housing demand. This study showed that the developer would be able to sell about 16,000 housing units during the period 1970-76. The developer later told HUD that it estimated it could sell about 35,000 units over a 15-year period because a new university was to be located in the project area.

Because the developer's estimate of 35,000 units was not supported by a market feasibility study, in June 1970 HUD contracted with a consulting firm to evaluate the market feasibility of the project. The consulting firm's report indicated that during the same 15-year period the developer would be able to sell only about 14,000 dwelling units. Subsequently, the developer and HUD agreed on a development plan estimating that the developer could sell 37,200 dwelling units over a 20-year period. Neither the developer nor HUD was able to document the estimate for us.

HUD officials told us that they used the higher estimate because they believed that, if the developer did not meet the development schedule, it would be risking its investment. They also said that another reason for accepting the higher estimate was that the developer believed the consulting firm's study should have considered the entire Chicago metropolitan area, rather than only the six-county area surrounding the project, as its market.

The Jonathan project developer estimated that it could develop and sell 1,815 acres for industrial use over the 20-year development period, or about 90 acres each year. Its estimate was based mainly on the anticipated sales of industrial land to two large retail companies which expressed interest in buying land at the Jonathan site. The developer believed that, if the two companies bought the land, other firms would follow the companies' lead and that this would result in above-average industrial land sales.

A HUD reviewer found that the developer's estimate was optimistic. He noted that sales of industrial land in the entire Minneapolis-St. Paul area during the past 5 years had averaged about 150 acres each year. He said an area realtor had told him that the developer might sell 20 acres each year.

HUD officials told us, however, that they had decided to accept the developer's 90-acre estimate because they felt that it could sell that many acres. The Jonathan project's general manager told us that it was unreasonable for HUD to base the success of selling industrial land on anticipated sales to two companies. The anticipated sales to the two companies did not materialize and, as indicated on page 22, the developer fell behind its schedule for selling industrial land.

HUD accepted, without sufficient verification, the developer's statements that a proposed freeway would be built through the Flower Mound project area. When HUD approved the project, the freeway was not part of the approved regional highway system, and there is still no assurance that the freeway will be built.

The developer's application, which was based on a market study prepared by the developer's economic consultant, stated that the Flower Mound project's development plans were based on the assumptions that (1) the new regional airport southwest of Flower Mound would be in full operation by 1975 and (2) the Mid-Cities Freeway would be open by 1979. The application also stated that the freeway's accessibility would stimulate manufacturing and wholesaling activities which were to be Flower Mound project's primary employment base and that the sharp increase in the number of single family detached units projected for 1976 and 1980 was directly related to the opening of the freeway and the impact of a town center. The location of the proposed freeway is shown on page 20.

The developer's application to HUD in July 1970 said that

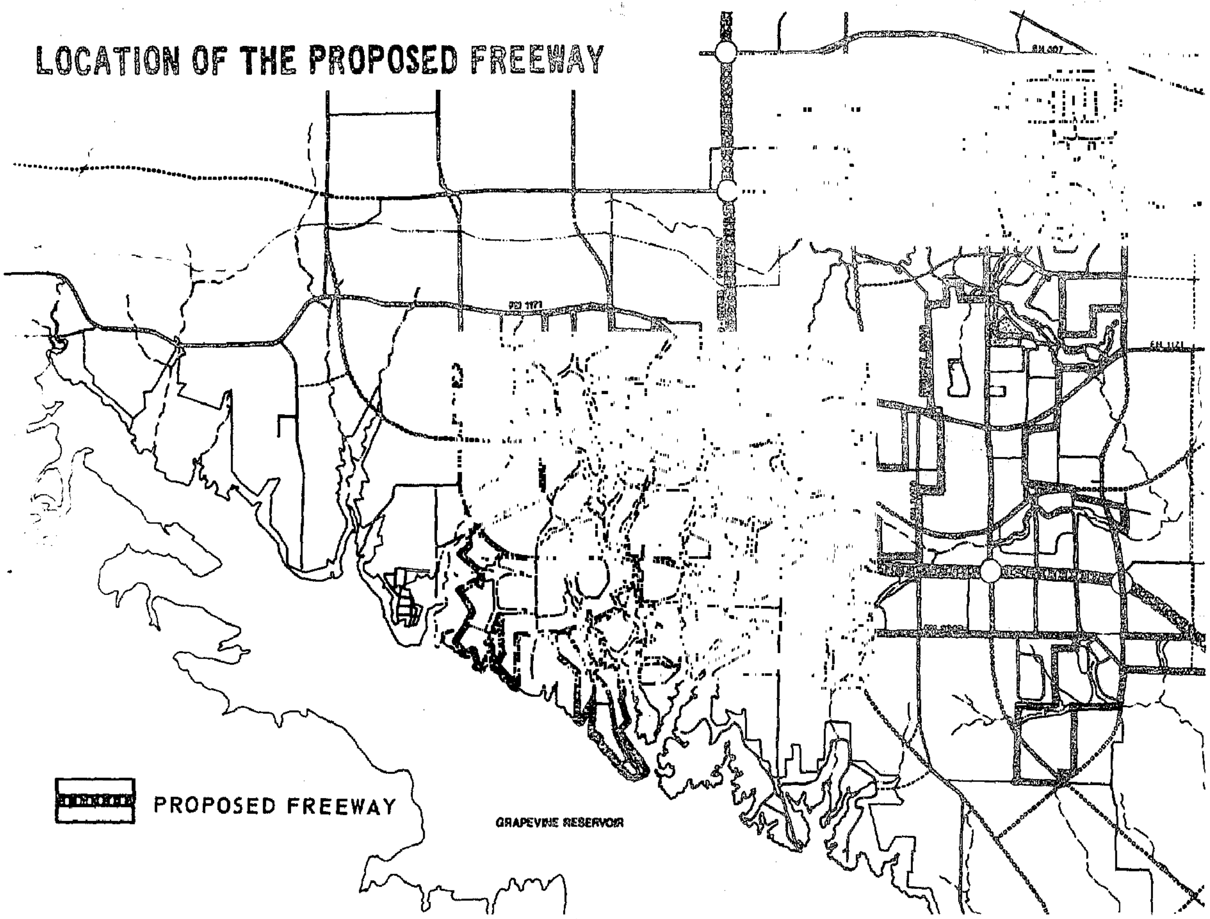
--the freeway was included in the Texas Highway Department's regional transportation plan for Dallas-Fort Worth;

--the local county would help the highway department buy the right-of-way and would also help with the final location of the freeway; and

--the highway department's full cooperation was necessary for the final routing, design, and timing of the freeway.

In July 1970 HUD questioned the developer about the possibility of opening the freeway in 1979. In October 1970 the developer replied that it had held meetings with officials of the highway department and that the projected opening date was reliable.

LOCATION OF THE PROPOSED FREEWAY



In February and March 1971, the Departments of Transportation (DOT) and the Interior, in reviewing the environmental impact of Flower Mound, questioned the freeway alignment. DOT officials noted that the freeway was not shown on the regional 1985 highway system plan. Interior officials said that the freeway seemed to violate basic planning concepts because it would physically divide the new community.

In responding to DOT, the developer said that the Texas State Highway Commission appeared to be favoring the proposed route and that, on the basis of its latest information, there appeared to be reasonable assurance that the proposed freeway would pass through Flower Mound. In a July 1971 reply to Interior, a consultant for the developer said that the Texas Highway Department and the Bureau of Public Roads were determining the actual location of the freeway.

Our discussions with Texas State Highway Department officials during the period June through November 1973 disclosed that

--the freeway was not part of the Regional Transportation Study of 1967 (the 1985 system), nor was it part of an October 1972 revision to the study;

--presentations to the highway commission by the Denton and Fort Worth Chambers of Commerce in November 1968 and February 1971 included requests for the freeway and in both cases the Commission deferred action due to lack of funds;

--the consultant's July 1971 statement that actual location of the freeway was being determined by the highway department was incorrect;

--during June through November 1973 the highway department was reviewing the 1985 system to extend it to 1990, and that it would consider a possible freeway through Flower Mound; and

--it took about 10 years from the time a freeway was designated as part of the State highway system until construction began.

The HUD official who reviewed the application said that he had not contacted DOT or the Texas State Highway Department concerning the freeway. The official said also that information he had received from the State division of planning coordination and from the North Central Texas Council of Governments supported the freeway's existence and routing of the freeway. He said also that, since these agencies had not raised any issues and since land was to be set aside for the freeway, he believed the freeway would be built. We noted, however, that the information which the HUD official believed supported the freeway's existence and routing contained only general statements that the Flower Mound project was consistent with regional and State planning practices and was beneficial to the character of the regional plan.

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HUD officials told us that HUD has not established formal guidelines on how to evaluate the market feasibility studies, including the extent to which information supplied by the developer should be accepted or verified. They told us that their review was subjective and was based generally on their expertise.

PROJECTS NOT MEETING DEVELOPMENT FORECASTS

Although it is too early to predict how the problems discussed in this chapter will affect the ultimate success of the four projects, we did note that two of the projects we reviewed were not meeting their sales forecasts, as discussed below.

Jonathan

As of December 31, 1972, the developer had not attained the land sales projected for the first 2 years of the project. According to the project agreement, the developer was to develop and sell land for 494 residential units during 1971 and 1972. During this period, it developed land for 583 units but sold land for only 319 units, or about 65 percent of the total number of units estimated in the project agreement.

The developer had agreed to develop and sell 227 acres of industrial land by December 31, 1972; as of that date, it had 157 acres but had sold or leased only 63.

Park Forest South

During the first 2 years of the project, the developer did not attain the projected rate of residential and commercial development. The project agreement stated that the developer would develop and sell land for a total of 2,200 residential dwelling units during 1971 and 1972. By December 31, 1972, however, the developer had developed and sold land for 1,660 units. We also noted that the builders who bought the developed land had limited success in marketing dwelling units. For example, lots for 898 units were sold to builders. At the end of 1972, the builders had constructed and sold only 69 units and expected to sell only 241 units in 1973.

The project agreement provided that the developer would develop and sell land for 160,000 square feet of space for commercial use by the end of 1972. As of December 31, 1972, the developer had developed and sold land for only 69,000 square feet of space.

CHAPTER 4

IMPROVEMENTS NEEDED IN DETERMINING

THE FINANCIAL FEASIBILITY OF

NEW COMMUNITY PROJECTS

If the market studies indicate that the proposed new community can be successfully marketed, can the land be sold at prices that will generate revenues sufficient to recover land acquisition and land development costs and to retire the federally guaranteed bonds? A positive answer to this question indicates to HUD that the proposed new community is financially feasible.

HUD guaranteed $77 million in obligations for the four new community projects without adequately determining the financial feasibility of each project. We noted that the financial projections the developers gave HUD either did not show that the federally guaranteed bonds could be retired or did not contain all the information HUD needed to determine whether the projects were financially feasible. For two of the four projects, HUD failed to adequately evaluate the developers' financial projections.

Title VII of the Housing and Urban Development Act of 1970 states that the Secretary cannot guarantee obligations for a developer unless the Secretary has determined that the new community represents an acceptable financial risk to the United States. According to the act, the Secretary must consider the financial and security interests of the United States, including how the developer proposes to finance and schedule land acquisition, land development, and marketing.

HUD regulations provide that a new community be developed according to a financial plan which will

--include anticipated project costs, including costs to be met with funds borrowed under the obligations guaranteed;

--demonstrate how these costs, including anticipated project revenues, the developer's financial resources, and funds borrowed, will be met;

--provide assurances that private developers will have an adequate incentive, in terms of equity invested and return expected, for completing the approved project quickly; and

--set forth a procedure for periodically updating the financial plan and considering changes in costs, revenues, and market conditions and other relevant changes affecting the plan.

HUD's instructions require developers to submit specific financial information including

--a cash-flow analysis summarizing projected inflows and outflows of cash for all land development activities;

--source and application of funds statements for each year of the development period;

--profit and loss statements for each year of the development period;

--revenues expected from land sales, supported by market data of competitive or similar properties in the market area;

--land development construction cost estimates supported by detailed engineering studies; and

--financing costs, land acquisition costs, and information on the availability of equity and working capital.

Generally, the financial projections are prepared by the developer or by the economic consulting firm which prepared the market study for the developer.

INADEQUACIES IN THE FINANCIAL PROJECTIONS PROVIDED TO HUD

HUD determined that the four projects represented acceptable financial risks to the United States although the financial projections the four developers gave HUD were not prepared according to HUD's regulations and instructions and contained a number of serious deficiencies. The developer of the Jonathan project sent HUD financial projections for only one-half the development period; the developer's projections for the Park Forest South project were not related to the development plan; the developer of Flower Mound based his projections on developing and selling over 2,000 acres of land it did not own or have an option to purchase; and the developers of Flower Mound and Riverton included major road and utility costs which were not supported by detailed site engineering studies or detailed site plans.

The financial projections for the Jonathan project covered only the first 10 years of the 20-year development period. This information showed that $15.2 million of the $21 million in bonds HUD guaranteed would still be outstanding at the end of the first 10 years. HUD and its developer entered into a project agreement in October 1970 on the basis that the developer would subsequently submit a revised financial plan for the 20-year development period. However, HUD did not request, and the developer did not submit, the revised plan until we brought this matter to HUD's attention in July 1973--almost 3 years later.

HUD guaranteed $30 million in obligations for the Park Forest South project on the basis of a project agreement which included a development plan to construct 37,200 residential units during a 20-year period. The developer, however, did not submit financial projections to show how the obligations could be retired. The developer's financial projections were based on plans to construct only about 20,000 residential units during the same period. These projections were based on the estimated revenues and costs for residential development but did not show revenues and costs for commercial and industrial development. Also certain costs of developing water and sewer facilities were not included in the projections.

We raised numerous questions about the validity of the information submitted and were told by the developer's controller that the projections were hurriedly made to satisfy HUD's request for a financial projection before the project agreement was signed.

The financial projections supporting the $18 million in obligations HUD guaranteed for the Flower Mound project were based on developing a 6,156-acre tract. At December 1973, the developer had no control over, or any assurance of acquiring, 2,106 of the 6,156 acres. If the developer fails to acquire this land, retirement of the federally guaranteed bonds may be seriously jeopardized. We noted that HUD regulations did not require developers to purchase the additional land or obtain options to purchase the land later before signing a project agreement.

The developer's financial projections prepared in August 1971 showed costs of $16.4 million for sewer, water, and roads. In May 1972--8 months after HUD entered into the project agreement with the developer--the developer estimated these costs to be $48.7 million, almost triple the earlier projection. Developer officials told us that the earlier projection had not been based on detailed engineering estimates because, at that time, they did not have the funds to prepare such estimates. The officials also said that they had not verified the estimates at first because the estimates had been prepared by an experienced consulting firm. The developer's engineers later made detailed engineering studies and found that the August 1971 costs were greatly understated.

The Riverton project's financial projections, which supported the $12 million in bonds HUD guaranteed, showed costs of major roads and utility lines to be $4.9 million. The developer's construction engineer prepared these cost estimates in February 1972 without using detailed site plans for these roads and utility lines. The developer obtained detailed site plans 18 months later and estimated these costs to be $11.7 million, or $6.8 million more than the February 1972 estimates. An increase in drainage costs from $334,000 to $4.9 million accounted for most of the difference.

INADEQUATE EVALUATION OF THE FINANCIAL PROJECTIONS SUPPLIED BY THE DEVELOPERS

Land sales revenues for the Flower Mound project were overstated because the developer computed the increase in land values over the development period using a rate that was more than twice the rate HUD generally allowed. HUD told us it was not aware that the higher rate was used in the financial projections. The Riverton project developer did not give HUD any support, nor could it give us any support, for its estimate of $6.2 million for general administrative costs.

The Flower Mound project's developer increased the projected selling price of undeveloped land by an annual "urbanization rate." An urbanization rate reflects the anticipated increase of land values due to urbanization of the new community site. The projected selling price of land for residential and commercial uses remained the same for the first 4 development years. In the fifth year, however, the selling price increased 28 percent over the earlier selling price, and each year thereafter the price increased 7 percent over the first year's selling price. The projected selling price of land for industrial use was $15,000 an acre for the first development year. The price increased $4,500 an acre (30 percent) in the first year and each year thereafter.

The former director of NCA's Market and Financial Analysis Division (who did not review the Flower Mound project) told us that he had informally used an urbanization rate of 2.5 to 3.5 percent in cases when the rate appeared justified. An official from an economic consulting firm told us that his firm used, when warranted, a 3-percent urbanization rate for new community projects. He cited a research report of the National Commission on Urban Problems which states that, in recent years, vacant land in urban areas appreciated in value at 4.5 percent and that land in rural areas and farmland appreciated in value at 3 percent. On the basis of this report, and on trends in maturing new community developments, the firm conservatively appreciates land sales prices at a compounded rate of 3 percent annually for the period 1979-2000.

The HUD official who reviewed the financial projections told us that he was not aware that the urbanization rates were included in the selling prices. We recomputed the sales revenues for the residential, commercial, and industrial land by adding a compounded rate of 3 percent annually over the 20-year development period. On this basis, we estimated that the projected sales revenues would have been about $49 million less than the revenues the developer projected and that the project would not have generated sufficient revenues to retire the federally guaranteed bonds.

The financial projections for the Riverton project included $6.2 million for nonconstruction development costs for the development period. Nonconstruction development costs include costs for planning, engineering, legal and accounting services, and other administrative support. The developer told us that the $6.2 million cost figure was based on industrial standards and was its best estimate at the time, but that it had no support for the estimate. We could find no evidence that HUD had requested the developer to provide support for the estimate.

We noted that, before HUD approved the project in May 1972, the developer had sufficient data to provide more realistic cost estimates for the financial projections. The developer's operating statement for March 1972 showed nonconstruction development costs of $566,000 for the 6-month period of October 1971 through March 1972. This indicated annual costs of over $1 million, or a total $16 million for the development period. Yet HUD approved the developer's estimated annual costs of about $300,000. Developer officials agreed that the nonconstruction development costs they included in the financial projections were grossly understated and that they should have made more accurate estimates.

PROJECTS NOT MEETING FINANCIAL FORECASTS

Although it is too early to predict the impact of the problems discussed in this chapter on the four projects' ultimate success, we did note that the projects were not meeting their forecasts of revenues and costs, as discussed below.

Jonathan

This project's developer experienced greater losses than it anticipated during the first 2 development years. For 1971 and 1972 the developer had predicted net losses of $394,000 and $373,000, respectively, but its actual losses were $800,000 and $867,000, respectively, or $900,000 more than it expected. The losses were primarily attributable to lagging sales of residential and industrial lands. During 1971 and 1972, revenue from land sales was only $1.7 million compared with a projected revenue of $3.4 million.

Park Forest South

The developer of this project has realized much less income from the project than it projected. Net income for 1971 and 1972 was $867,500. The developer had projected income of $2,699,000. The developer's financial position as of December 31, 1972, was substantially below that projected. Net working capital was $661,000 compared with the projected capital of $7,828,000.

Flower Mound

The developer of Flower Mound has sold fewer acres than it had projected. For 1972 the developer projected sales of 191 acres. Actual sales, however, were only about 24 acres. Actual costs were about the same as projected costs.

We noted that the sales were less than expected because the developer had tried to make substantial revisions to the physical plan of the project and because it had formed a municipal utility district to operate the project's water, sewer, and sewage treatment activities. It also had experienced delays in obtaining required HUD area office approvals of subdivision plans and in obtaining building materials because of national shortages. The developer told us that it expected to accelerate its sales in the period 1974-76 to compensate for the slower sales in 1972 and 1973.

Riverton

By December 1973, the developer of Riverton was experiencing serious difficulty in meeting cash-flow needs. As indicated in this chapter, costs for the major roads and utility lines and for nonconstruction development activities were significantly understated.

In September 1973--16 months after HUD approved the project--the developer applied to HUD for an additional guarantee authority of $8 million, or a total guarantee authority of $20 million. The developer's projections were based on an increase in project acreage from 2,335 to 2,926 acres, an increase in dwelling units from 8,010 to 10,060, and increases in projected selling prices for land and project costs. A comparison between the estimated revenue and cost figures included in the May 1972 financial projections supporting the project agreement and in the September 1973 projections follows.

	May 1972	September 1973
	(000 omitted)	
Sales revenue	$50,528	$122,487
Master plan costs	4,929	11,677
Site development costs	11,418	33,811
Nonconstruction costs	6,204	23,612

To assist HUD's evaluation of the Riverton application, we discussed with HUD officials in October 1973 the results of our fieldwork and suggested that they consider asking the developer for additional information or support for statements included in the application. As of March 1, 1974, HUD was reviewing the developer's application.

CHAPTER 5

NEED TO IMPROVE FINANCIAL REPORTING

OF NEW COMMUNITY PROJECTS

Because HUD did not require the developers to periodically revise their financial projections, it was not fully aware of the financial difficulties the developers of the four projects were encountering. Also, HUD did not require developers to submit enough information for it to determine their current financial condition.

The financial plan is designed as a management tool for HUD and the developer to use to evaluate the project's financial progress. The annual and long-term goals set forth in the financial plans serve as benchmarks for measuring the developer's annual progress and financial condition. It provides cost estimates for developing the project within a specified time. Financial plans also identify the timing and amount of revenues and other sources of income needed to meet the developer's financial objectives. HUD regulations provide that the developer have a system for updating his financial plan to reflect changes in the market conditions, revenues, and costs and other relevant changes affecting the plan.

HUD requires developers to submit the following financial reports for the development company and restricted subsidiaries.

--Monthly balance sheets, income and expense statements, and source and application of funds statements.

--Annual statements of the computations of the ratios of revenues to fixed expenses.

Although HUD regulations require developers to have a system for updating financial plans to reflect relevant changes, HUD did not require the four developers to periodically update their financial plans to recognize changes in costs or revenues or to show the effect which their financial performance might have on the projects' prospects for success over the remaining development period.

The financial reports that were being submitted to HUD showed developer's general financial conditions at particular dates and the results of operations for particular times. The reports, however, were not designed to show the differences between the developer's financial plans and actual financial position for the reporting periods or the impact of such differences on the project's financial feasibility. Examples of these deficiencies follow.

--Jonathan's financial plan was predicated on the sale of 210 acres of industrial land during the first 2 years of operation. Only 63 acres were actually sold or leased. In addition, one tract of about 25 acres of industrial land was sold at an average price of about $4,600 an acre, whereas the financial plan estimated a market price of $12,000 to $13,000 an acre.

--The financial plan for Park Forest South indicated that the developer would advance $3 million to a subsidiary for construction and operation of a water and sewer system. For the 2 years ended December 31, 1972, it advanced or invested $4.6 million in the utility system--about $1.6 million more than projected in the financial plan--and estimated that $2.2 million more would be invested in the utility system during 1973.

As of July 1973, Jonathan officials had not revised the project's financial plan to recognize the impact that lagging sales would have on the project's financial feasibility. Park Forest South officials had prepared a revised informal analysis of working capital reflecting the above changes for the period 1972-76 but did not send HUD a copy.

--For the year ended December 31, 1972, Jonathan reported that the company and its subsidiaries had a net loss of about $617,000. The revised analysis did not recognize the impact of the difference between the net loss and the financial plan's projected net profit of $218,000.

--The 1971 annual source and application of funds statement Jonathan and its subsidiaries submitted showed that the developer had experienced a $2.3 million decrease in cash during the year. The report did not show, however, that the developer's actual cash position was about $1.4 million lower than the projections for 1971, primarily because land sales revenues were below the projections. Also, the report did not show the impact of the reduced cash position on the developer's capability to successfully continue project development.

HUD requires the development companies and their restricted subsidiaries to submit financial reports but does not require the developers to report the financial performance of companies affiliated with the developers. We believe that, in projects where affiliated companies take part in the development of the new community, disclosure of the financial performance of affiliates is necessary for evaluating the project's overall financial progress. For example, most of the land development activity at Park Forest South has been carried out by a partnership entity affiliated with the developer. The affiliate acquires partially developed land from the developer; develops the land; and retains the land for investment purposes, builds for direct sale or rental investment, or sells bulk land to other builders.

Internal budget reports for the development company and the affiliate showed a projected consolidated net income of about $723,000 for 1971 and $2 million for 1972, respectively. The reports also projected a consolidated net working capital balance of $7.8 million at December 31, 1972. Financial reports of actual operations, however, showed a consolidated net income of about $250,000 for 1971 and about $618,000 for 1972, or about one-third of the net income projected. At December 31, 1972, the consolidated net working capital amounted to about $661,000, or $7.1 million less than projected.

None of this information was sent to HUD. The developer, following HUD's reporting requirements, reported only net incomes of the development company--$32,366 and $837,452 for 1971 and 1972, respectively. This information did not show that the affiliate had a $219,500 net loss in 1972.

HUD has done little financial monitoring of the new community projects. In December 1973 financial monitoring was the responsibility of a two-man staff in NCA. This staff told us that it received reports from the developers but, because of its heavy workload, usually did not evaluate the reports. The staff is deluged with financial reports--about 750 each year for the 10 projects HUD approved as of January 1, 1974. The staff added that it spent most of its time processing the developers' cost certificates which HUD must approve before the developers can use the bond proceeds to pay expenses.

In the 1975 budget justification, NCA is requesting two financial analysts positions to help with the financial reporting and monitoring system (see p. 47) which is scheduled to be fully operational in 1975. The system is to provide data and analyses essential for monitoring the current financial performance of all projects.

In 1972 HUD added a new community liaison officer to each of HUD's regional offices in the regions where new community projects are located. HUD regulations require the liaison officers to visit the project sites every 6 weeks and to report to HUD headquarters. Their reviews are limited to monitoring the physical development of the new community project. They do not do any financial monitoring.

CHAPTER 6

NEED TO REEVALUATE COLLATERAL REQUIRED

FOR FEDERALLY GUARANTEED OBLIGATIONS

HUD requires the developers of federally assisted new communities to provide adequate collateral to protect the Federal Government from losses if the developers default on the HUD-guaranteed bonds. The Government may not be adequately protected from financial loss for the four projects we reviewed because HUD accepted as collateral (1) real property that was not properly valued and (2) certain items that would have little or no value if the developer defaulted.

HUD requires that the collateral be at least 110 percent of the outstanding principal amount of the guaranteed obligations. Collateral generally consists of cash proceeds from the sale of the guaranteed obligations, certain investments of the cash proceeds, and real property which is owned by the developer and on which HUD has a lien.

Most of HUD's collateral is in the form of real property. The value assigned to the real property is determined by appraising the land's fair market value. In its report on the bill which enacted the new communities program in 1968, the Senate Committee on Banking and Currency said that it intended that "the greatest care be exercised by the Department of Housing and Urban Development in the valuation of land" under the program. The Committee also stated that:

> "In making an estimate of value to the greatest extent possible, reliance should be placed on recent actual prices in arm's length sales transactions of the land involved or of nearby comparable land. Also, while it is reasonable to disregard, as unrepresentative of present values, transactions made at considerably earlier periods when local land values were much lower, it is equally

important that unusually high prices paid for remaining parcels needed to round out a site, or resulting from the guarantee application becoming known to sellers, be considered as unrepresentative of values of the site as a whole.

"Similarly, while it is reasonable to take into account rising sales prices resulting from the influx or expected influx of population or of commerce or industry into the area, it is definitely not the intention of the committee that the valuation take into account the increased values resulting from the guarantee expected to be issued under this title, and the development made possible by that guarantee, as distinct from normal growth that would have been expected in any event."

HUD's regulations provide that valuations assigned to land reflect the "as is" value of the land based on the highest and best uses for which a current market demand existed before development of the land as part of a new community project. To the greatest extent possible, the values were to be established by using recent arm's length sales transactions.

INADEQUATE VALUATIONS OF REAL PROPERTY

For each of the four projects we reviewed, HUD improperly increased the value of the real property pledged by the developers as collateral for HUD's guarantee. For example, HUD increased, without an adequate basis, the value of certain real property in the Park Forest South project by $3.4 million. For other real property in the project, HUD accepted an appraisal which was not prepared according to HUD's instructions. In the Riverton project, HUD, contrary to its regulations, added $840,000 to the value of the land pledged as collateral on the basis of anticipated zoning changes.

Park Forest South project

HUD valued at $19.6 million about 3,700 acres of land that was pledged as collateral for the guaranteed bonds. The primary basis for the valuation was an independent appraisal a consulting firm prepared in December 1970. HUD's reviewer, a former HUD appraiser, did not accept the firm's valuation of 1,247 acres of land zoned for residential use at prices ranging from $1,650 to $3,449 an acre. He said that the land could not be purchased for less than $3,000 to $3,500 an acre. Records showed that the reviewer, before HUD's valuation of the property, attempted to salvage the material from the appraisal reports and to reconstruct more realistic conclusions of value. He indicated that his new conclusions could not be substantiated because they were simply adjustments of an appraisal in which he had little faith and had been made under the pressure of time. HUD subsequently increased the value of the 1,247 acres to $3,500 an acre. This valuation was $1.3 million more than the consulting firm's valuation.

The HUD reviewer also determined that the consulting firm's valuation of 246 acres of land zoned for residential use should be decreased from $7,638 to $6,943 an acre and its valuation of 50 acres zoned for residential use should be decreased from $5,710 to $5,194 an acre. He also determined that the value of 306 acres of land for commercial use should be increased from $4,064 to $4,252 an acre. HUD later increased the value of the residential land to $10,000 an acre and increased the value of the commercial land to $8,000 an acre. This valuation for the 602 acres was $2.1 million more than the consulting firm's valuation.

HUD records show that the increase had been based on an agreement which required one of the developer's affiliated companies to purchase, over a 10-year period, the 602 acres from the developer at the increased values. We believe the increased valuation was not warranted because it did not represent the as is values based upon recent arm's length transactions which are, according to HUD's regulations and the Senate Committee's report, the basis that HUD should use in estimating the real property value.

By January 1973 the developer added as collateral 737 acres consisting of 12 parcels. HUD valued the land at $3,175,300 on the basis of appraisal reports prepared by an independent appraiser.

The appraisals were not prepared in accordance with HUD's appraisal instructions.

--The appraiser based all of his estimates on future uses as proposed in the development plan for the new community rather than the highest and best uses in the current market. For six parcels, the highest and best uses cited by the appraiser were not permissive under current zoning.

--The appraiser did not consider the acquisition price of the properties being appraised in arriving at his estimates and, in fact, told us he avoided obtaining this information. For four of the parcels, acquired within 1 to 5 months after the appraisals, the appraised values exceeded the purchase prices by 12 to 28 percent.

The following case shows an example of these deficiencies. The developer acquired a parcel of 154 acres which was zoned for farming and which contained a frame farmhouse, three barns, and several accessory buildings. Water and sewer facilities were not available, but the developer planned to extend utilities to the parcel within 3 years. The developer acquired the land on November 1, 1971, for $385,895--about $2,500 an acre. On November 19th, 18 days later, the appraiser valued the land at $494,000--about $3,200 an acre.

To arrive at the value of the land, the appraiser referred to 7 sales transactions made 5 to 55 months before his appraisal.

--Two sales involved farmland of 40 and 160 acres. The parcels had sold for $850 and $1,100 an acre 30 to 55 months earlier.

--One sale involved 15 acres of farmland. The parcel was at the intersection of a six-lane highway and sold for $3,500 an acre in June 1971.

--One sale involved 28 acres of land zoned for apartment and residential use. The parcel sold for $4,000 an acre in May 1970.

--Two sales involved 19 and 11 acres, respectively, zoned for commercial use. Both properties were at an interchange of an interstate highway and sold for $4,441 and $5,500 an acre in September 1967 and July 1970, respectively.

--One sale involved 7 acres zoned for residential use. The parcel sold for $3,928 an acre in November 1968. No other description was given.

Although there were several major differences among the earlier sales transactions (time of previous sales and size, location, and zoning of the land), the appraisal report did not show how these factors were considered in arriving at the land value. The appraiser told us that he did not have any workpapers showing how he arrived at the valuation. He said that all adjustments had been made subjectively.

The developer and the appraiser told us that they were not aware of HUD's appraisal instructions when the appraisals were made. The appraiser also said that, because HUD took no exception to the appraisals, he assumed HUD had accepted his report.

Riverton project

Contrary to the Senate Report on the Housing and Urban Development Act of 1968 and HUD regulations, HUD increased the land valuation by $840,000 for anticipated zoning changes. HUD officials told us that the increase was made to help the developer meet HUD's equity requirements.

In February 1972 an independent appraiser estimated the land value on the basis that the land would be zoned for a new community. HUD did not accept the appraisal because of a March 1972 opinion of a HUD assistant general counsel who stated that the appraisal:

"* * * apparently contemplates that the new town will be built pursuant to PUD [Planned Unit Development] zoning. We believe HUD's acceptance of such appraisal would violate these valuation mandates of the Senate

Report. The Riverton appraisal is a particularly extreme case since the zoning itself is contingent on acceptable financing and the HUD guarantee appears to be the only form of financing available. Thus, the appraiser has clearly included increases to value resulting from the guarantee."

The assistant general counsel concluded that the new communities legislation and HUD's regulations did not contemplate increases in value due to zoning changes obtained specifically for the new community. HUD then valued the land at an amount which did not take into consideration the anticipated change in zoning.

To help provide assurances that the developer will have an adequate incentive for completing the project in a timely manner, HUD generally requires that the developer have equity of at least one-fourth of the amount of the guarantee. Equity generally consists of cash, or cash expended, and of unrealized land appreciation which is represented by the difference between the cost of the land owned and the land's appraised value. The amount of unrealized land appreciation cannot be more than one-half of the equity. Since the developer was applying for a $12 million guarantee, its equity had to be at least $3 million.

In April 1972 the developer had an equity of $2,160,000. The HUD reviewer told us that he believed the developer could not possibly come up with the additional $840,000 in cash, and that HUD had to choose between increasing the value of the land by an amount for unrealized land appreciation and forcing the developer out of the project.

In April 1972 the HUD General Counsel overruled the HUD assistant general counsel and told NCA that HUD could legally take the planned unit development zoning into consideration in arriving at the value of the Riverton land. We were unable to obtain any written response or ruling to show the basis for the General Counsel's decision. When the project agreement was signed in May 1972, HUD's collateral for the guaranteed bonds included $840,000--the value of the land for the anticipated zoning.

QUESTIONABLE COSTS INCLUDED AS COLLATERAL

HUD recognizes as acceptable collateral certain nonconstruction costs (interest expenses on the bonds, HUD fees, and HUD financing costs) and general developer overhead costs (legal and management fees, selling and administrative expenses, and travel and entertainment expenses). We believe that these items should not be included because they would have little or no salable value to a prospective buyer or to a creditor if the developer defaulted.

HUD requires the amount of collateral to be 110 percent of the principal amount of the outstanding bonds. This requirement anticipates that, in the event of default, there would be enough collateral to pay off the outstanding bonds and also pay 1 year's interest on the bonds. HUD also has set up a revolving fund, pursuant to the new communities legislation, which is financed from fees and charges paid by the developers and which, in the event of default, can be used to pay off bonds not adequately secured by assets. By June 30, 1973, the fund totaled about $8.9 million.

HUD allows nonconstruction and general overhead expenses on the basis that such costs have value to a going concern; that is, a business venture with a continuous life. We believe that the development of a new community involves certain risks and that a new community project should not be considered a going concern until the developer can demonstrate development ability and adequate financial performance.

A nationwide public accounting firm, which is currently designing and carrying out a financial reporting system for NCA, suggested that NCA require collateral amounting to 100 percent of the principal amount of the outstanding bonds. According to the firm, the collateral should include land acquisition costs and actual construction and carrying costs for paving and water and sewer facilities but should not include selling, administrative, and general expenses. An official of the firm told us that the mortgage banking industry had no hard and fast rules for the amount or type of collateral the industry would accept for financing new communities. He said that, because of the risks involved in the development of new communities, mortgage banks probably would not become involved in financing these projects.

Collateral for the four projects we reviewed included a large amount of nonconstruction costs and general overhead expenses, as shown below.

Project	Date of collateral report	Collateral required (110% of guaranteed bonds)	Collateral reported	Nonconstruction and overhead costs included in collateral	Net collateral
		(millions)			
Jonathan	1-15-73	$23.1	$23.1	$6.2	$16.9
Park Forest South	12-31-72	33.0	35.0	3.3	31.7
Flower Mound	12-31-72	15.4	15.4	2.5	12.9
Riverton	12-31-72	13.2	13.3	2.7	10.6
Total		$84.7	$86.8	$14.7	$72.1

As is evident from the above chart, if these items were excluded from the collateral on each project, the remaining collateral would not be adequate to meet HUD's 110-percent requirement. In this case, the Federal Government would have to make up the difference of $12.6 million ($84.7 million less $72.1 million) from the revolving fund. If this amount was not sufficient, HUD would have to request funds from the Congress.

In February 1973 an Assistant Inspector General of HUD issued an audit report which questioned nonconstruction costs and overhead expenses as valid elements of collateral. HUD's Acting Assistant Secretary for Community Planning and Management responded that what constituted adequate collateral was a matter of opinion and, in his considered judgment, adequate collateral existed.

CHAPTER 7

INTERIM REPORT ON TWO NEW COMMUNITY PROJECTS,

CONCLUSIONS AND RECOMMENDATIONS

INTERIM REPORT

In June 1973 we completed our fieldwork on the Jonathan and Park Forest South projects. We thought that our observations on the two projects clearly showed that HUD needed to take certain immediate action to help insure that the Federal commitment to the projects was adequately safeguarded.

On July 27, 1973, we reported to the Acting Assistant Secretary for Community Planning and Development (predecessor to the Administrator of NCA) the weaknesses we noted regarding HUD's determinations of the projects' market and financial feasibility; HUD's monitoring efforts; and the type of collateral pledged for the federally guaranteed obligations. We recommended that HUD:

--Evaluate the current market and financial feasibility of the Jonathan and the Park Forest South projects. For each project, the Office of New Communities Development should (1) analyze the approved development plans in terms of present market conditions and revise the plans as appropriate and (2) prepare a current financial plan to determine whether the projects currently appear able to generate enough revenues to meet the anticipated costs and retire the federally guaranteed bonds.

--Require that all developers submit financial projections each year for the entire development period.

--Review the collateral pledged for the Jonathan and Park Forest South federally guaranteed obligations. The amounts pledged should be based on independent appraisals of real estate market values and the liquidation values of items included as collateral. Also HUD should consider revising its current policy regarding the type of items accepted as collateral for the federally guaranteed obligations.

HUD response and GAO evaluation

On December 26, 1973, the general manager of the Community Development Corporation and NCA's current Administrator responded to our report. The Administrator noted that a key step in strengthening all aspects of the program, including the important matters we addressed in our review, was the appointment of a general manager who would report directly to the Secretary and who would have full-time responsibility for directing the program. He said that he had taken steps to initiate a comprehensive and searching review of all aspects of the program's operation, organization, and staffing needs and that our review was an important and timely input to this review process.

With respect to the specific matters contained in the report, the Administrator said that certain steps had been taken or were being developed.

Market and financial feasibility

The Administrator said that, since the 1970-71 period when the Jonathan and Park Forest South applications were reviewed, the staff responsible for reviewing the economic, marketing, and financial aspects of pending applications had been considerably increased. As a consequence, pending projects were now being more rigorously reviewed with respect to these matters.

We noted that during the 1970-71 period when Jonathan, Park Forest South, and Flower Mound were approved, an average of four and one-half professional staff members were assigned to the application review division. In March 1972, shortly before the Riverton project was approved, 20 staff members were assigned. This number dropped to 17 by January 1974.

The Administrator also stated that the final report on a New Community Simulation System (NUCOMS), prepared under a $349,000 contract with Decision Sciences Corporation, had recently been sent to HUD and that work under the contract was continuing with respect to preparing a users' manual and training HUD personnel to use the model. He said this work was to develop operational tools to strengthen the program staff's capability to make sound determinations of the market feasibility of projects proposed for title VII assistance. Specifically, the model will permit HUD to project regional employment, income, and population growth. Then HUD can allocate these factors to the market areas and anticipate the capture rate of a new community regarding residential, industrial, and commercial development. NUCOMS includes the development of a developer's financial model, a local government fiscal impact model, a land use model, a community facilities model, a community association model, and an overall risk assignment model showing how all the above interrelate. The Administrator said that HUD had provided close monitoring and guidance to the contractor throughout this lengthy and complex effort and anticipated that it would provide valuable analytical tools to strengthen those aspects of the application review process we studied.

A HUD consultant has been hired to implement the system for NCA. He told us that NUCOMS would be used to (1) test the validity of the developers' market projections and (2) periodically evaluate the market conditions for the new communities HUD had approved to determine whether any changes might be needed in the development and in the developers' financial plans. He said the system should be operating smoothly by August 1974.

The Administrator said that he had initiated a comprehensive program for evaluating at least five new community projects, probably including Jonathan and Park Forest South, which were furthest along in construction and marketing. He said this study would involve a complete review of the economic and financial feasibility of these projects and would also provide some useful information about the financial and other problems confronting the new community projects selected for study. It would also provide a basis for strengthening program policies and procedures.

On March 19, 1974, HUD sent out a Request for Proposal to design and implement an analysis of the operational problems of nine new community projects. Seven of the nine projects are being assisted by HUD; two are being privately financed. HUD told us that the four projects discussed in this report will be evaluated under the contract. The study will cost between $830,000 and $1.1 million. HUD hopes to award the contract by June 30, 1974, and expects the study to be completed by September 1975.

Monitoring

The Administrator stated that he had asked both the Park Forest South and the Jonathan developers to send HUD an updated annual cash-flow statement for the remainder of the respective development periods. We were told by the Director of the Financial Reporting and Monitoring Division that both developers were currently reviewing their marketing plans and that the revised development and financial plans would probably be sent to HUD in July 1974.

The Administrator also said that HUD was involved in a long-range effort to systematize and strengthen the financial evaluation and monitoring capabilities in both the application review and the post-approval implementation stages and had contracted with a nationwide public accounting firm for the development, by December 1973, of a Financial Reporting and Monitoring (FRAM) system for the new communities program. He said the FRAM system would provide for standard and systematic submission of financial reports by title VII developers; establish guidelines and criteria for the project financial evaluation and monitoring functions of the program, including collateral valuation procedures; and provide for early warning of potential financial problems.

As of March 1, 1974, the accounting firm which designed the system had generally completed its work under the contract. The FRAM system requires developers applying for guarantee assistance to give HUD detailed cost and revenue data in their financial plans, including descriptions of the bases for the estimates. The accounting firm's project director told us that HUD would have to evaluate the basis for the cost and revenue estimates and decide whether to accept the estimates or ask the developers for additional facts. He also told us that FRAM was dependent on an accurate and reasonable market study which, in his opinion, was the cornerstone of a new community project and that the accuracy of the financial plan depended upon the market study's accuracy.

The FRAM system will eliminate HUD's current requirement for monthly financial reports. Instead, HUD will require quarterly reports. Also FRAM will require developers to prepare detailed financial budgets for 2 years. FRAM's design also calls for comparing actual costs or revenues with budgeted costs or revenues and, if there are significant differences, HUD and the developer might have to reevaluate the entire financial plan.

The project director told us that FRAM's implementation by current new community developers will depend largely on their present financial management capabilities. He said some developers would have no difficulty implementing the FRAM system immediately. However, other developers would have to make some changes in their management systems.

The project director expressed the view that NCA would need more people to operate the system. He said HUD had asked his firm to estimate the costs, time, and number of people needed to implement FRAM.

Collateral

The Administrator did not comment on our recommendations concerning the collateral for the federally guaranteed obligations.

CONCLUSIONS

The new communities program has experienced some progress. At January 1, 1974, HUD provided guarantee assistance to 10 projects; was committed to guarantee 5 other projects; and had determined that 2 other projects, which did not request guarantee assistance, were eligible for grant and loan assistance. During fiscal year 1974, three more projects are scheduled for approval.

But the program has also experienced problems. The development of new communities in the central cities and in nonmetropolitan areas has not materialized as the Congress intended, primarily because of the higher costs and/or higher risks to the developers of such communities and the lack of financial assistance currently afforded by the new communities legislation. We concluded earlier in this report that it appeared that changes in legislation were needed to stimulate the development of new communities in central cities and rural areas.

Each of the four projects we reviewed is having difficulty meeting development plans and financial projections. HUD contributed to these problems by approving a Federal guarantee of obligations without adequately determining market and financial feasibility. Because of deficiencies in its financial reporting system, HUD has been unable to keep fully informed of the developer's financial difficulties. Also, the collateral for the federally guaranteed bonds for each project may not be adequate to protect the Federal Government from financial loss if the developers default.

HUD has recently increased staffing and initiated certain actions to improve the administration of the new communities program. These actions include (1) designing a simulation model for use in evaluating the new community projects' market and financial feasibility during the application review process and periodically thereafter, (2) designing a financial reporting and monitoring system to assist HUD in more effectively monitoring existing projects, and (3) planning to contract for a comprehensive evaluation of seven approved projects to determine why the projects have experienced marketing and financial problems.

Because these actions have just recently been initiated, we were not able to determine how effective they would be in correcting the problems discussed in this report.

RECOMMENDATIONS

We recommend that the Secretary of HUD:

--Evaluate the current market and financial feasibility of each project HUD has approved. HUD should (1) analyze the approved development plans in terms of present market conditions and revise the plans, if necessary, and (2) prepare a current financial plan to determine whether the projects appear able to generate enough revenue to meet the anticipated costs and to retire the federally guaranteed obligations.

--Require the New Communities Administration to periodically monitor the financial progress of the developers and affiliated companies and reevaluate the market and financial feasibility of each project when actual performance is much lower than projected.

--Require the New Communities Administration to establish guidelines for evaluating the proposed project's market and financial feasibility, including how information supplied by the developer should be accepted or verified.

--Require that developers either own or control all project land before project agreements are signed.

--Revise HUD's current policy pertaining to collateral so that only items which can be liquidated will be accepted as collateral for the federally guaranteed obligations and review each approved project's collateral to determine its current value.

AGENCY COMMENTS AND OUR EVALUATION

HUD generally agreed with our recommendations and outlined actions it was taking or planning to take. (See app. IV.)

HUD agreed that the current market and financial feasibility of each approved project should be evaluated and said that during the past year it had made considerable progress evaluating these projects. NUCOMS, which evaluates proposed projects and reevaluates approved projects to determine their market and financial feasibility, is HUD's major evaluative tool. (See p. 46.) According to HUD, implementation of NUCOMS to the 12 approved projects was begun several months ago and was to be completed by September 1974. HUD subsequently told us that the implementation would be completed in November 1974. HUD said that if a project was experiencing financial difficulties and the developer could not prepare a revised financial plan to generate sufficient revenues, NCA would work with the developer to arrange a course of action leading to a positive financial conclusion.

HUD agreed that improvements are needed in the financial monitoring of new community developers and their affiliated companies and said NCA was improving both monitoring and evaluation systems along with NCA's organization and staffing patterns. According to HUD, in June 1974 NCA sent instructions to developers of approved projects for partial implementation of the FRAM system (see pp. 47 and 48). HUD said that it would increase its reviews of affiliates' financial reports as staffing increases and the monitoring and evaluation systems are formalized.

HUD stated that NCA had been developing a comprehensive set of market and financial instructions for potential developers and had recently issued instructions on preparing the financial part of an application for guarantee assistance. According to HUD, NCA now (1) follows the general practice of verifying basic sources of information used by developers or their consultants in preparing projections, (2) makes field trips to verify or modify statistics or assumptions, and (3) uses NUCOMS to prepare independent market projections.

HUD said that our recommendation requiring developers to either own or have control over project land before project agreements are signed might be better accomplished by only requiring the developer to own part of the land and hold options on the remaining land, exercising these options as land is needed. HUD's suggestion agrees with our recommendation.

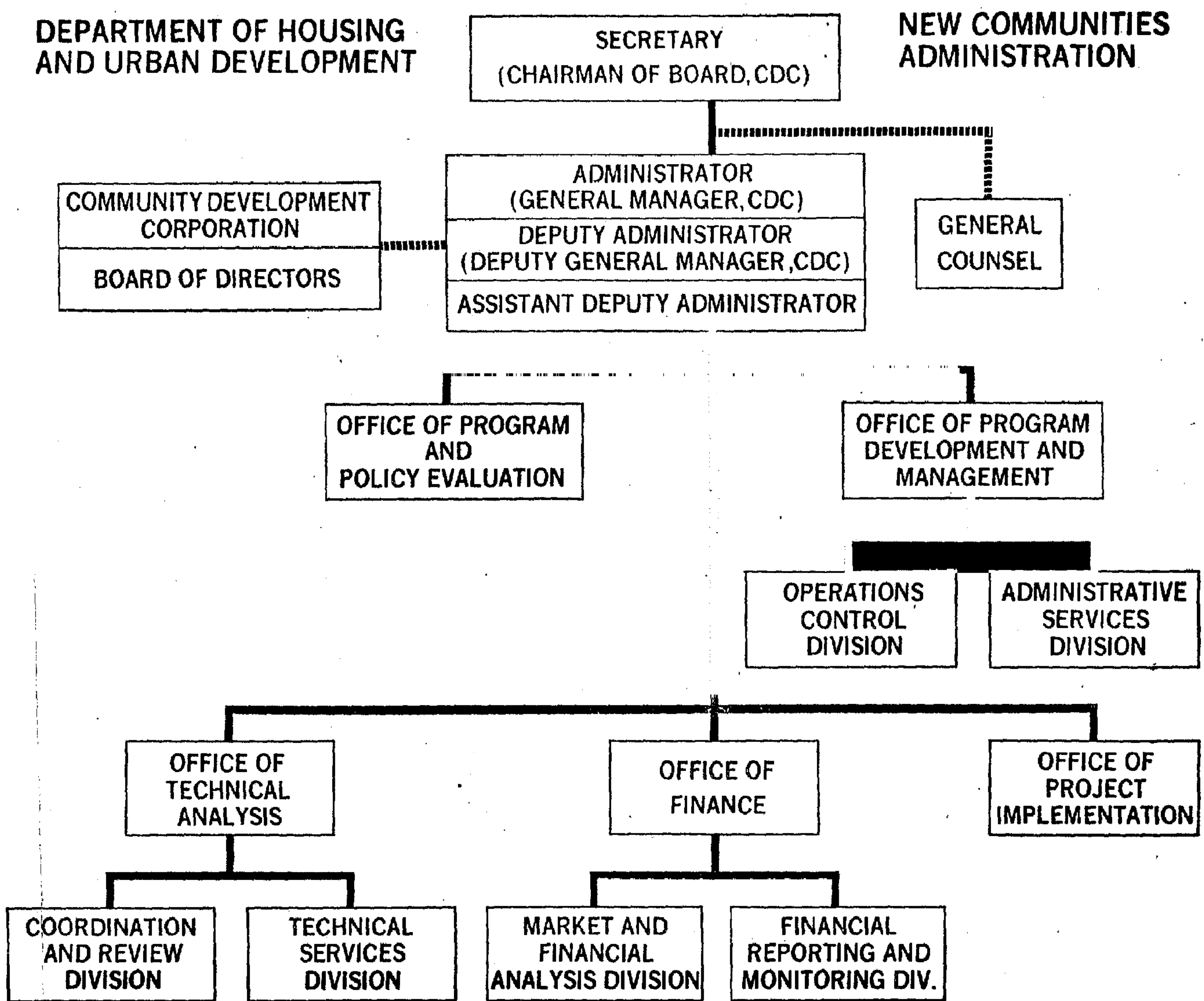
HUD said that NCA was reevaluating the security concept and would carefully consider our suggestions of items acceptable as collateral. However, HUD said that our concept of valuing land held in security on a liquidation basis rather than a going-concern basis would negate the Congress' intent of financing land development costs, including certain nonconstruction costs. We agree that certain nonconstruction costs are eligible for financing as land development costs. The legislation, however, does not specify what types of costs are acceptable collateral for the guaranteed bonds and leaves this determination to the Secretary's discretion. We believe that nonconstruction costs do not constitute adequate collateral for the guaranteed bonds in the event of default and that HUD's policy should be revised.

HUD also stated that it was reviewing the collateral pledged for each approved project to determine its current value. HUD said that NCA was processing revaluation appraisal contracts for a number of approved projects and anticipated that all but the most recently approved projects will be reappraised before the year's end. NCA recently added a real estate appraiser to its staff and has obtained the services of a consultant who is an appraiser and an attorney.

We believe HUD's actions reflect its desire to provide a much-needed evaluation of the projects it has approved and to improve the administration of the new communities program.

ORGANIZATION CHART OF THE

NEW COMMUNITIES ADMINISTRATION



PROJECTS APPROVED BY HUD
AS OF JANUARY 1, 1974

	Location	Date of HUD commitment	Date of project agreement	Guarantees committed	Guaranteed obligations issued	Projected dwelling units	Projected population
				(------- millions -------)			
PROJECTS GUARANTEED:							
Jonathan, Minnesota (S)	20 miles southwest of Minneapolis	2/70	10/70	$ 21.0	$ 21.0	15,000	50,000
St. Charles Communities, Maryland (S)	25 miles southeast of Washington, D.C.	6/70	12/70	24.0	24.0	25,000	75,000
Park Forest South, Illinois (S)	30 miles south of Chicago	6/70	3/71	30.0	30.0	37,000	110,000
Flower Mound, Texas (S)	20 miles northwest of Dallas	12/70	10/71	18.0	14.0	18,000	64,000
Maumelle, Arkansas (S)	12 miles northwest of Little Rock	12/70	12/71	7.5	6.9	14,000	45,000
Cedar-Riverside, Minnesota (NTIT)	Downtown Minneapolis	6/71	12/71	24.0	24.0	13,000	30,000
Riverton, New York (S)	10 miles south of Rochester	12/71	5/72	12.0	12.0	8,000	26,000
The Woodlands, Texas (S)	30 miles north of Houston	4/72	8/72	50.0	50.0	47,000	150,000
Gananda, New York (S)	12 miles east of Rochester	4/72	12/72	22.0	22.0	17,000	56,000
Newfields, Ohio (S)	7 miles northwest of Dayton	10/73	11/73	32.0	18.0	13,000	40,000
Subtotal				240.5	221.9	207,000	646,000
PROJECTS WITH OFFERS TO GUARANTEE:							
San Antonio Ranch, Texas (S)	20 miles northwest of San Antonio	2/72	-	18.0	-	29,000	88,000
Soul City, North Carolina (FS)	45 miles north of Raleigh	6/72	-	14.0	-	13,000	44,000
Harbison, South Carolina (S)	8 miles northwest of Columbia	10/72	-	13.0	-	6,000	23,000
Shenandoah, Georgia (S)	35 miles south of Atlanta	2/73	-	40.0	-	23,000	70,000
Beckett, New Jersey (S)	18 miles south of Philadelphia	10/73	-	35.5	-	20,000	60,000
Subtotal				120.5		91,000	285,000
PROJECTS WITHOUT GUARANTEES:							
Radisson, New York (S)	12 miles northwest of Syracuse	-	-	-	-	5,000	18,000
Roosevelt Island, New York (NTIT)	East River between Manhattan and Queens	-	-	-	-	5,000	18,000
Subtotal						10,000	36,000
Total				$361.0	$221.9	308,000	967,000

LEGEND

S Satellite new community
NTIT New-town-in-town
FS Free-standing new community

DESCRIPTION OF THE FOUR PROJECTS INCLUDED IN THE GAO EVALUATION

JONATHAN

Jonathan, the first new community to qualify for HUD guarantee assistance, is being developed over a 20-year period on 8,200 acres southwest of Minneapolis. It is expected to accommodate about 50,000 residents.

Jonathan is rising in the Chaska, Minnesota, area which has been designated a regional growth center by the Metropolitan Council of the Twin Cities. Jonathan is 20 minutes from the metropolitan airport, has major U.S. highway access and trunkline rail access to Minneapolis, and has rapid transit potential.

The general design concept of Jonathan is to develop five villages, each with a population of 5,000 to 7,000 people. In addition, some 10,000 people are to be located adjacent to the town center in high-density dwelling units and 5,000 in a 300 acre "learning center" having a branch of a major university.

About 30 percent of the land is planned for residential use, 27 percent for commercial or industrial use, and 43 percent for open space and other uses. The developer had considered preserving the site's natural environment.

The project will provide about 50 percent of the dwelling units for low- and moderate-income housing. Some of these units will be federally subsidized.

HUD's records show that on December 31, 1973, 1,864 residents lived in Jonathan and 45 business firms employed over 1,080 persons.

PARK FOREST SOUTH

Park Forest South is being developed over 20 years on 8,200 acres. The project borders Interstate Highway 57 in Will County, 30 miles south of Chicago.

The community's 37,200 homes will house families of all income levels, including about 6,000 units for persons of low and moderate incomes. When development is completed, Park Forest South is planned to have a population of 110,000 persons.

Three expressways will provide fast auto access to growing industrial areas in and around Chicago. There is also rail access within the project, and a commuter station is planned.

A new college of 15,000 students and a town center will serve as focal points for the community. It is planned that about 60 percent of the land will be for residential development, 16 percent for commercial and industrial use, and 24 percent for open space and other uses.

HUD records show that as of December 31, 1973, the new community had over 5,400 residents and over 925 persons were employed by 34 firms.

FLOWER MOUND NEW TOWN

Flower Mound New Town is being built within the existing community of Flower Mound in Denton County, Texas, about 20 miles northwest of Dallas. The 6,156-acre new community is to be developed over a 20-year period and will provide housing for over 64,000 persons.

Flower Mound will meet the full economic range of housing needs in the Dallas-Fort Worth area. More than 18,300 homes will be built and about 3,700 of these will be for low- and moderate-income families.

Fourteen neighborhoods are to be grouped into four villages around the town center and each village will have its own schools, shops, and parks. About 49 percent of the land is planned for residential use, 11 percent for commercial and industrial use, and 40 percent for open space and other uses.

Existing access to the community is by an interstate highway from Dallas and by two State routes. A rapid transit system is also a possibility for the project.

RIVERTON

Riverton is being built over a 16-year period and will house about 26,000 people. The project, about 10 miles south of Rochester, New York, is planned to be developed on 2,335 acres adjacent to the Genesee River.

Of Riverton's 8,010 residential units, about 40 percent are planned for low- and moderate-income families, including the elderly.

Planned community facilities include an 18-hole golf course, 11 outdoor and 1 indoor swimming pools, 3 lakes for recreation use, and a riverside park. The land use planned for the project includes 49 percent for residential use, 27 percent for commercial and industrial use, and 24 percent for open space and other uses.

A planned expressway and rapid transit system will provide additional access to the property. The site is also adjacent to the New York Thruway.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

NEW COMMUNITIES ADMINISTRATION

September 27, 1974

Mr. Henry Eschwege
Director, Resources and Economic Development Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Eschwege:

Subject: Draft GAO Report on Progress and Problems in the New Community Program

Secretary Lynn has requested that I respond to the materials contained in the draft report to the Congress on progress and problems in the New Communities Program, requested in your June 13, 1974, letter to the Secretary. As previously indicated in our response to the General Accounting Office's interim findings, your review has provided an important and constructive input to NCA's consideration as to ways of strengthening the effectiveness of the program. The draft report also points out weaknesses identified by GAO as a result of its investigation and sets forth thoughtful reflections on potential remedies. It is to the recommendations contained in the draft report on which I will comment.

1. EVALUATE CURRENT MARKET AND FINANCIAL FEASIBILITY OF APPROVED PROJECTS. NCA agrees that an evaluation should be made of current market and financial feasibility on each approved project. In this regard, NCA has made considerable progress during the past year.

When NCA finds that a project is experiencing difficulties because revenue projections are not materializing or development costs have been underestimated and continuing to pursue an existing development plan or time schedule will not resolve the difficulty, it is NCA's responsibility to request that a developer revise his plans as appropriate and prepare a new financial plan which will generate sufficient revenues. If the developer cannot do this, NCA then must work with the developer to arrange a course of action leading to a positive financial conclusion.

A major effort to evaluate current economic, market and financial feasibility of NCA new communities has been the development and implementation of the New Community Simulation Model (NUCOMS). The NUCOMS system implementation to the twelve (12) approved projects was begun several months ago and is estimated to be completed by September 1974. The regional model has been completed on ten approved projects, the sector model on eight approved projects, the community level models on one project, and the financial model on one project. The attached Exhibit A shows the status of implementation of NUCOMS for the 12 approved projects.

The NUCOMS system is intended to evaluate proposed projects and re-evaluate approved projects as to market, economic and financial feasibility. Systems and procedures are currently being designed which will utilize the latest market and demographic data for the regions under consideration. Revised market projections will then be compared to the market penetration assumed by the developers in their latest plans. The output format of NUCOMS' financial model is being changed to conform with NCA's financial reporting and monitoring system (FRAM) format and will appropriately interface with the most recent reports submitted by the developers.

Immediate priorities for use of NUCOMS are to (1) apply it to projects where critical decisions by NCA are required, (2) implement all models for all approved projects, and (3) develop systems and procedures for updating the data. The NUCOMS system has been slightly modified from the initial design concepts. The following set of eleven (11) interlocking models describe the major aspects of the system as it is now working: (1) regional economic model, (2) sector model, (3) community level-residential demand model, (4) community level-industrial location model, (5) community level-office space model, (6) community level-retail demand model, (7) economic financial interface, (8) financial model-developer, (9) financial model-utility authority, (10) financial model-community association, (11) fiscal impact model.

2. NCA TO PERIODICALLY MONITOR FINANCIAL PROGRESS OF DEVELOPER AND AFFILIATED COMPANIES. NCA agrees that improvements are needed in the financial monitoring of new community developers and affiliated companies. NCA has been moving to improve both monitoring and evaluation systems together with NCA's organization and staffing patterns. NCA's staff now scrutinizes certificates of actual cost, the financial condition of the developer, and adherence to applicable financial covenants contained in the project agreement and indenture. In addition, the status of the escrow account, exercised indorsements, and adherence to the security requirements by the trustee are more closely examined. With the engagement of additional staff, NCA contemplates more extensive review of developer's financial statements, and preparation of procedures and manuals to formalize the monitoring process. Implementation of the FRAM system will further strengthen NCA's review and monitoring capacity, as more fully discussed below.

In response to your July 27, 1973, letter on interim findings, NCA indicated that it had contracted with Arthur Young and Company for development of a financial reporting and monitoring system (FRAM) for the New Communities Program. The FRAM system is to provide standard and systematic financial reports by New Community developers and establish guidelines and criteria for project financial evaluation and monitoring functions. In June 1974, NCA sent instructions to the developers of approved projects for partial implementation of the FRAM system (copy of instructions attached as Exhibit B). A portion of the initial submission was received at the end of July 1974, with the balance thereof due at the end of October 1974, and quarterly thereafter. When fully implemented, the FRAM system will conform with the simulation model of NUCOMS described in section 1 above.

The recommendation that NCA periodically monitor the financial progress of affiliated companies is most constructive. NCA considers affiliates (or Interested Parties) to be (1) partially or wholly owned subsidiaries of the developer, or (2) entities in which individuals, corporations or partners have an interest in the New Community developer. Much of the construction in the new community is accomplished through these affiliates, and the economic viability of the project as a whole is directly related to the financial stability of these affiliates. As such, NCA periodically receives financial reports of these affiliates in addition to those of the developer. These financial reviews shall increase in magnitude as NCA's staff increases and the monitoring and evaluation systems are formalized. A standardized format for reviewing interested party transactions is being prepared for use of project managers, and financial and legal staff.

3. <u>ESTABLISHMENT OF GUIDELINES FOR EVALUATING MARKET AND FINANCIAL FEASIBILITY IN PROPOSED PROJECTS</u>. NCA has been developing a comprehensive set of market and financial instructions for potential developers. Recently NCA issued a set of instructions on the preparation of the financial portion of an application for new community guaranty assistance. These instructions will be included in the New Communities Financial Reporting and Monitoring (FRAM) system handbook currently being developed under HUD contract. They cover initial applications and applications for additional guarantees. Developers are instructed as to the form and substance of submissions on market and financial information required to make a finding on economic and financial feasibility.

NCA strongly believes that economic, market and financial analysts must use their professional judgment on the appropriateness of methodologies used by developers to provide forecasts in their particular market areas. Generally, these methods are standard techniques used in the trade. Those not commonly used in the trade are closely scrutinized and substantiated with estimates produced by conventional techniques.

The GAO draft report commented on the need for verification of information submitted by developers. The NCA staff has followed the general practice of verifying all basic sources of information used by developers or their consultants in preparation of projections. At times, there may be a lag between the submission of economic or market data and approval. NCA analysts examine the submitted material for soundness of methodology and reasonableness of projection. Field trips to the market are made to verify or modify the base statistics or assumptions utilized for these projections. In addition to these review procedures, the NUCOMS economic and market models are utilized in preparing independent computerized economic and market projections.

Periodically, NCA staff or consultants conduct field visits to verify or substantiate market information prepared by developers. These reviews cover growth, housing starts, competitive position and description of other sites, and building trends as observed by local financial institutions, builders, realtors, etc.

4. REQUIRE DEVELOPERS TO OWN OR CONTROL ALL PROJECT LAND PRIOR TO SIGNING PROJECT AGREEMENTS. NCA agrees that it would be desirable for the developer to either own or have control over all project land before the Project Agreements are executed. It is NCA's opinion, however, that the purpose of this recommendation might be better accomplished by the developer owning a portion of the project land, and holding firm options on remaining project land with the right to exercise these options and draw down land as needed.

This process would provide a vehicle for staged development of new communities without over-extending the developer. Additional project land could be drawn as needed and additional guarantees could be approved as required. Unutilized land would not sit fallow and carrying costs would be substantially reduced, thereby creating far greater financial feasibility. Utilization of this approach would reduce substantial outlays of cash necessary for initial purchases of land during the assembly period.

5. <u>REVISE NCA POLICY REGARDING ACCEPTABLE ITEMS FOR COLLATERAL, AND PERIODICALLY REVIEW PLEDGED COLLATERAL FOR VALUE</u>. NCA agrees with the recommendation that the current policy regarding items accepted for collateral be carefully reviewed. NCA is presently undertaking a re-evaluation of the entire security pool concept. The suggestion cited in the draft report as to the use of a nationwide public accounting firm is only one of the possible alternatives under consideration.

NCA is currently processing individual revaluation appraisal contracts for a number of approved projects and anticipates that all but the most recently approved projects will have revaluation appraisals prior to the end of the year. Enclosed as Exhibit C is a copy of the latest "Appraisal Instructions for Revaluation of Security for New Community Guarantees - Criteria for Valuation", dated June 1974. These revaluation appraisals were provided for on a bi-annual basis in the NCA project agreement. Also, NCA has recently added a staff real estate appraiser, and has obtained the services of a full time consultant who is a M.A.I. and an attorney. The security calculations are used primarily to control draw downs from the escrow account of the guaranteed loan funds and to establish release prices between revaluation appraisals. The typical debentures issued by the private developer and guaranteed by the Federal Government are twenty year bonds that are noncallable for 10 years with a Sinking Fund payment starting in the eleventh (11th) year and ending in the twentieth (20th) year. The land "release price" does not represent cash payment to the trustee but rather is used as a control mechanism enabling the developer to have use of all the borrowed funds for a minimum of 10 years.

The concept expressed in the draft report that valuation of land held in security be made on a liquidation basis rather than on a going-concern basis would negate the intent of Congress in financing the actual costs of land development, including certain nonconstruction costs which are defined in section 711 (g) of Title VII of the Urban Growth and New Community Act of 1970.

It should be emphasized that NCA is not satisfied with the "security pool" and "release price" mechanisms as currently implemented, and is carefully reviewing these concepts and several staff suggestions for improving and strengthening them. The suggestions contained in the draft report are most welcome, and will be carefully considered in NCA's over-all review of the subject.

6. ADDITIONAL METHODS NOW USED FOR IMPROVING THE NEW COMMUNITIES PROGRAM. The four projects under consideration in the draft report, Jonathan, Park Forest South, Flower Mound, and Riverton were all approved in 1970 and 1971. Since the advent of new community responsibility within the Department of Housing and Urban Development, there have been numerous officials responsible for administration of new community activities. (See Exhibit D, Principal Officials of the Department of Housing and Urban Development Responsible for Administration of Activities.) The present General Manager of the Community Development Corporation and Administrator of the New Communities Administration is Mr. Alberto F. Trevino, Jr., who assumed his position in July 1973.

In August 1973, NCA faced numerous problems. The existing organizational structure was and had been insufficient and inappropriate to implement and conduct a viable program. There were virtually no internal management controls and the staffing level was substantially below that required by the workload. As a consequence, a large number of applications and preapplications were pending review and many had become inactive. In addition, monitoring and financial review of projects in implementation had been conducted at an unsatisfactory level.

Since August 1973, a number of positive steps have been taken to improve monitoring and financial reviews of projects and the total responsiveness of NCA to the needs of the program. Major actions taken to date include:

1. In July 1973, Secretary Lynn announced that the Office of New Community Development under the Assistant Secretary for Community Planning and Development would be abolished. A full time General Manager for the Community Development Corporation with equivalent status of an Assistant Secretary would be responsible for overseeing the New Communities program. Staff support for the General Manager would come from a newly established New Communities Administration.

2. The new General Manager undertook several actions to immediately deal with the most pressing problems.

a. A new organizational structure was developed which called for an internal management staff, the Operations Control Division, and the centralization of field liaison activities with responsibility for rigorously screening project inquiries. The Offices of Finance and Technical Analysis were formally established and specific responsibilities were defined (see Exhibit E for organizational chart).

b. The existing preapplications and applications were given an intensive review. Projects not clearly meeting program criteria were disqualified by NCA or withdrawn by the developer. (From July 1, 1973, to March 31, 1974, eleven applications and 28 pre-applications pending as of June 30, 1973, were affected). Viable applications and projects with commitments which had not been "closed" were expedited to closing. Two full applications (Newfields and Beckett) were approved in October 1973. In addition, three projects (Shenandoah, Soul City and Newfields) were taken to closing in FY 1974.

c. The FY 1975 budget, prepared in the fall of 1973, requested that NCA staffing be increased from 73 positions in FY 1974 to 91 positions in FY 1975. The Secretary authorized the use of outside consultants to supplement NCA staff resources.

d. The National Archives was engaged to review records management procedures. A program involving indexing, centralization of files, and utilization of microfische storage was initiated.

e. A series of internal management controls were initiated in late 1973 and early 1974. These include:

(1) A centralized correspondence control point was established. Routing procedures, information dissemination guidelines, and a tracking system were initiated.

(2) Project activity scheduling sheets were developed containing six-month work plans on each project in implementation. These sheets are updated on a weekly basis by Project Managers, and are used as a basis for coordinating staff activities.

(3) Weekly project review sessions involving the General Manager, Assistant Administrators, senior staff and Project Managers were initiated in early 1974 and are held regularly. Current problems, priorities and the allocation of limited staff resources are discussed at these sessions. The Assistant General Counsel for New Communities attends each meeting.

(4) In June 1974, a contract was issued to Planalysis for purposes of designing a management information graphics system. The objective was to project critical

financial and nonfinancial data regarding projects in implementation. This contract is nearing completion, and a series of thirteen charts depicting progress on each project is being prepared.

(5) In June 1974, the General Manager instructed each Project Manager to begin preparing the necessary data to utilize NUCOMS economic market analysis models. This is now underway with data loaded for twelve projects. Four projects are intensively being reviewed by NUCOMS.

(6) The General Manager recently moved to take a more direct role in supervision of projects in implementation. On June 18, 1974, all Project Managers were detailed to report directly to the General Manager. Some reassignment of project management responsibilities took place simultaneously and several individuals with strong management systems backgrounds were assigned to the project management staff. In addition, each Project Manager was instructed to prepare a comprehensive project information book and to develop a one year project schedule and work plan. An initial evaluation of progress on these assignments took place during the week of July 15 through 19, 1974. (See Exhibit F)

(7) The General Manager has committed himself to the objective of placing one full time senior project manager on each project. Unfortunately, this objective cannot be fully achieved with the FY 1975 personnel and is thus not fully obtainable until FY 1976. In June 1974, work was initiated on the development of detailed flow charts depicting the steps involved in all routine and special activities associated with project management. A list of twenty separate activities was compiled of which nine had been developed in a rough basis by July 1, 1974. Refinement of these flow charts is underway with work regarding the cost certification process and land valuation now complete.

It is hoped that by utilizing all of the systems and concepts discussed herein that the New Communities Administration can become more effective in responding to the needs of developers and improve the program. With the increase in staff and development of more sophisticated evaluative tools, the New Communities Administration can successfully accomplish the task at hand.

The New Communities Administration appreciates your efforts to improve and strengthen the program. We look forward to additional comments and suggestions in the future in an effort to make the New Communities program a successful endeavor.

Sincerely,

Alberto F. Trevino, Jr.
General Manager

Enclosures [See GAO note]

GAO note: Enclosures were not included because they were too voluminous.

PRINCIPAL OFFICIALS OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT RESPONSIBLE FOR ADMINISTRATION OF ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
SECRETARY OF HOUSING AND URBAN DEVELOPMENT:		
James T. Lynn	Feb. 1973	Present
George W. Romney	Jan. 1969	Jan. 1973
Robert C. Wood	Jan. 1969	Jan. 1969
Robert C. Weaver	Feb. 1961	Dec. 1968
GENERAL MANAGER, NEW COMMUNITY DEVELOPMENT CORPORATION:		
Alberto F. Trevino, Jr.	July 1973	Present
Samuel C. Jackson	Jan. 1971	Feb. 1973
ADMINISTRATOR, NEW COMMUNITIES ADMINISTRATION:		
Otto G. Stolz	Sept. 1974	Present
Alberto F. Trevino, Jr.	Nov. 1973	Sept. 1974
ASSISTANT SECRETARY FOR COMMUNITY PLANNING AND DEVELOPMENT (note a):		
David O. Meeker, Jr.	Aug. 1973	Present
Clifford Graves (acting)	July 1973	Aug. 1973
ASSISTANT SECRETARY FOR COMMUNITY PLANNING AND MANAGEMENT (note b):		
Clifford Graves (acting)	Mar. 1973	July 1973
Samuel C. Jackson	Feb. 1969	Feb. 1973
Charles Haar	July 1967	Jan. 1969

	Tenure of office From	To
DIRECTOR, OFFICE OF NEW COMMUNITIES DEVELOPMENT:		
Edward M. Lamont	Oct. 1972	Nov. 1973
Edward M. Lamont (acting)	May 1972	Oct. 1972
William F. Nicosin (note c)	Dec. 1969	May 1972

a The Office of New Communities Development was part of this organization from July to November 1973, when it was absorbed into the New Communities Administration

b Community Planning and Management was absorbed into Community Planning and Development in July 1973

c From December 1969 to January 1971, Mr. Nicosin's title was Assistant for New Community Development

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