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TO: Maria F. Cremer, Director, San Francisco Office of Community Planning and Development, 9AD

Dane Narode, Associate General Counsel for Program Enforcement, CACC

//Signed//

FROM: Tanya E. Schulze, Regional Inspector General for Audit, Los Angeles Region IX, 9DGA

SUBJECT: The City of Phoenix, AZ, Did Not Always Comply With Program Requirements When Administering Its NSP1 and NSP2 Grants

HIGHLIGHTS

What We Audited and Why

We completed a review of the City of Phoenix's Neighborhood Stabilization Program (NSP) grants NSP1 and NSP2. We performed the review because it supports the U.S. Department of Housing and Urban Development, Office of Inspector General's (HUD OIG) strategic plan for fiscal years 2010 to 2015 to contribute to the oversight objectives of the American Recovery and Reinvestment Act of 2009. We selected the City because it received a \$60 million grant as one of 56 NSP2 grantees.

Our objective was to determine whether the City administered its NSP2 grant in accordance with HUD requirements. Specifically, we focused on whether the City properly procured goods and services, made program expenditures that were eligible, and ensured that consortium members' grant charges complied with

HUD requirements. Additionally, we reviewed the Park Lee Apartments rehabilitation activity for compliance with NSP1 and NSP2 requirements.¹

What We Found

The City did not administer its NSP1 and NSP2 grants in accordance with HUD rules and regulations. Specifically, the City's rehabilitation contract administration was not adequate and did not comply with the NSP2 grant agreement, resulting in an insufficient contract scope of work, inadequate oversight and verification of contract work and expenditures, insufficient maintenance of procurement documentation, inappropriate contract modifications, installation of substandard air conditioning units, and noncompliance with the grant's Buy American requirements. Additionally, the City inappropriately charged the NSP1 and NSP2 grants for actual losses that could have been covered by insurance, unsupported Park Lee Apartments additional payments, and salaries and wages that did not comply with applicable Federal cost principles.

What We Recommend

We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to (1) stop incurring costs for NSP-funded multifamily rehabilitation projects until HUD determines whether the City has the capacity to carry out these activities in compliance with HUD rules and regulations; (2) support or repay from non-Federal funds expenditures totaling \$6.16 million identified in this report;² (3) reimburse HUD \$140,121 from non-Federal funds for ineligible actual loss charges related to the theft and vandalism of air conditioners; (4) reimburse the City's NSP2 grant from non-Federal funds \$299,901 for substandard equipment, \$31,270 for equipment that did not meet the grant's Buy American provisions, and \$60,051 for ineligible actual loss charges related to the theft and vandalism of air conditioners; (5) develop and implement policies and procedures to ensure that HUD-funded construction contracts are managed according to HUD rules and regulations and are adequately monitored; (6) develop written procurement policies and procedures for HUD-funded projects that conform to HUD requirements; (7) develop and implement policies and procedures to ensure that grant charges comply with the applicable Federal cost eligibility requirements.

¹ The audit scope was expanded to include NSP1 activity for only the Park Lee Apartments multifamily rehabilitation activity.

² These expenditures include amounts from findings 1 and 2, recommendations 1B, 1C, 1D, 1E, 2C, and 2D.

In addition, we recommend that HUD's Associate General Counsel for Program Enforcement determine legal sufficiency and if legally sufficient, pursue civil remedies (31 U.S.C. (United States Code) 3801-3812), civil money penalties (24 CFR (Code of Federal Regulations) 30.35), or both against the City, its principals, its contractor, or all of the above for incorrectly certifying to the integrity of the data or that due diligence was exercised during the approval of rehabilitation payments.

For each recommendation in the body of the report without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-4. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the City a discussion draft report on April 23, 2012, and held an exit conference on April 30, 2012. The City provided written comments on May 18, 2012, and strongly disagreed with our findings and recommendations.

The complete text of the City's response, along with our evaluation of that response, can be found in appendix B of this report. Attachments to the City's comments were not included in the report because they were too voluminous, but are available for review upon request.

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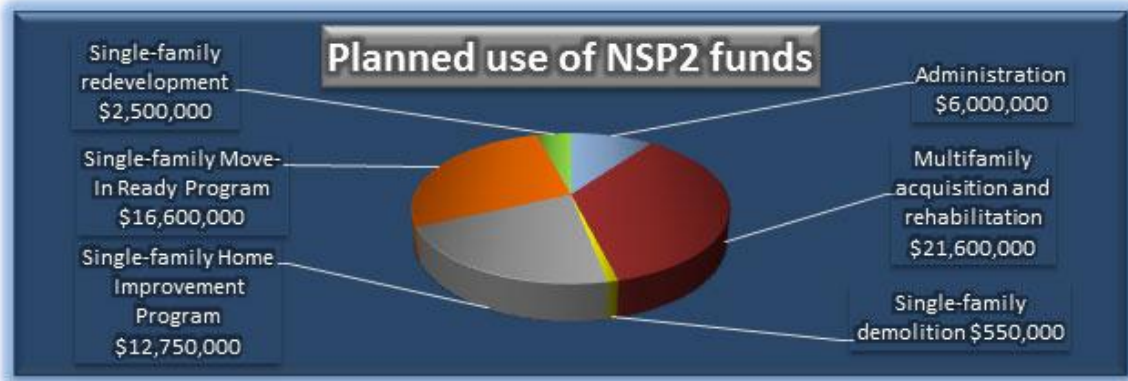
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BACKGROUND AND OBJECTIVES

On July 30, 2008, Title III of Division B of the Housing and Economic Recovery Act of 2008 (HERA) authorized \$3.92 billion for the redevelopment of abandoned and foreclosed-upon homes and residential properties. The U.S. Department of Housing and Urban Development (HUD) established the grant amounts to the States and units of general local government based on a funding formula. HUD treats the funds as Community Development Block Grant (CDBG) funds. This grant program, referred to as the Neighborhood Stabilization Program (NSP), provides targeted emergency assistance to State and local governments to acquire and redevelop foreclosed-upon properties that might otherwise become sources of abandonment and blight within their communities. NSP1 references the grant program authorized under HERA.

On February 17, 2009, Title XII of Division A of the American Recovery and Reinvestment Act of 2009 authorized additional funding for the provision of emergency assistance for the redevelopment of abandoned and foreclosed-upon homes as authorized under HERA. HUD allocated nearly \$2 billion in program funds for emergency assistance for the redevelopment of abandoned and foreclosed homes. NSP2 references the grant program authorized under the Recovery Act. NSP2 provided 56 grants competitively awarded nationwide to local governments, nonprofits, consortiums, and one State.

The City of Phoenix received a \$39.4 million NSP1 grant on January 15, 2009. The City planned to use the funds to address the areas of greatest need through single-family and multifamily activities to include financing mechanisms (home-buyer assistance), acquisition, rehabilitation, demolition, and redevelopment. Through December 2011, the City had drawn more than \$24 million of the NSP1 grant. The City also received a \$60 million NSP2 grant on January 14, 2010, as the lead member of a 23-member consortium of governmental, nonprofit, and for-profit entities. The consortium plans a multipronged single-family and multifamily strategy to arrest decline and restore stability to target area neighborhoods. The strategy includes the Home Improvement Program (downpayment assistance with housing rehabilitation); the Move In Ready Program (acquisition, rehabilitation, and resale); subdivision acquisition, rehabilitation, and resale; redevelopment and reuse of vacant land (subdivisions and postdemolition); demolition; acquisition and rehabilitation of foreclosed-upon multifamily properties; and preservation of affordable units created with Federal funding. As of January 2012, the City had drawn more than \$23 million of the NSP2 grant. The chart below demonstrates the City's planned use of NSP2 funds.



Our overall objective was to determine whether the City properly procured goods and services, made program expenditures that were eligible, and approved consortium members' grant charges in accordance with NSP2 requirements. In addition, because the Park Lee Apartments rehabilitation project received both NSP1 and NSP2 funds, we expanded our objective to determine whether the City properly procured goods and services and made program expenditures that were eligible and adequately supported for the project in accordance with NSP1 requirements.

RESULTS OF AUDIT

Finding 1: The City Did Not Adequately Administer the Park Lee Apartments Multifamily Project Rehabilitation Contract

The City's administration of the rehabilitation contract for the Park Lee Apartments multifamily project was not adequate, did not comply with the NSP2 grant agreement, and allowed

- An insufficient contract scope of work,
- Inadequate oversight and verification of contract work and expenditures,
- Insufficient maintenance of procurement documentation,
- Inappropriate contract modifications,
- Installation of substandard air conditioning units, and
- Noncompliance with Buy American requirements.

This noncompliance occurred because the City's policies and procedures were not adequate to ensure responsible rehabilitation contract management and the City disregarded HUD's rules and regulations. As a result, the City allowed project cost overruns of \$3.44 million,³ installation of substandard equipment, and installation of materials specifically prohibited by the NSP2 grant. In addition, the City expended \$2.78 million⁴ of its NSP1 funds and \$3.75 million⁵ of its NSP2 funds for work that it could not ensure was completed. Further, the City did not have a firm fixed price contract in place to complete the project.

The Contract Scope of Work Was Insufficient

The City prepared the Park Lee Apartments rehabilitation project scope of work intending for it to complete the entire 523-unit, 18-block project. However, the scope of work contained mathematical errors resulting in incorrect item counts. Additionally, the scope of work did not provide for adequate mold abatement and remediation or asbestos abatement and remediation, although the City was aware

³ The City agreed to additional project costs of \$3,436,289 using change orders to modify the contract.

⁴ Consists of NSP1 funds: \$1,707,554 in unsupported original contract costs + \$934,015 in unsupported change order costs + \$140,121 in ineligible change order costs. See appendix D, table 1.

⁵ Consists of NSP2 funds: \$1,235,004 in unsupported original contract costs + \$2,118,814 in unsupported change order costs + \$279,143 in ineligible original contract costs + \$112,079 in ineligible change order costs. See appendix D, table 1.

that both would be required. In the bid solicitation, the City included comments regarding damage to specific units, several of which included notations of mold damage. There were also comments such as, “Heavy flood damage and copper theft,” which may lead to mold damage. However, the bid solicitation did not specifically provide for mold remediation. The mold remediation resulted in at least \$240,000 in additional rehabilitation costs. Additionally, an asbestos study had been performed before the bid solicitation that indicated the presence of asbestos. However, asbestos remediation was not included in the scope of work. The City acknowledged that the need for asbestos abatement was known before the bid solicitation but was “missed” and not included. As a result, the City issued two change orders totaling more than \$340,000 for the asbestos abatement.

When the City and the contractor determined that the original contract’s scope of work was not sufficient to complete the entire project, they agreed to allow the contractor to use the contracted project funds, intended for the entire project, to complete only a portion of the project, one block at a time. The contractor used a majority of the budget to complete blocks one and two, with other blocks to be completed as funding allowed. Rather than requiring the contractor to complete the original contract according to its specifications, as specified in 24 CFR (Code of Federal Regulations) 85.36(b)(2) (see appendix C), and determining the specific additional materials needed to complete the project, the City agreed to additional lump-sum amounts. For example, the City contracted for items such as “Electrical \$36,911” for an entire block without detailed supporting information that could be used to verify completed work.

Additionally, change order 43 for \$1.7 million⁶ provided only a per-apartment-unit lump-sum cost of \$5,466. Based on the change order information, it would be impossible for the City to determine what specific work was included, whether that work was duplicated elsewhere in the contract scope, and whether that work had been completed when the contractor requested payment. When asked, two department managers were unable to identify specifically what work was included in the change order. One stated that the change order “is not detailed...it does not tell me how many air conditioners we are buying.” The other manager did not know “if it is materials or what it is.” Without a specific scope of work, the City could not review proposed procurement items for duplicate or unnecessary items as required by 24 CFR 85.36(b)(4) or determine whether the related costs were reasonable, necessary, allocable to the grants, or adequately documented as 2 CFR 225(C)(1) requires.

As more funding became available, the City used change orders to fund the remaining work, increasing the contract by \$3.44 million, or 93 percent of the original contract value of \$3.68 million. Several change orders were created as a result of “shifting funds” to the first few blocks and not having enough remaining to complete the other blocks. The “contract” became a function of available

⁶ See appendix E.

funding rather than being based on fixed, agreed-upon costs for specific work to complete the project.

The most recent change order provided to us, number 43 for \$1.7 million⁷ to complete the funding for the project, stated in the scope, “At this time 75 units will not include finishes unless [the contractor] has enough money left over to complete.” The scope also contained the caveat, “This change order breakdown is only a base budget, at the time of block completion and turnover [the contractor] will revise the actual cost per block for the City of Phoenix.” Although the City intended to complete the entire project based on the original contract, the change order caveats indicated that at the time of the change order, the City did not have a firm fixed price established with the contractor for the completion of the project. During an interview, a manager in charge of the project commented that the change order “Looks like an estimate.” Without a firm fixed price, the project was subject to significant potential cost overruns. When the City agreed to the change orders and related caveats, it demonstrated that it did not have the capacity to responsibly administer multifamily rehabilitation projects in accordance with HUD regulations.

Oversight and Verification Were Inadequate

The City did not apply sound management practices to the administration of contractor payments. It paid the contractor more than \$6.5 million⁸ in NSP funds without

- Verification of completed work,
- Verification that the City appropriately approved the work,
- Verification that related charges conformed to Federal cost principles, and
- Knowledge of what specific work the payments represented.

The City agreed to pay the contractor progress payments based on operations completed in accordance with the schedule of values. Along with each payment request from the contractor, an attached statement from a City employee certified that the payment request “Appeared to reflect the actual work completed.” The contractor also certified that “To the best of the Contractor's knowledge, information and belief the Work covered by this Application for Payment has been completed in accordance with the Contract Documents.” However, during interviews, both the contractor’s project manager and a City employee stated that

⁷ See appendix E.

⁸ Appendix D, table 1

payment requests' percentage of completion⁹ ratios were incorrect; they were calculated based on funding needs rather than on completed work. The employee further indicated that other City employees involved with the project also knew that the ratios were incorrect.

Additionally, the City should have questioned some obvious ratio miscalculations. We visited the Park Lee Apartments multifamily project site on October 26, 2011, and on February 16, 2012, and took the pictures below. The site visits confirmed that the percentage of completion calculations and related certifications were not accurate.



Picture 1: Renovated “block 2” building (October 2011)



Picture 2: “Block 11” building that needs painting more than seven months after the contractor represented that “paint” was complete and one and a half months after the contractor represented that “Alternate 2 Exterior (sic) Painting” was complete (February 2012)

⁹ Percentage of completion method refers to a system under which payments are made for construction work according to the percentage of completion of the work rather than to the cost incurred, according to 24 CFR 85.3.



Picture 3: Painting in progress more than seven months after the contractor represented that “paint” was complete and one and a half months after the contractor represented that “Alternate 2 Extirior (sic) Painting” was complete (February 2012).



Picture 4: Irrigation system installation more than 4 months after the contractor represented that irrigation was complete (October 2011)

During the October 2011 site visit, we identified areas in which it appeared that renovation had not begun and some buildings that appeared to have been completed. We also observed workers installing the irrigation system. The contract item “Irrigation” was clearly not complete, yet the June 2011 payment requests’ percentage of completion calculation, more than 4 months earlier, represented it as 100 percent complete. During the February 2012 site visit, we observed painting in progress and unpainted buildings. Contract items such as “Paint” and “Alternate 2 Extirior (sic) Painting” were clearly not complete, yet the June 2011 payment requests’ percentage of completion calculation, more than 4 months earlier, represented “Paint” as 100 percent complete and the December 2011 payment requests’ percentage of completion calculation, more than a month earlier, represented both items as 100% complete. The City employee who prepared the payment requests visited the property approximately once per week, and the department manager who approved the payment requests visited approximately once per month. City employees who prepared and approved the payment requests either knew or should have known that the percentage of

completion calculations were incorrect. The City paid for work that it did not verify was complete and that was not adequately documented in accordance with 2 CFR 225(C)(1)(j) requirements. Because the percentage of completion calculations and related certifications were not accurate, HUD had no assurance that the work represented as complete and paid for using HUD funds had been completed.

An employee who approved change orders also prepared the related payment requests and attested to the requests’ validity, although the employee knew that the percentage of completion ratios supporting the requests were not correct. Program regulations at 24 CFR 85.20(b)(3) require that grantees maintain effective control over and accountability for all grant assets. The City did not comply with the requirements when its lack of effective control over and accountability for grant assets allowed the employee to agree to expend funds and approve payment for those same funds without sufficient evidence of completed work.

The City’s Housing Department policies require that before payment processing, employees compare contractor charges to the contract to ensure that the charges are correct according to the terms of the underlying contract. However, City employees that managed the project disregarded policies and procedures and did not compare the draw requests to the contract, relying solely on the information in the contractor’s draw request. Although the total contracted amounts agreed, the contractor presented draw requests that were inconsistent with the contract, thereby making it difficult to determine what specific agreed-upon work was complete. For example, some work specifications had different values on the contract than on the draw request, and others that had scheduled values on the draw request did not appear on the contract (see table below). The payment requests’ source documentation did not sufficiently support the payments as required by 24 CFR 85.20(b)(6) and 2 CFR 225(C)(1).

Comparison of selected contracted values to draw requests		
Work specification	Per contract	Per draw request
01050 General conditions	Not listed	\$492,362
02810 Irrigation system	\$256,787	\$185,926
05700 Ornamental metal	Not listed	\$14,213
09910 Paint (painting)	\$267,528	\$306,737

The City’s poor contract management resulted in 5 charges totaling more than \$357,000 that it did not associate with either the original contract or a change order. However, the City included the amounts in its overall contract total, which equaled the original contract plus any change orders. Without association with some portion of the contract, neither the City nor HUD could determine whether the charges were reasonable and necessary.

Therefore, HUD had no assurance that \$2.78 million¹⁰ in NSP1 grant funds and \$3.75 million¹¹ in NSP2 grant funds were used solely for their intended purpose as required by 24 CFR 85.20(b)(3), charges conformed to Federal cost principles, and unnecessary or duplicate items were not purchased.

Procurement Documentation Maintained Was Insufficient

The City did not maintain adequate procurement documentation. The City's policies and procedures did not explicitly provide for retention of the unsuccessful bids, allowing the City to destroy competing project bids after it awarded the original rehabilitation contract. Although the City provided its own compilation of the competing bids, the compilation was not sufficient for us to determine the validity of its information or the basis for contractor selection or rejection. For example, there were no contractor signatures or letterhead to support that contractors submitted the bids as presented in the compilation. The procurement documentation was not sufficient to provide for supervisory or audit review or detail the significant history of the procurement as required by 24 CFR 85.36(b)(9). Therefore, HUD had no assurance that the City performed the procurement in accordance with HUD regulations.

Contract Modifications Were Inappropriate

The City inappropriately approved 25 Park Lee Apartments rehabilitation project contract modifications valued at \$3.51 million without performing a cost or price analysis¹² as required by 24 CFR 85.36(f)(1). For 17 of the 25 contract modifications valued at \$3.44 million,¹³ the City did not follow the required method of procurement and did not conduct the procurement in a manner to provide for full and open competition as required by 24 CFR 85.36(c)(1). As the project's rehabilitation progressed, the City and the contractor agreed to contract modifications. Rather than seeking competition for the additional work, the City chose to use the general contractor from the original scope of work to provide all additional services, believing that having too many contractors on site would be inefficient. However, by doing so, the City used the sole source method of procurement for the modifications, contrary to program requirements specified at 24 CFR 85.36(d)(4). The sole source procurement method does not provide for

¹⁰ Consists of NSP1 funds: \$1,707,554 in unsupported original contract costs + \$934,015 in unsupported change order costs + \$140,121 in ineligible change order costs. See appendix D, table 1.

¹¹ Consists of NSP2 funds: \$1,235,004 in unsupported original contract costs + \$2,118,814 in unsupported change order costs + \$279,143 in ineligible original contract costs + \$112,079 in ineligible change order costs. See appendix D, table 1.

¹² Appendix D, table 3

¹³ Appendix D, table 2

competition. Because the work represented in the change orders was not competitively bid, HUD has no assurance that the related charges of \$3.05 million¹⁴ are reasonable.

Further, the City employees who managed the project did not appear to understand that Federal procurement regulations are required to be followed at the grantee level. For example, when asked why the City did not seek competitive bids for the asbestos remediation that was not included in the original scope of work, a manager overseeing the project responded, “Because we have a general contractor who goes out to bid.” The City believed that although all change orders were awarded to the original contractor without seeking additional bids, the “Change orders for new elements were competitively bid.”

The City’s inadequate procurement policies referred to unique requirements for federally funded procurements that should be overseen by departments but did not explicitly define those requirements. We attribute the deficiencies to the City’s lack of written procurement policies and procedures that complied with HUD rules and regulations. Additionally, the City’s inadequate procedures allowed a sole City employee, who did not have contract modification authority, to agree to \$3.44 million in change orders. Although the City’s policies required the signature of the department director or a designated individual authorized by a Delegation of Authority Memo, for all procurements and amendments, the department’s procedures allowed the project manager, who was not authorized by a Delegation of Authority Memo, to approve all contract amendments, regardless of the value. Although other City employees may have been aware of the potential change orders, the department did not require additional signatures.

Air Conditioning Units Were Substandard

In its grant application, the City stated to HUD that energy-conscious practices such as 14 SEER¹⁵ (seasonal energy efficiency ratio)-rated Energy Star air conditioning units would be implemented in grant-funded multifamily housing rehabilitation. In its rating of NSP2 grant applications,¹⁶ HUD awarded points to applicants demonstrating that gut rehabilitation activities would be required to exceed the Energy Star for New Homes standard and that moderate rehabilitation or energy retrofits would purchase only Energy Star products and appliances. However, the City ignored its agreement with HUD and in the Park Lee Apartments rehabilitation scope of work, required only 13 SEER-rated air conditioning units and did not specify that they must be Energy Star certified. This noncompliance resulted in the purchase and installation of substandard 13

¹⁴ Consists of unsupported change orders totaling \$2,118,814 NSP2 + \$934,015 NSP1. See appendix D, table 1.

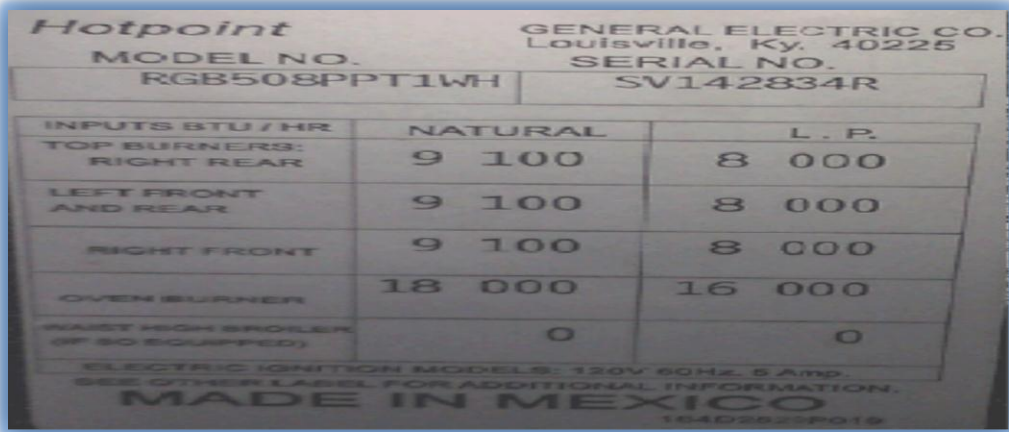
¹⁵ A higher SEER rating indicates a more energy-efficient unit.

¹⁶ The grant application is a part of the grant agreement and must be followed.

SEER non-Energy Star-certified air conditioning units using \$299,901¹⁷ in NSP2 funds. If HUD had known that the City planned to use 13 SEER-rated air conditioners that were not Energy Star products, it may have affected HUD’s original funding decision.

The City Did Not Always Comply With the NSP2 Grant’s Buy American Requirements

The City installed 130 gas ranges and 38 vent hoods in the multifamily project that did not comply with the NSP2 grant’s Buy American provisions. As part of the Recovery Act, the NSP2 notice of funding availability stipulated that NSP2 grantees could not use grant funds for manufactured goods that were not produced in the United States. Although compliance with the Buy American requirements was part of its written agreement with the City, the contractor did not comply with the requirements when it installed 38 vent hoods. The contractor stated that after inquiring with three vendors, it determined that there were no vent hoods made in America. However, the contractor did not provide evidence to support the claim. The contractor also chose to purchase 130 non-United States-made gas ranges for installation in the apartment complex because it could purchase them less expensively than those made in the United States.



Picture 5: Sticker from gas range “made in Mexico” installed at the project (February 2012)

The Recovery Act allows for an exemption from the Buy American requirements if there is not a sufficient supply of goods that fit specified requirements. The City did not apply for such an exemption. Therefore, it inappropriately allowed the contractor to purchase and install appliances specifically not allowed by the grant at a cost of \$31,270.¹⁸

¹⁷ Appendix D, table 4
¹⁸ Appendix D, table 5

Conclusion

The noncompliance and associated program violations discussed above occurred because the City's policies and procedures were not adequate to ensure compliance with HUD rules and regulations. Additionally, the City disregarded HUD rules and regulations when implementing its NSP1 and NSP2 grants. As a result, it allowed project cost overruns of \$3.44 million, payments of more than \$6.5 million for work it could not ensure was complete, the installation of substandard equipment, and the installation of materials specifically prohibited by the NSP2 grant and did not have a firm fixed price contract in place to complete the project. Because of the City's inadequate contract administration of the Park Lee Apartments multifamily rehabilitation project, it did not have the capacity to responsibly manage NSP-funded multifamily rehabilitation projects in accordance with HUD requirements.

Recommendations

We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to

- 1A. Stop incurring costs for NSP-funded multifamily rehabilitation projects until HUD determines whether the City and its management have the capacity to carry out these activities in compliance with HUD rules and regulations.
- 1B. Support that \$1,707,554 in NSP1¹⁹ project funds was used solely for its intended purpose and met the terms, conditions, and specifications of the contract for Park Lee Apartments rehabilitation project charges or repay HUD from non-Federal funds. Supporting documentation should include evidence showing that all costs incurred under the contract met the applicable cost eligibility requirements of 2 CFR Part 225.²⁰
- 1C. Support that \$1,235,004 in project funds²¹ was used solely for its intended purpose and met the terms, conditions, and specifications of the NSP2 grant for Park Lee Apartments rehabilitation project charges or reimburse its NSP2 grant from non-Federal funds. Supporting documentation should include evidence showing that all costs incurred under the contract met the applicable cost eligibility requirements of 2 CFR Part 225.

¹⁹ Total unsupported NSP1 amount is \$2,641,569, consisting of \$1,707,554 in unsupported original contract costs + \$934,015 in unsupported change order costs (recommendation 1D). See appendix D, table 1.

²⁰ Compliance with OMB Circular A-87 is required by 24 CFR 570.502(a), compliance with which is required by the notice of funding availability. OMB Circular A-87 is implemented at 2 CFR Part 225.

²¹ Total unsupported NSP2 amount is \$3,353,818, consisting of \$1,235,004 in unsupported original contract costs + \$2,118,814 in unsupported change order costs (recommendation 1E). See appendix D, table 1.

- 1D. Support the reasonableness of \$934,015²² in unsupported Park Lee Apartments NSP1 rehabilitation charges resulting from contract change orders or repay HUD from non-Federal funds. Supporting documentation should include evidence that the charges are reasonable and comply with program requirements.
- 1E. Support the reasonableness of \$2,118,814²³ in unsupported Park Lee Apartments NSP2 rehabilitation charges resulting from contract change orders or repay its NSP2 grant from non-Federal funds. Supporting documentation should include evidence that the charges are reasonable and comply with program requirements.
- 1F. Reimburse the City's NSP2 grant \$299,901 from non-Federal funds for the use of substandard equipment.
- 1G. Reimburse the City's NSP2 grant \$31,270 from non-Federal funds for equipment that did not meet the grant's Buy American provisions.
- 1H. Develop and implement policies and procedures to ensure that HUD-funded construction projects are managed according to program requirements and are adequately monitored.
- 1I. Develop written procurement policies and procedures for HUD-funded projects that conform to HUD requirements.

In addition, we recommend that HUD's Associate General Counsel for Program Enforcement

- 1J. Determine legal sufficiency and if legally sufficient, pursue civil remedies (31 U.S.C. (United States Code) 3801-3812), civil money penalties (24 CFR 30.35), or both against the City, its principals, its contractor, or all of the above for incorrectly certifying to the integrity of the data or that due diligence was exercised during the approval of rehabilitation payments.

²² See footnote 18 above and appendix D, table 1.

²³ Total unsupported amount is \$3,353,818, consisting of \$1,235,004 in unsupported original contract costs (recommendation 1C) + \$2,118,814 in unsupported change order costs. See appendix D, table 1.

Finding 2: The City Charged Its NSP1 and NSP2 Grants for Unallowable Costs

The City charged its NSP1 and NSP2 grants for actual losses that could have been covered by insurance, unsupported Park Lee Apartments additional payments, and wage-related charges that did not comply with applicable Federal cost principles. This noncompliance occurred because the City's policies and procedures were not adequate to ensure compliance with HUD rules and regulations and the City generally disregarded HUD's cost eligibility requirements. As a result, \$140,121 in NSP1 funds and \$221,569²⁴ in NSP2 funds were not available for other eligible expenditures, providing HUD with no assurance that current and future costs would conform to program requirements.

The City Charged Its NSP2 Grant for Unallowable Actual Losses

The City charged its NSP2 grant for unallowable actual losses that could have been covered by insurance, contrary to Federal cost principles detailed in 2 CFR 225, appendix B(22)(c). A multifamily rehabilitation project suffered substantial theft and vandalism of air conditioning units before and during the project's rehabilitation. After the City took possession, 84 air conditioning units valued at \$210,708²⁵ were stolen or damaged between January 2010 and July 2011. However, the City did not file insurance claims for the stolen or vandalized air conditioners. According to City staff, the City did not file the claims because the losses would not have been large enough to meet the insurance deductible of \$50,000 per occurrence. The City self-insured up to the deductible. A City employee informed us that "Since it did not meet the deductible, it has to come out of NSP," illustrating the City's position that it could not fund the replacements with its own self-insurance funds but could with NSP funds. The City defended the use of NSP funds for some of the units because the City's original rehabilitation plan called for replacement of the units with NSP funds. Regardless of whether the City's original rehabilitation plan called for replacement of the units with NSP funds, 2 CFR 225, appendix B(22)(c), specifically disallows actual losses that could have been covered by insurance, including self-insurance, unless certain exemptions apply. In this case, the exemptions did not apply. Therefore, the City charged unallowable costs of \$140,121²⁶ to the NSP1 grant and \$60,051²⁷ to the NSP2 grant.

²⁴ These funds include amounts from recommendations 2B, 2C, and 2D.

²⁵ Eighty-four units at a cost per unit of \$2,508.43 totals \$210,708.

²⁶ Appendix D, table 6

²⁷ Appendix D, table 6

The City Charged Its NSP2 Grant for Unsupported Additional Park Lee Apartments Costs

The City used \$146,540 in NSP2 grant funds for payments to the general contractor of the Park Lee Apartments rehabilitation project for a job labeled “Extras 2nd Job.” The City insisted that the funds were not charged against the grant. However, we determined that they were charged to the grant and the funds were not reimbursed. We repeatedly asked the City to support the charges.

Based on the available documentation, the City did not adequately support the charges in accordance with 2 CFR 225, appendix A(C)(1), and HUD has no assurance the charges were necessary, reasonable, and allocable. Therefore, the charges of \$146,540 were unsupported costs.

Wage and Salary Charges Were Not Adequately Documented

The City charged its NSP2 grant for wage and salary costs that were not supported as required by Federal cost principles. The documentation provided did not adequately support the salary and wage charges, providing HUD with no assurance that the costs of \$14,978 were allocable to the NSP2 grant.

2 CFR Part 225, appendix B(8)(h)(4), requires personnel activity reports to support wage and salary charges when employees work on multiple activities or cost objectives. On the last day of the fiscal year, June 30, 2011, the City allocated portions of two staff members’ wage-related charges to its NSP2 grant. 2 CFR Part 225B(8)(h)(5), requires that personnel activity reports prepared at least monthly and signed by the employee support a distribution of salaries or wages.

The charges of \$14,978 covered a 5½-month period for one employee and a 10½-month period for the second employee. In both cases, the City provided one personnel activity report for each employee covering the entire period, beginning in August 2010, as support for the charges. Neither employee signed the associated personnel activity report. After the City was informed of the potential finding, it retroactively prepared additional personnel activity reports for the employees covering the same period in an attempt to comply with the requirements. However, because one employee was no longer employed by the City, the related personnel activity reports were not signed by the employee. Additionally, the personnel activity reports were not prepared at least monthly, as required by 2 CFR Part 225 Appendix B(8)(h)(5), see appendix C.

For employees who work solely on a single Federal award, 2 CFR Part 225, appendix B(8)(h)(3), requires that their salary and wage charges be supported by employee certifications that the employees worked solely on that program for the period covered by the certification and be prepared at least semiannually.

Although the City knew of this requirement, it disregarded HUD requirements and did not complete certifications for NSP-funded employees until we asked for them. The City completed certifications in February 2012 for the entire grant period, not semiannually as required. Additionally, the first set of individual certifications the City submitted stated that the employee “worked 100% of his/her time on NSP1 and/or NSP2 and/or NSP3” for the period, disregarding requirements that the certifications be specifically attributable to a sole Federal award. After the City was informed of the potential finding indicating that the certifications did not satisfy 2 CFR Part 225 requirements, it retroactively prepared certifications specific to NSP2 for those affected employees. The City did not comply with the requirements until we questioned the related costs.

Conclusion

The City did not follow HUD rules and regulations when it charged its NSP1 and NSP2 grants for actual losses that could have been covered by insurance, unsupported Park Lee Apartments “Extras 2nd Job” payments, and unsupported wage-related charges. Costs that do not comply with 2 CFR Part 225 are ineligible and not allowable grant charges.²⁸ We attribute the unallowable charges to the City’s lack of adequate policies and procedures as well as its disregard for HUD requirements. As a result, \$140,121 in NSP1 funds and \$221,569 in NSP2 funds were not available for other eligible expenditures, providing HUD with no assurance that current and future costs would conform to program requirements.

Recommendations

We recommend that the Director of HUD’s San Francisco Office of Community Planning and Development require the City to

- 2A. Repay HUD \$140,121 from non-Federal funds for ineligible actual loss charges related to the theft and vandalism of air conditioners.
- 2B. Reimburse the City’s NSP2 grant \$60,051 from non-Federal funds for ineligible actual loss charges related to the theft and vandalism of air conditioners.

²⁸ The notice of funding availability III(A)(3)(k) requires compliance with OMB Circular A-87, implemented at 2 CFR Part 225.

- 2C. Support \$146,540 in charges related to the Park Lee Apartments rehabilitation project additional payments or reimburse its NSP 2 grant from non-Federal funds. Supporting documentation should include evidence showing that the charges met the applicable cost eligibility requirements of 2 CFR Part 225.
- 2D. Support \$14,978 in salary and wage charges or reimburse its NSP2 grant from non-Federal funds. Supporting documentation should include evidence showing that the charges met the applicable cost eligibility requirements of 2 CFR Part 225.
- 2E. Develop and implement policies and procedures to ensure that grant charges comply with applicable Federal cost eligibility requirements.

SCOPE AND METHODOLOGY

Our review of the NSP2 grant activity generally covered the period October 2010 through January 31, 2012, and was expanded to other periods when necessary. We expanded the scope of our review to include all of the Park Lee Apartments rehabilitation project's NSP1 activity. We performed our onsite work from October 2011 to January 2012 at the City's offices in Phoenix, AZ.

To accomplish our objective, we

- Reviewed applicable HUD rules, regulations, guidance, etc.;
- Reviewed relevant background information related to the City and its NSP1 and NSP2 grants;
- Reviewed the City's applicable policies and procedures for administering the NSP grants;
- Interviewed City staff and relevant contractors;
- Discussed potential findings with HUD and City staff;
- Reviewed the City's recent audited financial statements;
- Reviewed HUD's recent monitoring report;
- Reviewed the City's NSP2 application and NSP1 and NSP2 grant agreements;
- Reviewed the City's records pertaining to rehabilitation, expenditures, and disbursements,
- Reviewed the City's current and proposed NSP2 grant activities to determine their eligibility; and
- Visited a multifamily property that was acquired and being rehabilitated using program funds (Park Lee Apartments).

We selected a nonstatistical survey sample of two single-family properties' charges from the City's Move In Ready Program to review. We selected the two properties because their environmental review charges appeared excessive. We also selected a rehabilitation activity survey sample from four multifamily projects. At the time of our sample selection, the City had expended more than \$11 million in NSP2 funds for four multifamily acquisition and rehabilitation projects. However, only one project, Park Lee Apartments, had incurred rehabilitation charges. The other three projects' costs were acquisition-only charges. Because we intended to review rehabilitation activity, we selected the Park Lee Apartments rehabilitation

activity for review. When we determined that the project's management was not sufficient to ensure compliance with HUD regulations, we expanded our review to include the project's NSP1 rehabilitation activity.

Based on the Disaster Recovery Grant Reporting system drawdown reports, from 13 program administration draws, we selected a nonstatistical sample of one draw to review. During the audit, we expanded the sample to include all salary- and wage-related charges as well as charges based on a central service cost allocation plan.

We used computer-processed data to select the nonstatistical samples and through our testing, determined that the computer-processed data were adequate for our purposes.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Policies and procedures intended to ensure adequate contract administration of construction rehabilitation and related activities (finding 1).
- Policies and procedures intended to ensure compliance with HUD procurement requirements (finding 1).
- Policies and procedures intended to ensure that grant charges are eligible and adequately supported (finding 2).

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- The City did not have adequate controls to reasonably ensure proper NSP1 and NSP2 contract administration in compliance with HUD standards (finding 1).
- The City did not have adequate controls to ensure that its NSP1 and NSP2 procurement and rehabilitation activities complied with HUD rules and regulations (finding 1).
- The City did not have adequate controls to ensure that NSP1 and NSP2 grant charges were eligible and adequately supported and complied with HUD rules and regulations (finding 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible <u>1/</u>	Unsupported <u>2/</u>
1B		\$1,707,554
1C		1,235,004
1D		934,015
1E		2,118,814
1F	\$299,901	
1G	31,270	
2A	140,121	
2B	60,051	
2C		146,540
2D		14,978
Total	\$531,343	\$6,156,905

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations. In this case, the ineligible costs included the \$299,901 for the use of substandard equipment, the \$31,270 for equipment that did not meet the NSP2 grant's Buy American provisions, and the \$200,172 for actual loss charges related to the theft or vandalism of air conditioners.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures. The unsupported costs of \$2,942,558 in recommendations 1B and 1C are detailed in appendix D, table 1. The unsupported costs of \$3,052,829 related to recommendations 1D and 1E are also unsupported under recommendations 1B and 1C because the costs related to change orders that violated HUD's requirements that grant funds be used solely for their intended purpose also violated HUD's requirement that a cost or price analysis be performed for all procurements, including change orders. To avoid double counting, the unsupported amounts associated with the lack of a cost or price analysis violation are only included under recommendations 1D and 1E of this appendix. See appendix D, table 1, for further details. The \$146,540 represents unsupported charges related to the Park Lee Apartments additional payments. The unsupported costs of \$14,978 in recommendation 2D represent the unsupported salary- and wage-related costs charged to the NSP2 grant.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

May 18, 2012

Ms. Tanya E. Schulze
Regional Inspector General for Audit
Office of Inspector General, Los Angeles Region IX
611 West Sixth Street, Suite 1160
Los Angeles, California 90017-3101

RE: Office of Inspector General Draft Audit Report No. 2012-LA-100X (City of Phoenix Administration of NSP1 and NSP2 Grants)

Dear Ms. Schulze:

The City of Phoenix, Arizona (the "**City**") is in receipt of the draft audit report (the "**Draft Report**") and your accompanying letter dated April 23, 2012 prepared by the U.S. Department of Housing and Urban Development's ("**HUD**") Office of Inspector General (the "**OIG**") following its recent audit of the City's Neighborhood Stabilization Program ("**NSP**"), which eventually focused on the City's rehabilitation of the Park Lee Apartments ("**Park Lee**"). The City appreciates the opportunity to review the Draft Report and to provide you with our perspective on the matters described therein.

I. Highlights

The OIG reviewed the City's administration of NSP grants totaling almost \$100 million in NSP1 and NSP2 funds. What the OIG found were technical mistakes resulting from inadequate scoping of a single unique project, the City's rehabilitation of Park Lee. The findings presented in the Draft Report are overstated, unsupported, and quite simply assert error without regard to context. Some of the findings exhibit either misunderstanding or outright distortion of the voluminous information provided for the OIG's review, most notably the findings alleging that oversight and verification were inadequate.

There is substantial documentation confirming that every penny of NSP funds expended on Park Lee was used to rehabilitate the property in a cost effective manner, converting a crime-infested blight on the neighborhood into an attractive affordable housing community. The Draft Report contains not a shred of evidence of the "waste, fraud, and abuse" that the OIG was established to combat. At most, the OIG identifies instances involving a single project (Park Lee) in which the City departed from its regular best practices due to unique circumstances. HUD officials, Phoenix Police and neighborhood residents all tout the turn around and success of this project. Competitive bidding ensured all work was fairly priced and inspections ensured quality work was completed and excellent value was received. Despite ample documentation, the OIG has recommended that HUD require the City to stop ongoing work on all NSP-funded projects, require the City to repay virtually all funds expended on Park Lee, and determine if civil penalties against the City, its principals, and its contractor are warranted for "incorrectly certifying to the integrity of the data or that due diligence was exercised." Such recommendations are made despite the overwhelming documentation provided to the OIG that confirms the City's proper use of NSP funds.

Comment 1

Comment 2

The disproportionality of these recommendations and the OIG's complete disregard for the real world consequences that would result from their implementation belie the claim that the OIG's objective is to improve the effectiveness and efficiency of NSP. The City strongly disagrees with the recommendations, which unfairly and wrongly characterize technical departures from OIG-preferred contract management practices as wasteful or inappropriate, without regard to the circumstances surrounding the alleged deficiencies or the practical consequences of the proposed solutions. The City requests that the OIG modify its findings and recommendations as more specifically described in this response.

II. The Context: Acquisition and Rehabilitation of Park Lee

Park Lee is a 1950's vintage apartment complex comprised of 523 units, in 18 separate blocks, situated on approximately 31.6 acres and spanning several city blocks. Located close to the City's light rail system, Park Lee is well situated to serve the needs of low and moderate income families. Community Services of Arizona, Inc., an Arizona non-profit corporation ("CSA"), purchased Park Lee in 2005 and rehabilitated the property using the proceeds of a HUD-insured loan. The City acquired Park Lee at HUD's request, after CSA defaulted on its loan in 2008. HUD specifically appealed to the City due to the City's capacity in managing and rehabilitating apartment communities and its successful track record of managing three HOPE VI grants and millions of dollars of federal funds for multifamily and other programs.

Understandably reluctant to become a mortgagee in possession, HUD proposed during the first quarter of 2009 to sell its note (the "**Note**") and deed of trust on the recently rehabilitated Park Lee to the City. By the time HUD approached the City, Park Lee had become a serious blight on the neighborhood. The aging property suffered from high operating costs and extremely low occupancy rates, and it had become a magnet for criminal activity and vandalism. Additionally, no on-site management existed. Nonetheless, the City was willing to assist HUD in a crisis and attempt to work towards turning Park Lee around for the benefit of the greater Phoenix community. Both the City and HUD anticipated that NSP1 funds would be used for the rehabilitation. By April of 2009, the City had engaged outside legal counsel and project consultants to provide guidance on the myriad issues raised by HUD's proposed transaction. The City authorized the creation of ownership entities and drafted and negotiated numerous agreements with HUD, CSA and others involved with Park Lee to ensure that the proposed transaction was properly documented and effected—all at significant expense to the City.

Unfortunately it took HUD the better part of a year to conclude the transaction, during which time conditions at Park Lee continued to deteriorate and the deadline for obligation of NSP1 funds loomed. In September of 2009 HUD provided the City with HUD's Post-Closing Repair Requirements, in which HUD estimated the cost of required rehabilitation at Park Lee to be \$5,028,639. HUD did not execute the Loan Sale Agreement by which the City purchased HUD's loan for \$5,143,997 of nonfederal funds until December 16, 2009. In so doing, HUD recouped part of its investment and extricated itself from the cost and other burdens of the blighted property.

The City immediately commenced preparation for the rehabilitation of Park Lee. On December 17, 2009, CSA executed a deed in lieu of foreclosure, title vested in the new owner entity, and acquisition and rehabilitation loan agreements were executed. Between December of 2009 and March of 2010 experienced City staff, including a registered engineer, with assistance from a very experienced property management company, inspected the property and prepared a scope of work. Because the property had so recently been rehabilitated by CSA, and based in part upon HUD's repair estimate, which included no estimate for mechanical systems or structural repairs apart from roofing, the City believed that the nature of the work was primarily cosmetic and suitable for unit price bidding and contracting. The City structured the contract and bid documents accordingly. Before any bids were accepted the engineer assigned to the rehabilitation by the City's Engineering and Architectural Services Department reviewed and approved the scope of work and estimated the cost of the Park Lee rehabilitation at \$4,522,920. Seven bids were received. On August 24, 2010, the contract was awarded to Caliente Construction, whose base bid of \$3,331,885 was the lowest bid received.

Comment 3

Although there were some minor arithmetic errors in the scope of work, those minor miscalculations were addressed by the unit pricing structure of the bid package. The most significant changes to cost and scope of the work resulted from circumstances that did not occur or were not discovered until the City was irrevocably committed to the rehabilitation in process, such as vandalism and the theft of air conditioning units and copper plumbing. Most of the technical deficiencies identified by the OIG occurred as the City labored to assure that the work progressed within the time and budgetary constraints despite these circumstances. While managing an unexpectedly difficult rehabilitation that required ongoing adjustments to budget and scope, the City also spent over \$2.5 million in nonfederal funds to carry the property and pay operating losses.

Comment 4

The City took great pains to assure that value was received for all federal funds expended. As the need for additional work became apparent, the City worked with the contractor to adjust the scope of work to incorporate unexpected additional work that was required and to adjust project schedules so that units and blocks would be completed in a manner that allowed the City to begin leasing the rehabilitated units to generate cash flow to defray operating expenses. The City had an experienced construction superintendent on site almost daily, and City staff met with the contractor as needed to address developing issues. Agreements on revisions to the scope of work were incorporated in and reflected on "unit tab" sheets that were prepared for each unit, which by course of dealing were incorporated into the construction contract. Where a unit price for additional items was established in the bid and the existing contract, it was applied to determine the price of the additional work. Where work was required for which no unit price had been established by bid, the price of the additional work was based upon at least three bids by subcontractors or suppliers. Before a payment request was processed the completed work was inspected with reference to the unit tab sheets and supporting invoices, to verify that the work represented on the payment request as being complete was, in fact, completed. The records reflecting this process were made available for review by the OIG and apparently disregarded.

Comment 5

Comment 6

Comment 7

Comment 8

Although the contracting process may not have been perfect when viewed in hindsight, the Draft Report does not acknowledge the circumstances that necessitated the contract modifications nor the real-time decisions and challenges the City faced in managing costs. Had the City followed the OIG’s recommended processes—halting construction to rebid each time the need to change the scope of work became apparent—the rehabilitation cost would have grown enormously due to the delays and disruption caused by repeatedly starting and stopping the work. Instead, the contractor and City staff worked together to make the very best use of available funds in what was legitimately a sole source procurement for increased scope items. Cost reasonableness was assured through this process due to the unit pricing established by bid and the securing of no less than three competitive bids from subcontractors for all other items.

HUD should commend the City for assuming the revitalization of Park Lee, for the City’s investment of millions of nonfederal dollars to acquire a severely blighted property with significant unknown defects that otherwise could have cost HUD millions of dollars, for bearing the operating losses and the other burdens of rehabilitating the property, for helping the federal government to deploy funds intended to preserve neighborhoods impacted by foreclosures and stimulate the economy in a short time frame, and for accomplishing all of this amid an ever-changing regulatory environment. Instead, based upon its characterization of the City’s efforts as "poor contract management," the OIG leapt to the conclusion that all of the City’s expenditures (including the \$3.7 million, competitively procured low bid base contract) were unreasonable "cost overruns" and recommended that HUD require the City to repay \$6.18 million in NSP funds, halt all of the City’s NSP-funded projects indefinitely, and prosecute the City for arguably using certain forms incorrectly. Such overly aggressive audit tactics do not serve HUD or the taxpayers.

The results of the City’s efforts speak for themselves.¹



¹ Additional photographs of the City’s renovation work are enclosed as [Exhibit A](#).

Before

After



III. The City's Response to Individual Draft Recommendations

Recommendation 1A: We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to [s]top incurring costs for NSP funded multi-family rehabilitation projects until HUD determines whether the City and its management have the capacity to carry out these activities in compliance with HUD rules and regulations.

Comment 9

The City (and its Housing Department specifically, in coordination with other City departments) has a long and successful record of providing high quality, HUD-funded housing programs in compliance with applicable requirements. The City consistently has been awarded funding opportunities based on its capacity to manage federal funds and has successfully passed HOPE VI and other federal program audits and monitoring. In fact, the City owns approximately 5,500 units of public and affordable housing and manages approximately 5,200 housing choice vouchers. The City has successfully developed the five-phase Matthew Henson HOPE VI development and the McCarty on Monroe senior development and is in the process of developing other projects in the City for low income residents. The OIG's suggestion that individual technical deficiencies as set forth in the Draft Report (and which the City refutes) should call into question the City's overall capacity to manage affordable housing is neither merited nor supported. Although there is much anecdotal evidence to support the view that HUD finds the City's housing management efforts more than adequate (including, for example, the numerous funding opportunities HUD has made available to the City and the many successful projects undertaken by the City utilizing federal funds), HUD's own statements with respect to Park Lee are most telling. For example, in the Loan Sale Agreement drafted by HUD and by which the City purchased the Note from HUD, the preamble affirms HUD's belief that the City "has the servicing and monitoring capabilities, as well as the expertise and resources to provide long-term affordable housing asset management for the portfolio".

Comment 10

The NSP program was rolled out very quickly in the wake of the national financial crisis. The regulations governing the use of NSP funds followed in a fluid, ever-changing regulatory environment. The City made exhaustive efforts—including employee participation in legal consultations, training/webinars and frequent HUD consultations—at all stages of the Park Lee rehabilitation project in order to ensure compliance with applicable requirements, including NSP1 and NSP2 program requirements. While the OIG can now review such efforts with the benefit of hindsight, relying upon program requirements that have since become more formalized, at the time of the various activities in question applicable program requirements were in a state of flux. NSP program requirements appeared in numerous formats, including federal register notices, notices of funding availability, training materials, HUD-issued policy alerts, guidebooks, toolkits and other such mediums as "frequently asked questions" that were constantly being updated on HUD's website and all of which were purportedly authoritative. Although the City applauds HUD for moving quickly, innovatively and collaboratively to provide parameters for the NSP program that would facilitate the economic stimulus Congress intended to create through the program, the multitude of formats and rolling nature of applicable requirements made complete compliance difficult for recipients receiving multiple funding awards.

As the City demonstrates in the remainder of this response, any technical deficiencies alleged by the OIG in the Draft Report are either premised upon the OIG's misunderstanding of the basis for the City's activities and decisions with respect to Park Lee or result from the lack of early and clear direction from HUD regarding applicable requirements that necessitated the City making decisions in real-time based on the best information then available. There is no question that the City's overarching goals included meeting the mandates of NSP funding generally, taking advantage of HUD preservation and foreclosure opportunities, addressing major neighborhood blight, creating housing affordability along light rail corridors and meeting obligation and expenditure deadlines. By all accounts, the City's foresight and continued efforts with respect to Park Lee have been nothing short of "heroic" in the words of one HUD official. For example, Phoenix community members¹, industry experts¹, legislators¹ and even HUD¹ have

¹ See, e.g., Sadie Jo Smokey, *City-Rehabbed Apartments Almost Ready for Move-In*, ARIZ. REPUBLIC, April 24, 2011, available at <http://arizonarealestatenewsaccess.blogspot.com/2011/04/city-rehabbed-apartments-almost-ready.html> (reporting that "Tom Elgin, who lives in the Grandview Neighborhood east of the [Park Lee], said he's extremely happy with the [C]ity's effort to clean up the blighted area . . . [and that] '[t]he police used to be there a lot . . . [d]rugs, graffiti . . . was a real problem. I'd paint over graffiti every weekend. All of that has basically gone away.'").

¹ See, e.g., NAT'L LAW HOUS. PROJECT, *INNOVATIVE DEVELOPMENT STRATEGIES FOR VERY LOW-INCOME HOUSING 12-13* (2010), available at http://www.nhlp.org/files/NHLP%20NSP%20Best%20Practices%20Final_0.pdf (profiling the Park Lee rehabilitation project as one of the most innovative NSP projects in the country among other projects analyzed in its NSP best practices guide).

¹ See, e.g., Sadie Jo Smokey, *Phoenix Buys Park Lee Apartments As Low Income Rentals*, ARIZ. REPUBLIC, Dec. 26, 2009, available at <http://www.azcentral.com/news/articles/2009/12/24/20091224Phx-ncparklee1226.html> (reporting on how Congressman Ed Pastor "lauded the work of the multiple city, state and federal departments involved in acquiring the [Park Lee]" and his statements that "'[t]his is important not only to the city of Phoenix . . . [t]his was part of the Federal Transit Administration's initiative to have affordable housing near light rail [and] [a]ll of these residents will be able to take light rail to work, shopping.'").

¹ See U.S. DEP'T OF HOUS. & URBAN DEV., *SPOTLIGHT ON THE HOUSING MARKET IN: PHOENIX-MESA-GLENDALE, ARIZONA*, May 2011, at 3, available at <http://portal.hud.gov/hudportal/documents/huddoc?id=PhoenixScorecard.pdf>

Comment 11

touted the City's initiative and numerous improvements made since the City took control of Park Lee. Based on these assessments, the OIG's suggestion that the City is incapable of properly managing the remainder of NSP funds earmarked for Park Lee—let alone its management of NSP funds for other multifamily rehabilitation projects that have nothing but sterling records—strains credulity, and risks harm to the population served by the City's housing programs grossly out of proportion to any detriment resulting from any technical deficiencies that might be ultimately established.

To summarize, the Draft Report simply does not support the view that, under the totality of the circumstances, City staff failed to appropriately manage the rehabilitation of Park Lee and to properly administer the use of federal funds during that process. To the extent that the recommendation is based on the approval of change orders under the unique circumstances applicable to Park Lee, the need for and cost reasonableness of the change orders was thoroughly established, as explained below. In fact, this unsubstantiated attack on the City's capacity and recommended moratorium on NSP funding will likely produce no public benefit and simply adds risk and expense to an already cost-burdened project. For instance, the City's contractual commitments to contractors and others could be jeopardized by a temporary pause in funding that may lead to significant legal liabilities and costs. Suspending work may also jeopardize other applicable requirements, like HUD expenditure deadlines for NSP funds. From a practical perspective, Park Lee is nearly complete and any temporary stoppage in funding is likely to risk full contract completion. In short, a suspension in funding is not warranted based on the Draft Report and will only exacerbate existing issues with respect to the Park Lee rehabilitation project. Therefore, the City requests that Recommendation 1A be deleted in its entirety from the Draft Report.

Recommendations 1B, 1C¹, 1D, and 1E: We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to: [(i) [s]upport that \$1,707,554 in NSP1 project funds was used solely for its intended purpose and met the terms, conditions, and specifications of the contract for Park Lee Apartments rehabilitation project charges or repay its NSP1 grant from non-Federal funds. Supporting documentation should include evidence showing that all costs incurred under the contract met the applicable cost eligibility requirements of OMB Circular A-87; [(ii) [s]upport that \$1,235,004 in project funds was used solely for its intended purpose and met the terms, conditions, and specifications of the NSP2 grant for Park Lee Apartments rehabilitation project charges or reimburse its NSP2 grant from non-Federal funds. Supporting documentation should include evidence showing that all costs incurred under the contract met the applicable cost eligibility requirements of OMB Circular A-87; [(iii) [s]upport the reasonableness of \$934,015 in unsupported Park Lee Apartments NSP1 rehabilitation charges resulting from contract change orders or repay its NSP1 grant from non-Federal funds. Supporting documentation should include evidence that that the

(lauding the City for taking on a project that "had become notorious for crime, vandalism, drug activity, and poor maintenance, leading to 20% occupancy and squatting of vacant units").

¹ The recommendations in the Draft Report were not correctly numbered. These references list the letters the City assumes will be assigned in the corrected version of the Draft Report.

charges are reasonable and comply with program requirements; [and (iv)] [s]upport the reasonableness of \$2,118,814 in unsupported Park Lee Apartments NSP2 rehabilitation charges resulting from contract change orders or repay its NSP2 grant from non-Federal funds. Supporting documentation should include evidence showing that all costs incurred under the contract met the applicable cost eligibility requirements of OMB Circular A-87.

Comment 12

These recommendations are grouped because they are duplicative—a general demand for substantiation of supporting documentation inappropriately split into multiple recommendations—and appear to be based on the OIG's assessment under the captions "The Contract Scope of Work Was Insufficient", "Oversight and Verification Were Inadequate", "Procurement Documentation Maintained Was Insufficient" and "Contract Modifications Were Inappropriate" in Finding 1 of the Draft Report. In essence, these sections argue that overall rehabilitation costs at Park Lee, including cost increases incurred via contract change orders, were excessive and permitted without appropriate oversight. The OIG's focus elevates form over substance, ignores the fact that the monies were necessary and were spent on Park Lee and, particularly as to the OIG's suggestion that the City repay funds expended under the original scope of work, is both curious and unfounded given the context within which the additional costs were incurred and the lack of evidence presented in the Draft Report to substantiate that amounts expended were unreasonable. The City expects to complete the rehabilitation of all units for a cost of under \$20,000 per unit, after taking into account funding from all sources including City nonfederal funds, NSP funds, and insurance proceeds. To convert a dilapidated "tear down" into a jewel of a property located in the heart of the City along the light rail corridor at a per unit rehabilitation cost of under \$20,000 is a remarkable achievement, and patently demonstrates that HUD has received more than appropriate value in return for the NSP funds expended.

Comment 13

Comment 14

The City agrees that scope and quantity figures were underestimated at the outset of the Park Lee rehabilitation project, which necessitated additional work and increased costs. However, given the circumstances that led to the additional work and the specific actions taken by the City to appropriately alter the project's scope as the rehabilitation unfolded, the OIG cannot properly conclude that funds were improperly managed or misspent. As detailed in Section II of this response, Park Lee was in a gross state of disrepair by the time HUD transferred Park Lee to the City. At that time, approximately 80% of the units in Park Lee were vacant, had no utility service and were frequented by squatters, all of which exacerbated the high levels of crime plaguing Park Lee and the surrounding community. HUD was quite familiar with Park Lee's poor condition when it proposed to transfer the Note to the City; in fact, the OIG issued an audit report in late 2009 detailing its concerns with Park Lee—even providing photographs of the deplorable conditions—and describing how, without finding a partner to takeover the fledgling development, "HUD stands to lose millions on the sale of the [N]ote."¹ The City could not conduct unit walk-throughs until after the Note was transferred. Its scoping was premised on the mistaken belief that the work required was largely cosmetic, and those scoping the work could not observe the problems hidden behind the walls, or the defects in

Comment 3

¹ See OIG Audit Report No. 2009-LA-1019, September 15, 2009, at 1, available at www.hudoig.gov/pdf/AuditReports/AZ/ig0991019.pdf.

mechanical systems that only became apparent when utilities were restored and systems were able to be tested.

Comment 15

When the City was finally able to conduct a walk-through it did so with representatives of Dunlap & Magee ("**D&M**"), a highly respected, City-procured property management firm with over thirty years of management experience. D&M assessed 100% of Park Lee's units to develop a scope of work. Due to the deteriorating nature of the units, coupled with the fact that utility service was neither connected nor safe enough to connect at a vast majority of the units, team members were forced to rely on visual inspections. Team members also did not know the extent to which vandals had looted copper plumbing and other unit components, which triggered water and mold problems, all of which were not visually apparent. In this context, it is understandable that the scope of rehabilitation was underestimated. Once work commenced, utilities were connected and walls opened up, the extent of destruction and the true scope of the necessary rehabilitation work came into sharper focus.

Comment 16

The Draft Report criticizes the City's bid solicitation because it "did not provide for asbestos and mold abatement and remediation" citing as evidence the fact that "the City included comments regarding damage to specific units, several of which included notations of mold damage" and other comments like "Heavy flood damage and copper theft". These comments, highlighted in the excerpts enclosed as Exhibit B, evidence the fact that such conditions were included in the bid documents to the extent that they were known. The very fact that the bid solicitation included these items within the scope of rehabilitation that was sent to prospective bidders confirms that mold rehabilitation was within the original scope of work. Although more mold than was originally thought to exist was discovered as work on Park Lee commenced, to say that the original bid solicitation did not contemplate such work is patently false.

Comment 17

With respect to asbestos, when the City scoped the work it had in hand excerpts from a 2004 asbestos report that had been prepared for CSA, and which indicated that there was minimal asbestos present that would not require extensive remediation (primarily asbestos in the insulation for hot water tanks and in mastic for tiles that would be encapsulated). Because the report was too old under applicable county requirements, a new report was ordered but not received until the week before bid submittals were due. An addendum to incorporate the asbestos remediation in the bid was required by the project manager but was not issued due to timing and miscommunication. The City could not rebid the Park Lee rehabilitation work and still meet its NSPI obligation deadline. The City made the choice to proceed with the project, and required the contractor to competitively bid the asbestos remediation work to ensure cost reasonableness.

As the extent of disrepair at Park Lee became more evident, the City was left in the unenviable position of attempting to complete a much larger rehabilitation effort within the confines of its existing funding and scheduling parameters. Contrary to the OIG's assertion that the City "agreed to additional lump sum amounts without detailed supporting information that could be used to verify completed work and that the rehabilitation contract became a function of available funding rather than being based on fixed, agreed-upon costs for specific work to

Comment 18

complete the project", the City took great pains to vet and document changes to the scope of rehabilitation. During the audit the City made available to the OIG: (i) a bid tab summary for the original contract, (ii) supporting documentation for each change order, (iii) summaries for each individual block which accounted for all rehabilitated units and common areas at Park Lee, (iv) copies of all supporting invoices, and (v) photographs of the work in progress. Additionally, OIG staff visited Park Lee to personally view work in progress and OIG staff was offered the opportunity to view contractor files concerning the rehabilitation work. The records previously provided establish that all scope items and costs were documented and that inspections ensured that the agreed upon scope of work was properly completed.

Comment 19

One of the primary change orders challenged by the OIG in the Draft Report as being unsupported is change order #43 in the amount of \$1,700,000. The Draft Report indicates that this change order "provided only a per-apartment-unit lump-sum cost of \$5,466 . . . [thus] it would be impossible for the City to determine what specific work was included, whether that work was duplicated elsewhere in the contract scope, and whether that work had been completed when the contractor requested payment." The OIG apparently assumes that the only information relevant to determination of the scope and performance of the work is the naked change order form. However, change order #43 must be viewed in the context of the course of dealing of the parties, as described above. Although Change order #43 committed an additional \$1.7 million in funding to the project, and tentatively allocated that funding by spreading it over the remaining blocks and units to be rehabilitated, the parties were aware that the existing funding was inadequate to complete the entire rehabilitation of Park Lee. Because the City could not commit additional funding to the rehabilitation at that time, and given the uncertainties of the rehabilitation process as experienced by the parties, it was obvious to all concerned that the additional funding would have to be reallocated to specific costs that would be incurred as the contractor proceeded with the work.

Comment 4

Comment 20

Comment 19

The parties had established in their course of dealing a process by which, before work on a unit commenced, representatives of the City and the contractor and others would review the work in detail, determine what work would be done and in what manner, and memorialize their agreements in the unit tab sheets. The City's construction superintendent was on site almost every day and personally observed and monitored the work in progress. Throughout the rehabilitation process, the contractor made extraordinary efforts to reduce costs, for instance by cannibalizing parts from equipment, rebuilding and repairing equipment wherever possible. All work performed was evidenced by subcontractor invoices and both documentation and the work itself were reviewed and compared to the unit tab sheets before payment was approved. The voluminous documentation underlying this process (a sample of which is enclosed as Exhibit C) clearly demonstrates specific rehabilitation costs by type of cost and unit block. Additionally, the documentation provided by the City to the OIG and enclosed as Exhibit D identifies specific work items for change order #43 by unit block. The City has provided similar information for other project change orders to substantiate the appropriateness and reasonableness of all additional project costs.

Comment 3

Because of funding limitations and the magnitude of additional repair costs to mechanical systems—which were largely hidden from view until they were discovered during the construction process—the City elected to direct the contractor to complete work on a block-by-block basis, which involved performing the work originally scoped in those blocks as well as performing the necessary repairs to make the units in those blocks habitable (e.g., repairing burst water lines, replacing wiring to provide for electricity, etc.). Had it not done so, the City could have been left with a property consisting of half-finished, uninhabitable units, with no income from tenants, and which would continue to be blight on the neighborhood despite the expenditure of funds to rehabilitate Park Lee. Since vacancy of the property was a significant contributor to its deteriorated condition, and occupancy is a key to successful rehabilitation, neighborhood renewal, and affordable housing objectives, this was a prudent course of action that was obviously preferable to the course of action the OIG claims should now take place—stop work on Park Lee, spend additional funds to develop a more accurate scope of work, and rebid Park Lee. Quite simply, the City’s actions were entirely consistent with the substantive principles that guide the expenditure of HUD funds.

Comment 21

Comment 22

The OIG’s suggestion in the Draft Report that overall Park Lee project costs are unreasonable is also unmerited. HUD itself did an analysis in 2009 to determine the scope and cost of necessary repairs at Park Lee. As shown on the Post-Closing Repair Requirements schedule attached to the Loan Sale Agreement that effected the transfer of the Note from HUD to the City and which is enclosed as Exhibit E, HUD concluded that over \$5 million dollars would be required to rehabilitate Park Lee. HUD’s estimate did not accurately reflect the scope of work that eventually was required and: (i) omitted any estimate for certain items including asbestos remediation, drywall repairs, blinds and shades, concrete, masonry, finish carpentry, bathroom fixtures, and site utilities, (ii) estimated less than \$100,000 for plumbing and hot water, heat and ventilation, and air conditioning combined, and (iii) estimated only \$33,062 for cabinetry. These miscalculations caused HUD’s own cost estimate to be significantly understated. Adjusted to include the cost of the additional items that HUD failed to contemplate, it is reasonable to assume that the full amount of rehabilitation costs under HUD’s own analysis would have amounted to a figure in excess of \$6 million. The City’s engineering staff estimated the cost of the rehabilitation as originally scoped at \$4,522,920. These estimates provide substantial evidence of the overall cost reasonableness of the Park Lee rehabilitation work.

Comment 23

Comment 24

For the foregoing reasons, the City believes that all purchases satisfied firm fixed price requirements, that change orders met or improved upon original bid prices for items covered in the original scope, and that change orders for new elements were bid in accordance with federal procurement requirements and were reasonable as to overall cost. Moreover, thanks to the City’s management of Park Lee and despite numerous challenges encountered by the City, upon completion of the project the City expects to realize a cost of under \$29,000 per unit (including rehabilitation, property acquisition, fire insurance and related work) in connection with Park Lee—an extremely cost-conscious figure given the extent of rehabilitation necessary. Nonetheless, in an abundance of caution, the City has contracted a third party firm, Abacus Project Management, to perform a cost reasonableness analysis of Park Lee rehabilitation work (including each change order). As indicated in its draft report (excerpts of which are enclosed as

Comment 25

Exhibit F), Abacus' review confirms that overall rehabilitation costs were "reasonable for the work included," thus further substantiating the appropriateness of the City's activities, the reasonableness of additional costs and the propriety of documentation maintained with respect to Park Lee.

Comment 26

The OIG's claim that "the City's inadequate procedures allowed a sole City employee, who did not have contract modification authority" to agree to change orders does not take into account the integrated and collaborative nature of decision-making with respect to Park Lee. The City held frequent status meetings and inspections with participation by a range of interested parties including the City's Housing, Legal, Engineering and Architectural Services, Neighborhood Services, Planning and Development, Public Works and Street Transportation, and Phoenix Police Departments, as well as D&M, contractor and inspector representatives. A sampling of the meeting minutes enclosed as Exhibit G evidence the nature and content of these meetings in detail. Although it is true that the only signature on the change order itself is that of the project manager, the change order was not executed until it had been thoroughly vetted by City staff during the project team meetings. The project manager and a supervisor both reviewed and signed all pay applications, which tied into the change orders as described above. In the case of change order #43, which was the culmination of the City's decision to commit \$2 million in additional funding to Park Lee, the change order was not executed until

Comment 27

City officials at the highest level had approved the funding. In response to the Draft Report, the City has conducted extensive inquiries and reviews of the work performed in the

Comment 28

rehabilitation of Park Lee, and is satisfied that all work performed was necessary and appropriate, that the cost of work performed pursuant to change orders was reasonable, and that appropriate value was received for all payments made. Based on this review, the

Comment 29

President of the owner entity has since executed a memorandum documenting and formally authorizing the project manager's contract actions. Put simply, there is simply no evidence that power to manage the project was vested unilaterally in any one individual in a manner that would create an opportunity for mismanagement, or that any particular modification was inappropriate, unjustified, wasteful or unauthorized.

Comment 30

On page 10 of the Draft Report the OIG claims that "both the contractor's project manager and a City employee stated that payment requests' percentage of completion ratios were incorrect; they were calculated based on funding needs rather than on completed work. The employee further indicated that other City employees involved with the Park Lee rehabilitation project also knew that the ratios were incorrect." This portion of the Draft Report mischaracterizes statements and information provided to the OIG. The City believes that the OIG has characterized the ratios as "incorrect" based upon the OIG's understanding of how the forms are intended to be used in a fixed price contract. By taking witness statements out of context and characterizing them in this fashion, the OIG apparently seeks to establish some basis for the recommendation that the City and its contractor be investigated and prosecuted for "incorrectly certifying to the integrity of the data or that due diligence was exercised during the approval of rehabilitation payments."

Comment 30

When the particular forms in question are examined in the context of this specific project it is apparent that characterization of the forms as "incorrectly certifying" information to HUD is insupportable. Management of the Park Lee rehabilitation contract was unnecessarily

Comment 31

complicated by the use of standardized forms that were prescribed by the City's Engineering and Architectural Services Department but which were not suited to a unit price contract arrangement. Those forms included the schedule of values and percentage completion forms. Because the project was bid based on unit pricing, the requirement to create a schedule of values was not straight-forward, and the contractor had to deconstruct its bid and allocate the unit prices to cover items such as general conditions, which were not separately stated in the bid documents.

Comment 32

For the same reason, percentage completion forms made little sense in the context of this project. Consequently, the project manager used these forms to measure and monitor overall progress against the base line of the project budget as allocated in the schedule of values, rather than overall percentage of completion of the work. For example, assume (hypothetically) that the contract specified that 20 toilets would be installed at a unit cost of \$200 per toilet. If the contractor billed for \$2,000 for toilets, the project manager showed the line item as 50% complete, because 50% of the funds allotted to that line item, *on a unit cost basis*, were being expended for delivery of 50% of the units in question, even if all concerned knew that more toilets might be required as the project progressed. The percentage completion thus reflected the percentage of the monies allocated for particular line items on the schedule of values based on the unit price, which was in fact a measure of the percentage of completion given the unit pricing under the contract. Apparently the preparers of the forms described this process, and the OIG drew its own conclusion that the percentage completion ratios were incorrect. However, the OIG's focus on these forms is inappropriate, as use of the forms was not required by HUD and the information presented in the forms represented the project manager's attempt to adapt the forms to circumstances for which they were not intended, not an attempt to mislead, defraud, or "incorrectly certify" anything to HUD.

Comment 33

The OIG also asserts that, with respect to change orders, the City "did not conduct the procurement in a manner to provide for full and open competition." On the contrary, the City competitively procured a contractor (a woman-owned small business, no less) through sealed bidding to undertake the rehabilitation work on a unit cost bid. Any additional items required by an increase in the scope of rehabilitation were priced at the cost stated in the contractor's original—and winning—bid. To require that the City re-bid every increase in the number of items required as rehabilitation work unfolded (for example, requiring a re-bid for an additional bathroom fixture for one unit that was found to be deficient months into the rehabilitation) is both unduly burdensome, overly costly given the procured contractor had already provided the lowest bid for such items and inconsistent with other HUD-published guidance.¹

Comment 34

Comment 6

Additionally, the City ensured that its contractor bid out to a minimum of three subcontractors all scope changes that related not to increases in the number of items originally contemplated for Park Lee but rather to a whole new work item that was not included in the

¹ See, e.g., U.S. DEP'T OF HOUS. & URBAN DEV., HUD HANDBOOK 7460.8 REV 2, at Section 10.3.C.5 ("When negotiating a modification to any contract (even if the basic contract was awarded competitively through sealed bidding) that changes the scope of work previously authorized and impacts the price or estimated cost, the PHA must use cost analysis to arrive at a reasonable cost. *The only exception to this rule is a contract modification based on pricing terms already established in the contract document, e.g., exercising an option to buy additional items at preset prices.*") (emphasis added).

Comment 35

Comment 6

original procurement. Pursuant to 24 C.F.R. § 85.36(d)(4), sole source procurement may be utilized in certain instances of public exigency, provided that a cost analysis is undertaken to support such procurement. The failing condition of Park Lee when the City took it over from HUD—including the rampant theft and vandalism which threatened occupants and the greater Phoenix community—certainly qualifies as a public exigency. Further, the process of having no less than three subcontractors provide quotes for scope changes is fundamentally a form of assessing cost reasonableness in furtherance of the cost analysis procedure required under 24 C.F.R. § 85.36(d)(4). For these reasons, the City believes its procurement practices were within both the letter and spirit of applicable procurement requirements.

The Draft Report also chastises the City for "destroy[ing] competing project bids after it awarded the original rehabilitation contract." This critique is inappropriate; although the City's Engineering and Architectural Department discards portions of competing bids in an effort to streamline and manage the intense volume of paper one might expect at an organization that houses approximately 30 departments and 15,000 employees, it maintains sufficient information about losing bids to permit procurement audits and record the significant history of the procurement, as required by HUD. The Draft Report asserts error without regard to context. The City is not like other public housing authorities with small staffs and an independent focus—the successful operation of an integrated City structure (of which the Housing Department is only a small part) demands some balancing of competing interests. The City's policies on paper and e-mail reduction, for example, are indicative of larger programmatic initiatives that are generally enviable for large governmental organizations.

Comment 36

More importantly, the OIG conveniently fails to recognize that applicable regulations at 24 C.F.R. § 85.36(b)(9) require only that "records sufficient to detail the significant history of a procurement" be retained. Neither in the federal regulations nor in available HUD guidance materials¹ is there any requirement that losing bids be retained. The City provided various items to the OIG evidencing the propriety of its primary contract procurement process, including the results of the bid opening, a comprehensive bid tabulation summary and an internal analysis which are collectively enclosed as Exhibit H. The City is confident these records demonstrate its compliance with applicable requirements.

Comment 37

In summary, the commentary in the Draft Report suggests that the OIG's real concern about Park Lee was that cost increases (which were a direct result of pre-existing conditions at the site that were not disclosed to or discovered by the City until after rehabilitation commenced) were unreasonable or inappropriate. However, the City believes that the supporting documents previously provided to the OIG and enclosed with this response show that all NSP funds were used for their intended purposes and in accordance with applicable requirements, including cost eligibility requirements. Accordingly, the City requests that Recommendations 1B, 1C, 1D, and 1E be deleted in their entirety from the Draft Report.

¹ See, e.g., CDBG FINANCIAL MANAGEMENT AND PROCUREMENT TRAINER GUIDE at 12-13 (suggesting that losing bid documentation is not required to be retained).

Recommendation 1F: We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to [r]eimburse the City's NSP2 grant \$299,901 from non-Federal funds for the use of substandard equipment.

Comment 38

The City objects to the OIG's characterization of the air conditioning units installed at Park Lee as "substandard," a loaded term that implies that the units were inadequate. Recommendation 1F refers to the OIG's assertion in the Draft Report that the City agreed in its HUD grant application to utilize 14 SEER- and Energy Star-rated air conditioning units at Park Lee and instead utilized 13 SEER- and non-Energy Star-rated air conditioning units. Although the Draft Report characterizes a portion of the air conditioner costs as being NSP2-funded through use of a proration formula constructed by the OIG—despite the fact that the project was initially scoped as an NSP1-funded undertaking and only later incorporated NSP2 funds—the reality is that the City did not use \$299,902 in NSP2 funds to purchase the air conditioners in question. In fact, the air conditioning units were pre-purchased to lock in a favorable price, and the City used only NSP1 monies for these purchases as evidenced by the materials enclosed as Exhibit I. Since the grant application does not prohibit such an allocation, and because appropriating funds to one grant or another is the City's prerogative, the OIG has no basis to challenge which grant monies were used to purchase the items in question.

Comment 39

Comment 40

Even if the City had used NSP2 money to purchase air conditioning units for Park Lee, that decision would have been fully justified and the expenditure would have been appropriate. The Park Lee rehabilitation did not entail a wholesale replacement of HVAC systems. The wiring, piping and compressors in the units were not compatible with 14 SEER units. Had the City required the contractor to provide 14 SEER units it estimates that the additional cost of that requirement alone would have added more than \$1.5 million to the overall project cost, as it would have required that new holes be drilled in exterior walls, and that plumbing and compressor units be changed so as to work with the 14 SEER units. Not only would such modifications to the buildings have provided a vector for the introduction of pests, water damage and other problems, the additional costs would not have been justified by the additional energy savings that might have resulted. Therefore, the City requests that this recommendation be deleted in its entirety.

Recommendation 1G: We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to [r]eimburse the City's NSP2 grant \$31,270 from non-Federal funds for equipment that did not meet the grant's Buy American provisions.

Comment 41

This recommendation refers to the OIG's assertion in the Draft Report that the City installed 130 gas ranges and 38 vent hoods in the apartment complex that did not comply with NSP2 program Buy American requirements. As with other recommendations concerning scope, the project was originally scoped and bid under the NSP1 program, which did not include Buy American requirements. NSP2 funds were not committed to the project until after the general contractor's bid had been accepted.

Comment 42

Additionally, HUD guidance material suggests that purchases under \$100,000 are exempt from Buy American requirements.¹ In this instance, the purchases at issue are exempt since the aggregate cost for the gas ranges and vent hoods is \$31,269. Nonetheless, the City recognizes the importance of the policies underlying the Buy American requirements in the NSP2 context and is willing to consider applying for a retroactive waiver of those requirements to the extent HUD deems necessary. The City expects that the size of the purchase in question (\$31,269) would support such a waiver, thus rendering this recommendation moot.

Recommendations 1H, 1I and 2H: We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to: [(i)] [d]evelop and implement policies and procedures to ensure that HUD-funded construction projects are managed according to program requirements and are adequately monitored; [(ii)] [d]evelop written procurement policies and procedures for HUD-funded projects that conform to HUD requirements; [and (iii)] [d]evelop and implement policies and procedures to ensure that grant charges comply with applicable Federal cost eligibility requirements.

Comment 43

As discussed in the City's responses to other recommendations, the City believes that it appropriately monitored, procured and otherwise managed the Park Lee rehabilitation in accordance with applicable requirements. The City has numerous policies and procedures in place, including with respect to procurement, that govern different aspects of the City's activities in this regard and the City would be happy to provide the OIG and/or HUD with such policies and procedures upon request. In an abundance of caution, the City has commenced its own internal audit of Park Lee and has created new instructional and procedural memos to more thoroughly and specifically instruct staff on compliance with HUD requirements at the transactional level. If the OIG has any specific recommendations for content that is lacking in City policies and procedures, the City is willing to entertain modifications. As it stands, these recommendations are too vague to be actionable. The City therefore requests that these recommendations be: (i) at a minimum, consolidated into a single finding since they address the same basic allegation; and (ii) tailored to address specific items allegedly lacking. If the OIG has identified no such specific items, the City requests that these recommendations be deleted altogether.

Recommendation 1J: [W]e recommend that HUD's Associate General Counsel for Program Enforcement [d]etermine [the] legal sufficiency and if legally sufficient, pursue civil remedies (31 U.S.C. (United States Code) 3801-3812), civil money penalties (24 CFR 30.35), or both against the City, its principals, its contractor or all of the above for incorrectly certifying to the integrity of the data or that due diligence was exercised during the approval of rehabilitation payments.

Given HUD's desire to turn over the failing Park Lee project to the City—and the City's willingness to take it on despite Park Lee's challenges, the high transaction costs and the significant investment of time and money—it is surprising that the OIG

¹ See, e.g., HUD Notice PIH-2011-12 (HA), at p.7 ("Where the size of a contract . . . is less than \$100,000 . . . the Buy American requirement is not applicable.").

Comment 44

would impose additional challenges and costs on Park Lee by conducting a full-scale audit. It is shocking that the OIG would make an unsupported allegation that the City acted improperly in its authorization of NSP funds made available for the Park Lee rehabilitation and that it lacks the capacity to manage projects generally. Although the Draft Report consists of several alleged technical deficiencies, overall it appears to stem from one primary issue identified by the OIG—additional rehabilitation costs that were incurred due to rehabilitation needs identified during the renovation process. The Draft Report suggests—without providing any identifiable instances or concrete evidence—that actions by City personnel in managing and documenting these costs were intended to deceive HUD. The OIG suggests that claims under 31 U.S.C. §§ 3801—3812 (the "Act") and related civil money penalties under federal regulations be brought against the City, its principals, its contractor or all of them in connection with Project funding despite providing no credible, specific information that might conceivably justify such action. As the OIG is aware, HUD is authorized to impose such penalties against a person who "makes, presents, or submits, or causes to be made, presented, or submitted, a claim [or a written statement] that the person knows or has reason to know: (i) is false, fictitious, or fraudulent; [or] (ii) includes or is supported by a written statement which asserts a material fact which is false, fictitious, or fraudulent." 28 C.F.R. § 28.10. Thus, to substantiate such an allegation there must be evidence of: (i) a "claim"; (ii) by a person who has knowledge or imputed knowledge; and (iii) that the claim is false. In other words, there must be knowledge of a falsehood and an intent to deceive. No such knowledge or intent is suggested, and no such allegation can be properly made.

While the Draft Report alleges various technical issues with respect to certain aspects of the City's NSP program compliance, the Draft Report does not indicate precisely what information is alleged to have been falsely communicated by the City to HUD. An allegation of deceit at this magnitude requires an explicit enumeration of the alleged falsehoods. The Draft Report offers little more than vague and unsubstantiated generalizations about the City's overall program compliance based on a few instances of alleged non-compliance (which are refuted in this response). Such generalizations do not establish a case under the Act.

As the Act and federal implementing regulations make clear, a claim under the Act must be supported by a showing of actual or imputed knowledge that the statement in question was a false one. A legitimate claim therefore must establish that the person offering false information: (i) has actual knowledge that a claim or statement is false, fictitious, or fraudulent; (ii) acts in deliberate ignorance of the truth or falsity of a claim or statement; or (iii) acts in reckless disregard of the truth or falsity of the claim or statement. *See* 31 U.S.C. § 3801(a)(5). Despite this requirement, the Draft Report is devoid of any specific information concerning knowledge by a City employee of a false statement made to HUD, let alone verifiable evidence of such knowledge. Rather, the Draft Report baldly contends that a claim under the Act may lie because of the City's "incorrectly certifying to the integrity of data" or that enough "due diligence was exercised during the approval of rehabilitation payments." Such allegations of mistake or negligence, even if true, do not establish knowing or reckless conduct as required by the Act. In fact, the City's own investigations of this claim by the OIG indicate that staff were doing their best to appropriately represent the status of the rehabilitation under the challenging circumstances described above.

In addition, the Act and federal implementing regulations also make clear that the Act only applies if there is a false "claim," as defined by 31 U.S.C. § 3801(a)(3)(A)—essentially a demand by a person for property, services or money. The Draft Report does not identify any communication by which the City demanded more in the way of property, services or money from HUD. Certainly the City accepted NSP funds to which it was entitled from HUD for use in connection with many City initiatives (including rehabilitating Park Lee), but there is no factual support in the Draft Report suggesting that the City, its principals or its contractor demanded that HUD provide more funding for Park Lee as a result of cost overruns than had already been appropriated by HUD to the City. Nor is there any assertion that the City, its principals, its contractor or anyone else benefited financially from any of the cost overruns identified in the Draft Report, and for good reason—all NSP funds made available by the City for Park Lee served Project-related needs at very competitive and reasonable cost.

This recommendation fails to meet the threshold legal requirements for such a claim. Instead, with no context and relying on nothing more than innuendo, the OIG apparently seeks to disparage the City with baseless accusations. For the reasons stated above, the City therefore requests that Recommendation 1J be deleted in its entirety from the Draft Report.

Recommendations 2A and 2B: We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to: [(i)] [r]epay HUD \$140,121 from non-Federal funds for ineligible actual loss charges related to the theft and vandalism of air conditioners; [and (ii)] [r]eimburse the City's NSP2 grant \$60,051 from non-Federal funds for ineligible actual loss charges related to the theft and vandalism of air conditioners.

These recommendations relate to the OIG's impractical position that the City should have filed insurance claims with respect to stolen and vandalized air conditioners at Park Lee despite the fact that no single occurrence of air conditioning theft or vandalism exceeded the deductible on the City's insurance policies. The crime and vandalism at Park Lee existed long before the City assumed responsibility from HUD and are well chronicled in Section II of this response. Following the purchase of the Note from HUD, the City undertook an inventory of Park Lee. It quickly became evident that many air conditioning units had been looted of their copper components.

While the City promptly engaged a security company, Valley Protective Services, thefts and acts of vandalism did not immediately stop. As shown in the security log and related insurance policy materials enclosed as Exhibit J, no single incident of theft or damage (or even a series of incidents in the same 72-hour period which might be construed as a single incident under the policies) exceeded the City's \$50,000 per occurrence deductible. Additionally, according to the City's insurance broker, the City's copper theft deductible is very much below deductible limits utilized by the City's peers. The OIG's suggestion that the City should have filed insurance claims it knew were below the deductible is ludicrous. To file such claims repeatedly would have been a waste of time and money and likely would have led to insurance premium increases that would further burden Park Lee's finances and even possibly jeopardizing its insurance coverage without resulting in any payment on the claims. Most importantly, given

Comment 45

Comment 46

the fact that there is little published guidance available on sub-deductible claim filing requirements in federally-funded projects, the City reached out to HUD officials on this very issue. The e-mail correspondence the City received back (and which is included in the Exhibit J materials) clearly states that the City was not required to file any claims and that replacement costs were eligible expenses. Therefore, the City requests that Recommendations 2A and 2B be deleted.

Recommendation 2C: We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to [s]upport \$146,540 in charges related to the Park Lee Apartments rehabilitation project additional payments or reimburse its NSP2 grant from non-Federal funds.

Comment 47

The OIG alleges that the City inappropriately utilized \$146,540 in NSP2 grant funds to pay for unallowable playground costs and actual losses incurred at Park Lee due to a fire while an insurance claim was pending. The Draft Report refers to this as a job labeled as "Extras 2nd Job." The "Extras 2nd Job" was created to document newly added scope equivalent to the previously noted costs. Although initially classification errors were made, City staff subsequently recognized that this work should have been added to the contract as a change order and staff promptly took remedial action as reflected in documentation previously provided to the OIG, including documentation showing that fire-related costs were directly charged to and paid from nonfederal funds. Despite the fact that the City appropriately documented and reimbursed NSP for these charges long before the OIG audited the project, the OIG continues to maintain that the charges are unsupported. Given that NSP funds were either reimbursed (with respect to unallowable expenses), or were never used in the first place such that there is no net impact on overall NSP funds, the City requests that Recommendation 2C be deleted.

Recommendations 2D, 2E and 2F: We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to: [(i)] [r]eimburse the City's NSP2 grant from non-Federal funds for \$34,086 in unallowable developer fees; [(ii)] [n]ot expend any of the \$262,914 in remaining contracted developer fee costs; [and (iii)] [s]upport \$24,144 in Arizona Labor's Community Service Agency charges or reimburse its NSP2 grant from non-Federal funds. Supporting documentation should include evidence showing that all costs incurred under the contract met the applicable cost eligibility requirements of OMB Circular A-122.

As the OIG is aware, the City was the lead member of a consortium on its original NSP2 grant application. This consortium included 22 other agencies or organizations. Due to the fluidity of the federal requirements and guidance during the programmatic shift from NSP1 to NSP2, it was not clear what restrictions might be placed on consortium members, including whether such members would be required to be treated as "sub recipients" and paid with "time and materials" contracts. After the NSP2 grant was awarded to the City and consistent with the existing federal requirements that have since materialized, the City submitted signed consortium funding agreements with its consortium members. A copy of the April 9, 2010 submittal letter to HUD accompanying these agreements is enclosed as Exhibit K. As the submittal letter shows, at that time the City requested that the consortium be restructured to remove the entities at issue—

Neighborhood Housing Services of Phoenix, Inc. and Arizona Labor's Community Service Agency—from the consortium and instead designate them as non-subrecipient development partners that would be eligible to subcontract with the City and, among other things, receive developer fees. Additionally, the submittal letter and correspondence from HUD on a clarifying Substantial Amendment request attached as Exhibit L further evidence that the two entities at issue did not sign (and the City did not submit to HUD) consortium funding agreements that are required as a prerequisite to attaining consortium member status under applicable program requirements. Thus, in the words of HUD staff, "[t]he Notice says consortium members need to sign two agreements (consortium funding agreement in addition to the application) therefore [Neighborhood Housing Services of Phoenix, Inc. and Arizona Labor's Community Service Agency] were never consortium members."

Comment 48

It is clear that the City provided HUD notice as to the restructuring of the consortium and that the entities at issue were thus eligible to receive developer fees. HUD has also recognized this reality, thus Recommendations 2D, 2E and 2F are inappropriate and should be removed.

Recommendation 2G: We recommend that the Director of HUD's San Francisco Office of Community Planning and Development require the City to [s]upport \$14,798 in salary and wage charges or reimburse its NSP2 grant from non-federal funds. Supporting documentation should include evidence showing that all costs incurred under the contract met the applicable cost eligibility requirements of OMB Circular A-87.

This recommendation focuses on alleged technical deficiencies in personnel salary and wage charge documentation. Like other OIG recommendations, Recommendation 2G fails to recognize the integrated nature of the City and its departments as well as the history of Park Lee as both an NSP1 and NSP2-endeavor.

At the initiation of the NSP1 grant, staff time was charged directly to the grant through SAP cost centers utilized across the relevant City departments. The City's Neighborhood Services Department accounting staff allocated those funds to the appropriate activities and drew the funds from HUD accordingly. After Park Lee became NSP2-funded, staff from both the City's Housing and Neighborhood Services departments began using CATS, the City's integrated timekeeping system in SAP, to log time to the appropriate grant and activity. This shift may have entailed some switching errors, but ultimately led to specific time allocations as required by applicable requirements. Despite providing the OIG with time sheets and other supporting documentation evidencing the appropriateness of staff time allocations, the OIG appears to have dismissed these materials.

Comment 49

While the City acknowledges that there may be some slight technical deficiencies concerning employee certification materials and activity reports, the City has provided the OIG with documentation supporting the relevant charges and this documentation substantially complies with applicable requirements. The City has prepared, executed, and submitted to the OIG additional employee certifications enclosed as Exhibit M and activity reports for the time period in question to further support salary and wage charges. Going forward, the City will prepare and have staff execute such certifications and activity reports. The City believes this

additional documentation will be more than sufficient to supplement the materials already provided to the OIG and will make Recommendation 2G moot.

IV. Conclusion

The City appreciates the opportunity to respond to the Draft Report and looks forward to working with the OIG and HUD to appropriately resolve any Project issues identified at the conclusion of the audit process and our subsequent discussions. Please feel free to contact us if you have any questions concerning the content of this response.

Very truly yours,

Kim Dorney, Housing Director

Chris Hallett, Neighborhood
Services Director

Enclosures

cc: David Cavazos, City Manager
Jerome E. Miller, Deputy City Manager
Gary Verburg, City Attorney
Lou Kislin, HUD Field Office
Angela Reviere, HUD Field Office
Noemi Ghirghi, HUD Field Office
Jonna Mueller, HUD OIG
Martin D. Herrera, HUD OIG
Holly Swoboda, HUD OIG
Michael H. Syme, Esquire

Index of Exhibits

Exhibit A – Assorted representative photographs depicting condition of Park Lee before rehabilitation, work in progress, and condition after rehabilitation.

Exhibit B – Excerpts of bid package including notations with respect to flood damage, mold damage and copper theft.

Exhibit C – Selected documentation evidencing work performed on representative block.

Exhibit D – Specific work items for change order #43.

Exhibit E – Post-Closing Repair Requirements schedule attached to the Loan Sale Agreement.

Exhibit F – Excerpts from Abacus draft report regarding cost reasonableness. Questions and comments are being addressed and responses will be reflected in final report.

Exhibit G – A sampling of various project meeting minutes.

Exhibit H – Results of the bid opening, a comprehensive bid tabulation summary and an internal analysis of the bids received.

Exhibit I – Evidence of air conditioner purchases with NSP1 money.

Exhibit J – Security log and related insurance policy materials evidencing deductible limits; HUD e-mail approving COP actions regarding insurance claims [irrelevant material redacted for privacy reasons; complete copy of policies available upon request by HUD or OIG].

Exhibit K – April 9, 2010 submittal letter to HUD re: consortium members.

Exhibit L – E-mail from HUD re: Substantial Amendment request clarifying consortium members.

OIG Evaluation of Auditee Comments

Comment 1 We disagree with the City's characterization of our audit work, analysis, and conclusions. We based the findings on facts established by evidence obtained throughout the course of the audit. As stated in the report, the City's contract administration was not adequate and did not maintain adequate supporting documentation.

Comment 2 The recommendations presented are fair and appropriate given the nature of the OIG's findings. The recommendations are based on the requirement that the City complies with HUD's rules and regulations, not OIG preferences.

Comment 3 We disagree with the City's assertions on timing and the scope of work. Documents provided by the City, dated near the time of scope development, illustrate how the City anticipated significant rehabilitation. For example, the initial Park Lee Apartments' inspection conducted around the time of the purchase from HUD by a City of Phoenix Housing Department Deputy Director noted:

- Built in 1955, 53 years old
- 523 apartments, 279 vacant of which 60 have been painted and maintained (all have been trashed)
- Partial rehab (rehabilitation), kitchens
- Many problems with plumbing, supply, and waste lines
- Original electrical system
- Sewer system problems (roots)
- Problems with transients, prostitutes, gangs, drugs, vandalism, and graffiti
- 55 air conditioning units stolen since May 2008
- Total capital expenditures first five years \$16,790,040

Given that the buildings were 53 years old and the original electrical system was still in place, the City, who mandates and enforces building codes, should have known that significant work would be required to bring the electrical to current code. The City also knew, near the time of the property's purchase and scope of work development, that the property experienced ongoing vandalism and the theft of air conditioning units. Additionally, another estimate performed by Dunlap and Magee in December 2009, near the time of the property purchase, estimated overall rehabilitation costs to be over \$12 million.

Comment 4 The City indicates that the parties to the contract memorialized their agreements in the unit tab sheets as provided in exhibit C. However, the unit tab sheets provided in exhibit C do not indicate any form of agreement between the parties. There are no signatures, initials, or other indicators that both parties agreed to the changes.

Additionally, the examples provided by the City are inconsistent with other documents it provided during the audit. The example of a unit tab sheet that the City provided is for block one and included changes in item counts for items such as a vent hood and blinds. However, no change orders specifically provided for additional vent hoods or blinds. The City provided a breakdown of costs for change order 43, consisting mostly of lump sum costs, but does not have any specific costs attributable to those items for block one. Therefore, we still cannot determine where, in writing, the City agreed to purchase the items, whether in the original contract or any of the change orders, nor can we determine the related costs.

As evidenced by our findings and as a result of the City's poor contract management, it cannot adequately determine specific purchases or the related costs. Therefore, it cannot demonstrate, by source documentation or otherwise, the details of its NSP grant spending.

Comment 5 Costs related to change orders that included items whose cost was previously determined by bid were already excluded from recommendations 1D and 1E. Recommendations 1D and 1E remain in the report unchanged.

Comment 6 We disagree with the City's assertion that the contractor provided three subcontractor bids for all items. The City did not provide documentation evidencing that the contractor provided three subcontractor bids for all new scope items. Regardless of how many bids the contractor received, the change orders reflect goods and services that the City purchased from the contractor; not the subcontractor. HUD's regulations at 24 CFR 85.36 require that the grantee, meaning the City, not the contractor, procure goods and services in a manner providing full and open competition and using specific methods. The regulations also require that a cost analysis be performed for each procurement action, including contract modifications. The City did not perform a cost analysis for any of the modifications that did not involve items whose costs were previously determined by bid.

Comment 7 We reviewed and considered all records made available to the OIG. The City did not provide evidence that completed work was inspected to verify its completion prior to processing the related payment requests. To the contrary, we interviewed City employees who stated that the City does not maintain any documentation supporting the completed work calculation.

- Comment 8** As with any audit, we are tasked with ensuring that HUD rules and regulations are followed. Our findings are a direct result of deficiencies identified through the comparison of the City's contract administration practices to the related HUD rules and regulations. Based on our conclusions, it was our duty and obligation to HUD, and the public, to recommend that the City support the reasonableness of the expenditures or reimburse the grant. The photos the City included in its response do not support the reasonableness of the costs incurred, nor that contract administration requirements were followed; rather, they only depict that rehabilitation work was or was not done.
- Comment 9** While we understand the difficulties presented in implementing and executing a time sensitive program such as NSP, we disagree with the City's mischaracterization of the OIG's audit findings. We did not question the City's capacity to manage affordable housing. Rather, our audit findings questioned the City's capacity to responsibly manage NSP-funded multifamily rehabilitation projects. In this area, the audit identified a number of deficiencies as outlined in findings one and two. The City's other programs were not within our audit scope.
- Comment 10** The NSP program adopted many of its rules from the Community Development Block Grant program. Many of the rules and regulations that the City was not compliant with are not NSP specific and have been in place for CDBG activity for many years. Since the City has received CDBG funds for many years, it should be familiar with the related rules and regulations. Regardless of how new any HUD rule is, the City agreed to abide by all related rules and regulations when it accepted the grant awards.
- Comment 11** OIG also recognizes the increased risk of executing a program that does not have the proper internal controls in place to ensure adherence to HUD rules and regulations. The City did not provide material information to change recommendation 1A. Therefore, it remains unchanged. The City has known about this recommendation for some time now, so it can, and should, be addressing any action it needs to take with HUD, so that it can minimize any stoppage of work.
- Comment 12** Recommendations 1B, 1C, 1D, and 1E are listed individually because the amounts were questioned for different reasons and were funded by multiple grants.
- Comment 13** While we realize that work is being completed on the Park Lee Apartments project, we also want to emphasize that the work and related contract/procurement process must adhere to HUD rules and regulations. In this area, we have determined the City did not meet its obligations. Additionally, in contrast to the estimated \$20,000 per unit cost presented here, the City presents contradictory information that the units will be completed for less than \$29,000 later in its response. See comment 24.

- Comment 14** The report’s findings are based on detailed analysis of the documents provided. In many cases, we determined that the City was unable to provide sufficient documentation to explain contract and cost items. See also Comment 1.
- Comment 15** We disagree with the City’s assessment. Mold problems were visually apparent, as noted on the contract bid documents.
- Comment 16** We agree with the City’s assertion that mold remediation was included, in some capacity, in the scope of work. Therefore, we modified the report language to say that the scope of work did not provide for adequate mold remediation and abatement.
- Comment 17** The City admits that an asbestos report was available for use prior to bid submission, however, it failed to utilize it because of timing and miscommunication. The City had an obligation to adhere to HUD rules and regulations, which it did not meet.
- Comment 18** We disagree with the City’s assertion that it provided documents to fully support changes to the scope of rehabilitation. The City did not provide source documentation that demonstrated specific scope items were agreed to at a reasonable cost. In addition, some change orders provided did not have any supporting documentation²⁹ and we were unable to determine what specific work some represented.³⁰ Lastly, documentation provided by the City in an attempt to support the Park Lee rehabilitation work was not consistent with other documents provided. See comment 19.
- Comment 19** The City explains it did not have a set plan for the use of the \$1.7 million represented by change order 43. However, it inappropriately agreed to purchase \$1.7 million worth of unknowns from the contractor. During the exit conference, City representatives indicated that the \$1.7 million had always been planned to be used for specific items. However, the City could not tell us if the work was agreed to in writing at the time of the change order.

The City provided a listing of those items that it claimed was agreed to at the execution of the change order. However, the City’s explanation of the costs behind the \$1.7 million is inconsistent and does not correlate with the documents it provided. For example, the City provided bid tab documents it says were created from walkthroughs of individual units by a City employee that were used to scope change order 43. The documents have columns for existing, replace, and original bid for each specific item. The City provided several bid tab documents for units in block 14. The City also provided a document with its response, Exhibit D “Specific work items for change order #43”, purportedly breaking

²⁹ Change orders 9, 42, and 43 were not accompanied by any supporting documentation. Change orders 10, 12, 16, 17, 18, 19, 20, 21, 25, 29, 31, 40, and 41 did not have adequate supporting documentation.

³⁰ We could not determine what specific goods and services were purchased or removed from the contract with change orders 19, 20, 41, 42, and 43.

down the costs of change order 43, as compiled by the contractor. However, that document does not identify any costs specifically related to block 14, even though it specifies costs related to other blocks.

Some of the bid tab documents indicate items the City deems necessary but were not included in the original bid. However, those items are not accounted for in the breakdown of change order 43 that the City provided. The change order clearly allocates the \$1.7 million to blocks 6, 8, 9, 10, 11, 12, 13, 14, 15, 16, and 17. However, the document the City provided as support for the change order identifies costs for block 7 that is not included in the change order. It also does not identify costs for block 10, block 14, or block 15.

The documentation that the City provided is inconsistent and does not adequately support the charges.

- Comment 20** The City did not provide evidence of review of completed work prior to payment approval. During the audit, we were told by two separate City employees that no documentation supporting a review of completed work exists. Additionally, our review of the City's contract management documentation did not result in any evidence that the reviews were completed.
- Comment 21** The City and HUD have a very specific set of contract and procurement rules and regulations that were attached to the agreement and execution of the NSP. We disagree with the City's continual assertion that the contract and change orders were executed based on the circumstances presented. The City had an obligation to meet each circumstance with a solution that was within HUD guidelines, complete with supporting documents. Again, in this capacity, the City failed and did not appropriately execute its NSP.
- Comment 22** Our audit and associated findings do not suggest that overall Park Lee project costs are unreasonable. Rather, we determined the City did not follow HUD's rules and regulations related to determining cost reasonableness when it amended its contract. As a result, HUD has no assurance that the related costs incurred were reasonable.
- Comment 23** We disagree that all purchases satisfied firm fixed price requirements. The City contradicts itself, as it admitted that change order 43 "additional funding would have to be reallocated to specific costs that would be incurred as the contractor proceeded with the work". Change order 43 does not represent a firm fixed price for specific goods or services nor were change orders for new elements bid in accordance with HUD's procurements requirements. See also comment 19.
- Comment 24** Again, the City appears to contradict its earlier statement that the units will be completed at a cost of less than \$20,000, stating here that they could be completed for under \$29,000. See comment 13.

- Comment 25** The City did not provide the complete cost reasonableness report. However, the report segments that it provided confirm that the contractor did not provide three subcontractor bids for each new scope item. Additionally, cost reasonableness was not the only issue identified as part of the audit. Of most concern, is the lack of supporting documentation that is complete and organized to adequately and easily support costs associated with the Park Lee Apartments' rehabilitation project.
- Comment 26** The City did not provide documentary evidence of collaborative discussions regarding change orders. Exhibit G is a small sample of minutes that only indicate the City was present in certain meetings. However, the minutes do not show that change orders and appropriate approvals were discussed in a collaborative manner by multiple City representatives. In one instance, only one City employee was present. Additionally, the minutes appear to be prepared by the contractor, using the contractor's software, rather than documented by the City. The City did not demonstrate that the change orders were collaboratively discussed and approved during project team meetings.
- Comment 27** To clarify, the change order was for \$1.7 million not \$2 million.
- Comment 28** We disagree with the City's statement that change order 43 had been approved only after "City officials at the highest level" had approved the funding. The original project funding had been approved prior to the project start by the City council. The funding for the change order did not require additional council approval because overall, the project was within its originally allocated funding. The change order itself was only approved by the sole unauthorized City employee as stated in the report.
- Comment 29** As stated in the report, we found the change order approval controls inadequate. Each of the change orders was approved by the sole City employee who did not have City authority to approve them. Even though they were approved without proper authority, related contractor payments were made. Any retroactive modifications to contract authority is not appropriate and does not change the facts stated in the report.
- Comment 30** The ratios were characterized as incorrect because they did not represent actual work completed or materials stored, i.e. materials purchased and stored but not yet used or installed, as the document indicates, as both a contractor and a City representative stated, and our direct observations substantiated. The witness statements quoted in the report were in context with the form and the related discussion. The contract requires that a schedule of values allocated to various portions of the work, prepared in such a form and supported by such data to substantiate its accuracy shall be used as a basis for reviewing the Contractor's application for payments. The schedule of values was broken out by the original contract portion as well as each individual change order. Each part of the contract

in its entirety was represented on the schedule. The forms were used as a basis for payments and did not correctly represent the work completed.

The audit report does not discuss or state in any of the findings the use of the terms “investigations” and/or “prosecution”. It is the OIG's responsibility to audit the use of HUD funds and to report its findings to HUD, along with proposed recommendations to remedy any deficiencies. That is what has been done here, with our recommendations each addressed to HUD. HUD, not OIG, would be ultimately responsible for determining if any type of civil or administrative action is appropriate based upon, not only the OIG audit report, but HUD's independent review of the facts and circumstances. Any conclusions drawn by the City regarding investigations or prosecutions are not appropriate and are not based on anything that is stated in the audit report.

Comment 31 We disagree with the City’s assertion that the rehabilitation contract was a unit price contract rather than a lump sum contract. The project rehabilitation contract is for and in consideration of the contract sum. The contract states, “The Owner shall pay the Contractor the Contract sum for the contractor’s performance of the work. The Contract Sum shall be Three Million Six Hundred Eighty Two Thousand One Hundred Fifty Two Dollars and 89/100 (\$3,682,152.89), subject to additions and deductions as provided in the Contract Documents.” The contract is a lump sum contract not a unit price contract.

Comment 32 We take exception to the City’s attempt to minimize the importance of the percentage of completion forms. Regardless of whether the Housing Department felt that the forms were appropriate, they were the basis for determining payment to the contractor. When used for the basis of payment, the forms became a part of the control environment. Incorrectly representing the percentage of completion increased the risk to the contract, the risk to the NSP program and the use of the NSP funds.

Comment 33 The percentage of completion forms used for payment requests represents specific attributes for each line item on the schedule of values. The original contract and each change order are shown separately. For each item, the related work completed from previous applications, the related work completed during the period; and the related materials stored, or items already purchased but not used yet, are totaled. That total is compared to the contracted value for the item and is expressed as a percentage, i.e. percentage of completion. The number is then reduced by a retainage, generally an amount to ensure the satisfactory completion of the contract, to arrive at an overall total payable to the contractor. This amount is then reduced by previous payments to determine the current amount payable. Because it expresses each portion of the contract individually, all involved can determine what portion of each line item is complete. The City’s hypothetical example underscores its lack of responsible contract management. In its example, the City fails to realize that only items purchased in the original contract will be included in that section of the percentage of completion and that change orders

should be used to purchase additional items. Using the City's example, "more toilets (that) might be required as the project progressed" should be purchased using a change order and tracked via that change order. Regardless of how the preparers explained the process to the OIG, the forms represent payment request for specific completed work, as agreed to by contract.

The percentage of completion represents exactly that, the percentage that the particular portion of the contract is completed. Whether one prepares it based on number of units, unit cost, or overall costs of the contract, all calculations should be equal. The form represents total work and materials completed and stored to date as a ratio of the contracted value. Contrary to the City's assertion, OIG's focus on these forms is entirely appropriate as the form is the basis for the contractor's pay.

Comment 34 The OIG did not question specific change order items where the price had previously been established by the sealed bid used for the original contract portion. If we determined the items specified in the change order to have been an increase in the units of an item previously competitively bid, OIG did not question that item's reasonableness. However, OIG questioned the change orders for new scope items that were not competitively procured. When the City accepted the grant funds, it agreed to abide by HUD rules and regulations. Those regulations require competitive procurement by the Grantee. The guidance that the City cited is based on compliance with 24 CFR 85.36 that we cited in the report. See also Comment 6.

Comment 35 The City did not establish that a public exigency existed. Further, HUD guidance³¹ requires that written justification for a non competitive award be maintained in the grantees files. The grantee did not provide any such justification or documentation for the establishment of a public exigency.

Comment 36 Any entity receiving HUD funding must adhere to the same rules and regulations, regardless of their size. Both large and small organizations are treated equally when it comes to the application of HUD's rules on record retention. The OIG has requested that the City maintain exactly what the regulations call for, sufficient records to detail the significant history of the procurement. The records the City provided did not sufficiently support that the bids were submitted as presented by the City. In discussions with City representatives, we explained that simply having a page or two scanned from the original bid showing original contractor signatures, contractor letterhead, or both is all that we recommend. It is our determination that the City did not maintain a sufficient audit trail.

Comment 37 We disagree with the City regarding any suggestions made by the audit report. Our report is based on the City's inability to adequately document its execution and procurement activities of the Park Lee rehabilitation contract. The City has

³¹ NSP & Procurement, Procurement Procedures, June 30, 2010, webinar slides states that, "cost analysis and written justification must be in files," for non-competitive awards.

not provided evidence that supports the funds mentioned in recommendations 1B and 1C were used solely for their intended purpose and met the terms, conditions, and specifications of the Park Lee Apartments rehabilitation contract. Additionally, the City has not provided evidence to support that costs mentioned in recommendations 1D and 1E were reasonable. Therefore, recommendations 1B, 1C, 1D, and 1E remain unchanged.

Comment 38 While the Park Lee project may have initiated as an NSP 1 project, the City identified the Park Lee Apartments in its NSP2 application, dated July 13, 2009, prior to the City's compilation of the scope of work in December 2009, as part of its multifamily units strategy to be funded by NSP2.

By its own admission, the City did not use the schedule of values to monitor percentage of completion of the work.³² The City mentions that the air conditioners were pre-purchased to lock in a favorable rate. However, the contractor made the pre-purchase, not the City. The City paid for the air conditioners when it paid the contractor for the original contract and specific change orders that relate to the air conditioners. We created an allocation to determine the amount of NSP2 funds used to purchase the air conditioners because the City has not been able to identify specifically what funds were used to pay for air conditioning units and cannot tie them to any particular payment request, again, illustrating the inadequacy of the City's records and document support.

Comment 39 We disagree with the City's statement that appropriating funds to one grant or the other is the City's prerogative. HUD guidance³³ states that different NSP allocations can be combined on the same project provided that there is a clear delineation of specific expenses being paid by multiple NSP allocations with no overlap. The City did not provide any such plan of its use of the NSP allocations. In fact, the City moved funding between the grants at will with no set plan in place, contrary to HUD guidance.

Comment 40 As stated in the report, the City received points during the competitive grant process for stating that it would use 14 SEER units. The agreements are clear; any change would require a re-scoring. The City did not inform HUD that it did not use the equipment that it contractually agreed to in its grant application. For this reason and the reasons outlined in comment 38 above, recommendation 1F remains in the report unchanged.

Comment 41 The City's suggestion that NSP2 requirements do not apply because the project was originally scoped under NSP1 is not correct. As stated in Comment 38, the City identified the Park Lee Apartments in its NSP2 application, dated July 13, 2009, prior to the City's compilation of the scope of work in December 2009, as part of its multifamily units strategy to be funded by NSP2. Additionally, the City

³² Page 13 of the City's response, first paragraph, second sentence.

³³ HUD published NSP FAQ ID 785.

included the Buy American provisions in its contract with the general contractor, indicating it expected to use NSP2 funding for the rehabilitation.

- Comment 42** The HUD guidance noted by the City, PIH Notice 2011-12, does not apply to funds administered under the NSP grants. However, CPD Notice 2009-05, with similar provisions regarding Buy American exceptions, would apply to the NSP2 funds. The contract amount in question is \$7,118,442, well over the \$100,000 exclusion. Therefore, the City is not exempted from the Buy American requirements. If HUD determines that an exception to the Buy American requirements can be provided to the City, the exception will need to be posted in the Federal Register and to Recovery.gov, per the Office of Management and Budget requirements at 2 CFR 176.80. For this reason, and Comment 41 above, recommendation 1G remains in the report unchanged.
- Comment 43** We recognize the City's efforts to make staff more aware of compliance issues and HUD rules and regulations. However, the City did not provide written policies and procedures to ensure that HUD-funded construction projects are managed according to program requirements and are adequately monitored, procurement policies and procedures that conform to HUD requirements, and policies and procedures to ensure grant charges comply with Federal cost principles. The recommendations are not combined because they address three separate areas; contract administration, procurement, and cost principles. The City should have written policies and procedures specific to the NSP program, especially covering the areas identified as deficient. Therefore, recommendations 1H, 1I, and 2H (now 2E) remains in the report unchanged.
- Comment 44** We note that the City has made a number of conclusions on its own, not based on the audit report. Nowhere in the audit report is there any allegation of fraud or deceit. The Inspector General Act of 1978 gives the OIG the authority (and the mandate) to conduct and supervise audits and investigations relating to the programs and operations of HUD. As such, the OIG has the responsibility to recommend corrective action, including administrative and/or civil actions based on the facts identified in their audit reports. Any recommendation or referral for civil and/or administrative actions are addressed to HUD for review and final determination. During the audit process, we also presented our audit conclusions to HUD's legal counsel, and it agreed that the matter warranted further review for possible pursuit of civil money penalties. During the audit resolution process, HUD will solicit any additional input from the City in making its final determination as to what corrective action and/or remedies are warranted and appropriate. Based on our analysis and the facts presented in the audit report, recommendation 1J remains in the report unchanged.
- Comment 45** The City is incorrect in its assessment as the audit report does not take the position that the City should have filed insurance claims. The City self-insures up to the deductible and its self-insurance fund has a fund balance of over \$43 million. The City's self-insurance fund is liable for the costs, not the grant. OMB

guidance at 2 CFR 225 Appendix B(22)(c) that actual losses which could have been covered by a self- insurance program or otherwise are unallowable is clear.

Comment 46 While the City did ask and receive guidance from HUD, the City did not inform HUD in its inquiry that it had a self-insurance fund and that its policy is to self-insure up to the deductible.³⁴ OMB guidance at 2 CFR 225 Appendix B(22)(c) is clear that actual losses which could have been covered by a self-insurance program or otherwise are unallowable.

Comment 47 We disagree. As a result of the potential finding, the City provided additional information related to the charges. At that time, the City stated that, “The separate stand alone AIA ‘contract’ for lack of a better word, was an attempt by an employee to track new NSP eligible Park Lee project scope equivalent to the amount of non-NSP allowable scope removed from the contract in change order 41 (\$46,981.00 for NSP unallowable playground/site furnishings) and change order 40 (\$99,559.00 for fire damage charged directly to non-NSP funds).” The City added, “The separate stand alone AIA ‘contract’ is new scope of work that should be added to the contract as the next available Change Order.”

Change order 40 increased the contract by \$99,559 for fire damage demolition and abatement. The change order costs were not paid from the NSP grants. Change order 41 reduced the contract by \$46,981 to remove site furnishings that the City deemed ineligible NSP charges. The net effect of change orders 40 and 41 was a net contract increase of \$52,578. However, the City retroactively amended the contract with change order 47 by \$146,540.00 (see the City provided table below detailing its corrective action) to accommodate the payments made for the “Extras 2nd Job”.

Ref	Date	Historical Activity	Original Contract Value	Original Contract Value			Funding/Accounting			Corrective Action	Corrective Action Reference	
				CO40	CO41	CO42	NSP1	NSP2	AHF			CO47
A1	7/13/11	Change Order 41 to remove above from contract since non-qualifying			(\$46,981.00)		(\$46,981.00)					
B1	5/18/11	Change Order 40 to add new scope for fire damage to contract		\$99,559.00					\$99,559.00			
C1	8/31/11	Created AIA Apps 1 & 2 on 8/31 & 10/31/11 to add new project scope approximate to lost scope from both non-NSP eligible A1 and B1 in an attempt to correct above)						\$146,540.00		Property add new allowable NSP scope to contract through a change order		\$146,540.00

Because the City amended the contract for items previously paid for, items not substantiated by supporting documentation, and again demonstrates that it views the contract as a mechanism to fund the project rather than a method used to purchase, in defined terms, goods and services, the attempted corrective action further illustrates our concerns with the City’s contract management.

³⁴ Phoenix municipal code, paragraph 42-7 A states, “Through the trust [fund] the City shall act as a self-insurer for all liability claims, special risk claims, funded property deductible and claim costs other than those falling within the coverage provisions of an insurance policy or surety bond.”

While it removed a portion of the charges from the contract through change order 41 and paid for change order 40 through a different grant, the City still drew funds from the NSP2 grant to pay for the “Extras 2nd Job” that were not accounted for at the time of payment in the original contract. The City has not provided evidence that the funds were reimbursed to the grant.

The City also provided a description of the work completed with the two “Extras 2nd Job” payments as well as subcontractor invoices and other documentation. Included in the description was “Site Furnishings” of \$46,981.00, the same amount that the City said it removed from the contract in change order 41 because it determined that the items were not eligible NSP expenditures. If the payments actually paid for the site furnishings, this would mean that the contractor was paid twice for the items, once from Affordable Housing funds and once from NSP funds. The other items and amounts described conflicted with the other information the City provided. Subcontractor invoices were dated after the change order, invoice amounts did not reconcile with the summary provided by the City, and the contractor included bond charges. Since these items were not covered by an official contract, we are not sure what the bond charges represent. Because of the conflicting information, we were unable to determine what the charges actually represented at the time of the payments. The documentation provided by the City did not support that the additional charges were adequately documented, allocable to the grant, reasonable and necessary, or allowable charges.

Comment 48 Although the two entities in question did not sign funding agreements within the timeframe allotted to complete the consortium member process, the City continued to list them in their publicly issued and HUD approved NSP2 action plan and quarterly reports until we brought it to HUD’s attention. HUD has since corrected the mislabeling. Therefore, recommendations 2D (as previously labeled), 2E, and 2F and their associated finding analysis have been removed from the report.

Comment 49 The time sheets that the City provided do not sufficiently support the charges in accordance with Federal cost principles. Because the personnel activity reports the City submitted were not prepared at least monthly and one employee did not sign the related personnel activity reports as required by 2 CFR Part 225B(8)(h)(5), they do not provide assurance that the related costs were allocable to the grant. We did not amend the recommendation.

Appendix C

CRITERIA

NSP2 Notice of Funding Availability

III. Application and Submission Information

A. Program information.

3. General Section

k. Ineligible costs.

Recipients may use NSP2 funds for allowable costs related to eligible activities. Allowable costs are described in OMB Circulars A-87³⁵ and A-122³⁶. Eligible activities are described in Appendix 1. All other costs are ineligible and unallowable.

IV. Application Review Information

5. Rating Factor 5: Energy efficiency improvement and sustainable development factors (10 points)

Describe how you will incorporate specific energy efficient, environmentally friendly or other sustainable or green elements in some or all of your NSP2 activities.

b. Green building standards. HUD will award up to 3 points for applications that comply with the required NSP2 rehabilitation standards and also demonstrate that new construction and gut rehabilitation activities will be required to exceed the Energy Star for New Homes standard and that moderate rehabilitation or energy retrofits will purchase only Energy Star products and appliances. If you will require NSP2 homes to achieve an established environmental or energy efficiency standard such as Green Communities or equivalent, you do not need to provide the entire standard in detail, but you must provide HUD enough information to locate and reference the standard.

VI. Administrative Requirements

K. Buy American.

Use of American Iron, Steel, and Manufactured Goods. Recipients may not use any funds obligated under this award for the construction, alteration, maintenance, or repair of a public building or public work unless all of the iron, steel, and manufactured goods used in the project are produced in the United States unless HUD waives the application of this provision.

Appendix 1 – NSP2 Program Requirements for All Recipients

The Department is using this Appendix to provide grant recipients, grant administrators and HUD field staff the program requirements and information about ways in which the requirements for NSP2 vary from regular CDBG and NSP1 program rules. Except as described in this notice, statutory and regulatory provisions governing the CDBG program shall apply to the use of these funds. State requirements include those at 24

³⁵ Implemented at 2 CFR Part 225.

³⁶ Implemented at 2 CFR Part 230.

CFR part 570 subpart I and for CDBG entitlement communities and other NSP2 recipients, those at 24 CFR part 570 subparts A, C, D, J, K, and O. For the purposes of NSP2, all non-governmental recipients shall comply with requirements applicable to entitlement communities under CDBG regulations, except nonprofit recipients are subject to (1) administrative requirements in 24 CFR 570.502(b) instead of 570.502(a) (see section M), (2)

Excerpt from the City's Neighborhood Stabilization Program 2 (NSP2) application:

“Overall home performance will be a focus of NSP2-funded housing rehabilitation, aimed at assessing how improvements to building components can deliver optimal results in terms of a healthy environment and lower utility bills. As a part of single- and multi-family housing rehabilitation, the following energy conscious practices would be among those implemented through NSP2:

Energy Star appliances, including 14 seer [seasonal energy efficiency rating] air conditioning units with appropriate sizing...”

Funding Approval and Grant Agreement for Neighborhood Stabilization Program (NSP2) Funds (B-09-CN-AZ-0050)

1. The Notice of Fund Availability for the Neighborhood Stabilization Program 2 under the American Recovery and Reinvestment, 2009; the three Notices of Fund Availability for Fiscal Year 2009 Neighborhood Stabilization Program 2 under the American Recovery and Reinvestment Act of 2009, Correction; the Recovery Act; HERA; the Grantee’s application for NSP2 assistance; the HUD regulations at 24 CFR Part 570; and this Funding Approval, including any special conditions, constitute part of the Grant Agreement.

8. This Grant Agreement may be amended only with the prior written approval of HUD.

2 CFR Part 225 Cost Principles for State, Local, and Indian Tribal Governments (OMB Circular A-87)

Appendix A To Part 225—General Principles For Determining Allowable Costs

A. Purpose and Scope

2. Policy guides.

a. The application of these principles is based on the fundamental premises that:

(1) Governmental units are responsible for the efficient and effective administration of Federal awards through the application of sound management practices.

(2) Governmental units assume responsibility for administering Federal funds in a manner consistent with underlying agreements, program objectives, and the terms and conditions of the Federal award.

C. Basic Guidelines

1. Factors affecting allowability of costs.

To be allowable under Federal awards, costs must meet the following general criteria:

a. Be necessary and reasonable for proper and efficient performance and administration of Federal awards.

b. Be allocable to Federal awards under the provisions of 2 CFR part 225.

e. Be consistent with policies, regulations, and procedures that apply uniformly to both Federal awards and other activities of the governmental unit.

j. Be adequately documented.

Appendix B To Part 225—Selected Items Of Cost

8. Compensation for personal services.

h. Support of salaries and wages. These standards regarding time distribution are in addition to the standards for payroll documentation.

(3) Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at least semi-annually and will be signed by the employee or supervisory official having firsthand knowledge of the work performed by the employee.

(4) Where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation which meets the standards in subsection 8.h.(5) of this appendix unless a statistical sampling system (see subsection 8.h.(6) of this appendix) or other substitute system has been approved by the cognizant Federal agency. Such documentary support will be required where employees work on:

- (a) More than one Federal award,
- (b) A Federal award and a non-Federal award,
- (c) An indirect cost activity and a direct cost activity,
- (d) Two or more indirect activities which are allocated using different allocation bases, or
- (e) An unallowable activity and a direct or indirect cost activity.

(5) Personnel activity reports or equivalent documentation must meet the following standards:

- (a) They must reflect an after-the-fact distribution of the actual activity of each employee,
- (b) They must account for the total activity for which each employee is compensated,
- (c) They must be prepared at least monthly and must coincide with one or more pay periods, and
- (d) They must be signed by the employee.

22. Insurance and indemnification.

c. Actual losses which could have been covered by permissible insurance (through a self-insurance program or otherwise) are unallowable, unless expressly provided for in the Federal award or as described below.

24 CFR Part 85 Administrative Requirements for Grants and Cooperative Agreements to State, Local, and Federally Recognized Indian Tribal Governments

24 CFR 85.3 Definitions

Percentage of completion method refers to a system under which payments are made for construction work according to the percentage of completion of the work, rather than to the grantee's cost incurred.

24 CFR 85.20 Standards for Financial Management Systems.

b. The financial management systems of other grantees and subgrantees must meet the following standards:...

3. Internal control. Effective control and accountability must be maintained for all grant and subgrant cash, real and personal property, and other assets. Grantees and subgrantees must adequately safeguard all such property and must assure that it is used solely for authorized purposes.
5. Allowable cost. Applicable OMB cost principles, agency program regulations, and the terms of grant and subgrant agreements will be followed in determining the reasonableness, allowability, and allocability of costs.
6. Source documentation. Accounting records must be supported by such source documentation as cancelled checks, paid bills, payrolls, time and attendance records, contract and subgrant award documents, etc.

24 CFR 85.36 Procurement.

b. Procurement standards.

1. Grantees and subgrantees will use their own procurement procedures which reflect applicable State and local laws and regulations, provided that the procurements conform to applicable Federal law and the standards identified in this section.
2. Grantees and subgrantees will maintain a contract administration system which ensures that contractors perform in accordance with the terms, conditions, and specifications of their contracts or purchase orders.
4. Grantee and subgrantee procedures will provide for a review of proposed procurements to avoid purchase of unnecessary or duplicative items. Consideration should be given to consolidating or breaking out procurements to obtain a more economical purchase. Where appropriate, an analysis will be made of lease versus purchase alternatives, and any other appropriate analysis to determine the most economical approach.
9. Grantees and subgrantees will maintain records sufficient to detail the significant history of a procurement. These records will include, but are not necessarily limited to the following: rationale for the method of procurement, selection of contract type, contractor selection or rejection, and the basis for the contract price.

c. Competition.

1. All procurement transactions will be conducted in a manner providing full and open competition consistent with the standards of § 85.36.

d. Methods of procurement to be followed.

4. Procurement by noncompetitive proposals is procurement through solicitation of a proposal from only one source, or after solicitation of a number of sources, competition is determined inadequate.
 - (i) Procurement by noncompetitive proposals may be used only when the award of a contract is infeasible under small purchase procedures, sealed bids or competitive proposals and one of the following circumstances applies:
 - (A) The item is available only from a single source;
 - (B) The public exigency or emergency for the requirement will not permit a delay resulting from competitive solicitation;
 - (C) The awarding agency authorizes noncompetitive proposals; or

- (D) After solicitation of a number of sources, competition is determined inadequate.
 - (ii) Cost analysis, i.e., verifying the proposed cost data, the projections of the data, and the evaluation of the specific elements of costs and profits, is required.
- f. Contract cost and price.
- 1. Grantees and subgrantees must perform a cost or price analysis in connection with every procurement action including contract modifications.

24 CFR Part 570 Community Development Block Grants

Subpart J - Grant Administration

Sec. 570.501 Responsibility for grant administration.

(b) The recipient is responsible for ensuring that CDBG funds are used in accordance with all program requirements. The use of designated public agencies, subrecipients, or contractors does not relieve the recipient of this responsibility. The recipient is also responsible for determining the adequacy of performance under subrecipient agreements and procurement contracts.

Sec. 570.502 Applicability of uniform administrative requirements.

(a) Recipients and subrecipients that are governmental entities (including public agencies) shall comply with the requirements and standards of OMB Circular No. A-87, “Cost Principles for State, Local, and Indian Tribal Governments”; OMB Circular A-128, “Audits of State and Local Governments” (implemented at 24 CFR part 44); and with the following sections of 24 CFR part 85 “Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments” or the related CDBG provision, as specified in this paragraph:

(4) Section 85.20, “Standards for financial management systems,” except paragraph (a);

(6) Section 85.22, “Allowable costs”;

(12) Section 85.36, “Procurement,” except paragraph (a);

(16) Section 85.42, “Retention and access requirements for records,” except that the period shall be four years;

(b) Subrecipients, except subrecipients that are governmental entities, shall comply with the requirements and standards of OMB Circular No. A-122, “Cost Principles for Non-profit Organizations,” or OMB Circular No. A-21, “Cost Principles for Educational Institutions,” as applicable, and OMB Circular A-133, “Audits of Institutions of Higher Education and Other Nonprofit Institutions” (as set forth in 24 CFR part 45).

Appendix D

SCHEDULES OF PARK LEE APARTMENTS REHABILITATION PROJECT NSP1 AND NSP2 ACTIVITY

Table 1

Net unsupported NSP1 and NSP2 funds drawn through February 10, 2012 ³⁷						
Contract component	Contracted value	Grant funded	Amount paid to contractor	Less: ineligible charges	Net questioned costs per grant	Net questioned costs per contract component
Original contract	\$3,682,153	NSP1	\$1,707,554	\$0	\$1,707,554	\$2,942,558
		NSP2	1,514,147	279,143 ³⁸	1,235,004	
Change orders	3,436,289	NSP1	1,074,136	140,121	934,015	3,052,829
		NSP2	2,230,893	112,079 ³⁹	2,118,814	
Total first contract	\$7,118,442		\$6,526,730	\$531,343	\$5,995,387	\$5,995,387
Total NSP1			\$2,781,690	\$140,121	\$2,641,569	
Total NSP2			\$3,745,040	\$391,222	\$3,353,818	

³⁷ Because we determined that the scheduled values for the original contract on the contractor payment requests was not comparable to the original contracted values, when determining which grant funded the original contract payments, we treated the original contract as a whole rather than line-by-line individual items.

³⁸ Total consists of ineligible costs: \$252,635 in ineligible costs for substandard air conditioning units + \$2,634 in ineligible vent hoods + \$23,874 in ineligible gas ranges. This amount includes NSP2-funded original contract charges from recommendations 1H and 1I. See tables 4 and 5.

³⁹ Total consists of ineligible costs: \$60,051 in actual loss change order costs for substandard air conditioning units + \$9,375 in change order 20 costs for substandard air conditioning units + \$37,891 in change order 31 costs for substandard air conditioning units + \$4,762 in change order 43 costs for vent hoods. This amount includes NSP2-funded change order charges from recommendations 1H, 1I, and 2B. See tables 4 and 5.

Table 2

NSP1- and NSP2-funded Park Lee Apartments rehabilitation contract change orders procured using an unallowable method (sole source) that did not provide for full and open competition	
Change order number	Change order amount
1	\$318,312
2	\$21,496
4	\$216,025
8	\$147,777
10	\$61,775
12	\$47,728
14	\$54,420
16	\$72,865
17	\$52,026
18	\$80,336
19	\$57,128
20	\$116,216
29	\$73,068
31	\$343,655
34	\$33,326
42	\$47,368
43	\$1,700,000
Total NSP-funded activity	\$3,443,521

Table 3

Park Lee Apartments NSP1- and NSP2-funded change orders for which no cost or price analysis was performed			
Contract order number	Change order amount	Cost or price analysis performed	Unsupported - no cost or price analysis performed
1	\$318,312	No	\$318,312
2	21,496	No	21,496
4	216,025	No	216,025
6	(17,303)	Partially	76,079
8	147,777	No	147,777
10	61,775	No	61,775
12	47,728	No	47,728
14	54,420	No	54,420
16	72,865	No	72,865
17	52,026	No	52,026
18	80,336	No	80,336
19	57,128	No	57,128
20	116,216	No	116,216
21	5,955	No	5,955
23	2,396	No	2,396
24	6,089	No	6,089
25	(13,813)	Partially	23,296
27	(8,708)	No	(8,708)
29	73,068	No	73,068
31	343,655	No	343,655
34	33,326	No	33,326
35	4,437	No	4,437
41	(46,981)	No	(46,981)
42	47,368	No	47,368
43	1,700,000	No	1,700,000
Total NSP-funded activity	\$3,375,593		\$3,506,084

Table 4

Substandard air conditioning units used in the Park Lee Apartments rehabilitation project					
	Contract component				Total
	Original contract	Change order 19	Change order 20	Change order 31	
Contracted values					
Contracted value - whole component	\$3,682,153	\$57,128	\$116,216	\$343,655	\$4,199,152
Contracted value - air conditioning units only	\$739,877	\$10,626	\$39,473	\$343,655	\$1,133,631
Ratio of contracted air conditioner units contracted value to whole component contracted value	20.0936%	18.6%	33.9652%	100%	
Allocation of costs based on grant funding					
NSP1 funding					
Amount paid with NSP1 funds	\$2,346,548	\$57,128	\$87,162	\$240,559	\$2,731,397
Less 5% retainage	117,327	2,856	4,358	12,028	\$136,569
Net contract component paid with NSP1 funds	\$2,229,221	\$54,272	\$82,804	\$228,531	\$2,594,828
Amount paid specific to air conditioning units with NSP1 funds ⁴⁰	\$447,931	\$10,095	\$28,125	\$228,531	\$714,682
Less actual loss (recommendation 2A)	0	0	0	140,121	140,121
Net amount paid with NSP1 funds	\$447,931	\$10,095	\$28,125	\$88,410	\$574,561
NSP2 funding					
Amount of paid with NSP2 funds	\$1,323,465	\$0	\$29,054	\$103,097	\$1,455,616
Less 5% retainage	66,173	0	1,453	5,155	72,781
Net contract component paid with NSP2 funds	\$1,257,292	\$0	\$27,601	\$97,942	\$1,382,835
Amount paid specific to air conditioning units with NSP2 funds ⁴¹	\$252,635	\$0	\$9,375	\$97,942	\$359,952
Less actual loss (recommendation 2B)	0	0	0	60,051	60,051
Net amount paid with NSP2 funds	\$252,635	\$0	\$9,375	\$37,891	\$299,901
Total paid with NSP1 and NSP2 funds	\$700,566	\$10,095	\$37,500	\$126,301	\$874,462

⁴⁰ Net contract component paid with NSP1 funds multiplied by ratio of contracted air conditioner units to whole component's contracted value

⁴¹ Net contract component paid with NSP2 funds multiplied by ratio of contracted air conditioner units to whole component's contracted value

Table 5

Vent hoods and gas ranges used in the Park Lee Apartments rehabilitation project that were not made in America					
	Vent hood costs			Gas ranges costs	Total costs
	Original contract	Change order 43⁴²	Vent hoods totals	Original contract	
Price (from original bid)	\$334.21	\$334.21	\$334.21	\$536.05	
Quantity	23	15	38	130	
Gross amount paid	\$7,687	\$5,013	\$12,700	\$69,687	\$82,387
Less 5% retainage	384	251	635	3,484	4,119
Net amount paid	\$7,303	\$4,762	\$12,065	\$66,203	\$78,268
Total amount paid for the contract component	\$3,670,012	\$1,581,000	\$5,251,012	\$3,670,012	
NSP1 funding					
Amount of contract component paid with NSP1 funds	\$2,346,548	\$0	\$2,346,548	\$2,346,548	
Ratio of NSP1 funds paid to total amount paid	63.938%	0.00%		63.938%	
Amount paid with NSP1 funds⁴³	\$4,669	\$0	\$4,669	\$42,329	\$46,998
NSP2 funding					
Amount of contract component paid with NSP2 funds	\$1,323,465	\$1,581,000	\$2,904,465	\$1,323,465	
Ratio of NSP2 funds paid to total amount paid	36.062%	100.00%		36.062%	
Amount paid with NSP2 funds⁴⁴	\$2,634	\$4,762	\$7,396	\$23,874	\$31,270
Total NSP1- and NSP2-funded costs	\$7,303	\$4,762	\$12,065	\$66,203	\$78,268

⁴² No change order specifically mentioned vent hoods. Because we could not determine a specific change order that would account for the additional 15 vent hoods, we applied the costs to change order 43, which specified only lump-sum amounts for each apartment unit.

⁴³ Ratio of NSP1 funds paid to total amount paid multiplied by net amount paid

⁴⁴ Ratio of NSP2 funds paid to total amount paid multiplied by net amount paid

Table 6

Actual loss due to air conditioning unit-related theft or vandalism at the Park Lee Apartments rehabilitation project (change order 31)	
Total costs	
Air conditioner unit price (from original bid)	\$2,508.43
Quantity	84
Total cost	\$210,708
Total change order value	\$343,655
Gross amount paid on change order (before retention)	\$343,655
Allocation of costs based on grant funding	
NSP1 funding	
Amount of change order costs paid with NSP1 funds	\$240,559
Ratio of NSP1 funds paid to total amount paid	70.00%
Gross amount paid with NSP1 funds ⁴⁵	\$147,496
Less 5% retainage	7,375
Net amount paid with NSP1 funds	\$140,121
NSP2 funding	
Amount of change order costs paid with NSP2 funds	\$103,096
Ratio of NSP2 funds paid to total amount paid	30.00%
Gross amount paid with NSP2 funds ⁴⁶	\$63,212
Less 5% retainage	3,161
Net amount paid with NSP2 funds	\$60,051
Total paid with NSP1 and NSP2 funds	\$200,172

⁴⁵ Total cost multiplied by ratio of NSP1 funds paid to total amount paid

⁴⁶ Total cost multiplied by ratio of NSP2 funds paid to total amount paid

Appendix E

PARK LEE APARTMENTS REHABILITATION PROJECT CHANGE ORDER 43

Project: Park Lee Apartments Renovations⁴⁷					
Request description: block 8-17 scope of work to complete project					
Request due to: existing conditions/owner changes					
Blocks 1-17 summary	Quantity	Type	Rate	Subcontract	Subtotal
Block 6	21	LS	5,466.23	\$ 114,790.83	\$ 114,790.83
Block 8	33	LS	5,466.23	180,385.59	180,385.59
Block 9	28	LS	5,466.23	153,054.44	153,054.44
Block 10	33	LS	5,466.23	180,385.59	180,385.59
Block 11	18	LS	5,466.23	98,392.14	98,392.14
Block 12	33	LS	5,466.23	180,385.59	180,385.59
Block 13	33	LS	5,466.23	180,385.59	180,385.59
Block 14	28	LS	5,466.23	153,054.44	153,054.44
Block 15	28	LS	5,466.23	153,054.44	153,054.44
Block 16	28	LS	5,466.23	153,054.44	153,054.44
Block 17	28	LS	5,466.23	153,054.44	153,054.44
Subtotal					\$1,700,000.00
Subtotal				\$1,699,997.53	\$1,700,000.00
P&P (performance and payment) Bond				1.10%	\$
Insurance				1.75%	\$
General conditions				14.0%	\$
Contractor overhead				3.0%	\$
Contractor fee				2.3%	\$
Subtotal					\$1,700,000.00
Tax				6.045%	\$
Total change order 43					\$1,700,000.00
Note: This change will add (180) days to this project					
SCOPE:					
1. This Change Order includes all additional bid quantities and additional repairs to the best of our abilities					
2. Each line item includes all taxes, insurance and fee					
3. At this time 75 units will not include finishes unless (contractor) has enough money left over to complete.					
4. All MPE (mechanical, plumbing, & electrical) will be completed in the remainder 311 units.					
5. This change order breakdown is only a base budget, at the time of the block completion and turnover (contractor) will revise the actual cost per block for the City of Phoenix					
6. (Contractor) will VE (value engineer) the Park Lee project to save money to complete any unknown repairs at this time.					

⁴⁷ Table created from document provided by the City. No items or numbers have been modified. A City employee approved the change order on August 12, 2011. We added items in parenthesis to either protect the identity of parties involved or define the contractor's acronyms.