

# **PACE Financing Emerges as a Valuable Resource for Property Owners Rushing to Comply with NYC's New Climate Mobilization Act**



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## INTRODUCTION

In May 2019, the City of New York passed the Climate Mobilization Act (CMA), the most ambitious climate legislation ever enacted by any city or county in the State of New York. The CMA mandates the reduction of the City's overall carbon emissions by 80 percent within 20 years. Generally, buildings are responsible for 70 percent of the City's emissions – by far the highest percentage of any sector (Climate Mobilization Act: Mayor's Office of Sustainability, 2019). Building emissions are likely only to increase compared to other sectors, such as transportation, which have had a head start in reducing their carbon emissions. Given buildings' contributions to carbon emissions and the lack of significant progress to date, this legislation is seen by many as overdue. With numerous large developments occurring throughout the City, this legislation could yield major long-term improvements to the environment. In fact, "the Climate Mobilization Act is a down payment on the future of New York City – one that ensures we lead the way in the ever-growing fight against climate change," Council Member Costa Constantinides said in a statement before the bill was passed (New York City Council [NYCC], 2019). With the help of Constantinides, the CMA also included Property Assessed Clean Energy (PACE) financing – a voluntary financing mechanism that enables energy efficiency and renewable energy projects to receive long-term financing for little or no money down – to assist building owners in complying with the CMA (NYCC, 2019).

The CMA, which will go into effect by 2024, impacts buildings that are "25,000 gross square feet or larger and 2 or more buildings on the same tax lot that together exceed 50,000 gross square feet (including condominiums)" (D&S Real Estate Finance Group [D&S], 2019). Despite the many exceptions to the law – buildings owned by the government or government-related entities, houses of worship, rent-regulated dwelling units, and low-income housing – the impact to owners and even possibly to lenders will be enormous. Complying with the CMA could be expensive for many building owners, which explains the inclusion of PACE financing as part of the CMA.

## CONCERNS FROM THE COMMUNITY

While acknowledging that cutting emissions is a laudable goal, the real estate community is concerned with the potential compliance costs as it is predicted that the cost of upgrades to bring buildings into compliance with the CMA could exceed \$14 billion (City of New York, 2019). The Real Estate Board of New York (REBNY) argues that the CMA would effectively discourage landlords from leasing space to industries with higher energy consumption such as technology, media, and life sciences, for fear of paying fines when the energy usage of their buildings exceeds the caps. The overall effect is that owners will have to carefully consider the ramifications of prospective tenants' energy usage before renting out space. "Is the next tenant I'm renting to going to be an energy hog or not?" mused Carl Hum, general counsel for REBNY, to the *New York Times* (Neuman, 2019). "There's a clear business case to be



Figure 1: Lower Manhattan as viewed from New Jersey.

made that having a storage facility is a lot better than having a building that's bustling with businesses and workers and economic activity," Hum concluded (Neuman, 2019).

However, according to Nomura's Global Market Research, commercial real estate owners have an opportunity to benefit from this legislation, with the most prominent advantage being the potential positive impacts to cash flow (Nomura, 2018). "Traditional financing for infrastructure projects typically requires large upfront expenditures and has long cost recovery timelines," according to the Nomura report, "with faster returns on other investments" (Nomura, 2018). This report further expounded on the inefficiency of using internal capital for infrastructure upgrades in situations subject to split incentive due to accretion in expenses for landlords to lower energy costs for tenants. Given the inefficiency of either using internal capital or traditional financing, it comes as no surprise that important infrastructure projects are often deferred or ignored by

property owners. PACE financing offers one solution to overcome this reluctance.

## ACHIEVING COMPLIANCE WITH PACE

City legislators anticipated pushback against the law due to concern about the high costs of installing new clean energy measures (Hosfelt, 2019). In conjunction with the CMA, the City allowed the use of PACE financing to provide an efficient capital source to support the mandated upgrades to commercial buildings. As explained by Patka and Miller, representatives from Duval & Stachenfeld LLP (D&S, 2019), a law firm based in New York City focusing on real estate transactions, “PACE financing is a way for owners to obtain fixed, competitive rates to finance up to 100% of the cost of the improvements that will be needed to meet the requisite carbon reduction targets. The financing is paid back through real estate tax assessments on the property which fully amortize over the expected useful life of the improvements that were financed” (D&S, 2019). Moreover, because it is a voluntary tax lien, “PACE is senior to mortgage debt” (D&S, 2019). In other words, in the case of bankruptcy, PACE and other tax liens will get satisfied first before any mortgages are repaid.

There are several reasons that PACE financing is a compelling option for building owners seeking to perform energy upgrades as compared to self-financing or traditional financing. First, the cost of PACE financing and the benefits generated can be shared with tenants under most lease forms. In other words, owners of properties with triple net or gross modified leases can pass through utility costs to tenants. For tenants, their cash flow can actually be increased by having annual energy savings over the lease term. Second, with PACE financing, the positive cash flow from comprehensive energy projects could translate into higher property values for building owners. With higher cash flow being realized for a building through utility cost savings, the collateral value rises. Indeed, through PACE financing, building owners can increase collateral value with no upfront capital outlay out of their own pockets and can bring their buildings into compliance despite the magnitude of the upgrades required by the new law. Third, since PACE financing is strictly property-based financing secured by a lien on the property, the owner is not personally obligated to repay the tax assessment (i.e., it is non-recourse financing). Fourth, compared to a typical loan that has to be repaid in full upon the sale of the secured property, PACE financing may automatically transfer to a new owner. Fifth, unlike with most

conventional financing, soft costs such as development fees can be financed through the program. Lastly, the financing can be used both for newly built construction as well as to retrofit existing buildings.

There has also already been a large nationwide movement toward accepting PACE financing among lenders despite the seniority of the PACE lien. This is because it is only the PACE payments, not the assessment itself, that are senior to mortgage debt. “[It] is non-recourse financing... [it] does not accelerate in the event of an assessment payment delinquency or default and it runs with the property in the event of an ownership transfer,” according to PACE Nation, the leading non-profit advocate for PACE financing (PACE Nation, 2018).

Although it only recently started to gain more attention from industry professionals and related media and reporters, PACE financing is not as new as many may think. It was first conceived and proposed in 2005 by the Monterey Bay Regional Energy Plan and was subsequently approved by California legislation in 2008. Since then, PACE-enabling legislation has been passed in 36 states and the District of Columbia (CleanFund, 2018).<sup>1</sup>

The efficiency of PACE financing for commercial real estate can be found in many cases throughout the country. For example, a 35-year old 200,481 sq. ft. Class-A office high-rise in Houston, Texas – better known as 1225 North Loop

<sup>1</sup> For quite some time, PACE financing for residential housing also existed, only to be discontinued in most states following the meltdown in the residential PACE sector. Unlike the owners of most commercial real estate properties, many homeowners’ ability to pay or credit scores were not taken into account during the loan approval process (Cox, 2011). Because the financing was designed to run with the property, there was more reason to approve eligibility based primarily on property information rather than income or credit scores, which resulted in many homeowners who were unable to make their PACE payments. Fannie Mae and Freddie Mac, soon after realizing the potential problem, refused to back mortgages with PACE liens on them starting in 2010 (Hsu, 2010). Similarly, the Federal Housing Administration (FHA) announced and clarified in 2017 that residential properties with PACE obligations were not eligible for FHA financing (U.S. Department of Housing and Urban Development, 2017). That meant that homeowners were no longer eligible to take out PACE financing if any of those three agencies held securities based on their mortgages, which represented the bulk of the U.S. residential mortgage market (The Urban Institute, 2018). As a result, states as well as local legislators quickly disallowed PACE programs in the residential sector. Currently, only three municipalities remain in the United States that still enable a residential PACE program, with approximately \$0.8 billion in overall securitization market size – a huge reduction from its 2016 peak of \$1.7 billion (National Association of State Energy Officials, 2018; PACE Market Data, n.d.). The commercial real estate market, on the other hand, has not proven as troublesome as the residential market as the primary purpose of commercial properties is already to generate profit through rental income, rather than just through capital gains.

West, Houston, TX – had an old chiller that had never been replaced since the building’s original construction (Texas-  
 PACE Authority [Texas], n.d.). The owner, 1225 North  
 Loop Investments, Inc., concluded that the building was  
 consuming above-average energy loads (Texas, n.d.). About  
 this time the General Manager of the property connected  
 with the Texas PACE financial provider and learned about  
 the program. The project included the replacement of the  
 old chiller with two new ones, installation of a new building  
 automation system, and a complete LED fixture upgrade.  
 It has been projected that the building’s utility consumption  
 will be reduced by as much as 38.0% and provide \$3.66  
 million in savings over the 20-year projection (Texas, n.d.).

Of course, just because PACE financing has worked  
 elsewhere is no guarantee that this financing will succeed  
 with New York City projects to the same degree. The  
 biggest immediate problem likely lies in the fact that almost  
 half of the existing square footage in Manhattan alone was  
 built more than 90 years ago, according to an analysis done  
 by Kohn Pedersen Fox, an architecture firm based in New  
 York (Bui, et al., 2016). The existence of so many outdated  
 buildings can increase the difficulty of future renovations,  
 which can then lead to increased design and construction  
 costs for building owners. New York City’s zoning laws have  
 become more restrictive over time, benefiting properties  
 built in the eras where the zoning was much less restrictive.  
 Now, what was once an advantage is becoming a drawback  
 for the building owners (Bui, et al., 2016).

Further, New York City differs from the rest of the country in  
 many aspects. It is not only home to much of the nation’s  
 most valuable commercial real estate but also is the nation’s  
 largest commercial real estate market  
 with a near one percent vacancy rate  
 (Alvarez, 2013). Moreover, New  
 York is the most densely populated  
 major city in the nation (by a high  
 margin), making public transport and  
 pedestrian access essential to New  
 York City commuters (Weinberger,  
 2011). This contrasts with the rest of  
 the country, where 91% of commuters  
 travel in automobiles to their  
 workplaces (Census Bureau, 2012).  
 How these differences will play out in  
 the PACE financing world is yet to be  
 tested.



Figure 2: New York City Skyline.

### OTHER ALTERNATIVES

Aside from PACE financing, building owners have other  
 options – adjustments, deductions and carbon trading – to  
 fund energy improvements and achieve compliance with  
 the new law.

#### Adjustments

If the condition of the building is difficult to retrofit, an owner  
 is facing high-energy-consuming tenants, or if a carbon-  
 reducing building improvement is hurting the building’s  
 cash flow, then the owner may be eligible to apply for a  
 temporary adjustment (increase) to the building emission  
 limits to achieve compliance with the law. Although this  
 might seem like an owner’s first choice, these adjustments  
 are likely to be difficult to obtain as buildings will first have to  
 qualify as part of “special categories of buildings” according  
 to the New York City Statute (the law is currently still under  
 development) (Climate Mobilization Act, 2019). Building  
 owners must also be aware that the City has the goal to

	Self-Funded	Conventional Loan	PACE Financing
Out-of-Pocket Investment	(\$1,300,000)	(\$260,000)	\$0
Savings (First Year)	\$200,000	\$200,000	\$200,000
Annual Payment	\$0	(\$282,803)	(\$118,437)
Cash Flow Impact Year 1	(\$1,100,000)	(\$342,803)	\$81,563
Net Project Cash Flow Year 2	(\$900,000)	(\$425,607)	\$163,126
Years to Positive Project Cashflow	6.5	8.4	(Immediate)
Debt Service Over Finance Term	\$0	(\$1,414,017)	(\$2,368,742)
10-Year Project NPV	\$172,017	\$20,747	\$600,310
Property Value Increase (20-Year NPV)	\$993,984	\$842,714	\$935,520

Table 1: Financial Scenario Summary of 1225 North Loop West, Houston TX (Texas, n.d.) — The study presumes three different scenarios for the same project – one, “Self-Funded”, which assumes that all the projects costs are paid directly by the owner; two, using the “Conventional Loan”, such as a bank or private loan; and three, using PACE financing.





Figure 3: Central Park.

progressively reduce the overall carbon emission, which makes it even more unlikely for landlords to obtain such adjustments.

### *Deductions*

Deductions provide an alternate incentive compliance method by allowing the purchase of renewable energy credits and/or greenhouse gas offsets. However, the related regulations and timing of implementation are still to be determined by the New York Department of Buildings, making it uncertain whether or when this will be a solution for most buildings.

### *Carbon Trading*

If the reduction in carbon for a property exceeds mandates, then the owner is eligible to apply these carbon credits (a tradable certificate representing the right to emit one ton of carbon dioxide) toward another building. This is another way of incentivizing building owners to reduce carbon emissions through monetary enticements. The details of the rules and thresholds are being developed and are anticipated to be announced before 2021.

## **GOING FORWARD**

Owners of buildings that qualify under the CMA are being urged to begin taking steps as early as possible – even though compliance is not mandated soon – because once the mandate takes effect in 2024, it is likely that the construction costs could skyrocket due to limited numbers of contractors able to perform the work (Riverra, 2019). This high volume of demand has already occurred in other cities with mandatory retrofit programs (Veklerov, 2018). In the case of San Francisco, when it passed a series of retrofit ordinances for soft-story wooden structures and non-ductile cement structures in 2013, most property owners responded by postponing the retrofit project as long



Figure 4 Central Park in the Fall.

as possible, despite the deadline and risk of being labeled as “delinquent” from the city (Coté, 2014). Five years later, the city promptly started to issue a “Notice of Violation” to each non-compliant property (Coté, 2014). The demand for, and therefore the cost of, the retrofitting construction skyrocketed immediately (Dineen, 2017). A similar trend is currently being observed in Los Angeles as it passed a law in 2016 called the “Los Angeles Soft-Story Retrofit Program” (Veklerov, 2018). Thus, New York City building owners that delay installation of retrofits risk paying significantly more for this work as demand increases shortly before the law goes into effect.

## **CONCLUSION**

The *Climate Mobilization Act* is an ambitious attempt to reduce carbon emissions in New York City. As the City’s building owners approach compliance enforcement deadlines, construction costs may increase and the values of noncompliant buildings may decrease. Owners will have a more difficult time selling properties that require extensive renovation to achieve energy efficiency in compliance with the law. Though there is pushback against the legislation from property owners and interest groups, the City has provided a means to address the cost concerns through PACE financing, a capital source that makes retrofitting buildings cost-effective and beneficial for New York City.

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