

CONDOS AND CO-OPS CAN BENEFIT FROM NEW INNOVATIVE FINANCING PROGRAMS TO ASSIST IN OIL-TO-GAS CONVERSIONS

Earlier this year, Mayor Michael Bloomberg took another bold step as part of his PlaNYC environmental program by announcing the enactment of rules aimed at phasing out the use of No. 6 heating oil in New York City by 2015 and the use of No. 4 heating oil by 2030. Mayor Bloomberg's vision is to have New York City lead the way in becoming the first environmentally sustainable 21st century city. For residential condominium and cooperative apartment owners who have a building burning a "dirty" heating oil, the need to convert is a significant and immediate priority. According to a recent Environmental Defense Fund (EDF) report¹, this mandate will affect close to 10,000 buildings, or roughly 1% of the city's buildings, which are responsible for 86% of the city's heating oil soot pollution.

A Case for Conversion

Dirty heating oils Nos. 4 and 6, known as residual fuels, constitute the sticky and soot-laden remains of the refining process. The black smoke emitted by burners fueled by Nos. 4 and 6 oils is full of particulates and sulfur dioxide, both of which are extremely harmful to the respiratory health of local residents. The EDF reports that the burning of these oils has contributed to New York's asthma hospitalization rate of children to be twice the national average, with the Bronx being four times the national average.

The good news for condos and co-ops is that a conversion from oil to gas not only has a positive environmental impact, but can be advantageous from an economic perspective as well. In many instances, building owners can reduce annual fuel burning costs by as much as 30% with a properly designed oil-to-gas conversion.

Then why, one might ask, have co-ops and condominiums been reluctant to make the switch? According to a recent EDF report on barriers to energy efficiencyⁱⁱ, the significant capital cost of converting from oil to gas is the biggest deterrent for property owners. While owners have relied on traditional funding sources, today's tough economic climate combined with a more difficult lending environment, have led many building owners to delay a much needed conversion. With this in mind, building owners are primed for new alternative sourcing programs and several have recently been introduced that have attracted the attention of condos and co-ops ("associations") as a conversion becomes mandatory.

Financing Opportunities for Oil-to-Gas Conversions

First, let's review what have been the traditional funding sources for a major capital investment, such as an oil-to-gas conversion. A condo or co-op could use cash reserves; borrow against the association's line of credit or take out a second mortgage; or finance through the equipment vendor or energy service company (ESCO). Lately, several creatively-designed financial options have been developed as a way of offsetting the drawbacks commonly associated with the aforementioned means of funding a major retrofit.

Cash Reserves to Pay for a Retrofit Project

If an association can afford it, paying for an energy retrofit with cash reserves makes strong economic sense, since besides the initial upfront cost, there would be no long-term loan payback period or interest associated with borrowing money. While this option may be suitable for associations with a large cash reserve, many condos and co-ops today simply are not in strong enough economic positions to pay for a retrofit in this manner. Adding to this difficulty is the fact that many associations are facing other needed capital projects which require funding.

Financing a Project through Loans

The most popular source of funding to date has been securing a loan through a financial institution, requiring an association to take out an additional mortgage on the property or increasing its existing line of credit. The good news is that a loan of this nature allows a building to avoid a substantial upfront capital investment. However, these loans require a long-term

payback program with interest that will eventually far exceed the initial cost of the retrofit project. If the association does not have an existing line of credit, there are added legal burdens. In order to take out a loan, condominium by-laws most often require a supermajority (usually 66 2/3%) vote for approval, and co-ops often have restrictions with regards to their existing underlying mortgages. Additionally, while financial institutions can provide many associations with loans for capital improvements, some Boards may not be convinced that the energy savings will materialize, yet they are still responsible for the loan. In light of this, associations have been looking for alternative means of financing a retrofit through loans.

One such creative financing program is FS Energy Loans, introduced earlier this year by FS Energy, the energy management subsidiary of Cooper Square Realty and its Goodstein Division. FS Energy has partnered with top-tier financial institutions to arrange for loans to residential buildings seeking to make capital investments to improve energy efficiency and reduce operating costs. The loans are the first of their kind to be implemented on a large scale for residential real estate properties. FS Energy facilitates these loans and the financial institutions rely on FS Energy's expertise to provide and document the energy savings achieved.

FS Energy loans offer preferred financing without many of the traditional drawbacks commonly associated with financing. These loans feature attractive interest rates, are unsecured by the property and are paid off entirely from the savings derived from the improvement. Transaction costs and approval time are minimized. Most importantly, no increases in monthly carrying costs are required to be imposed or budgeted. To avoid long-term payback periods, the loan terms are only two years longer than the projected payback period, meaning savings will always exceed loan payments and the loan will be paid off quickly. Although the legal issues pertaining to borrowing cannot be avoided, associations will realize immediate savings and continue to save once the loan is retired.

Financing Through a Vendor or ESCO

Another popular method is to finance through an equipment vendor or through the ESCO which provides the commodity change. Here again, the building owner avoids significant upfront costs. Unlike loans, there are usually no interest payments, and the vendor or ESCO takes the perceived risk of the savings being achieved. However, many of these companies require either a back-up loan or result in vendor ownership of the equipment. Both of these have drawbacks – a back-up loan has the same issues as discussed above while vendor ownership of equipment can potentially result in legal conflicts with association documents and/or underlying mortgage lenders. Another potential downside when financing through a vendor is they will have the ability to choose the design, specifications and quality of workmanship. The association might not get a project that has the appropriate lifespan or quality. Often, the vendor's interest is based on the short-term savings, whereas the Board is more interested in value and long-term operating costs.

Again, building upon the benefits and responding to the drawbacks of these types of financing options, FS Energy recently announced another economically feasible alternative called CRES (Cost Reduction through Energy Savings). FS Energy, through its corporate parent FirstService Corporation, has created a fund from which the initial capital cost of the conversion will be paid. Developed specifically for oil-to-gas conversions of buildings managed by Cooper Square Realty and its Goodstein Division, CRES is a customized shared savings program that allows a building to pay for the cost of a retrofit project directly from the savings associated with the conversion. Importantly, it requires no capital investment or increase in monthly operating expenses. This model is similar to the vendor financed or ESCO model discussed above, with some important distinctions. The association can choose its own design professionals, achieve the best prices through competitive bidding, and can select the project which the Board judges to be in the best interest of the co-op or condominium. No back-up loan is required and the association has immediate and full ownership of the equipment.

Following the completion of the retrofit, the association will share the energy savings with the fund for a predetermined period, after which the fund bows out and the savings go completely to

the association. Because of the nature of this financial agreement, the project can move forward solely with board approval; there is no need for a supermajority vote and underlying mortgages are not affected. Lastly, any Board reluctance due to skepticism of the energy savings is eliminated since FS Energy takes the “risk.” While still new, CRES has been favorably received by condos and co-ops looking to convert from dirty heating oils to gas.

Making Progress toward a Cleaner New York

As a company that has been dedicated to providing customized energy solutions to residential building owners, we applaud Mayor Bloomberg and his staff for introducing programs such as PlaNYC as a means of significantly improving the environmental sustainability of our city.

Creative financing programs such as FS Energy Loans and CRES should help to accelerate oil-to-gas conversions as building owners comply with these new dirty heating oil rules or simply want to take advantage of the significant cost savings and environmental benefits offered with a conversion.

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Works Cited

ⁱ Environmental Defense Fund, “The Bottom of the Barrel: How the Dirtiest Heating Oil Pollutes Our Air and Harms Our Health.” 16 December 2009. http://www.edf.org/sites/default/files/10085_EDF_Heating_Oil_Report.pdf

ⁱⁱ Environmental Defense Fund, “Show Me the Money: Energy Efficiency Financing Barriers and Opportunities.” July 2011
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