Exploring the Use of PACE for Multi-family Buildings in Ramsey County

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RAMSEY COUNTY

Resilient Communities Project
University of Minnesota
Building community-university partnerships for sustainability

The project on which this report is based was completed in collaboration with Ramsey County as part of the 2018–2019 Resilient Communities Project (RCP) partnership. RCP is a program at the University of Minnesota's Center for Urban and Regional Affairs (CURA) that connects University faculty and students with Minnesota communities to address strategic projects that advance local resilience and sustainability.

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Building Community-University Partnerships for Resilience

Ramsey County PACE for Multi-Tenant Housing

Case Study Analysis and Discussion

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In conjunction with the Resilient Communities Project (RCP), Ramsey County, and Jennifer Edwards of the Center for Energy and Environment

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Introduction

Ramsey County has designated the St. Paul Port Authority as the implementing entity for the Property Assessed Clean Energy (PACE) program. They have supported 14 projects, investing over $11.25 million into efficiency upgrades and installations. Most of these projects are located near downtown St. Paul.

PACE is a federal and state program that incentivizes energy efficiency and renewable energy installations and upgrades—primarily for commercial, industrial, and community not-for-profit facilities—by offering financing for these investments (Figure 1). Properly structured, programs such as PACE could provide incentives to both renters and owners of multitenant residential developments to make energy investments. To date, however, the program has been underutilized for such developments. Renters may be dissuaded from fronting the cost for in-unit energy efficiency upgrades or renewable energy investments due to several factors: short-term lease agreements that would limit the financial payback they would realize from such an investment, substantial upfront costs, and difficulty in securing advantageous interest rates for a loan. Similarly, property owners are likely dissuaded by upfront costs and non-advantageous loan interest rates, as well as the fact that utility bills are generally paid by tenants, so property owners would not realize the financial benefit from such investments.[1]

Not surprisingly, few multitenant developments across the nation have utilized PACE to date. Jim Hasnik of the Center for Energy and Environment suggests this may be due to state policies, which often place multi-family developments into Residential-PACE programs, rather than within the more easily accessible and widely available Commercial-PACE (C-PACE) programs. In Minnesota, multifamily units are eligible for the C-PACE program. However, Ramsey County has seen few multi-tenant residential PACE projects compared to other building classifications within the C-PACE program.

This report provides case examples of multi-tenant funded projects across the nation that might help inform the future use of PACE in Ramsey County. The intended audience for this report is Ramsey County, but other jurisdictions in Minnesota or other states might also find the report informative.

[1] Commercial PACE for Affordable Multifamily Housing, Energy Efficiency for All. Vermont Energy Investment Corporation. January, 2018.

Pace Finance Details

To participate, interested stakeholders must apply for a PACE loan with the local PACE affiliate. Governments generally facilitate PACE loan partnerships as conduit financiers of sorts; payments are collected from property owners and passed on to project investors (Figure 1).

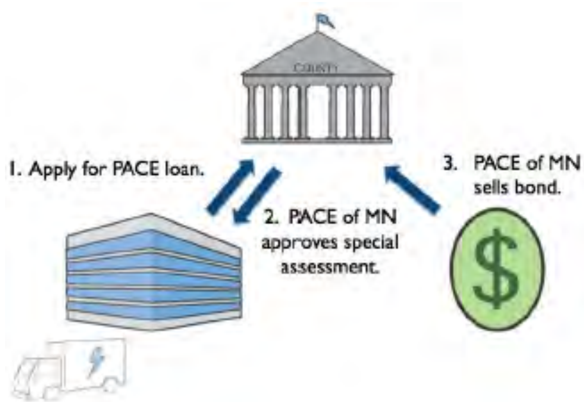

Figure 1: Minnesota Cash Flow Model (generalized by MN PACE)

PACE then either approves or denies a special assessment. In most instances, local governments offer bonds to investors or private lenders to finance loans to property owners for a customized retrofit. These loans, namely private lending or municipal bonds, may then be repaid over the course of 5–25 years and bear no liabilities in investment (Figure 2). For these reasons, interest rates on PACE loans are typically around 3–4% higher than traditional

Figure 2: This model outlines the generalized process of PACE financing. While this provides an overly-simplified schematic, it serves as a reminder of cash-flow throughout the PACE system.

mortgage loans, with additional administration fees of approximately 1%.[2] Even so, PACE financing is structured to offer immediate savings; upgrades come at no added cost to the owner. The program has many stipulations to ensure positive returns on investment. For example, PACE may reject certain upgrades that owners request because of concern about the return on investment.

Loans are designed to cover a range of cost to ensure little-to-no upfront cost by the applicant. This may include the cost of materials and labor, permitting fees, inspection fees, application and administrative fees, development and engineering fees, incidental modifications to existing property, and legal fees.

In Ramsey County, PACE funding is facilitated by the St. Paul Port Authority and invested into multi-tenant building upgrades (Figure 3). This is a net-negative initial cash flow. Over time, the owner realizes gains from the investments and pays interest on the initial investment at a rate that is equal to or lower than the realized financial savings from the efficiency upgrades.

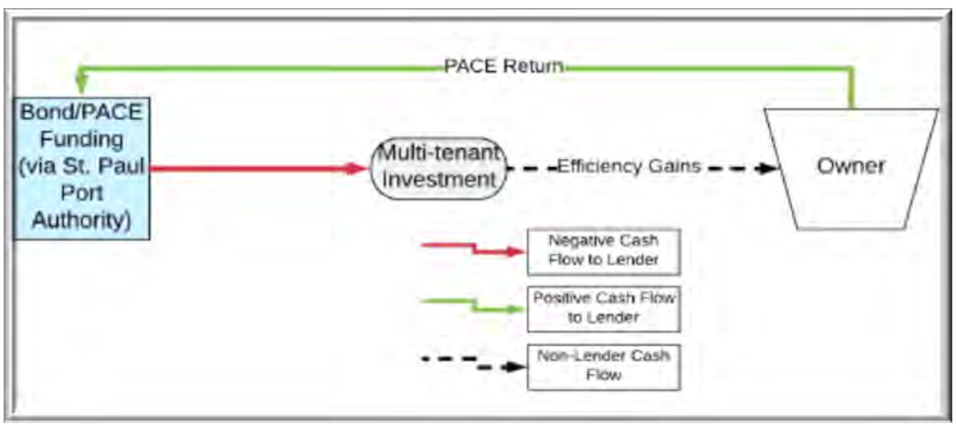

Figure 3: Generalized Cash-Flow from Investor to Owner

PACE Landscape and Nonprofit Participation

The PACE model began in North-Central California in 2008, and has since been adopted to varying degrees in 31 states, including Minnesota. A recent study by the U.S. EPA State and Local Climate and Energy Program was able to identify 1,151 C-PACE transactions, only 42 of which involved multi-tenant properties.[3]

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[2] Clean Energy Financing Programs, A Decision Guide for States and Communities. United States EPA State and Local Climate and Energy Program. July, 26, 2011.

[3] Commercial PACE for Affordable Multifamily Housing, Energy Efficiency for All. Vermont Energy Investment Corporation. January, 2018.

Because they are often unable to access financing options available to for-profit businesses, not-for-profit organizations that own or operate multi-tenant buildings may find PACE to be a helpful option for making long-term investments in efficiency measures. [4] This might be particularly true of nonprofits that purchase multi-tenant housing complexes to support and serve lower income residents. If tenants are responsible for utility payments, PACE-supported upgrades can provide significant monthly cost savings to tenants.

Case Studies

Texas

Texas' PACE program[5] facilitates projects for energy efficiency, water conservation, and on-site energy generation. Qualifying Investments include:

- High efficiency chillers, boilers, furnaces
- Water capture and recapture systems; conservation and wastewater reuse systems
- High efficiency lighting
- Energy management systems; recovery and redistribution systems
- Insulation and sealing
- HVAC systems
- Solar photovoltaics and hot water systems

The loan period is extended throughout the useful life of each improvement, thereby ensuring utility cost savings that exceed the repayment amount.

Texas PACE conducted a simple financial analysis of a hypothetical project for an integrated system that combines heat and a power system that generates electricity and thermal energy. Project costs were estimated at $2.5 million for a 1.3 MW system; annual net savings was assumed to be $473,000, resulting in a payback period of 5.3 years. To qualify for conventional funding, this investment would typically require a 20% down payment, and the loan would likely be denied because the return on investment is too low. PACE funding allows for a slightly higher interest rate (6% versus 4%), but has no down payment requirement and immediate payback. The ROI is not very favorable to company investors (see Figure 3), assuming a standard NPV discount rate of 8%.[6]

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[4] PACE for Nonprofit-owned Buildings. PACENation, Phyllis Weatley Building, Washington, D.C. May, 16, 2016.
[5] New Financing Option for Multifamily Property Owners, Texas PACE Authority, 2018, https://www.texaspaceauthority.org/what-is-pace/multifamily/.
[6] New Financing Option for Multifamily Property Owners, Texas PACE Authority, 2018, https://www.texaspaceauthority.org/what-is-pace/multifamily/.

Financing Scenario Comparison Summary			
	Self-Funded	Conventional Loan	PACE
Out-of-Pocket Investment	($2,500,000)	($500,000)	$0
Savings (First Year)	$473,000	$473,000	$473,000
Annual Payment	$0	($561,568)	($217,961)
Cash Flow Impact Year 1	($2,027,000)	($588,568)	$255,039
Net Project Cash Flow Year 2	($1,554,000)	($677,136)	$510,077
Years to Positive Project Cashflow	5.3	7.0	IMMEDIATE
Debt Service Over Finance Term	0	(2,807,839)	(4,359,228)
10-Year Project NPV	$673,869	$431,691	$1,711,330
20-Year NPV	$2,143,984	$1,901,806	$2,504,007

Figure 4: Financing Scenario Case Comparison

Arkansas

In West Little Rock, Arkansas, PACE funding was used for a new multifamily construction project, a highly unusual practice. Stakeholders in the project dubbed it a "positive experience," noting it was attractive because people in the community are interested in sustainability, and the installations brought an excitement factor to the project. Because of PACE, project owners were able to add upgraded windows, LED lighting, efficient heat and air systems, and roofing systems to the units.[7]

The owners and investors noted the ease of the application process. PACE handles "legal work, paperwork, approvals, and energy engineering so [project owners] can focus on project completion." Jordan Haas and Ben Gilbert, key stakeholders, added that another benefit was that initial improvement costs could be spread over time, providing more cash flow for the project. In this instance, PACE was able to fill an equity gap and provide the financials for a necessary upgrade to the project, which may not have been possible otherwise.[8]

California

In California, PACE was used for a HUD-facilitated multitenant commercial project to finance energy and water conservation equipment, as well as upgrades to existing equipment. The project was made possible by an agreement between the State of California and HUD to work together to accelerate multifamily energy efficiency retrofits in California. Governor Jerry Brown established a California Multifamily PACE Pilot in partnership with the MacArthur

[7] Aldersgate Project, Little Rock, AR, PACE Equity. "First Multi-Family New Construction Case Study." 2016.
[8] Aldersgate Project, Little Rock, AR, PACE Equity. "First Multi-Family New Construction Case Study." 2016.

Foundation.[9]

Obtaining written consent from existing lenders is a major prerequisite for using PACE financing in any project. To gain HUD's consent to enter into a PACE agreement, property owners participating in eligible multifamily housing programs need to submit the following documentation to demonstrate the request satisfies the minimum PACE approval conditions:

- Written consent from other lien-holders.
- A current REAC score of at least 60.
- An ASHRAE Level II-compliant energy audit completed within the past year.
- Lender underwriting that is based on 70% accuracy in savings estimates; shows a savings-to-investment ratio of 1.00 or greater; and uses a term that does not exceed the weighted average expected useful life of the measures as determined by the energy audit.
- A current appraisal or market assessment indicating that the PACE assessment will not increase the property's total debt beyond the maximum percentage of the property's value allowed under the applicable HUD program.
- Proof that proposed measures are permanently fixed to the property (i.e., cannot be removed from the property in event of a change in ownership).
- Documentation from the PACE lender detailing key operational elements of the program.[10]

Using PACE for HUD-facilitated project provides co-benefits such as housing affordability and housing stability in conjunction with environmental sustainability and emissions reductions. In spite of this, there is only one verified instance of PACE use on a HUD-financed property.

Washington, D.C.

In Washington, D.C., a multifamily housing complex used PACE to finance energy-efficiency upgrades in conjunction with a 112,000 square foot, $19 million project, that included targeted lighting improvements, control system, and a 37 kW solar array. Project financing spanned 10 years with a 20-year amortization. Project energy savings reduced energy use by 14% and totalled $40,000 in annual benefits.[11] This is a classic example of the use of PACE financing, and involves a relatively large building, which may be more attractive to investors. In addition,

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[9] U.S. Department of Housing and Urban Development, Background on New Guidance on Multifamily PACE in California, https://www.hudexchange.info/resources/documents/Background-on-New-Guidance-on-Multifamily-PACE-in-California.pdf.
[10] U.S. Department of Housing and Urban Development, Background on New Guidance on Multifamily PACE in California, https://www.hudexchange.info/resources/documents/Background-on-New-Guidance-on-Multifamily-PACE-in-California.pdf.
[11] PACENow Announces HOPE IV program administered by HUD uses PACE for D.C. Multifamily Project. PACE Houston. October 7, 2016.

$340,000 of the project was funded through HUD's HOPE IV program, which subsidizes energy bills for tenants, thus creating an additional incentive for the owner to participate in PACE.

St. Paul

An interview with the St. Paul Port Authority's Michael Linder offered a first-hand look into the landscape for multi-tenant homes within Minnesota. While the St. Paul Port Authority does provide education and assistance to vested parties interested in PACE, it is not within their budget or authority to seek out projects.

Because multi-tenant homes falls within C-PACE, buildings must be five units or larger in size to qualify. Linder noted that PACE for multi-tenant housing has not been widely utilized by any county. Incentives may exist for smaller buildings (5-10 units), because these buildings often include utilities in the rent (i.e., the building owner pays utility bills), so owners would want to provide the most efficient and cost-effective utilities possible (for electric, heat, water, etc.). Larger buildings typically require tenants to pay for utilities, so there is no financial incentive for the building owner.

The landscape for multi-tenant MN PACE projects is limited. Linder noted that there is a "handful" of multifamily buildings, ranging from 6-10 units, in Minneapolis and St. Paul. These are typically older buildings that had a much less efficient energy system. Therefore, a ROI could be realized by the building owner. Owners have been satisfied by the efficiency upgrades and also noted an increase in the value of the property, which further benefits owners. While strategies could be undertaken to provide joint incentives to the owner and the tenant in larger buildings, Linder notes that it is unlikely, as renegotiating a lease is typically very difficult and costly. Triple net leases can pass benefits along to the customer, but the owner is stuck paying the property tax assessment in case of default.

Generally, MN PACE projects have been well-received. People are satisfied with the process and have realized benefit from the investment. Linder suggested that greater participation is lacking because other opportunities exist—for example, Building Benchmarking, which is a voluntary program and widely used in the St. Paul region.

Evaluation

Incentives

There are a multitude of potential benefits from the PACE program.

1) PACE has nonrecourse loan structures, transferable between individuals and property; default generally results in repercussions similar to default on other property tax bills.[12] This means stakeholders will not have to worry whether their "investments" will be realized. Payments will continue to flow from future owners through property tax assessments. Repayment cannot be altered or accelerated at the time of sale. Owners also noticed an additional increase in the property value of their building, which may provide incentives to pursue PACE financing, as noted in the St. Paul Port Authority interview.

2) PACE will provide immediate benefits through reduced energy/utility payments. These savings may be shared with tenants, or directly captured by building owners. Many owners who would otherwise be ineligible for conventional loans may qualify for PACE, as assistance is based on owner's equity rather than future income. The example in the Washington, D.C. case study, for instance, is yielding over $40,000 in yearly savings.

3) Benefits may be creatively leveraged. PACE may be leveraged to finance leases and power purchase agreements, allowing for lower project costs because the provider may retain tax incentives and pass benefits along to owners with a lower service payment. Therefore, in multi-tenant properties, both owners and tenants can share costs and benefits of renewable energy installations, whereas other financing options such as self-financing or bank financing do not allow cost sharing.

4) PACE is not subject to spending caps or per-unit limitations. So long as projects meet the program guidelines, project size can be highly flexible, because there is little-to-no risk for either partner.

Barriers

Lack of participation in PACE from multi-tenant developments is more than just an issue of communication and coordination; limitations and barriers still exist.

1) PACE administrators would rather partner with large commercial projects, which have greater scale and simpler funding mechanisms. Multi-tenant units are often complex and involve federal subsidies, which complicate the process.

2) Stakeholders have options for more favorable financing elsewhere where there are lower

[12] Lessons in Commercial PACE Leadership: The Path from Legislation to Launch. Property Assessed Clean Energy Programs., Office of Energy Efficiency and Renewable Energy, 2018.

interest payments and more flexibility. PACE prioritizes efficiency measures over planned improvements, thereby reducing the ability to customize projects to meet individual objectives. In other words, PACE seeks to get the best value out of efficiency investments, which may not leave the owner with control over what is modified or retrofitted.

3) PACE does not come with technical-support options or assistance. Multi-tenant owners may lack expertise and/or time to take on projects on their own. Particularly in instances of rooftop solar installations, operating costs and maintenance may present issues for the owner.

4) PACE is difficult for use in new construction projects because the savings-to-investment ratio (SIR) is considerably lower than in old, inefficient houses.[13]

Recommendations

1) Ramsey County should target older (50+ years since construction) multi-tenant buildings containing between 5–10 units. This range provides enough units to be considered under C-PACE, but few enough so that it is likely utility bills are paid by the building owner, providing incentive for program adoption. In addition, by targeting older buildings, a greater ROI can be achieved, further benefiting the owner.

Figure 5: This picture depicts an old 5-10 unit building, which is an example of a project that should be targeted for PACE projects.

2) Ramsey County should also target nonprofit owners of multifamily homes who focus on serving low-income households and housing and energy affordability. By targeting this sector, Ramsey County could achieve multiple objectives. Examples of likely qualifiers include BRIDGE Housing, CommonBound Communities, and Homes for America.

[13] New Financing Option for Multifamily Property Owners, Texas PACE Authority, 2018.

Nonprofits may be more likely to participate in PACE programs because, unlike many property owners who may be indifferent to unit energy usage, they are seeking to provide energy assistance to multifamily units. This is central to many nonprofit mission statements. In addition, nonprofits often do not have the financial ability to invest in efficiency projects on their own, and therefore may see benefit from guaranteed financing programs such as PACE.[14]

3) Ramsey County should work to increase outreach and transparency of the MN-PACE program, and consider highlighting benefits that may be of particular interest to private building owners. By providing explicit cost/benefit projections, it is likely that owners will become interested in PACE adoption. Ramsey County should also provide the necessary tools to coordinate applications with the St. Paul Port Authority, to ensure steps are taken to increase the rate of multi-tenant applications.

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[14] PACE must avoid nonprofits supported by certain government loans, i.e., a HUD loan or SBA (Small Business Administration) financing.