

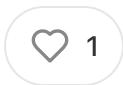
# Creating a Greener Future: Local Law 17 and the Conversion of Offices to Residences

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## Introduction

The summer of 2023 was marked by the most intense heat in modern history. June set a new record as Earth's hottest month on record, and the oceans are showing unprecedented warmth. <sup>1</sup> This comes as no surprise to New Yorkers, as we all endured an unbearable summer in NYC. It became impossible to tolerate the heat without the relief of air conditioning or fans. But what are the primary causes of this massive heat wave? Two main factors are at play: the ongoing emissions of heat-trapping gases, produced by human activities such as the burning of oil, gas, and coal; and the resurgence of El Niño, a cyclical weather pattern. <sup>2</sup>

While humanity still lacks the ability to control cyclical weather patterns, there is reason for optimism. Governments possess the power to reduce heat-trapping gas emissions. Cities such as New York have implemented plans like the Green New Deal, which includes Local Law 97, legislation aimed at combating greenhouse gas emissions. <sup>3</sup>

## Local Law 97

In 2019, New York City Council passed Local Law 97 as part of the climate mobilization act. This new law attempts to limit the excessive greenhouse gas

emissions generated by buildings.<sup>4</sup> Reports show that buildings in New York are responsible for nearly two-thirds of the city's total greenhouse emissions.<sup>5</sup>

Local Law 97 encompasses a range of new rules, aimed at reducing greenhouse emissions in specific building types. Specifically, this new law rules: [b]uildings exceeding 25,000 gross square feet, two or more buildings on a single tax lot that collectively surpass 50,000 square feet, and multiple buildings owned by a condo association, governed by the same board of managers, and together exceeding 50,000 square feet.<sup>6</sup>

The emission limits vary according to the building's occupancy type, such as residential, office, or retail.<sup>7</sup> New York City, also, provides detailed guidelines specifying the maximum allowable emissions in pounds of CO<sub>2</sub>e per square foot annually, with variations for each occupancy category.<sup>8</sup> These limits are designed to decrease over time, promoting continuous reductions in emissions.<sup>9</sup>

Local Law 97 has become the center for attention recently because the first compliance period begins in 2024, impacting buildings over 50,000 square feet. For buildings ranging between 25,000 and 50,000 square feet, the compliance period starts in 2025. Further, there is a sense of urgency because the law aims for a 40% reduction in emissions from the city's largest buildings by 2030, followed by an 80% reduction by 2050.<sup>10</sup> To ensure compliance, the New York City Council has imposed financial penalties, underlining their commitment to achieving these targets. Buildings that exceed the annual emissions limits will face an annual penalty of \$268 per ton of CO<sub>2</sub>e equivalent over the limit.<sup>11</sup>

Endless possibilities arise for building owners to comply with the restrictions set by the legislation. Among the various compliance solutions offered to building owners, one intriguing yet under-explored option is the conversion of office spaces into residential areas.

## Office to Residential Space Conversion

The possible transformation of unused office spaces into residential units, known as office-to-residential conversion, has long been part of the conversation in NYC. It started in the 1990s, when New York City faced a severe economic downturn caused by soaring inflation, a gas price shock, and banking and stock market crises. These factors left many offices vacant for an extended period.<sup>12</sup> With too many empty office spaces in lower Manhattan and a growing need for housing, Mayor Giuliani had to find a solution.<sup>13</sup> The Giuliani administration resorted to the concept of converting offices into residential spaces.<sup>14</sup> Giuliani's team proposed a set of incentives and legal changes to make this conversion process easier and more appealing.<sup>15</sup>

## Benefits

The practice of converting offices into residential spaces has been in use for over three decades, but there are still some unexplored benefits. This conversion not only increases housing availability, but also contributes to environmental improvements by reducing the greenhouse effect caused by office buildings. Research from the National Bureau of Economic Research shows that converting energy-inefficient class B and C office buildings into eco-friendly apartments can cut greenhouse gas emissions by a significant 1.5 million tons, resulting in an 80% reduction of total CO2 emissions from buildings in NYC.<sup>16</sup>

By repurposing offices into homes, cities can make efficient use of existing structures and address their current housing needs without resorting to costly demolitions and new construction. Repurposing existing buildings also has the potential to save developers time and money, depending on the project.<sup>17</sup> Converting existing buildings can be cheaper and quicker than building from the ground up, even when converting older buildings that require updates.<sup>18</sup> This approach also leads to between 50 and 75% fewer carbon emissions than constructing new buildings from the ground up.<sup>19</sup> With these assumptions, converting offices to residential spaces would push buildings to stay below 25% of the 2030 carbon emissions limit set by Local Law 97.<sup>20</sup>

## Drawbacks

This solution faces two main challenges: zoning restrictions and the structural complexity of certain office spaces. In New York City, zoning regulations impose limitations on alterations, which can hinder the potential for office-to-residential conversions. For instance, in the Financial District, buildings constructed before 1961 can be converted, while in Midtown, the cutoff date is set at 1961.<sup>21</sup> These limits are implemented to ensure that essential public services like schools and transportation networks can adequately support the newly-converted residential areas. However, these somewhat arbitrary cutoff dates can be frustrating for developers, slowing and impeding their conversion of these spaces.

Moreover, not all buildings are structurally suitable for repurposing. Challenges may arise from issues ranging from the ceiling to the plumbing of the building.<sup>22</sup> These factors are critical when assessing whether a building is a viable candidate for conversion.<sup>23</sup> Undertaking significant structural changes is a demanding task, often requiring skilled contractors who might be in short supply.<sup>24</sup> Finding a contractor and a reliable team capable of instilling confidence in building owners to execute such a complex and meticulous transformation can be a daunting process.

## Financing

Another important consideration in residential conversion is securing financing for the project. In the current market, there is a lack of developments due to increasing interest rates. Thus, building owners may find it challenging to embrace the prospect of residential conversion.

Nevertheless, there exist unexplored avenues for project financing, one of which is the Commercial Property Assessed Clean Energy (C-PACE) program. C-PACE extends financing to property owners for energy efficiency and renewable energy projects on existing commercial structures.<sup>25</sup> The property owner voluntarily commits to repay the financing through a special assessment.<sup>26</sup> Unlike other financing options, C-PACE allows property owners to fund improvements over time without a significant upfront investment.<sup>27</sup>

C-PACE provides long-term, non-recourse financing at rates as low as 6 or 7 percent, a considerably cheaper alternative to mezzanine or senior loans.<sup>28 29</sup> This affordability is made possible by attaching loan repayments to the property as an additional assessment, securing them with a more senior lien than many other creditors.<sup>30</sup> Consequently, in the event of default, C-PACE could take precedence over other senior loans. Fearful of subordination of their liens, some lenders are hesitant to engage with C-PACE financing. While developers may be enticed by the attractive interest rates, acquiring C-PACE financing necessitates the consent of other lenders involved in the property.<sup>31</sup> And those lenders are deterred to give consent because their mortgages may lose seniority against C-PACE special assessments.

Since its adoption in New York in 2019, C-PACE has only been utilized in two projects, leaving its potential largely untapped.<sup>32</sup> The future trajectory of C-PACE adoption remains uncertain; however, some believe that perceptions among lenders will shift. As the deadline for carbon emission compliance, mandated by Local Law 17 approaches, building owners are recognizing the need to reduce carbon emissions in their structures.<sup>33</sup> Due to the time constraints posed by the compliance period beginning later this year, adhering to the reduction of carbon emissions is not a luxury for building owners anymore, but a responsibility. In light of this, C-PACE emerges as a compelling option, offering some of the most favorable interest rates for financing these sustainability-focused projects.<sup>34</sup> It is anticipated that with an increasing number of borrowers recognizing the need for such financing and expressing interest, lenders will become more amenable to considering C-PACE proposals.

## Other Reasons Why Office to Residential Conversion is Appealing

### A. Office Space Downsizing & Demand for More Housing

Since the start of the COVID-19 pandemic, remote work has become the new norm. To adhere to social distancing measures, companies allowed their employees to work from home. This change prompted a reevaluation of the need for traditional office spaces. Many business owners realized that maintaining large office spaces is

expensive, and if they're not essential, why continue with them? <sup>35</sup> This led to a shift towards online work or opting for smaller, more budget-friendly offices. As a result numerous office buildings now sit vacant, incurring ongoing costs. Repurposing them into residential units could offer owners an opportunity to generate additional income.

Furthermore, there is a pressing housing shortage in New York City. As certain regulations, like 421-a, have expired and housing developers construct fewer residential properties each year, while the demand for housing has grown. <sup>36</sup> Convincing developers to embrace this conversion solution should be easier since there's a constant demand for rental options among New Yorkers. Moreover, it could potentially help alleviate the rising rents driven by the limited availability of apartments. Thus, converting offices into residential units can benefit property owners and everyday New Yorkers in search of affordable housing.

## B. "City of Yes" Proposal

Previously, we acknowledged the challenges associated with converting office space to residential units due to stringent zoning regulations. However, Mayor Adams during a speech last September unveiled a promising initiative under his administration, named the "City of Yes for Housing Opportunity." <sup>37</sup>

During his address, Mayor Adams outlined various aspects of the City of Yes initiative with two key proposals particularly relevant to our discussion. First, the City of Yes aims to amend zoning regulations citywide, permitting the conversion of non-residential buildings constructed before 1990 into housing. <sup>38</sup> Presently, such conversions are only allowed for buildings predating 1961 in Manhattan below 110th Street, parts of Brooklyn and Queens, and buildings erected before 1977 in Manhattan's Financial District. <sup>39</sup> This initiative also opens the door for commercial buildings to transform into a broader spectrum of housing options, including shared housing arrangements where apartments share communal kitchens and facilities. <sup>40</sup>

Beyond easing the conversion of office buildings to residential units, Mayor Adams administration plans to prompt City Planning to conduct a comprehensive review of existing zoning regulations.<sup>41</sup> The objective is to identify laws that have outlived their original purpose and now function primarily as impediments to new housing development.

These proposals, if implemented, would significantly alleviate the challenges faced by developers striving to comply with Local Law 97 while complying with complex zoning laws. Although the City of Yes proposals are currently in the proposal stage, Mayor Adams' administration appears genuinely enthusiastic about this solution as a means to address both the carbon emissions from buildings and the persistent housing crisis.

## Conclusion

Office-to-residential conversions seem like a promising idea with potential benefits for various stakeholders, including addressing housing needs for New Yorkers and reducing ongoing office space expenses. However, the current state of the market poses substantial challenges, making the feasibility of this idea impracticable or impossible for many properties. The primary challenge is the lack of financial incentives for property owners and developers to undertake such conversions. The transformation of office spaces into residential units involves significant costs, and without a guarantee of substantial profits, the associated risks may outweigh the potential rewards. Property owners would need to assemble a capable team for the conversion, and with slim expected profit margins, the project becomes less attractive. Consequently, property owners seem more inclined to endure short-term losses and wait for market conditions to improve before committing to such conversions.

While the current drawbacks of the project are evident, it is important to emphasize that signs point toward future changes. The increasing appeal of cost-effective financing alternatives and potential adjustments to zoning laws suggest that the burden on developers may lighten. The city's administration acknowledges the

challenges posed by Local Law 97 for building owners but emphasizes the importance of compliance for the public benefit. Collaboration among stakeholders, including lenders and the city administration, is underway to facilitate solutions like office-to-residential conversions.

Looking ahead, it is likely that lenders will become more open to working with financial tools such as C-PACE, and zoning laws may adapt to streamline projects involving office-to-residential conversions. This collaborative effort aims to provide New York with more environmentally friendly homes for all its citizens.

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