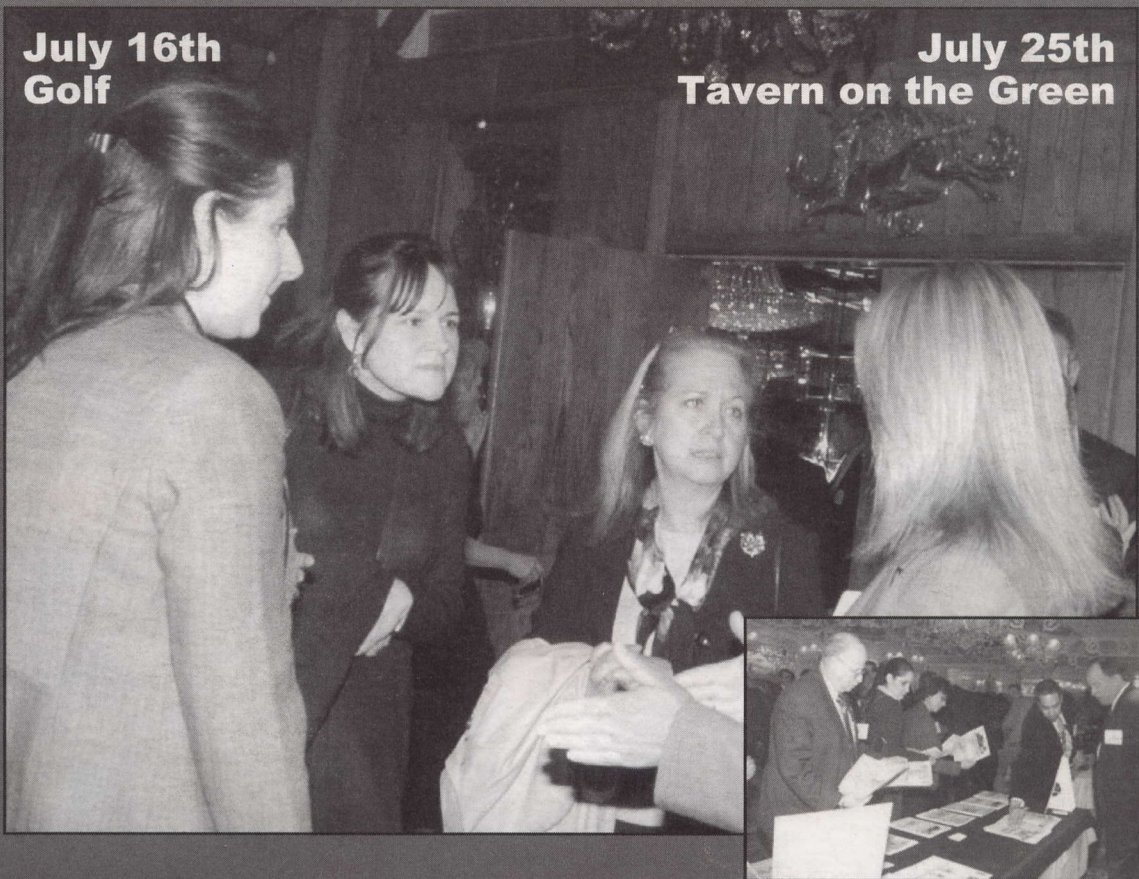


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Apt. Building Agreement	RAB & 32BJ.....9
Boiler Efficiency	Sandler.....11
Blow Down Your Boiler	Stankiewicz.....10
Upcoming NYARM Events	NYARM.....24
The New Law of the Street	Rice.....12
Performance Contracting	Kwit & Clevett.....14
Safety First: Springtime Clean Up	Hoesterman.....18
Code of Ethics	NYARM... CTR
The Color of Efficiency is GREEN	Pindus.....25
Intro 119 – Unfair to Coops	Mazel.....26
Litigating a Construction Dispute	Berger,.....36
School of Property Management	NYARM.....34
July 25th - Employee Management	Seminar.....39

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Performance Contracting:

Can you save \$\$\$ without ever spending a dime?

By Lewis Kwit & Steve Clevett

Time passes quickly in the life of a building. Improvements that were state of the art just five years ago are supplanted overnight by newer, more economical, more sophisticated technology. Piecemeal improvements, on the other hand, can mean years of forms, filings and bureaucratic requirements, so buildings often undertake several capital improvements at once to consolidate paperwork and take advantage of incentive programs.

But despite the obvious benefits, many property owners have limited reserves to undertake capital improvements and existing debt compromises their ability to borrow. Decisions to spend large amounts on multiple improvements are difficult when technologies are new and little data attests to their cost-effectiveness. While not a viable option for every building, performance contracting can be invaluable for cash-strapped buildings – and even for those that are not. But as with many things, the buyer must beware! A bad deal can lock a building into giving up the majority of savings or saddle it with poor performing technology and no exit strategy.

Selecting the right performance contractor and *knowing* what to look for begins with understanding exactly what a performance contract does. For example, some energy services companies, or ESCOs, offer performance contracts that enable buildings to implement capital and operating improvements through future savings. The ESCO guarantees the performance of specified improvements for the term of the contract, which ranges from 5 to 15 years depending on the improvements, and in effect, bases its profit on the savings generated. This enables property owners to implement state-of-the-art technologies while avoiding undue risk. Some “one-stop-shop” companies go a step further and finance the project themselves.

A well structured contract is essential to ensure the long-term benefits of energy improvements for your building. An ESCO assumes the risk that equipment and programs will function as promised. The company develops the scope of work, manages the implementation of selected energy measures, guarantees equipment performance and balances the distribution of benefits or energy savings with the property. Given this considerable investment of time and money, it is no surprise that energy service contractors design performance contracts to protect themselves against risk.

Under the best of circumstances, everyone wins. Poorly conceived contracts, however, can jeopardize savings, create ill will and lock everyone into an untenable situation for years. Buildings must pay close attention to contract language, including “base year adjustments,” which include things the owner or tenants do within a building to alter energy use, and “exterior”

issues such as weather and utility tariff rates. Although legitimate contractual issues, they should be clarified so as not to give the ESCO an “out” in terms of performance requirements. Careful planning, beginning with these four steps, can assure a smart and successful performance contracting experience.

Determine whether performance contracting is right for your building. If possible, perform your own analysis and set benchmarks for cost-effectiveness or hire an expert to do it. ESCOs can do this for you. A building should ask whether savings can service debt, what fees must be paid to get the job done properly, and what additional resources must be allocated to manage equipment performance after installation.

Obtain a responsible energy audit from a reliable firm. A thorough analysis will identify costs, savings and payback periods for individual items and for a comprehensive program of implementation. An objective audit based on real and verifiable data costs time and money but is essential to test future performance.

Look beyond energy savings to see if planned capital improvements qualify for additional benefits, including J-51 property tax abatements, MCI rent increases, lower maintenance and repair costs, depreciation tax benefits and operating cost enhancements. Review federal income tax credits and incentives from the New York State Energy Research and Development Authority (NYSERDA) that can offset capital costs.

Armed with a firm understanding of costs and benefits, solicit bids from qualified energy service companies. Be aware of the risks and costs involved in running your own project and entertain energy service performance contracts for evaluation.

Keep three key points in mind: **1.** The devil is in the details. It is difficult to form an objective comparison between proposals from different ESCOs. Different people have different ideas on how to solve problems, making creativity an important tenet; **2.** Don't kid yourself that you can run your own performance contract “on the cheap;” **3.** The only way to understand economic performance is to measure it each and every day.

Additional Points to consider:

1. Costly capital-intensive projects are not necessarily best. They are what most ESCOs want. Some companies are construction-oriented with little concern for service; others are subsidiaries of equipment manufacturers who want to sell their products. Either way the preference is “bigger is better.” Be careful to pick a company that can do large and small jobs.

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Performance Contracting - Cont'd

2. Look beyond equipment to operating and control improvements, such as calibrating the building. Develop a program that balances capital and operating improvements and looks at supply (procurement) as well as demand (usage) side opportunities.

3. The proposed improvement program should include a comprehensive scope of work that includes low-cost and high-cost measures. Properly managed, performance contracting allows everyone to "be in the black" from day one. The term of the deal is the question.

4. Measure, measure, measure! The performance contractor will want as much stipulated as possible. This is fine for fixed external items such as lighting applications, but stipulations can be a risky proposition for the building and a free ride for the contractor. Remember that the only way to understand economic performance is to measure it.

5. Try to assess the "creativity quotient" for the ESCO. Most will have a sales pitch with a "hook" that is out of the ordinary. It may be a piece of equipment or a new concept that separates their approach from others.

6. Review the credentials of personnel who will work on your job and stipulate their involvement when you go to contract.

7. Review monthly payments and the terms of the contract. Find out what percentage or amount of costs can be expensed for tax purposes. If a building cannot expense the repayment of principal for capital improvements, a creative contractor may propose a specific performance structure that is off-balance sheet and off-credit so that the entire amount can be expensed. Equipment ownership has different implications for different properties. If the building does not own the equipment, it may not be eligible to deduct depreciation or qualify for J-51 tax abatements and MCI rent increases. For cooperatives and not-for-profits that cannot claim depreciation, however, the contractor or lender may retain ownership and use depreciation to offset earnings.

8. The building should be able to withdraw from the deal without proving cause. If the ESCO owns the equipment, title must transfer to the property. It is important to have a clear "glide path" so that each party knows what to expect in case of future negotiations. And remember that the ESCO works for the property owner, not the reverse!

9. Some NYSERDA incentives accrue directly to contractors. The contract should include a formula by which the property benefits directly from subsidies. Subsidies should be deducted from principal amounts before calculations are performed for debt service, even if debt is a component of an omnibus service agreement.

10. Transparency and communication are a "must." A contract should demonstrate to the owner's

satisfaction how much would be earned at various junctures and through various components of the project. Should additional savings accrue to the building through the efforts of the ESCO, it is fair and good business to share the proceeds with the company. Conversely, the guarantee should contain performance parameters and state how performance is measured and what happens if savings fall short. Be aware that many ESCOs view measurement and verification of savings as nothing more than "revenue protection," and select an experienced team that is committed to measure what's going on, deliver outstanding customer service and offer clear and timely reports.

The bottom line: energy services performance contracts are complex. Something unanticipated will happen during the improvement process. Your challenge is to choose a "service-first" ESCO company that can deal with the unexpected.

Two Final Words: This guide has focused on measurable criteria and contract issues, however, you should not overlook the subjective criteria of trust and creativity. Trust is essential when performance contract terms and conditions are numerous and complex. Performance contracting agreements are generally in place for a long time and have substantial value. Communications rarely get better along the way. A trustworthy performance contractor can assist you with the inevitable contingencies and decision-making. It bears repeating: look for a service-first ESCO.

Tip Five speaks of creativity as innovation in the sales pitch, however, creativity is also a state of mind. A creative ESCO is a valuable resource long after the project is underway and the capital improvements are installed. New technologies, new ways to purchase commodities, new pricing mechanisms such as Real Time Pricing and Electricity Curtailment, and new incentives – from NYSERDA subsidies to the selling of pollution credits – are emerging at a blistering pace. When you are asked what to do next, a creative ESCO can help you answer the question with confidence.

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