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PACE Makers

A handful of states are reimagining Property Assessed Clean Energy financing, including California, Connecticutt, Florida, New York, and Vermont.

Property Assessed Clean Energy (PACE) financing was the most exciting thing in energy efficiency until June 2010. The idea was simple: homeowners could take out a loan to finance efficiency work as a property tax assessment. Because it became the senior lien on the property, the interest rates were lower.

The Federal Housing Finance Agency (FHFA) saw it differently. In its view, a senior lien devalued its mortgages by placing others in front of mortgage lenders in a bankruptcy. In July 2010, the FHFA advised member banks not to purchase mortgages with a PACE assessment attached to the property and to calculate the full amount of a potential PACE loan into any mortgage given in an area allowing PACE. The FHFA ruling effectively derailed the burgeoning residential PACE efforts around the country.

Since then, several states have moved forward with PACE in ways that stay clear of the FHFA ruling. They are altering the model to address the FHFA's concerns. In the process, these states are determined to get PACE back on track.

A series of legislative and judicial initiatives seeking to overturn the FHFA's directive are under way. In this article, however, we focus on the untold story of how state and local governments from coast to coast are forging ahead with new PACE programs, separate from the battle over the FHFA ruling.

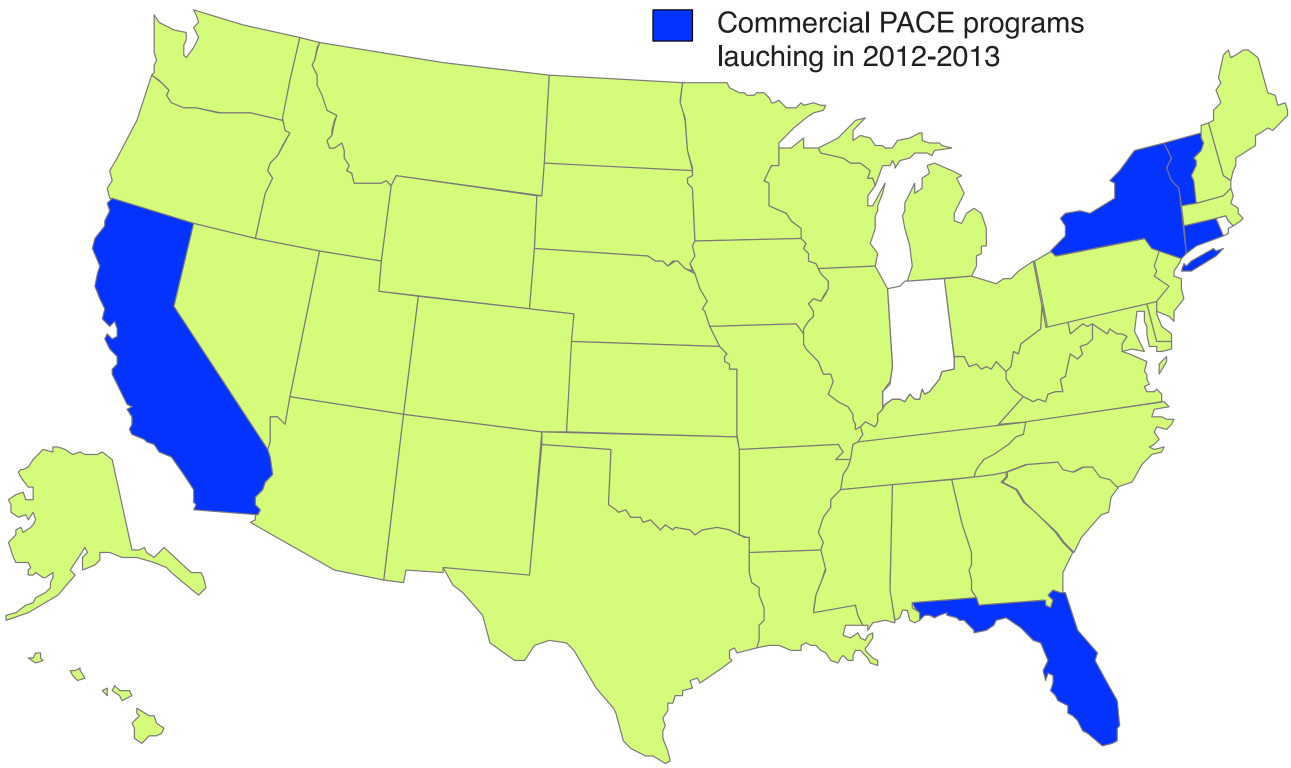
California

An early decision for any PACE program is how to source the capital for the energy upgrades. Around the nation, at least three different approaches to sourcing capital to finance PACE programs have emerged in the process: warehoused, pooled bond, or owner-arranged funds. Under warehousing, funds are temporarily taken from a warehouse until sufficient volume is aggregated for the capital markets. Under a pooled bond, the agency—often a local government—will collect individual financing amounts into a pool adequate for bonding. Under owner-arranged financing, lenders that participate offer capital directly to owners, essentially competing for the financing business.

Some programs are using more than one of these approaches, with California leading the way for the newest model of owner-arranged funds.

The FHFA decision only affected residential properties. Commercial properties have a different loan structure, not associated with Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) funds, and therefore are able to move forward. In California, counties with existing residential PACE programs are adapting those policies to commercial PACE programs.

"Residential PACE looks very different from commercial PACE," noted

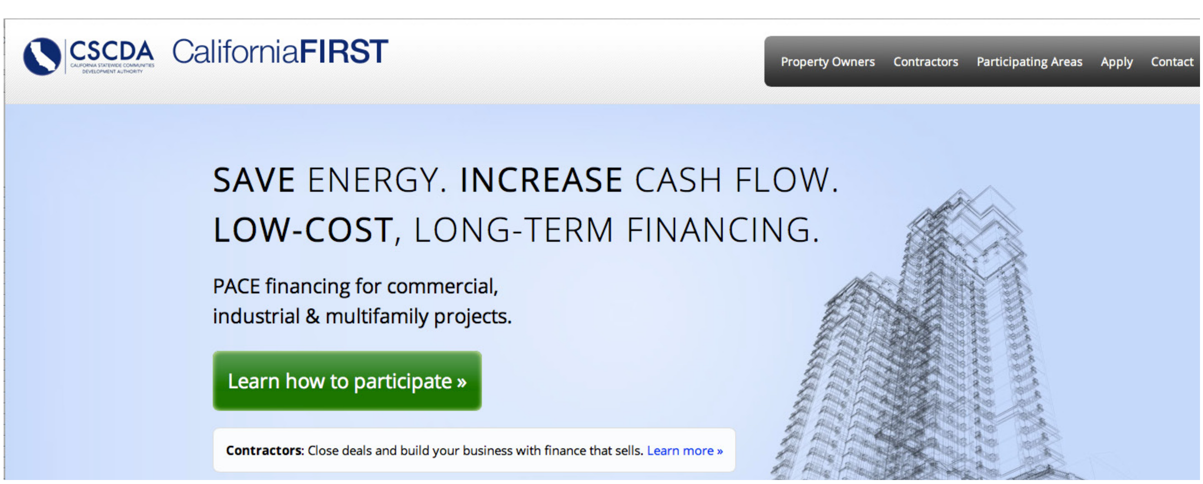


Cliff Staton, executive vice president for Renewable Funding, a program partner for PACE initiatives in several states.

"In residential PACE, most upgrades are very similar to one another, with some variation for age and size of home. But in commercial PACE, upgrades to an office building, a food processing facility, and a cement plant will all be very different from one another. Because of those differences, it is even more important that local governments have uniform program standards and paperwork to make the process simple for commercial property owners and their lenders and contractors."

Fourteen California counties representing 127 cities reached agreement with the California Statewide Communities Development Authority (California Communities) for a residential PACE program modeled on the programs established in Los Angeles and San Francisco. When the FHFA advisory of 2010 effectively froze progress on residential PACE, these local governments began to examine PACE financing for commercially owned properties. The resulting program, CaliforniaFIRST, replicates the standards and process used in the counties of Los Angeles and San Francisco.

After a competitive process, California Communities selected Renewable Funding and Royal Bank of Canada Capital Markets as project partners to offer a complete AB 811 program to cities and counties throughout the state, including administration, legal, and finance. The founders of Renew-



able Funding, the CaliforniaFIRST Program administrator, helped create the PACE program model and is assisting cities, counties, and states nationwide to launch these financing programs.

"Our hope and goal is to create a unified market in California with uniform standards for property owners, lenders, and contractors," says Staton. "Between Los Angeles, San Francisco, and CaliforniaFIRST, about two-thirds of the state's population lives in a commercial PACE community."

"What distinguishes these programs from others is the use of the 'open market' model." -California

In early June 2012, a coalition of these same counties and cities launched the Commercial Clean Energy Financing Alliance, bringing together leaders and experts at the forefront of PACE financing programs to share knowledge, skills, and tools with interested communities throughout California.

The existing programs that form the basis of the commercial PACE Alliance are the programs in San Francisco and Los Angeles. Under the Alliance, the three programs in California–CaliforniaFIRST, Los Angeles, and San Francisco–will not only have similar rules and process, but even similar forms for owners and lenders to use. This standardization will make comparing finance offerings from multiple lenders easier, and lenders active in multiple counties will only have to learn one set of underwriting standards.

"This is one of those great situations where local governments are collaborating on common guidelines for the benefit of all the stakeholders," explained Staton.

CaliforniaFIRST expects to launch its commercial PACE program by late summer 2012. As with Los Angeles and San Francisco, CaliforniaFIRST is taking an owner-arranged approach to sourcing capital, also known as "open market" financing.

"What distinguishes these programs from others," explained Richard Chien, program manager of GreenFinanceSF, "is the use of the 'open market' model, which means a property owner is able to secure and negotiate the specific terms of the PACE financing with a third-party capital provider of their choice."

Specifically, two aspects of California's programs make them an open market approach. First, under owner-arranged financing, an owner has access to multiple sources of capital from the many different participating lenders, creating some competition among lenders that benefits property owners. Second, the mortgage lenders must provide acknowledgement of the PACE senior lien, which is not the same as "consent" but serves the same purpose under California statutes of avoiding the "due upon encumbrances" clause in many commercial mortgages.

"For example, in California, Wells Fargo has expressed interest in participating as a PACE lender for those commercial properties on which it holds a mortgage," noted Staton, "and for whom the energy upgrade financed by PACE would improve cash flow for a property owner."

When asked whether capital sources for CaliforniaFIRST will be warehoused funds, pooled bonds, or owner-arranged, DeVries clarified, "The program is launching as 'open market,' which allows for all three options. But it will be primarily owner-arranged as we get started."

"We have the capacity under the program authorization to finance up to $14 billion, but obviously it will start small and work up from there," continued DeVries. "A number of capital providers are working to finance projects in the program."

The CaliforniaFIRST commercial PACE program should clear its last regulatory hurdle in August 2012, when it expects to receive validation from the courts for the benefit assessments. This validation will prevent a new property owner in any of the 14 counties from contesting the special benefit assessment at some future time.

CONNECTICUT

Not to be outdone, Connecticut adopted the nation's first statewide commercial PACE program in June 2012, enabling commercial PACE financing in every municipality in the state.

Governor Dannel P. Malloy signed the Commercial Sustainable Energy Program legislation on June 15, 2012, the very same day that the FHFA pub-

CLEAN ENERGY
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lished its notice for proposed rule making over the underwriting standards for Fannie Mae and Freddie Mac relating to mortgage assets affected by PACE programs.

Connecticut's Clean Energy Finance and Investment Authority (CEFIA) will develop the statewide Connecticut Sustainable Energy Program, which is specific to commercial and industrial property owners. CEFIA will provide financing for energy efficiency and renewable energy improvements. The assessments are called "benefit assessments" and will be considered a senior lien, with consent of existing mortgage holders.

"From what I see around the country, the hangover on the residential PACE side has faded away and the commercial PACE side is moving very quickly now," stated Jessica Bailey, program officer for the Rockefeller Brothers Fund and practitioner in residence at CEFIA.

"We feel having one statewide program will attract lower cost capital faster than having a different program in each of the state's 169 towns would," noted Bailey.

"We wanted to reduce the cost of managing the program with uniform policies and removing the need to adopt local benefit districts for each municipality," continued Bailey.

Under the CEFIA commercial PACE program, municipalities no longer need to establish local benefit districts or arrange finance options for property owners. To offer commercial PACE to local property owners, Connecticut's municipalities simply have to agree to collect the PACE assessment, remit the funds to the CEFIA trustee, and place the senior lien. CEFIA has established a working group of a dozen municipalities to work on the draft memorandum of understanding that would be required for a town or city to subscribe to the program.

In contrast, the 2011 Connecticut energy bill that established municipally based residential PACE put much more burden on local governments than this new statewide approach to commercial PACE.

For example, under Connecticut's residential PACE rules, municipalities had to establish local benefit districts, and then issue bonds, secure private funding, or use state or federal funds (or a combination of these) to finance the programs. No local governments had taken steps to enact local residential PACE programs in Connecticut, and the state has no counties to leverage any local work.

"We worked closely with the banking community throughout the policy process to design the financial parameters that would meet their needs," explained Bailey.

Also known as the state's "green bank," CEFIA will have the authority to back PACE bonds. CEFIA will work with the Connecticut Bankers Association, Connecticut Business and Industry Association, Connecticut Conference of Municipalities, Connecticut Energy Efficiency Fund, and others to develop the full details of the program.

"The one requirement we have so far is that the savings-to-investment ratio must be 1.0 or greater," stated Bailey.

Connecticut's program features will be in active development in the next few months, including whether to establish a debt service fund or a loan loss reserve fund, and under what circumstances to engage the bonding authority. In addition, the guidelines for requirements (e.g., an energy audit), eligible improvements, loan-to-value ratios, and funding minimums or maximums are all being developed this summer as well.

FLORIDA

Since mid-2011, three different inter-municipal jurisdictions in Florida have launched new commercial PACE programs. Each of the new programs builds on prior residential PACE precursors. Like California, Florida state law requires new benefit assessment districts to be validated in court.

According to PACEnow, each of the three new PACE programs in Florida will levy PACE assessments, offer financing, and subsequently receive assessment payments collected at the county level. The programs share some attributes but differ in whether they address residential PACE and how they approach financing, water efficiency measures, and issues regarding notice, and consent or acknowledgment of an existing mortgage lender for commercial projects.

In 2011, Flagler County in northeastern Florida and the City of Kissimmee in central Florida (with a combined population of about 155,000 residents) chartered the Florida PACE Funding Agency.

Two towns in Palm Beach County, Lantana and Mangonia Park, recently initiated the incorporation of the Florida Green Finance Authority and have been joined by the nearby cities of West Palm Beach, Delray Beach, and Boynton Beach.

A South Florida consortium started by the Town of Cutler Bay formed the Clean Energy Green Corridor, centered in Miami-Dade County.

In late 2011, Florida courts validated the commercial PACE assessments of the Florida PACE Funding Agency for up to $2 billion in bonding authority. The agency has the capacity to enroll any municipality in the Sunshine State. Other local governments will subscribe to join. In recent weeks, following a competitive process, the agency has hired SAIC subsidiary Energy, Environment and Infrastructure LLC as the program administrator.

Bob Reid, whose firm, Bryant, Miller and Olive, has been engaged by the agency as its special counsel and bond counsel, believes financing may ultimately be in the form of a warehouse facility that makes project funding available whenever it is needed.

Unlike CaliforniaFIRST, the Florida PACE Funding Agency will not require energy audits. However, interested property owners can get energy audits through qualified auditors. The agency will follow Florida law, which requires consent for projects in excess of 20% of the property's appraised value, but not below that threshold, and provides 30-day notice to existing lenders to present them with an opportunity to adjust monthly tax, insurance, or escrow payments.

The Florida program most similar to CaliforniaFIRST is the Florida Green Finance Authority's program, Florida Green Energy Works, which involves some of the same project partners, such as Renewable Funding. The Authority expects to conclude its bond validation process for Green Energy Works by the end of the summer.

The Green Energy Works commercial PACE program will be administered by EcoCity Partners L3C, Florida's first lowprofit limited liability corporation. The program will use an owner-arranged (open market) funding approach. Validation is expected by the end of August 2012.

"It's not an accident that our Green Energy Works program looks very similar to California's," said Michael Wallander of EcoCity Partners. "We work very closely with California and Renewable Funding, because taking the prudent approach that they have is very important."

Like CaliforniaFIRST, Green Energy Works requires an energy savings audit completed by a qualified energy auditor or a certified building energy rater. At a minimum, the audit will include the recommendations for energy savings measures, estimated energy savings and a priority ranking for each measure, estimated renewable energy to be produced (where applicable), estimated greenhouse gas reductions, and estimated cost savings resulting from the implementation of the recommendations and use of funds made available by the benefit district.

Green Energy Works also requires commercial property owners to provide notice and receive consent for the PACE assessment from their existing mortgage lender.

"Our biggest challenge is the long lead time in commercial work and avoiding unrealistic expectations about going to scale. That is why we are building a pipeline of potential commercial projects," noted Wallander.

Green Energy Works has been meeting with communities from Key West to the Panhandle to be potential program administrators for them. From Broward County to Fort Myers, a number of local governments have issued procurement solicitations for program administration for commercial PACE programs. Most will be making decisions in August or September.

"Our program has begun to scale already, as we are now up to five participating municipalities," continued Wallander. "We have both very small as well as larger municipalities participating already, ranging in population from 2,000 to 100,000. In fact, yesterday we presented to a smaller Gulf Coast municipality for whom our ability to serve both large and small towns is very important."

The five municipalities enrolled to date in Green Energy Works comprise about 240,000 residents, or about one-fifth of the entire Palm Beach County population.

"The real story will be having a completed upgrade project in the ground," concluded Wallander.

The third Florida program, the Clean Energy Green Corridor, is centered in Miami-Dade County. The Green Corridor plans to offer both commercial and residential PACE financing, though only commercial projects will be permitted in the City of Miami.

Ygrene Energy Fund is the Green Corridor program administrator charged with securing financing, contracting, and a range of assurances and performance guarantees to participating governments. Ygrene reports that it has secured funding through Barclays and is developing additional potential funding from other lenders capable of warehousing assessments. To date, the participating local governments in the Green Corridor District include the municipalities of Cutler Bay, Miami, Miami Shores, Pinecrest, Palmetto Bay, and South Miami, for a total of about 650,000 people.

NEW YORK

In 2011, the Town of Bedford formed the Energy Improvement Corporation (EIC) as a New York State Public Authority (a local development corporation) eligible to secure bond financing. Under New York State law, the EIC will be owned by the municipalities that become members, with a board of directors comprised of a subset of the members. The program will open in late summer 2012.

"Our goal is to make energy efficiency for buildings the new social norm," explained Mark Thielking, chair of the EIC board of directors. "Just like wearing seat belts became the norm for driving a car a generation ago."

The EIC just celebrated its first birthday and is on its way to launching commercial PACE.

"We are initially targeting commercially owned residential one- to four-family homes, with subsequent rollout to other commercial building stock in our member municipalities," noted Thielking. "We think this class of Freddie- and Fannie-exempt housing is about 5% of our area's residential building stock."

The EIC is the program's administrator, with outreach to the communities patterned after the Energize New York program that the Town of Bedford also housed within the EIC. The program has the capacity to enroll any municipality in the state that adopts a benefit district and agrees to participate in the assessment management and collection process.

"We anticipate using several different financing tools—from owner-arranged financing where the EIC issues a note to a bank, to a short-term warehouse facility backed by long-term takeout facility—and we may undertake bond issuances," explained Thielking.

The EIC program will rely on senior lien status as security and will back potential losses with a reserve fund. Property owners will be required to conduct energy assessments. Commercially owned one- to four-family residences will require a comprehensive energy assessment by a Building Performance Institute—accredited Home Performance with Energy Star contractor. Commercial nonresidential buildings will require an ASHRAE Level 2 or Level 3 audit.

"Our goal is to make energy efficiency for buildings the new social norm." –New York

"Clearly, the financial standards vary from program to program, but I am not sure that they vary dramatically," noted Thielking. "For example, most programs require a loan-to-value score with 80% to 100% as the range."

"Our residential energy efficiency outreach program, Energize New York, has more than doubled the number of homeowners who install energy upgrades," continued Thielking. "Combining that local outreach capacity with new financial options here in New York, such as the state's new on-bill recovery and our own new PACE program, should really capture the full range of building types not otherwise able to proceed."

VERMONT

Meanwhile, Vermont has designed a new approach to proceeding with residential PACE while obtaining

FHFA approval for access to Freddie- and Fannie-backed mortgages.

"Our going forward with residential PACE in Vermont is a case of what I call 'biased action,'" explained Peter Adamczyk, managing consultant at the Vermont Energy Investment Corporation. "There were lots of people very frustrated [after the 2010 FHFA advisory], saying to each other, 'There must be something that we can do.'"

Vermont's approach is based on the federal Power Saver loan program under Title I at the FHFA. This existing bank product sits below any existing mortgages. The Vermont PACE Program differs from the others described in this article in that it foregoes senior lien status and establishes a junior lien for residential assessments. The FHFA approved Vermont's junior lien approach in April 2011.

"We can determine the rate impact of junior liens and put a price tag on the cost of the FHFA's advisory." –Vermont

The Vermont partners considered whether requesting approval for a junior lien would hurt the national effort for residential PACE. But the team concluded that Vermont's small size would not hurt the course of action available to larger states.

"In fact, our approach should be able to help us quantify the impact of the FHFA's advisory," noted Adamczyk. "Junior lien status makes our loans more expensive than senior liens. We can determine the rate impact of junior liens and put a price tag on the cost of the FHFA's advisory."

Vermont law stipulates the assessments have the same status as a property tax. Towns with junior liens on properties will lose nothing in the transfer or sale of properties. Therefore, at least in Vermont, this junior lien perpetuates until the financed amount is paid off.

Although the program has not yet finalized the credit facility, Adamczyk anticipated the interest rate for junior liens would be about 2.5 points above the mortgage rate, yielding about 6.5% for fixed-rate financing on a 20-year term. Borrowing $7,500 on those terms means an annual charge of $400 collected by the town as an assessment

To address foreclosure defaults, Vermont will collect a 2% onetime nonrefundable fee on all residential PACE financing for a statewide reserve account. The FHFA has approved this approach to establishing a reserve.

The banks, such as Barclays and Citi, said that the 2% reserve account of about $400,000 was not enough. So Vermont is dedicating $1 million in Regional Greenhouse Gas Initiative (RGGI) funds–previously set aside for thermal improvements–to a loan loss reserve account to back an additional 5% of the $20 million in upgrades financed via PACE as bank loans.

Because Vermont exhibits the lowest foreclosure rate in the nation quarter after quarter, Adamczyk reports that this additional 5% reserve seems amply conservative, with several banks now examining the program. To lower a local government's workload in hosting PACE, Efficiency Vermont is available to act as PACE program administrator for towns, with all costs paid by participating property owners.

"Do I think Vermont's approach is something every state should try? Probably not. But Vermont had the benefit of both RGGI funds for a reserve account and a state energy efficiency utility to act as program administrator," continued Adamczyk. "Tying up $1 million is a big deal here, just as bringing $20 million in new financing is. But how big would that loan loss reserve need to be for a statewide program in California?"

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Stay tuned!

By this time next year, many of these PACE programs will have begun reporting results both in terms of energy savings and financing results. We will follow up as the PACE programs continue to emerge. E