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Political Battle Continues Over PACE Finance Issues As New Models Spring Up

The commercial market has developed its own version of PACE programs, while Congress sorts through legal issues.

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Property Assessed Clean Energy (PACE) programs were designed to provide funding for consumer-owned energy retrofits and on-site renewable energy projects by leveraging municipalities' access to capital and taxing authority. After the California State Assembly passed the first PACE program in 2008, roughly 20 states followed suit within the next two years and passed similar enabling legislation.

In summer 2010, however, the implementation of PACE programs came to an abrupt halt after the Federal Housing Finance Agency (FHFA) - the federal regulatory agency that oversees Fannie Mae, Freddie Mac and the Federal Home Loan Banks - issued a statement urging state and local governments to stop their PACE programs and laying the foundation for refusing to underwrite mortgages subject to PACE assessments.

Although most local governments suspended their PACE program after the FHFA's announcement, there are a number of ongoing efforts to revive or revise the PACE funding model. As the original vision of PACE works its way though judicial review and renewed legislative commitments, the marketplace has begun to redefine what PACE is and how it will contribute to the consumer-driven transformation of the energy landscape.

Under a PACE program, property owners may opt in to a special program set up by a state government in which Clean Energy Improvement Districts (CEIDs) are created in order to issue bonds. The money raised from the bonds creates a pool from which to make loans to residential and commercial property owners for the installation of approved clean energy equipment, such as PV arrays.

These loans are then paid back through special property tax assessment collections within five to 20 years, depending on the program, at an interest rate of between 3% and 7%. In return, the local government takes a senior tax lien on the property.

PACE initiatives around the country were immensely popular following California's implementation of the first program in 2008, because the model removed one of the most substantial hurdles for property owners in making energy improvements - access to loans for the upgrades. Loans for energy efficiency or distributed energy (located at the consumer site) projects were very difficult to obtain due to a lack of interest or understanding by lenders and the difficulty of lenders to establish adequate collateral to provide loan security.

FHFA's denunciation

In summer 2010, the FHFA announced that it would not support the purchase of mortgage loans with a PACE obligation if the PACE financing had priority over first-mortgage liens, which - at the time - was true of all PACE financing, as the PACE obligations were tied to higher-priority property tax rights. To the FHFA, and underwriters in general, that local governments would take a senior tax lien against a property in the event of default added an unacceptable layer of risk to mortgages.

This concern was, of course, intense in the wake of the collapse of the financial sector, which was driven by a broad failure to manage risk in pools of securitized mortgages. Although the initial reaction was that the FHFA's concerns may have been reasonable given the recent history of the mortgage market, the reality was that there is relatively little risk to lenders and underwriters from PACE programs.

Less than 1% of senior tax assessment liens on private properties experience losses, which means that private lenders benefit from energy retrofits that generate increased cashflow and the reduced risk of mortgage default.

Even if the property owner does default, the value of the seniority of PACE liens amounts to less than 1% of the mortgage value of the home. Perhaps most importantly, in the event of foreclosure, in general, only the back tax lien payment gets paid off before the mortgage, while the remainder of

the assessment continues as a lien on the property to be paid over time by subsequent property owners, so the actual risk of loss on default is limited to the unmade property tax payments, not the amount borrowed to finance the energy upgrades.

Both lenders and mortgage buyers have continued to resist even subordinate loans (loans to be repaid only once the primary mortgage holder has fully collected in the event of lender default) for renewable energy and energy efficiency projects attached to a residence.

The fallout

In response to the FHFA, most local governments suspended their PACE programs out of concern that mortgages within their jurisdictions could fail to receive the backing of Fannie Mae or Freddie Mac (and the potential for associated confusion) and that there was little value in risking high-quality credit ratings and the associated inexpensive capital for a program that the FHFA was clearly committed to opposing.

In addition, the U.S. Department of Energy redirected $150 million from federal stimulus funds that had originally been earmarked to encourage PACE programs around the country.

Following the FHFA's announcement, the Attorney General of California, local governments and the Sierra Club filed a series of lawsuits challenging the FHFA's position. U.S. District Judge Claudia Wilken of the Northern District of California issued separate orders holding the plaintiffs had standing to bring their claims for which judicial review was appropriate and requiring the FHFA to hold a notice and comment process concerning its approach to the PACE program.

In response, on Jan. 26, 2012, the FHFA issued an advance notice of proposed rulemaking (ANPR) concerning mortgage assets affected by PACE programs and a notice of intent to prepare an environmental impact statement under the National Environmental Policy Act to address the potential environmental impacts of the FHFA's proposed action.

The ANPR process will provide stakeholders with the opportunity to weigh in on the FHFA's position. Written comments for this ANPR must be received on or before March 26, 2012.

Prior to the ruling and subsequent release of the ANPR, the potential for a legislative fix had emerged. The PACE Assessment Protection Act (H.R. 2599), introduced by Rep. Nan Hayworth, R-N.Y., in July, is now slowly working its way through the U.S. House of Representatives.

The PACE Assessment Protection Act is designed to prevent the FHFA from adopting policies that contravene established state and local property assessed clean energy laws, while providing a set of benchmarks and requirements that PACE programs must incorporate to protect mortgage holders.

In an election year, with a number of items higher on the agenda and the rulemaking and judicial process now actively ongoing, it seems almost certain that Congress will wait to take further action on legislation concerning PACE until at least after the FHFA issues a final rule, and more likely not until after the election in November.

Despite the FHFA roadblock in the residential PACE market, the promise of this new financing platform and the early success of PACE programs created significant interest in the use of PACE or PACE-like financing in the commercial real estate sector to create a similar model. Commercial, or "open market," PACE has taken on different forms. These new versions require coordination among private banks, existing lenders, contractors, insurance underwriters and reinsurers.

In the most well-established approach, a bank or infrastructure fund will provide short-term loans to pay for renewable power such as solar photovoltaic arrays, as well as upgrades such as improved insulation, windows and doors, efficient lighting and mechanical systems. However, the banks must first obtain written consent from existing lien holders before any tax assessment can be levied.

The contractors installing the new equipment will offer warranties that the retrofits will generate savings on utility bills. Additionally, an insurance underwriter will back up the warranty, which will in turn be guaranteed by a large reinsurance company. Upon completion, these loans are bundled into long-term bonds similar to those issued by municipal CEIDs in traditional PACE. The bank or fund will market the bonds, which are repaid by tax surcharges on each property that has been retrofitted.

One example of this model is the PACE Commercial Consortium, which was created in September 2011 by the Carbon War Room, a nonprofit to be managed by California-based Ygrene Energy Fund. The consortium will provide up to $550 million in contracts for projects in Miami, Fla., and surrounding communities, as well as $100 million for projects in Sacramento, Calif.

The group has said the investments could create a combined $2.3 billion in economic activity and 17,000 jobs in the two metro areas. Similar programs are being designed and implemented in other cities, including San Francisco, Chicago and Ann Arbor, Mich.

The future of residential PACE appears to hinge on the judicial and legislative process. The FHFA's response to the stakeholder comments filed un-

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der its ANPR will likely guide the next response - whether from the courts or from Congress.

Although resolution and clarity would likely accelerate the use of commercial PACE, the market has stepped in and taken the opportunity, with some local and state support, to use the underlying concepts of PACE to develop some innovate financing platforms for consumer-based energy investment.

Commitments of capital, combined with support from contractors and insurers, can provide the basis for local governments to authorize bond initiatives and tax surcharges on properties to support the integration of energy efficiency and distributed-generation technologies such as solar. The public-private nature of this model will encourage much sought-after economic growth, job creation, reduced operating costs for property owners and the corresponding benefits that reduced congestion has on the infrastructure of the electric grid.