

ASSESSMENT FINANCE

For more than 100 years in the US, municipalities have levied assessments on their constituents to pay for upgrades to roads, sewers, schools, and other common assets that benefit the public good. A special assessment district is a defined area within a community in which property owners stand to benefit from an improvement project more significantly than the community in general. Essentially, the establishment of special assessment districts allows for communities to pay for improvements proportionately, based upon the extent to which certain areas will enjoy the benefits of the improvement, as those closer to the improvement, by virtue of benefiting more substantially from it, are charged more for the project.

The idea of special assessment districts has many applications. In 2007, for example, it was adapted by the city of Berkeley, CA to apply to renewable energy projects that could result in cleaner air and the mitigation of climate change. The application of special assessment districts to EEBE upgrades represents another innovative application of assessment financing, and its potential is most clearly exemplified by programs like Property Assessed Clean Energy (PACE).⁴⁰

PACE is a particular type of assessment financing that establishes an assessment district to finance not only EEBE projects but also renewable energy, water conservation, or other sustainability efforts.⁴¹ The creation of PACE financing districts is highly dependent on an individual municipality's property tax laws, and, in most cases, requires specific PACE-enabling legislation to be passed. The legislation must be built off existing financing and assessment authority of state and municipal statutes. Additionally, depending on the precise funding mechanism planned for the PACE project (many of which are discussed on page 37), steps may need to be taken to authorize the use of bonds to finance improvements, to insure that assessments are secured by liens on properties, or to authorize financing improvements on private property.⁴²

Projects approved for the special assessment district are paid for either by the municipality or by a third-party capital source like a fund or bank, meaning there is zero upfront cost to building owners. The EEBE financing instead works by attaching a special tax assessment in which the repayment obligation is actually attached to the property itself and not the property owner, and transfers to the new owner with the sale of the property. The participating property owners then pay off the debt via a property tax charge collected over the course of up to 20 years, though shorter periods may be used.⁴³ In most programs, estimated savings must exceed the investment amount. Figure 10 illustrates how payment flows occur between a municipality, lender, contractor, and property owner.

Given that property assessments usually qualify as eligible pass-through costs, PACE helps to overcome the split incentives of tenants and owners that can occur with triple-net-lease tenant-occupied buildings, such as commercial and multi-tenant residential buildings.

Ultimately, tenants benefit from the utility bill savings and also bear the costs of the PACE financing structure, while owners are able to monetize the soft benefits (associations with being green) and hard benefits (capitalization of energy savings) that accrue with carrying out retrofits.⁴⁴

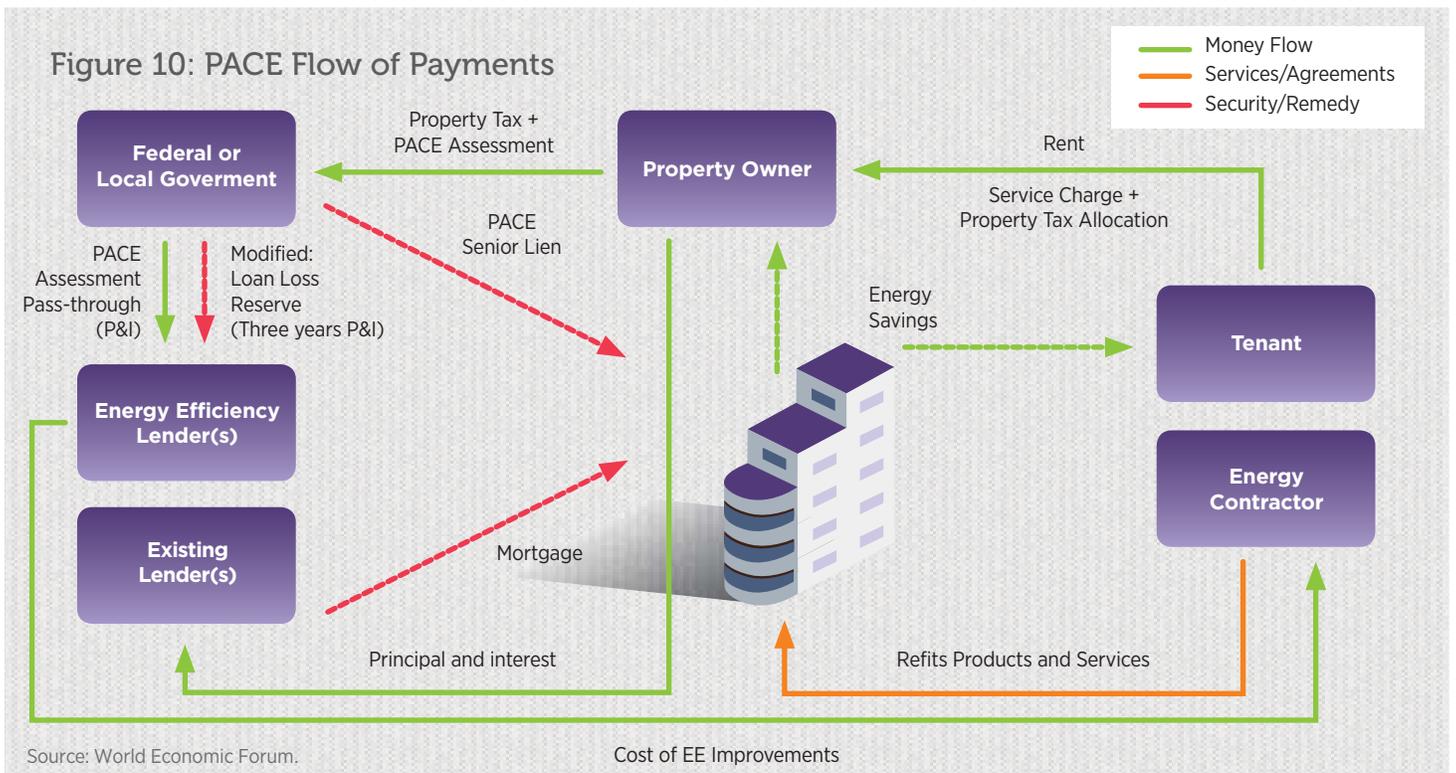
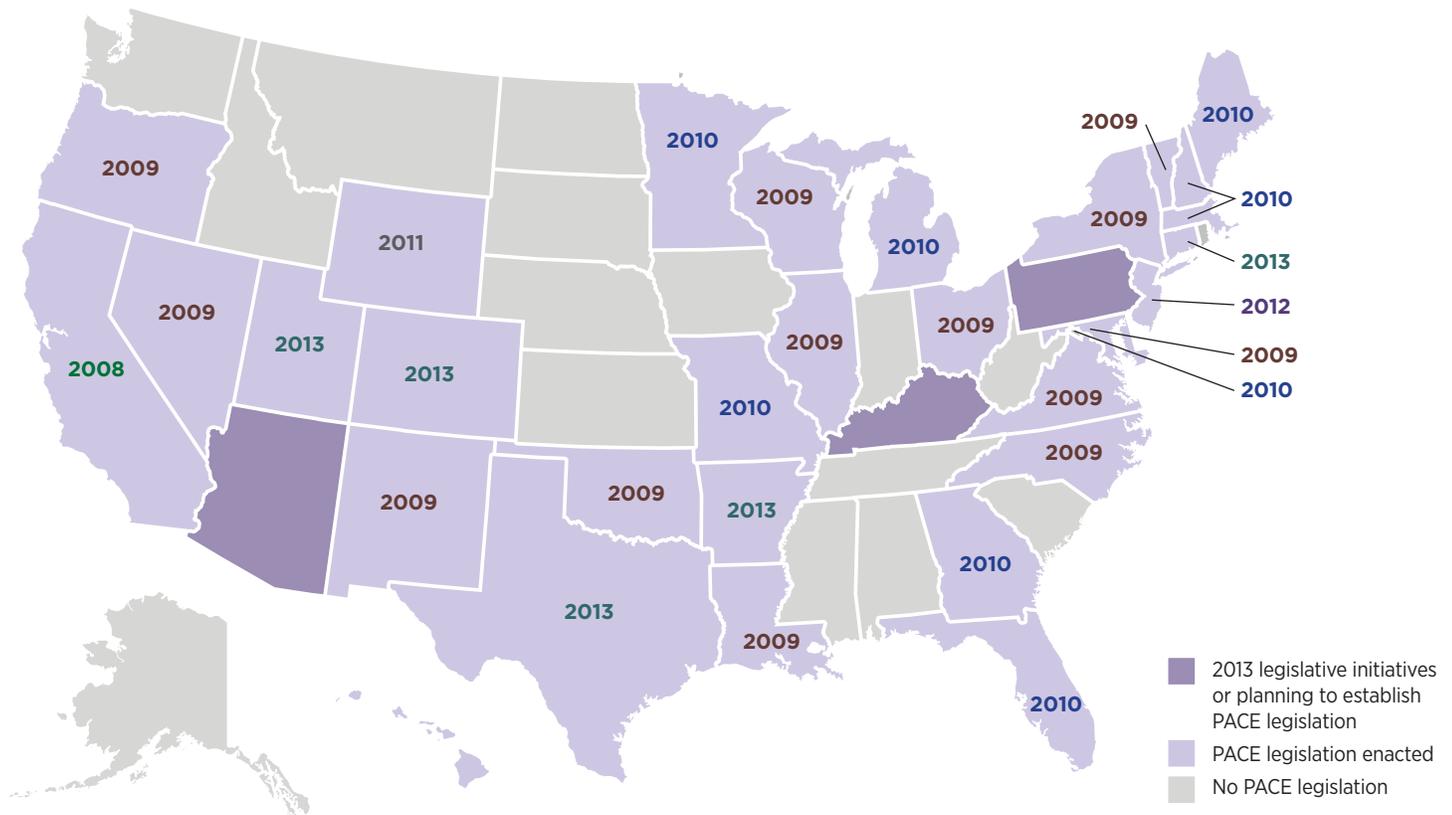


Figure 11: Status of PACE Enabling Legislation and Year Enacted



Source: PACENOW.

According to a baseline forecast scenario from a report by Pike Research, PACE will be used to finance retrofits for commercial properties at a rate of \$2.5 billion annually by 2015. The report estimates this investment will create 50,000 new jobs and prevent 8 million metric tons of carbon dioxide emissions. As of May 2013, approximately \$33 million in PACE renewable energy and efficiency deals have been completed in six states in residential and commercial buildings with an additional current pipeline⁴⁵ of \$100 million.

While some states have pursued this policy more aggressively than others, enabling legislation for PACE financing for commercial buildings has been passed in 30 states plus the District of Columbia, as Figure 11 above illustrates. Representatives Hayworth (R-Calif.), Lungren (R-N.Y.), and Thompson (D-Calif.) have also proposed federal legislation, called the PACE Assessment Protection Act of 2011, in the House of Representatives (H.R. 2599). That bill would increase the scope of PACE financing to include residential buildings by directing the Federal Housing Finance Agency (FHFA) to permit the PACE mechanism.⁴⁶ Despite these promising steps, one of the main impediments to rapid deployment has been confusion about the details of PACE.

PACE could be used to finance retrofits for commercial properties at a rate of \$2.5 billion annually by 2015 - according to Pike Research

⁴⁵ This pipeline is what has been reported by program administrators and has not been independently verified.

⁴⁶ "Financing Energy Efficiency Upgrades with Property Tax-based Repayment." Property Assessed Clean Energy Financing (PACE). Alliance to Save Energy. 2011. February 20, 2012. <http://ase.org/resources/property-assessed-clean-energy-financing-pace>

⁴⁷ For this reason, there is little, if any, standardized nomenclature for these programs. The Carbon War Room has attempted to consolidate existing literature into the most recognized names for these structures, but it should be noted that the models might have different names in other literature.

Existing PACE Structures

The following pages contain an examination of existing PACE structures and will attempt to delineate between the various models. As PACE is a relatively new financing mechanism to the market, it currently takes many different forms that depend on the legislative definitions of PACE in particular regions, and on the entities that are administering the PACE programs.⁴⁷ The Carbon War Room has chosen to try to simplify the myriad variations by defining four primary types of structures that support commercial PACE programs:

- 1. Municipally Financed:** In this model of PACE, a municipality uses a large line of credit, backed by the full faith and credit of the municipality, to fund qualified projects on an as-needed basis. When sufficient project volume is reached, the portfolio can be sold through a municipal revenue bond issuance. The proceeds of the sale can replenish the line of credit and facilitate a new funding cycle. As an example, please see the description of the Palm Desert Energy Independence Program in Palm Desert, CA, later in this document.
- 2. Pooled Bond:** In this model, a property owner's applications for PACE financing are approved during an aggregation period, which means that only once a sufficient number of approved applications have been assembled will the local government sell a bond to fund all of the projects at once. The ClimateSmart Loan Program in Boulder, CO is one such example.
- 3. Open Market:** In this model, property owners independently secure financing for a defined project with the lender of their choice. Financing terms are negotiated independently of the municipality and are predicated upon 1) senior lien position of PACE and 2) the underlying credit of the owner/building. This model avoids the timing delays associated with the pooled bond approach but still requires the consent of mortgage holders. With owner-arranged projects, terms are most likely to be 5–20 years with an interest rate of 5–8 percent—though given the ad hoc nature of funding methods for such projects, no published standardized rate exists. The Florida Green Energy Works Program uses this approach.
- 4. Owner-Preferred:** In this model, a vendor serving an active municipality pre-approves each qualifying property for assessment financing, which is usually limited to a maximum of 10 percent of the property's fair market value. The vendor either fully funds the program or pools projects before committing capital. All potential projects must meet strict underwriting guidelines. Some programs following the owner-preferred structure require the program administrator or the property owner to receive full consent from the primary lender, while others only require lender notification. Even in cases where only lender notification is required, if a mortgage holder can demonstrate that the assessment lien would violate the terms of an existing loan agreement, it may object to the assessment. In the event of a lender objection, property owners must meet additional requirements before proceeding (i.e., reversion to Open Market model). If the lender does not object, the vendor provides fixed-rate funding secured by individual PACE assessments. Amortized for terms up to 20 years, interest rates are fixed for the life of the assessment and are tied to a benchmark rate, such as US Treasuries, currently falling in the 5–6 percent range. The Clean Energy Sacramento Program in Sacramento, CA is an example of this model.

It should be noted that some PACE programs are designed with flexibility in several of the aforementioned structures. Unfortunately, describing every possible permutation of a PACE program is outside the scope of this paper. It should also be noted that none of the four structures described here have yet to show significant uptake in the market.

Generally, the Carbon War Room believes that the first three structures (Municipally Financed, Pooled Bond, and Open Market) have some important challenges to overcome. For example, both the Municipally Financed and Pooled Bond models require large numbers of projects to be aggregated for capital to be deployed, leading to long time horizons for project implementation. Open Market structures reduce the project development cycle compared to these other two. However, all three of these models typically (though not in every case) require explicit lender consent from mortgage holders. The Owner-Preferred structure, on the other hand, suffers less from these challenges. However, this model faces different challenges with respect to negotiations with mortgage holders, which will be discussed further in the Lender Consent section of this paper.

A potential advantage of the Owner-Preferred structure is that, if program administrators filter the PACE applications through a third-party vendor, and by pre-approving properties for financing, this model has the ability to easily scale to entire municipalities rather than relying on piecemeal applications retrofitting one building at a time.⁴⁸ The Carbon War Room recognizes that this perspective is not shared by all within the PACE community and therefore it is discussed in more detail in the Lender Consent section.

Table 2, overleaf, demonstrates the current (May 2013) status of commercial PACE-funded projects and those in development.

⁴⁸ For the purposes of full disclosure, the Owner-Preferred model was pioneered by the Carbon War Room-backed PACE Commercial Consortium, consisting of Ygrene Energy Fund, Hannover Re, Energi, and Lockheed Martin, with an initial \$650 million commitment from Barclays for the Miami and Sacramento markets. Projects began to be funded in Sacramento in January 2013.