PACE Financing Emerges As Project Financing Tool

January 10, 2012

Property assessed clean energy (PACE) is a financing initiative available in Ohio and 26 other states. In a nutshell, PACE is a way to access capital for alternative energy and energy efficiency projects using special assessments. This special assessment tool can be combined with other traditional public finance tools like bond financing or revolving lending to finance retrofits of publicly owned facilities, advanced energy components of commercial buildings, energy efficiency upgrades to industrial or manufacturing facilities and other similar projects. This article explores PACE as a project financing tool.

Origins of PACE Financing

In 2009, the White House released a policy framework for PACE financing programs to encourage states and local governments to adopt pilot or demonstration PACE programs.[1] The release of the policy framework coincided with the United States Department of Energy's release of guidelines for competitive grants under its Energy Efficiency Conservation Block Grant Program.[2] Together, these two federal programs sought to expedite the development of PACE programs at state and local levels.

The PACE policy framework described assessment-based financing as a known public finance tool:

> In a typical assessment district a local government issues bonds to fund projects with a public purpose such as streetlights, sewer systems or underground utility lines. Property owners that benefit from the improvement then repay the bond through property assessments secured by a property lien and paid as part of the property taxes.[3]

In other words, PACE was designed to extend market acceptance of known security mechanisms such as property tax-based assessments and tax lien status for unpaid assessments to facilitate alternative energy and energy efficiency projects.

As PACE has developed, three key policy distinctions have emerged that distinguish PACE from traditional assessment programs and that form the basis for many PACE laws enacted across the country, including Ohio's PACE program.

First, PACE is specifically intended for alternative energy and energy efficiency improvements whereas traditional assessment programs focus on infrastructure improvements like sidewalks, roads, water lines and sewer lines. Ohio's PACE law, Ohio Revised Code Ch. 1710,[4] specifically authorizes assessments for a basket of alternative energy and energy efficiency improvements.[5]

Second, PACE allows assessments for privately-owned improvements whereas traditional assessment programs establish assessments for publicly-owned improvements. In Ohio's PACE law, the General Assembly made a legislative determination that PACE financing was consistent with the purposes of Ohio Constitution, Article VIII, section 2o, including the "proper public purposes" of environmental, conservation, preservation and revitalization of private property. In addition, Ohio's PACE law contains special authority for transferring improvements acquired by an energy special improvement district (Energy SID) to private property owners.[6]

Third, PACE is an entirely voluntary assessment process whereas traditional assessment programs can involve involuntary, forced assessments on unwilling property owners. Ohio's PACE law requires all property owners seeking PACE projects to petition for inclusion within an Energy SID, and no property owner can force another to undertake or be assessed for an alternative energy or energy efficiency project.[7] In contrast, Ohio's traditional assessment laws permit a group of property owners seeking public infrastructure improvements to compel an unwilling property owner to receive an assessment for its fair share of the cost of such infrastructure improvements.[8]

PACE as a Project Financing Tool

PACE financing is ideal for a variety of projects. First, PACE makes economic sense for any project involving a significant amount of deferred maintenance. The energy savings generated by new improvements to existing office buildings, retail buildings, warehouses, manufacturing facilities and single-purpose sites can be significant and can support rapid repayment of the upfront capital investment in the improvements.

Second, PACE is well-suited for large, consistent users of power. Large users of power often find significant energy savings through energy efficiency upgrades or retrofits, and they often need or desire supplemental energy from alternative energy improvements like solar panels, geothermal systems, and wind turbines.

Third, PACE can be a creative way to finance publicly-owned alternative energy or energy efficiency improvements. A properly structured PACE program involving an Ohio municipality, county, school district or township can provide upfront capital for energy improvements to public buildings without impacting local debt limitations. In short, PACE can provide capital for a variety of projects and can be the sole funding source for a project or merely a small component of a larger project financing.

In Ohio, PACE assessments can be used to finance a variety of energy-related improvements, including energy efficiency, solar, geothermal, wind, biomass and gasification improvements.[9] In addition to alternative energy and energy efficiency improvements, other capitalizable improvement costs such as engineering, design, interest during construction, reserve funding and professional costs are eligible expenses in a PACE assessment financing.[10]

Importantly, Ohio's PACE law authorizes assessments for "energy efficiency improvements." Energy efficiency improvements are a valuable component of many projects because the energy savings generated by new improvements – including HVAC systems, lighting control systems and heat exchange technologies – can be significant and can serve as the indirect source for rapid repayment of the upfront capital investment in the improvements.

Ohio's definition of "energy efficiency improvements" allows for PACE assessments for any capital improvements that "reduce or support the reduction of energy consumption" or "allow for the reduction in demand" of energy.[11] This broad definition is helpful to allow for a conclusion that many project components qualify for PACE financing.

PACE financing involves a public-private partnership between the local government authorizing the establishment of an Energy SID for a project and the participating property owners. A key component of any project financing is the mechanism by which capital will be acquired by a local government to fund the upfront cost of the project. In a PACE project financing, a project owner makes a request of a local government to form an Energy SID and levy an assessment on the project site. The upfront capital for the project is acquired using the revenue stream generated by the assessments levied on the project site. There are several ways to monetize the future revenue stream generated by a PACE assessment.

First, a project owner can request the issuance of municipal bonds by a local government that are secured by the PACE assessment. In Ohio, such bonds would be "general obligation" secured by the full faith and credit of the local government issuing the bonds.[12]

Second, a project owner can request a conduit issuer of bonds like an Ohio port authority to issue bonds on behalf of the PACE project.[13] In this arrangement, a port authority uses its legal authority to issue bonds secured by an assignment of the PACE assessment and the local government can avoid being directly involved in the financing.

Third, a project owner can arrange for bank financing of the PACE project, and the Energy SID and the local government can assist in transferring the benefit of the future revenue stream generated by the PACE assessment to the project owner's lender. PACE financing involves application of Ohio's public finance laws and requires consultation with Ohio bond counsel.

Underwriting Guidelines for PACE Financing

PACE financing provides access to capital for a wide variety of projects, but each project is different and will be judged by market participants based on the credit of the project and its owner. Local governments, port authorities, underwriters, bondholders and banks will each examine the creditworthiness of a project and its owner differently. In the final analysis, whether a project can utilize PACE financing depends on the ability to pay assessments as evidenced by the financial strength of the project and the assessed property owner.

The ideal PACE project satisfies some or all of the following criteria:

- <u>The project should involve high-value investment</u>. PACE financing should involve high-value projects and should be limited to investments with a high return in terms of alternative energy or energy efficiency gains. More expensive projects make the use of PACE financing easier because a larger project will attract capital more easily and will mitigate the impact of financing and professional fees.
- <u>The project should not result in negative equity financing</u>. As a general matter, market participants will examine the value of the real estate – the ultimate security for an assessment-backed obligation – relative to the value of the project financing to determine whether a project is financially viable. PACE projects for risky owners (e.g. those with mortgages and other debts greater than the value of the assessed property) are particularly troublesome because of increased default rates. As a result, PACE owners should determine the value of their real estate to ensure that their existing debt, together with the PACE assessment obligation, will be significantly less than the value of the property.
- <u>The project property should have clear title with no encumbrances</u>. A PACE owner must be the proper legal owner of the property subject to the assessment, and title should be clear. A review of the property's title should show that (i) property taxes are current; (ii) there are no outstanding and/or unsatisfied tax liens on the property; (iii) there are no notices of default and/or other evidence of property-based debt delinquency on the property; (iv) the property owner is current on all mortgages on the property; and (v) there are no easements or subordination agreements that would conflict with the PACE assessment. If property does not have clear title, the consent of the other lien holders may be required before a PACE assessment can be placed on the property.[14] PACE projects involving high-value property without encumbrances will be viewed more favorably because the entirety of the value of the asset will be available to the secured lender if a default occurs.

- The project should have favorable savings-to-investment ratio. Each PACE project should be able to pay for itself, meaning that an investment should only be made if the property owner's expected savings on energy is greater than the expected increase in the cost of the PACE assessments.
- The project must have useful life longer than the term of the project financing. In Ohio, a PACE assessment may not be levied for longer than the expected useful life of the alternative energy or energy efficiency improvement.[15]
- The project might require credit enhancement. There are several ways in which the credit of a PACE project can be enhanced. One mechanism available is the establishment of a reserve fund to provide a backstop against late or missed assessment payments. The use of a reserve fund reduces the risk to mortgage lenders because initial delinquencies are paid out of the reserve fund instead of out of the proceeds of a lien foreclosure, thereby preserving the value of the lenders' collateral.

  A second mechanism employed in assessment financing is to establish the value of the assessment at a specific coverage ratio in excess of the debt service on the bonds or the loan made to fund the project. In this way, the secured lender is assured that debt service will be well-covered throughout the life of the project financing. A third mechanism available for project financing is a letter of credit provided by a banking or other financial institution. A letter of credit will pay debt service on the bonds or the loan made to fund the project in the event of a delinquency regardless of the underlying financial strength of the property owners.[16] Letters of credit can be difficult to obtain and often require annual renegotiation.

A project does not need to satisfy all of the criteria outlined above in order to be eligible for PACE financing, but the stronger the credit profile is for a project, the easier it will be to finance the project using PACE financing.

Ohio PACE Success Stories

Ohio already has PACE success stories to share. One example of a district-based program is the Toledo-Lucas County Port Authority's BetterBuildings Northwest Ohio program. Initially funded with U.S. Department of Energy Retrofit Ramp-Up grant funds, BetterBuildings uses PACE assessments and revolving loan funds to fund new energy efficiency improvement projects within the boundaries of the Toledo Ohio Advanced Energy Improvement Corporation, an Energy SID established under Ohio Revised Code Ch. 1710. New projects within the Energy SID can petition for funding through the BetterBuildings program.[17]

Ohio's district-based programs are important catalysts for project financing, especially in the urban centers in which they are located. However, it is expected that in the coming months and years PACE will emerge for individual projects independent of broader PACE districts. A PACE transaction for a single project allows a great deal of control over the scope of the project and the governance of the Energy SID and encourages flexible financing alternatives, but an individual project will need to be sufficiently large to substantiate the cost involved in establishing an Energy SID and seeking public financing for the project.

Footnotes

1. A copy of the Policy Framework is available on the White House website.
2. The DOE Guidelines are available on the U.S. Department of Energy website.
3. See the Policy Framework.
4. Before PACE was enacted in Ohio, Ohio Revised Code Ch. 1710 was a "special improvement district" statute limited to public infrastructure improvements for which assessments could otherwise be levied under Ohio Revised Code Ch. 727, Ohio's municipal special assessment statute. On July 17, 2009, Ohio House Bill 1 (HB 1) was passed to authorize PACE for solar photovoltaic and solar thermal improvements. On June 4, 2010, Ohio Senate Bill 232 (SB 232) was passed to authorize PACE for energy efficiency, wind, geothermal, biomass, and gasification improvements. Both HB 1 and SB 232 have been codified within Ohio Revised Code Ch. 1710.
5. Ohio Revised Code Section 1710.01(I).
6. Ohio Revised Code Section 1710.02.

7. Ohio Revised Code Section 1710.02(E); Ohio Revised Code Section 1710.06(B).
8. Ohio Revised Code Section 1710.02(E); Ohio Revised Code Section 1710.06(B); see also Ohio Revised Code Ch. 727.
9. Ohio Revised Code Section 1710.01(I).
10. Ohio Revised Code Section 1710.06; Ohio Revised Code Section 1710.07; Ohio Revised Code Section 727.08.
11. Ohio Revised Code Section 1710.01(K).
12. While such a structure might be legally permissible, unless the project were exclusively for a publicly-owned PACE project, it is highly unlikely that a municipality or township would be willing to pledge its own credit to such a financing.
13. See Ohio Revised Code Ch. 4582.
14. Because of underwriting restrictions placed on PACE programs by federal mortgage lenders Fannie Mae and Freddie Mac in 2009 and 2010, PACE financing is not available for residential properties on which a conventional residential mortgage is or is intended to be placed. Therefore, PACE financing is currently available in Ohio for commercial, industrial, nonprofit, and governmental use.
15. Ohio Revised Code Section 727.11.
16. The financial institution providing the letter of credit will undertake its own credit analysis of the property which are obligated to pay the PACE assessment, which would be the financial institution's source of repayment in the event of a drawing on the letter of credit.
17. More information about BetterBuildings Northwest Ohio can be found online at the Toledo-Lucas County Port Authority website.

Authors

John Caleb Bell

Partner & Public Finance Practice Group Chair

Columbus
614.227.2384
jbell@bricker.com