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Getting Ahead In The Commercial PACE Funding Race

Law360, New York (December 06, 2011, 1:09 PM ET) -- Property Assessed Clean Energy (PACE) legislation has been enacted in 27 states and the District of Columbia and will offer significant opportunities for owners of commercial facilities (e.g., office, retail, and industrial) (owners), PACE lenders and bondholders (program lenders), Energy Service Companies (ESCOs), existing property lenders (banks) and third-party administrators (TPAs) to benefit from a tax lien financing program that provides a business owner the ability to install energy retrofit equipment and components that could possibly create cash flow from day one and allow the owner to pay for the retrofit as part of the property tax bill. You can view a general model for PACE programs in Florida created by the combination of the state statute[1] and local ordinances here.

Three PACE Models

PACE programs will connect the owners and program lenders to the other parties, all of which have the ultimate goal of obtaining and funding energy performance upgrades. All PACE programs are alternate financing measures that provide alternatives to the two most prevalent problems with energy performance retrofits, the first being the availability of capital and the second being the ability to recover the investment before the asset is sold.

The structure of PACE programs is separated into the following three models, all of which have already been enacted by a few cities and counties in California, Colorado, Florida and New York:

The first model is a warehouse funding facility (Warehouse Model), where an investor makes available a line of credit for the cities and counties to use in funding the PACE program with the intention of reaching a critical mass of funding that results in bonds or other securities issued in order to replenish the line of credit. In Florida, this model is being presented to cities and counties by Ygrene Energy Fund Florida LLC at the Town of Cutler Bay and provides immediate funding at a scale that could allow multiple retrofit projects at one time.

The second model involves the issuance of bonds (Bond Model) to create a fund that the local government will then make available to the PACE program. The Florida PACE Funding Agency (Agency) is organized by Flagler County and the City of Kissimmee, and has validated the issuance (the bonds have not been sold) of $2 billion of bonds.

Although, both the Cutler Bay Warehouse and Flagler County Bond Models are set up so that i) other towns and cities can join these programs and ii) local governments will not be liable for any costs or liability under such programs, the Agency program claims to be a statewide program with one set of rules, procedures and guidelines for the entire state. Once the bonds are sold and this PACE program is funded, this Bond Model should be similar to the Warehouse Model.

The third model is known as owner-arranged financing (Owner-Arranged Model), where the owner finds a private institution or bondholder and specifically negotiates the rates and reserve requirements for the PACE funding needed. Renewable Funding LLC and Eco City Partners are promoting this model in San Francisco, California and Lantana, Florida.

The Owner-Arranged Model will have all the benefits of traditional PACE financing (e.g., the funding is repaid with special assessments that have priority over the existing mortgage) and may favor larger retrofits because the financing terms and draw schedule, schedule of performance, measurement and verification, and ESCO guarantee might be subject to greater modification and customization for a particular property. Additionally, the particular retrofit might not have to wait for bond terms to be agreed upon if the Bond Model was adopted but not yet funded.

However, most Owner-Arranged Models require the consent of the existing mortgage holder, whereas the other models require only that notice of any proposed PACE financing be given to existing mortgage holders. The issue with consent is the chance that the state and federal Constitutions prohibit the impairment of the contract rights established in a bank's existing mortgage. Some law firms point out that the courts have held that the prohibition on impairment is not absolute and believe that the PACE Programs fit within the impairment exception based on the public purpose of the PACE Programs, which would override any substantial impairment.

Each model is designed to allow a TPA to run the program, thereby reducing the amount of city or county employees/staff allocated to such PACE program. Of course, the TPA has to be paid a fee to administer the program, which is usually passed through to the owners as a cost of the program.

None of these models is funded in Florida as of this date, but they all are close. Each of the parties might take the following action to prepare for a fully operational and funded PACE program.

What Owners Can Do Now

- Confirm whether additional legislation needs to be adopted by your state or local community to enact PACE
- Explore your property's qualification for the program (e.g., no tax delinquencies, no involuntary liens, no mortgage notice of defaults)
- Catalog the potential benefits of the PACE program:
    - Probable improved cash flow
    - Tax lien financing frees up traditional financing that could be used for energy retrofits
    - Qualified ESCOs that are certified for the PACE Program will provide energy retrofits
    - Potential energy audits, performance guarantees, and available energy savings insurance
    - Sharing of retrofit costs with tenants and future owners

What ESCOs Can Do Now

Communities across the country are being pitched by PACE facilitators and potential TPAs to enact quickly a local PACE program/model, and any ESCO may want to position the ESCO as follows:

- Establish relationship with all PACE facilitators and TPAs for discussions on:
    - ESCO certification criteria
    - AUDIT requirements for each PACE program
    - Form of Energy Performance Contract that includes:
        - Form of energy savings guarantee
        - Measurement and verification protocols
        - Maintenance obligations
    - Frequency of draws for payment of the Energy Performance Contract services
- Weigh in on the political process for establishing the particular model adopted by the city or county
- Meet with selected program lenders for PACE funding, such as Bank of America, Wells Fargo and PNC, to help educate them about the ESCO — PACE process
- Prepare national marketing materials that demonstrate the ESCO is ready for and supports the development of PACE programs

What PACE Program Lenders Can Do Now

Warehouse lenders, bondholders, investment funds and Owner-Arranged PACE program lenders could do the following:

- Organize teams to a) determine the appetite for financing PACE programs and b) form policies for the asset-based PACE program financing
- Organize closing infrastructure (e.g., law firms and underwriters) for the special assessment financing, which is the foundation for repayment of this tax lien financing

What Banks Can Do Now

- Form a bank team to investigate PACE and formulate bank policies such as:
    - Confirming that PACE legislation has anti-acceleration provisions
    - Develop policies and timing for bank consent to PACE financing
    - Recognize improved borrower/owner strength via improved cash flow and enhanced value of secured assets
    - Develop underwriting to determine if Bank wants to be the program lender

What TPAs Can Do Now

- Assist cities and counties with any legislation required to implement a PACE program or join an existing PACE program.
- Design the model to allow multiple construction draws on financing arrangements more than a certain amount (e.g., $50,000).
- Publish a test run for one commercial deal from start to finish, together with a time line.
- Publish expected default payment procedures for when an owner defaults and does not pay the taxes and special assessments on a particular property, and the effect of the default (e.g., in Florida, tax certificates being purchased and not being purchased). One Warehouse Model requires the TPA to purchase the tax certificate if such tax certificate is not purchased (i.e., the addition of the special assessment might inhibit the purchase of a tax certificate). For cities and counties, this is important to prevent an interruption in the funds usually obtained from tax certificate sales.

Steps for Florida

See the following steps for the commercial Florida PACE program:

Step 1 involves the building owner making arrangements with the ESCO that is providing their energy retrofits to provide an audit or some assessment of the potential energy conservation measures. This process results in an energy performance contract being entered into between the building owner and the ESCO, where the ESCO agrees to perform and install certain energy conservation measures that will produce an amount of energy savings equal to or greater than the costs of the retrofit. The energy performance contract usually contains a guarantee of the energy savings, and the failure to realize the agreed-upon energy savings means that the ESCO must pay any shortfall to the owner.

Step 2(a) is an application to the city, county, or special taxing district that will be providing the funding for the energy performance contract.

Step 2(b) is a Florida law requirement that the existing mortgage holder of the building owner receive prior written notice of the proposed financing agreement, the maximum principal amount of the funding, and the maximum annual assessment. Section 163.08, Florida Statutes, does not require that the existing mortgage holder consent to the funding and the special assessments used to repay the funding. However, certain cities and counties may require the existing mortgagee consent based on the enabling legislation passed for the PACE program adopted by that city or county.

In Step 3, the city, county, or special taxing district — or a third-party administrator chosen by the city, county, or special taxing district — qualifies the owner to make sure there is reasonable evidence that there have been no tax delinquencies for the past three years, no involuntary liens (e.g., credit card judgments or other judgments), no notice of default of any existing mortgages for the past three years (e.g., a lis pendens recorded at the commencement of a foreclosure proceeding), and that the owner is current on all mortgage debt.

Step 4 occurs once the owner has been qualified and notice has been given to the existing mortgagee. The city, county, or special taxing district and the building owner enter into an approved financing agreement that also consents to the creation of a special assessment — all of which is finalized when a memorandum of the financing agreement is added to the public records.

Step 5 involves the city, county, or special taxing district either assigning the special assessment payment right to a bondholder or commercial lender, or granting a security interest in accounts held by the city, county, or special taxing district. This might be the result of the city, county, or special taxing district issuing bonds and granting the trustee of bondholders the security interest in certain collection accounts where the special assessments are deposited or certain reserve accounts that are funded by the collected special assessments.

Step 6 involves the installation of the energy conservation measures pursuant to the energy performance contract, which also discusses operation and maintenance liabilities that must be observed in order to maintain the performance guarantee obligation, and also involves measurement and verification decisions that are agreed to in the energy performance contract signed in Step 1. See Step 11 for a discussion of a possible payment and performance bond that might be required before any energy insurance company agrees to issue a policy on the energy-saving shortfall payments.

Step 7(a) involves construction draws from the bondholder, lienholder, or a trustee directly to the certified ESCO and the collection of lien releases in Step 7(b). Some funding models state that there is only going to be one draw that is made to the certified ESCO upon completion of the improvements. However, for larger commercial deals, it is anticipated that the ESCOs will demand periodic payments.

In Step 8, once the improvements are completed, the building owner will commence the payment of special assessments that will be collected by the city, county, or special taxing district via the tax rolls. This process commences in August of each year, resulting in the special assessments appearing on the tax bill to be paid commencing in November of the calendar year in which the special assessments are added to the tax roll and March 31 of the following year. There is no partial payment privilege for taxes and special assessments appearing on the tax bill, which means that the tax bill has to be paid fully or not paid at all. Unpaid taxes are subject to being collected by the sale of tax certificates. The holders of tax certificates can apply for a tax deed on the property two years after the nonpayment of such taxes.

In Step 9, the city, county, or special taxing district remits all collected special assessments to the bondholder, commercial lender, or a trustee.

In consideration for the payment of a premium from the ESCO to the insurance company (Step 10), which will be available to the building owner at an additional cost, most of the PACE funding models will offer an insurance policy that will insure the energy shortfall payments to the owner should the energy savings guaranteed by the energy performance contract not materialize (Step 11).

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[1] Section 163.08, Florida Statutes.