STAFF PAPER

Proposed Cancellation of Program Opportunity Notice 400-09-401

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Introduction

Since it was first conceived in Berkeley, California in 2007, Property-Assessed Clean Energy (PACE) financing has been recognized throughout the nation as a potential breakthrough mechanism to enable retrofits of existing buildings. In its December 2009 issue[1], Scientific American identified PACE financing as one of twenty "World Changing Ideas." At the time of this writing, twenty-three states enable the creation of PACE districts to finance permanent energy efficiency, water efficiency and renewable energy improvements.

The three California agencies responsible for developing and implementing energy efficiency and climate change policy and programs (Energy Commission, Air Resources Board, and California Public Utilities Commission) agree that achieving energy efficiency retrofits in existing buildings is a very high priority for the State. The Energy Commission has begun work to develop and implement a comprehensive program to achieve greater energy savings in California's existing residential and nonresidential building stock as part of its directive under Assembly Bill 758[2] (Chapter 470, Statutes of 2009). In addition, ARB's AB 32 Scoping Plan identifies improvement of the energy efficiency of existing residential and nonresidential buildings as the single most important activity to achieve reduced greenhouse gas emission reductions in the electricity and natural gas sectors. California's Energy Action Plan, Integrated Energy Policy Report, and Long Term Energy Efficiency Strategic Plan place high priority on achieving dramatically greater energy efficiency in existing buildings, including achieving an average energy savings of 40% in all California residential buildings by 2020. Such high levels of energy efficiency retrofits and the expansion of onsite solar electric and other renewable energy will not be possible without major expansion in the availability of effective financing to homeowners and nonresidential building owners.

PACE financing overcomes several barriers that block home and building owners from making investments in energy efficiency and onsite solar electric improvements. Firstly, PACE financing enables the amortized repayment of the cost of the improvements over time in parallel with the accomplishments of energy bill reductions resulting from the improvements. This allows the home/building owner to experience an immediate and ongoing positive cash flow.

In addition, repayment of the financing is an assessment on the property rather than a personal obligation of the property owner, and the assessment remains with the property if it is sold. This dramatically reduces the uncertainty and risk normally associated with the financing of energy efficiency and onsite solar projects. With other types of financing, repayment of the outstanding principle comes due at the time that the property is sold. Given that property owners are uncertain about how long they will own their buildings, and buildings are on average owned for as little as five to seven years, under other types of financing owners cannot be assured that they will receive enough energy bill savings to cover the costs of substantial energy improvements prior to their need to sell the property.

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[1] http://www.scientificamerican.com/article.cfm?id=world-changing-ideas

[2] http://www.energy.ca.gov/ab758/documents/ab_758_bill_20091011_chaptered.pdf

Also, most other types of financing readily available to property owners have shorter terms compared to the useful life of the improvements, so even if the buildings remain with the same owner for the entire term of the financing, the owner will likely not be reimbursed through energy savings by the time the principle must be fully repaid. PACE financing has the added advantage of providing funding for improvements without a down payment and enabling property owners to qualify more easily than with other financing.

California Supports PACE

California is a leader and innovator in the development and implementation of the PACE financing concept. In California, multiple cities and counties have directed both their own dwindling general funds and their ARRA Energy Efficiency and Conservation Block Grant funding to establishing PACE programs in an attempt to create jobs, save energy and meet their greenhouse gas emission reduction goals. The approach has been piloted in the City of Berkeley, City of Palm Desert and County of Sonoma (another important pilot of PACE financing has occurred in the County of Boulder, Colorado), and at least four other local governments in California have since followed suit, establishing their own PACE districts.

The success of these programs and the promise of PACE financing to enable local governments to create a means to take climate change action, improve the infrastructure represented by their local building stock, improve the local economy, create jobs and put their citizens back to work has resulted in a groundswell of interest in localities throughout California and across the nation. In planning how California should utilize its ARRA SEP funding, the Commission recognized the potential for empowering local governments through further piloting of strong programs that utilize PACE financing as an important tool to enhance the ability of achieving comprehensive and targeted residential and nonresidential retrofits. In early dialogue with DOE and Congressional leaders regarding California placing an emphasis on PACE financing via such local pilots, the Energy Commission received strong encouragement to follow up California's early leadership in PACE financing to take the next steps to expand these capabilities in model projects that other local governments in California and throughout the nation can learn from and replicate.

As a result, the Energy Commission invested $110 million of its ARRA SEP funding in pursuing a three-part competitive program solicitation for 1) municipal (PACE) financing, 2) municipal and commercial building targeted retrofits, and 3) comprehensive residential building retrofits. The Energy Commission designed the Municipal Financing Program to develop expanded PACE financing in California, which would in turn support comprehensive energy efficiency retrofits, simulate the green workforce and provide a foundation for the Commission's work under Assembly Bill 758. $30 million of the $110 million ARRA SEP total has been awarded to five proposals under the Municipal Financing Program and was expected to leverage $370 million, create 4,353 jobs, save over 336 million kilowatt-hours of energy, and avoid the emissions of 187,264 tons of greenhouse gasses over the contract period, which ends March 31, 2012.

Further support for PACE came in October 2010, when Vice President Biden announced that the Administration was backing the use of ARRA funding for PACE financing programs, which formed a major component of the Recovery through Retrofit Report[3].

PACE in California is enabled by Assembly Bill (AB) 811, Statutes of 2008, which allows cities and counties in California to create a program in which property owners may enter into contractual assessments to finance the installation of energy efficiency or renewable energy generation improvements that are permanently fixed to residential (including multi-family), commercial, industrial, or other real property. AB 474 (Statutes of 2009) expanded the law, including an authorization to fund water efficiency improvements. Under these municipal financing programs, property owners repay the assessments with their property taxes, and the liens associated with the assessments are given priority over previously-recorded private liens (such as a mortgage). In a lender letter issued September 18, 2009, Fannie Mae acknowledged this senior status, saying that, "Servicers should treat [PACE assessments] as any tax or assessment that may take priority over Fannie Mae's lien."[4]

Fannie Mae and Freddie Mac Target PACE

The position taken in September 2009 was reversed on May 5, 2010, when Fannie Mae issued a lender letter and Freddie Mac issued an industry letter; both letters advised their single-family loan sellers and servicers that "loans" with a priority lien over the primary mortgage are prohibited for their mortgage holders. No exceptions were indicated for property owners who had already joined PACE programs, or for PACE programs that were receiving federal funding through DOE.

DOE, the Office of the Vice President, private stakeholders and others worked with the Federal Housing Finance Agency (FHFA), which oversees Fannie Mae and Freddie Mac, to obtain clarification to the May 5 letters that would provide exemptions for PACE programs already in operation and for DOE-approved programs (i.e., programs receiving SEP or EECBG funding) following federal guidelines, released by DOE[5] on May 7, 2010, for the design of PACE programs that would provide protection against default on the contractual assessments and primary mortgages, safeguarding homeowners and lenders. DOE's Guidelines build from the October 18, 2009 "Policy Framework for PACE Financing Programs"[6] issued by the White House. The guideline provisions are expected to be met by the five awarded proposals under the Municipal Financing Program.

On July 6, 2010, FHFA unlawfully undermined the authority of local governments to issue priority lien tax assessments in a statement[7] that directed Fannie Mae and Freddie Mac to take punitive actions against homeowners who participate in PACE financing programs, although it did instruct the government-sponsored entities "to waive their Uniform Security Instrument prohibitions against such senior liens" for homeowners who already had PACE assessments on

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[3] http://www.whitehouse.gov/assets/documents/Recovery_Through_Retrofit_Final_Report.pdf
[4] https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2009/ll0709.pdf
[5] http://www1.eere.energy.gov/wip/pdfs/arra_guidelines_for_pilot_pace_programs.pdf
[6] http://www.whitehouse.gov/assets/documents/PACE_Principles.pdf
[7] http://www.fhfa.gov/webfiles/15884/PACESTMT7610.pdf

their properties. Because Fannie Mae and Freddie Mac purchase a large percentage of the nation's new home mortgages and also influence many other lenders, the new direction on PACE assessments is expected to severely harm citizens who would want to take advantage of this innovative method for financing energy improvements. Several existing PACE programs in California have already suspended their residential programs as a result.

The Office of the Comptroller of the Currency (OCC) followed with a bulletin[8], also on July 6, that referenced the FHFA statement and supplied somewhat vague guidance to national banks to exercise caution with their mortgage holdings in areas with PACE programs, including the suggestion of punitive actions against home and business owners. Because the bulletin was so generally worded and because OCC oversees banks that supply commercial mortgages, there is concern that a local government operating a commercial PACE program could find its residents subject to more stringent lending criteria for residential mortgages as a result. The White House, DOE and others are seeking clarification from the OCC on this matter, but until this clarification is issued, commercial PACE financing is on shaky ground.

FHFA's and OCC's recent direction flies in the face of over a century of lawful priority lien tax assessments issued by local governments to finance public benefits. In addition, in its July 6 statement, FHFA incorrectly asserts that:

- PACE assessments are "loans"
- PACE assessments "do not have the traditional community benefits associated with taxing initiatives" and
- "First liens for such loans represent a key alteration of traditional mortgage lending practice. They present significant risk to lenders and secondary market entities, may alter valuations for mortgage-backed securities and are not essential for successful programs to spur energy conservation."

PACE assessments are properly characterized as assessments because they are tied to the property itself. Loans, on the other hand, are made to an individual borrower and remain with that borrower; they are not tied to property. Regarding the second false statement, California law establishes the public benefit of PACE: "Energy and water conservation efforts, including the promotion of energy efficiency improvements to residential, commercial, industrial, agricultural, or other real property are necessary to address the issue of global climate change,"[9] and "the Legislature declares that a public purpose will be served by a voluntary contractual assessment program that provides the legislative body of any public agency with the authority to finance the installation of distributed generation renewable energy sources and energy or water efficiency improvements that are permanently fixed to residential, commercial, industrial, agricultural, or other real property."[10] FHFA's third false statement, that PACE assessments present a significant risk to lenders and secondary market entities, is contradicted by the fact that properties with assessments have a lower default rate than the average. Pilot PACE programs have been consistent with other tax assessments: properties in Sonoma County with a

[8] http://www.occ.treas.gov/ftp/bulletin/2010-25.html
[9] California Streets and Highways Code, 5898.14 (a) (1)
[10] California Streets and Highways Code, 5898.14 (b)

PACE assessment have a default rate of 1.2%, compared to 3.5% in the general housing stock, and properties in Berkeley's PACE program have no defaults.

Clearly, FHFA's and OCC's confrontational stance on PACE demonstrates a blatant disregard for the authority of local governments to make lawful property assessments and a lack of appreciation for the public value of this innovative financing mechanism for low risk investment in energy efficiency and distributed renewable energy generation. Unfortunately, the efforts of the White House and DOE to encourage sensible policies, with respect to coordinating PACE assessments and mortgage financing, fell on deaf ears at FHFA and OCC. This failure at FHFA and OCC has caused actions to be initiated to correct the problem: the California Attorney General, supported by Governor Schwarzenegger, filed suit on July 14, 2010, against Fannie Mae, Freddie Mac and FHFA, and federal legislation may be introduced that would override FHFA's and OCC's objections to PACE. FHFA's actions have also been publicly opposed by, among others, the California Public Utilities Commission[11] and the Mayors of San Diego and San Francisco[12].

Effect on the Municipal Financing Program

Program Opportunity Notice #400-09-401, which detailed the requirements of the Municipal Financing Program and solicited proposals, specifically targeted projects to implement or expand local programs incorporating first-priority PACE liens. No other types of financing programs were requested from or proposed by the sixteen local governments that submitted proposals to this solicitation.

In the aftermath of FHFA's direction and OCC's guidance, DOE and the Governor's Recovery Task Force have called on the California Energy Commission to explore other financing options with SEP funds:

> DOE: "The DOE and Administration continue to support pilot PACE financing programs. Recovery Act grantees are not expressly prohibited from using funds to support viable PACE financing programs, however the practical reality is that residential PACE financing programs with a senior lien priority face substantial implementation challenges in the current regulatory environment. In light of the clear opposition from the regulators for PACE financing programs with a senior lien priority, prudent management of the Recovery Act compels DOE and Recovery Act grantees to consider alternatives to programs in which the PACE assessment is given a senior lien priority."[13]
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> Governor's Recovery Task Force: "On October 8, 2009, your Commission issued Solicitation Number 400-09-401 and is now in the process of contracting with several entities as part of your Municipal Financing Program. However, due to recent decisions by Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency that would

[11] http://www.cpuc.ca.gov/NR/rdonlyres/413755D4-58CD-412E-A428-3E2AE7718298/0/PACELetter_071310.pdf
[12] http://www.sacbee.com/2010/07/16/2893861/fannie-and-freddie-put-brakes.html
[13] http://www2.eere.energy.gov/WIP/PACE.HTML

prevent the continuation of PACE programs, it is evident that the efforts of the [Energy Commission] to use the PACE financing model no longer constitutes a viable option.

"I am calling on the [Energy Commission] to adapt to the changed regulatory landscape in a way that will allow full obligation of the reallocated funds by September 30, 2010. If the [Energy Commission] does not respond to the challenges recently imposed by aforementioned federal entities, the [Energy Commission] is teetering on failing to honor both Governor Schwarzenegger's Executive Order and the federal mandate to put Recovery Act funds to work for the American people as quickly and efficiently as possible. Every day that passes without action by the [Energy Commission] increases the chance that stimulus funds so vital to California's recovery could be rescinded. The Governor has indicated in the past that any rescission of Recovery Act funds is unacceptable. Therefore, it is incumbent upon the [Energy Commission] to immediately find ways to encumber State Energy Program funds in a manner that prioritizes expediency and viability."[14]

The Energy Commission strongly supports the intent of the Municipal Financing Program's PON to develop and pilot in regions around the state PACE financing, the authority for California local governments to provide PACE financing through property assessments, and the extensive efforts at the local level over the past year plus to develop this innovative approach, as demonstrated by the awards made under this PON.

At this time, however, staff believes that it is necessary to broaden the range of financing approaches beyond PACE so that ARRA funds can be put to use at the earliest possible time. Staff believes that it is imperative that the Energy Commission act with all possible haste to encumber the funds under the Municipal Financing Program in a manner that allows alternate financing options in order to ensure that the benefits of this program are not lost.

Staff Recommendations

To this end, the staff recommends adopting the proposed amendments to the *State Energy Program Guidelines* (*SEP Guidelines*), to allow flexibility in the type of mechanisms used to finance the energy efficiency, water efficiency and distributed renewable energy generation retrofits under the Municipal Financing Program. The revised *SEP Guidelines* will be considered by the Energy Commission for approval at the August 6, 2010, Business Meeting.

Similarly, the staff recommends adopting similar amendments to the *Energy Efficiency and Conservation Block Grant Guidelines (EECBG Guidelines)* to permit the same flexibility where the projects initiated by local jurisdictions support or seek leverage from municipal financing options.

Staff further recommends that the Energy Commission cancel PON #400-09-401 along with the Notice of Proposed Awards (NOPA) issued for the solicitation, because the feasibility and viability of the selected projects have been virtually eliminated by the FHFA and OCC determinations. In order to meet the fast-approaching obligation and expenditure deadlines

[14] July 15, 2010 letter from Rick Rice of the California Recovery Task force to Chairman Karen Douglas

associated with the ARRA SEP, cancellation of the PON would release the $30 million currently encumbered by the NOPA and make it available for the Energy Commission to respond quickly to the changing regulatory landscape. Coupled with the flexibility in the proposed amendments to the *SEP Guidelines*, the Energy Commission would be able to redirect the funding to other activities permitted by the federal SEP grant, including investments in statewide and local energy efficiency financing programs that incorporate financing options not at risk from the FHFA and OCC determinations. Investment in alternative financing options would allow the State to continue laying the foundation for comprehensive energy efficiency retrofits as part of the Commission's Assembly Bill 758 program and developing California's clean energy workforce.