The Great PACE Controversy
Renewable Energy Financing Program Hits a Snag

By Jonathan B. Wilson, Maura A. Marcheski, and Elias B. Hinckley

Jonathan B. Wilson is a lawyer in the Atlanta, Georgia, office of Taylor English Duma LLP. Maura A. Marcheski is an associate in the Washington, D.C., office of Venable LLP. Elias B. Hinckley is a partner in the Washington, D.C., office of Kilpatrick Townsend & Stockton LLP.

Property Assessed Clean Energy (PACE) programs were embraced with great fanfare during the past several years as an innovative financing tool for local governments to encourage investment in clean energy projects. Enthusiasm for these programs has stalled in the last year, however, under concerns about the collateral impact these programs may have on mortgage lenders and struggling local government budgets. Although these local efforts have been endorsed by President Obama and the Secretary of Energy, the programs have come under fire by other elements of the Obama Administration and have become bogged down in the ensuing controversy.

This article explains the mechanics of PACE programs and the benefits they present for property owners and local communities. The article then discusses the controversy that has erupted over the programs and some of the efforts being made to break the impasse.

How PACE Programs Work

The concept of PACE programs is fairly simple: local governments use their bonding authority to raise funds that can be lent to public entities, private organizations, or individuals within the community to invest in renewable energy projects for their respective properties. The borrowers then repay the loans through an additional assessment on their property taxes.

PACE financing is attractive to property owners for two main reasons. First, it helps individuals and businesses avoid the high up-front costs that are a common barrier to solar installation and energy-efficiency upgrades. Although most renewable energy projects eventually pay for themselves in reduced energy costs, property owners are often reluctant (or unable) to make the initial outlay in cash. Moreover, because the payback period may range anywhere from 5 to 20 years, most commercial banks and mortgage lenders were reluctant to lend on such a long-term basis against collateral (such as a rooftop photovoltaic installation) that would have questionable foreclosure value and might fall second in line behind a senior mortgage lender. See generally PaceNow, http://pacenow.org/blog (last visited Feb. 21, 2011). PACE financing allows the property owner to pay for the project through a long-term, fixed-cost financing option that is underwritten by the value of the property (and not the property owner's credit). At the same time, the homeowner should see reduced energy costs as a result of the project, which would offset the increased property tax assessments required to repay the loan.

The second barrier that PACE programs address is the concern of property owners that they will not be able to recover their costs if they sell the property. Because PACE financing runs with the property, the buyer acquires not only the benefit of the energy improvements but the remaining payment obligation as well. In this way, PACE financing is intended to encourage renewable energy and energy efficiency investments even when the current owner may not retain ownership long enough to completely recoup the investment.

By removing these barriers, PACE programs offer several benefits to individual property owners as well as the community. Renewable energy and energy efficiency improvements should lead to lower energy bills for home or building owners, resulting in greater cash flow and higher property values. The community as a whole also benefits from PACE programs because they create jobs and help produce a sustainable green economy. They do so, however, without imposing burdens on other taxpayers because only those property owners that choose to participate are responsible for the costs of PACE financing. Each borrower repays his or her own financing and the tax lien on each property secures only the owner's individual obligation to pay.

Finally, there are benefits at the national level as well. Because PACE programs are locally funded, they have a very low fiscal cost to the federal government; thus, the programs promote energy security without federal regulation or increasing general energy taxes. In short, PACE financing enables owners to reduce carbon emissions while providing immediate energy savings for residents who take advantage of the program.

To implement a PACE program, local governments must have statutory authority to both issue bonds and use the bond proceeds to finance renewable energy projects. Typically, local governments create statutorily authorized special assessment districts, similar to those used for other public projects. Berkeley, California, and Boulder, Colorado, were early adopters of high-profile PACE programs. In 2008 Berkeley established the Financing Initiative for Renewable and Solar Technology (FIRST), which lent to property owners for the installation of solar photovoltaic electric systems and allowed the cost to be repaid over 20 years. See Berkeley FIRST, www.ci.berkeley.ca.us/ContentDisplay.aspx?id=26580 (last visited Aug. 27, 2010). In 2008, Boulder County, Colorado, authorized the issuance of $40 million in bonds to support a program that provides tax assessment "loans" from $15,000 to $50,000, to be repaid over 15 years at interest rates ranging from 6.75%–8.75%, Laura Snider, *Boulder County Suspends Residential ClimateSmart Loan Program Indefinitely*, ColoradoDaily.com (June 29, 2010), www.coloradodaily.com/ cu-boulder/_15401665#axzziEdVDvfym (last visited Feb. 21, 2011), although this program is on hold as of this writing because of mortgage underwriting concerns discussed below. See ClimateSmart Loan Program, www.climatesmartloanprogram.org (last visited Feb. 21, 2011). As PACE programs gained popularity, several states, including California, Colorado, Florida, Hawaii, Illinois, Louisiana, Maryland, Nevada, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Vermont, Virginia, and Wisconsin, passed laws authorizing local governments to establish similar programs.

After the initial fanfare following the Berkeley and Boulder programs and the subsequent adoption of PACE programs by more than a dozen states, PACE programs received a boost from the Obama Administration in the form of $100 million in stimulus funding. Since that initial burst of excitement, however, concerns over the implications of these programs have stalled the implementation of PACE across the country.

Local Government Debt Constraints

Virginia was one of the many states to authorize PACE. But Arlington County, perhaps the most progressive community in the state, is on record as having no plans to create a local program because of debt concerns. "Arlington is unlikely to float its own bonds for this, as the County is facing its self-imposed debt ceiling to maintain the coveted Triple-A bond rating." See Arlington County Statement, www.arlingtonva.us/departments/DES-CEP/Community EnergyPlan/documents/file76405.pdf (last visited Aug. 27, 2010). The PACE program would impose a significant administrative burden on the county. Embedded in the announcement was additional language: "For PACE financing to work," the statement read, "realtors, mortgage lenders, and mortgage underwriters would need to be comfortable with its application in the housing market." Arlington County recognized a serious flaw in the PACE program: although community governments may enjoy access to relatively inexpensive capital, that capital supports a broad range of community funding obligations, from roads to schools to emergency services. Increasing a community's total debt obligation, which a PACE bond issuance would do, can result in a lower credit rating for the community, which in turn increases capital costs for all community programs.

Mortgage Underwriters

Arlington's statement highlighted another very significant and growing problem: mortgage underwriters had concerns about the effect of the programs on traditional mortgage lenders. Standard government tax assessments—ones that are used to fund public projects—typically have senior lien priority over mortgages. Mortgage underwriters feared that the loans secured by mortgages would become subordinate to PACE liens and as a result would not be readily sellable on the secondary mortgage market. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), under the conservatorship of the Federal Housing Finance Agency, articulated this concern in a May 5, 2010, letter. It alerted lenders that the government-backed mortgage companies are construing PACE financing commitments as loans, stating that "the terms of Fannie Mae/Freddie Mac Uniform Security Instruments prohibit loans that have senior lien status to a mortgage." Letter from Fannie Mae to All Fannie Mae Single-Family Sellers and Servicers (May 5, 2010), available at www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2010/ll1006.pdf. The May 5 letter also stated that Fannie Mae and Freddie Mac would provide additional guidance should the programs move beyond the experimental stage.

FHFA July Statement

On July 6, 2010, the Federal Housing Finance Agency (FHFA) issued a statement that the PACE program's superior lien priority presents a risk to lenders and violates original lending guidelines. FHFA set forth a requirement that Fannie Mae and Freddie Mac not accept PACE financing because it "present[s] significant risk to lenders and secondary market entities" that could change the value of mortgage-backed securities. FHFA Statement on Certain Energy Retrofit Loan Programs (July 6, 2010), available at www.fhfa.gov/webfiles/15884/PACESTMT7610.pdf. The statement directed Fannie Mae and Freddie Mac, as well as the Federal Home Loan Banks, to "waive their Uniform Security Instrument prohibitions against" senior liens for any homeowner that has already obtained a PACE loan with a first lien, protect the soundness of their operations, and "review their collateral policies in order to assure that pledged collateral is not adversely affected by energy retrofit programs that include first liens." Id.

The Office of Comptroller of the Currency (OCC) released a concurrent bulletin on July 6, 2010, echoing FHFA's concerns about PACE programs and stating: "This lien infringement raises significant safety and soundness concerns that mortgage lenders and investors must consider." Office of the Comptroller of the Currency Bulletin on Property Assessed Clean Energy (PACE) Programs, OCC 2010-25 (July 6, 2010), available at www.occ.gov/ news-issuances/bulletins/2010/ bulletin-2010-25.html. The OCC bulletin urged national banks to be aware of FHFA directives and the availability of PACE programs in their jurisdictions. The banks were further urged to "carefully consider the programs' impact on both banks' current mortgage portfolios and ongoing mortgage lending activities."

Support for PACE Programs

Despite the position of FHFA and OCC, other federal agencies and the White House continued publicly to support PACE programs as a tool for job creation and clean energy growth. In response to the recent FHFA statement, additional state and federal officials have come forward to support continuing PACE programs. California, a state with strong PACE support, has taken specific action against the FHFA's statement.

The Administration's Support for PACE

The Department of Energy (DOE) and President Obama's administration issued policy frameworks and guidelines to support the implementation of PACE financing programs. The White House's Policy Framework was released in October 2009, and DOE's best practices guidelines for implementing PACE programs were issued on May 7, 2010, just after the publication of the May 5 letters from Fannie Mae and Freddie Mac.

The White House Policy Framework was released concurrent with a Funding Opportunity Announcement for competitive grants under the Energy Efficiency Conservation Block Grant Program. Under the State Energy Program, DOE also received $80 million to pilot PACE programs. In its description of the general parameters of PACE programs, the White House Framework pointed out the following critical distinction for liability of assessments if foreclosure results:

> Importantly, as a protection for mortgage lenders on the property, liability for the assessment in foreclosures should be limited to any amount in arrears at that time, and the full costs of the improvement are not accelerated or due in full. The assessment runs with the property at law and successor owners are responsible for remaining balances.

White House Policy Framework for PACE Financing Programs (Oct. 18, 2009), available at www.whitehouse.gov/assets/documents/PACE_ Principles.pdf.

This issue has been a focal point for mortgage underwriters' concerns about PACE as well as the key point of FHFA's July statement. The apprehension persists despite arguments by proponents that the limit on liability to the amount in arrears at that time, as opposed to the whole PACE assessment, significantly reduces the exposure that mortgage lenders face as a result of PACE participation if homeowners default. See, e.g., PACENOW Response to FHFA/OCC July 6 Statements That Block PACE (July 12, 2010), available at http://pacenow.org/documents/Response%20to%20FHFA%20 Statement%207.12.10.pdf.

In addition, the DOE Guidelines for Pilot PACE Financing Programs provide best practice guidelines for the administration of community programs. The DOE described its guidelines as "significantly more rigorous than the underwriting standards currently applied to land-secured financing districts." Department of Energy Guidelines for Pilot PACE Financing Programs (May 7, 2010), available at www1.eere.energy.gov/wip/pdfs/arra_guidelines_for_pilot_pace_ programs.pdf. Generally, the guidelines addressed the savings-to-investment ratio, the size and term of the assessment, notice and non-acceleration of liens, quality assurance and anti-fraud measures, rebates and tax credits, participant education, data education, and underwriting standards.

A Possible Legislative Mandate

In response to the concerns about PACE programs, federal legislators introduced the PACE Assessment Protection Act of 2010, which was designed to protect clean-energy initiatives across the country that are financed through PACE programs. Congressman Mike Thompson (D-Cal.) introduced the bill, H.R. 5766, with 29 cosponsors in the House of Representatives. Identical companion legislation was introduced in the Senate by Barbara Boxer (D-Cal.), Jeff Merkley (D-Ore.), Kirsten Gillibrand (D-N.Y.), and Mark Begich (D-Alaska). Senator Boxer said: "The current uncertainty surrounding PACE programs is jeopardizing $110 million in federal investments for California communities, which is simply unacceptable. We must take action to protect these initiatives because they create jobs, save homeowners money on their energy bills and help our environment." Press Release, Boxer, Colleagues Introduce Legislation to Protect Clean-Energy Initiatives (July 22, 2010), available at http://boxer.senate.gov/en/press/releases/072210.cfm.

The bills would have prevented FHFA and underwriters from "discriminat[ing] against communities implementing or participating in a PACE program, including by prohibiting lending within the community or requiring more restrictive underwriting criteria for properties within the community." See H.R. 5766, 111th Cong. § 2(b). In addition, the legislation would have mandated the adoption of underwriting standards aligned with the DOE guidelines released in May 2010. These underwriting standards would have explicitly incorporated the White House Policy Framework to provide that, "in the event that a tax or assessment under a PACE program is delinquent, only the unpaid delinquent amount along with applicable penalties, interests, and costs will be subject to foreclosure and not the entire amount." See S. 3642, 111th Cong. § 2(a).

In addition, in a letter dated July 2, 2010, Rep. Henry Waxman (D-Cal.), then chair of the House Energy and Commerce Committee, and Rep. Barney Frank (D-Mass.), then chair of the House Committee on Financial Services, called for Treasury Secretary Tim Geithner, Energy Secretary Steven Chu, and FHFA Acting Director Ed DeMarco to establish guidelines for the administration of PACE programs. See Letter from Reps. Henry Waxman and Barney Frank to Treasury Secretary Tim Geithner, Energy Secretary Steven Chu and FHFA Acting Director Ed DeMarco (July 2, 2010), available at http://af.reuters.com/article/energyOilNews/idAFN0221314120100703. Representatives Waxman and Frank praised the Administration and the objectives of PACE programs and urged that the questionable status of PACE programs be resolved quickly to permit these programs to continue. The letter also attempted to ease the concerns of participating homeowners about the current status of their mortgages, stating: "[W]e ask that homeowners participating in the pioneering PACE programs already in operation be immediately assured that they are not in violation of their loans."

California Sues to Save PACE

California's Attorney General Jerry Brown filed suit against FHFA, claiming the agency did not complete the required environmental review in violation of the National Environmental Policy Act (NEPA). Under 42 U.S.C. § 4321, a major federal action that may significantly affect the human environment cannot be approved without an environmental assessment or environmental impact statement. The lawsuit argues that FHFA's failure to comply with NEPA constitutes arbitrary and capricious agency action, is an abuse of discretion, and is contrary to procedures required by law. See Complaint at 14, *California v. Federal Housing Financing Agency*, No. C-10-03084 (N.D. Cal. 2010). In the pending case, the court will have to resolve whether the mortgage industry's concerns will limit the viability of PACE programs and whether FHFA's July statement and the lender letters represent "final administrative determinations."

The county of Sonoma filed a separate suit claiming that the FHFA, Fannie Mae, and Freddie Mac violated the right of state and local governments to determine which public purposes can be addressed by local governments using their constitutional authority. FHFA's statement in response to these lawsuits states that FHFA will "defend vigorously its actions that aim to protect taxpayers, lenders, Fannie Mae and Freddie Mac." Statement of FHFA Acting Director Edward J. DeMarco on PACE Programs (July 14, 2010), available at www.fhfa.gov/webfiles/15963/PACE_ststament_7_14_10.pdf.

California Governor Arnold Schwarzenegger also issued a strong statement against the dismantling of PACE programs, stating that "achieving energy independence has always been a top priority in my administration, and it would be preposterous to do away with a program that will create jobs, provide energy savings and benefit our environment. That is why I urge quick resolution to this lawsuit to allow the continuation of PACE programs in California." Press Release, Office of the Governor of California Arnold Schwarzenegger (July 6, 2010), available at http://gov.ca.gov/index.php?/ press-release/15545.

In addition, the president of the California Public Utilities Commission, Michael Peevey, petitioned the state's congressional representatives to intervene on the FHFA decision. On July 14 he wrote a letter to California's 53 house members and two senators stating that the FHFA's decision could terminate more than $450 million energy-efficient retrofit projects. Peevy wrote that PACE has become "an innovative local government tool that eliminates the upfront cost associated with energy efficiency, renewables and water conservation retrofits." Letter from California Public Utilities Commission to Members of the California Congressional Delegation (July 13, 2010), available at www.cpuc.ca.gov/NR/rdonlyres/413755D4-58CD-412E-A428-3E2AE7718298/0/PACELetter _071310.pdf.

Public Debate and Activism

Public debate over the benefits of, and drawbacks to, PACE programs has grown following FHFA's statements and subsequent governmental actions. Those with concerns about PACE programs are worried that the programs do not have adequate safeguards in place to protect both consumers and lenders. PACE supporters cite the White House and DOE guidelines as providing adequate protections, adding that changes to the PACE repayment structure limits mortgage lender exposure.

FHFA views PACE programs as an impractical departure from traditional mortgage lending practices and as harmful to existing mortgage lenders because of potential subordination issues and the resulting effect on valuations on the secondary mortgage market. Finally, the concern that PACE programs will significantly alter traditional lending priorities means that appropriate changes to PACE programs must be made before PACE programs would mesh with existing mortgage practices.

PACE backers contend that many of these risks were cured by the requirement that when a home is in foreclosure, only the past due PACE payments would be senior to the existing mortgage, not the remaining balance of the entire assessment. Some mortgage underwriters have expressed doubt that this fix is viable. The balance of PACE retrofit charges is assumed by the new home buyer. PACENOW, a grassroots organization dedicated to advocacy of PACE programs, argues that this change reduced PACE senior lien exposure from the entire cost of the upgrades ($15,000 on average) to only the delinquent back payment, approximately $1,500. PACENOW further argues that because mortgage defaults range from 5% to 10%, potential exposure for mortgage lenders is only between $75–$150 per PACE home.

PACE advocates also note that energy efficient retrofits would result in greater cash flow to the property owner, preventing mortgage delinquencies before they happen. They suggest, although concrete evidence does not currently exist to prove the point, that because households will be saving money on their energy bill every month, fewer PACE households will reach foreclosure. Some have questioned whether PACE programs will produce meaningful reductions in energy consumption or savings to homeowners, but PACE supporters point to the requirement that property owners conduct up-front energy audits in order to identify cost-effective and energy-saving plans that can be measured and verified.

A Path Forward?

Though appearing simple and straightforward, PACE has raised concerns that may prevent the widespread adoption of these programs. The evolution of the energy industry and emergence of the clean energy economy have created tension on a number of fronts as new technologies and applications are integrated into existing institutions. The implementation of PACE programs requires changes in existing infrastructure and regulation and, therefore, is inconsistent with important elements of the established mortgage and real estate finance process. A solution will require understanding on both sides of the goals and limitations of the other, and a willingness to work toward a manageable solution for all involved.

If, or how, this impasse gets resolved is unclear at the time of this writing. The pending lawsuits may provide clarity, but not for some time if the litigation follows the expected path through trials and the appellate process. Legislation could provide a quick path forward for PACE; although without a resolution to address the interests of mortgage underwriters, additional litigation could cloud the future of a legislative mandate.

An open dialogue between the affected parties could produce a workable solution. The easiest and fastest path to achieving the goals of PACE supporters and ensuring that mortgage markets are not disrupted would seem to be developing a program that meets the needs of mortgage underwriters, the secondary mortgage markets, and the communities that would issue supporting bonds yet still promote a simple accessible financing platform for individuals and businesses to make clean energy and energy efficiency investments.

By fall 2010 some work was underway to broker such a compromise, such as the dialogue pursued by Congressman Steve Israel (D-N.Y.) and Congressman Mike Thompson (D-Cal.). The compromise would have required some substantial work, because the complexities of both the clean energy marketplace and the real estate finance universe would need to have been reconciled. The odds of a legislative outcome, however, were reduced by the outcome of the November 2010 mid-term elections, because the Republican takeover of the House of Representatives signaled a decreased emphasis on renewable energy financing efforts.

The stakes are high, however. California has already cancelled a $30 million program and has another $100 million at risk despite the fact that PACE is still effectively in a testing period. The PACE program could create the potential for small-scale renewability and sustainability projects but only if lawmakers and regulators can reconcile PACE's methods with the need for mortgage lenders to secure first lien positions.