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Unique Opportunities in Property Assessed Clean Energy (PACE) Financing

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The Wisconsin-based Public Finance Authority (the "Authority") recently completed a first-of-its kind bond transaction that securitizes up to $30 million of commercial property assessed clean energy ("PACE") loans originated by the Connecticut Clean Energy and Finance Investment Authority ("CEFIA").[1] *von Briesen & Roper, s.c. is proud to have served as the Authority's counsel in the transaction. This* Update *discusses the legal context for PACE financing, and addresses special considerations for lenders and building owners involved in PACE financing transactions.*

Under the Connecticut PACE Program ("C-PACE"), CEFIA made loans of up to $2.5 million to commercial property owners in Connecticut to fund renewable energy and energy efficiency improvements on their properties (such as new HVAC and solar photovoltaic systems). The C-PACE loans are secured by "benefit assessment liens" on the improved commercial properties that, under the Connecticut enabling legislation, are superior to all other liens on the property except tax liens. CEFIA has the authority to enforce a benefit assessment lien if a borrower defaults.

As part of the securitization, the Authority issued energy revenue bonds to finance the purchase of a portfolio of C-PACE loans from CEFIA, with the debt service on the C-PACE loans and benefit assessment liens remaining as security for the bonds. Clean Fund—a project finance fund dedicated to nationwide PACE financing—committed to purchase up to $24 million of the bonds and CEFIA agreed to accept up to $6 million in bonds as partial payment for the portfolio.[2] Future securitizations of PACE assessments—in Connecticut and elsewhere—will likely follow a similar structure.

The Authority's securitization of the C-PACE loans was the first of its kind in commercial energy efficiency, and the appetite for similar investments appears to be growing. Wisconsin is well-positioned to be next and other states are expected to follow suit.

PACE in Wisconsin

C-PACE exists by virtue of a law that authorized a state-wide PACE program administered by CEFIA. On May 15, 2009, Wisconsin enacted a similar law—Wisconsin Statutes § 66.0627(8) (the "PACE Statute")—that authorizes a city, village, town or county to create a PACE program for property owners within its jurisdiction. However, unlike C-PACE, the Wisconsin approach relies on individual municipalities or counties to create the actual PACE programs through municipal or county ordinance. To date, only the City of Milwaukee and the City of River Falls have created PACE programs under the PACE Statute.

The PACE Statute establishes the basic framework for a Wisconsin PACE program:

- *PACE Loans*: Grants the power to make loans for, or arrange third-party financing for, energy efficiency, water efficiency or renewable energy improvements to real property.
- *PACE Loan Repayment*: Grants the power to collect the loan repayments as special charges in the tax rolls, and to allow the third party that provided the financing to directly collect the installments.
- *PACE Liens*: Provides that the delinquent loan repayments become liens on the benefitted property, which lien is given the same priority as tax and special assessment liens (such as sewerage or other special district assessments) and, therefore, primes mortgage liens.
- *Large Projects*: Requires that projects valued over $250,000 be certified as energy-saving by a qualified professional; and the borrower must obtain a guarantee from either the contractor or engineer that the energy savings will be greater than the PACE loan payments, and pay any shortfall. The energy savings have to be guaranteed to be greater than the PACE loan installment payments by the financing contract or an engineer, with the municipality or county to determine the form of the guarantee required.
- *Small Projects*: Allows municipalities and counties to require third-party technical review of projected savings for projects under $250,000.

The City of Milwaukee PACE program—the ME2 Property Assessed Clean Energy Financing Program ("ME2 PACE")—is available to commercial and industrial property owners in the City.[3] ME2 PACE is administered by the City's Department of Administration, Office of Environmental Sustainability (the "OES"). A building owner has to comply with the ME2 PACE Program Manual in order to obtain an ME2 PACE loan.

ME2 PACE financing culminates in a three-party financing agreement between the property owner, OES and the PACE lender (either an ME2 PACE program lender or a lender of the property owner's choice[4]). Thereafter, the property owner receives the loan from the PACE lender, which is secured by a special assessment on the real property being improved.

Because ME2 PACE is the largest active PACE program in Wisconsin, this article discusses PACE financings primarily by reference to ME2 PACE's requirements. Future PACE programs in other Wisconsin municipalities and counties may be different than ME2 PACE (other than the statutory components highlighted above), though ME2 PACE requirements may be seen as a model for future PACE programs in Wisconsin.

Lender Considerations for Consenting to ME2 PACE Financings

Under ME2 PACE, the borrower must obtain written consent to the PACE financing from the borrower's existing mortgage lender(s) and be current on its payments for all obligations secured by the property. Therefore, as the appetite for PACE financing grows, lenders should expect to be asked by their mortgagors to consent to PACE assessments. The circumstances surrounding each request for consent will be unique, but lenders should be aware of the following features of ME2 PACE:

- *Nature of the PACE Assessment*: PACE assessments are made against the benefitted property, and not the borrower. When the borrower sells the property, the purchaser takes title to the property subject to the PACE assessment. Further, in the event of default, the holder of the PACE lien can only foreclose on the lien to the extent of the amount in default; in other words, the balance of the PACE loan cannot be accelerated. A property owner is personally liable for the PACE assessments that become delinquent during their period of ownership (which is also generally the case with real property taxes). This feature of ME2 PACE is statutory and thus will be consistent for all Wisconsin PACE programs created under the PACE Statute.
- *Project Cost & Loan-to-Value Restrictions*: ME2 PACE limits project cost to between $20,000 and $3 million, but not to exceed 10% (industrial) or 20% (commercial) of the tax-assessed value of the property.
- *Insurance Requirements*: For ME2 PACE commercial property financings exceeding the lesser of 10% of the assessed property value or $2 million, the property owner must carry property insurance naming the City of Milwaukee and the PACE lender as additional insureds.
- *PACE Borrower Obligations to Its Mortgagee(s):* ME2 PACE tries to prevent a mortgagee from being unknowingly subjected to a superior PACE assessment on the same property by requiring the mortgagee to acknowledge that the borrower is subjecting the property to a PACE lien. The ME2 PACE program requires the lender acknowledgment before the PACE loan is even made. However, it is important to note that it is not the lender's acknowledgment of the PACE financing, but the PACE Statute itself, that gives the PACE assessment its super-priority over other liens. The acknowledgement avoids the situation in which a PACE borrower would otherwise breach its loan covenant to keep the property free of other liens without the lender's consent.

Evaluating Requests to Consent to PACE Financing—Suggested Underwriting Criteria

Since PACE programs are relatively new, lenders may not yet have established underwriting criteria to evaluate requests from borrowers to consent to PACE financing. Developing underwriting criteria will be important because, as previously noted, the PACE special assessment lien takes priority over a lender's mortgage. In addition to the general features of ME2 PACE outlined above, lenders should consider the following tools to evaluate the impact of energy efficiency improvements to real property collateral.

Energy Efficiency Underwriting and Valuation: "Energy efficiency" encompasses a broad range of structural and mechanical improvements to buildings that can be difficult to evaluate in the abstract. There are a growing number of methods to evaluate energy efficiency projects. Some of these methods include:

- Independent third-party energy efficiency audits.
- Analyzing the ratio of annual PACE costs to annual property value over the PACE financing term to show the change in the lender's exposure due to the PACE financing.
- Measuring debt service coverage before and after PACE financing (informed by the certified energy cost savings).
- Calculating the reduced variable operating costs relative to total building costs to show how replacing old building components can both reduce energy consumption and save on maintenance costs.
- Examining the expected increase in property value, possibly through a third-party appraisal. NOTE: Wisconsin statute exempts the increase in property value attributable to solar and wind energy systems from property tax, which may help mitigate any increase in tax liability a PACE borrower would incur due to increases in property value for PACE improvements.

The foregoing considerations may provide some comfort to lenders asked to consent to their mortgagor's PACE assessment. Overall, PACE financing and improvements should enhance the lender's collateral position because a more energy-efficient property (all other things being equal) should have a greater market value. Additionally, lenders may consider the potential opportunity of becoming PACE lenders, themselves.

PACE Considerations for Building Owners
In addition to the list of considerations for lenders, building owners should be aware of the following elements that may apply to their PACE loans (whether as part of ME2 PACE or another PACE program):

- *Commercial and Industrial Building Owners*: While the PACE Statute does not restrict what kind of building owner may utilize PACE financing, ME2 PACE limits the program to commercial and industrial properties. Future PACE programs may be open to residential property owners, as is the case with some PACE programs in California.
- *Pass-through to Lessees*: A building owner may be able to pass through the costs of the PACE special assessments to tenants, depending upon the structure and language of its underlying leases. Some lease arrangements require tenants to pay for both their proportional share of property taxes (which may include special assessments) and their own utility usage—though building owners should refer to the terms of their leases and consult with their attorneys to determine their ability to pass through the costs of their PACE financing to tenants. A PACE lender may also wish take this into account when underwriting a PACE loan (or deciding whether to consent to a PACE loan by another lender).
- *PACE Assessments Run With The Property*: PACE liens are assessed against the real property subject to the PACE project. This has at least two important implications for PACE borrowers in the event of a sale of the property: (1) the buyer will "inherit" the PACE assessment the same way as they would a tax assessment; and (2) the PACE assessment may show up as a title exception on a title report.
- *Accounting Considerations*: Because of the limited nature of PACE assessments, a borrower may be able to carry only the annual PACE assessment—rather than the full principal amount—as a liability on its balance sheet. PACE borrowers should consult an accounting professional for more information on PACE assessment accounting.

The PACE Opportunity
On June 2, 2014, the United States Environmental Protection Agency ("EPA") released a pre-publication version of its *Clean Power Plan Proposed Rule* (the "Proposed Rule").[5] The overarching goal of the Proposed Rule is to cut emissions of carbon dioxide from the power sector by 30% by 2030, using 2005 emissions levels as a baseline. The Proposed Rule sets state-specific goals for CO2 reductions while giving each state flexibility to decide how to meet its goals. The tools the EPA has proposed for states to meet the CO2 reduction goals include energy efficiency measures and renewable power sources—the very kinds of improvements most PACE programs target for financing.

The upgrades to energy infrastructure required by the Proposed Rule will likely require significant expenditures of capital. Just as PACE programs have unlocked new sources of capital for building owners across the country seeking to make energy efficiency and renewable energy improvements, so too could PACE programs provide new sources of capital to the power industry seeking to do the same in compliance with the Proposed Rule. The Proposed Rule presents multiple opportunities for creative PACE program implementation around the country. States and municipalities should consider how they could adapt PACE financing in this evolving regulatory climate.

PACE financing is a powerful tool that can help deploy capital to meet what experts identify as a multi-billion dollar opportunity—a $280 billion investment opportunity according to one industry report[6]—which opportunity existed even before the Proposed Rule. The size of the PACE opportunity after the Proposed Rule (or some variant thereof) is finalized could be even greater.

Due to our significant involvement with the first successful commercial PACE securitization transaction in the country, the von Briesen & Roper Public Finance Team—supported by lawyers in a number of other specialty areas including commercial finance, real estate, environmental law and property tax assessment—is uniquely positioned to help municipalities, lenders and property owners capitalize on this incredible opportunity.

[1] *See* Nick Lombardi, *In a 'Watershed' Deal, Securitization Comes to Commercial Efficiency*, GREENTECH MEDIA (May 19, 2014).

[2] The Bonds are being issued in tranches: The first $8 million tranche was closed in May 2014, with the balance of the bonds to be issued later this year or in early 2015.

[3] *See* "Milwaukee Energy Efficiency". The City of Milwaukee passed Ordinance 304-26 to create ME2 PACE. *See generally* Milwaukee, Wis. Ordinances ch. 304, § 26 *et seq*.

[4] The ME2 PACE Program Manual states that Clean Fund has committed $100 million total to fund Milwaukee PACE projects, with Milwaukee Economic Development Corporation committing an additional $5 million annually. The ME2 PACE Program Manual does not restrict borrowers to working with a specific lender. Interested lenders should contact OES for information about participating in the ME2 PACE program. NOTE: This *Update* addresses lender considerations for consenting to their mortgagors' PACE financings rather than lenders making PACE loans. Still, many of the issues raised in this article may be applicable to lenders evaluating whether to make a PACE loan.

[5] *See* EPA, *Clean Power Plan Proposed Rule*.

[6] *See* Katrina Managan & Kristina Klimovich, *Setting the PACE: Financing Commercial Retrofits* 4 (Institute for Building Efficiency, an Initiative of Johnson Controls, Feb. 2013).

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