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Options for PACE Financing Alternatives

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Addressing Practical Questions to PACE Financing Alternatives: From Financing Options to HUD Applications

Introduction

Responding to a variety of political, economic and energy policy imperatives at the federal, state and local levels, investors, commercial businesses and homeowners are finding creative ways to finance alternative and distributed energy generation and energy efficiency projects for their property, including through Property Assessed Clean Energy ("PACE") programs.

PACE programs typically permit the property owner to borrow money to pay for energy improvements to the real property and repay the debt obligation through a special assessment tax on the property over a certain number of years, generally creating a priority lien on the real property that will survive the sale of the property and be binding on the purchaser (i.e., such a lien "runs with the land"). PACE financing can come in a variety of forms and can often be used in conjunction with other forms of financing for a larger project, including debt financing such as private activity bonds. PACE financing may also be used in connection with projects ranging from those in public housing projects to general commercial building improvements.

The PACE concept originated several years ago and had gathered some momentum until July 2010, when the Federal Housing Financing Agency ("FHFA") issued a statement calling for a pause in residential PACE programs and directing Freddie Mac, Fannie Mae, and other residential mortgage lenders to no longer continue to underwrite mortgages for properties with a PACE assessment due to uncertainty and the high risk of PACE liens being imposed on the property superior to mortgage liens.

In July 2016, the Federal Housing Administration announced that it would begin insuring mortgages on certain PACE properties so long as the PACE obligation is treated as a tax and the lien does not have a priority over the FHA mortgage lien. However, as of early 2017, FHFA has not changed its position, and, while some residential mortgage lenders may be willing to consent to a PACE lien, others may not be, resulting in continuing uncertainty in the residential space. The outlook for commercial PACE projects and programs is brighter.

The priority lien issue is not the only challenge to PACE financing and PACE projects. Not all states have PACE-enabling legislation or other legislation pursuant to which PACE programs or PACE-like programs can be created. Each state is different and, even within a state, the relevant authority may differ among types of municipal entities. In addition, structuring a PACE-financed deal raises its own unique challenges and policy concerns.

This paper discusses several factors, including various financing options, the underlying legal basis for financing, potential limitations and policy barriers to PACE financing, key target areas and certain considerations with respect to the U.S. Department of Housing and Urban Development ("HUD") policies and HUD-related housing programs, including Rental Assistance Demonstration ("RAD") programs and Freddie Mac and FHA lending issues.

Financing Approaches – Can bond financing or municipal lease structures be used for, or in connection with, PACE financing?

In this section we discuss PACE financing in the context of some traditional debt financing approaches, including tax-exempt bonds, private activity bonds in the context of Low Income Housing Tax Credit ("LIHTC") projects and industrial facility projects, and tax-exempt municipal leases.

Bond Financing and PACE – is PACE financing allowable under a tax-exempt bond structure?

A traditional tax-exempt bond[1] structure involves a government or municipal entity issuing bonds directly for the benefit of that government or municipal entity, or an issuing authority issuing bonds on behalf of a conduit borrower (a third-party user of the funds issued by the issuing authority).

Private activity bonds are a type of bond financing in which bonds are issued by or on behalf of a government or municipal authority for the benefit of a conduit, or private entity borrower. Private activity bonds may be tax-exempt if they meet the conditions set out in the Code for certain "qualified" private activity bonds, which include exempt facility bonds, qualified 501(c)(3) bonds, qualified mortgage bonds and qualified redevelopment bonds.

All tax-exempt bonds are subject to the tax rules and requirements under Section 103 of the Internal Revenue Code of 1986, as amended (the "Code") and must also comply with any state or local government statutory rules, limitations and requirements.

For any PACE financing to occur, state or local enabling legislation providing for certain necessary preconditions must exist. Currently specific PACE-enabling legislation exists in 33 states and Washington D.C.[2] In many state PACE programs, including those in California, Texas, Utah and Arkansas, PACE projects are funded through private capital and administered through a local agency or a private sector company. However, in some cases, PACE projects can be financed through a PACE bond financing structure where generally, in its most basic form, a PACE district or authority is created as the issuer of the PACE bonds or notes. The proceeds of the PACE bond would be loaned by the issuer to the property owner

[1] A tax-exempt bond is a bond on which the interest earned by a bond-holder is exempt from federal income taxation.
[2] http://pacenation.us/pace-programs/ (accessed 2/2/2017).

who has applied through the PACE district to obtain financing for certain efficiency upgrades. Often there are restrictions or requirements for the types of efficiency upgrades allowed under the PACE program. The property owner then repays the loan through a special assessment on its property that forms a first priority tax lien on the property and remains with the property for the life of the repayment term, which term can be up to 20 years. Even where there is no PACE-specific legislation, it may be possible to use other existing authority that similarly provides for necessary preconditions. These preconditions include: (i) adequate bonding authority, and (ii) the ability to charge rates and fees that run with the land (or attach to the property). For example, the Pennsylvania Municipalities Authorities Act provides authorization for the establishment of an authority to make business improvements in a designated business improvement district and authorizes, under certain conditions, the imposition of an assessment on each property within such district to pay for such business improvements.[3] Nevertheless, relatively few PACE financings have occurred outside of states with formal PACE-enabling legislation.

PACE bond financing must be authorized or created by local law. One example of a bond issuance program is Florida's Evest Program through the Florida PACE Funding Agency.[4] The Florida PACE Funding Agency is a special purpose unit of government that can issue bonds for the benefit of eligible property owners in order to fund qualifying improvements under their program. Several counties throughout Florida subscribe to the program, and property owners in those subscribing counties can apply to have their PACE projects financed by Florida PACE Funding Agency bonds. In some cases, a state may provide broad authorization that could encompass a PACE-style program, depending on the statute, but such statutes would need to be reviewed on a case-by-case basis to determine whether they meet applicable requirements.

Specific steps to be taken to issue bonds are based on the type of authority issuing the bonds and the statutory authority or requirements applicable to such issuing authority. PACE bonds must comply with applicable state and local government statutory rules, limitations and requirements and could be tax-exempt depending on the applicable local laws and regulations. State and local laws vary across the country; however, generally, issuing bonds involves (1) a public meeting by the issuing authority, (2) adoption of resolutions authorizing the bond issuance by the issuing authority and/or the borrowing entity, and, (3) if the bonds are intended to be tax-exempt obligations, they would need to meet all the conditions for such treatment set forth in Section 103 of the Code, including requirements for Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") notices and hearings and local approvals, including in some cases approvals by the highest elected official in the jurisdiction in which the issuing authority has been formed. The TEFRA process is a federal requirement, applicable across all states, in most issuances of tax-exempt bonds and requires a 14 day

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[3] In this case, "business improvement" as defined in Section 5602 of the Pennsylvania Municipality Authorities Act could include an energy efficiency improvement or some other project, such as an improvement in street lighting, that benefits the residents of the business improvement district. Each benefited property in the district would be assessed a tax on its property that is one-half of the assessed value of the property for real estate tax purposes (See Section 5607(d)(27)). This can be contrasted with a scenario in which an individual property owner makes an improvement on his or her own property, where the repayment obligation is a tax assessed on that particular owner's property, rather than all properties in the district.

[4] https://www.floridapace.gov/

notice published in a daily newspaper of largest circulation in the project location and the issuing authority location (if different) in advance of a public hearing. The TEFRA hearing is usually held at the offices or location of the issuing authority and provides an opportunity for the public to ask questions or have comments on the use of proceeds from the bond financing and the project. For more details about your specific local bond issuance requirements and tax-exemption for bonds, please contact your local counsel or advisor.

Can PACE financing be used with Low-Income Housing Tax Credit ("LIHTC") projects?

PACE financing can also be used in conjunction with private activity bond financing with respect to both LIHTC projects[5] and industrial or manufacturing "exempt facility" projects.

Housing projects, including LIHTC projects, often utilize several different funding sources to meet development budgets. These funding sources can include private equity, private loans, tax-exempt 4% bonds (bonds used in conjunction with 4% LIHTC projects), tax credits and grants. Tax-exempt 4% bond financing for LIHTC projects involves many of the same steps as discussed above in terms of meeting applicable state and local requirements, holding public hearings, adopting authorizing resolutions and meeting TEFRA requirements. In LIHTC bond financed projects, the dollar amount of bonds that can be issued is subject to each state's "volume cap", which is a federally authorized maximum amount of tax-exempt private activity bonds that can be issued annually in each state. Every state varies in terms of its volume cap and LIHTC housing project process, but in general, a developer or entity wishing to use tax-exempt bonds to finance a LIHTC project would need to apply with the state through the state's LIHTC application program and be awarded, or allocated, an amount of the bond volume cap for the project.

PACE financing which is not in the form of 4% bonds, can be used as an additional funding source alongside tax-exempt 4% bonds used to finance a LIHTC project on a standalone basis. In this instance, state bond volume cap would not apply to the PACE financing because it would not be part of the LIHTC bond issuance. The type of PACE financing can include PACE bonds or notes as discussed above, which could be tax-exempt financing if such PACE bonds or notes meet the requirements for tax-exemption, also discussed above.

As an alternative, it may be possible to finance certain energy efficiencies or improvements through a traditional 4% bond structure as part of the overall project rather than as a separate asset or project with an assessment attached to the property. In this case, if the

[5] The LIHTC program is an indirect federal subsidy used to finance the construction and rehabilitation of low-income affordable rental housing. The LIHTC gives investors a dollar-for-dollar reduction in their federal tax liability, claimed pro rata over 10 years. The LIHTC is designed to subsidize either 30 percent of the low-income unit costs in a project (4% tax credit) or 70% of the low-income unit costs in a project (9% tax credit). Each state has an annual volume cap, which represents the maximum amount of LIHTCs and tax-exempt bonds each state may allocate each year. (*See* Novogradac & Company Affordable Housing Resource Center – About the LIHTC – available at https://www.novoco.com/resource-centers/affordable-housing-tax-credits/lihtc-basics/about-lihtc)

improvements were included in the overall project and were financed by tax-exempt 4% bonds, volume cap would apply but the project would not be a "PACE" improvement because there would be no "property assessment" securing payment, only a traditional bond loan structure.

The major areas of concern for public housing authorities ("PHAs") in the context of PACE financing include: (1) education efforts to ensure that stakeholders are comfortable with this financing structure, (2) HUD approval of the structure, including the necessary subordination to HUD's regulatory agreements, and (3) sufficient project funds to pay the assessment. With respect to LIHTC projects, 4% bonds would not likely present additional challenges to PHAs beyond those present in other transactions using PACE financing, as discussed in "HUD, FHA and Housing Considerations" below.

How can PACE financing be used with industrial development projects?

PACE financing may also be used in conjunction with private activity "industrial development bonds." Generally, private activity "industrial development bonds" are issued on behalf of a private entity to provide funds to finance the development or redevelopment of a specific project such as a factory or industrial facility or heavy equipment and tools. For the interest earned on these bonds to be exempt from federal tax, such as for an "exempt facility bond", the project must be one of those specifically listed in Section 142(a) of the Code. These projects include, but are not limited to, airports, mass commuting facilities, solid waste disposal facilities, qualified residential rental projects, facilities for the local furnishing of electric energy or gas or water, local district heating or cooling facilities, and qualified green building and sustainable design projects, but notably do not specifically include solar panels and certain other energy efficiency or retrofit upgrades. Under a traditional tax-exempt private activity bond issuance, the bond proceeds would not likely be used to finance PACE projects unless those PACE projects were incorporated into one of the qualifying types of facilities (e.g., a local district heating or cooling facility) and it satisfied the PACE program requirements; specifically, PACE financing through private capital can be used to bridge a funding gap in financing an energy improvement as part of an overall project, as long as (i) the energy improvement does not qualify for federal tax incentives, or (ii) if non-LIHTC federal tax incentives are applicable, the industrial development bonds are not tax-exempt. An example of such a structure is the Far Southeast Family Strengthening Collaborative, Inc. ("FSFSC") project through Washington, D.C.'s DC PACE and Urban Ingenuity program described below ("DC PACE").[6]

The FSFSC project utilized a combination of financing methods, including both "industrial revenue bonds" and $2.2 million of tax-exempt PACE financing through Urban Ingenuity, the private-sector administrator of DC PACE to fund a project to relocate FSFSC headquarters, and in the process fill a vacancy in the Ward 8 section of Washington, D.C. and promote neighborhood economic development.

[6] http://us10.campaign-archive1.com/?u=5b35c6ffd15dc5bcd7d7fe878&id=47e23a93ab&e=32d64dea17

Municipal Leases and PACE – does PACE work with "traditional" municipal lease structures?

Another municipal financing option is tax-exempt municipal leases. Tax-exempt municipal leases are a way in which a municipality can borrow money using a financing lease structure to pay for long-term assets. Traditional tax-exempt municipal leasing structures involve a government or municipal entity acquiring an asset through an installment purchase or financing lease structure in which the municipal entity pays "rent" over time for the asset and has an option to purchase the asset for a nominal amount at the end of the lease term. For federal tax purposes, the rent payments are treated as loan payments, with the interest component of those payments being tax-exempt to the lessor of the asset.

Generally, for the municipal lease to be tax-exempt, the lessee must be a state, municipality or political subdivision thereof. Tax-exempt municipal leases offer more flexibility than traditional bonds, as the leases can be for variable term lengths from 1 year to more than 10 years. There are generally lower interest rates available for leases, and usually no bond election is required. Additionally, under a tax-exempt municipal lease structure, the municipal entity must make annual appropriations of funds necessary to make the rent payments under the lease and therefore the tax-exempt municipal lease does not count as "debt" of the municipal entity for purposes of state law (although it does constitute "debt" for tax purposes).

Some of the challenges in blending PACE financing and municipal tax-exempt leases arise from the nature and ownership of the PACE-financed improvements. For example, if the PACE-financed improvements qualify for federal tax credits, as would be the case with solar projects, fuel cell projects, or other renewable on-site generation projects, ownership by a non-taxed entity would invalidate the tax credit. Additionally, if tax-exempt financing were used to finance the acquisition of the PACE-financed improvements, they would generally be ineligible for federal or state energy tax credits. LIHTC ownership rules and typical ownership structures provide greater flexibility than some other tax credits with respect to the joint ownership of tax-credit eligible assets by taxable and non-taxable entities.[7] In addition, since the municipal entity generally does not pay property taxes or have any tax liability for the asset repayments to attach to or be assessed upon, other payment mechanisms, such as a payment-in-lieu of tax credits or special assessment could be structured to facilitate the payments, but the ownership and tax credit allocation issues would remain. The bond holders or underwriters would also want long-term assurances that the use and ownership structure would continue to qualify for tax-exempt treatment.

In circumstances in which the PACE-financed improvement is not subject to federal tax credits, the tax-exempt municipal lease structure could be available to entities otherwise able to

[7] For example, while it is typical for LIHTC transactions to have partners consisting of both taxable and non-taxable entities, the typical structure for solar transactions does not permit such arrangements. See also, Historic Boardwalk Hall, LLC v. Commissioner of Internal Revenue, 694 F.3d 425(3d Cir. 2012) (regarding limitations on transferring benefits of tax credits to non-taxable entities).

access tax-exempt financing structures as described herein. Such entities may include public charter schools, transit authorities, and other quasi-public agencies and authorities. One advantage to these entities of utilizing tax-exempt municipal lease financing is that it is a relatively simple structure that is familiar to many advisors, financing parties, and staff that may be involved in the financing process, while other structures, including some of the PACE structures described herein are newer and less familiar to some.

In addition, there are other variations on the traditional tax-exempt municipal lease structures discussed above. One example is a true lease structure in which a municipality leases a commercial building from a private tax-paying landlord. Under this structure, if the landlord wanted to utilize the PACE financing and payment mechanisms for energy efficiency improvements, the landlord would likely be able to take advantage of such PACE financing and payment mechanisms, assuming there was a functioning local PACE program. If the municipal entity has an option to purchase the building at the end of the lease term, the municipal entity and landlord would likely have to contractually address any property assessments remaining with respect to the PACE improvement, including any outstanding amounts owed on the PACE financing debt, before any transfer of the property could occur. In addition, the transfer should occur after any tax credit recapture period has run, if applicable. Financing parties may require that, to address concerns about future non-payment, renewal and replacement reserve funds may be required. While the approach of financing parties is likely to vary based on individualized credit profiles, local policies, and PACE programmatic guidelines, those financing parties may also require that, if the real property on which the energy efficiency or renewable energy improvements are installed is transferred or sold, the oustanding PACE financing balance would need to be either repaid in full (potentially with a prepayment premium) or assumed by the new owner of the real property on which the energy efficiency or renewable energy improvements are installed.

Another example that is not part of a traditional tax-exempt municipal lease structure is the “third party ownership” (“TPO”) structure. This recent development and growing sector in PACE financing uses a TPO structure where the ownership of the energy efficient asset remains with the company that provides the asset and the property owner pays for the asset through a lease or power purchase agreement secured by the property tax assessment.[8] Companies like De-meter Power Group and SunRun have taken advantage of TPO programs in California, Colorado, Massachusetts and New Jersey.[9] While these TPOs are not tax-exempt municipal leases, they do provide a hybrid lease-type PACE option to financing energy efficiency improvements.

In conclusion, for any PACE projects to occur, regardless of the type of financing, there must be either PACE-specific or other enabling legislation. If your state has PACE-enabling legislation and local PACE programs, there is no need for the property owner to create a new type of bond or debt financing – the local PACE program typically addresses program administration, though some programs enable PACE financing to occur without extensive administrative support. PACE bonds can be issued depending on the local laws and programs, and private capital funded PACE financing can be used in connection with other forms of

[8] See http://www.cleanenergyauthority.com/solar-energy-news/hybrid-financing-tool-to-go-solar-102612/

[9] http://de-meter.com/home; and http://www.cleanenergyauthority.com/solar-energy-news/pv-leasing-closes-in-on-75-percent-of-installs-in-ca-040912/

financing for projects like LIHTC apartment complexes and industrial and manufacturing projects. In states where enabling legislation exists but has not been used, a program and related financing documents must be developed in light of the authorizing legislation providing powers to the sponsoring municipality.

Limitations, Potential Policy Barriers and Key Opportunities for Growth – What are the challenges to PACE financing and where are the key targets areas?

While PACE financing has gained ground in several sectors and states, there are several limitations to utilizing PACE financing. From a property owner perspective, PACE financing would generally be limited to those properties within the PACE district, and the property owner would need to complete the application process to be eligible. In addition, any tax-exempt bonds issued under a PACE financing structure would still be subject to the tax rules and requirements under Section 103 of the Code and must also comply with any state or local government statutory rules, limitations and requirements. For example, in the Texas counties or municipalities that have enacted Commercial Pace ("C-PACE") programs, the property owner: (1) first would need to determine if the proposed project is an eligible project under the Texas PACE Authority guidelines, then (2) find a PACE contractor, then (3) select a capital provider, or funder, for the project, (4) prepare and submit an application, and finally (5) get existing mortgagee consent to the PACE assessment.[10] Once the property owner completes each of these steps, an independent third party reviewer is selected and engaged by the property owner and capital provider to conduct a review of the project, assumptions, and projected savings (and ultimate verify the completion and operation of the project after completion). This can be a lengthy process if the property owner is not familiar with the documentation, does not already have connections with a contractor or other parties involved, or needs to get mortgagee consent.

Other limitations from a property owner perspective are restrictions on the percentage of the property's value that can be applied to financing. California's Figtree Financing program allows up to 100% financing for certain projects like HVAC, solar, roofing and windows, up to 20% of the property's value, with a minimum allowable project size of $5,000.[11] Another barrier from the property owner perspective is the unwillingness of a property owner to finance a PACE project that has a repayment term longer than the useful life of the asset, as a subsequent purchaser of the property may not be willing to purchase the property and pay the assessment without benefiting from the asset.[12]

The opportunities for growth are abundant. PACE programs can benefit property owners with strong credit that are interested in less expensive long-term financing options as compared to other financing alternatives. These programs can also assist borrowers in need of credit support, which the programs can also provide, depending on the program design. Non-

[10] http://www.texaspaceauthority.org/Documents/Program%20Guide%20Version%202.0.pdf?dl=0
[11] http://www.figtreefinancing.com/commercial-pace-financing/
[12] http://www.stroock.com/siteFiles/Pub987.pdf

taxpaying entities such as municipalities and housing authorities can benefit from partnerships with private entities as has been described herein, and individual property owners interested in long-term improvements on their properties (whether the properties have existing debt or not) can benefit.

Securitization

Another key target opportunity would be identifying or initiating programs that are conducive to securitization. These types of deals aggregate PACE bonds or other obligations, even across states, in large scale securitization packages, and can reduce the risk for investors of individual defaults and other credit risk concerns. Several securitizations of PACE bonds have already occurred, including one of the largest securitizations in 2016, the HERO Program, where Renovate America issued $305.3 million of Class A notes secured by 13,432 PACE assessments levied on residential properties in 31 California counties. Kroll Bond Rating Agency assigned “AA(sf)” ratings to the Class A notes.[13]

Finally, expanding the TPO-PACE hybrid financing structure may prove to be a key target area in the future. With a growing base of funded programs in PACE-enabled states and new programs being developed, a focus on the key target areas may help overcome the current barriers and limitations to PACE financing.

HUD, FHA and Housing Considerations – How is PACE being treated by HUD, public housing authorities and lenders with respect to HUD-assisted housing?

Can PACE financing be used with RAD projects?

In RAD conversion transactions, existing public housing units convert their subsidy to long-term, project-based Section 8 contracts. These new contracts provide a more reliable source of operating subsidy that allow PHAs and project owners to leverage debt and equity in order to finance the project’s rehabilitation or replacement.

In accordance with HUD guidance issued in January 2017,[14] PACE financing is now available for use in certain types of HUD-assisted multifamily housing, including projects financed with HUD-insured loans under Section 221(d) and projects that have project-based rental assistance contracts under Sections 8, 202, and 811. Public housing projects that

[13] http://www.bondbuyer.com/news/regionalnews/new-florida-pace-program-to-debut-1109518-1.html
[14] Housing Notice 2017-01, Administrative Guidance for Multifamily Property Assessed Clean Energy (PACE), available at https://portal.hud.gov/hudportal/documents/huddoc?id=17-01hsgn.pdf.

convert subsidy to Section 8 Project-Based Rental Assistance ("PBRA") through the RAD program are subject to Housing Notice 2017-01; however, public housing projects that convert subsidy to Section 8 Project-Based Vouchers ("PBV") are not. We are not aware of any guidance that HUD has issued on the use of PACE financing in PBV projects.

In order to use PACE financing in connection with a RAD conversion, the project owner must seek HUD approval, as detailed in this notice, prior to entering into a PACE assessment. In order to obtain HUD's preliminary approval, the owner must first provide a satisfactory letter to the HUD Regional Director from, or on behalf of, the local PACE administrator, which confirms the following operational elements of the PACE program: (1) the PACE special assessment will be assessed by a state, county or municipality pursuant to state law and sent with tax bills; (2) payments are collected with tax bills; (3) at any given time the only obligation is the semi-annual/annual payment(s) then or past due and payable, with no acceleration of the entire assessment amount; (4) in the event of a default on payment of the assessment, the mortgagee receives timely notice and a reasonable opportunity to cure the non-payment; and (5) an opinion from the state's attorney general that the obligations are special assessments and treated in a similar matter as the real estate taxes. If the owner is not able to obtain such a letter, HUD will accept an opinion from the owner's counsel that confirms the items (1) through (4) in the previous sentence. Once HUD makes its determination that the program is acceptable, it will notify the owner and local PACE program administrator.

Once HUD has issued its preliminary approval letter, the project owner must submit the following documents for HUD's review: (1) a cover letter addressing each of the PACE Approval Conditions set forth in Section V of the notice; (2) approval from the local PACE program; (3) all PACE agreements, unexecuted; (4) conditional approval from the project's lender(s) other than HUD, if applicable; (5) an energy audit performed by an independent third party; (6) an energy audit analysis performed by an independent third party indicating projected annual savings of energy/water saving enhancements commensurate with annual assessment; (7) a market assessment letter of comparable sales or appraisal; and (8) the opinion of owner's counsel or letter from or on behalf of the local PACE administrator that was submitted as part of the preliminary approval process. Once HUD reviews the submission and confirms that all of its conditions have been satisfied, HUD will issue a final approval letter to the owner so that it can proceed with the PACE financing.

After HUD issues its final approval letter and the owner closes on the PACE financing for a PBRA project, the special assessment payments should be accounted as an operating expense as follows:

> Properties with HUD Multifamily Housing Section 8 Project Based Rental Assistance . . . may not include the PACE special assessment in Section 6700: Taxes and Insurance line items of the budget worksheet HUD Form 92547-A, in the budget year after the initial pace assessment. The PACE assessment should be included in subsequent budget years; however, staff should ensure that the commensurate savings are reflected in the appropriate utilities (Section 6400) line items. Note that the property will not be eligible for a rent increase to cover utility line item increases in subsequent years that are result of underperforming improvements funded by PACE.

Note that the second and subsequent year budgets must reflect achieved first year savings and utility allowances should be adjusted to reflect actual savings.

HUD Form 92547-A is the budget worksheet used by multifamily projects to set forth the project's income and expense projections. This notice confirms that, following HUD approval, the project may include the special assessment payments as an eligible expense under the line item for taxes and insurance following the first year of the assessment. However, HUD also requires that the owner adjust the budget numbers for utility costs and the project's utility allowances to account for the projected energy savings from the PACE financed-improvements. Without this guidance, the project's finances would be hurt by the PACE financing as it would not be able to include the assessment payments as an expense, but it would have to include the lower utility costs in the budget to reflect the conservation measures.

The HUD approval process for the PACE financing, as detailed in the notice, is in addition to the process that the existing public housing project must undergo to receive HUD approval for the overall RAD conversion. In addition to satisfying the requirements detailed in Housing Notice 2017-01, the project owner should also include the PACE financing in the RAD conversion documents submitted for HUD approval.

Can PACE financing be used with mixed-finance projects?

In mixed-finance transactions, all or a portion of the units are public housing units that receive operating subsidy from HUD through the PHA. HUD calculates the operating subsidy for each project in accordance with the Operating Fund Formula set forth at 24 C.F.R. pt. 990, which is generally the difference between the formula expense and formula income. The project's formula expense represents the costs of services and materials needed by a well-run PHA to sustain the project. In accordance with 24 C.F.R. § 990.160, HUD uses the following three factors to determine the overall formula expense level for each project: (1) the project expense level (calculated in accordance with 24 C.F.R. § 990.165); (2) the utilities expense level (calculated in accordance with 24 C.F.R. §§ 990.170, 990.175, 990.180, and 990.185); and (3) other formula expenses, also called add-ons (calculated in accordance with 24 C.F.R. § 990.190).

In accordance with 24 C.F.R. § 990.185(a) and subject to HUD approval, the project may qualify for certain incentives associated with energy performance contracts ("EPC") that meet the following criteria: (1) the energy conservation measures are financed by an entity other than HUD, (2) the PHA or project owner enter into a contract to finance the energy conservation measures, (3) payments under the contract can be funded from reasonably anticipated energy cost savings, and (4) the contract period cannot exceed twenty years. The eligible energy conservation measures may include, but are not limited to: physical improvements financed by a loan from a bank, utility, or governmental entity; management of costs under the performance contract; or a shared savings agreement with a private energy service company.[15]

If HUD approves the EPC, the project can benefit from either an add-on subsidy or a frozen rolling base. Under 24 C.F.R. § 990.185(a)(2), the PHA can request an additional subsidy as an "add-on" to its total operating subsidy eligibility. This additional subsidy is applied to amortizing payments for a loan contracted to finance energy-conservation improvements with a repayment period not to exceed twenty years. Under 24 C.F.R. § 990.185(a)(1), the PHA can request that HUD freeze the project's 3-year rolling base utility allowance at the level of consumption before installation of the energy improvements. This incentive applies when loan payments are dependent on the amount of energy cost savings realized. With this incentive, the PHA retains one hundred percent of the cost savings during the contract period, and at least seventy-five percent of these yearly profits are used to pay off the loan until it is fully amortized. This portion of the profits would be applied to amortizing payments for a loan contracted to finance energy-conservation improvements with a repayment period not to exceed twenty years.

While the model structure for PACE financing likely satisfies the requirements for an energy performance contract under 24 C.F.R. § 990.185(a), the use of public housing operating subsidy to repay PACE financing appears to be a new concept for HUD. Ballard Spahr recently worked with a PHA on a mixed-finance project that included PACE as a funding source. However, in that project, the PACE special assessments were funded with a local rent subsidy rather than public housing operating subsidy. As such, that project does not provide a precedent for HUD allowing PACE special assessments to be funded with public housing subsidy. However, based on the determination by HUD's Office of Multifamily Housing Programs to permit the use of PACE financing in the programs overseen by that office, the Office of Public and Indian Housing, which oversees public housing and mixed-finance transactions, would likely be open to expanding financing for energy conservation measures to include PACE financing.

Alternatively if the mixed-finance project includes non-public housing units, the project could use the income generated from those units to pay the PACE special assessments, subject to any regulatory requirements that may affect those non-public housing units and HUD consent through the mixed-finance approval process.

Can PACE Security be Modified?

In the context of a partnership-owned housing project, one question that arises in RAD conversion projects that have PACE-secured assets is how or whether the PACE security can be modified to provide recourse to the partnership interest of the general partner of the partnership, as the first form of foreclosure, instead of reverting to a tax sale in a traditional foreclosure process. The guidance that HUD has issued on RAD does not prohibit financing that would be recourse to a tax credit owner's managing member or general partner. Instead,

[15] 24 C.F.R. § 990.185(a).

that issue would have to be negotiated with the managing member or general partner. If a PHA or its affiliate is the managing member or general partner, any guaranty provided by the PHA or its affiliate for the benefit of a lender would have to exclude the PHA's federal assets. The lender would then have to analyze whether the PHA has sufficient non-federal assets to satisfy the recourse liability.

In a recent mixed-finance project that included PACE as a funding source, the rights under the PACE special assessment, which could result in a tax sale in a traditional foreclosure process, had to be subordinated to the HUD Declaration of Restrictive Covenants through a form of intercreditor agreement, which set forth how the HUD requirements would interact with the rights under the special assessment. The Mixed-Finance ACC Amendment also disclosed the PACE special assessment and included descriptions of how it would interact with the HUD requirements. With this mixed-finance deal as a template, it is likely that HUD would allow the same structure in a RAD deal so long as the rights under the PACE special assessment are subordinated to the RAD Use Agreement.

What Are the First Priority Lien Concerns?

Considering the priority lien issue that PACE financing raises, in order to allow for the attachment of a senior PACE assessment on a HUD-assisted project, HUD would typically require that the rights under the PACE special assessment be subordinated to a HUD use restriction through a form of intercreditor agreement as described in the section above. In a RAD transaction, HUD requires that a RAD Use Agreement be recorded in first priority; in a mixed-finance transaction, HUD requires that a Declaration of Restrictive Covenants be recorded in first priority. In each instance, the HUD use restriction ensures that the affected property will be maintained as affordable housing for a set time period. This subordination is crucial to HUD so that it can ensure that the HUD use restriction survives foreclosure.

In contrast, foreclosure typically terminates a LIHTC regulatory agreement, subject to the new owner's compliance with a 3-year decontrol period. For existing projects, the lender would likely need the consent of the applicable housing finance agency ("HFA") to add a new financing source and to encumber the project with new financing instruments. For existing and future projects, the lender would also need to determine whether the HFA would require that the rights under the PACE special assessment be subordinated to any existing bond or LIHTC regulatory agreements.

Finally, with respect to the priority lien concerns from Freddie Mac and Fannie Mae, an intercreditor agreement may not yet be an adequate mitigant. While property subject to a lien that is prior to Freddie Mac's lien are not eligible for sale to Freddie Mac, Freddie Mac recently issued guidance that expands its previous requirements and allows for the purchase or refinance of mortgages currently in a pool of mortgages where the proceeds of the mortgage are used to pay off the PACE financing.[16] Freddie Mac has not yet issued guidance on

[16] http://www.freddiemac.com/singlefamily/guide/bulletins/pdf/bll1616.pdf

whether an intercreditor agreement subordinating or modifying the lien priority of a PACE assessment would offer a way forward for meeting the FHFA policy concerns, but given the growth of energy retrofit loan programs, this could be something that would be considered in the future. In addition, we are aware of transactions in which the PACE financing documents have been subordinated to the HUD use restrictions, and such subordination has been considered sufficient by the lenders. Any intercreditor agreement here, with respect to Freddie Mac and Fannie Mae, and also with respect to HUD use restriction, may also require an additional level of negotiation and approval with the local municipality regarding the property tax assessment.

What are the concerns from a property owner, lender and government perspective?

There are certain legal concerns that may also arise for property owners, including the treatment of PACE financing as a tax or as a voluntary encumbrance. If treated as a voluntary encumbrance, the financing could present a variety of problems. First, this would create a question as to whether the PACE improvements or interest on the repayment of the PACE financing will be deductible from income tax for property owners. Second, this would raise the first-priority lien issue because voluntary incurrence of PACE obligations could arguably be treated like other debt paid subsequently to the primary mortgage if there were a default.[17] Finally, if treated as a voluntary encumbrance, it might be difficult for property owners to pass along the cost of PACE financing to tenants with existing long-term leases or other long-term obligations.

From a state or local government or issuing entity perspective, not all states have passed PACE-enabling legislation, and even in states that have PACE-enabling legislation, there may be little support for actual implementation of a PACE program. Currently there is PACE-enabling legislation in 33 states and the District of Columbia, but not all of those places have programs that are operational. For example, Virginia, Georgia and New Jersey have PACE-enabling legislation and PACE projects "in development."[18] Nevada, New Mexico, Wyoming, Illinois, North Carolina and Maine, among others, have PACE-enabling legislation but no programs that are currently running or in development.[19] This can be a barrier to entry if the local government is not willing or interested in developing a PACE program.

From a lender and government agency perspective, the first priority lien concerns have limited the involvement of Freddie Mac, Fannie Mae and certain other FHFA programs from backing mortgages on PACE properties. Additionally, banks and other mortgage lenders may not provide consent to a PACE project or may refuse to lend money to property owners if a PACE assessment is attached to the property. The FHFA and mortgage lender policies have restricted some programs to commercial programs only. These policy decisions continue to

[17] http://www.stroock.com/siteFiles/Pub987.pdf
[18] http://pacenation.us/pace-programs/
[19] http://pacenation.us/pace-programs/

hamper the growth of PACE programs across the country. However, the U.S. Department of Energy published its Best Practice Guidelines for Residential PACE Financing Programs[20] on November 18, 2016, which provided detailed guidelines, criteria, concerns and consumer and lender protections that may help demystify first priority lien concerns and risk factors for property owners and residential lenders.

Despite these limitations and challenges, PACE programs have become common in certain parts of the country, such as California and Florida. A key target opportunity would be PACE programs in states, such as Florida that allow for non-ad valorem property tax assessments to finance qualifying improvements.[21]

Conclusion

PACE programs and PACE financing options for both residential and commercial users vary from state to state and from program to program. Owners, contractors, lenders and other PACE participants should consult CivicPACE, the Solar Foundation, Ballard Spahr LLP or their local counsel for details regarding availability of PACE financing, specific PACE-related questions or how to take advantage of PACE programming.

[20] https://energy.gov/sites/prod/files/2016/11/f34/best-practice-guidelines-RPACE.pdf
[21] http://www.bondbuyer.com/news/regionalnews/new-florida-pace-program-to-debut-1109518-1.html