



Series of Regulatory Choices

September 2010

No. 3

Local Governments and Federal Agency Clash Over Property Assessed Clean Energy Programs

By: Cynthia Boland, Esq.



DEFG's Series of Regulatory Choices explores the federal, state and local regulatory decisions that expand the choices available to energy consumers as they construct and inhabit buildings, purchase and maintain energy-consuming devices, purchase energy, or manage their consumption of energy. Greater choice increases efficiency.

◀ All agencies make a series of choices ▶

Executive Summary

Property Assessed Clean Energy (“PACE”) is a financing mechanism that allows local government entities in the United States to finance renewable energy and energy efficiency projects on privately-owned residential, commercial and industrial properties. Enabling legislation passed on the state level gives local governments the power to design and implement PACE financing programs. Monies lent to property owners for energy improvements are secured by liens on the subject property (commonly referred to as “land-secured financing”) and paid back through an assessment tax levied against the property. Pioneered in Berkeley, California in 2008, PACE very recently gained significant momentum on a national scale. On July 6, 2010, however, the Federal Housing Finance Agency (FHFA) issued a statement (“July Statement”) detailing objections to PACE and directing that mortgage giants, Fannie Mae and Freddie Mac, take precautions in response to PACE programs.¹ The chief concern is that if a property owner defaults on a mortgage and the property has a PACE lien, repayment of the PACE loan would take priority over the mortgage as property taxes are typically paid first from the proceeds of the sale of a foreclosed home. The July Statement had a major impact, effectively suspending PACE across the country and resulting in both a legal and political battle.²

Though PACE has the potential to both strengthen the retail renewable energy and energy efficiency marketplace and produce critical energy, environment and economic benefits, there is intense debate over whether a municipal government-sponsored lending scheme which poses potential risks to mortgage lenders is a prudent policy and thus best suited to achieve these goals.

The purpose of this third report in DEFG’s “Series of Regulatory Choices” is to present the status of PACE programs, analyze the risks, benefits and trade-offs associated with PACE, and to discuss reactions to the FHFA July Statement and potential alternative policies being considered should PACE be derailed indefinitely.

The Status of Property Assessed Clean Energy Programs

Background

The purpose of PACE is to incentivize property owners to make renewable energy and/or energy efficiency improvements to their property by loaning the money with little or no up-front costs and spreading payments over an extended period of time. Municipalities typically implement the program by issuing bonds to support the up-front renewable energy installation or retrofit costs (e.g., solar installation, insulation or window replacements). The cost is secured by a lien on the property, with repayment amortized through a special property tax assessment over a period of years.

Berkeley, California was the first municipality to implement PACE financing with its “Berkeley FIRST Program” in 2008.³ Renewable Funding LLC, the third party administrator for the program, partnered with the city and developed a system for financing home solar energy systems through an annual assessment on the homeowner’s property tax bill that would be repaid over twenty years. First-round funding for the program was quickly snatched up by Berkeley home owners. Generally viewed as a success, the Berkeley FIRST program was subsequently endorsed by Vice President Biden as a national strategy for clean energy and moreover spurred California’s state law AB811 (now suspended), allowing any city in California the ability to implement a PACE program.⁴

The White House and Vice President Biden’s Middle Class Task Force laid the groundwork for a self-sustaining home energy efficiency retrofit industry in October of 2009 with PACE as an integral piece of that effort.⁵ The *Recovery*

¹ See [FHFA Statement on Certain Energy Retrofit Loan Programs](#) (July 6, 2010).

² See Todd Woody, [Loan Giants Threaten Energy-Efficiency Programs](#), NY Times (June 30, 2010).

³ See [City of Berkeley, Berkeley FIRST Program](#).

⁴ See <http://pacefinancing.org/>.

⁵ See Middle Class Task Force and Executive Office Counsel on Environmental Quality, [Recovery Through Retrofit](#), at pp. 8-9 (October 2009).

Through Retrofit plan builds on investments made in the American Recovery and Reinvestment Act (ARRA) of 2009 to expand the home energy efficiency and retrofit market. The plan notes the “exciting potential” of PACE financing programs to overcome several barriers that may otherwise discourage property owners from making energy investments by providing:

1. access to capital;
2. beneficial financial terms;
3. a streamlined application process with lower transactions fees relative to other lending options; and
4. a financing mechanism by which the debt obligation is tied to the property and the owner is responsible for paying the assessment while also receiving the energy savings benefit (i.e., new owner takes over the remaining balance of the assessment following a sale of the property).⁶

Additionally, the White House and the U.S. Department of Energy (DOE) developed a policy framework for PACE financing programs specifically receiving federal funding.⁷

With a policy framework in place, several months later in April of 2010, the DOE announced the selection of twenty-five communities to collectively receive up to \$452 million in Recovery Act funding to “ramp-up” energy efficiency building retrofits.⁸ The funding included money for PACE pilot projects to be accompanied by a significant research effort on the part of the DOE to assess the efficacy of PACE as a funding source for energy improvements and both the homeowner and lender protections set out in the policy framework.⁹ Thus, in addition to administering funds, the DOE was tasked with facilitating data collection, objectively measuring and evaluating the performance of PACE programs, and accelerating the adoption of uniform and universal best practices that include effective homeowner and lender protections.¹⁰ In light of the exceptionally challenging economic environment and recovering housing market, the DOE also issued best practice guidelines for pilot PACE Financing Programs to help ensure prudent financing practices and protect both program participants and the lenders who hold mortgages on properties with PACE tax liens.¹¹

By summer 2010, with the backing of the White House, Vice President Biden’s Middle Class Task Force and the DOE, PACE has gained substantial traction across the U.S. PACE legislation has in fact been enacted in twenty-two states and received support from high-profile politicians such as Governor Arnold Schwarzenegger (R-CA) and Mayor Michael Bloomberg (New York City).¹² The momentum however was suddenly halted when the FHFA issued its July 6, 2010 Statement detailing objections to PACE.

PACE Program Experiences in Sonoma County, California and Babylon, New York

Mark Boslet of Greentech Media recently examined the PACE program designs and experiences in Sonoma County, California and Babylon, New York.¹³ Though these are nascent programs with limited performance data, Boslet’s accounting was quite informative. Launched in March 2009, Sonoma County is probably the largest and most firmly established PACE program in the country, with nearly \$100 million in funding.¹⁴ To date, work has been completed on

⁶ *Id.*

⁷ See White House and US Dep’t of Energy, [Policy Framework for PACE Financing](#) (October 18, 2009). (The policy framework can of course also serve as a resource for state and local governments implementing PACE without any federal funding.)

⁸ See US Dep’t of Energy, [Vice President Biden Kicks Off Five Days of Earth Day Activities with Announcement of Major New Energy Efficiency Effort](#) (April 21, 2010).

⁹ See [U.S. Awards \\$452 Million for PACE Programs, Other Energy Retrofits](#), Sunpluggers.com (April 21, 2010).

¹⁰ See [Policy Framework for PACE Financing](#).

¹¹ See [The DOE Guidelines for Pilot PACE Financing Programs](#) (May 7, 2010).

¹² See Jonathan Hiskes, [House Democrats Introduce Bill to Defend PACE Clean-energy Program](#), Grist.org (July 15, 2010); see also [Database of State Incentives for Renewables and Efficiency](#).

¹³ See discussion at GreentechMedia, [PACE’s Respectable Track Record](#) (Aug. 2, 2010).

¹⁴ *Id.* (“The county draws money from an investment pool managed by its treasurer and from the Sonoma County Water Agency ... With an average project size of \$30,000, the county has spent \$30.4 million. Payback periods vary from 5 to 20 years – most residential work has a 20-year payback – and the interest rate is 7 percent ... Fifty percent of residential projects include solar.

967 homes and buildings, and more than 300 additional projects have been approved for construction. Thus far, the program has yielded some “respectable” key metrics:

- No defaults have occurred and less than two percent of repayments are late
- The county also has seen a boost in its construction industry
- Employment rose 8.4% in the program’s first nine months, though a drop in new construction starts this year wiped out the gain (without the program, layoffs would be likely have been deeper)
- Some lending standards are in place – borrowers need to have equity in their homes, no involuntary liens, must be current on tax and mortgage bills, and cannot have declared bankruptcy in the past year

It appears however that “better yardsticks are needed to measure retrofit success ... [as] the county isn’t yet sure whether energy savings fully cover loan repayments.”¹⁵ A goal of PACE is to have the expected average monthly utility savings be greater than the expected monthly increase in tax assessments.¹⁶

Likewise, yet on a smaller scale, the town of Babylon has seen strong consumer participation and a modest increase in construction activity as a result of its program. Launched in 2008, the program has financed work on 370 homes, with 180 additional homes under contract. The average project size is \$9,000 with a payback period of 8.7 years. During its first year, the program created 20 construction jobs, as well as additional positions behind sales counters and in municipal government. Furthermore, no defaults have occurred.¹⁷ According to Sammy Chu, director of Babylon’s PACE program, “[t]he lesson we’ve learned is you have to continue doing this to get better at it ... We’re not going to find the best way to run this program by shutting it down.”¹⁸

The Potential Benefits of PACE

With the goal of making energy efficiency investments easier and less expensive, PACE has the potential to increase the amount of capital invested in energy efficiency. The potential benefits of PACE moreover can positively impact both the consumer and society, with potential benefits including:

- A new source of capital for energy efficiency/renewable energy improvements;
- Longer repayment periods;
- Streamlined application process and lower transaction fees;
- Repayment associated with the property vs. the individual, so the obligation transfers with ownership;
- Tax deductible interest repayments;
- Information from a trusted source (state and local governments);
- Lower utility bills
- Job creation in the energy efficiency and renewable energy industries; and
- Reduced greenhouse gas emissions.¹⁹

These potential benefits have garnered interest from property owners, and the support of energy efficiency/retrofit and renewable energy businesses, and environmentalists. Additional supporters include the investors who provide funding for PACE programs (such as Renewable Funding LLC discussed above), and who also benefit from the priority lien status

Sometimes solar is installed along with energy remodeling; sometimes it is not. The county does not insist upon loading order requirements, such as mandating that a home’s energy consumption be reduced 10 percent or 20 percent with an energy retrofit before solar is installed. The region doesn’t have a high heating or air conditioning load, so the payback from retrofits such as adding insulation or installing a slightly more efficient furnace is modest. Solar can have a big impact on electricity use, though, replacing grid electricity for appliances and televisions.”)

¹⁵ *Id.*

¹⁶ See [Policy Framework for PACE Financing](#).

¹⁷ GreentechMedia, [PACE’s Respectable Track Record](#).

¹⁸ *Id.*

¹⁹ See Merrian Fuller Lawrence Berkeley National Laboratory, [PACE Financing Programs: Enabling Investment in Clean Energy](#) (Feb. 25, 2010).

offered in most PACE programs.²⁰ The priority lien status minimizes credit risk for PACE program investors, while, according to the FHFA, the PACE first lien status can be disruptive to a fragile housing finance market and long-standing mortgage lending protocols.²¹

Issues Presented by PACE

Balancing the FHFA Regulatory Objections against the PACE Policy Framework

In the July Statement, the FHFA directed that Fannie Mae, Freddie Mac and the twelve Federal Home Loan Banks undertake certain actions to protect their interests, noting that PACE programs pose “unusual and difficult risk management challenges for lenders, servicers and mortgage securities investors.”²² The FHFA’s overarching concern is that most PACE assessments acquire priority lien status, and thus place funds advanced for energy improvements ahead of existing first and subordinate mortgage liens:

*While the first lien position offered in most PACE programs minimizes credit risk for investors funding the programs, it alters traditional lending priorities. Underwriting for PACE programs results in collateral-based lending rather than lending based upon ability-to-pay, the absence of Truth-in-Lending Act and other consumer protections, and uncertainty as to whether the home improvements actually produce meaningful reductions in energy consumption.*²³

Policymakers however note that there should be a protection for lenders inherent in the design of PACE programs – a requirement that liability at the time of a foreclosure be limited to only the amount owed in arrears at that time. The full costs of the energy improvements are therefore not accelerated or due in full.

The goal of PACE is that the assessment run with the property, i.e., successor owners are responsible for any remaining balances.²⁴ Tying the retrofit loan directly to the property is considered a work around to a retrofit barrier as property owners tend to be far less inclined to invest in retrofitting if a move within a few years is even a remote consideration. This aspect of the program also seeks to solve credit and collateral issues by significantly reducing up-front costs to a very low initial payment or zero dollar hurdle rate with the provision that both the payment and value of the retrofit be transferred from one owner to the next.²⁵

The FHFA finds fault in the underlying premise of the PACE design – specifically that underwriting for PACE programs results in collateral-based lending rather than lending based upon ability-to-pay, and that the program omits the Truth-in-Lending Act and other key consumer protections.²⁶ Offering a different perspective, proponents assert that PACE can in fact improve an owner’s ability to pay and also aid in strengthening the mortgage market as the PACE loan and energy improvements should result in improved cash flow. Pointing to Boulder, Colorado’s (now canceled) PACE program, Clean Energy Wonk (a blogger) notes that under a PACE program, a property owner is first required to get an energy audit, which is then used to identify the cost savings estimates of possible energy improvements.²⁷

The energy audit requirement also ties into the issue of consumer protections, as the goal of PACE is that the monthly assessment cost be less than the monthly energy savings, so the energy improvement would effectively pay for itself. In addition, Clean Energy Wonk highlights the simplicity of PACE compared to the complex mortgages that were underwritten and securitized during the housing bubble that significantly weakened the global economy, and further

²⁰ See [Renewable Funding LLC](#).

²¹ See [FHFA Statement on Certain Energy Retrofit Loan Programs](#).

²² *Id.*

²³ *Id.*

²⁴ See [Policy Framework for PACE Financing](#).

²⁵ *Id.*; see also [Recovery Through Retrofit](#).

²⁶ See [FHFA Statement on Certain Energy Retrofit Loan Programs](#).

²⁷ See Clean Energy Wonk, [Will PACE Financing Damage the Mortgage Market?](#) (July 7, 2010).

suggests that appropriate protections can easily be included in PACE without canceling the whole program.²⁸

The federal policy framework for PACE financing programs in fact supports measures to limit risk to mortgage lenders, including:

- A reserve fund at the local government level to protect against late or non-payment of the assessment, meaning that the value of the mortgage lenders' collateral should not be reduced by any failure by the property owner to pay the PACE assessment
- The length of time for a property owner to repay the PACE assessments should not exceed the life expectancy of the energy improvements
- PACE assessments should not exceed a certain percentage of the appraised value of the property, generally 10%
- Applicants must have clear title
- Property taxes must be current, and no notices of default, other property-based debt delinquency or outstanding tax liens in existence
- No PACE loans to borrowers who are "underwater" – whose mortgage and other debt is greater than the current appraised value of the house

PACE typically seeks to foster lending for retrofits through a municipality's tax assessment regime, a commonly-used financing mechanism for funding projects such as sewers, sidewalks, fire safety improvements, etc. The FHFA however asserts that PACE is unlike a routine tax assessment and rather poses unusual and difficult problems, namely that the size and duration of PACE assessments exceed typical local tax programs and do not have the traditional community benefits associated with taxing initiatives.²⁹ Proponents conversely characterize PACE as a creative application of the local tax assessment regime yielding both environmental, economic, and quality of life benefits to taxpayers. FHFA's characterizations of the PACE benefits as lacking "traditional" benefits simply confounds proponents, with confusion primarily around how proposed benefits such as reducing greenhouse-gas emissions, saving homeowners money on utility bills, and creating local jobs working on homes cannot be categorized as "traditional community benefits."³⁰

The FHFA guidance further criticizes PACE for the "the lack of energy retrofit standards to assist homeowners, appraisers, inspectors, and lenders determine the value of retrofit products combines to raise safety and soundness concerns."³¹ Proponents react strongly to this critique, holding that any good PACE program requires an energy audit and professional installation in order to ensure energy savings.³² The federal policy framework for PACE financing programs moreover highlights consumer protection as "a crucial first line of defense against defaults that would harm both homeowners and lenders."³³ PACE programs should indeed help ensure that energy retrofits are designed to pay for themselves within a reasonable period, that the expected average monthly utility savings to property owners is greater than the expected monthly increase in tax assessments, and that homeowners are protected against fraud or substandard work.³⁴ Moreover, the DOE and U.S. Department of Housing and Urban Development were tasked with establishing training and certification standards to prevent against faulty work.

In addition to the FHFA objections, some PACE opponents have questioned why tax dollars should be allocated to people for retrofit purchases in order to reduce their power consumption and utility bills. Why not give these people tax credits to make the retrofits, resulting in a simpler process that is directly between the property owner and the IRS? Thus, the taxpayers remain out of the equation, and moreover no government agency is necessary to promote and monitor PACE. Proponents, on the other hand, view PACE as government at work – a program that has a clearly planned and structured means for paying and recouping loans, lowering utility bills, creating jobs, and helping reverse environmental damage.

²⁸ *Id.*

²⁹ See [FHFA Statement on Certain Energy Retrofit Loan Programs](#).

³⁰ See Jonathan Hiskes, [Fannie and Freddie to Clean Energy Program: Drop Dead](#), Grist.org, (July 6, 2010).

³¹ See [FHFA Statement on Certain Energy Retrofit Loan Programs](#).

³² See Clean Energy Wonk, [Will PACE Financing Damage the Mortgage Market?](#)

³³ See [Policy Framework for PACE Financing](#).

³⁴ *Id.*

Legal and Political Challenges to the FHFA July Statement

Many cities and counties had already implemented PACE or were just getting programs underway, and thus were hamstrung by the FHFA's July Statement. Constituents however have pushed back, challenging the FHFA's stance through both litigation and proposed legislation.

First, Jerry Brown, the California Attorney General and Democratic candidate for Governor, filed a lawsuit in U.S. District Court in Oakland against the FHFA, Fannie and Freddie seeking a declaration from the court that participation in PACE programs does not violate the standards of government-chartered Fannie Mae and Freddie Mac, and an injunction to prevent Fannie and Freddie from taking any action against homeowners whose properties have PACE liens. The suit alleges that the FHFA's actions violated California law authorizing PACE programs and moreover has resulted in a severe hampering of the state's efforts to assist thousands of homeowners in reducing their energy and water use, helping to drive the state's green economy, and creation of significant numbers of skilled, stable and well-paying jobs.³⁵

The suit further alleges that the "actions of these government-sponsored, shareholder-owned private corporations have placed California's PACE programs – and the hundreds of millions of dollars in federal stimulus money supporting them – at immediate risk while benefiting their own pecuniary interests."³⁶ Considered a novel allegation, the suit also claims that the FHFA violated federal environmental law by not conducting a review of the potential environmental impact of restricting PACE programs. Responding to the lawsuit, Edward DeMarco, the FHFA's acting director, stated that "[h]omeowners should not be placed at risk by programs that alter lien priorities and fail to operate with sound underwriting guidelines and consumer protections ... Mortgage holders should not be forced to absorb new credit risks after they have already purchased or guaranteed a mortgage."³⁷

Sonoma County, California and Sierra Club have filed lawsuits alleging similar claims. Sonoma County, being the first in the nation to launch a county-wide program, is considered a PACE pioneer.³⁸ The Sonoma suit claims that since the FHFA released its July Statement, twenty one applicants have withdrawn from the Sonoma County PACE Program and several participants in the program have been unable to refinance their homes or sell without first paying off the full amount owed to the county.³⁹

Sonoma County and Babylon⁴⁰ represent the only communities to keep their PACE programs alive in the face of the FHFA's July Statement. Both counties emphasize their success with PACE and hold that the programs are anything but high risk.⁴¹ With repayments at a high level, defaults non-existent and the benefits of stimulating local business, both communities decided to stay the course. Both communities moreover have basic lending standards in place and concluded that the energy savings to date have justified the lending. The lack of standards to evaluate retrofits however seems to be the weak link in the chain in both jurisdictions, but can of course be improved over time.⁴²

Additionally, Congressman Mike Thompson (D-CA),⁴³ joined by 29 other members of Congress, recently introduced legislation called the "PACE Assessment Protection Act of 2010." The goal of the Act is to ensure that underwriting standards of Fannie Mae and Freddie Mac facilitate the use of PACE programs to finance the installation of renewable

³⁵ See Todd Woody, [Fannie and Freddie Are Sued in California](#), NY Times Green Blog (July 14, 2010).

³⁶ *Id.*

³⁷ *Id.*

³⁸ See [Sonoma County Energy Independence Program](#).

³⁹ See Robert Digitale, [Sonoma County Sues Feds Over Energy Retrofit Policy](#), PressDemocrat (July 27, 2010).

⁴⁰ See [Long Island Green Homes](#).

⁴¹ GreentechMedia, [PACE's Respectable Track Record](#).

⁴² *Id.*

⁴³ See [Mike Thompson's Web Site](#) (California PACE programs had been operational in the City and County of San Francisco, Sonoma County, Placer County, Palm Desert and Yucaipa, and additional programs were set to launch in 2010 in the following jurisdictions: Los Angeles County, San Diego City, Alameda County, Fresno County, Kern County, Monterey County, Sacramento County, San Diego County, San Benito County, San Luis Obispo County, San Mateo County, Santa Barbara County, Santa Clara County, Santa Cruz County, Solano County, Ventura County).

energy and energy efficiency improvements.⁴⁴ This bill, having been referred to the House Committee on Financial Services, is only in the first stage of the legislative process.⁴⁵

What are the Alternatives?

Government Action

While there is legislative action at the federal level with regard to the proposed PACE Assessment Protection Act, the bill is very much in the initial stages of the legislative process, and thus any meaningful impact will likely not take place in the immediate future. For the time being, PACE programs are basically frozen while alternatives are being considered. For instance, California, the state with the most PACE programs in operation and set-to-launch, has canceled solicitation and is at a standstill. The California Energy Commission is currently developing alternatives, though a director within the agency expressed via email to the author that further discussions around next steps would be premature to discuss at this juncture.

In light of the FHFA regulatory determinations, the DOE has been compelled to direct state governments to consider alternatives to programs in which the PACE assessment is given a senior lien priority.⁴⁶ The DOE notes one alternative PACE option – PACE assessments that are subordinate to first mortgages, a program design currently being piloted in Maine.⁴⁷ Subordinating the PACE loan, however, makes the program less attractive to investors looking to minimize risk. Additionally, the DOE supports ARRA grantees pursuing other promising approaches to retrofit financing, including, but not limited to [Loan Loss Reserve Supported Unsecured Revolving Loan Funds](#)⁴⁸ and [On-Bill Utility Financing Programs](#).⁴⁹

On the local level, cities and counties have chosen different courses of action in response to the FHFA objections. As discussed above, Sonoma County initiated a lawsuit while keeping its PACE program alive at the same time. Likewise, Babylon decided to forge ahead with its PACE program in the face of the FHFA opposition. Though the town of Babylon threatened litigation against the FHFA, it has yet to file a lawsuit.⁵⁰

⁴⁴ See [Mike Thompson's Web Site](#).

⁴⁵ To track status, see [Gov Track H.R. 5766](#).

⁴⁶ See [The DOE, Energy Efficiency & Renewable Energy Page](#) (“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.”)

⁴⁷ “In passing LD 1717 to authorize PACE loans in Maine, the state legislature decided not to establish a PACE system that might interfere with the priority (seniority) of home mortgages. Instead, a PACE assessment in Maine is secured by recording a “notice of a PACE agreement” in the registry of deeds, creating a PACE mortgage on the property. In Maine, a PACE mortgage is not entitled to any special or senior priority. The PACE mortgage is junior and subordinate in priority to the first mortgage, regardless of the date that any of the mortgages were recorded.” See <http://www.energymaine.com/pace/faqs>.

⁴⁸ State and Municipal Revolving Loan Funds (RLFs) are funds of capital used to provide loans for energy efficiency and renewable energy improvements; loan repayments recapitalize the funding pool to enable additional lending. Government-sponsored RLFs typically offer lower interest rates and/or more flexible terms than are available in commercial capital markets. These programs typically focus on financing the cost of efficiency upgrades such as appliances, lighting, insulation, and heating and cooling system upgrades. See [DOE Solution Center RLFs](#).

⁴⁹ The utility or some other entity (such as a third party financial institution) incurs the cost of the upgrade and the customer repays the investment through a charge on their monthly utility bill. This eliminates the upfront cost to the consumer for clean energy improvements by financing all costs not covered through rebates. These programs stretch out the financing costs over a sufficiently long period to make the repayments less than the savings. On-bill repayment allows for a streamlined process as utilities already have a billing relationship with their customers, as well as access to information about their energy usage patterns and payment history. See [DOE Solution Center On-Bill Repayment Programs](#).

⁵⁰ See Jonathan Hiskes, [Long Island Town Threatens to Sue Fannie & Freddie over Clean-Energy Program](#), Grist.org (July 13, 2010).

Houston alternatively has opted to pursue a new course by launching an approximately \$3 million revolving loan program to fund energy efficiency improvements. The revolving fund is modeled after the long-running “Texas LoanSTAR Program” (a statewide program granting loans for energy efficiency improvements in public buildings), which attributes its success to strong quality controls.⁵¹ Though the revolving fund is initially only for commercial properties, Houston does want to expand the program to include residential properties whenever feasible.

Similar to PACE, the Houston Commercial Building Energy Efficiency Loan Program seeks to cover the full cost of the energy efficiency installation upfront, offer a low-interest rate compared to the competitive loan market, and provide an extended repayment period (approximately three to five years). This is the criteria being considered along with a projected launch date in late October 2010. Laura Spanjian, Houston’s Sustainability Director, noted to DEFG that she has not yet given up on PACE and is still advocating for the reversal of FHFA’s position, but the city of Houston desires to move forward in the meantime and “wants to give property owners the tools to make energy efficiency improvements.”

Actions Taken by Interest Groups

Some environmentalist groups have pursued litigation while others are implementing grass roots efforts in response to the FHFA. As mentioned above, Sierra Club filed a lawsuit against the FHFA in U.S. District Court in San Francisco,⁵² and the Executive Director Michael Brune asserted that, “Fannie Mae and Freddie Mac are overstepping their bounds by preventing Americans from using these programs. PACE programs provide middle class Americans a means to invest in affordable energy upgrades that will in turn create thousands of clean energy jobs. Fannie Mae and Freddie Mac need to stop blocking participation in these programs.”⁵³ Among other things, Sierra Club seeks a declaration from the court that the FHFA July Statement is not in accordance with law and further that the FHFA not be permitted to take any action that discourages lenders from offering mortgages secured by homes with PACE assessments.⁵⁴

Meanwhile, the non-profit group Vote Solar, whose organizational mission is to fight climate change and foster economic opportunity by bringing solar energy into the mainstream, has taken a different course, implementing a grassroots electronic letter writing effort to urge representatives in Congress to support legislation that “gets PACE back on track.”⁵⁵

The Future of PACE is Uncertain

While Sonoma and Babylon have well-established PACE programs and have opted to keep them alive, it remains to be seen how current participants in these programs will fare and moreover how these communities will garner new interest from investors and consumers. The proposed federal legislation would require mortgage financiers to facilitate the use of PACE programs to finance the installation of renewable energy and energy efficiency improvements, but there is no

⁵¹ See [State Energy Conservation Office of Texas](#) (The Texas LoanSTAR Program uses a revolving loan mechanism and was initiated by the Texas Energy Office in 1988 and approved by the DOE as a statewide energy efficiency demonstration program. The funding source is petroleum violation escrow funds from the federal government. LoanSTAR is unique in a number of ways – the size, \$98.6 million, makes it the largest state-run building conservation program in the US. The loans are targeted for public buildings, including state agencies, school districts, higher education, local governments and hospitals. In order to comply with the mandate, the State Energy Office developed program procedures and guidelines to allow the LoanSTAR Program to not only prove that the financed energy retrofits would pay for themselves, but also to demonstrate that the actual energy savings were being exceeded by over 20% of the originally estimated savings. Included as part of the quality controls for the program were: 1) development of LoanSTAR technical energy assessment report guidelines; 2) training of energy engineering consulting firms on audit techniques and the LoanSTAR guidelines; 3) development of protocols to have each LoanSTAR project metered and monitored to track pre- and post-retrofit energy consumption; and 4) creation of methods of analyzing energy savings from retrofits. Due to quality controls such as good audit guidelines, training, metering and monitoring, follow-up with agencies to ensure the retrofits were working properly, and building commissioning assistance for improved operation and efficiency, the measured LoanSTAR savings exceeded audit estimates of energy savings. Few energy efficiency programs can make this claim.)

⁵² See [Complaint Filed by Sierra Club](#).

⁵³ See Sierra Club, [Press Release: Fannie Mae, Freddie Mac Must Stop Blocking Home Energy Program](#) (July 30, 2010).

⁵⁴ See [Complaint Filed by Sierra Club](#).

⁵⁵ See [Democracy in Action](#).

way of knowing how long the legislative process might take or whether the proposed bill will even pass. Likewise, pending California lawsuits may result in a favorable outcome for plaintiffs calling for PACE to possibly be reinstated in California, however both the timeline and outcome are unknown.

Furthermore, the FHFA's concerns are valid. Deemed "a key alteration to traditional mortgage lending practice" by the FHFA, the first lien status of a PACE loan poses risks to mortgage financiers, and moreover, PACE is not seen as "essential" to spur energy conservation.⁵⁶ This debate is also taking place in the midst of an economic recession caused largely by risks taken in the mortgage markets, thus requiring the FHFA to exercise extreme caution at this juncture. Two critical public policy objectives are therefore colliding from a financing perspective – homeownership underwritten by a stable mortgage lending system and increased investment in energy efficiency improvements.

Legislators and Obama administration officials have been in talks with the FHFA, working to address the agency's concerns and keep PACE alive. Nonetheless, in an August 26, 2010 letter to Rep. Ed Perlmutter (D-Colo.), Edward DeMarco (acting director of the FHFA) asserted that despite "diligently" working to find a solution with Congress, and state and local governments, the agency remains convinced that PACE loans create too much risk:

*No satisfactory conclusion has been reached to address problems associated with liens created after a mortgage is in place, thereby transferring credit risk to banks, secondary market parties and investors in mortgage-backed securities ... FHFA, therefore, has determined that its guidance to its regulated entities must remain in place.*⁵⁷

Perhaps the answer is that PACE can only survive in a modified form similar to the program implemented in Maine, where PACE loans are treated as a junior mortgage on the property subordinate in priority to the first mortgage – regardless of the date any of the mortgages were recorded.⁵⁸ Additionally, programs that do not involve land-secured financing may be the necessary alternative. By example, in the case of the planned Houston Commercial Building Energy Efficiency Loan Program, the upfront cost of the energy efficiency installation is paid from a revolving loan fund and the repayment terms and interest rates are considered favorable, yet there are no financial risks posed for mortgage financiers.

Conclusion

Democracy at its best calls for a healthy debate where all stakeholders have an opportunity to present their concerns and influence regulatory choices. The PACE debate involves numerous public and private sector constituents and has brought some clear weaknesses to light. As the FHFA had the power to single handedly derail a large-scale energy efficiency program with nationwide traction, the agency is clearly an influential stakeholder, and thus probably should have been engaged at the onset of PACE policy formation. While the concerns expressed by the FHFA and the mortgage financiers are legitimate, objective analyses by other parties also hold that the fundamental tenets of PACE are sound, and that with additional time to evaluate and make adjustments, any drawbacks could be remedied and appropriate protections could easily be implemented without canceling the whole program. While the FHFA may have felt an obligation to act quickly and with excess caution in the current economic environment, PACE proponents may alternatively assert that the guidance effectively derailing PACE was careless or at minimum premature. Nevertheless, as the future of PACE is currently tied up in litigation and Congress' painstakingly slow legislative process, stakeholders across the country continue to create and implement innovative financing schemes with the intent of spurring investment in energy efficiency programs. As our energy, environment and economic challenges are indeed connected, there is a need for a systemic solution that satisfies a multitude of stakeholders over the long term.⁵⁹

⁵⁶ See [FHFA Statement on Certain Energy Retrofit Loan Programs](#).

⁵⁷ See Emily Gertz, [Mortgage Regulator Continues to Block Home Energy Conservation Program](#) Onearth.org (Aug. 31, 2010).

⁵⁸ See Footnote 46, *supra*.

⁵⁹ See the first segment of a three-part series on PACE by Peter Atkin and Corey Glick, [How the Fate of PACE Could Influence the Clean Energy Economy](#), GreenBiz.com (Sept. 1, 2010).

Appendix

Cynthia Boland is a Senior Associate with DEFG LLC and LEED G.A. Prior to joining DEFG, Ms. Boland was a practicing attorney in New York City. Most recently, she handled general business and commercial matters with Leader & Berkon LLP. Prior to joining Leader & Berkon, Ms. Boland practiced securities litigation with Paul, Weiss, Rifkind, Wharton & Garrison LLP, and served as counsel to Riverkeeper, a non-profit organization dedicated to protecting the ecological integrity of the Hudson River.

DEFG's *Series of Regulatory Choices* provides general information and is not intended as legal or financial advice. Your specific circumstances may vary from those described in this document. For more information about Distributed Energy Financial Group LLC or its publications, please contact Nat Treadway, ntreadway@defgllc.com or (713) 729-6244 or go to <http://www.defgllc.com>.

You may quote portions of this document with proper citation: DEFG's Series of Regulatory Choices, No. 3, ©2010 DEFG LLC.