PROPERTY ASSESSED CLEAN ENERGY

PACE financing in Ohio

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INTRODUCTION

The Property Assessed Clean Energy (PACE) financing is a dynamic and rapidly growing mechanism to finance energy efficiency and renewable energy projects in Ohio. Through PACE, special assessments are used to repay and secure upfront funding for improvements that save or generate energy. PACE financing leverages the security of special assessments to open up new sources of capital, allow for better financing terms, and incentivize development in an economical and environmentally conscious way. PACE requires minimal upfront investment from a property owner. Local governments can use PACE as an incentive tool without foregoing tax revenues or pledging its credit. The use of special assessment financing in Ohio spans over one hundred years. The application of special assessment financing to energy improvements through PACE has more recently transformed them into engines for growth around the state.

PACE allows property owners to pay for energy efficiency and renewable energy technologies through special assessments paid with their property taxes.

What is PACE Financing

ACE financing in Ohio involves public-private cooperation between a property owner, a lender, a municipal corporation or town- ship and an energy special improvement district (ESID). The lender makes a loan to the property owner for the property owner to undertake solar photovoltaic, solar thermal, geothermal, wind, biomass, gasification and energy efficiency projects. The loan can take a variety of forms, and the lender can be either a public or private entity. From this point of view, PACE is not substantially different than other forms of financing. But PACE's innovation is in how this loan is secured and repaid.

PACE allows the municipal corporation or township to levy special assessments on the property in installments sized to repay the loan and associated financing costs. In order to levy these special assessments, Ohio law provides for the creation of an ESID. The ESID provides for the PACE project by working with the property owner to develop a plan for the project. The municipal corporation or township where the property is located is automatically part of the ESID when it approves the ESID's formation or the addition of property to it.

Once levied, the special assessments are added to the property owner's tax bill. The special assessments are collected by the county with the rest of the property taxes and settled under its normal processes. The amount of the special assessment for that period is transferred to the lender to repay the loan as provided for in the financing documents. If any current special assessments are not paid, then a lien is placed on the property by operation of law for the amount of the unpaid special assessment. This lien has the same priority as unpaid property taxes, which is the highest priority in Ohio, and is ahead of a first mortgage lien position.

The special assessments are tied to the land, rather than the property owner. So the special assessments can stay with the property upon conveyance.

The ESID can grow to support other projects in the same municipal corporation or township, or it can extend to contiguous municipal corporations and townships. Most major metropolitan areas in Ohio are already supported by regional ESIDs to allow for projects in their areas.

PACE in Ohio

The development of PACE programs

Although PACE is a creation of state law, two of the first steps of the process occurred at the national level around 2009: the White House released a policy framework for PACE programs, and the U.S. Department of Energy announced grant funding opportunities for energy efficiency projects. These two developments raised awareness for the opportunities afforded by PACE and recommended some of the safeguards a full program would require. Ohio acted quickly by passing its first PACE law in mid-2009, and the General Assembly and the Ohio governor expanded the breadth of the projects allowed under the law less than a year later. The legislation amended Ohio's special improvement district statute to allow for ESIDs and the financing of solar photovoltaic, solar thermal, geothermal, wind, biomass, gasification and energy efficiency projects.

Projects eligible for PACE financing

PACE financing in Ohio is available for:

- Energy efficiency improvements, which are technologies, products and activities that reduce or support the reduction of energy consumption, allow for the reduction in demand or support the production of clean, renewable energy and that are or will be permanently fixed to real property
- Solar photovoltaic improvements
- Solar thermal improvements
- Geothermal improvements
- Customer-generated energy projects that include wind, biomass or gasification facilities that are either:
    1. Designed to have a generating capacity of 250 kW or less; or
    2. Located on the project owner's property, operated in parallel with electrical transmission and distribution facilities serving the property, not producing energy for direct sale to

the public, and intended primarily to offer all or part of the electricity requirements of the facility-owner

Energy Special Improvement Districts

An integral component of PACE financing is that the property where the PACE project is to take place must be within an ESID. An ESID is a public body created under Ohio law and controlled by the board of directors of a non-profit corporation set up for that purpose. An ESID is a specific type of special improvement district. Special improvement districts have long been used by townships and municipal corporations to undertake locally controlled public improvement projects.

The territory of an ESID is limited to the specific parcels of land on which a PACE project is planned. But any parcels in a municipal corporation or township that creates or joins an ESID can easily be added to the ESID. Once a potential PACE project is identified on a property, the PACE project components and costs are identified in a petition to impose special assessments on that property and a plan for the undertaking of those improvements. While the municipal corporation or township follows its own legislative process, the ESID board must also approve the project plan and the agreements for the project at a meeting of the ESID board of directors held specifically for that purpose.

Creating an ESID is a straightforward, statutory process. A single project in a municipal corporation or township is necessary for the creation of an ESID that is then fully prepared to easily provide for PACE projects on any parcel within that municipal corporation or township or in any adjacent municipal corporation or township.

Unlike a traditional special improvement district, the parcels located within an ESID do not have to be contiguous, and participation in an ESID is completely voluntary for a property owner. Generally, a single property owner will determine that PACE financing is well-suited for their property and will then reach out to the municipal corporation or township to initiate the process of creating or joining an ESID. A municipal corporation or township alternatively can create or expand an ESID by using property it owns as a way to encourage the use of PACE financing within its borders.

Many of the major metropolitan areas in Ohio are subject to a regional ESID that encompasses the surrounding municipal corporations and townships. Examples include the Columbus Regional ESID, the Northeast Ohio Advanced Energy District in and around Cleveland, the Suburban Communities ESID around Cincinnati, the Northwest Ohio Advanced Energy Improvement District in and around Toledo, the Dayton Regional ESID and the Akron-Summit County ESID. These ESIDs operate organized and robust programs, and they generally have close relationships with the local governments they cover. But the ESIDs are independent bodies. They typically have strong operational support from a program administrator, a port authority or another interested party. These regional ESIDs actively seek new PACE transactions and are prepared to help guide a deal from inception to closing.

Financing a PACE project

Assessments are powerful tools that allow each participating property owner to finance new PACE projects in installments instead of requiring upfront capital investment. A municipal corporation or township, in cooperation with an ESID, can levy special assessments on participating property owners' real property for up to 30 years. Since a special assessment is an item on a property's tax bill, the obligation to make the special assessment payment can be passed through to the tenant if a lease requires the tenant to pay all or a portion of the property taxes and special assessments.

Special assessments are the key to PACE financing. The initial capital for the improvements can come from any source, as long as the capital provider will accept repayment through the special assessments. Generally, the initial capital comes from a public lending program, such as a port authority, or through a private lending institution, such as a PACE-specific lender or commercial bank. The source of capital and the terms of repayment depend on the fac- tors of the project, including the type and use of the property, the location of the property and the type of improvements.

Public lending programs and bond financing

For large projects or projects in regional ESIDs, some form of public funding may be available for the project. Public funding is generally available through one of Ohio's port authorities in the form of a loan program or through the proceeds from a port authority bond. PACE financing can be a prime economic development tool for a port authority or local government, as it encourages investment without sacrificing tax revenue.

Some port authorities in Ohio operate lending programs for economic development purposes, which may include PACE projects. In those cases, a property owner can apply to the port authority for access to the program. The source of capital for the loan may require the imposition of additional requirements on the loan, but a port authority's familiarity with tax-bill financing structures allow for competitive rates. These loans are sometimes backed by federal or state loan, grant or guarantee programs.

Direct conduit bonds may provide another source of capital for a lending program. Individual projects are considered on a case-by-case basis, and factors determining whether conduit bonds are suitable include whether the project is stable enough to market to purchasers and large enough to support the costs of issuance. One of the primary benefits of bond financing is its ability to fund very large projects and provide lower interest rates. With a bond financing, the special assessments from one or more PACE transactions are assigned to a trustee to make principal and interest payments on the bonds.

Private lenders

Specialized lending institutions have developed alongside the growing PACE market. These private lenders operate to specifically offer PACE loans in states around the country and often partner with local contractors, ESIDs and PACE professionals to originate and service PACE loans. Private lending options also include traditional commercial banks, especially in situations where a particular bank is already involved in a project and desires to access an additional part of the capital stack for a project.

In certain well-established ESIDs, a specialty PACE lender that has previously done a project within that ESID will move quickly through the credit process. Many specialty lenders have clear guidelines and requirements that are designed solely to fund PACE projects. These lenders may have requirements that are narrower than what is allowed by law, including limits on project size, the length of the assessment term or the type of improvements financed. These lenders generally fund both renovation and new construction projects, with financed amounts of between $200,000 and $5,000,000.

Commercial bank lending is highly dependent on the individual bank and its relationship with the property owner and the subject property. PACE lending can be a valuable tool for a commercial bank, as a PACE loan will provide the commercial bank with the additional security of the property tax lien without changing any current security arrangement. The PACE loan also doesn't affect the ratio of collateral for any previous or contemplated loans. If a bank is involved with other sources of financing on a project, becoming a PACE lender allows for the bank to maintain greater control with- out redoing other credit decisions.

Residential PACE programs

However a PACE transaction is financed, a property owner may still have access to tax credits or other incentives for energy efficiency and alternative energy projects. There have been, and may continue to be, tax credits available from the federal government, the State of Ohio and local utilities. The various financing options and the ability for a property owner to take advantage of other incentives allows for a property owner to flexibly incorporate PACE financing into a project.

PACE was originally conceived of for use on residential properties as a way to remove financial barriers for families to invest in energy efficiency and renewable energy improvements. Since the obligation to pay the special assessments runs with the property, the burden of paying for the improvements exists for whoever owns the property and gets the benefits of the improvements, rather than the individual that undertook the improvements. PACE proponents hoped that the availability of PACE financing would increase the investment in energy efficiency measures to lower energy costs and lower a property's environmental footprint.

In 2010, and before the widespread implementation of residential PACE programs, Fannie Mae, Freddie Mac, the Federal Housing Finance Agency (FHFA) and the Comptroller of the Currency raised concerns about the priority status of PACE liens and how PACE loans interacted with the documents used by Fannie Mae and Fred- die Mac for mortgages it purchased. With the risk that Fannie Mae and Freddie Mac would not buy mortgages for residential proper- ties with PACE loans, or that PACE loans would violate the existing loan and mortgage documents, residential PACE transactions were severely curbed. The concerns for residential PACE transactions did not extend to commercial PACE transactions, as commercial mort gages generally already contained more restrictive covenants, and Fannie Mae and Freddie Mac do not buy commercial mortgages.

But the various statements issued in 2010 were principally focused on perceived risks more than actual market conditions. PACE proponents continued to present residential PACE as a viable incentive. California, an early adopter of PACE financing, became the largest market for residential PACE. One catalyst of residential PACE financing in California was the state legislature's creation of a loan loss reserve fund to offset some of the risks identified by the various federal government agencies. With the strong commitment of state and local governments, thousands of residential PACE deals have taken place in California.

In 2015 and 2016, the Federal Housing Administration (FHA) and the Department of Housing and Urban Development issued guidance for the refinancing or purchase of homes with FHA-backed mortgage products for properties with certain existing PACE loans outstanding. While this opened the door for FHA-insured mortgages of properties encumbered by PACE obligations, the guidance was reversed in December 2017.

But California's residential PACE programs have continued to grow. Residential PACE markets have also developed in Missouri and Florida. Ohio's PACE law allows for residential PACE transactions.

As the stakeholders in residential PACE programs continue to discuss its merits and implications, residential PACE programs are likely to expand to more markets throughout the country.

Stakeholder Protections

Consumer protections

PACE transactions are completely voluntary, and Ohio law requires a property owner to initiate the PACE legislative process. In so doing, a property owner must take care to fully understand his or her rights and responsibilities under the PACE documents and state law. As with any loan, a property owner must rigorously consider the terms of the loan and its current financial position to determine whether the financing is prudent under the circumstances. One piece of additional due diligence that is generally necessary for PACE projects is an energy audit or an engineer's certification of the current energy usage and expected savings due to the PACE project. The cost of an energy audit is often offset by the savings metrics and usage information it contains. In most cases, it can be paid for as part of the overall cost of the PACE projects. Some lenders and ESIDs may require an energy audit for a PACE transaction to commence.

Certain additional safeguards or terms may help put the property owner in the optimal position for full and timely repayment. Per- haps the most important of these safeguards is ensuring that the planned improvements are well-designed for the property and the property owner's needs. Specifically, the project should have a savings-to-investment ratio of close to or greater than one. The energy savings or other measurable economic benefits, such as operations and maintenance savings, should nearly equal (or, optimally, be greater than) the amount of the PACE special assessments. The best case scenario for a property owner is for the improvements to “pay for themselves” over the special assessment term by saving a greater amount of money than is required to be paid as PACE special assessments.

To this end, a property owner may want to focus on improvements with a high return in energy efficiency or renewable energy gains. For instance, LED lights generally have considerable and immediate energy savings. However, not all improvements produce enough energy savings to offset their initial cost, especially for larger, more expensive improvements, such as boilers. These larger improvements are nevertheless often necessary for the use of a property, and they can play a valuable role in a well-crafted PACE project. They often have a longer useful life, which may help sup- port a longer special assessment term and, thereby, lower individual special assessment payments.

Property owners must carefully select the contractors and service providers for their PACE projects. In order to realize the projected energy savings or generation levels, the improvements must be constructed, installed and maintained correctly. PACE financing is fully utilized only when the improvements are complete and correct. Otherwise, the energy savings or generation expectations may not be attainable. Many licensed contractors have experience with energy efficiency or energy generating technologies, and quality assurance reviews should take place following the completion of the project.

In some cases, a property owner may be able to seek a limitation of liability for the outstanding PACE loan balance in a default situation in negotiations with a lender. Under Ohio law, only the special assessment levied for a given year is then due and payable. For in- stance, if a PACE loan is designed for repayment through a special assessment collected every year for 20 years, and a property owner does not make the payment in year four, then only that missed special assessment payment is delinquent at that time. The remaining special assessments are not accelerated. Although uncommon, a lender could require that the outstanding balance of the PACE loan itself is accelerated, even though the special assessments themselves are not. Whether the outstanding balance of the loan is accelerated upon the nonpayment of one special assessment payment is a contractual obligation between the parties, so property owners should consider all of the loan terms, as well as the special assessment requirements.

Safeguards for mortgage holders

Ohio law does not require the consent of mortgage holders be- fore PACE special assessments are placed on a property. But the best and most widely employed practice is to obtain the consent of the mortgage holder of a property prior to entering into a PACE transaction. A PACE transaction can benefit a mortgage holder, as the property receives needed improvements to make the property more usable, marketable and potentially valuable. Although the mortgage holder is not making the credit decision on the PACE loan, many of the same factors are involved in offering mortgage holder consent, including:

- Length of repayment obligation
- Size of financing relative to property value
- Clear title
- No uncured defaults
- No negative equity financing
- Vulnerable lands

A mortgage holder may have already considered one or more of these elements throughout its relationship with a property owner. A PACE lender will have considered these elements in making its credit decision, and a mortgage holder is encouraged to have a conversation with a property owner or the potential PACE lender, should it need further clarification.

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