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How Cool: Changes to Municipal Finance Law Address Global Warming, Create Green Jobs and Promote Energy Independence

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Many, if not most, property owners could save money by investing in energy efficiency or renewable energy systems for their homes and businesses. However, although it may be economically irrational, we stubbornly resist paying for improvements that will make a handsome return on our investment over time.

The central problem is that, while buying power from your utility is a simple, pay-as-you-go service, making energy efficiency retrofits and installing renewable energy systems requires a significant upfront investment. In many cases, the money spent on these improvements will take up to 20 years to be recovered in savings on utility bills.

We've known for decades that most individual property owners are unwilling to invest in renewable energy due to the high upfront costs and delayed return on investment. However, the growing climate crisis, dramatic energy price increases, and the opportunity to create green jobs in the face of high unemployment levels have created a window of opportunity for overcoming this reluctance. If we can overcome the upfront cost hurdle and provide incentives for home and business owners to make these clean energy improvements, we can address some of the most pressing crises facing our nation and the planet.

Municipal finance—yes, the staid world of municipal bonds—has the potential to essentially eliminate upfront cost barriers and spread the cost of energy efficiency improvements over their useful life. Local governments across the country are engaging an innovative municipal finance model to encourage local property owners to do their part to reduce greenhouse gas (GHG) emissions.

Property Assessed Clean Energy (PACE) financing programs use land-secured finance districts which allow property owners to pay for clean energy improvements through a lineitem on their property tax bill.[1] 100 percent financing is commonplace in the municipal finance world. The repayment is secured as a senior lien against the property, which means that the bonds receive repayment priority should property owners default on tax and/or mortgage payments. And, because property tax obligations transfer with property when it is sold, rather than being due on sale, the costs are repaid over the useful life of the financed improvements, regardless of who owns the property.

The initial success of these programs in the first communities to adopt PACE has been remarkable, as has its march across the country. Sixteen states have now passed enabling legislation authorizing some form of PACE program,[2] and the White House has adopted it as a key strategy for retrofitting the nation's existing building stock.[3] Retrofitting existing buildings is an essential part of reducing America's GHG emissions; today's buildings account for nearly 40 percent of our nation's demand for energy[4] and create roughly one-third of our GHG emissions.[5]

The rapid expansion of the PACE model has also spawned objections that PACE may put consumers or lenders at risk. At first blush, PACE may appear to be more like a home improvement program than a legitimate use of municipal financing. However, those concerns are misplaced. First, as explained below, PACE is just another example of using government's taxing power to achieve a public good. Second, a well-designed PACE program will enhance property values, increase cash flows to property owners, and protect lenders.

The History of Land-Secured Financing Districts

Land-secured financing districts—which are creatures of state law and are variously referred to as assessment districts, public improvement districts and community facilities districts, among other terms[6]—are an essential building block of municipal finance. They are used to finance projects including street paving, parks, open space, water and sewer systems, and street lighting, among others.

Land-secured financing districts operate by placing a senior tax assessment lien on properties that receive a benefit from the financed improvement. The lien secures an assessment payment that is levied on properties through the property tax bill. Tens of thousands of these districts already exist throughout the country and are a standard part of the property appraisal, underwriting and disclosure process.[7]

The key element of these assessments is that they are levied by a local government to advance a valid public purpose. Courts have concluded that what constitutes a public purpose may be broadly defined by legislative bodies, and courts defer to legislative bodies in their declaration of a public purpose.[8]

Designed to Meet Valid Public Needs

Whether it is melting glaciers, droughts, or plumes of jellyfish devastating fisheries, the effects of global climate change are being felt across the planet. It is already a crisis for many in our country, with dramatic wildfires plaguing much of the West and drought affecting large swaths of the Southeast and West. Moreover, the importance of increasing America's energy independence has been of growing concern over recent decades. Efforts like PACE that encourage individuals to reduce their energy consumption are vital to reaching national goals in this area. Last, the design of PACE inevitably leads to the creation of green jobs in communities where the program is active.

President Obama has made increased energy efficiency a cornerstone of his agenda, saying that "unless we free ourselves from a dependence on these fossil fuels and chart a new course on energy in this country, we are condemning future generations to global catastrophe."[9]

While the federal government has failed thus far to take aggressive action on climate change, many state and local governments have started to act. Over 1,000 cities have signed on to the GHG reduction goals proposed by the U.S. Conference of Mayors. Many states have set reduction targets as well,[10] most notably California with the passage of Assembly Bill 32 in 2006. AB 32 created legal mandates for the reduction of GHG emissions in California,[11] which has the 8th largest economy in the world.

There is little doubt that that our nation must take aggressive action to both prepare for unavoidable climate change and take meaningful steps to reduce our GHG emissions to avoid the most catastrophic changes. At all levels, government has a responsibility to meet this challenge through collective action. The additional benefits of increased energy independence and job creation are also significant. These pressing priorities establish a clear public purpose under the law, allowing for the exercise of a government's power to place a senior lien on properties that use PACE financing to pay for energy efficiency improvements.

Indisputable Public Benefits

A large body of research documents our country's ability to achieve major reductions in GHG emissions and reduce energy use through energy efficiency improvements in existing buildings. A study released in 2009 by the consulting firm McKinsey & Co. found that a $512 billion investment in energy efficiency would result in $1.2 trillion in savings by 2020, as well as more than 1 gigaton in GHG emission reductions.[12]

Governments at all levels have been working for decades to help property owners achieve these savings through a variety of means, from aggressive marketing campaigns to cash incentives and tax credits for solar power installations and energy efficiency improvements.

Despite these incentives, a number of challenges to widespread energy efficiency upgrades persist. Namely, significant upfront costs combined with common ownership patterns (the average homeowner moves every eight years, which is not long enough to recoup the expense of energy efficiency improvements through energy savings) and the high cost of traditional sources of financing have prevented many property owners from making these improvements.[13] PACE programs help property owners overcome those barriers.

How Does PACE Work?

With a land-secured financing district, a local agency creates a financing district that includes the properties that benefit from a financed project. The local agency sells bonds to pay for project costs and the property owners who receive a benefit—connection to the municipal sewer system, for example—pay back the costs through an addition to their property tax bill over a fixed period.

The PACE model requires a few slight modifications to the rules for a typical land-secured financing district. First, existing laws must be re-written to allow the financing of energy efficiency and solar projects on private property (in California, the list of authorized improvements has also been modified to include water conservation improvements).[14] However, PACE programs are not the first to use land-secured financing districts to finance privately owned improvements with a public purpose. For example, California allows the financing of seismic improvements, geologic hazard abatement and toxic remediation to private property.[15] Massachusetts provides septic tank replacement programs and secures repayment with assessment liens[16].

Second, PACE programs are entirely voluntary. Property owners only pay additional property taxes if they "opt-in," and they only pay for the cost of their project. However, voluntary taxes and assessments are not a PACE innovation. Neighborhoods voluntarily pay for the full costs of undergrounding utilities and other neighborhood-specific improvements using the same mechanism.

In states like California, taxpayer reformists have increasingly demanded the right to vote on and consent to taxes and assessments.[17] The opt-in nature of PACE assessments avoids these challenges. In fact, in California, land-secured financing districts are commonly used by land developers, who voluntarily assess their undeveloped property to finance the public improvements that must be constructed before the land developers' private projects can proceed, and then apportion the assessments among parcels as they are subdivided, developed and sold to long-term residents.[18] PACE's use of municipal finance to allow private property owners to voluntarily finance privately-owned improvements that serve a public purpose is not a meaningful departure from existing practice in even the most restrictive taxing environments throughout the country.

Early Success of the PACE Model and its Spread Across the Country

PACE has enjoyed tremendous success since its inception in 2008. Slots in the City of Berkeley's pilot program sold out in nine minutes,[19] and Boulder County, Colorado has sold bonds for over $10 million, covering 500 projects.[20] Sonoma County, California, is nearing $40 million in approved projects.[21] Palm Desert, CA has approved over $7.5 million in projects thus far.[22] The modified PACE program in place in Babylon, NY has also been successful.[23]

The rapid expansion of the PACE model to more than a dozen states is encouraging. A University of California at Berkeley study published in early 2009 shows that, if adopted widely, PACE could infuse $280 billion into the economy in the form of bond financing and could reduce overall GHG emissions by up to one gigaton.[24]

Concerns About PACE and Responses

In June of 2009, the Federal Housing Finance Agency (FHFA)—the federal government agency that regulates Fannie Mae, Freddie Mac and the Federal Home Loan Banks—wrote a letter expressing concern that PACE programs may put homeowners and lenders at risk of fraud, property loss, and unreasonable fees.[25]

Local agencies around the country collaborated to respond to the FHFA's concerns, and detailed the arguments in favor of PACE. These agencies argued that PACE is simply one example of the exercise of the local taxing power and that any threat to PACE is a threat to the exercise of the power to tax in general.[26]

Properly-designed PACE programs are a legal exercise of the municipal taxing power and do not pose threats to property owners or lenders. Moreover, energy efficiency improvements like the ones covered by PACE programs typically increase property values, further protecting property owners and lenders from risk associated with funding these improvements.

First, as explained above, PACE is not a radical departure from existing municipal financing programs, and PACE is narrowly tailored to achieve a menu of important public purposes. Although PACE programs may provide a less expensive source of financing and save property owners money on their energy and water bills, financial savings is not the purpose of these programs. PACE was designed in Berkeley in response to new state requirements that all California municipalities reduce GHG emissions.[27],[28] States, counties, and cities throughout the country have adopted the model with the same goal.

Second, PACE programs may be even more protective of the interests of property owners and lenders than traditional land-secured financings. The underlying premise of land-secured financing—the premise that has been held by courts to justify the potentially adverse impact on the rights of pre-existing private lenders[29]— is that the financed improvements add value to the properties assessed to pay for the improvements. The economic nexus between energy efficiency improvements and assessments levied to pay for the improvements is uniquely direct; PACE programs not only improve the assessed property but also offer immediate savings in utility bills that more traditional public improvements do not. And, according to a recent article in *Realty Times*, "[r]esearch studies have found that houses with high energy-efficiency ratings sell at premiums ranging anywhere from 7 to 14 percent over comparable, non-efficient houses, and take fewer days on the market to sell."[30]

Third, the risk to private lenders is extremely limited. Although PACE assessments are senior to private debt, only delinquent amounts are subject to foreclosure. Like all land-secured property taxes, the remainder of the assessment remains as a lien on the property to be paid over time by subsequent property owners. If the delinquent assessments are secured by a senior lien, a subordinate private lender may protect its lien by paying the delinquent assessment amount (which will typically be a nominal amount compared to the outstanding balance of the private mortgage) and adding the amount of any such protective advance to the amount of its loan. On the other hand, in the event a property owner defaults on a mortgage loan, the mortgage loan will be accelerated; the entire outstanding balance becomes due. If the mortgage loan were secured by a lien that was senior to assessments, a local government could only ensure the repayment of delinquent taxes by paying the entire outstanding balance of the mortgage loan. In most cases, this would be impracticable if not impossible. In other words, if assessments were subordinate to private loans, local governments would be unable to protect their interests (and those of its bondholders) and, therefore, be unable to finance the important work of local government.

Finally, the PACE community is working to develop "best practices" with respect to underwriting criteria. For example, programs are screening out all properties that exhibit financial distress or are delinquent in the payment of taxes, and they are restricting the amount that can be financed to a small percentage of the overall value of the property.[31]

White House and Federal Support

Both Congress and the White House have shown tremendous support for the PACE model and worked collaboratively to help overcome the concerns raised.[32] We are in a time that calls for creative ways to address our nation's environmental and economic challenges. The PACE model has the potential to address both of these issues. While the driving principle behind PACE is to incentivize private property owners to invest in energy efficiency improvements, a natural outgrowth of bringing these programs into a community is an increased demand for labor to do everything from conducting energy efficiency audits on current structures to installing triple-paned windows and solar energy systems. The construction trades have suffered tremendous blows in this recent recession; expanding the PACE model across the country has the potential to provide new jobs that would require minimal retraining for unemployed workers in these fields.

Because of these benefits, members of Congress and the Vice President have publicly lauded the PACE model as an important tool in addressing America's environmental and economic challenges.[33] In October 2009, Vice President Biden announced White House support of the PACE model, including the availability of millions of federal dollars aimed at expanding the PACE model to municipalities across the country.[34] Policy-makers at the federal level see the tremendous potential of PACE and are encouraging local governments to make these programs available to local residents and business owners.[35]

Conclusion

For a variety of reasons, the U.S. must now do all it can to reduce its energy consumption. PACE is poised to play an important role in this effort, and continued expansion of the model will both achieve important environmental goals and stimulate green job growth around the country. With several programs already in place, states and municipalities considering adopting PACE have the opportunity to evaluate what has worked well in different communities and to develop local programs best suited to their communities. By developing thoughtful guidelines for each PACE program, municipalities can design programs that ensure both lenders and property owners are protected from fraud, risk of property loss, and unreasonable fees. With so much at risk, policy-makers are increasingly seeing PACE as an important part of local and state efforts to reach national goals for reducing GHG emissions.

For a state-by-state analysis of state authority for PACE loan programs, see Bloomberg LawNotes®, *Quick Reference to State Authority for PACE Loan Programs*.

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[1] See PACENow, Property Accessed Clean Energy (PACE) Bonds: Innovative Funding to Accelerate the Retrofitting of America's Buildings for Energy Independence, www.pacenow.org (last visited Dec. 22, 2009).

[2] PACENow, *Clean Energy Municipal Financing Legislation*, *available at* http://pacenow.org/documents/PACE%20Legislation%20Map%20Table.pdf (last visited Dec. 22, 2009).

[3] *See* Brian Coppa, *Recovery Through Retrofit Program Offers Numerous Homeowner Benefits*, Examiner.com (Oct. 20, 2009), http://www.examiner.com/x-8178-Phoenix-Green-Business-Examiner~y2009m10d20-Recovery-Through-Retrofit-program-offers-numerous-homeowner-benefits (last visited Dec. 22, 2009).

[4] *See* U.S. Department of Energy (DOE), Buildings Energy Data Book, *Table 1.1.3 Buildings Share of U.S. Primary Energy Consumption (Percent)*, *available at* http://buildingsdatabook.eren.doe.gov/docs/xls_pdf/1.1.3.pdf.

[5] *See* U.S. Environmental Protection Agency (EPA), *Buildings and their Impact on the Environment: A Statistical Summary* (revised Apr. 22, 2009), *available at* http://www.epa.gov/greenbuilding/pubs/gbstats.pdf.

[6] *See* Stone & Youngberg LLC, *Land Secured Financial Guide*, at 2 (Jan. 2004) (on file with author).

[7] *See* Stone & Youngberg LLC, *Land Secured Municipal Debt: A Guide to Buying Non-Rated, Land-Secured Bonds*, at 1–2 (2007) (on file with author).

[8] *See, e.g.*, *Daggett v. Colgan*, 92 Cal. 53 (1891); *Bank v. Bell*, 62 Cal.App. 320 (1932).

[9] *See* Bootie Cosgrove-Mather, *Obama Stresses Energy Independence*, CBS News (Apr. 3, 2006), http://www.cbsnews.com/stories/2006/04/03/politics/main1466288.shtml (last visited Dec. 22, 2009).

[10] *See* Pew Center on Global Climate Change, *A Look at Emissions Targets*, http://www.pewclimate.org/what_s_being_done/targets (last visited Dec. 22, 2009).

[11] *See* California, Office of the Governor, Press Release, *Gov. Schwarzenegger Signs Landmark Legislation to Reduce Greenhouse Gas Emissions*, (Sept. 27, 2006), http://gov.ca.gov/press-release/4111/ (last visited Dec. 22, 2009).

[12] *See* Hannah Choi Granade et. al., *Unlocking Energy Efficiency in the U.S. Economy*, McKinsey & Co. (July 2009), *available at* http://www.mckinsey.com/clientservice/electricpowernaturalgas/downloads/US_energy_efficiency_full_report.pdf.

[13] *See* Kristen A. Hansen, *Seasonality of Moves and Duration of Residence*, U.S. Census Bureau (Oct. 1998), *available at* http://www.census.gov/sipp/p70s/p70-66.pdf.

[14] 2009 Cal. Acts, ch. 444 (2009-2010 Leg. Sess.) (A.B. 474). "The Legislature finds all of the following: (1) Energy and water conservation efforts, including the promotion of energy efficiency improvements to residential, commercial, industrial, agricultural, or other real property are necessary to address the issue of global climate change…." *Id.* at § 3. http://info.sen.ca.gov/pub/09-10/bill/asm/ab_0451-0500/ab_474_bill_20090916_enrolled.html

[15] *See* Stone & Youngberg LLC, *supra* note 6, at 39–40.

[16] *See* Mass. Department of Environmental Protection, *Community Septic Management Programs*, http://www.mass.gov/dep/water/wastewater/onsite.htm (last visited Dec. 22, 2009).

[17] *See* Proposition 13 (1978) (adding Article XIIIA to the California Constitution, and providing that "Cities, Counties and special districts, by a two-thirds vote of the qualified electors of such district, may impose special taxes on such district, except ad valorem taxes on real property or a transaction tax or sales tax on the sale of real property within such City, County or special district."); Proposition 62 (1986) (adding Art. 3.7 Voter Approval of Taxes, Cal. Gov. Code, § 53720 *et seq.*; and Proposition 218 (1996) (adding Arts. XIIIC and XIIID to the California Constitution). Proposition 218 declared that:

> Proposition 13 was intended to provide effective tax relief and to require voter approval of tax increases. However, local governments have subjected taxpayers to excessive tax, assessment, fee and charge increases that not only frustrate the purposes of voter approval for tax increases, but also threaten the economic security of all Californians and the California economy itself. This measure protects taxpayers by limiting the methods by which local governments exact revenue from taxpayers without their consent.

[18] *See* Susan Kraemer, *New Cycle Capital, Draper Fisher Jurvetson Invest $12.2 Million in PACE Solar Renewable Funding*, Scientific American (Nov. 5, 2009), http://www.scientificamerican.com/article.cfm?id=new-cycle-capital-draper-fisher-jur-2009-11 (last visited Dec. 22, 2009).

[19] *See* Paul Danish, *Double your bet on ClimateSmart*, Boulder Weekly (Oct. 8, 2009), http://www.boulderweekly.com/article-4-double-your-bet-on-climatesmart.html (last visited Dec. 22, 2009).

[20] *See* Sonoma County Water Agency. Press Release, *Green Jobs Created Through $100*

Million Sonoma County Energy Independence Program (Dec. 8, 2009), http://www.scwa.ca.gov/lower.php?url=press-releases&article=green-jobs-created-through-100-million-sonoma-county-energy-independence-program-2009-11-20 (last visited Dec. 22, 2009).

21 *See* Barbara Kessler, *Palm Desert, Calif., Sizzling Green*, ABC 7, Green Right Now (Sept. 8, 2009), http://www.greenrightnow.com/kabc/2009/09/08/palm-desert-calif-sizzling-green/ (last visited Dec. 22, 2009).

22 *See* Noah Buhayar, *Home-Energy Plan Spreads Out Costs*, The Wall Street Journal (Aug. 19, 2009), http://online.wsj.com/article/SB125064722656442071.html (last visited on Dec. 22, 2009).

23 *See* Stone & Youngberg LLC, *supra* note 6, at 36.

24 *See* Merrian C. Fuller et. al., *Toward a Low-Carbon Economy: Municipal Financing for Energy Efficiency and Solar Power*, Environment: Science and Policy for Sustainable Development (Jan. – Feb. 2009), http://www.environmentmagazine.org/Archives/Back%20Issues/January-February%202009/FullerPortisKammen-full.html (last visited Dec. 22, 2009).

25 *See* Letter from James B Lockhart III, Director, Federal Housing Finance Agency, to Neil Milner, President and CEO, Conference of State Bank Supervisors, et al. (June 18, 2009), *available at* http://pacenow.org/documents/FHFA%20Letter.pdf.

26 *See generally* PACENow, *Property Accessed Clean Energy (PACE) Bonds: Innovative Funding to Accelerate the Retrofitting of America's Buildings for Energy Independence*, No. 6 (PACE Federal Correspondence with FHFA, http://www.pacenow.org/ (last visited Dec. 22, 2009).

27 *See* City of Berkeley, Ballot Measure G, *Greenhouse Gas Emissions*, *available at* http://www.ci.berkeley.ca.us/uploadedFiles/Clerk/Elections/Ballot%20Measures%202006.pdf ("Should the People of the City of Berkeley have a goal of 80% reduction in greenhouse gas emissions by 2050 and advise the Mayor to work with the community to develop a plan for Council adoption in 2007, which sets a ten year emissions reduction target and identifies actions by the City and residents to achieve both the ten year target and the ultimate goal of 80% emissions reduction?"). Measure G passed by a margin of 82.30 percent.

28 City of Berkeley, Office of the Mayor, *Creation of Sustainable Energy Financing District*, Action Calendar Item No. 30 (Nov. 6, 2007), *available at* http://www.ci.berkeley.ca.us/citycouncil/2007citycouncil/packet/110607/2007-11-06%20Item%2030%20Creation%20of%20Sustainable%20Energy%20Financing%20District.pdf.

29 *Dressman v. Farmers' & Traders National Bank of Covington*, 38 S.W. 1052 (1897) (cited with approval by *O'Dea v. Mitchell*, 144 Cal. 374 (1904).

30 See Kenneth R. Harney, *Investor Report: Energy Efficiency*, Realty Times (July 10, 2009), http://realtytimes.com/rtpages/20090710_investorreport.htm (last visited Dec. 22, 2009).

31 Sonoma County, Cal., *Sonoma County Energy Independence Program: Program Report and Administrative Guidelines* (revised Nov. 9, 2009), *available at* http://drivecms.com/uploads/sonomacountyenergy.org/2080310839program_report_and_administrative_guidelines.pdf.

[32] *See* Letter from Bernard Sanders et al., U.S. Senator, to James B. Lockhart, III, Director, FHFA (Aug. 3, 2009), *available at* http://pacenow.org/documents/Letter%20to%20FHFA.PDF; Terrell McSweeny, *Going Green — And Saving You Money*, The White House, Council on Environmental Quality (Oct. 19, 2009), http://www.whitehouse.gov/blog/Going-Green-And-Saving-You-Money (last visited Dec. 22, 2009).

[33] *See* N.Y. Congressman Steve Israel, *New York Keeps PACE with Green Power*, Timesunion.com (Nov. 23, 2009), http://www.timesunion.com/AspStories/story.asp?storyID=869293&category=opinion (last visited Dec. 22, 2009).

[34] U.S. DOE, Press Release, *Vice President Biden Unveils Report Focused on Expanding Green Jobs And Energy Savings For Middle Class Families*, Oct. 19, 2009, http://www.energy.gov/news2009/8148.htm (last visited Dec. 22, 2009).

[35] *See* N.Y Congressman Steve Israel, *Roll Call: PACE Bonds Promote Efficiency*, Oct. 19, 2009, http://israel.house.gov/index.cfm?sectionid=157&parentid=5&sectiontree=5,157&itemid=755 (last visited Dec. 22, 2009).