Advancing Clean Energy for a Sustainable Economy

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NC PACE Policy Choices

There are many choices to be made in designing a successful plan for a Property-Assessed Clean Energy (PACE) program in North Carolina. This document discusses some of the dimensions on which PACE plans in other states have varied, provides descriptions of the different choices available and their advantages and disadvantages, and, where certain options seem clearly preferable, provides recommendations. On many of these issues, though, decisions will need to reflect assessments of the current political and business climate, and the judgments and preferences of stakeholders.

Initiation Model

PACE models can take several different forms, the differences between them largely reflecting the varying role of the state and local governments in initiating and supporting PACE programs (National Association of State Energy Offices, 2016). PACE models can be classified into four types: single statewide option, state and local option, local option with strategic state support, and local option with little or no state support (NASEO, 2016 p. 14).

- Single Statewide Option: Under this model, a state will have only one PACE program, which is administered at the state level. Municipalities have the option to join or not join the state program, but cannot create their own programs. Connecticut's PACE legislation is of this type. The single statewide option model creates transparency and consistency across the state for stakeholders, and minimizes the administrative burden and financial risk faced by municipalities. However, it limits the ability of municipalities to tailor their PACE program to local characteristics, and requires significant state government support.
- State and Local Option: This model involves a statewide PACE program that municipalities may opt into but also allows municipalities to create their own programs or join other existing programs. New York, Florida, Missouri, Utah, Colorado, and Maryland have this type of model. This model combines the advantages of state support present in the single statewide option model with the ability for municipalities to create a different program if necessary to match local characteristics. In some of these states the state-created programs appear to be dominant, while in others locality-based programs have carved a niche.
- Local Option with Strategic State Support: In this model the state does not create a statewide program, but provides standards and model rules to localities that wish to create their own programs. This can create consistency and transparency without involving direct state control. Texas's PACE in a Box initiative is an example of this model.
- Local Option with Little or No State Support: In this model localities take almost all of the responsibility for PACE program development. California is the most prominent example of this model, while Virginia's recent PACE legislation appears to be of this type as well. Localities under this model can still join larger PACE programs that operate in more than one locality, but such larger programs are not supported by the state government. The boundary between this model and the strategic support model is not sharp, as state

governments may still provide some support for PACE even in this model, but this model generally indicates that the state does not take a directing role in developing PACE programs.

North Carolina's current PACE legislation would probably be classified as creating a local option with little or no state support, but this should not be seen as indicating that all PACE models of that type will be unsuccessful, as evidenced by California. However, the recent trend has been towards state involvement in PACE. North Carolina's municipalities, especially in less-populated areas, generally lack the staff and resources to design and implement PACE programs themselves, so a state-supported PACE program would likely help PACE to become more widespread across the state. If state government seems unlikely to commit significant resources to developing a PACE program, a Texas-like model where the state provides or assists in the development of model PACE program rules would be a good option.

Funding Options

North Carolina's current PACE-enabling legislation already authorizes municipalities to issue bonds to finance PACE assessments. However, all locally-issued debt must be approved by the state government's Local Government Commission, making this process cumbersome. If this local debt restriction remains in place, it may be advisable to add state bonding authority to new PACE legislation (this would entail the state government creating a statewide PACE program, although not necessarily as the sole option).

While bonding is an important issue for PACE financing, the larger issue in North Carolina is probably that state law does not explicitly allow for private sector funding of PACE. In other states such as California, local governments are allowed to create "contractual assessments," where financing for a PACE project can come through a private funder (NASEO, 2016, p. 12). North Carolina does not allow such arrangements, which limits the availability of private funding for PACE. New PACE legislation should explicitly allow contractual assessments.

Who Administers the Program, and at what Level?

PACE programs can be administered by local or state governments, nonprofit organizations, or for-profit companies. PACE programs in other states typically use a third-party administrator, whether nonprofit or private for-profit. Nonprofit administrators may be less expensive than for-profit administrators and therefore may be able to facilitate more attractive financing for customers, but for-profit administrators often have better access to capital markets and more resources available to get a program started.

PACE programs also differ in whether they are administered at the state or local level; some programs (including many in California) are limited to a certain local jurisdiction, while others (e.g., Connecticut's program) are state-wide, and others enable local jurisdictions to join programs which can operate across multiple jurisdictions, but do not operate statewide (Missouri has four different PACE programs, and several of California's programs contain multiple jurisdictions).

A problem with the current NC PACE legislation is that it may require local governments to expressly approve each PACE contract made under their programs. This effectively requires direct local government administration, which is difficult given the resource and time constraints faced by local government offices. Even the locally-based California PACE programs typically use third-party administrators rather than relying on local government offices to administer their programs.

New NC PACE legislation should explicitly allow for third-party administration of PACE programs and should allow for local jurisdictions to join multi-jurisdiction or statewide programs. Legislation could also directly create a statewide program and either provide public resources for it or delegate it to a third party administrator (or some combination of the two), but this is not absolutely necessary. If a statewide program is not created, though, there should at least be provisions directing state government offices to assist local governments with developing and standardizing PACE program rules.

Residential vs. Commercial and Mortgage Lender Issues

Residential PACE programs operate in fewer states than does commercial PACE, but the overall residential market size is considerably larger than the commercial market in the states where it does exist. Residential PACE faces challenges due to the FHFA guidance preventing federal mortgage underwriters from underwriting mortgages subject to a PACE lien. However, residential PACE is still possible for homeowners without a mortgage, and for mortgages backed by the Federal Housing Administration rather than Fannie or Freddie.

Lender Consent

Provisions requiring lender consent from lenders of existing mortgages before entering a PACE contract are helpful in obtaining political support from the banking community. However, these provisions make residential PACE extremely difficult to develop, as banks are unlikely to consent to PACE liens being placed on residential properties. Commercial PACE is less affected by lender consent, so if a commercial-only PACE model is decided on, lender consent provisions would be advisable to include in the PACE legislation. If a residential PACE program is envisioned, lender consent is not advisable.

Even if lender consent provisions are not included, lender notification requirements should be included in the legislation. PACE-enabling legislation should also include specific eligibility criteria and underwriting standards; this may help to alleviate the concerns of home mortgage lenders.

Mortgage Seniority

Another option available to make mortgage holders more comfortable with PACE is to make PACE liens junior to first mortgages. Vermont has pursued this strategy with some success (Adamczyk, 2012). However, making PACE liens junior to mortgages makes them riskier for the PACE financing providers, as defaults become more likely. To counter this, Vermont created a loan-loss reserve program which compensates financing providers that face losses due to defaults (Adamczyk, 2012).

The loan-loss reserve fund is partially publicly financed, so this option is probably not feasible in states without the willingness or ability to provide public money to support PACE. In general, making PACE liens junior to mortgages reduces the advantages of PACE and therefore its attractiveness to both property owners and financing providers, and is probably not advisable for North Carolina.

Mortgage Acceleration

State laws differ on whether defaults on a PACE financing arrangement legally induce an acceleration of the payment of the entire loan amount; most states do not have acceleration (PACENation, 2010). Laws that require such an acceleration may provide more security for the funders of PACE projects (whether private or governmental). However, acceleration also places burdens on property owners and mortgage holders, given that PACE liens are typically senior in priority to mortgages. Federal policy has encouraged non-acceleration for PACE defaults (Zimring & Fuller, 2010).

Open vs. Closed vs. Hybrid Market

An “open” PACE market allows multiple PACE financing providers to operate and negotiate with customers directly, whereas a “closed” market gives one provider exclusive rights to operate in the market.

Closed markets can vary depending on the type of financing they are using. State or local government can function as the sole financial provider. Alternatively, a for-profit company can be given an exclusive contract to both manage the project and provide financing, or financing can be provided through the bond market, with the program administrator offering financing to customers, but obtaining this financing through the bond market.

Having an open market does not mean that public entities do not participate; Connecticut’s PACE program, for example, has used public funding and a public administrator (the Connecticut Green Bank), but allows for customers to negotiate their own financing (NASEO, 2016, p. 5).

The “open” and “closed” terms reflect extreme positions, and in practice many PACE markets are “hybrids” between the two. A hybrid market will allow multiple financial providers to operate, but gives advantages to some providers, such as pre-approval of deals and the ability to use standardized documents and procedures (Public Financial Management, 2014, p. 5). The advantages listed below should be seen as advantages to relatively more closed or open market systems, not things that only accrue to totally closed or open markets.

Closed Market Advantages:

- Gives some certainty to the financing provider
- Encourages the provider to invest more resources into its PACE operation
- Better for residential PACE, where the customer base is less sophisticated and more numerous, requiring more administrative work to reach and manage
- Introduces less uncertainty for the banking community, as there being only one provider means more standardized PACE contracts, less variation among customer arrangements
- Less oversight and quality assurance burden on administrator, as terms will be more standardized and financial provider is familiar

Open Market Advantages:

- Introduces competition, which can lead to better outcomes for customers and better program design
- Allows customers more flexibility in financing terms, which can appeal to larger, more financially sophisticated customers
- Limits need for up-front work by local government or third-party administrator, although oversight and quality assurance may require more work
- Better for commercial (especially large commercial) PACE, where customers do not require as much outreach and can handle some administrative matters in-house

The decision on whether to adopt a relatively more closed or open market system should be driven by an assessment of the stakeholders of whether closed market features are necessary in North Carolina to induce financial providers to contribute to developing and administrating the PACE program. If financing providers appear eager to promote PACE in NC, or if sufficient resources appear to be available for the program administrator to operate well without support from financing providers, an open market system would become relatively more advantageous.

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