State of Hawaii

REPORT TO THE GOVERNOR AND THE LEGISLATURE OF THE STATE OF HAWAII

Pursuant to

House Resolution 47, HD1, in reference to House Bill 2643 Relating to a Clean Energy Bond / Property Assessed Clean Energy Program

Submitted By
State of Hawaii Department of Business, Economic Development and Tourism

December 8, 2010

Overview

Property Assessed Clean Energy (PACE) is a discretionary financing strategy employed by local governments to assist property owner's finance and repay renewable energy and energy efficiency installations on residential, commercial, and industrial properties. Under a PACE program, a property owner may elect to have up to 100% of the cost of clean energy improvements to be repaid via a special property tax assessment on the property. The assessment or special tax is secured by a lien on the property and the obligation for repaying the assessment remains with the property owner, even upon sale of the property. Financing may be secured through a variety of options from private lending to government issued bonds.

The primary feature of the PACE financing strategy is "land-secured financing," a longstanding and widely-adopted mechanism used by local governments to finance improvements benefitting the public through tax levies or special taxes against the property benefited by such improvements. Land-secured financing districts (also known as special assessment districts) have been used for more than a century throughout the United States to fund sewers, sidewalks, fire safety improvements, and many other projects that serve a public purpose.

Assessments or special taxes are collected as part of the regular property tax bill and are secured by a lien on the property. Like other local government assessment or tax liens, PACE liens are senior to private liens, including those for pre-existing mortgage loans.

HR-47 Question 1- What is the true burden on the counties with respect to administering the program?

Answer: Counties would realize one-time start-up and ongoing operational costs. Start-up costs would include those for software integration and legal services regarding the tax assessment district formation and possible bond issuance. Because county tax assessment departments have similar software systems and procedures for processing and collecting property taxes, DBEDT had planned to use American Recovery and Reinvestment Act (ARRA) funds for a PACE pilot program to offset much or all of the start-up costs and to serve as a transferrable model for PACE programs throughout the state. Depending on the volume of PACE transactions, operational costs for tax collection, handling of liens, billing, and accounting could be considered as marginal to ongoing operations, although a modest transactional fee could be added to cover part or all of the operational costs of the program.

HR-47 Question 2- What jurisdiction should be responsible for underwriting loans and foreclosing on those loans when property owners default?

Answer: The most efficient way to manage the financing part of a PACE program is through a loan administrator that has experience in lending from origination through collections. The loan administrator could be the source of funds for loans, or could manage funds that were sourced from governmental sources, such as grants, bonds or the general fund. It is noteworthy that of the 22 states that have working PACE programs across the country, the default rates are less than 1%

of all originated liens. In addition, assessment lien defaults are not due in full as opposed to mortgage liens. Specifically, only the delinquent amount is due upon foreclosure of a property with a PACE lien, not the entire balance of the loan. The strength of the program resides in the assessment lien collection mechanism and the net savings the customer realizes in that their utility costs drop below that amount owed on the PACE lien. This in turn lowers the customers overall costs. The default rates are further reduced when debt service reserves are created to offset the minimal default ratios.

HR-47 Question 3- Whether property owners with clean energy loans fully understand that their loan repayments will be in addition to their regular real property taxes and that they should not expect to be shielded from probable real property tax increases in the future.

Answer: Taxpayers accustomed to special assessment liens understand that the structure of these liens is independent of their regular property tax bill. Unlike property taxes, PACE liens are a fixed rate over a fixed period, therefore the PACE portion of their payment will remain a fixed rate. In addition, part of the program design will include mandatory disclosures to all qualified participants outlining the distinction between the real property tax and the PACE special assessment lien.

HR-47 Questions 4,5 and 6- Whether interest rates on the loans will be affordable to most home owners; what type of bonds should be issued; and would bond financing be competitive in private markets?

Answer: The benefit of bond financing is that longer loan terms can be realized to lower the monthly payments on energy efficiency measures in which the private lending markets are unwilling or unable to provide. Private lending markets offer higher rates and prohibitively shorter term loans that are inhibiting lending in the energy space, therefore, bond financing provides a very competitive product against the private lending markets due to this reason alone. The cost savings is further enhanced when General Obligation bonds are issued due to the lower interest yield owed on those bonds. The lower yielding GO bond will represent a lower interest rate passed through to the consumer as a result. The changing of the funding structure from GO to GO reimbursable to revenue bond was by political action and was not part of the originally intended GO bond funding structure.

HR-47 Question 7-FHFA Opposition to PACE

Answer: The Federal Housing Finance Agency (FHFA) raised serious concerns to Property Assessed Clean Energy Pilot programs throughout the United States in a July 2010 statement. FHFA advised that liens on PACE loans are unlike routine tax assessments and pose unusual and difficult risk management challenges for lenders, servicers and mortgage securities investors. FHFA further advised state and local governments to reconsider employing programs already in place and called for a halt of new PACE programs until such time that its concerns could be addressed on the national level.

FHFA continues to maintain that first liens for PACE program loans represent a key alteration of traditional mortgage lending practices and that they continue to present significant risk to lenders and secondary market entities. In addition, FHFA continues to view these liens as altering valuations for mortgage-backed securities and are therefore, prohibiting all FHLA lenders from engaging in any lending activity where priority PACE liens remain.

In reaction to the adverse position taken by FHFA, several jurisdictions with existing or planned PACE programs have filed lawsuits against the FHFA asserting that in its opposition to PACE programs, FHFA had unlawfully impeded local governments in its lawful issuance of special assessment liens for the public good.

Hawai`i Impacts on FHFA's Position on PACE Programs

Several Hawai'i counties have been interested in pursuing PACE financing strategies to further their renewable and energy efficiency goals. In particular, Kauai and Hawaii County had seriously explored teaming with DBEDT on demonstrating PACE using federal funds from the American Recovery and Reinvestment Act (ARRA).

However, the counties have been dissuaded on implementing PACE at this time in part by FHFA's position as well as time constraints to enact ordinance modifications necessary to implement a PACE demonstration prior to U.S. Department of Energy 2012 deadlines on expending ARRA funds.

Alternative Financing Programs

In the absence of a PACE financing strategy in Hawai`i, DBEDT continues to seek additional methods to assist property owners with financing renewable energy and energy efficiency systems to meet the state's renewable and energy portfolio standards. Access to low-cost financing is viewed as a crucial part of achieving the state's clean energy agenda since the initial capital investment required by consumers to install renewable energy systems and energy efficiency improvements remains a significant financial barrier to property owners.

A promising DBEDT financing strategy under development is a loan loss reserve demonstration funded by ARRA funds that is expected to be launched in the first quarter of 2011. Loan loss reserve programs use a reserve against possible loan losses to encourage lenders to finance energy efficiency improvements and renewal energy systems. Loan loss reserves can provide risk coverage for a lender's losses on a portfolio of loans for eligible renewable energy and energy efficiency investments. A key feature of a loss reserve is that no guarantor is required.

Another alternative pursued by DBEDT is the issuance of general obligation or revenue bonds at the state level as a means to leverage new financing programs such as the loan loss reserve and direct loan programs administered via a revolving loan fund under a strategic partnership with one of the state's major lending institutions. As additional funds are added to the loan fund through DBEDT's program partners, the loan fund would achieve self-sufficiency for operation in perpetuity resulting from the revenue of loan repayments and sound investment of non-loaned portions of the fund.