Property Assessed Clean Energy (PACE) Program
Review of PACE Program
September 21, 2015

Management & Financial Services Recommendation

The Finance Office, with assistance from the City's Financial Advisor and Bond Counsel, has reviewed the potential impacts of the City establishing a Qualified Energy Conservation Bonds (QECB) or a Property Assessed Clean Energy (PACE) program for clean energy improvement projects for private businesses. This review was also in consideration of a specific proposal that had been made to the City's Energy and Sustainability Manager by Deutsche Bank. Based upon this review, Management & Financial Services does not recommend moving forward at this time with the PACE proposal from Deutsche Bank for the key reasons listed in the "Executive Summary of Risks and other Considerations" and "City Attorney's Office Recommendation" sections below. While supporting energy efficiency is important for the City's future, the proposed PACE program comes with significant financial and legal risks. Alternative programs which are provided at the end of this discussion paper may be more suitable for the City.

City Attorney's Office Recommendation

The City Attorney's Office, in collaboration with Bond Counsel, has reviewed the legal issues connected to the PACE project proposed in this memorandum. It is our opinion that, while lawful, the program as designed under the North Carolina General Statutes and implemented by borrowing agreements may lead to certain disadvantageous legal outcomes for the City. Those outcomes are tied to the design of the governing State legislation. Two concerns stand out among others. First, in the event of nonpayment by a benefitting property owner, the City would be required to pursue all available legal remedies, including instituting foreclosure proceedings, which may lead to political challenges. Second, since a special assessment lien would supersede the lending interest of a mortgage holder, a property owner with a mortgage interest secured by the property would likely need to seek the legal consent of a mortgage lender before participating in the PACE program and encumbering the property with another potential lien. Without such consent provided at some point in the process, the program loans likely could not be made. Therefore, it is our recommendation that the City seek to change the underlying State legislation or secure other more readily available and legally solid means of meeting its policy objectives.

Executive Summary of Risks and Other Considerations

- The City is issuing debt, providing the proceeds to a private entity to be used for energy savings measures on private property, and re-paying the debt with special assessment revenue. In the event the private entity does not make the special assessment payment, the City would be exposed to several significant risks:
  - Political/Public Policy risk – a) Elected officials would be asked to approve a loan program for private businesses, some of which could be perceived publicly as businesses with questionable need for public sector support, and to potentially apply the City's credit if needed; b) the City would be forced to foreclose by bond covenants regardless of whether it wanted to do so or not, which would be a public process with Council.
  - Timing risk – the foreclosed property may not be sold in time to make the debt payment.
  - Credit risk – there is legal uncertainty regarding the City's ability to appropriate funds to make the debt payment on behalf of a borrower in the event that a borrower is unwilling or unable to repay the debt. As a result, the City may in the position of not being able to pay its debt from the dedicated source(s) or from any of the City's other sources.
- It is uncertain whether the current prospective bank (Deutsche Bank) would continue to support the program long-term as a core bank product despite the City's significant startup costs including legal, financial advisory, City administrative costs, and County administrative/technical costs. Currently, it is our understanding that Deutsche Bank is the only bank interested in offering this program in North Carolina.
- Due to inexperience with the program nationally and no prior usage of the program in N.C., and its high-level of complexity, the City likely does not know all of the risks and challenges that would be encountered to establish such a program.
- The relatively small borrowing ($7m to $9m) makes this an expensive financing (effort to finance is similar - if not greater - than a typical $100+ million City financing).
- Concerns have been expressed by the City's Financial Advisor, Bond Counsel, and City Attorney's Office on the rationale for proceeding.

Background Information

- **See Attachment 1** "PACE Overview Flowchart" for a graphical depiction of the PACE program.
- **See Attachment 2** "Pace Foreclosure Flowchart" for a graphical depiction of the PACE program in the event of foreclosure.
- Deutsche Bank (DB) has a program they call PACE that they have implemented in other parts of the country. City issues bonds to DB and loans the proceeds to a private

business that then makes energy improvements to the property. The loan is backed by a special assessment lien on the property. The County collects special assessment taxes on the property and remits it to the City, and the City uses it to pay debt service.

- The vetting process of determining who will receive the loans would be conducted by Envision Charlotte and DB and their local partner.
- The NC Department of Commerce has allocated Qualified Energy Conservation Bond tax credits (QECB) to the City ($7 million) and County ($2 million). It is our understanding that the intent is to have the County re-allocate their allocation to the City.
- The City is among the first in North Carolina to consider issuance of PACE Special Assessment Bonds and City Finance, Legal, City Bond Counsel and the City's Financial Advisor have studied the potential for these bonds inside the current N.C. issuance parameters and prudent financial practices by the City.
- Although this program offers benefits from an energy saving and efficiency prospective, N.C. Statutes limit certain financial criteria and thereby create credit rating and Local Government Commission (LGC) approval concerns. These concerns include potentially creating a moral obligation if special assessment revenues are insufficient, and potential issues concerning legality. Additionally, the small size of the program available at this time results in borrowing costs that are a much greater percentage of the amount borrowed in comparison to other financings that have been undertaken by the City.
- SB 284, Special Assessments for Critical Infrastructure Needs Act, was signed into law by the Governor on June 29, 2015 (SL 2015-121). It extends the sunset for counties and cities to use special assessments for certain infrastructure projects until July 1, 2020.
- Information provided in this overview is based upon our current knowledge level and many other points for discussion and clarifications could occur if we move forward.

<u>General Considerations</u>

- Use of Special Assessment Bonds in North Carolina is rare and is customarily used for infrastructure purposes. Implementation of the DB type program has not occurred at this time in our State.
- A limited number of banks provide this type of program. Bank of America was initially interested in Qualified Energy Conservation Bonds but determined that it was not feasible for them, due to a lack of means for the City to provide credit support to the bonds. We are not aware of any other bank currently interested in a program similar to the DB approach.
- The City has never engaged in this type of program so there would be significant startup costs and time commitment involved in establishing it, including involvement of the County in the assessment collection and foreclosure. County staff has reviewed this program and currently does not have a system in place to implement the special assessments.

- It is uncertain whether the current bank (Deutsche Bank) will continue to support the program. A Capital Markets sector of DB is providing the funds and business decisions inside a Capital Markets part of the bank might choose to eliminate the program at any time based upon profitability, size of the program and the like. DB has indicated that they would provide some sort of financial contribution to offset some of the startup costs but an amount has not been determined at this point.
- The process for approving the Special Assessments is relatively lengthy. How often would the loan program be available for new loans? The statutory process to make an assessment requires several Council actions, including a public hearing and would need to be repeated with each assessment. This would also include the process of issuing bonds for each new loan and LGC approval process.

Legal Considerations

- Program has been discussed with the City Attorney's Office and outside counsel.
- State statutes require the City to enforce the assessments and, as a practical matter, the lender is going to require the City to enforce the assessments to the full extent of the law, i.e. ultimately foreclosing on the property for lack of payment. The City will effectively be giving up control of the foreclosure process on nonpayment of assessments and will proceed as directed by the lender.
- In the event of default by a property owner that received a special assessment loan, the City would likely be forced to foreclose on the property, but the City may not receive the proceeds from the foreclosure sale in time to make payment on the special assessment bond. The financing documents will make it clear the loan is secured solely from the proceeds of the special assessment and no other funds of the City. See credit considerations below for future discussion of this important structure factor.

City Credit Rating and Local Government Commission Approval Considerations

- The structure of the bonds and contemplated legal documentation has been reviewed with rating agencies and staff of the LGC by our financial advisor. Although DB has agreed to hold the City harmless from a debt service shortfall from the assessment collections, significant credit and other potential statutory issues discussed above remain based upon discussion with City legal and financial advisors.
- The statutory structure permitting these bonds in N.C. does not provide a clear mechanism for the City to intervene in any assessment collection deficiency. Additionally, the ability of DB to actually shield the City from rating risk is uncertain.
    - Despite not being contractually/legally required to do so, it is unclear whether or not the City could use other funds to re-pay special assessment bondholders either as a policy matter or to protect its credit.
    - A default by one or more of the businesses that received the special assessment loan could have a negative impact on the City's credit. For example, in a similar

situation, when the NASCAR loan was written off, the rating agencies were concerned with the City although the loan was specifically not a debt of the City.

- LGC approval is uncertain due to the first time nature of this program, deficiency in statutory abilities and credit rating impacts for the City and any other issuer considering this program.

<u>Outstanding Questions</u>

- Status of identifying borrowers/ overall sizing of the first deal – Where are we on the number and amount of first tranche borrowers?
- Mecklenburg County to collect special assessments – Recent meeting resulted in uncertainty on current ability and cost to perform their potential duties.
- Develop a process and procedures for the City to implement and manage the program.
- Deutsche Bank structure – Have we heard from Deutsche about continued availability of their capital markets approach?
- Beyond the special assessment bond concept, how will the LGC react to the details in the loan documents?
- How will the LGC react to the DB capital market / syndication process whereby DB will resell our loan repayment to other parties?
- Need to develop upfront cost that will be necessary and to approach DB about their participation in upfront cost. These costs would be developmental in nature even if the borrowing could not move forward and therefor City and potentially DB out of pocket costs.
- Can the city pay debt service shortfall, if any, if the borrower does not receive full debt service from annual assessment revenues?

<u>Alternatives</u>

- Explore use of QECB allocation to energy upgrades/uses for City owned buildings
- Explore Revolving Loan Fund
    - Funded by City’s general fund or other sources not yet defined
- Re-allocate the City’s allocation to another City or County
- Consider use of “green bonds” to demonstrate environmental leadership