

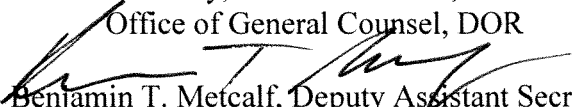


**U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**  
WASHINGTON, DC 20410-8000

JAN 29 2015

MEMORANDUM FOR: Tom Azumbrado, San Francisco Hub Director, 9AHMLAP

COPY TO: Harriet Tregoning, Director, Office of Economic Resilience  
Helen Kanovsky, General Counsel,  
Office of General Counsel, DOR

FROM:   
Benjamin T. Metcalf, Deputy Assistant Secretary,  
For Multifamily Housing Programs, HT

SUBJECT: Administrative Guidance for Multifamily Property Assessed Clean  
Energy (PACE) in California

PACE-enabling legislation has been passed in 31 states. PACE is a means of financing energy efficiency upgrades or renewable energy installation in a building and the concept has been in use in California since 2001.

Consistent with the President's Climate Action Plan, the Department has entered into initiatives such as streamlining the utility analyses process, promoting the Better Buildings Challenge, and increasing minimum construction standards to comply with federal legislation. The Department's Office of Multifamily Housing Programs, Office of Housing, is constantly exploring additional ways to make the Multifamily portfolio more energy and water efficient, to reduce owner's and agent's operating costs and reduce HUD outlays for utilities, and has been identifying alternative sources of capital investment as part of such effort. PACE may be a viable way to achieve such efficiencies, however a mortgagee must receive written consent from its mortgagee and HUD to enter into a PACE assessment.

PACE assessments allow property owners to avoid the upfront costs of energy saving installations by entering into an assessment contract with the participating PACE locality, which stipulates that the property owner will repay the cost of improvements through a property tax assessment, typically over 20 years with semi-annual payments. PACE is premised on an analysis that demonstrates that the cost of the energy and water improvements will be paid in full on a one-to-one basis over time by the savings generated from the improvements. The funding is provided by local government funding or private capital channeled through a bond issuance. This memo recognizes the potential benefits of PACE for the multifamily portfolio and includes clarifying information regarding the processes under which HUD insured and assisted properties located in California may receive support for energy and water efficiency improvements by entering into PACE agreements.

## **BACKGROUND**

California passed the first legislation for PACE financing in 2008. PACE financing programs for rooftop solar, and more broadly the financing of any eligible renewable technology, energy efficiency, or water efficiency investment, can be set up and administered under either of two different California statutory frameworks: the Improvement Act of 1911 (Improvement Act) as amended by AB 811 or the Mello-Roos Act under a city's charter authority or as amended under SB 555. Both the Improvement Act and Mello-Roos Act authorize creation of special tax districts, contractual agreements for financing between an authorized entity and the property owner, use of available funding from any source including existing bond issuing statutes, and attachment of the assessment to the property (as opposed to the individual owner) for repayment. Additionally, several programs were created by charter cities under their Mello-Roos Act authority before the passage of SB 555.

PACE was originally implemented in Berkeley, California as a means to help achieve the Bay Area's climate goals for homeowners. California's program allows multifamily property owners to finance energy saving equipment such as insulation, lighting, HVAC systems, onsite renewable energy (wind turbines, fuel cells, etc.) and water-saving upgrades such as low-flow plumbing fixtures and grey water systems. After an audit identifies the energy and water saving opportunities, the property owner enters into an assessment contract with the financing agency. The contract requires reimbursement of the cost of improvements through an annual property tax assessment lasting up to 20 years. The PACE obligation remains with the property through sale or transfer.

So far, local jurisdictions, within the State of California participate in the PACE program through multiple entities which can be found at <http://www.pacenow.org/resources/all-programs/>. Additionally, Los Angeles County, the City and County of San Francisco, and the City of Sacramento have PACE programs.

## **MULTIFAMILY HOUSING GUIDANCE**

The FHA insurance programs are governed by the National Housing Act and the Act requires that the FHA insured mortgage be in first lien position as such first liens "are commonly given . . . under the laws of the State in which the real estate is located . . .". HUD's Office of General Counsel has received confirmation from the California Attorney General as to the nature and impact of the PACE special assessment; specifically that under California law, PACE assessments are treated in the same manner as property taxes and other assessments and delinquencies must be paid before any mortgage. While this impacts an FHA loan, PACE assessments are compatible with the Act because the FHA mortgage remains a first lien as is commonly given in California. Multifamily property owners will need approval from their lenders and the Department, however, to consent to a PACE program assessment because such participation will result in an increased, or additional, tax assessment, with corresponding ongoing obligations against the property and such approval is required under the owner's mortgage loan documents. Once HUD staff is made aware of an owner's desire to enter into a PACE program, the contents of this memorandum should be reviewed to ensure compliance with

the Department's guidance for the minimum conditions under which the Department will approve a PACE assessment.

**HUD Programs under which a PACE Assessment may be considered:**

- A. Project-based Section 8
  - a. New Construction Part 880 Contracts
  - b. State Agency Financed Part 883 Contracts
  - c. Substantial Rehabilitation Part 881 contracts
  - d. Section 202/8 Part 891 Contracts
  - e. Rural Housing Services (RHS) Section 515/8 Part 884 Contracts
  - f. Loan Management Set-Aside (LMSA) Part 886, Subpart A Contracts
  - g. Property Disposition Set-Aside (PDSA) Part 886, Subpart C Contracts
- B. Section 101 Rent Supplement Contracts
- C. Section 202 Direct Loan Mortgages
- D. Section 202/162 Project Assistance Contract (PAC)
- E. Section 202 Project Rental Assistance Contract (PRAC)
- F. Section 202 Senior Preservation Rental Assistance Contracts (SPRAC)
- G. Section 811 PRAC
- H. Section 236 Insured and Non-Insured Projects
- I. Section 236 Rental Assistance Payments (RAP) Contracts
- J. Section 221(d)(3) Rental and Cooperative Housing
- K. Section 221(d)(4) Rental Housing
- L. Section 220 Rental Housing for Urban Renewal and Concentrated Development Areas
- M. Section 223f Purchase or Refinance of Existing Rental and Cooperative Projects
- N. Section 231 Rental Housing for the Elderly
- O. Section 241(a) Supplemental Loan Insurance for Multifamily Rental Housing
- P. Section 542 Risk Sharing Program
- Q. Section 213 Cooperative Projects
- R. Section 207 Manufactured Home Parks

**PACE APPROVAL CONDITIONS**

Owners shall not enter into a PACE assessment without the Department's consent. The Department will consider granting such consent to owners of projects participating in one of the programs enumerated above under the following minimum required conditions (PACE Approval Conditions):

1. The owner must be in compliance with all business agreements on the affected property.
2. The property must have received a REAC score of at least 60. This may be waived by the Hub Director if the owner is under an approved CDE plan with appropriate owner certifications as to exigent health and safety repairs. Note the property must have a current score, in accordance with 24 CFR Part 200.857.
3. An energy audit, in compliance with ASHRAE Level II, must be completed within the past year.

4. The property owner must provide written evidence that the mortgage holder (or holders) consents to the PACE assessment.
5. A project financed under the PACE program must have a savings to investment ratio of one or greater, meaning that projected annual savings from the total project, not the individual components, exceed the assessment, except in the first year. The underwriting should be based on up to 70% accuracy in savings estimates. If underwriting is based on greater than 70% accuracy, then there must be a loss reserve in place.
6. Any shortfalls in the first year may be funded by residual receipts or reserve for replacement funds, so long as use of those funds meets all applicable programmatic requirements.
7. Properties with HUD Multifamily Housing Section 8 Project Based Rental Assistance or a Project Rental Assistance Contract (PRAC) may not include the PACE assessment in Section 6700: Taxes and Insurance line items of the budget worksheet HUD Form 92547-A, in the budget year after the initial pace assessment.
8. For properties subject to FHA insured and/or HUD-held mortgages, maximum total property debt, when added to the PACE assessment, must not exceed 85% to 90% (depending on the section of the Act) of the property's value, or 83.3% to 90% (depending on the section of the Act) for HUD assisted and subsidized properties, as currently appraised or assessed. See applicable loan ratios in ML 2010-21 or current guidance as updated. The owner may submit a current appraisal or market assessment (e.g. a rent comparability study) to address this condition. HUD may require the owner to submit a market assessment of comparable sales if this condition comes into question. The cost of procuring the assessment is a project expense.
9. The measures proposed for the project must be permanently fixed to the property (i.e. the PACE improvements cannot be removed from the property in the event of a change of ownership). Examples of permanently fixed improvements include, but are not limited to upgraded insulation, solar hot water preheating and energy efficient heating equipment, solar photovoltaic (PV) rooftop systems, fuel cells, natural gas piping installed underneath the property owner's land
10. The HUD Project Manager should review the financial performance of the project to determine the following minimum criteria:
  - a. Positive operating profit and net income in the previous 3 audited fiscal years.
  - c. Current debt service coverage ratio of at least 1.00:1.10.
  - d. Interim statements disclose no material adverse change in financial condition.

The criteria in number 10 may be waived by the Hub Director on a case by case basis for those properties that may not meet each of the criteria, but would benefit from PACE participation.

11. The term of the PACE assessment must not exceed the weighted average expected useful life of the measures as determined by the energy audit.

12. The owner must have provided the PACE program a copy of their market assessment letter establishing comparable sales value, etc. or an appraisal.
13. Owner must agree to provide Lender and HUD with a variety of post assessment information from time to time such as mortgage and assessment amounts; benchmarking data; and prompt notice of a PACE assessment delinquency.

In addition to the submission of documents that evidence the satisfaction of the PACE Approval Conditions, the Owner must provide i) copies of all PACE assessment documents submitted on its behalf to, and those received from, the locality/PACE administrator, and ii) either an opinion of its counsel or a satisfactory letter from or on behalf of the locality/PACE administrator, which confirms the following operational elements of the PACE program (Assessment Procedures):

- A. The PACE assessment will be assessed by a state, county or municipality pursuant to state law and sent with tax bills;
- B. Payments are collected with tax bills;
- C. At any given time the only obligation is the semi-annual/annual payment(s) then or past due and payable, with no acceleration of the entire assessment amount;
- D. In the event of a default on payment of the assessment, the mortgagee receives notice and an opportunity to cure the non-payment; and
- E. Allows prepayment of the entire outstanding assessment.

### **PACE APPROVAL PROCESS**

After the owner of a property has received preliminary PACE approval from the locality, they should contact their lender and provide the lender with all of the above referenced submissions. The lender is responsible for reviewing the PACE Program and assessment documents, all other submissions, any related property improvements, and the impact on income and expenses. After review of the documents, improvements, and expenses, the lender should respond to the owner with their conditional approval, which will remain contingent upon HUD review and approval. Owners and lenders should be cautioned to not enter into any agreements without prior HUD review and approval. Owners will then forward their request to their HUD Project Manager/Account Executive for review.

For projects where HUD is the lender, or 202/811s, or where there is only rental assistance, the owner's request will be sent directly to their HUD Project Manager/Account Executive. The review should take no longer than 60 days.

#### **Submission Requirements:**

For HUD's consideration of the owner's request, the owner should provide HUD with the following documents:

1. Cover letter addressing each of the above PACE Approval Conditions.
2. PACE Entity/locality Approval letter.

3. All PACE agreements, unexecuted.
4. Lender Conditional Approval (not applicable to HUD held mortgages).
5. Energy audit. This must be performed by an independent third party.
6. Energy audit analysis indicating projected annual savings of energy/water saving enhancements commensurate with annual assessment. This must be performed by an independent third party.
7. The market assessment letter of comparable sales or appraisal.
8. Owner's Counsel Opinion or letter from or on behalf of the locality/PACE administrator that provides satisfactory assurances of compliance with the Assessment Procedures.

**Review Process:**

The Project Manager/Account Executive will complete the following steps: (1) perform a completeness check to ensure that all required submission requirements are in the package, including conditional lender consent and all unexecuted PACE agreements. (2) The opinion of owner's counsel or letter from or on behalf of the locality/PACE administrator on the Assessment Procedures should be sent to field counsel for a sufficiency review. (3) The Project Manager/Account Executive will review the package to ensure that the project is in compliance with the approval conditions noted above. (4) The assistance of an appraiser may be needed to review an appraisal or other submitted valuation information. After determining that all conditions are met and OGC determines that the Assessment Procedures have been satisfactorily addressed, (5) an approval letter should be issued to the owner under the signature of the Hub Director.

**Substantial Rehabilitation/Refinance Underwriting:**

As stated above, it is anticipated that the PACE program will be largely applicable to multifamily properties with existing FHA-insured loans. However, in the event that an owner seeks a substantial rehabilitation or refinance using FHA mortgage insurance the PACE assessment will need to be included in the lender's underwriting and addressed in the processing, firm commitment issuance and closing. For MAP transactions, the lender will perform their required underwriting of the PACE documents, improvements and expenses, and include their conclusions in their underwriting summary to be forwarded to HUD as part of the application. HUD Production staff will review the application under normal MAP processing and it is not anticipated that a review of the PACE assessment, improvements and corresponding obligations will unduly impact review or timeliness. It is not anticipated that any waivers will be required.

The FHA lender should include the owner's intent to enter into the PACE program, or current inclusion in the program for refinance transactions, in the Concept Meeting package. This will enable HUD staff to provide the Department's basic PACE requirements and underwriting considerations, as set forth in this memorandum, to the lender and owner.

The cost savings analysis derived from the Energy Audit, and the increase to the taxes, need to be supplied to the third party appraiser and contained in the FHA MAP application. A detailed description of the energy retrofit items, and the cost associated with each, needs to be supplied to the PCNA analyst and contained within the application.

The FHA lender will have reviewed the owner's request to enter into the PACE program, including plans and specifications (where applicable) that reflect the energy/water saving devices. The appraisal will take into account the energy saving measures, the expense associated with the assessment, and any impact of the energy savings on valuation as well as remaining economic life. The PCNA (where applicable) will provide a third party review and will reflect the projected needs; critical and non-critical repairs and reserve schedule; and the appropriateness of costs associated with energy/water saving devices. The lender should also review the acceptability of any repayment terms associated with the PACE assessment. It is recommended that the lender include a section in their underwriting summary specifically addressing the property's inclusion in the PACE program including the energy saving measures, costs, and their analysis.

FHA staff will then have the lender's summary and third party reviews reflecting the impact of the PACE program on the project underwriting. Staff should perform the standard underwriting review, focusing on highlights as discussed below. It is not anticipated that inclusion of the PACE program will require additional review time.

The Architectural and Engineering review should ensure that the building envelope (windows, doors, roofs, and walls) is addressed in any energy efficiency measures. All energy retro-fit items need to be included in the PCNA as non-critical repairs and need to be completed within one-year of endorsement. The PCNA will need to take into account the energy upgrades to accurately set the projected reserve for replacement schedule and amount, as well as set critical and non-critical repairs. Assuming the retro-fit timing is in-line with the non-critical repairs timing (i.e. within one-year of endorsement), the appraiser and the underwriter can forecast the applicable utility expense(s) based on the cost savings analysis while also taking into account the historic operations.

The Valuation review should include the additional taxes associated with the energy retro-fit as an expense line item on line 26 or 27 in Section E of the 92264 (i.e. this tax needs to be separated from the other taxes; such as, real estate). After the assessment repayment ends, the property will receive the benefit of decreased expenses. If the market-at-large recognizes energy efficiency as a value driver, then this can and would be reflected in the capitalization rate. As usual, the capitalization rate selected needs to be supported and the primary support would be comparable sales. The selection of a lower capitalization rate should not be based on an increased NOI or a decreased expense ratio, rather should be based on the fact that the Project is energy efficient.

Any specific approvals related to PACE will be addressed in the Firm Commitment letter. The financing agreement can be executed at closing.

### **REQUEST FOR FEEDBACK**

The Office of Multifamily Housing Programs seeks feedback regarding PACE and other alternative sources of capital that support energy and water efficiency. Please send any questions and comments to Bob Iber at [Robert.G.Iber@hud.gov](mailto:Robert.G.Iber@hud.gov).