PACE Financing: What Appraisers Should Know

By Michael V. Sanders, MAI, SRA

PACE, an acronym for Property Assessed Clean Energy, is a relatively new and somewhat innovative financing mechanism for energy efficiency, renewable energy and water conservation projects (think insulation, replacement windows and photo-voltaic solar systems as typical examples). While PACE is effectively a loan, it is repaid as an assessment on an owner's property tax bill, and is available for both residential and commercial/industrial properties in selected areas of the country. So what does this have to do with appraising?

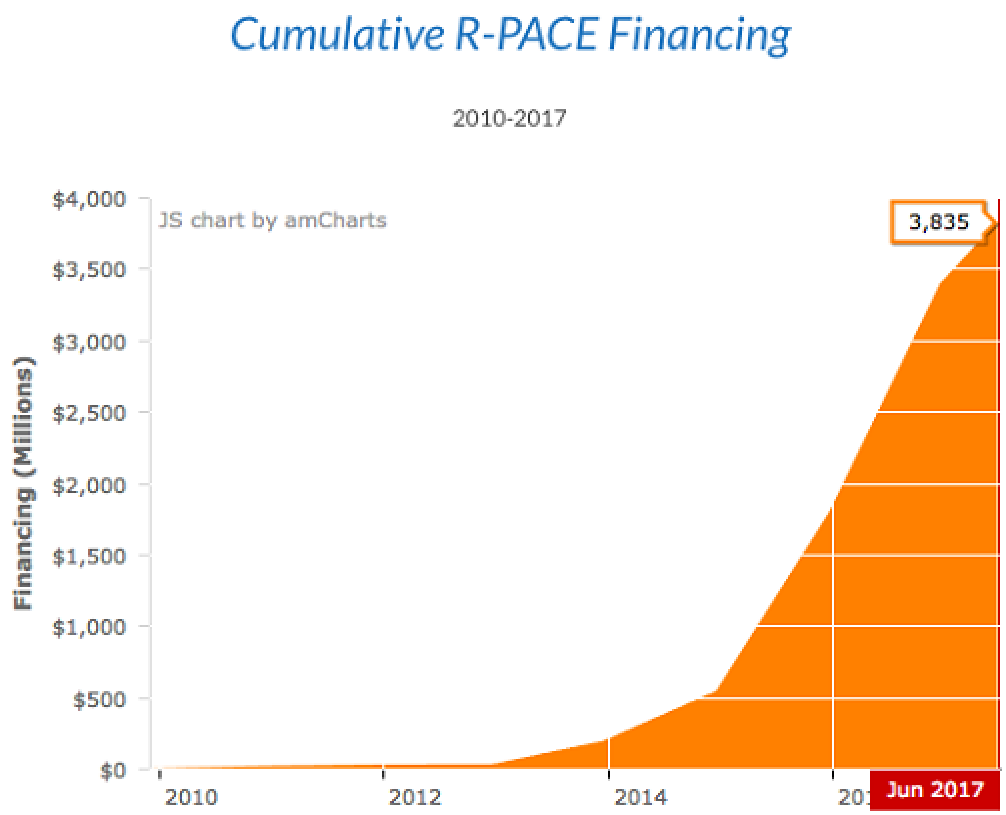
PACE assessments can be substantial depending on the improvements funded. And because they are paid as a tax assessment that runs with the property over a specified term, they have priority over normal financing. Existing PACE loans have reportedly been an issue in many transactions, due to both buyer resistance and reluctance of lenders to finance the sale and potentially jeopardize their loan security to a superior lien. In some cases, sellers have been required to pay off a PACE loan before closing, significantly reducing their net proceeds. Thus it is clear that PACE assessments can and do impact property value.

The PACE program effectively started in 2009. PACE-enabling legislation has currently been passed in 33 states, authorizing local governments to establish PACE programs for both residential and commercial properties. While residential PACE programs presently operate in only three states – California, Florida and Missouri – widespread government support for energy efficiency and renewable energy improvements makes it likely that use of this financing mechanism will increase in the future.

A major issue with PACE financing is its status as a "super lien.” Since PACE is a tax assessment, it technically has priority over new or existing loans, which has generated significant resistance from regulatory agencies and the secondary market. FNMA and FHLMC have refused to back mortgages on properties with PACE loans, noting the most recent FNMA Selling Guide in May 2017 stating that the agency "will not purchase mortgage loans secured by properties with an outstanding PACE loan unless the terms of the PACE loan program do not provide for lien priority over first mortgage liens." Cash-out refinancing is permitted to pay off an existing PACE loan as part of the refinance, however.

FHA and VA guidelines in mid-2016 seek to maintain their first lien position by classifying a PACE loan as a tax assessment and not a super lien, although several prominent housing industry trade groups are unconvinced, characterizing the guidance as "form over substance."

Notwithstanding problems in the lending markets, the cumulative dollar volume of residential PACE loans, which was relatively small prior to 2014, has since skyrocketed, exceeding $3.8 billion in June 2017. The chart below from PACENation (pacenation.us/pace-market-data) shows the exponential growth of residential PACE financing in the residential sector from late 2009 to date.



On the surface, advantages of the PACE program are compelling. Municipal governments can promote energy efficiency, create local jobs and spur economic development, and property owners can defray significant upfront costs of energy improvements, potentially realizing energy savings that may exceed the amount of the special tax assessment. While commercial PACE programs have generated little controversy, publicized problems in the residential sector include failure to properly qualify borrowers, lack of standard financial disclosures (since PACE loans are technically classified as a tax assessment rather than a loan, they do not come with standard CFPB disclosures), and sometimes unscrupulous contractors who misrepresent program costs, with interest rates that are typically higher than for conventional loans or equity credit lines.

In response to identified problems, the Department of Energy (DOE) issued Best Practices Guidelines in November 2016 (a revision to original guidelines issued in May 2010). Among recommendations are the following:

- Enhanced consumer protection and contractor management;
- Confirmation that property owners can support the added cost of the PACE assessment;
- Term of assessment should not exceed useful life of improvements;
- Reliable public information source to ascertain whether a property is encumbered by a PACE assessment;
- Loan loss reserve funds to protect mortgage lenders who make payments for PACE assessments in the event of foreclosure.

While these guidelines unquestionably address significant concerns about the residential PACE program, the National Consumer Law Center noted that guidelines lack teeth if the industry doesn't have to follow them. A new California law (AB-2693 effective January 2017) requires statutory disclosures and imposes additional requirements on PACE financing, and pending bipartisan federal legislation would subject PACE loans to the same Truth in Lending Act disclosures as conventional loans (S. 838 and H.R 1958, both titled PACE Act of 2017).

It seems clear that the existence of special tax assessments for PACE financing is something that can impact property value, in the same way as Community Facilities Districts (CFD) and other substantial special assessments. The difference is that PACE financing is specific to a particular property, while CFD's and other assessment districts generally impact properties throughout a larger geographic area. Below is an excerpt from a California property tax bill showing what a PACE tax assessment actually looks like.

SPECIAL ASSESSMENT CHARGES		PHONE NO.	
MOSQ,FIRE ANT ASSMT		(800)273-5167	4.03
VECTOR CONTROL CHG		(800)273-5167	0.67
CA HERO PGM-CLEAN ENERGY-RESIDENTIA		(949)955-1500	3,872.51
MWD WATER STDBY CHG		(866)807-6864	10.08
ORANGE COUNTY CFD 87-5B RSM		(949)955-1500	354.81
TOTAL CHARGED	1.31380		8,593.24

It is worth noting that for this property, the PACE assessment is over ten times that for a local CFD, and comprises roughly 45% of the total tax bill.

Valuation

How would this properly be handled for valuation purposes? If the property is appraised with the PACE assessment in place, its impact on the value of the property would have to be considered, in the same manner as substantial CFD or other special assessments. Let's consider four valuation scenarios, three assuming continuation of PACE financing and the fourth assuming that PACE financing is extinguished or retired.

1) Case studies are typically used to measure the impact of a particular issue or condition. Case study properties are not necessarily directly comparable to the subject, but share an issue or condition of interest (existence of a PACE assessment). An MLS search for green features or a word search for specific features (e.g., solar panels) would likely yield a number of matching sale properties; tax bills could then be examined to ascertain whether any properties were encumbered by a PACE assessment. Additional research relative to properties sold with PACE assessments could include comparison to otherwise similar properties without a PACE assessment (empirical research) and/or verification of the transaction to determine the terms and reported price impact (anecdotal evidence). If confirmed by the market, this information could be applied to valuation of the subject property.

2) With limited market data for application of the case study method above, calculating the present value of the subject's PACE assessment over its remaining term is another alternative. Recall the exemplar tax bill with an annual PACE assessment of $3,872.51

above. With a remaining term of four years, annual discounting at a safe rate of 1% would indicate present value of approximately $15,100, which could be used to adjust for the subject's PACE assessment.

3) A third alternative for an existing PACE assessment is to obtain the payoff amount from the agency or entity that administers the program, if available. For the assessment referenced above, the current payoff amount is approximately $13,000, another method of adjusting for the subject's PACE assessment.

4) Finally, the PACE assessment might be disregarded entirely, assuming that it will be extinguished or retired in connection with a sale or refinance transaction. Reluctance of lenders to finance a property with a PACE assessment might make this the only viable scenario to consummate a sale or refinance transaction. It is important to note, however, that this alternative would require the use of a Hypothetical Condition relative to the existing PACE assessment.

Note that the four valuation alternatives described above relate only to the financial obligations associated with the PACE assessment, and not the contributory value of the energy or conservation upgrades themselves. While energy efficiency and renewable energy projects might increase the value of properties with such improvements, this isn't always the case, and it is important for associated financial obligations to be known and disclosed.

About the Author
Michael V. Sanders, MAI, SRA is principal of Coastline Realty Advisors in Southern California, with over 35 years experience appraising various property types. His practice specializes in real estate damages, consulting and litigation support. He has published in The Appraisal Journal, Valuation, Right Of Way and California Lawyer, among others.