

Residential PACE Programs: A Path Forward

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Policy-makers in the United States have given increased attention to improving energy efficiency in recent years, in part due to the fact that significant, economically feasible gains in energy efficiency are achievable in the residential and commercial sectors.² However, despite cost-effective opportunities for gains in energy efficiency and new reasons for our country to turn to energy efficiency, the private residential and commercial sectors have faced considerable financial obstacles to the significant deployment of energy-efficiency measures.³ Enter the property-assessed clean energy (PACE) program, a new financing mechanism that shows great potential to overcome some of the main financing obstacles to significant private investment in energy-efficiency improvements in the residential and commercial sectors.⁴ Unfortunately, the Federal Housing Finance Agency (FHFA) has come out staunchly opposed to residential PACE programs, stalling such programs in their tracks across the country.⁵

This paper focuses on the regrettable stalled status of residential PACE programs. It argues that the FHFA should promulgate a final rule through notice-and-comment rulemaking that both reduces financial risk to mortgage holders from senior-lien residential PACE programs and allows PACE programs to return to being a viable option for encouraging gains in energy efficiency in the residential sector. This paper also considers some of the alternatives that states and the federal government could pursue if FHFA does not promulgate such a final rule.

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² See *infra* Part I(b).

³ See *id.*

⁴ See *id.*

⁵ See *infra* Part I(d).

Part I will provide an introduction to PACE programs and the federal opposition that residential PACE programs currently face. Specifically, Part I will discuss the following topics: what PACE programs are and how they address our nation's energy needs; FHFA's statutory authority and duties both as regulator and as conservator; actions taken by FHFA that have stalled the development and implementation of residential PACE programs; and a summary of an initial successful court challenge to FHFA's position.

Part II will argue that FHFA should promulgate a final rule that allows senior-lien PACE programs to continue, but that imposes uniform and more stringent underwriting criteria and reduces the financial risk of PACE programs to mortgage holders. This Part will consider FHFA's primary concerns regarding residential PACE programs and weaknesses in some of FHFA's key arguments. It will then argue that it would be possible and advisable for FHFA to craft a final rule that is consistent with its statutory authority and roles, while still allowing senior-lien residential PACE programs to continue under increased federal regulation and uniformity.

Finally, Part III will consider alternatives to senior-lien residential PACE programs that could be pursued to promote gains in energy efficiency in the residential sector in the event that FHFA either prevails on its appeal of a recent federal court decision unfavorable to FHFA or promulgates a final rule that prohibits the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") from purchasing mortgages of properties subject to senior PACE liens.

I. Background

a. PACE Program Basics

The PACE program model is “a financing structure that enables local governments to raise money through the issuance of bonds or other sources of capital to fund energy-efficiency and renewable energy projects.”⁶ States have created PACE programs for both the residential and commercial sectors.⁷ In communities that offer PACE programs, property owners can voluntarily choose to receive financing to complete energy-efficiency improvements on their property and then pay back the city for the cost of the improvements through a special assessment on their property taxes that runs with the property.⁸ Importantly, these special assessments are set at a level so that they amount to less than the financial savings from PACE improvements, yet are generally sufficient to pay off the PACE loan within five to twenty years.⁹ In addition, like traditional special assessments—which have been “used for more than 100 years in the U.S. to pay for infrastructure improvements deemed to be in the public interest, including improvements on private property”¹⁰—PACE special assessments are land secured (i.e. secured by a property lien on a PACE program participant’s real property).¹¹ It should be noted that because PACE programs are creatures of state law and not subject to national standards, PACE programs can vary by locality.¹²

⁶ *Property-Assessed Clean Energy Programs*, U.S. DEP’T OF ENERGY, <http://www1.eere.energy.gov/wip/solutioncenter/financialproducts/PACE.html> (last visited Apr. 19, 2012).

⁷ MARK ZIMRING ET AL., LAWRENCE BERKELEY NAT’L LAB., PACE STATUS UPDATE 3 (2010).

⁸ PACENow (Apr. 18, 2012), <http://pacenow.org/blog/>; U.S. DEP’T OF ENERGY, GUIDELINES FOR PILOT PACE FINANCING PROGRAMS 1 (2010), available at http://www1.eere.energy.gov/wip/pdfs/arra_guidelines_for_pilot_pace_programs.pdf.

⁹ PACENow, *supra* note 8; *The Inception of PACE Financing, Its Support, and Its Potential*, ALLIANCE TO SAVE ENERGY, <http://ase.org/resources/inception-pace-financing-its-support-and-its-potential> (last visited Apr. 25, 2012).

¹⁰ MARK ZIMRING & MERRIAN FULLER, LAWRENCE BERKELEY NAT’L LAB., ACCELERATING THE PAYMENT OF PACE ASSESSMENTS 1 n.1 (2010).

¹¹ *Id.*

¹² Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. 3,958, 3,960 (Jan. 26, 2012).

If a property owner has opted into a PACE program and then defaults on her PACE assessment, several things may happen depending on the rules of that particular program. First, state law differs on whether its state’s PACE programs require, prohibit, or allow acceleration of the payment of PACE assessments upon default.¹³ Acceleration “allows municipalities to declare the entire value (not just the late payments) of a property owner’s outstanding balance payable if a default occurs.”¹⁴ In PACE programs that require non-acceleration of a lien upon default, only the past-due assessments, plus interest and penalties, must be paid immediately upon default.¹⁵ It should be noted that even in the case of acceleration, accelerated assessments are often a small fraction of the property’s value.¹⁶ Second, in most states, the property liens securing PACE special assessments are “senior to almost all other debt and their balance must be paid before subordinated debt holders, such as mortgage holders, can begin foreclosure proceedings.”¹⁷

Now that the basic characteristics of PACE programs have been explained, the following section explores how these programs can help our country reduce its energy use.

b. How PACE Programs Address Our Nation’s Energy Needs

Although the United States has had energy-efficiency and conservation laws on the books for several decades,¹⁸ policy-makers have given increased attention to the possibility of increases in energy efficiency for a variety of new reasons in recent years.¹⁹ These reasons have included:

the threat of climate change; a desire to move the economy in a greener and more job-creating direction; global economic competition; growing global demand for

¹³ ZIMRING & FULLER, *supra* note 10, at 1.

¹⁴ *Id.* at 1.

¹⁵ *Id.* at 2.

¹⁶ *Id.*

¹⁷ *Id.*; accord Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,959.

¹⁸ John C. Dernbach & Marianne Tyrrell, *Federal Energy Efficiency and Conservation Laws*, in THE LAW OF CLEAN ENERGY: EFFICIENCY AND RENEWABLES 25, 26 (Michael B. Gerrard ed., 2011).

¹⁹ *Id.*

energy resources; and the environmental effects of fossil fuels, an old issue made new by the BP Gulf of Mexico oil disaster in 2010.²⁰

Part of the explanation for this increased attention is that significant, economically feasible energy-efficiency gains are achievable in the residential and commercial sectors.²¹ In 2010, the National Research Council concluded that the United States “could, through the ‘full deployment of cost-effective, energy-efficient technologies,’ *reduce* its annual energy consumption by about 10 percent by 2020 and even more after that.”²² It also should be noted that saving energy through energy-efficiency measures can be significantly less expensive—sometimes up to half the cost—compared to supplying that energy from new electricity generation.²³

Although energy-efficiency measures can be very cost effective, meaningful degrees of retrofitting in the United States will be expensive and will require private investment.²⁴ It will cost more than \$1 trillion to install comprehensive energy-efficiency retrofits in extant residential and commercial buildings.²⁵ Moreover, as explained by the Lawrence Berkeley National Laboratory, “[i]t is essential that retrofit programs harness private capital to achieve the scale required to tap into our energy savings potential and significantly reduce our greenhouse gas emissions.”

²⁰ *Id.*

²¹ NATURAL RES. DEF. COUNCIL, BOOSTING ENERGY EFFICIENCY NATIONWIDE THROUGH MEASUREMENT AND PERFORMANCE-BASED REWARDS 1, 3 (2009), *available at* <http://www.nrdc.org/globalwarming/cap2.0/files/efficiencyperformance.pdf>; Ben Block, *Study Finds Rich U.S. Energy-Efficiency Potential*, WORLDWATCH INSTITUTE, <http://www.worldwatch.org/node/6212> (last updated Feb. 25, 2012); LEADERSHIP GROUP, NATIONAL ACTION PLAN FOR ENERGY EFFICIENCY: EXECUTIVE SUMMARY 1 (2006).

²² Dernbach & Tyrrell, *supra* note 18, at 25 (quoting NAT’L ACAD. OF SCIENCES, REAL PROSPECTS FOR ENERGY EFFICIENCY IN THE UNITED STATES 2 (2009) (prepublication copy)).

²³ LEADERSHIP GROUP, NATIONAL ACTION PLAN FOR ENERGY EFFICIENCY: EXECUTIVE SUMMARY 4 (2006).

²⁴ ZIMRING & FULLER, *supra* note 10, at 2.

²⁵ *Id.*

In addition to the high cost of some energy-efficiency measures, three other phenomena have frustrated consumer use of available energy-efficiency measures.²⁶ First, consumers frequently mentally discount future savings, placing more weight on up-front costs compared to greater, but future, savings.²⁷ Second, “the lack of an existing economic and legal infrastructure for many energy efficiency improvements means that many interested homeowners or businesses lack a reliable and relatively easy way to make those improvements.”²⁸ Third, property owners fear that they will not recoup the costs of an energy-efficiency project prior to a future sale of the property.²⁹

PACE programs respond to and show great potential to overcome these three obstacles. PACE programs allow participants to avoid what could otherwise be high up-front costs of energy-efficiency measures.³⁰ They also provide a much more definite economic and legal infrastructure for energy-efficiency improvements by consumers.³¹ Finally, because PACE special assessments run with the real property benefited by the PACE improvement, PACE programs negate the fears of property owners wishing to make energy-efficiency investments that they will not recover the cost of those investments due to a sale of the property.³²

Recognizing energy efficiency as a cost-effective way to meaningfully reduce America’s energy consumption, and also recognizing the obstacles discussed above to deployment of energy-efficiency measures by property owners, twenty-seven states have enacted legislation that enables local governments to establish a PACE program that encourages private investment in

²⁶ Dernbach & Tyrrell, *supra* note 18, at 25, 26.

²⁷ *Id.*

²⁸ *Id.*

²⁹ PACENOW, *supra* note 8.

³⁰ *See supra* Part I(a).

³¹ *Id.*

³² *Id.*

energy-efficiency measures.³³ One arm of the Obama Administration, the U.S. Department of Energy (DOE), also has strongly supported PACE programs.³⁴

The next section considers FHFA’s statutory duties and authority as regulator and conservator to help understand why FHFA has been opposed to residential PACE programs.

c. FHFA’s Statutory Authority and Duties as Regulator and as Conservator

FHFA is an independent agency that Congress created in 2008 to be the exclusive regulator of the Federal National Mortgage Association (“Fannie Mae”), the Federal Home Loan Mortgage Corporation (“Freddie Mac”), and the Federal Home Loan Banks (the “Banks”).³⁵ Fannie Mae and Freddie Mac only operate in the secondary mortgage market, purchasing mortgage loans from lenders but not lending money directly to borrowers.³⁶ Both entities are currently in conservatorship, with the FHFA serving as its Conservator.³⁷

There are several aspects of FHFA’s statutory role and authority as regulator. First, FHFA must ensure that Fannie Mae and Freddie Mac operate in a “safe and sound manner”³⁸ and that “the activities of each regulated entity and the manner in which such regulated entity is operated are consistent with the public interest.”³⁹ The Director is required to “issue any

³³ PACENOW, *supra* note 8. For an overview of the substance, history, and current status of PACE programs, see *The Inception of PACE Financing, Its Support, and Its Potential*, ALLIANCE TO SAVE ENERGY, <http://ase.org/resources/inception-pace-financing-its-support-and-its-potential> (last visited Apr. 25, 2012).

³⁴ See *Status Update – Pilot PACE Financing Programs*, U.S. DEP’T ENERGY, <http://www1.eere.energy.gov/wip/pace.html> (last updated Jan. 27, 2011); Letter from David Sandalow, Assistant Sec’y for Policy & Int’l Affairs, U.S. Dep’t of Energy, and Henry Kelly, Acting Assistant Sec’y for Energy Efficiency & Renewable Energy, U.S. Dep’t of Energy, to Alfred M. Pollard, Gen. Counsel, Fed. Housing Fin. Agency 4 (Mar. 26, 2012), *available at* http://www.vnf.com/assets/attachments/369_U.S._Department_of_Energy_with_Attachments1.pdf.

³⁵ Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,959.

³⁶ *Id.*

³⁷ *Id.*

³⁸ 12 U.S.C. § 4513(a)(1)(B)(i) (2012); Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,959.

³⁹ 12 U.S.C. § 4513(a)(1)(B)(v).

regulations, guidelines, or orders necessary to carry out the duties of the Director,⁴⁰ and such regulations must be issued using a process that complies with section 553 of the Administrative Procedure Act,⁴¹ which specifies the proper procedures for informal “notice-and-comment” rulemaking.⁴² In addition, FHFA has discretion “to exercise such incidental powers as may be necessary or appropriate to fulfill the duties and responsibilities of the Director in the supervision and regulation” of Fannie Mae and Freddie Mac.⁴³

In addition to its role as regulator of Fannie Mae and Freddie Mac, FHFA has also been the conservator of these entities since the September 2008 financial crisis in the United States.⁴⁴ As conservator, FHFA is authorized “take such action as may be necessary to put the regulated entity in a sound and solvent condition[] and appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity.”⁴⁵ As conservator, FHFA is also authorized to “take over the assets of and operate the regulated entity [(e.g. Fannie Mae or Freddie Mac)] in the name of the regulated entity,’ ‘perform all functions of the entity’ consistent with the Conservator’s appointment, and ‘preserve and conserve the assets and property of the regulated entity.’”⁴⁶ Moreover, FHFA may take any of these authorized actions when it deems them to be “in the best interests of” Fannie Mae or Freddie Mac.⁴⁷

⁴⁰ 12 U.S.C. § 4526(a) (2012).

⁴¹ 12 U.S.C. § 4526(b).

⁴² 5 U.S.C. § 553 (2006).

⁴³ 12 U.S.C. § 4513(a)(2)(B).

⁴⁴ Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,959.

⁴⁵ 12 U.S.C. § 4617(b)(2)(D) (2012).

⁴⁶ Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,959 (quoting 12 U.S.C. § 4617(b)(2)(A), (B)).

⁴⁷ 12 U.S.C. § 4617(b)(2)(J)(2).

d. Actions Taken by FHFA That Effectively Stalled the Development and Implementation of Residential PACE Programs

Despite the support for PACE programs from DOE,⁴⁸ FHFA to date has squarely opposed residential PACE programs.⁴⁹ During 2010 and 2011, FHFA, Fannie Mae, and Freddie Mac took a series of actions that have effectively halted the development and implementation of residential PACE programs.⁵⁰ On July 6, 2010, FHFA issued a statement (“Statement”) announcing that PACE programs with liens senior to all other obligations were contrary to Fannie Mae and Freddie Mac’s uniform security instruments (USIs)⁵¹ because the USIs prohibit Fannie Mae or Freddie Mac from purchasing a mortgage when another lien would be senior to it.⁵² FHFA declared that PACE programs “present significant safety and soundness concerns” that Fannie Mae, Freddie Mac and the Federal Home Loan Banks would have to address.⁵³ In this Statement, FHFA took the position that first liens created by PACE programs are not the same as traditional tax assessments and also pose “significant risk to lenders and secondary market entities.”⁵⁴ The FHFA called on state and local governments to take a second look at residential PACE programs and to temporarily halt the operation of such programs while re-evaluating them in light of FHFA’s concerns⁵⁵ The FHFA also directed Fannie Mae, Freddie

⁴⁸ See *Status Update – Pilot PACE Financing Programs*, *supra* note 34.

⁴⁹ Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,960–61; *California v. Fed. Hous. Fin. Admin.*, Nos. C 10-03084 CW, C 10-03270 CW, C 10-03317 CW, C 10-04482 CW, 2011 U.S. Dist. LEXIS 96235 at *9–11 (N.D. Cal. Aug. 26, 2011) (summarizing the actions of FHFA, Fannie Mae, and Freddie Mac taken in opposition to PACE programs in 2010 and 2011).

⁵⁰ PACENOW, *supra* note 8; *The Inception of PACE Financing, Its Support, and Its Potential*, *supra* note 33.

⁵¹ Statement, Federal Housing Finance Agency, FHFA Statement on Certain Energy Retrofit Loan Programs (July 6, 2010), available at <http://ase.org/efficiencynews/rulemaking-pace-comment-period-open-residential-efficiency-financing-model>; Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,960.

⁵² Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,960.

⁵³ Statement, *supra* note 51.

⁵⁴ *Id.*

⁵⁵ *Id.*

Mac, and the Banks to respond with appropriate action on a prospective basis, including reconsidering collateral policies to ensure that PACE programs would not harm their interests.⁵⁶

Then, on August 31, 2010, Fannie Mae and Freddie Mac told lenders that they would not purchase mortgages that originated on or after July 6, 2010 that were secured by properties subject to PACE assessments.⁵⁷ In doing so, Fannie Mae and Freddie Mac cited the July 6, 2010 FHFA Statement.⁵⁸

Finally, on February 28, 2011, FHFA sent a letter (“Directive”) in its capacity as conservator to Fannie Mae and Freddie Mac.⁵⁹ This Directive reaffirmed the position FHFA took in its July 6, 2010 Statement.⁶⁰ In the letter, the FHFA directed Fannie Mae and Freddie Mac to “continue to refrain from purchasing mortgage loans secured by properties with outstanding first-lien PACE obligations.”⁶¹ The Directive ordered Fannie Mae and Freddie Mac to “undertake . . . steps necessary to protect their safe and sound operations from these first-lien PACE programs.”⁶²

e. An Initial Successful Court Challenge to FHFA’s Position

Over the past two years, supporters of PACE programs from around the country have sued FHFA, Fannie Mae, and Freddie Mac in federal court, bringing procedural and substantive challenges to the actions and positions described above⁶³—and some have done so successfully

⁵⁶ *Id.*

⁵⁷ California v. Fed. Hous. Fin. Admin., 2011 U.S. Dist. LEXIS 96235 at *10.

⁵⁸ *Id.*

⁵⁹ Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,960.

⁶⁰ *See id.* at 3,960–61.

⁶¹ *Id.* at 3,961.

⁶² California v. Fed. Hous. Fin. Admin., 2011 U.S. Dist. LEXIS 96235 at *10 (quoting the February 28, 2011 Directive from the FHFA's General Counsel to General Counsel for Fannie Mae and Freddie Mac).

⁶³ Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,961 (summarizing the litigation initiated by PACE supporters to date).

on procedural grounds.⁶⁴ In one of these cases, *California v. Federal Housing Finance Administration*,⁶⁵ the court found that FHFA's policy with regard to PACE obligations amounted to substantive rulemaking and ordered FHFA to use the notice-and-comment rulemaking procedures required by the Administrative Procedure Act to properly formulate this policy after FHFA had failed to use such procedures to do so before.⁶⁶ In that case, the court neither invalidated nor required withdrawal of FHFA's July 6, 2010 Statement or its February 28, 2011 Directive.⁶⁷ Both remain in effect.⁶⁸

As for the current status of the *California v. Federal Housing Finance Administration* litigation and the required rulemaking process, FHFA appealed the District Court's order to the United States Court of Appeals for the Ninth Circuit.⁶⁹ The Ninth Circuit stayed, pending the outcome of the appeal, the part of the District Court's order that required FHFA to publish a *final* rule.⁷⁰ FHFA published an Advanced Notice of Proposed Rulemaking (ANPR) but reserved the right to withdraw the ANPR should it prevail on appeal.⁷¹ The ANPR was published in the Federal Register on January 26, 2012⁷² and affirmed the position that FHFA had taken in its July 6, 2010 Statement.⁷³ Public comments in response to FHFA's ANPR were due on March 26, 2012.⁷⁴

⁶⁴ See *California v. Fed. Hous. Fin. Admin.*, 2011 U.S. Dist. LEXIS 96235 at *5, *53–54 (granting in part and denying in part defendants' motions to dismiss, and granting in part and denying in part Sonoma County's motion for a preliminary injunction).

⁶⁵ *California v. Fed. Hous. Fin. Admin.*, Nos. C 10-03084 CW, C 10-03270 CW, C 10-03317 CW, C 10-04482 CW, 2011 U.S. Dist. LEXIS 96235 (N.D. Cal. Aug. 26, 2011).

⁶⁶ See *Mortgage Assets Affected by PACE Programs*, 77 Fed. Reg. at 3,961; *California v. Fed. Hous. Fin. Admin.*, 2011 U.S. Dist. LEXIS 96235 at *5, *35–38, *53–55.

⁶⁷ *Mortgage Assets Affected by PACE Programs*, 77 Fed. Reg. at 3,961.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.* at 3,958.

⁷³ Compare *Mortgage Assets Affected by PACE Programs*, 77 Fed. Reg. at 3,959–61 with Statement, *supra* note 51.

⁷⁴ *Mortgage Assets Affected by PACE Programs*, 77 Fed. Reg. at 3,958.

II. FHFA Should Promulgate a Final Rule that Allows Senior-Lien Residential PACE Programs to Continue in a Manner that is More Uniform and Less Financially Risky for Fannie Mae and Freddie Mac

FHFA should promulgate a final rule that allows senior-lien residential PACE programs to continue, but that imposes uniform and more stringent underwriting criteria and reduces the financial risk to mortgage holders of PACE programs.⁷⁵ Prohibiting Fannie Mae and Freddie Mac from purchasing home mortgages encumbered by PACE obligations is within FHFA's statutory discretion and authority as a regulator and conservator.⁷⁶ As one scholar has noted, "[t]he unilateral refusal of federal lending agencies to purchase the mortgages of any PACE-encumbered properties, regardless of the strength of their underwriting or likelihood of default, represents the most aggressive action then available to those agencies."⁷⁷ However, such a flat prohibition is too blunt a tool for FHFA to use to carry out its statutory duties with regard to protecting the financial interests and soundness of Fannie Mae and Freddie Mac.⁷⁸ Although such extreme action best protects holders of primary and secondary mortgages in PACE jurisdictions, it does so without objectively considering the extent of the risk that PACE programs present to mortgage holders and without weighing the significant costs of such absolute protection (i.e. rendering useless a popular model for financing residential energy-efficiency projects).

⁷⁵ Although PACE programs have been criticized as lacking adequate consumer protection measures, *see, e.g.*, Statement, *supra* note 51, FHFA's notice of proposed rulemaking focused much more heavily on PACE programs' asserted lack of adequate protections for mortgage holders, *see* Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,959–63. Consequently, this paper will focus on the primary risks to primary and secondary mortgage holders about which FHFA has appeared most concerned.

⁷⁶ *See supra* Part I(c).

⁷⁷ Ian M. Larson, Note, *Keeping PACE: Federal Mortgage Lenders Halt Local Clean Energy Programs*, 76 MO. L. REV. 599, 616 (2011).

⁷⁸ *See supra* Part I(c).

a. FHFA’s Primary Concerns About Residential PACE Programs with Regard to the Financial Interests of Mortgage Holders

FHFA has voiced several primary concerns surrounding residential PACE programs with regard to the interests of mortgage holders. First, FHFA is extremely concerned about the fact that most PACE liens have seniority to the security interest of mortgage holders, especially because PACE liens “run” with the property.⁷⁹ This priority allows PACE lenders to “step ahead of the mortgage holder . . . in priority of its claim against the collateral”⁸⁰ It also means that a mortgage holder foreclosing on a property with a senior PACE lien has to pay off past-due payments and pay future principal and interest payments that become due, unless he can sell the property (in which case the new property owner would become responsible for PACE assessments that become due).⁸¹ Second, FHFA is concerned that either the PACE improvements themselves or simply an outstanding PACE lien may diminish the value of the property subject to that lien and may not be attractive to potential buyers in the event that the mortgage holder had foreclosed and was trying to sell the associated property.⁸² Third, FHFA posits that “[t]he homeowner’s assumption of this new [PACE] obligation may itself increase the risk that the homeowner will become delinquent or default on other financial obligations, including any mortgage obligations.”⁸³ More specifically, FHFA worries that a lack of stringent underwriting standards may lead homeowner-borrowers to “undertake PACE projects, or select PACE financing terms, that adversely affect the homeowner-borrower’s ability to repay other debt, including mortgage debt.”⁸⁴ Fourth, FHFA is concerned that PACE programs currently do

⁷⁹ Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,959–60.

⁸⁰ *Id.*

⁸¹ *Id.* at 3,960.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.* at 3,963.

not use nationally uniform standards to determine eligibility of homeowners and projects for PACE programs.⁸⁵

Finally, it should be noted that FHFA strategically classifies PACE obligations as a loan—rather than as a traditional tax assessment—and challenges the legality of PACE “loans” in order to add support to its attack on residential PACE programs.⁸⁶ In contrast, PACE supporters insist that PACE funding is appropriately characterized as a special tax assessment and that the granting of seniority to PACE liens by the states is within state power to levy assessments for public improvements.⁸⁷

In arguing that PACE assessments are not an appropriate use of state assessment authority, FHFA asserts that PACE assessments “pose unusual and difficult risk management challenges for lenders, servicers and mortgage investors.”⁸⁸ FHFA further suggests that “[t]he size and duration of PACE loans exceed typical local tax programs and do not have the traditional community benefits associated with taxing initiatives.”⁸⁹

One scholar has concisely explained the legal significance of the classification of PACE programs as tax assessments as opposed to loans, or vice versa:

Seniority [of municipal assessments for PACE home improvements] is premised on the distinction made by the PACE programs between lending and assessments: any loans would follow the “first-in-time, first-in-right” principle that gives seniority to any antecedent loan. Under the state assessment power, however, the state is entitled to be reimbursed prior to any existing mortgages, regardless of chronology.⁹⁰

⁸⁵ *Id.* at 3,960.

⁸⁶ *See id.* at 3,960; Statement, *supra* note 51; Larson, *supra* note 77, at 616.

⁸⁷ Larson, *supra* note 77, at 616.

⁸⁸ Statement, *supra* note 51.

⁸⁹ *Id.*

⁹⁰ Larson, *supra* note 77, at 605–06.

b. Responding to and Contextualizing Some of FHFA's Key Concerns

A close examination of the facts shows that a number of the key concerns underlying FHFA's opposition to PACE programs are unfounded. In addition, FHFA has failed to provide a rational explanation for its choice to distinguish PACE special assessments from traditional special assessments.

i. Facts Cutting Against FHFA's Position

Some of FHFA's key concerns regarding the extent of harm to mortgage holders caused by PACE-encumbered properties are exaggerated, and FHFA ignores or hides key facts that are not in its Advanced Notice of Proposed Rulemaking.⁹¹ Several facts sharply cut against FHFA's argument that the assumption of PACE obligations makes a person more likely to become delinquent on a mortgage or other financial obligations. First, PACE assessments are set to be less than the amount of savings from the energy-efficiency gains for the same period,⁹² so homeowners should actually have more money for other financial obligations such as mortgages, compared to the case when they had not opted into a PACE program. Second, initial studies have shown that the mortgage default rate of PACE homeowners is very low, below 1%,⁹³ compared to an average mortgage default rate of 3.2% for communities.⁹⁴

In addition, FHFA appears to have overstated the extent of the financial risk of senior PACE liens to mortgage holders. As just explained, the mortgage default rate of PACE homes is much lower than the average default rate,⁹⁵ and for the few homes that do go into default, PACE obligations generally do not accelerate upon default, so only past-due assessments—not the full

⁹¹ Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. 3,958 (Jan. 26, 2012).

⁹² *What is PACE?*, PACENow (Apr. 26, 2012), <http://pacenow.org/blog/about-pace/>.

⁹³ ZIMRING ET AL., *supra* note 7, at 5; PACENOW, MAKING THE CASE FOR PACE LEGISLATION 10 (2011), *available at* <http://pacenow.org/blog/wp-content/uploads/Making-the-Case-for-PACE-Legislation.pdf>.

⁹⁴ PACENOW, *supra* note 93, at 10.

⁹⁵ *See supra* notes 93 and 94 and accompanying text.

principal and interest for the retrofit—have a senior lien.⁹⁶ Estimates strongly suggest that the impact of the PACE senior liens on mortgage holders would be immaterial, with a senior-lien exposure to mortgage bond investors valued at less than \$200 per home that has opted into a PACE program and at less than \$5 per home in a PACE jurisdiction (only a small percentage of homes within a PACE jurisdiction opt into a PACE program).⁹⁷ Moreover, even where PACE assessments do accelerate upon default, they are often “a small fraction of a property’s value.”⁹⁸

Further, several recent studies support that there is a lack of cause for FHFA’s concerns that PACE improvements, or the associated assessments, will lower property values and be unattractive to buyers. These studies show a positive correlation between residential energy-efficiency and renewable-energy measures on the one hand and a home’s value on the other.⁹⁹ First, a 2011 study by Lawrence Berkeley National Laboratory, which used a large dataset, produced “strong evidence that California homes with PV systems have sold for a premium over comparable homes without PV systems.”¹⁰⁰ Homes with relatively new, average-sized solar PV systems had a sales premium of around \$17,000.¹⁰¹ Second, the results of a 2011 study on the “incremental effect of energy efficiency on home value” indicated that “ENERGY STAR homes originally sold for \$8.66 more per square foot than non-ENERGY STAR homes.”¹⁰²

⁹⁶ PACENOW, PROPERTY ASSESSED CLEAN ENERGY: FHFA REGULATOR CONCERNS AND RESPONSES 3 (2001), available at <http://pacenow.org/blog/wp-content/uploads/PACE-FHFA-Concerns-Responses.pdf>.

⁹⁷ *Id.* at 3, 5. To see the assumptions and calculations for these estimates, see *id.*

⁹⁸ ZIMRING & FULLER, *supra* note 24, at 2.

⁹⁹ Bryan Bloom et al., *Valuing Green Home Design: A Study of ENERGY STAR Homes*, 3 J. OF SUSTAINABLE REAL ESTATE 109, 109 (2011); BEN HOEN ET AL., ERNEST ORLANDO LAWRENCE BERKELEY NATIONAL LABORATORY, AN ANALYSIS OF THE EFFECTS OF RESIDENTIAL PHOTOVOLTAIC ENERGY SYSTEMS ON HOME SALES PRICES IN CALIFORNIA, LBNL 4476E, at iii (2011), available at <http://eetd.lbl.gov/ea/emp/reports/lbnl-4476e.pdf>.

¹⁰⁰ HOEN ET AL., *supra* note 99, at iii.

¹⁰¹ *Id.*

¹⁰² Bloom et al., *supra* note 99, at 109.

ii. FHFA Has Not Rationally Supported Its Assertion That PACE Obligations Are Unlike Traditional Tax Assessments

FHFA has not rationally connected the facts to its conclusion that PACE assessments are meaningfully distinguishable from traditional tax assessments—which FHFA has not challenged¹⁰³—and that Fannie Mac and Freddie Mae should therefore treat PACE assessments differently.¹⁰⁴ In its ANPR, FHFA does not present any accurate distinctions that explain why PACE obligations do not “fit squarely within the longstanding tradition consistently upheld by courts of land-secured financing for municipal programs,” as proponents argue they do.¹⁰⁵ Land-secured special assessment districts, such as those used in PACE programs, “have been used for more than 100 years in the U.S. to pay for infrastructure improvements deemed to be in the public interest, including improvements on private property.”¹⁰⁶ As of 2007, there were more than 37,000 special assessment districts in the United States.¹⁰⁷

So how do PACE assessments fit squarely within the tradition of local governments’ land-secured financing of infrastructure projects in the public interest? First, PACE liens’ seniority to mortgages does not differentiate them from other special assessments; generally, local governments have made the liens associated with traditional special assessments senior to other, private obligations, such as mortgages.¹⁰⁸ Second, PACE programs cannot be distinguished from other special tax assessments on the basis that there are not uniform standards for project eligibility or terms of repayment among the nation’s PACE programs. Because

¹⁰³ See Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,960; Statement, *supra* note 51.

¹⁰⁴ See Statement, *supra* note 51; Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,960.

¹⁰⁵ SANJAY RANCHOD ET AL., PAUL, HASTINGS, JANOFSKY & WALKER LLP, THE CONSTITUTIONALITY OF PROPERTY ASSESSED CLEAN ENERGY (PACE) PROGRAMS UNDER FEDERAL AND CALIFORNIA LAW: A WHITE PAPER 5 (2010).

¹⁰⁶ ZIMRING & FULLER, *supra* note 10, at 1 n.1.

¹⁰⁷ FHFA Talking Points, PACENOW, <http://pacenow.org/blog/talking-points-for-fhfa-rulemaking-anpr/> (last visited Apr. 26, 2012) (citing UNITED STATES CENSUS BUREAU, LOCAL GOVERNMENTS AND PUBLIC SCHOOL SYSTEMS BY TYPE AND STATE: 2007 (2007), available at <http://www.census.gov/govs/cog/GovOrgTab03ss.html>).

¹⁰⁸ ZIMRING ET AL., *supra* note 7, at 2; RANCHOD ET AL., *supra* note 105, at 3.

traditional special assessments are creatures of state and local law,¹⁰⁹ there are similarly no uniform national standards for repayment terms or participation in the improvements associated with those assessments. Yet, FHFA has not challenged such traditional assessments. Third, PACE assessments cannot be distinguished from other special tax assessments on the ground that individuals opt in to PACE assessments voluntarily; individuals opt into at least some “traditional” special assessments.¹¹⁰

Fourth, PACE assessments cannot be distinguished from other special assessments based on their duration. For example PACE assessments generally last five to twenty years (after that point the upgrade has been paid for),¹¹¹ and a survey of special assessment programs in Sonoma County, California, showed that non-PACE assessments ranged from ten to forty years.¹¹² Fifth, PACE assessments cannot be distinguished from other special assessments based on the size of the assessment.¹¹³ For example, whereas PACE assessments can range from a few thousand dollars to over \$50,000 (paid over a period of up to twenty years), a survey in Sonoma County, California showed average non-PACE assessments to have a similar, varied range.¹¹⁴ Sixth, PACE assessments cannot be distinguished from other traditional tax assessments on the basis of a lack of “the traditional community benefits associated with taxing initiatives.”¹¹⁵ Traditional special assessments fund projects in the public interest such as sewers, sidewalks, seismic retrofitting, and fire safety improvements,¹¹⁶ and improvements in residential energy efficiency

¹⁰⁹ RANCHOD ET AL., *supra* note 105, at 3.

¹¹⁰ FHFA *Talking Points*, *supra* note 107 (providing recent examples of voluntary special assessment districts such as “[those] for septic upgrades in Virginia, or seismic strengthening for homes in California”); PACENOW, *supra* note 96, at 7.

¹¹¹ *The Inception of PACE Financing, Its Support, and Its Potential*, *supra* note 33.

¹¹² Larson, *supra* note 77, at 618.

¹¹³ PACENOW, *supra* note 96, at 6–7.

¹¹⁴ *Id.* at 7.

¹¹⁵ Statement, *supra* note 51.

¹¹⁶ RANCHOD ET AL., *supra* note 105, at 3.

serve a similar public interest.¹¹⁷ As others have pointed out when considering the benefits of PACE programs, "cleaner air, local economic development in the form of opportunities for local businesses to retrofit more properties and cost savings all provide legitimate community benefits."¹¹⁸

For these reasons, there is a strong argument that FHFA should not distinguish PACE special tax assessments from their non-PACE counterparts, unless FHFA can make a sound distinction on other grounds.

c. The PACE Assessment Protection Act of 2011 and DOE Guidelines Can Serve as Models For How to Allow Residential PACE Programs to Continue With Decreased Financial Risk to Mortgage Holders

The PACE Assessment Protection Act of 2011 ("PACE Act"),¹¹⁹ currently only a bill in the U.S. House of Representatives,¹²⁰ and the DOE's *Guidelines for Pilot PACE Financing Programs* ("DOE Guidelines")¹²¹ demonstrate that increased federal regulation of PACE programs could allow residential PACE programs to continue with greater uniformity, but "provide an extra layer of protection to both participants who voluntarily opt into PACE programs, and to lenders who hold mortgages on properties with PACE tax liens."¹²² Even if FHFA can ultimately rationally distinguish PACE assessments from "traditional" assessments, it should not ban Fannie Mae and Freddie Mac from purchasing mortgages on properties with PACE liens. Instead, FHFA should promulgate a final rule that makes senior-lien PACE programs consistent with Fannie Mae and Freddie Mac's uniform security instruments and incorporates the following standards proposed by the PACE Act and/or the DOE Guidelines.

¹¹⁷ See *supra* Part I(a).

¹¹⁸ Larson, *supra* note 77, at 618 (internal quotations omitted).

¹¹⁹ PACE Assessment Protection Act of 2011, H.R. 2599, 112th Cong. (2011).

¹²⁰ *Bill Summary and Status 112th Congress (2011–2012) H.R. 2599*, THE LIBRARY OF CONGRESS, <http://thomas.loc.gov/cgi-bin/thomas> (last visited Apr. 26, 2012).

¹²¹ U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 1.

¹²² *Id.*

The DOE Guidelines were “significantly more rigorous than the underwriting standards . . . applied to land-secured financing districts” at the time the DOE Guidelines were issued in 2010.¹²³

The PACE Act and the DOE Guidelines offer several more stringent standards for program design and assessment underwriting that FHFA should incorporate into its final rule addressing PACE programs. First, FHFA’s final rule should create quality assurance mechanisms to ensure that expected energy savings from PACE-financed projects are actually realized.¹²⁴ The final rule should create standards that must be met before someone can become a certified auditor or contractor for conducting PACE energy audits and retrofits.¹²⁵ The FHFA also should require some inspections (perhaps randomly conducted) of PACE retrofits following installation “to ensure that contractors participating in the PACE program are adequately performing work.”¹²⁶

Second, FHFA should require that residential retrofits that receive PACE funding should have an expected savings-to-investment ratio (SIR) that is greater than one.¹²⁷ DOE has explained the value of such a SIR: “Although traditional land-secured assessment districts do not require projects to ‘pay for themselves,’ PACE financing should generally be limited to cost-effective measures to protect both participants and mortgage holders until PACE program impacts become more widely understood.”¹²⁸

Third, the duration of PACE assessments should not be longer than the useful life of the PACE improvement.¹²⁹ This requirement will help “ensure that a property owner’s ability to

¹²³ *Id.*

¹²⁴ See H.R. 2599 § 5(f); U.S. DEPARTMENT OF ENERGY, *supra* note **Error! Bookmark not defined.**, at 4.

¹²⁵ See H.R. 2599 § 5(f); U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 4.

¹²⁶ U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 4.

¹²⁷ See H.R. 2599 § 5(g)(1); U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 2.

¹²⁸ U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 2.

¹²⁹ See H.R. 2599 § 5(g)(1); U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 3.

repay is enhanced throughout the life of the PACE assessment by the energy savings derived from the improvements.”¹³⁰

Fourth, in states where non-PACE special assessments do not accelerate upon default, there should similarly be non-acceleration for PACE obligations.¹³¹ As discussed earlier, non-acceleration is an important protection for mortgage holders because it limits their liability for PACE payments on foreclosed properties to those payments in arrears.¹³²

Fifth, FHFA should require that the total value of PACE assessments for a property be not more than ten percent of the property’s estimated value¹³³ and that a property owner have equity in at least fifteen percent of the estimated property value as calculated without consideration of the value of the PACE improvements or the PACE assessments.¹³⁴ Similarly, the estimated value of the property should be greater than the value of the sum of all of the owner’s public and private debt on the property and the PACE assessment.¹³⁵ These measures should provide greater peace of mind to mortgage holders concerned about the ability of homeowners with senior PACE liens to pay off mortgage debt.

Lastly, “due to the current vulnerability of mortgage lenders and of the housing market in many regions,”¹³⁶ FHFA should create minimum standards for the general ability of property owners to pay special assessments before they can opt into a PACE program.¹³⁷ In addition to requiring SIRs greater than one, FHFA should require PACE programs to exclude a property owner from participation in the program unless he or she “is current on [on-time in paying] property taxes and has not been late more than once in the past 3 years, or since the purchase of

¹³⁰ U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 3.

¹³¹ See H.R. 2599 § 5(h)(2)–(3); U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 3.

¹³² U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 3.

¹³³ See H.R. 2599 § 5(g)(2); U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 3.

¹³⁴ See H.R. 2599 § 5(g)(3).

¹³⁵ See U.S. DEPARTMENT OF ENERGY, *supra* note 8, at 6.

¹³⁶ *Id.*

¹³⁷ See *id.*

the house if less than three years.”¹³⁸ FHFA also should exclude property owners unless they have “not filed for or declared bankruptcy in the last seven years.”¹³⁹ These requirements go beyond the routine underwriting of other types of special assessments.¹⁴⁰ In sum, the proposed standards and requirements for PACE programs suggested in this section would impose uniform and more stringent underwriting criteria, thereby reducing the financial risk of PACE programs to mortgage holders, allowing FHFA to still fulfill its statutory duties to Fannie Mae and Freddie Mac, and allowing residential PACE programs to move forward.

III. Alternatives to Senior-Lien Residential PACE Programs

This section briefly considers alternatives—some more feasible than others—that could be pursued to promote energy efficiency in the residential sector in the event that FHFA prevails on its appeal of the Northern District of California court decision or promulgates a final rule that prohibits Fannie Mae and Freddie Mac from purchasing mortgages on properties subject to senior PACE liens.

a. Congressional Action

One alternative would be for Congress to enact a version of the PACE Assessment Protection Act of 2011.¹⁴¹ If enacted, this act would provide that:

the levy of a PACE assessment and the creation of a PACE lien do not constitute a default on any loan secured by a uniform instrument of Federal National Mortgage Association or Federal Home Loan Mortgage Corporation and do not trigger the exercise of remedies with respect to any provision of such uniform security instrument if the PACE assessment and the PACE lien meet the requirements of [the Act].¹⁴²

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ *See id.* (“The standard underwriting for [non-PACE] special assessments only consists of examining assessed value to public debt, the total tax rate, and the property tax delinquency rate.”).

¹⁴¹ PACE Assessment Protection Act of 2011, H.R. 2599, 112th Cong. (2011).

¹⁴² H.R. 2599 § 4(a)(1).

Such a congressional statute would override an FHFA rule or policy inconsistent with the Act.¹⁴³ Yet, the likelihood that Congress will enact legislation protecting PACE programs any time soon is remote because of frequent congressional gridlock.¹⁴⁴

b. Subordinate-Lien PACE Programs

A second option for continuing to promote investment in energy efficiency in the residential sector would be for states with senior-lien PACE programs to amend their PACE-enabling legislation to “provide[] that the PACE lien does not subordinate a first mortgage on the subject property.”¹⁴⁵ A few states currently have such programs.¹⁴⁶ FHFA is not opposed to such programs because under these programs, first mortgage holders would recoup their full investment before holders of subordinate PACE liens ever recovered their funds.¹⁴⁷ Municipalities have demonstrated reluctance, however, to adopt PACE legislation with a deferred lien priority.¹⁴⁸ There is great concern that states would be without an efficient recovery mechanism in the event of a property owner’s default on PACE assessments with only a junior lien, and that without an efficient recovery mechanism, it would be difficult to attract low-cost private capital to fund PACE programs in the first place.¹⁴⁹ In addition, there is concern that subordinate PACE liens would make PACE programs less attractive to states due to increased administrative costs relative to senior-lien PACE programs.¹⁵⁰ A report from Lawrence Berkeley National Laboratory explains the potential differential in administrative costs: “Senior-lien PACE special assessments are attractive to local governments because payment collection can be

¹⁴³ See U.S. CONST. art. VI, cl. 2.

¹⁴⁴ See, e.g., *As Gridlock Consumes Congress, Boehner Says House “Has Done Its Job,”* ABC NEWS (Jan. 29, 2012, 9:04 a.m.), <http://abcnews.go.com/blogs/politics/2012/01/as-gridlock-consumes-congress-boehner-says-house-has-done-its-job/> (noting the “bitterly divided political environment” in Washington, D.C.).

¹⁴⁵ Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. at 3,959 n.1 and accompanying text.

¹⁴⁶ *Id.*

¹⁴⁷ See *id.*; ZIMRING ET AL., *supra* note 7, at 5.

¹⁴⁸ *The Inception of PACE Financing, Its Support, and Its Potential*, *supra* note 33.

¹⁴⁹ ZIMRING ET AL., *supra* note 7, at 5.

¹⁵⁰ *Id.*

easily integrated into existing tax collection infrastructure. New procedures and collection mechanisms may be required for managing the tax collections for subordinate tax liens.”¹⁵¹ For these reasons, subordinate-lien PACE programs are not likely to be a viable option.

c. PACE Pilot Programs

A third solution—a compromise until more data on the performance of PACE programs and their threat (or non-threat) to mortgage holders could be ascertained—would be for FHFA to allow only *pilot* PACE programs to be consistent with the USIs, with the goal of collecting and analyzing more data to determine the best future course of action.¹⁵² DOE argues that such pilot programs, if they complied with the DOE Guidelines, “would generate data for analysis without posing significant risk to mortgage lenders.”¹⁵³

d. On-Bill Repayment Programs

The fourth alternative to senior-lien PACE programs for encouraging improvements in energy efficiency in the residential sector is on-bill repayment programs. This would be the most viable alternative of the four considered if Congress cannot enact a version of the PACE Assessment Protection Act and if FHFA will not even allow pilot PACE programs. In on-bill repayment programs, “[t]he utility or some other entity (such as a third party financial institution) incurs the cost of the [clean energy] upgrade and the customer [who pays utility bills] repays the investment through a charge on their monthly utility bill.”¹⁵⁴ On-bill financing can be used in the residential, commercial, and industrial sectors.¹⁵⁵ There are two types of on-bill

¹⁵¹ *Id.*

¹⁵² Letter from David Sandalow, *supra* note 34.

¹⁵³ *Id.*

¹⁵⁴ *On-Bill Repayment Programs*, U.S. DEP’T OF ENERGY, <http://www1.eere.energy.gov/wip/solutioncenter/financialproducts/OnbillRepayment.html> (last updated Nov. 25, 2011).

¹⁵⁵ CATHERINE J. BELL ET AL., AMERICAN COUNCIL FOR AN ENERGY-EFFICIENT ECONOMY, ON-BILL FINANCING FOR ENERGY EFFICIENT IMPROVEMENTS: A REVIEW OF CURRENT PROGRAM CHALLENGES, OPPORTUNITIES, AND BEST PRACTICES at iii (2011).

repayment.¹⁵⁶ In the case of the first—“on-bill tariffs”—the repayment “tariff” stays with the meter if the customer moves, and the next customer at that meter takes over payment of the tariff.¹⁵⁷ In the case of the second type of on-bill financing—“on-bill loans”—the customer must repay the full “loan” even if the customer moves to a new residence.¹⁵⁸

On-bill financing has a variety of advantages and disadvantages that are sometimes similar to and sometimes different from those of PACE programs. The advantages of on-bill financing will be considered first.

i. Advantages of On-Bill Financing for Encouraging Gains in Energy Efficiency

Like PACE programs, on-bill financing overcomes the obstacle of high up-front costs of residential energy-efficiency and clean-energy improvements.¹⁵⁹ Second, like PACE assessments, the repayment period is set so that payments are less than the savings from the improvement.¹⁶⁰ Third, and unlike most PACE programs, on-bill financing has no senior-lien status.¹⁶¹ Accordingly, FHFA has not opposed on-bill repayment programs. Fourth, also unlike PACE programs, on-bill financing does not require cities to create and administer new institutions and financing mechanisms that use limited staff resources because the city is not providing or managing the program’s funding.¹⁶² Fifth, where tenants are responsible for paying utility bills, on-bill tariffs can overcome the split incentives faced by landlords and tenants regarding investment in energy-efficiency improvements.¹⁶³ A tenant can pay for desired energy-efficiency improvements through her bill and must only pay for such improvements for

¹⁵⁶ *On-Bill Repayment Programs*, *supra* note 154.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *See id.*

¹⁶² *See* BELL ET AL., *supra* note 155, at iii.

¹⁶³ *On-Bill Repayment Programs*, *supra* note 154.

as long as he or she is a renter at that property.¹⁶⁴ In contrast, because PACE financial obligations run with the property, there remains a split incentive for property landlords and renters to invest in energy-efficiency improvements. Sixth, even customers with questionable creditworthiness under traditional measures may qualify for on-bill financing when programs use past history of utility bill payment as a proxy for credit.¹⁶⁵

ii. Disadvantages of On-Bill Financing

Unfortunately, although no federal agency has staunchly opposed on-bill financing, it has its own set of barriers to adoption that may prevent it from being more successful than PACE programs in encouraging gains in energy efficiency in the residential sector. First, some utilities have expressed great worry about the up-front costs that *utilities* would need to make to overhaul their billing systems before they could offer on-bill repayment.¹⁶⁶ This concern is absent in the PACE discussion because no changes in a utility's billing system is ever needed for PACE programs to exist. Second, choosing to act like a financial institution by providing financing can subject utilities to additional licensing requirements, upfront fees, and consumer protection laws—laws with which utilities are unfamiliar and have limited resources with which to become familiar.¹⁶⁷ For this reason, many utilities have been reluctant to offer on-bill repayment.¹⁶⁸ In addition, while utilities may be able to temper the legal challenges posed by becoming a quasi-financing entity through offering on-bill tariffs instead of on-bill loans,¹⁶⁹ on-bill tariff systems are especially complicated for utilities to set up.¹⁷⁰ Third, there are a several important but

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*; BELL ET AL., *supra* note 155, at iii.

¹⁶⁶ BELL ET AL., *supra* note 155, at 21.

¹⁶⁷ *Id.*

¹⁶⁸ Merrian Fuller, Lawrence Berkeley National Laboratory, *Retrofit Ramp-Up Implementation Workshop*, July 8, 2010, available at <http://aeg-group.us/wp-content/uploads/2010/08/8-On-Bill-Utility-Financing.pdf> (see slide eight of presentation).

¹⁶⁹ See BELL ET AL., *supra* note 155, at 21.

¹⁷⁰ *On-Bill Repayment Programs*, *supra* note 154.

unresolved legal issues surrounding non-payment in on-bill financing programs. For example, in the case of on-bill loans, state laws are not clear regarding how a customer's payment should be applied to the loan, as opposed to the energy bill, when a customer pays only *part* of her utility bill.¹⁷¹ In contrast, in the case of on-bill tariffs, in most states, it remains unresolved what should happen when a tenant moves out and that tenant had taken on an on-bill tariff that the landlord would not have taken on and the cost of the improvement has not yet been fully repaid.¹⁷² PACE programs avoid these questions because the PACE assessment is assessed by, and paid to, a different entity than the utility company that provides energy to the home.

IV. Conclusion

Cost-efficient, significant gains in energy efficiency in the residential sector are necessary and possible,¹⁷³ and PACE programs can provide a popular mechanism for such progress if FHFA assumes a more reasoned, balanced approach to its statutory duties and authority with regard to Fannie Mae and Freddie Mac.¹⁷⁴ This paper has pointed out how FHFA's reasoning regarding the "threat" of residential PACE programs is faulty in a variety of respects.¹⁷⁵ It also has shown how increased regulation through FHFA rulemaking—modeled after the PACE Assessment Protection Act of 2011 and the DOE Guidelines—could both allow residential PACE programs to continue and better protect the financial interests of mortgage holders compared to the currently federally unregulated system.¹⁷⁶ If such a final rule does not result, however, the most promising alternatives of those considered in this article would be the pursuit

¹⁷¹ BELL ET AL., *supra* note 155, at 22.

¹⁷² *Id.*

¹⁷³ *See supra* Part I(b).

¹⁷⁴ *See supra* Parts I(a)–(b), II.

¹⁷⁵ *See supra* Part II(b).

¹⁷⁶ *See supra* Part II(c).

of pilot PACE programs and increased encouragement and development of on-bill repayment programs.¹⁷⁷

¹⁷⁷ See *supra* Part III.