Commercial PACE Financing: Bonds or Direct Financing? Let the Market Competition Begin.

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Commercial Property Assessed Clean Energy (C-PACE) programs provide Property Owners with a financing tool to improve the energy performance, water efficiency, and resiliency of their commercial buildings. C-PACE programs typically offer Capital Providers two methods to fund a transaction– direct financing or bond funding. Policymakers, municipalities and program sponsors should understand the differences between these two options when considering the design of their C-PACE program.

Because the optimum funding method depends case-by-case on many variables, this note urges that ***both direct financing and bond funding should be allowed, if possible, in order to maximize the overall flexibility and success of the C-PACE program***.

Overview of the Difference between Direct Financing and Bond Funding

Most C-PACE financing can be classified as direct financing or bond funding:

In a <u>direct financing</u>, the Property Owner and Capital Provider negotiate the financial terms and the documentation. The Program Administrator reviews the documents to ensure compliance with state law. The Property Owner obtains funds for the property improvement directly from the Capital Provider via a promissory note and financing agreement (or non-bond instrument).

In a <u>bond funding</u>, the Property Owner and Capital Provider agree on the financial terms, and then a third party– such as a municipality or a conduit bond issuer– issues a bond purchased by the Capital Provider. The proceeds of the bond sale, in turn, fund the property improvements. C-PACE bonds may be issued by cities, counties, or authorized political subdivisions. Some states indicate which local public authorities can issue C-PACE bonds; when no local issuer is indicated, C-PACE Capital Providers have successfully used a multi-state conduit bond issuer. Regardless of who issues the bond, the Property Owner is responsible for repayment. No public funds are used, and there is no financial obligation by the state or local government. The bond issuer will require other parties to join in the transaction, too, such as the trustee that is responsible for disbursements, collections and payments, and the bond counsel that writes a legal opinion attesting to the validity and enforceability of the bond and the C-PACE financing.

Some programs use a transaction structure that is not clearly direct financing or bond funding: funds pass through a government entity, like bond funding, but without that entity issuing a bond. The Capital Provider buys an assignment of receivables or an assignment of the assessment from the government authority (e.g., an energy district entity). The assignment entitles the Capital Provider with legal rights as if it owned the assessment contract directly. With this assignment in hand, the Capital Provider sends its funds to the government entity, which then conveys them to the Property Owner.

Direct Financing Offers Lower Closing Costs and Less Complexity, While Bond Funding Promotes Better Liquidity and Potentially Lower Interest Rates Over Time.

Most states use direct financing in their C-PACE programs, although bonds are the most prevalent funding method in California, the largest state program. Why is direct funding most common? In most states, bond funding is not a requirement, as is the case for certain PACE statutes in California. The closing costs are higher and the lead time longer for bonds due to the additional parties involved. Second, direct financing has a fairly uncomplicated set of documents and is more readily understandable by Property Owners. Third, by comparison, bond financing requires the development of a specialized set of documents specifically for C-PACE transactions, which costs time and money and requires a well-developed infrastructure at the local government level to process, disburse, collect and remit. Finally, some jurisdictions prefer authorizing direct financing to reduce the perceived burden on public officials involved in the levy, collection, enforcement of C-PACE assessments.

Direct Financing	Bond Funding
The Property Owner and Capital Provider negotiate the financial terms and the documentation. The Property Owner obtains funds directly from the Capital Provider. • <u>Lower cost of issuance</u> due to greater flexibility in documentation and fewer parties. Costs of bond funding are about 50-to-75 basis points higher than direct financing, subject to variations on either side. The minimum cost of issuing a a bond is about $25,000 (recognizing that in certain jurisdictions it's possible to issue a bond backed by multiple assessments, spreading the cost of issuance across multiple PACE assessments). • <u>Fewer parties are involved</u>. Direct financing requires no public approval process after the review by the Program Administrator (although some jurisdictions require a public approval or all C-PACE assessments, regardless of funding method).	The Property Owner and Capital Provider negotiate the financial terms. The Property Owner obtains funds from the proceeds of a bond sale by a third-party bond issuer to the Capital Provider. The bond issuer engages a trustee to handle certain closing matters, disbursements, collections and payments. Legal counsel writes an opinion attesting to the validity and enforceability of the C-PACE bond. Certain Capital Providers' investment criteria require bonding. • A bond <u>may be deemed more liquid and marketable.</u> Liquidity and marketability can be enhanced by the reputation of the issuer, trustee and bond counsel, as well as the standard form of bond indenture. • <u>Bond financing requires an independent trustee to disburse proceeds and collect payments,</u> which creates the perception of greater reliability in servicing the C-PACE Bond. • Bonds <u>can facilitate the division of a property assessment into multiple tranches</u> to further enhance liquidity, or to provide for structural

Direct Financing	Bond Funding
• Direct financing programs are often non-exclusive, which preserves a CP's choice to issue bonds at a later date through a bond issuer. • Policymakers may require that the responsibility to levy, collect, and enforce C-PACE assessments be performed by the program administrator or Capital Provider and not as part of the regular property tax collection process. Capital markets and rating agencies will scrutinize the process for collection and enforcement processes more stringently in an "off-bill" situation.	elements such as credit support for the senior bond. (This division of one assessment into multiple tranches may be accomplished with direct financing if the Capital Provider issues its own bonds.) • Bonds can be registered and assigned a CUSIP number, which is a standardized method for identifying securities to facilitate the clearance and settlement of trading market transactions. This feature can be valuable for certain investors. (Registration and assignment of a CUSIP number may be accomplished with direct financing if the Capital Provider issues its own bonds.) • Some C-PACE bond issuances allow for an exemption from state and local income taxes. • Bond funding can offer accelerated foreclosure process in some states, e.g., California.

The Differences Between Bond and Direct Financing Can Be Moderated

The difficulty in quantifying the difference between bond funding and direct financing is that bonds can sometimes work cost efficiently and in other cases the cost is excessive.

- The initial start-up cost (and time invested) in the development of standardized documents, and on the due diligence on the issuance and remittance process, requires continued usage by Capital Providers to amortize these costs over multiples transactions.

- The parties can control the extra *closing* costs of bond financing by using the issuer's standardized bond documents without any extraordinary negotiating, assuming the standard documents are acceptable. Regarding the cost of bond counsel opinion, the potential savings from using direct financing may be less than expected because most investors will want transactions to provide some type of legal opinion on enforceability.

- While direct financing might seem to be more cost-effective and less burdensome on local government's tax administration, the extra *servicing* costs of using a Trustee in bond financing can be a delicate topic. Some investors prefer that a local government collect and the Trustee reconcile the assessment payments, because they are neutral parties required to follow the tax law or the indenture.

- The other part of servicing is stability. Changes in deal structure can occur post-closing: for example, the Capital Provider may sell the bond or assign the note to a new investor; a Property Owner may sell the assessed property; or the designated servicer might want to exit the PACE business in a few years. These changes in the deal structure can create confusion and disruption. A tax bill serviced by local government plus a financially sound Trustee offers stability for the term of the PACE assessment, assuming the local government and Trustee remain stable themselves. This servicing arrangement may be an extra cost over direct financing, but in the long run, parties may find it worthwhile.

Some financial experts believe a hybrid is possible, one based on a low-cost bond structure while employing the servicing stability of a Trustee or County Treasurer. In the near term, this concept is difficult to implement due to a strong tradition in bond transactions of following custom, even when no actual statutory or constitutional limitations prevent this innovation.

Conclusion

For the long-term health of the C-PACE industry, the issue should be framed in this way: will selecting bond funding or direct financing as the exclusive funding method increase the use of the C-PACE more than permitting both options? Unless there are compelling state-specific political or legal realities that require choosing one approach over the other, this Policy Note urges programs to offer both methods and allow market competition and Property Owners to determine which option becomes prevalent.