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Bond Lawyers Craft New Ways to Finance Clean Energy Projects

14 States Have Followed California's Lead in Adopting New Public Finance Tools

By Fiona Smith

SAN FRANCISCO – Local governments around California are putting a new spin on public finance law in an effort to boost clean energy and combat climate change one home at a time.

The idea is to let property owners finance the installation of solar panels or energy and water saving improvements through their local governments. Property owners pay back the loan over several years through an assessment on their property tax bill and the debt stays with the property if it is sold. The government finances the debt through municipal bonds.

The mechanism known as Property Assessed Clean Energy, or PACE, attempts to get over a major barrier stopping people from taking action on their own – the high upfront cost, which can reach upwards of \$20,000.

Lawyers have been key in helping public officials overcome the legal hurdles facing PACE programs, including drafting legislation, structuring contracts and advising on program financing and potential bond issuances worth hundreds of millions of dollars.

“It’s like a kaleidoscope,” said Roger Davis, who heads Orrick, Herrington & Sutcliffe’s public finance practice out of San Francisco. “All the pieces have been there but it never added up and now

the kaleidoscope has turned to create a new picture.”

Orrick is advising San Francisco County in its \$150 million program, as well as working on a statewide effort dubbed CaliforniaFirst that involves 14 counties and more than 100 cities. Others planning programs include Los Angeles County and the City of San Diego.

While PACE has caught on quickly around California and spread nationwide, it is too early to say how many property owners will actually join up and how many investors will be on the program, Davis said.

“The question is, ‘How much market is there for the bonds?’” Davis said. “But we think it’s a viable area with strong public purpose, and a lot of enthusiasm in cities . . . and so it’s creating a lot of good legal work for us right now.”

The idea was first hatched in Berkeley when officials there were looking for ways to meet the city’s ambitious goals to slash greenhouse gas emissions. They called bond attorney Christopher Lynch with Jones Hall in San Francisco and asked him if they could use the long-standing Mello-Roos public finance law, typically used to fund public improvements such as sewers and sidewalks, to help homeowners cut their carbon footprint.

“My answer was intuitively ‘Yes,’” Lynch said.

But it did take some legal maneuvering. Cities and other local agencies typically use Mello-Roos securities to fund public improvements on public property, but in some instances they can be used for private improvements including seismic retrofits and hazardous waste removal, Lynch said. As a charter city, Berkeley had the power to create a Mello-Roos-based special tax to finance renewable energy and efficiency improvements to private property. In 2008, it launched a modest \$1.5 million pilot program, which filled up with applications in a matter of minutes.

Lynch helped write legislation that would have enabled such Mello-Roos financing statewide, but Gov. Arnold Schwarzenegger twice vetoed it, arguing it would have caused a dramatic shift in how the law was used. But the Governor did sign different legislation in 2008 that enabled such programs under another public finance law, the Improvement Act of 1911. That law allows government agencies to create so-called contractual assessments that are technically different from a Mello-Roos special tax, but achieve the same end.

The City of Palm Desert and Sonoma County were the first to launch programs after the passage of AB 811.

Sonoma County's \$100 million program is the furthest ahead; it has already received applications for \$40 million in financing and it is preparing to launch its first bond sale in the near future.

All told, there is about \$1 billion worth of improvements that could be done in Sonoma County alone, and the potential for this program nationwide is massive, said Kathleen Larocque, deputy county counsel in Sonoma.

"It's hugely significant – I don't know how else you're going to arrange the financing for the kinds of improvements people need in their homes and commercial property," Larocque said. "It creates jobs while saving energy, and if we can do it in a way that doesn't negatively impact lenders, which under California law I think we can . . . it's a great model for moving forward with these improvements."

Using the AB 811 model to create contractual assessments does raise some legal issues, said **Trisha Ortiz, a senior associate with Richards, Watson & Gershon in San Francisco**, who helped draft AB 811 and who has worked with Palm Desert and Sonoma on their programs.

The uncertainties center on scenarios where the property owner fails to make

payments, raising questions as to whether PACE debt would gain priority for payback over the mortgage debt, according to Ortiz. But while the state Constitution bars interference with prior contracts such as mortgage debt, Ortiz points out that courts have allowed such interference if the Legislature passes a law in the interest of the public's general welfare – in this case, AB 811.

"There's a public benefit to each home becoming more energy efficient and having them produce less greenhouse gases," Ortiz said.

In order to settle any doubts over Sonoma County's program, Larocque and Ortiz initiated a so-called validation action in Sonoma County Superior Court. Such actions are commonly used to help parties confirm the correct interpretation of a contract, and the court found that the PACE assessments would have top priority for payback.

Legislation enabling PACE has exploded in other parts of the country beyond California. After the state, along with Colorado, passed laws in 2008, 14 other states adopted similar laws in 2009 and about a dozen more are currently considering such laws, said Cliff Staton, vice president of marketing with the Oakland startup Renewable Funding.

The company, founded in 2008 by Berkeley Mayor Tom Bates' former chief of staff Cisco DeVries, has seized on the business opportunities provided by PACE by offering to administer the programs for local governments. Renewable Funding is currently working with most local governments in California that are starting PACE programs, and it attracted \$12.2 million in venture capital financing last year.

Traditional government efforts encouraging energy efficiency have never been able to attract more than 1 percent of consumers, but PACE has the potential to be a real breakthrough, Staton said.

Still, he acknowledged that no programs have gone large scale yet and bond buyers are wary of something without a track record.

"It's a very secure investment, but nonetheless, it's new," Staton said. "With any new idea or new technology, there will be early adopters and it may take time for the numbers to gel and people to pick up on it."

For advice from RW&G concerning AB 811, please contact Trisha Ortiz at tortiz@rwglaw.com.