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

OFFICE OF HOUSING

Special Attention of:

Multifamily Regional Center Directors
Multifamily Regional Satellite Directors
Supervisory Housing Project Managers
Housing Project Managers
Contract Administrators
Multifamily Owners and Management Agents

Notice: H 2017-01

Issued: January 11, 2017

Expires: This notice remains in effect until amended, revoked, or superseded.

Subject: Administrative Guidance for Multifamily Property Assessed Clean Energy (PACE)

I. PURPOSE

This notice provides guidance to owners and management agents (O/As) for determining if the PACE program in their locality meets the standards for compatibility (Assessment Procedures) with the Department of Housing and Urban Development's (HUD) multifamily housing programs. The specific Assessment Procedures are discussed below in Section IV. For those properties in jurisdictions located in areas with acceptable PACE programs, the Notice provides further guidance on obtaining HUD approval for property participation in PACE.

II. APPLICABILITY

This notice is applicable for the following programs:

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. Loan Management Set-Aside (LMSA) Part 886, Subpart A Contracts
   f. 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

III. BACKGROUND

PACE-enabling legislation has been passed in 31 states and the District of Columbia. PACE is a means of financing energy efficiency upgrades or renewable energy installation in a building and the concept has been in use 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 financing may be a viable way to achieve such efficiencies, however in order to protect a mortgagee's and FHA's interest, a mortgagor must receive written consent from its mortgagee and HUD to enter into a PACE special assessment or special assessment.

PACE Program special assessments allow property owners to finance the upfront costs of energy saving installations by entering into a special assessment contract with the participating PACE locality, which stipulates that the property owner will repay the cost of the energy improvements through a property special 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. This arrangement spreads the cost of clean energy improvements – such as energy efficient boilers, upgraded insulation, new windows, or solar installations – over the expected life of the measure. Because the payment is tied to the property tax bill, a secure payment stream, PACE financing is seen as less risky to the financing provider than typical loans for energy efficiency upgrades, and low interest capital can be raised from the private sector with no government financing required. This Notice recognizes the lack of energy efficiency financing tools and 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 qualifying localities may receive support for energy and water efficiency improvements by entering into PACE agreements.

IV. PACE PROGRAM ASSESSMENT PROCEDURES

The Owner must provide a satisfactory letter to the Regional Director from, or on behalf of, the locality/ PACE administrator, which confirms the following operational elements of the PACE program (Assessment Procedures):

A. The PACE special 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 timely notice and a reasonable opportunity to cure the non-payment; and
E. An opinion from the state's attorney general that the obligations are special assessments and treated in a similar matter as the real estate taxes.

If the owner is unable to obtain the above letter from the locality/PACE administrator, an opinion from its counsel that confirms the four above operational elements (A through D) will be accepted for review. The submission of a counsel opinion must also provide evidence of the owner's efforts to obtain the locality letter. **A locality may send the letter directly to the Regional Director.**

HUD staff will review the submission, in conjunction with Field Counsel, and make a determination on whether the locality PACE program meets HUD's required Assessment Procedures. PACE subject matter experts (noted at the bottom of this Notice) in both Housing and the Office of General Counsel are available to assist field staff in reviewing these submissions. A letter will be issued to the owner and locality providing HUD's determination on the PACE program compliance.

V. PACE APPROVAL CONDITIONS

In accordance with the various business agreements (regulatory agreement, mortgage note, housing assistance payment contract, use agreement), owners shall not enter into a PACE assessment without the Department's consent and approval. Once a local PACE program has received notice from HUD that the locality's PACE program meets HUD's required Assessment Procedures in accordance with Section IV above, HUD will consider granting 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 is not located in a Special Flood Hazard Area designated on the latest Flood Insurance Rate Map or Flood Insurance Study or identified in interim flood hazard data provided by the Federal Emergency Management Agency, and is not located on a wetland.
3. The property must have received a REAC score of at least 60 or an MOR of satisfactory or above. This may be waived by the Regional 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.
4. An energy audit, in compliance with ASHRAE Level II, must be completed or have been completed within the past year. A property seeking PACE financing for renewable energy installations only is exempt from the energy audit requirement if it meets one of three criteria: the property has a recent, independently verified benchmarking score of 75 or higher from EPA's Portfolio Manager; the property has completed an ASHRAE Level II energy audit within the past three years; or the property has 20 units or fewer. If the local PACE program requires an

energy audit different from the ASHRAE Level II, HUD will review that requirement.

5. The property owner must provide written evidence that the mortgage holder (or holders) consents to the PACE assessment.
6. A project financed under the PACE program must have a savings to investment ratio of one or greater, as determined by the energy audit as specified in number 4 above, meaning that projected annual savings from the total project, not the individual components, exceed the assessment, except in the first year. When feasible, savings calculations should consider the monetized utility bill savings for energy and water services, avoided labor and maintenance costs, avoided capital investments in the future, and equity financing benefits. The underwriting should be based on up to 75% accuracy in savings estimates. If underwriting is based on greater than 75% accuracy, there must be a loss reserve in place, to serve as additional collateral for the FHA-insured loan, with disbursements therefrom subject to the approval of the FHA lender or HUD. The amount of the loss reserve would be based on the difference between 75% of the estimated savings and the actual underwritten amount multiplied by three (representing three years for the project to demonstrate savings results that justify release, or retainage, of the reserve). If the project does not achieve savings to meet its obligations, the reserve will continue to be held and available to meet project needs in the event of a shortfall. The reserve account must be held or controlled by the FHA insured lender, the lender that holds the reserve for replacement account, or for non-insured projects without reserve for replacement accounts, another institution approved by HUD.
7. Any shortfalls in the first year may be funded by residual receipts or reserve for replacement funds, so long as use of those funds meet all other applicable programmatic requirements.
8. Properties with HUD Multifamily Housing Section 8 Project Based Rental Assistance or a Project Rental Assistance Contract (PRAC) may not include the PACE special 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. The PACE assessment should be included in subsequent budget years; however, staff should ensure that the commensurate savings are reflected in the appropriate utilities (Section 6400) line items. Note that the property will not be eligible for a rent increase to cover utility line item increases in subsequent years that are result of underperforming improvements funded by PACE. Note that the second and subsequent year budgets must reflect achieved first year savings and utility allowances should be adjusted to reflect actual savings.
9. For properties subject to FHA insured and/or HUD-held mortgages, maximum total property debt, when added to the PACE special assessment, must not exceed 85% to 90% (depending on the section of the National Housing 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.
10. The energy and water saving 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, and natural gas piping installed underneath the property owner's land.

11. The HUD Account Executive will review the financial performance of the project to determine the following minimum criteria:
a. Positive operating profit and net income in the previous three audited fiscal years.
b. Current debt service coverage ratio of at least 1.00:1.10.
c. Interim statements disclose no material adverse change in financial condition.

The criteria in number 11 a and b may be waived by the Regional Director on a case by case basis for those properties that may not meet each criterion, but would benefit from PACE participation.

12. The term of the PACE special assessment must not exceed the weighted average expected useful life of the measures as determined by the energy audit.
13. The owner must have provided the PACE program a copy of their market assessment letter establishing comparable sales value, etc. or an appraisal.
14. The owner must contractually agree to provide the lender and HUD with a variety of post assessment information from time to time such as mortgage and assessment amounts; benchmarking data utilizing EPA Portfolio Manager; and prompt notice of a PACE special assessment delinquency.

VI. PACE APPROVAL PROCESS

The locality's PACE program must receive approval from HUD as described in Section IV above. After the owner of a property has received preliminary PACE approval from the locality, they should contact their FHA lender and provide the lender with all of the below referenced submissions. For an owner to participate in PACE, its lender must agree to be responsible for reviewing the PACE Program and special 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 Account Executive for review.

For projects where HUD is the lender, or for 202/811s, or HUD's only involvement with the project is rental assistance, the owner's request will be sent directly to their HUD 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 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 Account Executive will complete the following steps: (1) The locality/ PACE administrator letter or the opinion of owner's counsel on the Assessment Procedures should be sent to field counsel for a sufficiency review to confirm HUD approval of the locality PACE program. (2) Perform a completeness check to ensure that all required submission requirements are in the package, including conditional lender consent and all unexecuted PACE agreements. (3) The Account Executive will review the package to ensure that the project is in compliance with the PACE Approval Conditions noted in Section V above. (4) The assistance of an appraiser may be needed to review an appraisal or other submitted valuation information. After the Account Executive determines 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 Regional 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 loan using FHA mortgage insurance the PACE special assessment will need to be included in the lender's underwriting and addressed in the processing for the 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. For Section 223f loan applications, PACE special assessment funds should not be included in calculating the dollar amount of the improvements or major systems being replaced that could preclude a 223f and require a substantial rehabilitation loan.

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 ensure that the lender and owner are aware of the Department's basic PACE requirements and underwriting considerations, as set forth in this Notice.

The cost savings analysis derived from the energy audit and the special assessment payment obligations 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.

Prior to the submission of the application for mortgage insurance, 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 special assessment. The lender must 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 special assessment payment obligations associated with the energy retro-fit as an expense line item on line 26 or 27 in Section E of the 92264 (i.e. the special assessment needs to be separated from the 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 PACE assessment agreement can be executed at closing.

VII. USE OF EPA'S ENERGY STAR PORTFOLIO MANAGER

Number 13, under Section III, PACE Approval Conditions above, requires the periodic submission of data. The Energy Star Portfolio Manager is the required submission tool. ENERGY STAR Portfolio Manager is a no-cost, secure online resource that enables O/As to benchmark, track, and manage energy and water consumption at the property and portfolio level. O/As can use EPA's ENERGY STAR Portfolio Manager to identify under-performing buildings, set investment priorities, monitor and verify efficiency improvements, receive EPA recognition for superior energy performance, and report out on building and portfolio performance.

For more information on the use of the EPA Portfolio Manager, please contact Michael Zatz at zatz.michael@epa.gov or go to http://www.energystar.gov/buildings/facility-owners-and-managers/existing-buildings/use-portfolio-manager.

VIII. INFORMATION COLLECTION

The information collection requirements contained in this document have been approved by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) and assigned OMB control numbers 2502-0352. In accordance with the Paperwork Reduction Act, HUD may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a currently valid OMB control number.

Owners should note that HUD will require submission of periodic data on actual property energy usage in comparison to the baseline of the energy audit and subsequent year's usage.

IX. CONTACT

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 MFBBC@hud.gov.

For more information on utilizing PACE in HUD properties or questions about this Notice, please contact Robert Iber at Robert.G.Iber@hud.gov.

Edward L. Golding
Principal Deputy Assistant Secretary for Housing

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