OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: April 30, 2010 **IBA Report Number:** 10-38

City Council Docket Date: May 4, 2010

Item Number: # 331

San Diego Clean Generation Program: Proposed Administration Agreement

OVERVIEW

On April 27, 2010, the City Council acted to form the City of San Diego Renewable Energy, Energy Efficiency, and Water Conservation Improvement District No. 1 (District) and incur bonded indebtedness on behalf of the District not to exceed $200 million. This was the third action the City Council has taken in 2010 to create a legal framework to provide property owners in the City with an option to finance renewable energy, energy efficiency improvements and/or water conservation measures (Conservation Improvements).

The City Council is now being asked to approve an Agreement for Administrative Services (Administrative Agreement) with Renewable Funding, LLC (Renewable). The intent of the Administrative Agreement is to provide for the performance of administrative services for the San Diego Clean Generation Program (Program). Staff plans to negotiate and return to Council in June 2010 with a separate agreement with Renewable to provide services relating to financing the Program (Financing Agreement).

The IBA has previously issued Report 10-10 on January 29, 2010, and Report 10-28 on March 23, 2010, related to proposed City Council actions to create the legal framework for the District. In each of these reports, we recommended that staff provide the City Council with additional Program detail for consideration. Although certain financing terms are still being negotiated, the City Council is now being provided with specific administrative information related to the Program. This report discusses the Program, the proposed Administrative Agreement, proposed compensation/financing terms, and other considerations that have come to our attention regarding the proposed financing option.

FISCAL/POLICY DISCUSSION

Overview of the Proposed Clean Generation Financing Program

As described in Ordinance No. O-19930, the Program provides for an alternate method of financing Conservation Improvements by creating a citywide special tax district comprised of properties that may be improved through the issuance of bonds secured by special taxes levied on the improved properties. Property owners in the City would be allowed to "opt into" the District to access special tax financing for Conservation Improvements. Specifically, the Ordinance authorizes financing for "the acquisition, construction, expansion, installation and improvement of energy efficiency, water conservation, including pollution control, and renewable energy improvements and equipment with an expected useful life of five years or longer to or on real property and in buildings, whether such real property or buildings are privately or publicly owned."

Property owners interested in installing Conservation Improvements could apply for District financing secured by a special tax lien against their properties. This financing feature is notable in that the responsibility to repay the debt stays with the property rather than with the property owner who opted to use District financing to fund Conservation Improvements. Property owners who subsequently purchase a property with financed conservation improvements would enjoy the beneficial value/use of the improvements and only be responsible for repaying the remaining term of the debt.

City Council Actions to date Related to the Program, and Remaining Actions

The City Council has taken the following actions to create the District:

02-16-10: Adopted Ordinance O-19930 to amend the City's Municipal Code to facilitate the implementation of the Program

03-23-10: Adopted: 1) Resolution of Intention to Establish the District and 2) Resolution of Intention to Incur Bonded Indebtedness in an amount not to exceed $200 million

04-27-10: Adopted: 1) Resolution Establishing the District, 2) Resolution Determining the Necessity to Incur Bonded Indebtedness, and 3) Ordinance Levying Special Taxes within the District

Staff has informed the IBA that anticipated dates for the remaining actions requiring City Council approval are as follows:

05-04-10: Request Approval of the Administrative Agreement

05-24-10: Initial Property Owner Election to Opt Into the District

06-14-10: Request Approval of Financing Agreement and Bond Purchase Agreement

Proposed Administrative Agreement with Renewable

As noted in the staff report, the process for selecting a Program Administrator began in February of 2009. In September 2009, the Mayor convened three meetings of a Clean Generation Program Working Group to advise staff on 1) the design of the Program and 2) how to inform the community and stakeholders regarding program design and participation. Additionally, staff conducted a series of public meetings to allow property owners to provide program design input. With this information, City staff (including representatives from the Mayor's Office, Environmental Services, Debt Management and the City Attorney's Office) has been working on the development of the Administrative Agreement, Financing Agreement and formation of the District since December 2009.

The proposed Administrative Agreement with Renewable is for an amount not to exceed $625,890 over five years. Renewable proposes to use the California Center for Sustainable Energy (CCSE) as a key subcontractor in the provision of services, and the Administrative Agreement reflects this. A "Scope of Work for Program Design and Administration" (Attachment A to the Administrative Agreement) assigns anticipated responsibility for services and provides Program details. Attachment B provides an estimate of fixed and variable costs for the Program over the first three years. This information is consistent with section 6.(c)(1) and 6.(c)(2) of the Administrative Agreement.

Start-up and direct implementation costs for the Program are projected not to exceed $1,122,390, including the $625,890 for the proposed Administrative Agreement. Staff indicates there will be no impact to the General Fund. Program start-up and implementation costs will be funded using $992,390 of the City's allocation of Energy Efficiency Conservation Block Grant (EECBG) and $130,000 of grant funds awarded to the City from the CPUC/SDG&E Partnership Program. These funds will be used to compensate Renewable/CCSE, City staff and consultants for the District. A breakdown of these expenses is provided on page 4 of the staff report.

Compensation for Renewable

The proposed Administrative Agreement provides for two forms of compensation for Renewable. Section 6.(a)(1) allows Renewable to collect a non-refundable application fee of $300 from each Program applicant. Section 6.(b) allows Renewable to receive an amount not to exceed 1.6% of the amount of Conservation Improvements financed for each participating property. This amount will be charged as a capitalized expense and added to the amount being financed.

In addition to compensation provided for in the proposed Administrative Agreement, it is expected that the Financing Agreement will provide Renewable with .95% of the annual interest rate charged to participating property owners (this is in their response to the City's RFP).

Although actual numbers could be considerably different, staff has suggested it would not be unreasonable to assume 1,000 property owners could finance Conservation Improvements through the initial phase of the Program. These property owners would receive funding from the first $20 million tranche of Microbonds. Utilizing these assumptions (assuming 1.3% for section 6. (b) compensation), the IBA estimates Renewable could receive compensation from the first phase of the Program that is significantly above $750,000.

Proposed Financing Interest Rates, Prerequisites and Limitations

Renewable's proposal in response to the City's RFP indicates that the base interest rate for a 20-year Program loan will be determined by the rate on a 20-year Treasury Bond plus 245 basis points (2.45%), or approximately 7% based on recent interest rates. According to the project financing example provided by staff, when program administration and finance costs (including the establishment of a debt service reserve fund) are factored into base interest rate, the current annual percentage rate (APR) for Program participants is approximately 8.74%. It should be noted that this does not include certain annual ongoing administrative fees, which staff has estimated to be approximately $106/year per property owner participant.

Recent State legislation (SB 77) may provide an alternative source of funds to credit enhance clean energy programs, thereby eliminating the need for a debt service reserve fund and lowering the Program APR by approximately 1.36% to 7.38%, according to the project financing example. However, staff informs the IBA that credit enhancement is not available for the Program at this time.

In order to maximize energy efficiency home improvements, staff has indicated that property owners must complete a few prerequisites before they can utilize Program financing for other Conservation Improvements. These include: replacing air conditioners if rated Seer 7 or lower, replacing single-speed pool pumps and undergoing a HERS energy audit. Additionally, if a homeowner has a mortgage that exceeds the value of their home by more than 10%, they would not be eligible for Program financing. Financing is proposed to be limited to 10% of the value of the home, with a maximum loan amount of $50,000 and a minimum of $5,000.

Other Considerations

In IBA Report 10-28, we raised several questions for staff and the proposed Program Administrator to address when the Administrative Agreement is presented for City Council consideration. We would add the following considerations for City Council to consider and staff to address in their presentation:

- Although staff is to be commended for developing a financing proposal that will not impact the General Fund, we note the current estimated APR of 8.74% is comparatively high in a low interest rate environment. Property owners with home equity can finance energy efficiency improvements with home equity lines of credit that are currently less than 6%. The City of Berkeley recently discontinued a similar energy efficiency home improvement pilot program (limited to solar home improvements) given lower than expected participation, in part attributable to the availability of less expensive alternative financing (the BerkeleyFIRST interest rate was 7.75%). Is there anything that the City or Renewable could do to make the rate more competitive without eliminating important Program elements?

- It should be noted that although the BerkeleyFIRST program was discontinued to pursue participation in a larger energy efficiency program (the California First Program), Berkeley staff believes the pilot program was successful in increasing property owner interest in financing solar energy efficiency improvements irrespective of how those improvements were funded.

- General counsel for the Federal Housing Finance Agency (the regulator of Fannie Mae and Freddie Mac loans) recently raised concerns about Property Assessed Clean Energy (PACE) programs. While professing support for enhancing energy efficiency, he expressed concern about inserting PACE liens in front of mortgage liens. Property taxes and other property-based public improvement liens (i.e., CFDs) are deemed to be senior to mortgage liens; however, some question has been raised as to whether this would continue to be the case for property based liens for private improvements to private property. City staff, legal counsel or representatives from Renewable should address this issue.

- Others have raised concerns about PACE programs making credit available to property owners who owe more on their mortgage than the value of their home (a significant number of homeowners in the current market). The City's Program proposes to make financing available to homeowners with mortgages that do not exceed the value of their home by more than 10%. Understanding the desire to make this program as inclusive as possible, how did staff or Renewable determine that this is the appropriate threshold?

- Although the Financing Agreement is still being negotiated and has yet to come to the City Council for consideration, staff should share the assurances they have received that Renewable will in fact be able to access necessary Program financing from the North American Development Bank (NADB).

CONCLUSION

The IBA has reviewed the back-up documentation supporting the proposed Administrative Agreement. Considerable detail has been presented relative to Program design, proposed administrative costs and potential benefits for participating property owners. As the proposed Program potentially impacts numerous City property owners and would provide public benefit by encouraging energy efficient home improvements, it will be important for the City Council to be provided with information to facilitate their understanding of the design and financing elements. Prior to or after receiving the staff report at the Council meeting on May 4, 2010, the IBA recommends that the City Council address with staff the issues discussed above and/or any other matters, and be comfortable with the Program design, financing plan, and the recommended administrator before adopting the proposed Administrative Agreement.

[SIGNED]	**[SIGNED]**
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