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MEMORANDUM

To: **Shift Zero Coalition**

From: **Eric Christensen**
Nicole Springstroh

Re: **PACE Legislation: Whether Legislation Following The Texas PACE Model Would Violate the Washington Constitution**

Date: **August 30, 2018**

QUESTION PRESENTED

The Texas PACE program uses private, rather than public, funds to finance energy conservation loans and limits the governmental role to administrative functions. Could a PACE program modeled after the Texas program be adopted in Washington without violating Article 8, Section 5 or Article 8, Section 7 of the Washington Constitution?

BRIEF ANSWER

Yes. Legislation modeled on the Texas version of PACE could be adopted in Washington without running afoul of the constitutional prohibitions against gifts of public funds and lending of public credit. The Texas model relies on private rather than public financing, and Washington's constitutional prohibitions relate only to public funds and financing. Further, to the extent public funds are expended to support administration of the PACE program, those expenditures would generate public benefits through the conservation of resources and the reduction of pollution, so that the public would receive consideration for these expenditures adequate to avoid any implication that the Washington Constitution has been violated.

STATEMENT OF FACTS

Property Assessed Clean Energy (PACE) financing has been adopted in states across the country, generally relying on public funding. Fears that a PACE program would violate the Washington Constitution's prohibition on gifts of public funds have held back efforts to pursue PACE legislation in our state. Newer PACE models, however, have shifted toward private funding models. This memorandum addresses whether PACE models that utilize private financing, using the Texas PACE program as an exemplar, can be adopted in Washington without running afoul of the state constitution.

The Shift Zero Coalition is proposing PACER legislation, referring to Property Assessed Clean Energy and Resilience, because it would allow for financing of seismic retrofits of existing buildings and other types of retrofits to improve building resiliency. This memo uses the more standard "PACE" acronym, but the analysis applies equally to PACER. The expansion of the program to cover financing of resiliency upgrades does not change our legal analysis.

PACE has a long track record of success in other parts of the country in providing long-term financing to allow property owners to install energy conservation measures. In some places, PACE has also been used for other purposes such as seismic retrofits. The distinguishing characteristic of PACE is that loans are secured against the property, and repayments are assessed against the property rather than the borrower. PACE works because energy conservation measures reduce the utility bills associated with a property, creating borrowing capacity that can be tapped to fund energy conservation measures. Because the repayment obligation runs with title to the property, lenders can be assured that the added borrowing capacity created by the conservation measures they fund will remain available to repay PACE loans. Similarly, seismic and other resiliency upgrades reduce insurance costs, which creates added borrowing capacity that can be leveraged to finance resiliency upgrades.

Property owners benefit from PACE because the energy savings created by PACE-financed conservation measures will exceed the PACE loan's repayment obligation, generating net cash savings for the property owner. This result is assured through oversight of PACE loans, so that only cost-effective conservation measures are financed. Public benefits are created through conservation of resources and reduction of the environmental impacts associated with energy production that would be required to be produced in the absence of the PACE-funded efficiency gains. Similarly, seismic and other resiliency upgrades reduce insurance costs for property owners and reduce the burdens of government in responding to earthquakes and other emergencies.

While many states have implemented PACE programs that utilize public financing, newer PACE models rely to a much greater extent on private financing. PACE legislation adopted by Texas in 2013 is a good example. Under the Texas PACE Act, participation by property owners is voluntary,[1] and the program relies exclusively on private, third party financing.[2] The Texas PACE Act authorizes local governments to implement the program. PACE loans are recorded in county property records and local governments are authorized to collect PACE repayments along with property taxes, although the loan servicing function is often performed by private contractors.

Property owners are responsible for finding a contractor, selecting a project, identifying a

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[1] Although the term "assessment" is often associated with taxation, in the model proposed here, the "assessment" is not an exercise of the governmental power to tax, but simply the repayment of a private obligation voluntarily undertaken by the property owner and assumed with notice by any subsequent owner of that property when the property changes hands. "Assessment" in the PACE context signifies that the repayment obligation runs with the property rather than that PACE payments are a form of taxation.

[2] The Texas model also permits public funds to be used for PACE financing, if available. We understand, however, that the Texas PACE authority has encouraged private financing over public, and that public financing has not been used in Texas to date.

capital provider, and obtaining written consent from the original mortgage holder.[3] A wide range of third parties are able to offer PACE loans in Texas. After the property owner has negotiated the agreements with the contractor and lender, the owner completes and submits a PACE application. The local government then reviews the application to ensure that funds are expended for cost-effective conservation measures. The review function is often performed by private PACE contractors on behalf of local governments. If approved, the administrator notifies the property owner, obtains a signed contract, records the lien, and issues the funding. Regardless of whether the local government or a third party administers the program, the government is never the guarantor of the PACE loan. In addition, the PACE loan includes a service fee that compensates the local government for providing this service.[4]

When the contractor completes all approved work, the administrator is notified and verifies completion. Consistent with the terms its financing contract, the property owner then amortizes the PACE financing by making periodic payments that are assessed against the property benefitted by the PACE-financed improvements. The local government has the discretion to determine whether to perform the loan servicing functions itself, outsource those functions to a third party, or delegate those functions to another governmental body such as the

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[3] While concerns about subordinating home loans to PACE loans from the Department of Housing and Urban Development have greatly limited the availability of PACE loans for residential housing, the same is not true of commercial and industrial properties and the Washington legislation would be aimed primarily at facilitating deep energy efficiency retrofits and resiliency upgrades in those types of properties. Experience in other states suggests that lenders in Washington would be willing to subordinate mortgages to PACE loans once they learn that PACE is designed to significantly increase the borrower's repayment capacity.

[4] Local administration of the program is not a requirement. In Washington, it would make sense to designate, for example, the Office of Energy of the Washington Department of Commerce to administer the approval of conservation loans because of that agency's deep expertise in identifying cost-effective energy conservation measures. If an agency of state government, rather than local government, were involved, the analysis would not change because the courts construe the restrictions of Article VII, Section 1 (requiring all taxes to be put to "public use") and Article VIII, Section 5 (prohibiting the credit of the state from being used for private benefit) in substantially the same way as Article VIII, Section 7, which applies to local governments. *See, e.g., CLEAN v. State,* 130 Wn.2d 782, 796, 928 P.2d 1054, 1061 (1996), as amended (Jan. 13, 1997). Local government involvement likely would be required only for the property-based assessment, because property taxes in Washington are generally administered at the County level.

county tax assessor-collector.[5] Frequently, the PACE assessment is reflected on the property tax bill for the property, and the county tax assessor-collector receives payments and passes them on to the PACE lender. This has resulted in a tremendously high collection rate. Nevertheless, the local government is under no obligation to take on this responsibility and the local government has no obligation to the PACE lender if the property owner fails to pay its PACE assessments.

[5] Another possibility worth considering in Washington is administration by a public body, like the Washington State Housing Finance Commission, that is funded through a self-sustaining fund rather than through tax dollars. This would further insulate the program from claims that tax funds are being used for private benefit and might also add administrative benefits.

DISCUSSION

A. BECAUSE THE TEXAS MODEL RELIES ON PRIVATE RATHER THAN PUBLIC FINANCING, LEGISLATION ADOPTING THE TEXAS MODEL WOULD NOT TRIGGER SCRUTINY UNDER THE WASHINGTON CONSTITUTION'S PROHIBITIONS AGAINST GIFTS OF PUBLIC FUNDS AND LOANS OF PUBLIC CREDIT.

The Washington Constitution includes prohibitions on gifts of public funds and loans of public credit. The Texas PACE model relies on private, not public, financing. Thus, the Texas model could be adopted in Washington without violating the state constitution.

Article 8, Section 5 of the Washington Constitution provides that "[t]he credit of the state shall not, in any manner be given or loaned to, or in aid of, any individual, association, company or corporation." Wash. Const. art. VIII, § 5. Similarly, Article 8, Section 7 states that "[n]o county, city, town or other municipal corporation shall hereafter give any money, or property, or loan its money, or credit to or in aid of any individual, association, company or corporation . . . ." Wash. Const. art. VIII, § 7. "Although the[] . . . provisions are worded slightly differently, th[e] [Washington Supreme Court] has held that they have identical meaning, as well as the same prohibitions and exceptions." *CLEAN v. State*, 928 P.2d 1054, 1061 (Wash. 1996). As the Court has explained, "[t]he manifest purpose of the[] provisions . . . is to prevent state funds from being used to benefit private interests where the public interest is not primarily served." *Id.*

Under the Texas PACE model, the government role is limited to administrative functions, including recording PACE liens, adding PACE assessments to property tax bills, and passing on collections to the private PACE lenders to service their loans. There is no direct expenditure of public funds for PACE loans, no lending of public resources, and no public guarantee of loan repayments. Because Article 8, Sections 5 and 7 govern the expenditure of public funds and credit, not private funds, PACE legislation following the Texas private funding model would not violate either provision.[6]

The expenditure of public funds for the administrative functions related to PACE financing is not, by itself, sufficient to trigger scrutiny under either constitutional provision. On the contrary, "[t]h[e] court has generally required actual lending of credit in lending of credit cases." *Citizens for Clean Air v. Spokane*, 785 P.2d 447, 458 (Wash. 1990). Accordingly, Washington government agencies are permitted to administer programs that bestow incidental benefits on private parties so long as public funds are not given directly to those private parties. For example, the Washington Department of Licensing administers a system of automobile titles that records the holder of any loan outstanding against an automobile as an equitable owner of that automobile. While this program obviously benefits private financing companies, the private benefits are merely incidental to the public purposes of the program, and there is no serious argument that Washington's system of automobile titles violates the state constitution.

While there is older authority, *Lassila v. Wenatchee*, 576 P.2d 54, 58 (1978), holding that the government is "absolutely prohibited from acting as a financing conduit for private enterprise," we believe that authority is inapplicable where private rather than public financing is involved and, in any event, that *Lassila* been limited to its facts by subsequent cases such as *CLEAN*.

Lassila involved a challenge to the City of Wenatchee's purchase of land that was later resold to a private party. The court held that this transaction violated Article 8, Section 7

[6] The Texas program allows but does not require public financing. We believe it would be wise for Washington to adopt a similar mechanism so that any federal PACE funding could be used by Washington residents. Further, to the extent future state or local funding became available, the permissibility of using those funds for PACE financing could be resolved at the outset under RCW Chapter 7.25, which provides for declaratory actions to establish the constitutionality of bond issuances. For the reasons stated in subsection B of our analysis, we believe there is a good chance that state or local bonds could be used to fund PACE loans.

because the City used its own credit to purchase the property, then passed the property on to a private developer. The expenditure lacked a public purpose because the city expressly intended, at the time it purchased the property, to pass the property on to the private party for development. In the court's view, this demonstrated that there was no planned public purpose for the acquisition, and the city used its credit to facilitate a transaction for purely private benefit. *Id.* at 57-58.

The administrative function that government would take on under the Texas PACE model is not a "financing conduit" of the kind condemned in *Lassila*. Rather, to the extent PACE can be characterized as a "conduit," under the Texas model, funds are transferred from private lenders to private borrowers, then back to the private lenders as PACE loans are repaid. Because neither public funds nor public credit are involved, there is no "conduit" allowing private parties to access public resources.

In any event, because PACE financing serves a public purpose by conserving resources and reducing pollution, the government receives valuable consideration for any public expenditures. Later cases have held that *Lassila* does not apply if public purposes are served by the government's expenditures. *CLEAN v. State*, 928 P.2d at 1062 (holding that, in *Lassila,* the government neither received anything of value for its expenditure of public funds nor was a public purpose served by the expenditure).

In sum, Washington could implement PACE legislation following the Texas model without implicating the Washington Constitution's prohibitions against gifts of public funds or loans of public credit. By relying on private financing and limiting the role of the government to administrative functions, PACE legislation using the Texas model would not trigger scrutiny under either Article 8, Section 5 or Article 8, Section 7. Further, because the program services important public functions by reducing energy consumption, lowering energy costs, improving community resiliency, and reducing the environmental impacts associated with energy production, it produces public benefits that justify any public expenditures associated with the program. We discuss this aspect of the analysis in greater detail in the next section.

B. BECAUSE THE PACE PROGRAM CREATES CLEAR PUBLIC BENEFITS, ANY PUBLIC EXPENDITURES WOULD PASS MUSTER UNDER THE WASHINGTON CONSTITUTION.

PACE produces substantial public benefits in the form of reduced energy consumption, a more efficient use of resources, reduced energy bills, and a reduction of the environmental impacts associated with energy production. Similarly, PACE loans used to improve property resiliency produces substantial public benefits in the form of increased community resiliency and reduced costs for emergency response and reconstruction. Because the expenditure of public funds would produce tangible public benefits, the PACE program would pass muster under the Washington Constitution even if the expenditures required for administering the program were considered under the framework of Article 8, Section 5 or Section 7.

In resolving questions arising under the constitutional prohibition against gifts of public funds, the courts follow a two-pronged analysis. *See Citizens for Clean Air v. Spokane*, 785 P.2d 447, 457 (Wash. 1990). First, the courts determine whether "the funds are being expended to carry out a fundamental purpose of the government." *Clean v. State*, 928 P.2d at 1061. If so, the analysis ends because "no gift of public funds has been made." *Id.* However, if a court decides "the expenditures . . . [do] not serve a fundamental purpose[] of government," *id.*, but rather "are pursuant to the government's proprietary authority, the court focuses on consideration and donative intent to determine if a gift has occurred." *Citizens for Clean Air v. Spokane*, 785 P.2d at 457. "Unless there is proof of donative intent or a grossly inadequate return, courts do not inquire into the adequacy of consideration." *Tacoma v. Taxpayers of Tacoma*, 743 P.2d 793, 805 (Wash. 1987).

Consistent with Washington case law that generally finds governmental utilities to be proprietary rather than governmental functions, we assume for purposes of this analysis that energy conservation is not a fundamental purpose of government. *See Tacoma v. Taxpayers of Tacoma*, 743 P.2d at 805; *Scott Paper Co. v. Anacortes*, 578 P.2d 1292, 1297 (Wash. 1978). Nonetheless, we conclude that the PACE program provides adequate consideration in return for the expenditure of public funds and that there is no donative intent as understood by the Washington courts. Hence, there would be no violation of the prohibitions on gifts of public funds or lending of public credit.

It has long been established that cost-effective energy conservation measures produce public benefits that provide adequate consideration for public expenditures, so that such public expenditures are not a "gift." This foundational principle was established in *Tacoma v. Taxpayers of Tacoma*, which held that the public received adequate consideration when Tacoma Public Utilities provided grants for private parties to install energy conservation measures. Cost-effective conservation measures, the court concluded, create substantial public benefits because the cost of conservation measures is less than the costs that would be incurred to purchase new energy supplies to provide the energy that would be required in the absence of the conservation measures. 743 P.2d at 794, 806 (reasoning that even though the conservation measures were installed in privately owned structures, aid to individuals is not absolutely prohibited and is only improper when public money is used *solely* for private purposes (emphasis added)). Under the Texas PACE model, the PACE administrator conducts a review of PACE contracts in part to ensure that only cost-effective conservation measures are financed. This would assure, under the

Tacoma rubric, that any conservation financed through the program would produce net benefits by reducing the net costs of utility services. Hence, because the PACE program would produce demonstrable public benefits, any benefits to the private participants, such as lower utility bills and small increases in property values, are incidental and do not constitute a gift of public funds. *Id.* at 806.

Resiliency loans would pass muster under the same analysis. That is, because the expenditure of public funds produces public benefits in the form of increased community resiliency and reduced costs for government responses to earthquakes and other emergencies, the public receives meaningful consideration for the government expenditures.

Nor would a privately-funded PACE program involve donative intent. This prong of the analysis requires "proof of donative intent," *Tacoma,* 743 P.2d at 805, which is absent here. For example, the fact that PACE loans include a service fee that would compensate governments for providing recording liens and providing property-based assessments defeats any implication of donative intent. Further, in *CLEAN v. State*, where taxpayers challenged the expenditure of public funds to finance a major portion of a new baseball stadium meant to house the Mariners franchise, a private entity, the Washington Supreme Court held that "[t]he fact that private ends are incidentally advanced is immaterial to determining whether legislation furthers a public purpose." 928 P.2d at 1058. The Court further held that "[a]n expenditure is for a public purpose when it confers a benefit of reasonably general character to a significant part of the public," and, if it is "debatable as to whether or not an expenditure is for a public purpose, we will defer to the judgment of the legislature." 928 P.2d at 1059. In addition, the Court reasoned, if the government maintains direct control over how the funds are spent, this is strong evidence that there is no donative intent. *Id.* at 1062. In the PACE model, the PACE administrator ensures public benefits by requiring that only cost-effective conservation or resiliency measures are funded through PACE.

C. WASHINGTON CONSTITUTION ARTICLE 8, SECTION 10, WOULD PERMIT A PACE PROGRAM, SUBJECT TO SPECIFIC LIMITATIONS.

In 1979, Washington voters approved an amendment to the state constitution, Article 8, Section 10, which created specific constitutional authority for municipal utilities to provide loans for cost-effective energy conservation measures for private residences, and exempted such loans from scrutiny under Article 8, Section 7. This provision creates independent constitutional authority for PACE legislation, and authorizes property-based liens, so long as the program is limited to the parameters specified in Article 8, Section 10. Those parameters are: (1) the program must be administered by municipal utilities;[7] (2) financing can be used be used only for conservation in existing structures; and, (3) financing cannot result in a conversion from one energy source to another.

[7] A Texas-style program could be administered through Washington's investor-owned utilities because they are privately-owned entities, so the program would be even further from the proscriptions of Article 8 than programs administered by government-owned utilities.

CONCLUSION

For the reasons described in the memorandum, we conclude that Washington could adopt PACE legislation based on the Texas model, which relies on private financing and limits government's role to administration of the PACE program, without violating the Washington Constitution's prohibitions on gifts of public funds or lending of public credit.