PACE

ACCOUNTING TREATMENT

Background

California Assembly Bill 811, ("AB811"), was signed into law July 21, 2008. (Please note that Renewable Funding has created the acronym PACE to describe the AB811 program. "Property Assessed Clean Energy") The law allows public agencies (cities, counties or special districts, including joint powers) within the State of California to place contractual assessments on private property which allows for a revenue stream that supports loans to property owners, both commercial and residential, to finance energy improvements including solar panels. AB811 was written as an amendment to the 1911 California Streets and Highway Code which provided for the establishment of property assessment districts that enabled the use of municipal bonds backed by property tax assessments to finance streets, sidewalks, utilities, parks, etc. within the designated assessment district.

AB811

AB 811 provides for the establishment of property assessment districts in order to allow property tax payers within those districts to vote to allow the imposition of additional property taxes, tax assessments, to help facilitate the construction of streets, sidewalks, utilities, parks as well as fund any necessary community services, police, fire, etc., within the district.

The additional property tax assessment is used as security for the issuance of municipal bonds, either taxable or tax-exempt depending on the assets financed, to fund the improvements and services within the district. The security for the bonds and their only source of repayment, unless guaranteed by a third party, is the property being financed and the cash flow generated by the property tax assessment.

AB811 provided for the use of the 1911 Assessment Act law to provide PACE financing. It is a real estate finance tool. The assets being financed are often tangible assets which lend value to the property or properties within the financing district. The source of repayment, unless guaranteed by a third party, is the tax assessment. This implies that investors in PACE bonds look solely to the value of the property as their source of repayment.

Mechanics

The 1911 Assessment Act and AB811 require the property owner who opts into the Los Angeles County PACE program to sign an assessment contract. The assessment contract provides for the property owner to a pay a fixed assessment amount each year for the term of the assessment contract. The amount of the assessment is based on the cost of the proposed improvements, the term of the improvements and a proposed rate of interest which compensates the bond holders for providing the financing.

The PACE assessment appears on the property tax bill of the property owner each December and April. It is labeled as "PACE Assessment". There is no breakdown as to the amount of principal and interest associated with the bond on the property tax bill. The total "principal amount" of the assessment is also not disclosed on the tax bill.

There are a couple of unique characteristics associated with PACE assessment district financing:

- Transfer – Since PACE financing is based on the value of the property there is no acceleration of the principal amount of the assessment upon sale of the property. Unlike traditional mortgage or corporate finance there is no pre-approval of the buyer of the property. The PACE bond holder looks solely to the value of the property and not to the credit of the property owner.

- Liability - Property taxes do not become a legal liability of the property until August of each year when they are placed on the property tax roll. This applies also to the PACE assessment. For this reason future property taxes, although a known inevitability, are not placed on the balance sheet of a property owner until the year in which they are levied and placed on the tax rolls. (August of each year.)

- Foreclosure – Since the PACE assessment only becomes a legal liability of the property when it is placed on the property tax rolls each year in an event of default, non-payment of property taxes, the PACE bond holder can only bid the amount of the unpaid assessment in the year of the default, plus penalty interest and fees. The PACE bondholder does not have the option of accelerating the entire unpaid principal amount plus penalty interest and fees like a mortgage debt holder. In a foreclosure auction the PACE bond holder can only bid that year's amount of the assessment plus penalty interest and fees. A traditional mortgage debt holder may bid the entire principal amount of the mortgage plus forgone interest payments as well as penalty interest and fees.

- Title Report - Future property tax assessments are not disclosed on the title report of the property as a lien against the property. In the case of PACE the total "principal" amount of the assessment is not included on the title report of the property as a lien against the property. Only the property taxes and PACE assessment that are placed on the property tax rolls are recorded as a lien against the property. (That year's PACE assessment.)

Accounting Treatment Assessment District Financing by Publicly Held Real Estate Firms

Unfortunately given the novelty of PACE financing and the fact that only two publicly held companies have utilized this financing tool to the best of our knowledge there is nothing in the accounting literature which speaks to the proper accounting for PACE. The only public companies that have used PACE are Simon Property Group and ProLogis which are discussed below.

Since the proceeds of assessment district financings are often used to finance tangible improvements that could be depreciated and that add value to the property it is relevant to look at how other companies that use assessment district financing account for the financing on their balance sheets. The firms which primarily utilize assessment district financing are homebuilders and industrial REITs. The form 10-K for the most recent financial year, 2013, for the following companies was reviewed.

Name	Auditor
Lennar	Deloitte & Touche
Pulte Group	Ernst & Young
K&B Homes	Ernst & Young
Hovnanian Enterprises, Inc.	Deloitte & Touche
Shea Homes Limited Partnership	Ernst & Young
Standard Pacific Corp	Ernst & Young
ProLogis	KPMG
First Industrial Realty Trust	Price Waterhouse Coopers
Duke Realty Corp	KPMG
DCT Industrial Trust	Ernst & Young
Simon Property Group	Ernst & Young

In the financial statements of Lennar assessment financing was mentioned in the summary of accounting policies section. The liabilities and corresponding assets were not placed on the balance sheet.

Pulte Group and Duke Realty Group report in the notes to their financial statements in the contingent liabilities section that they will record a liability and corresponding asset where the amount is fixed and determinable when looking at their assessment bonds.

Standard Pacific Corp and ProLogis mention assessment financing in the debt section of their notes to their financial statements and place this indebtedness on their balance sheets.

For the following companies assessment district financing was not mentioned in the debt section in the notes, in the summary of accounting policies nor in the commitment and contingencies section

K&B Homes	Ernst&Young
Hovnanian Enterprises, Inc.	Deloitte & Touche
Shea Homes Limited Partnership	Ernst & Young
First Industrial Realty Trust	Price Waterhouse Coopers
DCT Industrial Trust	Ernst & Young
Simon Property Group	Ernst & Young

Finally, Simon Property Group and ProLogis are the only publicly traded firms which have utilized PACE. Simon has completed the most PACE financing transactions in terms of numbers and dollar amounts. In Simon's financial statements there are no disclosures of the existence of the assessments nor are they included on their balance sheet. Ernst & Young is the auditor for the Simon Property Group. As mentioned ProLogis mentions assessment financing in the notes of its balance sheet and records a liability. KPMG is the auditor for ProLogis.

Conclusions

The following summarizes the "arguments" with regards to the accounting treatment of PACE.

A) Mechanics

The Assessment Contract obligates the property owner to pay the PACE property assessment over the next 20 years. This implies a long-term liability.

At the same time the following points contradict the fact that PACE is long-term liability.

1) PACE is not a legal liability of the property until the time when the assessment is placed on the tax rolls. Only that year's assessment payment is placed on the tax roll for any particular year and only then does it become a legal liability of the property. This is the same as "normal" property taxes.

2) Similar to property taxes PACE is a legal liability only of the property. There is no corporate guaranty with regards to the payment of the assessment.

3) The PACE assessment is identified on the property tax bill solely as "PACE assessment" and the amount is that year's assessment payment. There is no break-out

of principal or interest nor is there any discussion as to the total amount of the assessment and the “principal” amount remaining outstanding.

4) In the case of a default only the amount of the PACE assessment placed on the tax rolls, (One year’s assessment payment.), may be accelerated plus any penalties and interest. This is the same treatment as property taxes.

5) The total amount of the PACE assessment is not shown on the property’s title report as a lien against the property. Only that year’s PACE assessment along with other property taxes would be shown as a lien against the property on the title report.

6) Like property taxes the PACE assessment does not require the prepayment of the assessment upon change of ownership of the property. There is no provision for the approval of the new buyer of a property by the owners of the PACE bonds.

B) Industry Practices

As discussed only four firms disclose the liability associated with assessment district financing, ProLogis, Standard Pacific, Pulte and Duke Realty. Pulte and Duke discuss the assessment financing in their commitments and contingencies section of the notes and include the amounts for future assessments under accrued liabilities. ProLogis and Standard Pacific discuss assessments in the debt section and include them on the balance sheet.

Six other firms make no mention of assessment financing on their financial statements. These six firms utilize a number of different auditors. In addition, Simon Property Group and ProLogis who have completed a PACE financing, have different approaches towards the treatment of their PACE assessments. Simon does not mention the PACE financing in its notes to its financial statements. ProLogis does discuss assessment financing on its financial statements.

Given the arguments associated with the mechanics of the PACE assessment plus the fact that the majority of firms that utilize assessment financing do not include any mention of it in their financial statements we would recommend that the firm considering a PACE assessment not include the proposed PACE financing on its balance sheet going forward. We strongly urge any firm considering PACE to work with its accounting firm to determine its own approach to the accounting of any PACE obligations that it takes on.