Me^2 Financing Plan

August 31, 2010 Planning Document for Common Council Review

I. Objectives

The Me^2 financing plan has the following three objectives:

- Use grant funds to stimulate community energy efficiency investment at a ratio of at least 5:1.
- Develop a mechanism for loan servicing and securing loans and identify a third-party to service loans. The loan mechanism should overcome existing limitations of energy efficiency financing.
- Develop an approach for capitalizing $60 million pool for energy efficiency loans, while ensuring that the City is protected from risk.

II. Overview

The City of Milwaukee (City) and Wisconsin Energy Conservation Corporation (WECC), along with most, if not all, BetterBuildings grantees, have experienced several set-backs with regard to the preferred financing options. These setbacks have delayed or eliminated the opportunity to implement the more innovative forms of energy efficiency financing, such as Property Assessed Clean Energy (PACE) financing or utility tariff model. Despite these set-backs, the City and WECC have narrowed the financing options approach for Me^2. WECC issued a Request for Information (RFI) with responses due September 10, 2010 from local financial institutions. No local banks responded to the RFI, and three national banks responded. RFI responses have been useful in shaping the RFP.

The financing programs underlying the BetterBuildings grant have been affected by regulatory decisions and the severity and nature of the current recession. This has required a consideration of other financing options that would be effective in achieving the overall objectives of the grant award. The review of alternatives has narrowed down the potentially valuable options as well as the potential timeframe to develop and implement those options.

Based on two key program parameters (effectiveness and lack of risk to the City) the two main financing alternatives are:

(1) using the designated loan loss reserve funds to attract a private lender to provide financing programs with adequate terms that would be attractive to customers; and/or
(2) using a revised HUD Title I program that is trying to be developed and may be available later this fall or by the end of the year.

A proposed RFP (with a response deadline expected in mid- to late October) would be used to attract a private lender and determine if acceptable lending rates and customer eligibility/underwriting criteria will be available to the program. The program can only encourage a speedy development of an improved HUD Title I program.

Given the continued policy uncertainty at the national level, this resolution authorizes a transitional financing mechanism for the program that would allow the program to proceed while these issues are finally resolved.

A transitional energy efficiency financing mechanism could be created by establishing a revolving loan fund using some portion of the overall grant award. The trade-off in terms of the amount of such a fund would be that the more loans are made under such a transitional fund, the less funds will be immediately available during the project period for the other necessary tasks. The reason is that any funds actually expended from a revolving loan fund will take time to recycle back to the fund if loans terms are in the 5-10 year range. But, because WECC and the City are not responsible for loan defaults with a revolving loan fund based on DOE Guidance, there would be no risk to the City from such a transitional financing mechanism. In addition. DOE Guidance provides that a revolving loan fund can be ended at any point in time and the available funds used for another valid program purpose (e.g. as loan loss reserves to support the leverage of grant funds to achieve increased attractive private capital for the financing program).

A draft transitional residential program is attached that seeks to achieve an attractive value offer to customers while using customer eligibility/underwriting criteria adequate to ensure that the loans are likely to be repaid and that customers who are able to afford the loan will improve, rather than jeopardize their current financial condition.

In light of an evolving policy national policy environment and urgency to effectively use ARRA program funds to stimulate the economy, OES and WECC propose the financing road map outlined in the sections below.

III. Loan Loss Reserve

- The loan loss reserves funded by the grant will be used to leverage private capital to fund the Me^2 financing programs. Utilizing grant funds for a loan loss reserve is a key element of the program design as prescribed by the US Department of Energy (DOE).
- These grant funds will be used to leverage private capital by providing more attractive conditions for a private lender to provide capital for Me^2 and/or to support the cost of debt reserve for the issuance of bonds that would provide a low-cost source of capital.
- The residential loan loss reserve has been established at $1,500,000 (less $500,000 for temporary revolving loan fund) while the non-residential reserve fund has been established at $3,850,000 (less $250,000 temporary revolving loan fund). Per DOE guidance, grantees may use the loan loss reserve funds for a revolving loan. The revolving loan fund will be in place until a permanent source of capital is identified and terms negotiated.
- It is anticipated that these funds will be able to leverage approximately $60,000,000 for the Me^2 financing programs.
- The terms of a Loan Loss Reserve Agreement between the third party financing provider and the program (in this case WECC) depend on the structure and terms of the energy efficiency loans.

Loan Servicing and Securitization

- Utilize a third party entity to provide funding and loan origination and servicing for the residential and non-residential financing programs.
- Issue a Request for Proposal (RFP) that seeks a full service provider for both loan capitalization funds and loan origination and servicing; a loan capitalization provider only and a loan origination and servicing firm only. **Common Council approval is required for an RFP.**
- The RFP also seeks proposals from financial institutions with experience in loan origination and servicing, including performing the necessary underwriting reviews of potential borrowers. The selected vendor must be able to implement an unsecured loan product, but be able to transition to loan servicing using the PACE model or the utility tariff model if policy conditions allow later in the grant term. Selecting a third-party loan origination and servicing company will be a critical element of the Me^2 program, regardless of whatever type of loan security is ultimately selected.
- **The loan originator identified through the RFP would also administer the revolving loan fund according to the terms outlined in this document. WECC may contract with Energy Finance Solutions to administer the temporary revolving loan fund. The interest rate associated with the temporary revolving loan may be used to pay fees associated with the cost of servicing the loan or may be used as program revenue.**
- The PACE model and the utility tariff model were the top two options for the City and WECC for the residential components of Me^2. Due to Federal Housing Finance Agency PACE guidelines issued this summer and WE Energies most recent refusal to entertain the utility tariff model, the City and WECC have had to explore other financing options.
- WECC and the City currently recommend an unsecured financing product(s) for residential with terms similar to those outlined in the following Background section.
- WECC and the City tentatively recommend a commercial PACE program for the non-residential sector, focusing on small to medium business customers.
  - A commercial PACE program would require authorization from the existing mortgage holder, thus, a non-residential customer would be offered the choice of unsecured or PACE financing.
  - Because the use of a non-residential PACE program is possible, the RFI requests information on lending rates for both unsecured and PACE secured commercial financing (since one would expect a lower financing rate for a PACE secured loan).
  - A commercial PACE program may include the use of an owner/lessee-arranged project that meets program criteria as authorized by state statute.
  - A commercial PACE program will require an additional Common Council resolution. Based on results of the RFP for commercial services, WECC and OES will recommend to the Council at a later date on whether to pursue PACE for commercial.

IV. Capitalization of Loan Pool

There are two methods of raising private capital to support Me^2 loans that appear potentially capable of attaining the overall program objectives: entering into a direct arrangement with a financial institution or issuing government bonds. The Me^2 team continues to gather information on both options to ensure that they will meet the needs for an effective program while protecting the City (as well as continues to identify and assess other potential options as they might arise).

- **Short Term-** In order to effectuate a 2010 "soft launch" of the Me^2 program for residential properties, OES recommends using up to $750,000 of what had been budgeted in the two loss reserve accounts for a temporary revolving loan fund. This revolving loan fund would provide attractive interest rates (see Appendix A below). Any funds from this pool that have not been spent when a permanent financing plan has been established shall revert to the loan loss reserve for residential loans.
- **Long Term:** Option 1 below is preferred.
    - Option 1: Direct private sector capitalization from private equity firm, pension fund, bank, or credit union
        - Pros: 1) less administration for the City; 2) more sustainable model; 3) more "natural" fit with market-based economy; 4) same entity could provide both loan capitalization and loan servicing; and 5) private bank takes risk of loan losses that exceed loan loss reserve
        - Cons: 1) higher interest rate; 2) tighter underwriting standards; and 3) there is a risk in locking into a long-term arrangement with a financial institution and an unsecured loan product if a better financing mechanism becomes viable later in the grant period.
        - Development approach: Both the RFI and RFP will seek additional information and proposals for this option. **If a private financial institution identified through a competitive RFP process can provide significant loan capitalization at within 500 basis points of Wall Street Journal Prime Rate and with other favorable terms, WECC may enter into a contract with the winning vendor with approval from the City representative. Additional Common Council approval would not be required to approve the vendor contract.**
        - DOE is working with HUD to revise the HUD Title 1 loan program for potential launch later this year. If this develops as discussed by DOE, this will likely be the most attractive financing option for residential loans. WECC and OES will pursue this option if it becomes available.

    - Option 2: Government bonds, especially Qualified Energy Conservation Bonds (QECBs)
        - Pros: 1) lower interest rates; and 2) could serve as a short-term bridge, allowing a program to launch in the near term.
        - Cons: 1) more administration for the City; 2) City allocation of QECBs is limited; and 3) City may take on risk of loan losses that exceed loan loss reserve absent mitigating alternatives.
        - Development approach: The DOE bond council and City Comptroller Office are exploring this option. WECC and the City sent a series of question to DOE's

technical advisor and bond Council on August 20, 2010. **Common Council approval would be needed to authorize the issuance of QECBs.**

Background

Residential. The PACE model and the utility tariff model are not viable financing options for the foreseeable future. FHFA issued guidance to its lending institutions this summer advising against use of the PACE model—this effectively killed the residential PACE market (PACE is still viable for the non-residential market). We Energies rejected the City and WECC overtures to participate in a utility tariff model. In addition, if We Energies had been interested, this method must receive regulatory approval which could take months. Another option that no longer seems feasible in the near term is use of the existing HUD Title I program, which would depend on federal modification of the current application process (i.e. faster response to customer and less paperwork would be desirable) as well as the development of a Title I lender in Milwaukee. The use of this latter option continues to be explored with the DOE/HUD and the Housing Authority of the City of Milwaukee.

For these reasons, the City and WECC recommend utilization of a third party provider to provide funding and loan origination and servicing for the residential and non-residential financing programs. The loan loss reserve funds would be used to negotiate lower lending rates and adequate terms for an unsecured loan program for eligible customers. The key attributes of the unsecured loan program sought from a third party provider would be:

- An interest rate to the customer not to exceed 500 basis points over WSJ Prime Rate
- Fixed interest rates only with no prepayment penalty
- Unsecured loan terms up to 10 years
- Residential loan amounts from $1,000 to $12,500

Loan eligibility criteria and underwriting criteria would be developed jointly between the third party lender, WECC, and the City. However, it is anticipated that an eligible customer must at least have: an acceptable FICO score established by the program; no bankruptcy, foreclosure, or repossession in at least the last four years; and no more than $1,000 in unpaid collection accounts as well as no unpaid judgments or tax liens in addition to criteria to ensure that a borrower can afford the loan sought.

On August 27, 2010 an RFI was issued to primarily banks and credit unions located in the City of Milwaukee (and to a few national lenders who currently provide third party energy efficiency lending programs) as to whether they would be interested in responding to an RFP for a loan product(s) with the above attributes as well as soliciting comments on other attributes that they would be willing to provide. The RFI sought information from firms interested in being full service loan providers, capital providers, or loan servicing companies. Responses were due on the RFI by September 10, 2010. WECC received only three responses, two for commercial and one for residential. These responses from national firms provided useful guidance on structuring the RFP.

The terms of a Loan Loss Reserve Agreement (LLRA) between the third party financing provider and the program (in this case WECC) depend on the structure and terms of the energy efficiency loans. These terms include: eligible borrowers; eligible projects and use of proceeds; minimum and maximum loan size; loan application and documentation; loan tenors/terms; interest rate; customer capital contribution, if any; payment schedule; loan size; loan underwriting guidelines; loan disbursement pattern; and prepayment option. The key terms of the LLRA itself are the risk sharing ratios, the definition of "default/loss," and the process for disbursements out of the fund.

The LLRA cannot be done until a third party lender is retained and the program information noted above is available. There does not need to be an RFP to determine who holds the loan loss reserve (although obviously the lender should not hold the loan loss reserve funds). Any LLRA would ensure that neither the City nor WECC would be responsible beyond the funds available in the LLRA. WECC will retain independent outside legal counsel to help draft the LLRA.

In addition to a third party lender supported by the loan loss reserve, the program will also seek to develop more effective programs that: 1) work with lenders to include cost-effective energy improvements costs in new or refinanced mortgages (Energy Efficient Mortgages, or EEMs); and 2) work with the City in its foreclosed home program to achieve more cost-effective energy efficiency improvements through that program. Neither of these efforts is expected to require the use of program financing, but would require project resources.

Non-Residential. The RFI issued on August 27, 2010 also sought third party providers for non-residential financing product(s), especially for small to medium business customers. Because the use of a non-residential PACE program is possible, the RFI requests information on lending rates for both unsecured and PACE secured commercial financing (because one would expect a lower financing rate for a PACE secured loan). The non-residential loan loss reserves would be used as increased loan security to leverage at least $40 million for program financing. WECC and the City have also been pursuing low-cost funding that would allow an enhanced performance contracting program for larger non-residential buildings.

Because a commercial PACE program would require authorization from the existing mortgage holder, a non-residential customer would be offered the choice of unsecured or PACE financing. However, if the PACE lending rate is not appreciably lower than the unsecured rate, the primary non-residential financing program will be the unsecured financing program.

WECC and the City have also been exploring the potential use of a Qualified Energy Conservation Bond (QECBs) for use in the non-residential sector (or perhaps even in the residential sector) that could be blended with the loan rate attained through the use of the loan loss reserves to achieve a lower interest rate for customers. QECBs are direct subsidy bonds similar to Build America bonds designed to achieve lower bond financing costs and can be used to finance "Green Community Programs" like Me^2 (Section 54D of the Recovery Act). The City of Milwaukee has a QECB allocation from the State of Wisconsin of approximately $6.2 million. The total QECB allocation to the State of Wisconsin from the federal government was $58 million. Under this scenario, the City would issue the QECB to capitalize a portion of the Me^2 program. Grant funds could be used to support the debt servicing reserve fund while the bond issuance cost could be recovered in the lending rate to customers. By design, the expected borrowing cost of a QECB is well below bank financing rates. WECC and the City are working with bond counsel, provided at no cost as part of the technical services to grant recipients, and are awaiting responses to a number of questions submitted about QECBs and their use. Because the City's QECB allocation is only a fraction of the total leverage necessary for the Me^2 program, other financing options would still need to be considered. It is possible that the State of Wisconsin could distribute a greater share of the State QECB allocation.

In addition to Common Council approval for an RFP for financial services, subsequent Common Council approval would be needed to authorize the issuance of QECBs.

Appendix A: Residential Transitional Financing Program

Eligibility Criteria

Amount: $750,000 in a revolving loan fund

Lending rate: Below 8% per year including loan origination/servicing costs (See “Eligible Measures”)
No pre-payment penalty

Loan amounts: $1,500 - $12,500

Loan term: Loans up to $5,000 = 5 years or less
Loans up to $12,500 = 10 years or less

Eligible properties: Owner-occupied 1 - 4 unit homes (primary residence)

Loan Nature: Unsecured

Credit Scores and Quality

Minimum FICO: Above 640 (multiple borrowers the lower score must pass)

Other:
1. No bankruptcy, foreclosure or repossession in last 4 years (and pending must be closed first)
2. No judgment and tax liens (must be paid or in repayment)
3. Unpaid collection accounts (no more than a @1,000 excluding medical collections)

Income Verification

Requirements: Income verification not required if FICO score is above 720

Salaried employment income: One (1) pay stub with YTD earnings dated within 30 days of application

Retirement income: 1. Benefit letter or pension showing income amount, payment frequency and start and end dates, or
2. Copy of bank statement showing direct deposit of retirement income

Self-employment income: Two (2) most recent federal income tax returns (first 2 pages plus Schedule C, if applicable)

Other income (if applicable): Other income than primary income being used to qualify for the loan (e.g. rental, alimony or investment income) must be verified

Debt to Income Ratio

Total monthly obligations:

- Exclude any loan with a remaining term of less than 6 months from the calculation
- If revolving accounts do not show a minimum payment, use the greater of 3% per month or $10
- Real estate taxes and homeowners insurance (if not included in the mortgage payment) must be included in the ratio

Total monthly obligations to total monthly income: 50% or less

Eligible Measures

- For non-moveable appliance replacement only (e.g. furnaces and water heaters)
  - Interest rate is 5.99%
- Home Performance with ENERGY STAR Program (must have a pre- and post- energy assessment completed by a Focus on Energy Home Performance with ENERGY STAR partnering consultant)
  - Interest rate is 3.99%

Interest rate revenues may be used to pay for loan servicing costs or be used as program income.

Fees

Participating contractor fee = 1.0%

- Disclosed to customer in print
- Only applied to contractors installing replacement equipment (per above)