ABS Research

New California Building Requirements Could Spark PACE Growth

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Morningstar Perspective

The California Energy Commission adopted building energy efficiency standards last month that will not only require solar installations in newly constructed homes starting in 2020 but will also necessitate enhanced lighting and ventilation systems in commercial buildings, including newly built healthcare facilities--a first-time requirement for this sector. Morningstar Credit Ratings, LLC believes the CEC's new energy renewal and efficiency standards are positive for property assessed clean energy programs and will help support further development of the sector.

New Building Standards Will Heat up Solar Demand

Adopted on May 9, the 2019 Building Energy Efficiency Standards go into effect on Jan. 1, 2020, and apply to both residential and commercial buildings, although the requirements for each differ. Most noteworthy is the solar requirement for all new residential construction in 2020. This will significantly increase demand for solar energy and will benefit local operators. It may also serve as a blueprint for other states if California can decrease energy usage and increase customer savings.

Another component of the new requirements that has largely been overlooked will help to further bolster solar adoption on the residential level. The standards require new homes to have smart systems, which may include the installation of storage services, albeit voluntarily. Battery storage facilities would enable homeowners to store solar energy for use during higher priced peak periods (late afternoon to evening on weekdays and all day on weekends). This feature will be attractive to homeowners, given California's migration to time-of-use pricing, which we expect to occur in 2019. Three major utility companies--Pacific Gas and Electric Co., Southern California Edison, and San Diego Gas & Electric--will implement a TOU pricing scheme next year, in which rates will be higher during peak usage periods and lower during off-peak periods to incentivize electricity usage during slower times.

Whether with TOU or dynamic pricing, which fluctuates more fluidly in relation to real-time demand, battery storage is a compelling option to add to solar energy systems, especially as net metering agreements become less common. With net metering, customers can sell power back to the utility company's grid and receive a credit if their kilowatt-hour usage is less than the energy produced. Utility companies have lobbied to eliminate net metering agreements as the proliferation of solar panels has significantly cut into their bottom line. As a result, it's likely that demand for storage will significantly increase with the transition to tiered pricing and the removal of net metering.

On the commercial side, new construction of healthcare facilities will be subject to energy efficiency standards--the first time the healthcare sector has ever seen such a mandate. In addition, the building requirements also call for enhanced lighting and ventilation systems on existing commercial properties. Indoor air quality should benefit from the use of filters, while indoor and outdoor lighting may increase efficiency with the use of LEDs.

Will the Residential Side Pick Up the PACE?

While it's too early to tell whether residential builders will simply add the incremental solar costs, estimated at roughly $9,500, to selling prices, the possibility exists that residential developers may use PACE programs to help finance their properties, borrowing a page from the playbook of their commercial counterparts. On the residential side, we have yet to see builders use PACE as a financing tool because with a new construction loan, the borrower would need to get consent from the lender to add on a PACE assessment. Lenders may be reluctant to allow such financing because of the supersenior lien status that PACE assessments enjoy over mortgage loans. In addition, the Federal Housing Finance Agency prohibits Fannie Mae and Freddie Mac from buying mortgages with PACE liens, while the Federal Housing Administration no longer insures new mortgages on homes with existing PACE assessments.

On the commercial side, the benefit to PACE is more straightforward because property developers have already used PACE as a financing alternative. Most commercial programs require borrowers to obtain the mortgage lender's consent before providing PACE financing. Builders working on commercial properties, including newly constructed healthcare facilities, may use PACE programs to help finance the new building requirements, or otherwise they may seek out a higher-cost construction loan or mezzanine financing.

Prospects Are Looking Bright

The new building standards that take effect in California in 2020 will require property owners and building developers to spend more money to meet those new measures that include solar requirements for residential properties and energy efficiency standards for commercial properties, including newly constructed healthcare facilities. PACE programs stand to benefit as builders look for financing alternatives to pay for these new energy efficiency and energy renewal requirements.