

Alternative Energy Manufacturing Sales and Use Tax Exclusion (SB 71) Program

LEGISLATIVE ANALYST'S OFFICE

Presented to:
Senate Energy, Utilities and Communications Committee
Hon. Alex Padilla, Chair
Senate Governance and Finance Committee
Hon. Lois Wolk, Chair





Structure of This Presentation

- Program background.
- Reaction to Solyndra's failure.
- The challenges in evaluating the success of this and other tax expenditure programs.
- This program in perspective—as one small part of a much broader renewable energy and climate policy.
- General LAO findings concerning the program.



Background

- Sales and Use Tax (SUT) Exclusion Approved in 2010.*** Chapter 10, Statutes of 2010 (SB 71, Padilla), authorizes an exclusion from the state and local SUT for equipment used in manufacturing eligible advanced transportation or alternative energy products, such as solar panels. This law expires at the end of 2020. Our office is required to report to the Legislature on the effectiveness of this program at the end of 2018.
- SUT Exclusions Are Not Capped.*** There is no dollar limit on SUT exclusions under this program. Chapter 10 requires the California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) to notify the Legislature when approved exclusions exceed \$100 million annually.
- Applications Required.*** Chapter 10 requires CAEATFA to review applicants for the SUT exclusion for their subsidized projects' projected "net benefit" to the state. The application considers projected environmental and fiscal benefits resulting from the manufacturing, as well as the creation of jobs in high unemployment areas.
- Alternative Source Energy Generation Facilities Excluded From Program.*** The program currently excludes alternative source *generation* projects—instead, limiting its assistance to *manufacturers* of alternative source products, components, or systems.
- Some Tightening of Program Rules Recently Went Into Effect.*** Recent changes in program regulations tightened requirements for future recipients to keep subsidized equipment in California for a number of years and use it consistent with program rules. The rules allow CAEATFA to seek recovery of excluded SUT plus interest in future cases of noncompliance.



Background

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- ☑ ***New Application Consideration Now Suspended.*** Solyndra, an Alameda County solar manufacturer, has received \$25 million of the \$31 million in SUT exclusions used by all program recipients to date. On September 6, 2011, Solyndra filed for bankruptcy protection and suspended operations. On September 27, the CAEATFA board suspended review and consideration of new applications for the SUT exclusion program.



The Failure of Solyndra

- ☑ ***Alternative Energy Is a Burgeoning, Volatile Business.*** In providing tax incentives for alternative energy manufacturers, the Legislature sought to provide assistance to a sector that faces significant financial challenges—due, among other things, to the dominance of carbon-based energy in our economy and strong competition from elsewhere, such as China. A large portion of companies in any sector fail. Given the challenges facing the alternative energy sector, the Legislature should expect that a substantial portion of companies in this program will fail.
- ☑ ***Financial Viability Test Problematic.*** The suggestion has been made that the state could require a credit evaluation—to determine that a prospective subsidy recipient in this program is likely to be “financially viable” for some period of time in the future. Such changes would be problematic for a variety of reasons.

 - ***Difficult to Assess.*** It is difficult even for investors to assess corporate viability in this sector. State government officials would be ill-equipped to second-guess investors in companies applying for a SUT exclusion.
 - ***Could Substantially Increase “Windfall Benefits.”*** If this exclusion were directed only to the soundest companies, its benefits might flow largely to companies that do not need assistance to survive. In tax expenditure analysis, these might be windfall benefits—subsidies that would go to companies for doing what they were going to do anyway.



The Failure of Solyndra

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Adding Strings to the Program Also Would Be Problematic.

Suggestions also have been made to tighten further the requirements of this program—to allow the state to “claw back” SUT subsidies if projections of California jobs are not met or to cap SUT exclusions for individual companies. Such changes are problematic.

- ***Companies Need Flexibility.*** Facing a competitive, changing business environment, companies in this sector often need flexibility to grow and thrive and produce affordable, high-quality renewable energy products. Additional limits on this program—while well-intentioned—could sour companies that are considering siting operations here in California that might be eligible for this program.
- ***Existing Requirements for Keeping Equipment in California Justified.*** The program’s existing requirements to keep equipment in California for a certain period of time seem justified. Moreover, while it is impossible for companies to project precisely what their employment levels will be in the future, any instances of fraud on program applications should be pursued aggressively.



Evaluating Tax Expenditure Programs



Very Difficult to Evaluate Success of a Program Like This.

Solyndra and other companies have begun to *use* this tax benefit, by claiming SUT exclusions on purchases of eligible equipment. Use of the tax benefit—and employment of Californians by the companies using the tax benefit—is *not* in and of itself an indication this program is successful. Instead, analysis of tax expenditures should focus on how much, if at all, the tax benefit changed a company’s behavior from what it would have been anyway.



Example: The Prior Administration’s Cost Estimate for This Program.

The Senate floor analysis for SB 71 said the prior administration indicated this program “would have no impact on the budget, since absent the program, the projects approved by CAEATFA would not have occurred.”

■ ***Solyndra Was Up and Running Prior to This Program.***

Solyndra began shipping products in 2008—well before the Legislature’s approval of SB 71. It received its \$535 million federal loan guarantee in 2009. While the SUT exclusion program *may* have enabled the company to invest in equipment it would not have otherwise have purchased, it is impossible to know for sure whether the federal government or other investors would have provided funds to allow Solyndra to purchase the subsidized equipment anyway... or whether Solyndra would have purchased this equipment absent the SUT exclusion.



Energy Policy Likely a Bigger Contributor to Industry Success Than This Tax Policy

- ☑ ***California's Clean Energy Policies.*** The state's clean energy policies—developed over more than three decades—are complex and comprehensive. They are focused on (1) reducing energy consumption through energy efficiency programs and building and appliance standards, (2) increasing access to renewable electricity resources, (3) decreasing petroleum dependence through alternative transportation fuels and vehicles, and (4) reducing greenhouse gas emissions to 1990 levels by 2020.
 - ***33 Percent Renewable Portfolio Standard (RPS).*** The state's RPS requires utilities to increase the percentage of their electricity generated by eligible renewable energy resources. This policy should play a major role in spurring demand for the products of manufacturers that receive benefits through this tax program.

- ☑ ***Alternative Energy Sector Benefits When the State's Policy Signals Are Clear.*** To the extent that state energy policies and regulations send clear market signals to the public and businesses, they can be instrumental in encouraging demand for alternative energy products and services (such as those manufactured by companies in this program) and interest from venture capitalists and other investors.

- ☑ ***This Tax Program Appears to Be a Very Minor, but Complementary, Effort.*** We think that the state's broader energy policies, such as RPS, will play a far more important role in stimulating alternative energy manufacturers than this relatively modest tax exclusion. This tax program, however, appears complementary to the state's overall energy policies.



LAO Findings

- ☑ ***Eliminating SUT on Manufacturing Equipment Generally Has Merit.*** This program excludes a small subsector of manufacturing from SUT on equipment purchases. We have long noted the potential benefits of excluding *all* manufacturing equipment from SUT. Such a policy change would reduce “tax pyramiding”—an economically distortionary feature of our tax code whereby manufacturers pay sales tax on their equipment and their customers then pay additional sales tax on the final product itself. Moreover, such a policy change would bring California more in line with sales tax policies of other states.

- ☑ ***Be Realistic About What This Program Can Do.*** The net benefits test established by Chapter 10 seems premised on the idea that companies and the state can readily predict in advance how much employment and environmental benefit will result from a particular tax exclusion. We doubt this premise. Moreover, changing the program in an attempt to ensure that it produces short-term jobs and investment in California risks unintended, negative consequences that could push some manufacturers away from the state and/or result in them producing higher-priced alternative energy products. By contrast, leaving program participants with more flexibility may result in lower-cost alternative energy products that could play a small role in helping the state achieve goals concerning carbon emissions reduction and the use of renewables.



LAO Findings

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- Unsure of the Value of the Program's Current Application Process.*** The application process consists of (1) a fairly objective component establishing that a company manufactures products in this sector and (2) a subjective component related to a project's net fiscal and environmental benefits. Solyndra's experience shows the difficulty in predicting how many jobs and how much investment will result for a company even in the short run. We suggest that the Legislature eliminate the subjective part of the application process and instead grant the SUT exclusion to all eligible manufacturers in this sector on their equipment purchases. A small reduction in state and local sales tax revenues may result. (We do recommend that CAEATFA continue to gather information on participating companies' investment, employment, and products, which may prove helpful for future program evaluations.)
 - May Wish to Clarify Legislative Intent Concerning Generation Facilities.*** While the program generally excludes alternative source energy generators, it appears to us that it may nevertheless provide certain benefits to biogas, biomass, landfill gas, and geothermal power producers. Specifically, as the law now is administered by CAEATFA, the SUT exclusion has been extended to equipment used by these types of electricity producers for their gas production processes, even when those processes occur on the same property as the electricity generation resulting from that gas production. The Legislature may wish to clarify whether it intended to provide such benefits to these types of power producers, while excluding similar benefits for other generators. Any changes along this line could increase or decrease state and local revenue losses related to the program.