

**CALIFORNIA ALTERNATIVE ENERGY AND
ADVANCED TRANSPORTATION FINANCING AUTHORITY**
Meeting Date: October 25, 2011

***Consideration of Temporary Suspension of the SB 71 Advanced Transportation and
Alternative Source Manufacturing Sales and Use Tax Exclusion (STE) Program***

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Summary.

On September 27, 2011, CAEATFA Chairman, Treasurer Bill Lockyer, requested the CAEATFA Board to consider pausing the SB 71 Program in the wake of Solyndra's bankruptcy. The "pause" on the program would allow CAEATFA staff to continue to monitor the federal investigations into the Solyndra bankruptcy, examine program regulations and processes for reviewing and approving exclusions under the program, prepare for an upcoming legislative hearing on the SB 71 Program, and consider the potential outcome of that hearing. The pause would only impact review and approval of future sales and use tax exclusions under the program, not existing awards.

This agenda item provides the CAEATFA Board with a formal process to consider the need for a temporary suspension of SB 71.

Solyndra's Bankruptcy and SB 71

Solyndra submitted an application for the SB 71 Program in October 2010, for its facility to produce cylindrical module photovoltaic panels in Fremont, CA. The Solyndra project met the eligibility and evaluation criteria established in SB 71 Program regulations and was approved at the November 2010 Board meeting, along with eleven other projects, for a maximum of \$381,776,000 in Qualified Property (QP) which equated to approximately \$34.7 million in sales and use tax exclusions (STEs). See Attachment A for additional information on the SB 71 Program and the nature of sales and use tax exclusions.

On September 6, 2011 Solyndra filed for bankruptcy. Upon hearing about the closure of the facility in the news, Staff immediately tried to reach their contacts at Solyndra but have not received a response.

Under the SB 71 Program, Solyndra has purchased \$277 million in equipment from over 350 vendors, utilizing an estimated \$25.1 million in STEs to date.

The abrupt closure of Solyndra drew an abundance of media coverage as the Department of Energy (DOE) and Federal Bureau of Investigation (FBI) began to conduct investigations into Solyndra's conduct. There have been two Congressional hearings held surrounding due diligence of a \$535 million DOE loan guarantee given to Solyndra. Senator Padilla, the author of SB 71 and chair of the Senate Energy, Utilities and Communications Committee, called for a joint

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hearing with the Senate Governance and Finance Committee to review the SB 71 program. The hearing took place on October 19, 2011.

With respect to recovery of the STE, Staff has talked to legal counsel and the Board of Equalization (BOE) and under current circumstances it does not look as though the State will be in a position to recover the avoided STE. However, Staff will continue to monitor the findings in the federal investigations and the bankruptcy proceedings to see if there is a discovery that could support a recovery at the State level. CAEATFA would need to prove a material misrepresentation in the information Solyndra provided.

Legislative Hearing

Subsequent to Solyndra declaring bankruptcy, State Senator Alex Padilla, author of SB 71, and Senator Lois Wolk called a joint legislative hearing to review the program and discuss potential changes to ensure that the state is prudent with its resources.

At the September 27, 2011 CAEATFA Board meeting, Treasurer Lockyer requested that his fellow CAEATFA board members consider “pausing” or temporarily suspending the review of new applications under the SB 71 program while staff conducted a review of the program and responded to the legislative oversight hearing.

A joint oversight hearing between the Senate Committees on Energy, Utilities and Communications and Governance and Finance took place on Wednesday, October 19, 2011. Attachment B and Attachment C are the briefing documents provided at the hearing by the Legislative Analyst’s Office (LAO) and committee staff respectively.

The hearing included presentations by: the CAEATFA Chair, Treasurer Lockyer; the LAO; representatives from California solar companies (Stion and Solaria); and the California Tax Reform Association (See Attachment B for the legislative hearing agenda). The hearing included a review of the program from the Legislators, LAO, program users, tax policy advocates, and industry representatives.

SB 71 Program Internal Review

Also during this time period, CAEATFA staff reviewed the Program’s regulations, policies and procedures, both widely and specific to the Solyndra Application, and have outlined a number of the safeguards, including reporting requirements, that are in place under the program (further discussed below).

Staff will continually review the program’s regulations to ensure they are appropriate and consistent with the goals of the statute. In addition, Staff will strengthen its review of the media coverage/financial coverage of applicants and will make this information available to the Board when it considers an application.

As noted above, the SB 71 Program includes several provisions that ensure that the SB 71 financial assistance is provided to eligible companies under the statute, and protects the taxpayers' dollars. The most significant of these provisions are listed below. Several of these provisions were incorporated into the program with the recent enactment of modified regulations on September 28, 2011, including:

- A **substantial use test** to ensure that the equipment and machinery purchased under the program are used for the intended purposes. This test was recently tightened in the regulations enacted in September 2011 to require the equipment be used at least 50% of the time each year and more than 75% of the time on average for eligible equipment (Section 10033(b)(1)).
- A **net benefit evaluation** to ensure that the environmental and economic benefits to the State outweigh the potential cost to the State (Section 10033 (c)). The net benefit scoring methodology was recently revised to make it more reflective of reality by taking into account the capital intensity of an Applicant's manufacturing process.
- A requirement that the Applicant inform CAEATFA of any **material changes in their application** (Section 10032(c)(1)(J)). CAEATFA staff is currently considering how it could strengthen the enforcement of this provision.
- A requirement that the Applicant disclose any material legal issues (Section 10032(c)(2)).
- A requirement the **equipment be maintained in California** for the term of the agreement (half of the useful life of the equipment)(Section 10035(b)(1)(F)).
- An **Annual Report requirement from each Applicant** that requires it provide the following data (for a time period equal to half the useful life of the equipment): total payroll; number of full time equivalent permanent jobs at the Applicant's Facility; number of full time equivalent construction or installation jobs created as a result of the Qualified Property purchases; total annual product sales (in dollars) including the fraction in California; total number of units sold including the fraction in California; anticipated corporate or personal income tax related to the Facility for the preceding calendar year; the amount spent on supplier purchases, including the fraction of such purchases from California Suppliers; the total amount of Qualified Property purchased as of the date specified in the compliance report; a narrative description of the project status and consistency with the timeline contained in the Application; anticipated purchase dates of any additional items of Qualified Property, and an explanation of any material changes to the product or manufacturing process implemented since the approval of the Application; and a statement indicating the fraction of the time that the Qualified Property has been used to make Advanced Transportation or Alternative Source products, components, or systems (Section 10035(c)(3)).

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- A mechanism for the Board to **rescind the award** upon a finding that an Applicant provided false information or has otherwise violated the agreements (Section 10035(c)(6)).
- A provision that enables the **recovery of financial assistance** in the event an Applicant does not use the equipment for its intended purposes (e.g. manufactures glass for windshields instead of solar panels); or if an Applicant moves the equipment out of state. (Section 10035(d)).

Ongoing Program Review and Refinement

CAEATFA Staff will continue to review the program, work with legislative and LAO Staff on potential program adjustments that may be identified in the future, provide regular reports to the Board on the status of SB 71 Applications, and recommend any modifications to the program when it becomes appropriate.

Attachments

- Attachment A: CAEATFA Background on SB 71 Program Development
- Attachment B: Legislative Hearing Agenda
- Attachment C: LAO's report to the October 19, 2011 Joint Legislative Hearing (Senate Energy, Utilities and Communications Committee and Senate Governance and Finance Committee) on the Alternative Energy Manufacturing Sales and Use Tax Exclusion (SB 71) Program.
- Attachment D: Committee Staff Report on the October 19, 2011 Joint Legislative Hearing (Senate Energy, Utilities and Communications Committee and Senate Governance and Finance Committee)

Attachment A
SB 71 Program Background

About SB 71

SB 71 (Padilla), introduced into the legislature on January 10, 2010 and signed into law on March 24, 2010, authorized CAEATFA to approve projects for sales and use tax exclusions on Qualified Property (equipment and machinery) utilized for the design, manufacture, production or assembly of Advanced Transportation Technologies or Alternative Source products, components or systems. The purpose of SB 71 is to promote the creation of California-based manufacturing, California-based jobs, the reduction of greenhouse gases, or reductions in air and water pollution or energy consumption. The bill established two primary elements: 1) it identified a specific industry/sector that was eligible for a sales and use tax exclusion (green manufacturing), and 2) required CAEATFA to evaluate applications' net benefit to the state, that the economic and environmental benefits of the project outweigh the potential sales and use tax not collected by the state.

Program Development

In developing the SB 71 Sales and Use Tax Exclusion Program ("Program"), CAEATFA staff ("Staff"), with assistance from its technical consultant, Blue Sky Consulting Group (Blue Sky), underwent a five month implementation process. Staff and Blue Sky worked together to gather relevant information, and conducted stakeholder meetings and public workshops involving: State agencies, cities and counties, advanced transportation technology and alternative source manufacturers, renewable energy generators, law firms and consulting groups representing various advanced transportation technology and alternative source industries, and other interested parties.

CAEATFA conducted a significant public participation process prior to the formal regulatory process. CAEATFA held four public workshops with stakeholders to discuss key issues and gain substantial input to develop the Program. Through this process, Staff gained a strong understanding of the Program's mandate, California's need for advanced transportation technology and alternative source manufacturing incentives, and Program administration issues and concerns.

Draft emergency regulations were presented at both the third and fourth workshops, and were also posted on the CAEATFA website. Approximately 40-45 public comment letters were received from stakeholders who engaged in the public rulemaking process. Staff analyzed and considered all comments and incorporated changes to the emergency regulations when appropriate. The proposed emergency regulations balanced stakeholders' comments with the statutory, legal and Program administration framework and requirements.

Regulations

The initial program regulations were approved by the Office of Administrative Law (OAL) on Oct. 4, 2010 last year. Subsequent to adoption of the emergency regulations, Staff and Blue Sky continued to work on modifications to the regulations to address the "lessons learned" from early implementation of the Program. In addition to several other changes, Staff added language to

seek recovery of the STE if the QP does not meet the substantial use requirements, or the QP is taken out of California.

Applicant Evaluation

Applications are evaluated based on criteria in the Regulations. CAEATFA Staff evaluates the fiscal and environmental results that stem directly from the STE. Only the marginal additional production (and resulting fiscal and environmental benefits) associated with the STE are included for purposes of evaluating Applications. The marginal additional production resulting directly from the STE is determined based on an estimated increase in equipment purchases resulting from the STE. The resulting increase in output associated with the additional equipment purchases is subsequently calculated, and the fiscal and environmental effects associated with just this additional output is used for purposes of scoring the Application. The value of these benefits (in dollars) is compared to the value of the STE in order to calculate the Applicant's score.

Reporting Requirements

Approved applicants must agree to rigorous reporting requirements on an annual basis. Data such as total payroll, jobs created as a result of the STE, total annual product sales, units sold, anticipated corporate or personal taxes, purchases from CA suppliers, etc., is collected to calculate and measure the fiscal and environmental benefits of the program. Regulations include an ability to rescind the STE in the event of a finding that false information was provided, or there was a violation of the regulatory agreement requirements.

In August 2011, as required by SB 71, Staff provided notice to the Legislature that the SB 71 Program was reaching \$100 million in approved STE. Additionally, the Legislative Analyst Office (LAO) is required to report to the Joint Legislative Budget Committee on the effectiveness of the program, on or before January 1, 2019, by evaluating factors, including the number of jobs created by the program, the amount of businesses that have remained in California or relocated to California as a result of the program, the amount of state and local revenue and economic activity generated by the program and the amount of reduction in greenhouse gases, air pollution, water pollution, or energy consumption.

How is a Tax Exclusion Different from a Loan Guarantee?

It is important to note the differences and similarities between government tax exclusions and government loan guarantees in the context of the Solyndra bankruptcy.

A tax exclusion exempts an entity from the requirement to pay a particular tax. For example, the SB 71 program grants qualifying businesses a sales and use tax exclusion on purchases of manufacturing equipment. This tax exclusion reduces the cost of manufacturing equipment by an amount equal to the sales tax that would otherwise be charged (currently about 8.1%, on average).

A tax exclusion does not require the state to spend any of its existing funds. However, the state may forgo some revenues that it might otherwise have collected. The amount of revenue

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foregone is difficult to estimate, because it depends on what would have happened without the tax exclusion.

For example, if, without the tax exclusion, a business would have purchased the same equipment, produced the same amount of product, and sold it at the same price, then the state will have foregone revenues equal to the amount of the tax exclusion.

However, if the availability of the tax exclusion causes the business to purchase more equipment, or to expand in California when it otherwise would have expanded elsewhere, then the state will have foregone less revenue than the amount of the tax exclusion, and might not have foregone any revenues. For example, what if the sales tax exclusion causes a business to purchase more equipment, hire more workers, and therefore buy more supplies and sell more finished products? In that case, sales and income tax revenues generated by this additional economic activity would offset some (or even potentially all) of the sales tax exclusion.

This is the premise of the SB 71 program. The program's goal is to help green manufacturers become more competitive by lowering their production costs. The intent is to encourage green business creation and expansion in California that might not occur in the absence of the tax exclusion.

In contrast to a tax exclusion, in which the government agrees to forego some revenues it might otherwise have received, a government loan guarantee commits the government to spend money in the event a business defaults on a loan. In the case of Solyndra, the Federal Financing Bank guaranteed a \$535 million loan to the company. Now that Solyndra has filed for bankruptcy, the federal government may lose all of the \$527 million that had been disbursed to Solyndra by the time the company closed its doors. The fact that some of Solyndra's private investors are first in line for the company's assets and intellectual property make this more likely.

The most common way for a large, new manufacturing business to gain financing is through private investment. Established businesses, banks, venture capital firms, and wealthy individuals sometimes choose to invest in a new, often risky, business in the hope that the new business will succeed and generate large financial returns for the investors. Solyndra received capital from a number of private investors in addition to its federal loan guarantee.

Attachment B

AGENDA

Wednesday, October 19, 2011
2 p.m. – Room 4203

INFORMATIONAL HEARING
Committees on Energy, Utilities and Communications and
Governance and Finance

Advanced Transportation and Alternative Sources Manufacturing Sales and
Use Tax Exclusion Program

Treasurer's Perspective.

State Treasurer Bill Lockyer, Chair of the California Alternative Energy and
Advanced Transportation Financing Authority (CAEATFA)

Legislative Analyst's Review and Options.

Jason F. Sisney, Deputy Legislative Analyst
Mark Newton, Managing Principal Analyst, Corrections, Transportation &
Environment

Advice & Comment.

Frank Yang, Senior Director of Business Development, Stion Corporation
Melissa Zucker, Vice President of Human Relations, Solaria Corporation
Lenny Goldberg, Executive Director, California Tax Reform Association

Public Comments.

Time for public comments.

Legislators' Observations.



October 19, 2011

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



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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.

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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.

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Background

(Continued)

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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.

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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.

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The Failure of Solyndra

(Continued)

- 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.

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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.

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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.

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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.

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LAO Findings

(Continued)

- 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.

**Advanced Transportation and
Alternative Sources Manufacturing
Sales and Use Tax Exclusion
Program**

Reviewing SB 71 (Chapter 10, Statutes of 2010)

A Legislative Oversight Hearing

Senate Committee on Energy, Utilities and Communications
and

Senate Committee on Governance and Finance

Wednesday, October 19, 2011

State Capitol, Room 4203

2 p.m. to 4:30 p.m.

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PART ONE: REVIEWING SB 71

This briefing paper prepares the nineteen members of the Senate Energy, Utility & Communications and the Governance and Finance Committees for their October 11, 2011, oversight hearing on SB 71 (Padilla, Chapter 10, Statutes of 2010), the advanced transportation and alternative sources manufacturing sales and use tax exemption program.

While this hearing was prompted by the recent bankruptcy of Solyndra, Inc., which was also approved for a sales and use tax exemption under the SB 71 program, the Committee's review of this program is to analyze the entire program to assess whether changes or modifications are necessary.

Existing Law

The California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) provides financing for facilities that use alternative energy sources and technologies. CAEATFA also provides financing for facilities needed to develop and commercialize advanced transportation technologies that conserve energy, reduce air pollution, and promote economic development and jobs. CAEATFA's board, composed of Treasurer, Controller, Director of Finance, Chairperson of the Energy Commission and President of the Public Utilities Commission, decides which projects to assist. On March 24, 2010, Governor Arnold Schwarzenegger signed SB 71 (Padilla) into law, which authorizes the CAEATFA to provide eligible projects financial assistance in the form of a sales and use tax exemption on property used for the "design, manufacture, production, or assembly" of either advanced transportation technologies or alternative energy source products, components or system. Prior to the passage of SB 71, Governor Schwarzenegger used CAEATFA to assist a joint venture between Tesla Motors and Toyota Motors to purchase the Nummi assembly plant in Fremont, California where the two companies focus on manufacturing hybrid and electric vehicles.

The SB 71 program promotes the creation of California-based manufacturing, California-based jobs, and the reduction of greenhouse gases, air and water pollution, or energy consumption. To date, CAEATFA has approved financial assistance for private entities in the following fields: electric vehicle manufacturing, solar photovoltaic manufacturing, landfill gas capture and production, biogas capture and production (dairies and waste water treatment plants), demonstration hydrogen fuel production, electric vehicle battery manufacturing, biomass processing and fuel production, and others.

Eligibility Criteria. Applicants must show the property to be purchased will be used to design, manufacture, produce or assemble an eligible advanced transportation technology or alternative source product – including energy efficiency – component or system.

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This definition includes manufacturers of alternative source electricity generation equipment such as solar panels or wind turbines, but it excludes the purchase of that equipment for power generation.

Loan Guarantees vs. Tax Exemptions

What's a loan guarantee?

When firms invest in innovative clean technology or commercial scale renewable energy generation projects, these unproven technologies may not attract loan certainty because of its risk. If a government entity is interested in investing in a project, the government entity may assume obligation to repay a lender if the borrower fails to repay a loan. This loan guarantee allows firms to bring more technologies to the market.

The United States Department of Energy (DOE) Loan Guarantee Program is different in several fundamental ways from the SB 71 program. Authorized by the Energy Policy Act of 2005, the DOE program is a loan guarantee, where a government entity assumes the obligation to repay a lender if the borrower fails to repay a loan. DOE solicits firms that invest in either innovative clean technology or commercial scale renewable energy generation projects, which then apply. Because these technologies are unproven, the loan guarantee program provides certainty for lenders to make loans to these firms that they may not otherwise, as these technologies lack the proven capacity to produce sufficient net income for the firm to repay the loan. Therefore, the loan guarantees allow firms in this area to bring more technologies to market than would otherwise, but for the program. In consultation with the Office of Management and Budget (OMB), DOE assesses the investment risk assumed by its loan guarantee.

The SB 71 program allows CAEATFA to grant a sales and use tax exemption to an eligible firm that purchases property necessary to design, produce, manufacture, or assemble advanced transportation technologies or alternative energy source products, components, or systems. Selected firms purchase equipment without paying the sales and use tax that would normally apply, lowering their cost of capital. Neither CAEATFA nor the state is a creditor to the selected firm in any way under the SB 71 program. Instead, CAEATFA calculates whether the exemption will yield a net environmental and economic benefit for the state. Thus far, CAEATFA has approved \$104 million to 33 firms that applied for the SB 71 benefit, of which 33 firms have monetized \$31.6 million in exemptions. Some of the firms have purchased the property and deployed it in the manufacturing process, while others have won the award, but not yet purchased the equipment.

Solyndra and the DOE Loan Guarantee Program. DOE has issued 17 loan guarantees, totaling \$7.84 billion, as of September, 2011, and announced conditional commitments to an additional 16 projects totaling \$10.4 billion. All projects must commence construction before September 30, 2011.

Solyndra first applied to DOE for a loan guarantee in December, 2006 in response to a solicitation. On March 20, 2009, DOE announced its conditional commitment to the loan

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guarantee to Solyndra, and closed on September 2, projecting 3,000 construction jobs and 1,000 ongoing jobs in the factory.

In March 2010, Solyndra’s auditor warned about its ability to continue as a going concern in an SEC filing. In June 2010, the company cancelled a \$300 million initial public offering. The Solyndra Board announced its bankruptcy on August 30, 2011. Two days later, the Federal Bureau of Investigation working with the DOE’s inspector general executed search warrants at the firm and at the home of its executives, but authorities have not yet charged the firm or its executives with wrongdoing. Solyndra filed for bankruptcy on September 6th in the United States Bankruptcy Court for the District of Delaware. As such, DOE must repay the loan, made under another DOE program, and pursue its claims for repayment in the bankruptcy proceeding.

Tax expenditures vs. SB 71 sales and use tax exemption

The SB 71 program stands in stark contrast to other tax credits, where a certain class of individuals or businesses may claim a credit based on making a certain investment, such as research and development, or business location, such as an enterprise zone. First, CAEATFA approves tax benefits to applicants based on its evaluation of the applicant’s net benefits, although CAEATFA can and has approved applicants that did not demonstrate a net benefit. Applicants supply information to CAEATFA, which performs its own independent net benefits analysis. In this way, SB 71 is similar to the Low Income Housing Tax Credit (LIHTC) program, administered by the California Tax Credit Allocation Committee, part of the Treasurers’ Office. LIHTC differs mechanically from SB 71, most notably by capping the amount of tax credits to a specified amount, whereas the SB 71 exemptions are not subject to a cap. However, CAEATFA must notify the Legislature within 20 days of each \$100 million in exemptions it grants prior to approving new ones.

How is SB 71 different from other tax credits?

- CAEATFA approves tax benefits to applicants, based on the application’s net benefit.
- The program is an exemption for the sales and use tax, not a credit against the income or corporation income tax.
- SB 71 targets firms that produce renewable electricity technology or produce alternative forms of transportation.

SB 71 is also different because it’s an exemption from the sales and use tax, not a credit against the personal income or corporation income tax. Sales tax applies to property purchased by firms, and any firm making a purchase benefits from the exemption when purchasing an exempted product. Meanwhile, income tax credits reduce tax on a dollar-for-dollar basis, thereby benefitting only those firms that generate net income, and therefore pay tax. Many firms in this industry do not become profitable until they are producing at commercial scale, so the sales and use tax exemption provides a much more immediate and direct benefit than a tax credit, which the firm may not be able to apply until it generates net income, if at all.

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Additionally, SB 71 targets only those firms which qualify under CAETFA’s definition of “project,” which generally applies to firms that produce technology that generates renewable electricity or produces alternative forms of transportation. As such, the exemption applies to firms in a relatively small sector of the economy in the hopes that such firms will choose California to manufacture its products, thereby increasing employment, that these more innovative industries will grow more in the future more than settled firms that use established technologies, and that the products made by these firms are more environmentally beneficial than incumbent technologies. In contrast, the Governor’s proposal to require firms to use the sales factor to apportion corporate income and reduce other business taxes in the hopes of creating jobs applies to almost all firms regardless of the product or service they produce (AB 40x, Fuentes, and SB 116, DeLeon, 2011).

Solyndra, Inc. Background

On September 5, 2011, Solyndra LLC, a California-based manufacturer of solar cells, filed Chapter 11 petitions for bankruptcy in the United States Bankruptcy Court for the District of Delaware. According to papers filed by Solyndra in its bankruptcy proceeding, several factors attributed to its bankruptcy filing. Like Evergreen Solar, who filed for bankruptcy in August, 2011 Solyndra suffered from a worldwide drop in solar panel prices, low market pricing, a drop in demand and a drop in polysilicon pricing used for traditional solar panels. Solyndra’s bankruptcy was met with more public scrutiny due to the \$535 million Department of Energy loan guarantee to construct its second production facility, which came online in January, 2011. Additionally, Solyndra received \$25.1 million in sales and use tax exemptions for equipment used to manufacture solar panels at the same plant from the CAETFA program.

Solyndra Timeline.

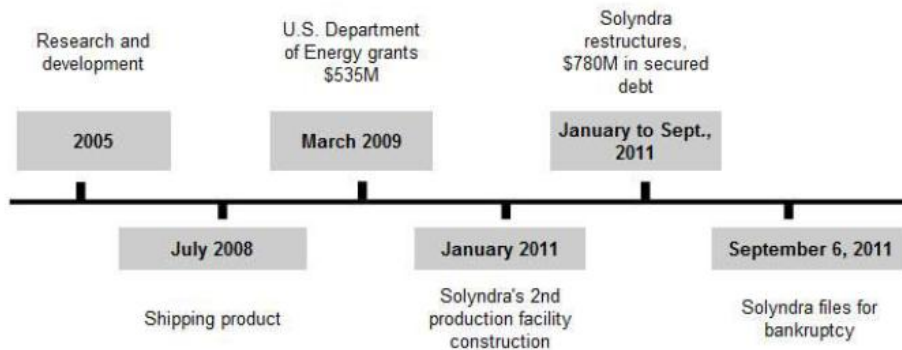


Figure 1: Solyndra’s timeline, from 2005 to present.

The company formed in 2005, focusing on research and development of its products. By 2007, Solyndra entered into a lease for its first production facility and by July of 2008, it began shipping product. Solyndra’s business model used chemical-coated cylinders instead of

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traditional polysilicon solar panels betting that the cylinders would be cheaper to produce and more energy efficient (see graphic below). Solyndra raised initial funding for its operations through a series of preferred stock offerings. In addition to the preferred stock, the company also received funding in the form of loan guarantees. In March of 2009, Solyndra received a conditional commitment from the U.S. Department of Energy for a \$535 million loan guarantee. Solyndra used these funds to construct a second production facility. Several months prior to filing for bankruptcy, Solyndra implemented a restructuring with its secured creditors. Although the restructuring generated an additional \$75 million in cash, it also left the company with over \$780 million in secured debt. On the eve of bankruptcy, Solyndra sought additional funding from investors, however; it was unsuccessful, due in part to the size of its debt.

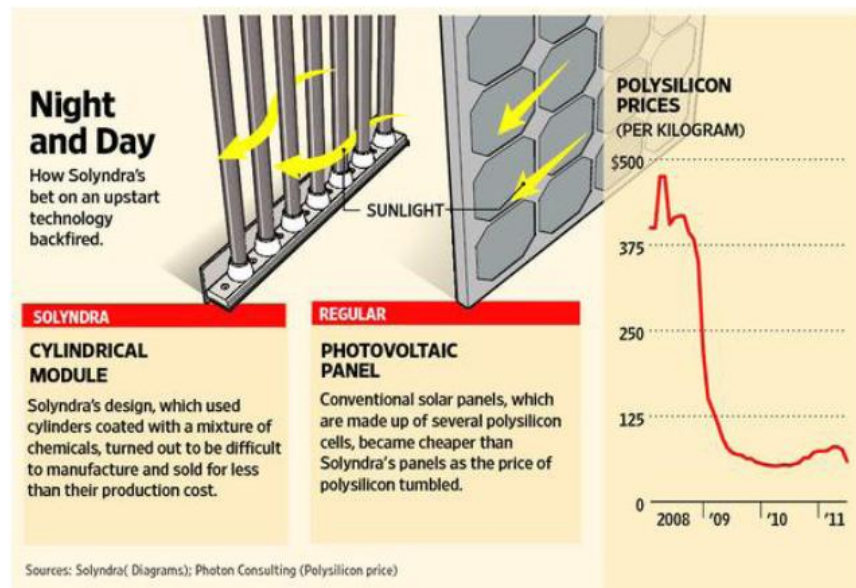


Figure 2: Comparing Solyndra's cylindrical modular design to a conventional photovoltaic solar panel.

Solyndra and the SB 71 Program. On November 17, 2010, Solyndra applied for \$24 million in SB 71 exemptions. CAEATFA calculated that the program had \$22,202,063 in environmental benefits, \$20,765,274 in economic benefits, providing a \$8,226,021 net benefit to the state according to its test for the \$34,741,616 in sales and use tax exemptions approved by CAEATFA in November, 2010. CAEATFA granted the exemptions for property that Solyndra would use in its Fab 2 facility, the same funded by the DOE loan guarantee. Solyndra applied \$25,127,322.31 of that amount to property it purchased.

On September 27, 2011, CAEATFA Executive Director Christine Solich asked the CAEATFA Board to consider State Treasurer Lockyer's request to suspend or pause the program at its next hearing as a result of the Solyndra bankruptcy and this hearing. Also at that hearing, Bob Hendricks, Counsel to the CAEATFA board informed the members that any action on behalf of

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the state to require Solyndra to repay the state the exemption amount was only possible if Solyndra made a material misrepresentation in its SB 71 application.

What Legislators Should Ask

The October 11 hearing is one of a series of oversight hearings in the Legislature to ensure that the program's objectives are aligned with its outcomes. The hearing gives legislators a chance to look more closely at five questions:

- What did the Legislature intend for the CAETFA program under SB 71?
- Are the CAETFA applicants meeting the stated goals of the program?
- What are the specific outcomes associated with the CAETFA program in general and SB 71 specifically?
- What specific economic and employment indicators should improve as a result of SB 71?
- What are the feasible alternatives to the current evaluation procedures and net benefits test?
- Should the Legislature "claw back" a firm's exemptions if it doesn't meet its job creation and retention promises?

PART TWO: CAEATFA INFORMATION

Application Assessment

SB 71 requires the following information be included in an evaluation of applicants for a sales and use tax exemption:

- The extent to which the project develops manufacturing facilities, or purchases equipment for manufacturing facilities, located in California.
- The extent to which the anticipated benefit to the state from the project equals or exceeds the projected benefit to the participating party from the sales and use tax exclusion.
- The extent to which the project will create new, permanent jobs in California.
- To the extent feasible, the extent to which the project, or the product produced by the project, results in a reduction of greenhouse gases, a reduction in air or water pollution, an increase in energy efficiency, or a reduction in energy consumption, beyond what is required by any federal or state law or regulation.
- The extent of unemployment in the area in which the project is proposed to be located.
- Any other factors the authority deems appropriate in accordance with this section.

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The following information from a CAEATFA staff report from September, 2010 explains the eligibility, evaluation and scoring for each CAEATFA applicant to implement the language of SB 71.

Eligibility Criteria. To qualify, an Applicant must show that the property to be purchased subject to the sales and use tax exemption will be used to design, manufacture, produce or assemble an Advanced Transportation Technology or Alternative Source product, component or system. This definition includes, for example, manufacturers of Alternative Source electricity generation equipment such as solar panels or wind turbines, but would exclude the purchase of that equipment for use of power generation.

Evaluation Criteria. Applications that meet the Project definition criteria will be evaluated based on criteria developed and specified in the proposed emergency regulations. These evaluation criteria are designed to measure and quantify the fiscal and environmental benefits of the Project and to compare the result to the cost of the sales and use tax exemption.

In order to specifically evaluate the fiscal and environmental results that stem directly from the sales and use tax exemption, only the marginal additional production (and resulting fiscal and environmental benefits) associated with the sales and use tax exemption are included for purposes of evaluating Applicants. The marginal additional production resulting directly from the sales and use tax exemption will be determined based on an assumed increase in equipment purchases resulting from the sales and use tax exemption. That is, because the sales and use tax exemption in effect lowers the cost of purchasing capital equipment, Applicants are assumed to purchase more such equipment than would be the case in the absence of the STE. The increase in capital purchases resulting from the sales and use tax exemption is derived based on a calculation performed by the Executive Director and the Staff in the evaluation process pursuant to parameter assumptions approved by the Board.

The resulting increase in output associated with the additional equipment purchases are subsequently calculated, and the fiscal and environmental effects associated with just this additional output is used for purposes of scoring the Application.

- To calculate fiscal effects. A pro rata share of the corporation tax, personal income tax, sales tax, and property tax is calculated (over the life span of the Qualified Property purchased).
- To calculate environmental effects. The increased output associated with the marginal equipment purchases is calculated based on Applicant-provided information. The environmental effects of each additional unit of increased output is calculated based on the efficiency gains or energy generation potential of the product. For example, in the case of a solar panel manufacturer, the number of additional panels is calculated and then the generation capacity of the panels in megawatt hours is determined (based on Applicant-provided data). The additional generation capacity results in a reduction in the amount of non-alternative source power that otherwise would be needed. To determine the dollar value of the pollution that is not produced as a result of the deployment of the

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solar panels, the amount of pollution (CO₂ and non-CO₂) associated with a megawatt hour of electricity generation is estimated and a dollar value is assigned based on available research and analysis. The total value in dollars of the pollution benefits associated with the Applicant's marginal production is calculated and added to the fiscal benefits.

Scoring. Applicants will receive scores in the areas of fiscal benefits and environmental benefits which will translate into a numerical score. In addition, Applicants may receive up to 200 points for optional supplemental information related to the economic and environmental benefits of the Project if the Applicant provides such data. Applications that receive a total score greater than or equal to 1,000 points and a total pollution benefit score (i.e., environmental benefits) greater than or equal to 100 will be recommended to the Board for approval. The Executive Director may recommend to the Authority that the 1,000 point threshold be adjusted if it is in the public interest and advances the purposes of the Program. Where a Project receives a total score of less than 1,000 points, the Executive Director may recommend it to the Authority for approval upon a statement articulating specific reasons why the approval is in the public interest and how it advances the Program.

Parameter Assumptions. In order to evaluate the fiscal and environmental benefits of an Application, the evaluation criteria embodied in the emergency regulations rely on a number of specific parameters which the Executive Director must recommend to the Board for approval. In consultation with experts, economists, other State agencies, and data provided by Applicants, the Executive Director will determine the most accurate and appropriate value for each parameter. The following is a list of the specific parameters that the Executive Director must recommend to the Board for approval (these parameters will be brought forward to the Board for approval today in Agenda Item 4.C.):

- Current Statewide Average Sales Tax Rate
- Percent Increase in Capital Investment
- Appropriate Discount Rate for Fiscal and Environmental Effects
- Economic Multiplier
- Average State Income Tax Rate
- Applicable Local Property Tax Rate
- Ratio of State and Local Government Revenues to Gross State Output
- Pollution Cost Per Unit (Gallon of Gas Equivalent or Megawatt hour of electricity) of Volatile Organic Compounds (VOCs), Nitrous Oxide (NO_x) and Carbon Dioxide (CO₂) Released in California and the Rest of the United States
- List of Emerging Green Industries (if applicable)

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Energy Policy Considerations

1. Quantification of Pollution Benefits. A significant component of the net benefits test is the quantification of the pollution benefit from the green component that is manufactured. Specifically the statute calls for the Treasurer to consider the “to the extent feasible, extent to which the project, or the product produced by the project, results in a reduction of greenhouse gases, a reduction in air or water pollution, an increase in energy efficiency, or a reduction in energy consumption...”

The net benefits test used by the CAEATFA takes the total units to be produced by the equipment produced, values the energy to be produced or saved as a result of the use of the product, and includes the dollar amount as a financial benefit to the state. Is this a necessary program element?

Although CAEATFA has followed the law, the necessity of this element to achieve program goals is not clear and may unnecessarily complicate program administration.

Under law, the definition of eligible projects is specifically limited to “advanced transportation technologies or alternative source products, components, or systems” which are further defined and basically include solar, wind, energy efficiency and other technologies designed to save energy. Advanced transportation technologies are also defined and include intelligent vehicle highway systems, advanced telecommunications for transportation, command, control, and communications for public transit vehicles and systems, electric vehicles and ultralow-emission vehicles, high-speed rail and magnetic levitation passenger systems, and fuel cells.

However, without quantifying the pollution benefit provided by the green technologies, some companies might fall out of eligibility based strictly on the economic benefits of jobs created vs. sales and use tax exemption received.

2. Scope of Approved Projects. The committees should also consider whether the benefitting products and companies are what was intended by the Legislature. Several companies involved in the direct manufacturing of clean energy products have applied for the program including solar panels, fuel cells, and batteries and clearly meet the program’s intent. However, gas excavation projects have also been made eligible such as landfill gas. These projects generally have two elements – gas extraction and energy production. Only the gas extraction equipment has been made eligible for the sales and use tax exemption. However, gas extraction may be a bit astray from the manufacturing benefit anticipated by the program.

Two demonstration projects have also been approved for sales and use tax exemptions. Research and development projects or demonstration projects, although broadly beneficial to achieving the state’s clean energy goals, do not appear to meet the primary

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goal of the bill which was to develop “manufacturing facilities, or purchase equipment for manufacturing facilities.” The temporary nature of these projects also does not appear to be consistent with the Legislature’s intent. The CAEATFA has authority to waive the net benefits test to approve a project and appears to have used that waiver authority to qualify these projects.

3. Renewable Energy Generation. – Finally, during the regulatory process to implement SB 71, the CAEATFA was under great pressure to also include assembly of renewable energy generation projects and therefore its component parts, as eligible under the program. One commenter in the proceedings opined that:

The term “alternative source products, components, or systems” clearly can be interpreted to include the production of alternative renewable energy. We see no reason that CAEATFA cannot determine that certain forms of renewable energy constitute a “product” eligible for sales and use tax exclusion under SB 71. Similarly, “alternative source system” can be interpreted by CAEATFA to include renewable energy production systems – including equipment used to generate renewable electricity according to the provisions of SB 71. Finally, “alternative source components” can clearly be interpreted to include renewable energy production components – including the equipment used to generate renewable electricity according to SB 71.

The CAEATFA rejected this proposition and found that:

In sum, the Legislature tailored the SB 71 Program to give CAEATFA a limited ability to provide assistance to manufacturers of alternative source products, components or systems. By omitting the reference to facilities that utilize an alternative source, it carved alternative source generation out of the Program.

Going beyond the plain language of the statute and looking to the Legislative history of SB 71 reinforces this conclusion and demonstrates that the Legislature firmly believed that generation was encompassed in CAEATFA’s pre-existing authority. That being the case there was no need to include it in the SB 71 Program.

When speaking of SB 71 the Legislature understood the provisions to apply to equipment used to manufacture products that produce energy from alternative sources. Logically then, SB 71’s project definition would be limited to the machinery and equipment necessary to manufacture solar panels or wind turbines. In contrast, when speaking of existing law, the Legislature spoke in terms of equipment that uses alternative sources.

Although many parties found CAEATFA’s decision lacking, many others lauded CAEATFA and the State Treasurer for sticking to the primary focus of the program – manufacturing – and recognizing that those renewable generation projects have viability on their own due to power purchase agreements that have been entered into with electric utilities throughout the state.

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Alternative Considerations

Above, the Treasurer's office outlines the current "net benefits test" under existing law to ensure that every company that receives a sales and use tax exemption under the SB 71 CAETFA program make a positive impact on both greenhouse gas emissions and the economy. Either in addition or instead of the current evaluation procedures, the Committee may wish to consider the following evaluation alternatives.

1. Perform an "investment grade" financial viability. CAETFA would assess an applicant's business plan, financial statements, credit references, and/or other financial information in an effort to determine whether the company is likely to be viable over the time horizon covered in the application.
2. Cap individual award amounts or total award amounts. The total amount awarded to any one company could be limited to a specific dollar threshold (e.g. \$10 million per applicant).
3. Provide the sales and use tax exemption upon completion of certain milestones. Under this option, companies would pay sales tax up front on their equipment purchases. However, the sales tax would be refunded to the company after the business operates for a specified period of time (e.g. three years) or meets specific milestones (e.g. hires 100 workers).
4. Create a "claw back" and make sales tax payable upon bankruptcy or the manufacturer leaving the state. This alternative would require that applicants repay the amount of the sales tax exemption to the state under certain circumstances, such as bankruptcy within a certain time period after granting of the sales and use tax exemption or in the event that the qualified property is moved out of the state.
5. Partial or Proportional claw back for employment, (less than promised). This alternative would require a proportional claw back commensurate with the number of jobs less than the applicant's proposal.
6. Delete net benefits test. The information provided for the net benefits test is self-reported by project sponsors. The information is not certified by an outside party and assumes significant increases in product demand that likely do not exist without significant price parity.

PART THREE: CAETFA COMPANIES

Existing companies with the exemption, “Approved project pipeline”

Appendix A is a list from the Treasurer’s office of the current status of applications for SB 71 sales and use tax exemption dollars.

Geographic information on SB 71 companies

Appendix B is a list of all available geographic information for each of the CAETFA companies.