

Market for Business Tax Credit Pass-Through As an Energy Efficiency Tool

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ABSTRACT

In Oregon, a State Business Income Tax Credit for efficient equipment can be passed from one business or institution to another in exchange for its present value. This provision allows businesses or institutions without tax liability or with cash shortages to enjoy the benefits of the tax credit in cash, while another business enjoys deferred taxes.

A market study was conducted to identify additional markets for this pass-through. Efforts were made to identify three types of businesses and institutions:

- those that needed the tax break but could not themselves use it;
- those that could use the tax break and might be willing to trade it for its cash value; and
- vendors of efficient equipment who might act as brokers to match up the first two types of businesses and institutions.

While the sample was limited, the responses provided significant encouragement for expanded pass-through of tax credits. Large energy services and lighting vendors were highly motivated to broker transactions, but had limited tax liability themselves. A wide variety of businesses and institutions were interested in getting cash in exchange for the tax break. The number and types of businesses which might provide cash in exchange for the tax credit was more limited but significant. Interest was low among financial institutions, but higher among some green businesses, efficiency businesses, and retailers with many local stores.

Introduction

This paper summarizes the research conducted for the Oregon Office of Energy (OOE) regarding the market for the Oregon Business Energy Tax Credit (BETC) Pass-Through (Gordon & Nelson 2001) and ensuing efforts by OOE to market the Pass-Through. The BETC pass-through allows a business or institution that installs qualifying efficiency measures (savings estimated as at least 10% of energy use for a building or system based on engineering calculations) to pass tax benefits to another business in exchange for their cash present value (Oregon Office of Energy 2002a). Pacific Energy Associates, Inc. was asked to assess what types of businesses would provide the best marketing opportunities for increasing use of the pass-through.

The first section of this paper reviews the methods and the responses received. The second section provides a brief summary of the substance of those responses. Subsequent

sections discuss the most interested parties, the barriers, and the least interested parties with respect to the BETC pass-through. A final section provides our recommendations.

In Oregon, the Business Energy Tax Credit is offered to those who invest in energy conservation, recycling, renewable energy resources and less-polluting transportation fuels. The tax credit is 35% of the eligible project costs—the incremental cost of the system or equipment that is beyond standard practice. The credit can be taken over one year for projects where the efficiency investment is under \$20,000, or five years for larger projects. For the larger projects, the credit is 10% in the first and second years and 5% each year thereafter. If the full tax credit cannot be taken each year, the unused credit can be carried forward up to eight years.

To date, more than 5,500 Oregon energy tax credits have been awarded. Altogether, those investments save or generate energy worth about \$100 million a year (Oregon Office of Energy 2002b).

Business or rental property owners who pay taxes for a business site in Oregon are eligible for the tax credit. The business, its partners or its shareholders may use the credit. The applicant must own or be the contract buyer of the project (the project owner). The business must use the equipment for the project or lease it for use at another site in Oregon.

A project owner also can transfer the net present value of the tax credit for an eligible energy project to a third party. This is called the Pass-Through Option. In addition to private, taxable businesses, public entities and non-profit organizations that have no tax liability also can use the Pass-Through Option.

The provisions of the pass-through are relatively simple. The business with the tax liability provides the business or institution that installs the efficient equivalent with the present value of the taxes avoided, calculated at a rate set by the Office of Energy.

The net present value rate for five-year Business Energy Tax Credits effective February 1, 2002, is 27%. The net present value rate for one-year Business Energy Tax Credits (those with eligible costs of \$20,000 or less) effective February 1, 2002, is 33.5%. The Oregon Office of Energy sets the net present value fixed rates on an annual basis.

The initial users of the pass-through were Oregon's electric and gas utilities, which utilized it to help pay for the energy conservation programs in rental properties. Their use was later expanded to other customer classes as well. However, the role of Oregon's electric utilities in delivering efficiency services is evolving, and the use of the pass-through by the utilities is uncertain.

OOE believes that there are opportunities to more fully use the pass-through to help business customers conserve energy. In summer of 2001, the Oregon Office of Energy began an initiative to explore opportunities to engage other businesses in using the pass-through and providing conserving businesses with the cash equivalent of the tax break. This initiative consisted of direct contact by OOE staff with some large customers, and retention of a market research contractor to help explore potential markets for the pass-through.

The remainder of this paper summarizes the market research and marketing by the Oregon Office of Energy.

Market Research

Overview of Market Research Activities

The objectives of the research were to:

- identify types of businesses that are likely to be interested in using the pass-through to reduce their taxes;
- assess how they might link up with businesses and institutions that would like to receive the present value in cash to the tax credit; and
- provide recommendations to the Office of Energy for marketing the pass-through.

The consultant, working with the Office of Energy, developed a telephone interview guide to act as a general framework for discussions with potentially interested businesses. The actual focus and length of interviews depended on the level of interest and specific reactions of respondents. Then specific targets were identified for telephone interviews, selected to provide a small number of responses from a wide array of business types, including potential tax beneficiaries and go-betweens that might set up beneficiaries with businesses or institutions that install efficient equipment. Since this was a very modest research project, statistical targets were not set. Rather, the consultant tried to reach a few of each type of business and use the non-response rate as an additional gauge of interest. Respondents were identified based on the existing contacts of the consultant and the Office of Energy, telephone book and Internet search, and referrals from other respondents.

It is important to recognize that this type of research is valuable, but has its limitations. Due to the small sample and non-rigorous sampling techniques, the authors cannot with any confidence speak to the likely response of any group as a whole. However, the study identified business types that, based on the response, appear to be more or less promising.

Response rates by respondent type are shown in Table 1.

Summary Observations on Market Research

- There are plenty of businesses with an interest in installing efficiency measures and getting cash in exchange for a tax credit.
- The pass-through has become a critical element of marketing, in particular for many lighting vendors.
- It was difficult in a phone survey to definitively identify businesses that were interested in reducing their tax liability through the pass-through. Responses were inherently speculative, except for a few firms that had already researched the BETC pass-through due to pre-existing active interest. There are a few promising candidates, but it may take a greater level of effort to identify them and bring them around.
- The most promising avenues to identify “tax beneficiaries” appear to be: (1) selected large retailers, (2) those few energy businesses with consistent tax liability, (3) co-marketing with green foundations, and (4) helping various types of consultants

- promote and arrange for the credit as a service to their clients, and (5) businesses of all types who have made public commitments to environmental stewardship.

As the contractor conducted the survey, Oregon moved into a recession and energy rates increased. Later responses indicated increased hesitance of businesses to put up cash in exchange for a tax break, as they may not have a tax liability this year or next.

Table 1. Responses to Business Energy Tax Credit Phone Survey

	Response	No Response	Dropped by Consultant
Contractors			
Energy Service Companies	2	1	
Mechanical Contractors		2	1 (out of state, interest less likely)
HVAC Distributors	1 partial	1	
Lighting Distributors	1 partial	1	1 (out of state, interest less likely)
Boiler Distributors	1		2
Lighting Contractors	3	1	
Consultants			
Engineering Consultants	3	1	
Architects	0	2	
Environmental Intermediaries, Arrangers, and Consultants	3		1
Tax Accountants	4		
Financiers			
Banks	3		
Credit Unions	1		
Leasing Companies	1		
Developers	3		
Utilities	1		
FDIC	1		
Mutual Funds	1		
Other Businesses			
Retailers	1	2	
Manufacturers	2		
Manufacturer's Business Group	1		
School District		1	
Total	33	13	5

Most Interested Respondents

Efficiency contractors. By far the most motivated parties were larger energy efficiency contractors who have made the BETC pass-through to utilities a part of their marketing approach. Lighting contractors and energy service companies who take on complex projects are the most highly motivated. Many of these contractors are already stymied because in late 2001 the Oregon investor-owned utilities had reached their tax liability cap and stopped doing pass-throughs. Some of the firms have significant Oregon tax liability, but many others may need a pass-through recipient because their tax liability is small or mostly in other states.

At least one large retailer. A tax accountant with a large grocery firm expressed active interest in attaining tax credits through the pass-through. This firm is big enough to be a major player. It was difficult to assess how serious their interest is. When the contractor asked why the firm was interested, the respondent did not mention the public relations benefits or environmental credits, but simply stated interest in the tax credit itself. It is possible that the respondent did not register the modest level of rate of return available, even though the researchers fully described it. The researchers could not get a response from two other major retailers with whom they did not have a reference to an influential party. It may be significant that the one retailer who responded is headquartered in Oregon.

Environmental foundations. One organization that develops carbon emissions reduction projects was very interested in co-marketing the BETC pass-through when they solicit donors. This may be an indication that environmental foundations may provide a fertile, if modest, route for marketing to businesses.

Business consultants of many stripes. A variety of consultants (engineering, project management, accounting, environmental) expressed interest in bringing information about the pass-through to their clients. This is difficult to interpret, because consultants are always looking for new services to offer that are of no cost to the consultant. This does not necessarily mean that their clients are interested. Two stood out because their interest seemed most credible. A CPA was interested in working with clients to use the pass-through to reduce tax liability, and thought other CPAs would likewise be interested. While this CPA seemed unusually oriented toward environmental issues, she felt others would feel the same. She saw this as a fee-for-services opportunity. The contractor got a less enthusiastic reading from a “big six” CPA. A large engineering and project management firm also expressed considerable interest in helping clients fold BETC into large projects. The engineering consultant would more likely identify firms with certifiable measures but limited tax liability, whereas the CPAs would likely identify firms with liability and an interest in the credit.

Green businesses. In general, a more eager and serious response came from businesses that were members of green business groups such as the Natural Step or otherwise had shown a strong commitment to environmental issues. For example, a progressive mutual fund was interested in providing their own modest tax liability for BETC use and was willing to educate their clients. Another example—the contractor found one green building developer with a non-profit client. When the pass-through was raised as an opportunity (through a consultant the contractor talked to) the developer decided to certify the space for BETC in

hopes of finding a pass-through recipient. However, the developer did not plan to offer their own tax liability to others, since they could use it directly through BETC. The other interested environmental businesses were modest in size.

The most effective opportunity for marketing to environmentally oriented businesses may be to identify very large businesses that are looking to take conspicuous and positive environmental actions. The Office of Energy is already pursuing this track, as discussed below.

Less Motivated Respondents

Some firms clearly stated disinterest and others who were slow to respond may be disinterested.

Most financial institutions. As mentioned above, most financial institutions require a higher rate of return than is available from the BETC pass-through. One environmentally oriented bank would participate when they accumulate tax liabilities, but not for financial reasons.

The contractor only talked to one leasing firm. The responding leasing firm was actively interested in arranging for BETC pass-throughs for its leasing clients. While this firm was out-of-state, it had in-state affiliates that could become tax beneficiaries of such an arrangement. This firm had worked through similar programs in other states. A leasing firm can make money on setting up such a transaction by rolling the arrangement costs into the lease. However, their required rate of return for such projects is 14.8%. The rate of return allowed by the Office of Energy has been far lower, in keeping with the intent of the legislature that the pass-through be an assignment of a tax credit but not a significant profit-making opportunity.

It is unclear whether there are other leasing firms with the know-how and situation to make this work. Another firm that had previously specialized in efficient equipment leasing was out of business. Furthermore, since lessors own the equipment under some leasing arrangements, many leasing firms can take advantage of BETC without the pass-through. The respondent did not discuss the type of lease that they would use. Our overall conclusion is that leasing firms may provide some opportunities, but it would take significant additional research to flesh these out.

HVAC and boiler firms. These have been less responsive than lighting firms and ESCOs who deal with multiple end uses. However, the researchers started contacting the HVAC and boiler firms later in the project, with weaker contacts. One respondent of each type was interested enough to run the possibility by personnel in headquarters, but they never responded definitively.

Small contractors. Most small contractors are unlikely to arrange pass-throughs because they have very limited tax liability and lack the time, contacts, and motivation to work with other businesses.

Most developers. Developers provided mixed responses. Some would use the pass-through for public or non-profit facilities. It might make sense to target developers of schools and

public and nonprofit buildings. These particular specialties were not targeted in the market research but merit further investigation. Many developers use BETC on their own buildings. The respondents did not seem to have thought through the issue of whether they have enough liability to offer it to others. Further discussions may be warranted with developers who specialize in environmentally sensitive properties. However, not all developers make money every year, and many are facing a declining market, so they may not view five-year tax breaks as a great idea.

Utilities. Utility participation is probably largely dependent on the attitude taken by the Public Utility Commission (PUC). The one utility contacted, which provides some pass-through, wants a higher rate of return to do more. Another is considering continuing with the pass-through. Another does not have state tax liability anymore.

Lighting distributors. The researchers had difficulty finding the right person to talk to in lighting distributor organizations. Many are headquartered out-of-region, and Oregon is a modest part of their service territory. Some initial interest was found in one firm in using their own equity to help customers of their contractors. The firm is regionally based. The respondent was going to check with headquarters and never got back to the researchers in spite of several callbacks. The pass-through may prove of interest to the two or three distributors where Oregon is a large part of their business, but we could not confirm this.

Industry. One large Oregon corporation with several in-state facilities stated a preference to use their own tax liability for their projects. The same firm, based on discussions at a higher level with the Office of Energy, is currently interested in using the pass-through, as discussed in the next section. This points out the limitations of this market research. Researchers sometimes had limited access to key decision-makers and sometimes may not get the time and access to fully explain the pass-through.

In general, most large industrial firms are not making profits now and therefore are not interested in providing cash and have little tax liability to reduce. Industrial profits are cyclical. Perhaps firms with more stable profits would be more interested at the beginning of the “up” phase of a profit cycle. Exceptions to the general low level of interest may occur among environmentally oriented businesses (as is the case of the firm that made a major commitment), those with counter-cyclical or non-cyclical profits, or local, one-town firms where there is strong community commitment.

Retailers. The contractor attempted to contact three large chain retailers. We had hoped that these firms would be interested in public relations benefits that would come from use of the pass-through for public buildings in communities where they have stores. The contractor got through to only one of these businesses, as discussed above. We wonder if, with the right introductions, the other firms might have been more pliable. However, they are based out-of-region, and may view Oregon as a small concern.

Barriers

Paperwork. While the pass-through paperwork was considered to be relatively simple by all who reviewed it, there was still concern expressed about the review process. However, these concerns were primarily expressed by businesses that did not have BETC experience.

Matching up efficiency project donors and tax beneficiaries. Many respondents were concerned about the logistics of making a match. Two ideas met with favor in the interviews:

- assign a single staff member at OOE as the repository of information about people seeking credits and offering them; and
- have an electronic bulletin board set up for this purpose.

In the long run, the authors believe that alliances will evolve to streamline referrals. For example, Energy Service Companies may set up a relationship to line up retrofit clients with a particular CPA, or with a large firm with large tax liability. Such established alliances could significantly simplify referrals.

Limited rate of return. The limited rate of return available for the pass-through is a showstopper for most of the banks and the one leasing firm that was interviewed. One community bank would participate when they accrue tax liabilities, but not for financial reasons as much as because their mission focuses on related issues. It is possible that other financial institutions with a community orientation would participate for the public relations benefits, but it would take a concerted effort to sell them on the idea. The contractor wondered if they simply failed to find the right person in each banking organization to sell the idea as a public relations opportunity. One utility also described rate of return as a major issue.

Performance uncertainty. Financial institutions were also concerned about the non-performance risk (i.e., if the measures stop working, does the tax break terminate?). A discussion with the FDIC indicated that from a regulatory perspective, the risk of the pass-through was not yet evaluated, but could be considered high, the equivalent of junk bonds. This would exacerbate concerns about the modest rate of return. Financiers wanted clearly delineated rules regarding non-performance and its consequences.

Other types of businesses did not focus on this element to the same degree. Businesses more familiar with efficiency, BETC, and the Office of Energy seemed less concerned.

Secondary market. Many financial respondents thought it important that the tax benefits could be transferred to other businesses. Rules for this type of transfer are not clear.

Unpredictable tax liabilities. Many efficiency vendors are limited by their modest Oregon tax liability. This is also a problem for industrial businesses and firms with out-of-state headquarters. The current combination of utility rate increases and a recession has eliminated profits for many industrial concerns. A prominent industrial association spokesperson suggested that most industrial firms wouldn't even want to think about something like the

pass-through for the next year or two. One more motivated bank did not have Oregon tax liability. A leasing firm was in the same situation, but had local partners with tax liability. The one credit union called has no tax liabilities.

Flexibility. An industrial representative emphasized the ability to move tax credits from year to year. There is some flexibility to do this under current rules, but this may not be clear from the marketing materials.

Internal barriers. Since the BETC pass-through is not a major profit-making opportunity, most firms that will pursue it will do so for public relations or environment interests combined with the modest rate of return. Some of the difficulty in getting responses from retailers may stem from the fact that this proposition does not fall into the responsibilities of any single person or department within many businesses. In many firms, this requires that the public affairs and tax departments work out the costs and benefits together. This will require the identification of an internal “champion” who will take the time to call attention to something that is not “business as usual” and requires new top-level thinking in more than one department.

Rate hikes and recession. As noted above, the recent and incipient utility rate hikes have reduced profits for many businesses and distracted them from other issues. Businesses are likely to look for ways to reduce their own energy costs, rather than expend management time on a pass-through with modest financial benefits.

Collectively, these barriers indicate that tax incentive assignments may be effective in certain situations, but are far from a universal tool for encouraging efficiency. There are business situations that are commonplace where this tool is not attractive.

Direct Marketing by Office of Energy

The Oregon Office of Energy directly approached several large corporations to see what kind of interests they have in this pass-through provision. As a result of this effort to date, a large manufacturer has requested a Preliminary Certificate to reserve a tax credit of \$1,000,000 as the pass-through partner for the year 2002. This firm is very interested in promoting energy efficiency and has chosen to help school districts in the State of Oregon save energy by becoming a BETC pass-through partner. The estimated total cost for the schools’ projects will be around \$3,700,000, based on the five-year pass-through rate of 27 percent of the eligible project costs. At the time of writing this paper, it is not yet known which school districts will partner with this corporation.

Conclusions and Recommendations for Further Marketing

These are provided in rough order of priority.

1. Set up and advertise some sort of clearinghouse to help those with projects link up with those with tax liabilities. This could either be a web-based site or simply an assigned coordinator. It will be important to have some ground rules for matchmaking so the process is transparent and fair.

2. As a first priority, pursue energy efficient equipment providers, starting with energy service companies and large lighting contractors. These parties have the most to gain. However, their tax liabilities in Oregon are variable and may not add up to much. In addition to providing some tax liability, they may help link up their clients with tax beneficiaries.
3. Pursue firms with which the Office of Energy, the Energy Trust of Oregon, or other energy efficiency advocates have business relationships. Those business relationships may create a way to get the idea of using the pass-through at a higher corporate level and with greater seriousness.
4. Try to land a small number of retail chains that would provide cash in exchange for tax benefits. These firms may be able to provide a large and steady stream of tax deferral opportunities in multiple locations. Focus on Oregon-based chains because: (a) it may be easier to make high-level contacts, (b) they may focus more on community identity, and (c) they are more likely to have significant in-state tax liability. Propose linking investments to locations of their specific retail stores. Offer public relations support in contacting media. Develop a plaque. Perhaps have a “tax donor’s dinner.”
5. Continue to identify and pursue large businesses of all types that are making significant environmental commitments. Natural Step may be a good promotional avenue. It is worth pursuing the idea (thus far speculative) of co-marketing with environmental foundations that seek grants or other help from businesses. While it is difficult to know what this will accomplish, it is a fairly low-cost, low-effort avenue.
6. Provide information for tax, engineering, and environmental consultants. Probably the best option is to work with the large engineering management firms. However, these firms are more likely to identify efficient projects than to identify tax liability reduction beneficiaries. Their projects are likely to outstrip their own in-state tax liability.
7. Small, innovative accountants may be able to identify tax liability reduction beneficiaries.
8. Explore leasing opportunities. We recommend direct discussions with the out-of-state firm that we contacted and with additional leasing firms.
9. Emphasize personal contacts, and firms where OOE knows or can find someone to champion the BETC pass-through. Since it will often take internal champions and teamwork to persuade most firms to use their tax liability for the pass-through, knowing the right people may be essential.
10. Use business groups such as the Building Owners and Manager’s association to provide more general information about BETC and the pass-through to a wide range of businesses. Property manager associations are another attractive target. Business group marketing can provide broad marketing at a low-cost broad marketing. While it should not be the primary tool, it could provide significant benefits, and is easy.
11. As a relatively low priority, investigate whether investment in BETC pass-through could be classified as compliant with the Community Reinvestment Act (CRA). CRA investments are viewed favorably when banks are applying for mergers, acquisitions and new product offerings. This may be an avenue for increasing interest from banks.

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