Capitalizing on the Green Transition:

Tax Credits and Corporate Leadership

FOSS & COMPANY
TAX CREDIT SPECIALISTS
Since 1983

About Foss & Company

Founded in 1983, Foss & Company is a national tax equity investor and fund sponsor that has deployed over $8 billion in tax equity on behalf of insurance, banking, and other large corporate clients into tax credit enhanced transactions including historic rehabilitation projects, renewable energy and advanced energy production facilities. Foss & Company is a full-service advisor with proven expertise navigating the world of tax equity investments. For additional information, visit www.fossandco.com.

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Contents:

Abstract

Environmental, social and governance (ESG) analysis has matured rapidly over the last half-decade, becoming increasingly incorporated into investment decision-making processes. Simultaneously, unprecedented challenges from climate change to the COVID-19 pandemic have dominated the economic and political landscape in recent years allowing ESG to emerge as a crucial and non-negotiable component of modern investment strategy.

ESG-aligned investments will ensure that companies use their financial resources to address urgent social and environmental problems, while still capitalizing on the investment to ensure aligned incentives. As investors continue to pursue new and innovative strategies to support their ESG goals, often overlooked is an area that is a cornerstone to the advancement of various socially and environmentally responsible policies: tax credit investments.

As companies continue to develop their reporting mechanisms to ensure they're able to present themselves as well-governed and transition-aligned entities, tax credits can utilize the improved data quality this reporting facilitates. In the following paper, we will discuss the opportunities tax credits and ESG-disclosures can unlock for growing companies in this age of transition and transformation.

Introduction

Environmental, social and governance (ESG), as it pertains to financial investments, is a way of tracking and considering key stakeholders outside of shareholders while performing investment analyses.

Introduction

Environmental, social and governance (ESG), as it pertains to financial investments, is a way of tracking and considering key stakeholders outside of shareholders while performing investment analyses. [1] By incorporating this data into investment decisions, investors can protect against hazardous risks, capitalize on opportunities from the green transition, attract ESG-conscious investors and provide sustained returns in the long run. This change in thinking is part of the broader paradigm shift away from Milton Friedman's concept of "shareholder capitalism", in which the sole purpose and goal of businesses should be to maximize shareholder profits, and towards Edward Freeman's concept of "stakeholder capitalism", in which companies have a responsibility and sensitivity to their broader stakeholders – whose social license to operate they rely on. [2]

The year 2022 saw a strong pushback against ESG analysis. The development and incorporation of environmental, social and governance factors into investment analysis has been criticized by some for not being the complete solution to a sustainable future; others perceive it to be an ideologically driven attempt to curtail shareholder capitalism and promote a scientific consensus that is perceived as mistaken. In part, this derives from a lack of clarity around the role of ESG analysis, the meteoric rise of which, particularly amongst the investment community, has outpaced many people's understanding of it. This is not helped by the conflation of ESG with socially responsible investing (which chooses or disqualifies investments based on ethical criteria) and impact investing (which aims to help businesses that produce a social benefit) nor by the origins of the ESG nomenclature, which was to address non-financial impacts. However, in spite of this pushback, ESG-aligned investments have continued to accelerate in the face of "anti-ESG" campaigns.[3] Assets in global ESG equity products increased 98% between 2019-2021, with net inflows of $25 billion in 2020 and $35 billion in 2021 – driven, in no small part, by the products' outperformance of the market.[4]

In 2019, the World Economic Forum (WEF)'s Global Risk Survey listed 4 of its 5 "most severe" risks and 3 of its 5 "most likely" risks as arising from environmental degradation. [5] The pandemic only heightened societies' concerns over environmental and social degradation and corporate governance failings. In 2022, WEF's survey showed environmental and social factors in the top five positions for both likelihood and severity. [6] Faced with scientific inevitability, the sentiment countering ESG investing has not slowed the movement of investor dollars into impact funds - investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return – which reached $1tn assets under management (AUM) in 2022. [7]

The primary drivers of this development are connected to the concept of double materiality. This refers to the environmental or social impacts as well as the financial materiality of a corporation's investments. As stakeholders become increasingly aware and engaged in the ESG impacts of companies' activities and governments respond with regulation, those corporations that incorporate ESG analysis into their operations and investments will gain competitive advantages. [8] Likewise, as the global economy shifts towards a low-carbon future, ESG-aligned corporations will be best positioned to become ESG early adopters and capitalize on areas of growth.

With this transition comes a myriad of challenges, such as the lack of clear standards and frameworks around ESG measurement, reporting and incorporation. Tax credits, which aim to incentivize ESG-aligned investments through either tax rebates or discounts, help companies become "future fit". With expert views from Foss & Co., CDP, Sustainalytics, Oliver Wyman and the Taskforce for Climate-related Financial Disclosures (TCFD), the following paper will illustrate how companies can utilize tax equity as a financial product that generates high returns and creates external societal benefits through examining the relevancy of ESG data to companies, the role tax credits can play specifically, and the challenges / solutions to ESG-related disclosures.

Section 1

The ESG landscape: the new normal

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ESG Landscape: The New Normal

To distinguish between all the factors that the ESG category may encompass, experts have favored breaking-down ESG into its several components, with environmental factors and more specifically, climate, taking precedence. [9] Regardless of which ESG factor is the most pressing and whether the category should be combined or broken-up, ESG and its representation is here indefinitely. Mitigating ESG risks, supporting positive social impact, and fostering accountability through transparent business practices are all part of the new rulebook for corporate strategy and investment.

The primary risks posed by unsustainable practices can usually be grouped into physical risk, transition risk, and liability risk:

- **Physical risk** is the risk of depletion of assets by severe climate-related events. In a recent study, S&P found that 92% of the S&P1200 will have at least one asset highly exposed to physical risks by 2050. [10]
- **Transition risk** refers to the risk of "stranded assets", when the green transition (for example, away from fossil fuels) renders assets valueless. One recent report found that carbon economies could see a loss of US$1.4 trillion in stranded fossil fuel assets. [11]
- **Liability risks** stem from a failure to comply with incoming ESG-related regulation. In Europe, where regulation is now in force, we are beginning to see such legal action. For example, in May 2022, the offices of Deutsche Bank's asset management arm, DWS, were raided by the German police for greenwashing claims regarding certain financial products. [12] Clothing retailer H&M was similarly forced to clarify or abandon its sustainability labels in Europe,[13] while in the US, lawsuits were also lodged against the company for misleading its customers via deceptive scores on the industry's Higg Index.[14] Indeed, with the emergence of more clarity and sustainability standards, investors are seeing liability risk growing for North American companies as well. At the end of 2022, Goldman Sachs Asset Management received a fine for not following its own ESG policies and procedures. [15]

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The Financial Stability Board's recognition of the material risks that climate change poses to society and the economy saw the creation of the TCFD, which aims to further the understanding of exposure to environmental risk among companies and investors via a framework for corporate reporting on ESG factors. Hastened by the TCFD, climate-related disclosures (and broader ESG-related disclosures) have expanded internationally on a voluntary basis and have led, more recently, to mandated reporting standards, starting with the EU's Corporate Sustainability Directive. [16] Driven by double materiality concerns, "there is now unprecedented agreement from governments and capital market actors that this [ESG incorporation] is a market necessity" notes Elizabeth Small, Head of Policy at CDP, an organization that runs a global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts.

In the United States, two regulatory developments can be expected. The US Securities and Exchange Commission's (SEC) proposed disclosure rule will mandate, to begin with, public companies to report on their ESG impacts and seek assurance on that data from a third party. As the EU rules are currently the strongest, fulfilling the EU's rules will likely mean compatibility with other mandates. We can also expect comparability between the reporting standards, as we see with financial standards. Finally, the Department of Labor's ruling, removing barriers prohibiting workplace retirement plans from considering ESG factors and from exercising their shareholder rights, will increase the pressure on public companies to report and progress on ESG impacts and progress towards ESG goals, tilting the capital markets further in favor of transition aligned companies. [17]

The EU Action Plan on Sustainable Finance consists of various steps to provide clarity and guidance on ESG and its incorporation into investment decisions. Though these requirements currently exclude organizations which do not operate in the EU and it is an open debate whether or not we see a move towards a global standard, those who supply to EU organizations will increasingly find themselves being asked to align and report by their buyers.[18]

As noted, without reporting mandates, the dramatic growth of voluntary corporate reporting and engagement with ESG is evident, driven by the markets that have an incentive to measure and mitigate physical, transition and liability risks. In addition to being a "compliance exercise," ESG is "seen as a strategic tool by companies to remain competitive," says Small. Financial markets have recognized the advantages of portfolio companies with better ESG performance and predict long-term benefits for returns. [19] One of the largest meta-studies on ESG and financial performance combined the findings of more than 2,000 empirical studies, in which 90% showed either positive or neutral correlations between ESG factors and financial performance.[20]

These benefits become particularly apparent with longer time horizons. Institutional investors, as universal owners with longer time horizons, are taking particular notice. As the Alberta Investment Management Corporation's (AIMCo) CEO notes, 'ESG is really a matter of "What's your time horizon?"'. [21] The incorporation of ESG into the capital markets, in turn, has knock on effects for the cost of capital available to corporations, which defers a considerable advantage to ESG leaders. As BlackRock CEO, Larry Fink, put it in his 2022 letter to CEOs, 'shareholders need to understand the guiding principle driving your vision and mission. They will be more likely to support you in difficult moments if they have a clear understanding of your strategy and what is behind it'.[22]

To date, Europe has been a leader in the ESG market, but North America is quickly catching up. Investments that aligned in some way with ESG considerations experienced the largest increase in absolute terms in Canada from 2018-2020 (48% growth), followed by the United States (42% growth). [23] Canada is now the market with the highest proportion of sustainable investment assets at 62%, followed by Europe (42%), Australasia (38%), the United States (33%) and Japan (24%). The changing legislative context in the US, in addition to the Biden administration's Inflation Reduction Act (IRA), will fuel further growth that could be 'exponential,' according to Bryen Alperin, Managing Director of Renewable Energy & Sustainable Technologies, at Foss & Company. Commenting on the IRA, Victoria Mills, Managing Director of the Environmental Defense Fund said, 'Now is the moment' for smart businesses to 'lean in' and 'take advantage of the incentives to lower the cost of energy, to accelerate towards their climate goals and improve their competitive position.'[24]

Section 2

Where does tax come into this?

Tax policy plays a vital and often overlooked ESG function. Tax reporting is a pillar of a corporation's social contract as well as an act of financial transparency.

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Tax policy plays a vital and often overlooked ESG function. Tax reporting is a pillar of a corporation's social contract as well as an act of financial transparency. [25] Mitigating climate change in line with the Paris Agreement's 1.5°C global warming limit requires an estimated $5.2 trillion per year by 2030, requiring an average increase of roughly $460 billion a year (more than 10 times faster than current rates). Through taxes, governments can finance public initiatives. [26] Through tax credits, governments can subsidize private investment in green industries and initiatives, incentivizing a shift in private capital towards activities that will further the net zero transition. Such investments will help prevent us from breaching our planetary boundaries and mitigate physical risks such as extreme weather which, according to the NOAA National Centers for Environmental Information (NCEI), cost the United States $165bn in 2022. [27]

Tax credit investments

Tax credit investments return financial capital to companies to deploy directly into investments such as renewable energy, which boost the investor's ESG credentials and help align the business with a low carbon economy. Tax equity investments enable corporations to use their access to capital to pursue their own path towards a sustainable economy in accordance with their risk/return assessments.

Tax equity investment has been an increasingly popular option as part of an organization's ESG strategy and is set to become even more so with the IRA's ambitious climate and energy policies, most of which relate to its more than 24 available tax credits. This makes it a 'game changer for humanity', according to Small. The IRA, which imposes a 15% corporate minimum tax, will drive $380 billion of investment in renewable energy and sustainable technologies, opening up new areas for tax credit investments such as electric vehicle charging infrastructure, biogas, green hydrogen, battery storage and nuclear energy.

SIDEBAR

Case Study
ESG-aligned tax credit investments

Korea Electric Power Corporation (KEPCO)

In May, 2022, Foss & Company helped facilitate a tax equity partnership with Korea Electric Power Corporation (KEPCO) for approximately $50 million of investment.

Korea Electric Power Corporation (KEPCO) is a state-owned integrated electric utility in South Korea. It is one of the world's top 10 power providers with generation capacity of 82.5GW using nuclear, thermal, renewable and other sources. It also transmits and distributes electricity with world's best T&D efficiency and performs global business in 25 countries as of Dec. 2021.

The investment will fund Mangilao Solar, a 60 MWdc photovoltaic power plant with a 32 MWh battery energy storage system located in Mangilao, Guam. The power plant aims to provide ongoing, positive economic benefits to the island

"Foss & Company is proud to partner with KEPCO on this impactful solar power plant. Currently, Guam mostly relies on fuel oil and diesel for its gross electric generation. Once operational, the solar power plant will expand access to low-cost clean electricity for the island of Guam."

- **Bryen Alperin,** *Director of Renewable Energy & Sustainable Technologies,* **Foss & Company**

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Transferable tax credits are a new offering, which allow companies to sell their tax credits to other entities for cash. Refundable credits, which allow cash payment for tax credits even in excess of tax liability, are also part of the Act and will simplify the complicated prior process of tax equity investments. The uncertainties around accounting for tax credit investments has kept some corporations away in the past. The Financial Accounting Standards Board (FASB) is now developing new guidance to clarify and smooth the process and the IRS will be publishing guidance on the transferability of investment tax credits by mid-2023. Under the new rules, corporations can offset up to 75% of their federal income tax liability and roll this back three years, effectively gaining a rebate of taxes already paid to reinvest in ESG-positive opportunities.

Finally, renewable energy credits (RECs) are 'tradeable, market-based instruments that represent the legal property rights to the "renewableness"— or all non-power attributes— of renewable electricity generation'. [28] In effect, they assign ownership for the renewable aspects of the energy creation to the owner, allowing consumers to offset some of their carbon footprint. [29] Many US companies need RECs in order to make progress towards their publicly stated goals, such as the US' commitment to be net zero by 2050.[30] Such credits provide a market and revenue stream for renewable energy producing organizations.

These opportunities enable companies to align themselves with a sustainable, green, low-carbon economy. In turn, this will likely lower their transition and liability risks and their cost of capital. There are also upsides as investors, lenders and consumers recognize the companies' ESG-credentials.

hese opportunities for ESG-aligned investment will have notable social impacts which are central to the ethos of Build Back Better, the precursor to the Inflation Reduction Act, which saw $3tn committed by the federal government towards investment in infrastructure, human capital and R&D. Job creation is a key outcome of investment in renewable energy, contributing to a just transition away from fossil fuels. Under the IRA, a two-tiered system for renewable energy investment tax credits provides a "base" credit equal to 20% of the maximum credit and a "bonus" credit equal to an additional 80% of the maximum credit only if certain prevailing wage and apprenticeship requirements are satisfied in connection with the relevant project. In addition to this, there are three "adder credits" that can be stacked on top of underlying credits for either meeting specific, domestic content requirements, placing projects in the IRA's defined energy communities or for certain low income solar activities. [31]

Bringing more manufacturing jobs to the US will strengthen employment while selecting rural communities for large solar investments, for example, will provide an economic boom to those areas, enriching them through tax equity. There are further social benefits to community solar investments, which will sell over 50% of electricity generated to low-income families at discounted rates.

Section 3

ESG measurement and reporting

The importance of ESG-related disclosures can best be explained by 'what gets measured, gets managed', as CDP's Elizabeth Small puts it.

ESG measurement and reporting

The importance of ESG-related disclosures can best be explained by 'what gets measured, gets managed', as CDP's Elizabeth Small puts it. Through ESG-related disclosures, companies provide all stakeholders – from the capital markets to the consumer – with the ESG data needed to analyze the material impacts of an organization. It is because of this expansion of data that the last year has seen a growing body of evidence on the correlations between ESG performance and financial materiality. [32] Such reporting, data gathering and good governance procedures help companies to make both smarter tax credit investment decisions and to report the investments afterwards - meeting stakeholder expectations, fulfilling disclosure requirements and enhancing a business' leadership credentials.

Companies will need to meaningfully act on their commitments to remain safe from public controversies and be attractive to investors. Misrepresentation of environmental impacts by companies has led to growing scrutiny, mistrust and legal liability. Companies need to know the true ESG-related impacts of an investment, such as tax credits, both to mitigate the physical, transition and liability risks they face and to capture the opportunities discussed above. An Edelman survey reported that three-quarters of institutional investors do not trust companies to achieve their stated sustainability, ESG, or diversity, equity, and inclusion (DEI) commitments.

The ESG measurement and reporting space is a crowded and confusing one: there were at least 34 regulatory bodies and standard setters in 12 markets undertaking official consultations on ESG in 2021 alone.[33] The lack of a universal framework and consistency in terminology, data and practices is the resounding difficulty faced by those grappling with collecting reliable ESG data for their reports. Sustainability reporting standards can be messy and difficult to put into practice, appearing as a kind of "alphabet soup". However, huge strides have been made in a relatively short period of time.

As this new 'investment research discipline' matures, the alphabet soup is being drained through standardization both from the public sphere - such as the EU Taxonomy - and the private one - in 2021, the International Financial Reporting Standards (IFRS) brought together a group of standards to form the International Sustainability Standards Board (ISSB). Whether there will be a universal standard may be up for debate but comparable reporting frameworks, similar to the Generally Accepted Accounting Principles (GAAP) and IFRS in financial reporting, are fast approaching.

When looking at how to increase disclosure, Shilpi Singh, Director of ESG Services at Sustainalytics, a leading independent ESG and corporate governance research, ratings and analytics firm, says that ratings are an effective way forward. Companies can use ESG ratings to figure out where they currently sit, how they compare to others and where they can go next. The reasons for doing this can range from capital raising to investor or stakeholder engagement, supply

SIDEBAR

Case study – ESG-related disclosure

Schneider Electric

Multinational energy company, Schneider Electric, has disclosed on sustainability for over a decade and found the exercise essential to identifying internal gaps and addressing sustainability as a strategic issue.

In 2020, the company pioneered a first-of-its-kind biodiversity footprint assessment with CDC Biodiversité. Reporting on the World Economic Forum's metrics, Schneider's adapted its reporting, established a new approach to biodiversity and set specific biodiversity action plans for all sites.

As biodiversity risks rise in prominence, the role of businesses in addressing them is coming into focus. To keep up with the evolving ESG reporting landscape, companies must start analyzing their biodiversity footprint to understand its impact and set specific targets.[34]

chain reporting or marketing. Companies are invariably at different stages of ESG implementation, with different challenges, but many do not realize that they do not need to wait to establish a 5-year strategy in order to get started. There is often low-hanging fruit to take advantage of in the form of available investment strategies, reporting frameworks and measuring tools. Singh observes that the pandemic has shown the importance of ESG inclusion and has been a stimulator for ESG measuring and reporting expansion.

All of this serves to help companies identify and direct tax credit investments to where they will have the greatest utility in mitigating physical, transition and liability risks as well as orienting business operations that provide the company with competitive advantages as we move towards a low carbon economy and regulatory environment.

The net zero transition is a key driver of ESG investing, yet the connection between the two is not always clear in measurement and reporting. A new development for Sustainalytics is the inclusion of 'transition ratings' to provide more visibility and confidence in creating an investment portfolio that will comply with net zero targets. Another area for further development is nature risk. As the 'E' of environment continues to develop beyond climate, so will the frameworks. This process of continual improvement cannot provide a perfect solution, but nor does it promise to. As Kaja Perger, Strategic Advisor to TCFD and Principal on Climate and Sustainability at Oliver Wyman, reminds us, "we should already have started much sooner and must not let perfect be the enemy of good."

Conclusion

ESG alignment is the future of corporate investment and companies should take advantage of the numerous investment opportunities that are emerging in the green transition. In order to understand how companies can maximize their double materiality, improve their status as social and environmental citizens and mitigate ESG-related risks, accurate measuring and reporting is the first step. Tax credit investments are a direct, straight forward way to turn this knowledge into a business upside.

The cost of capital is "already growing" for incumbents that are slow to react, slow to utilize the tax credit incentives of IRA and who are not well placed for the future, according to Ivan Frishberg, Chief Sustainability Officer for Amalgamated Bank. [35] Likewise, according to Frishberg, the financial sector is ready with capital and financing for ESG-aligned opportunities as "the returns are great". Over the last three years, Amalgamated Bank has grown its climate solutions portfolio from effectively 0 to 32% of its balance sheet loans and investments.

Combined with a clear strategy, measured and reported ESG-aligned tax credit investments are a win-win-win solution for investors who want to increase their ESG credentials, increase their social and environmental impact and exploit financial materiality in a straight-forward and low-risk way.

In a time of economic and stock market uncertainty, tax credit investments offer a clear opportunity to grow and strengthen one's business and align with the green transition. As BlackRock's Paul Bodnar, Global Head of Sustainable Investing, states: 'We believe that climate risk will reshape the global economy in the coming decades, whether it's managed successfully or not'. [36]

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