Pros And Cons Of Recent Renewable Energy Bill

Law360, New York (May 08, 2013, 12:17 PM ET) -- On April 24, a bipartisan group led by Sen. Chris Coons, D-Del., introduced a bill intended to permit renewable energy projects to use a master limited partnership (MLP) structure currently available to nonrenewable projects. The proposed MLP Parity Act is a revision of a bill introduced by Coons and co-sponsors in the prior Congress.

In the press release accompanying the bill, Coons indicated that the bill is intended to foster a "level-playing field" for renewable projects, by permitting them — like certain of their nonrenewable counterparts — to raise funds from public investors but still benefit from partnership tax treatment.

Companies treated as partnerships for tax purposes are not subject to federal income tax. Instead, their owners (or partners) pay taxes on their shares of the company's income as if they earned it directly. This results in a reduced tax burden as compared to the taxation of a corporation and its shareholders, each of whom may be subject to tax on the earnings of the business (i.e., a corporation's earnings are taxed first at the corporate level and then again at the shareholder level when distributed as dividends or reflected in the sale price for stock).

Current law generally reserves partnership tax treatment for private companies. Thus, most partnerships automatically become treated as corporations for tax purposes upon making an initial public offering. An exception to this general rule applies for certain "passive" partnerships, which generate mainly dividends, interest, capital gains or rents from real estate.

Under a special rule, publicly traded partnerships are also permitted to generate income from certain minerals or "depletable" natural resources without losing the benefit of partnership tax treatment. These types of publicly traded partnerships are sometimes referred to as MLPs due to their similarity to historical oil drilling partnerships that were rolled up underneath an umbrella, or master, limited partnership.

The investing public has recognized the benefit of MLPs. The market capitalization of MLPs trading today is nearly $400 billion. What distinguishes this investment category, however, goes beyond tax benefits. Investors in MLPs have come to expect that MLPs will distribute all of their available earnings in cash at the end of each quarter.

Initial public offering documents usually describe the MLP's expected "minimum quarterly distribution," and for many MLPs, the businesses and individuals who form and manage the MLP are permitted to share in distributions that exceed this expected minimum distribution. Investors generally have no voting rights, and thus, the sponsoring businesses or individuals maintain operational control over the projects they contribute to the MLP.

While a dividend-paying corporation could replicate the basic structure of an MLP, the corporate level tax it is obligated to pay would reduce the cash it could pay in distributions. Consequently, an MLP with the same amount of earnings can pay greater distributions than a corporation can pay under similar circumstances.

This "cost of capital" advantage has made MLPs the vehicle of choice for financing many important natural resource infrastructure projects. It is expected that MLPs will continue to be used to help finance the substantial additional infrastructure that will be needed, for example, to bring newly discovered domestic oil and gas resources to market in the coming years.

Under current law, however, infrastructure projects eligible to benefit from the MLP structure do not include renewable projects, such as wind and solar (unless they can be structured to generate rents from real property, in which case, they may also be eligible to organize as a real estate investment trust or REIT).

Coons and his co-sponsors would like to change that and open the MLP franchise to renewable and other clean energy projects on a more straightforward basis. Aside from the hurdles encountered in attempting to pass any legislation in the current environment, however, Coons' bill faces a few additional obstacles.

First and foremost, Coons' bill may cost the government some tax revenue. Coons has requested that his bill be "scored" to determine the cost, but as of this writing, the cost has not yet been determined. In the latest report from the Joint Committee on Taxation, MLPs are expected to cost the government around $7 billion in tax dollars over the next five years.

By contrast, the home mortgage deduction has been scored to cost the government $380 billion over the same period. So, it can be seen that MLPs do not represent a relatively large amount of potential revenue, but in the current environment, everything counts.

Second, Congress is currently engaged in a debate over "fundamental" tax reform. Sen. Max Baucus, D-Mont., chairman of the Senate Finance Committee, has indicated that such reform is his main priority for the year and a half he has remaining before his recently announced retirement at the end of 2014.

Republicans have also made tax reform a priority. In general terms, they desire to reduce the corporate tax rate and pay for the cost of this measure by eliminating special exceptions or "loopholes." It remains to be seen exactly how MLPs fit into their plans.

Finally, recent adverse press reports about some of the administration's "green energy" initiatives, involving defaulted loans to bankrupt companies, and the general reduced interest in green energy investing may dampen enthusiasm for additional incentives.

Assuming the MLP Parity Act is able to overcome these obstacles, there are also the questions of how much it will help and who will benefit. As previously stated, the bill is an expanded version of a bill introduced by Coons and co-sponsors last year. The prior version of the bill had a similar goal, to permit renewable energy projects to make use of the MLP structure, and would have applied to the generation, storage or distribution of various types of renewable energy (including energy produced from wind and solar assets); thermal energy produced from combined heat and power assets; as well as renewable fuels and renewable fuel infrastructure.

The new bill refines the foregoing categories, which continue to be included within the scope of the proposed qualifying activities, but expands this scope further to include:

- The receipt and sale of electric power that has been stored in a device connected to the electric transmission "grid"

- The use of recoverable waste energy from certain industrial processes

- The production, storage or transportation of "renewable chemicals" (including plastics produced from renewable biomass)

- The audit and installation of certain energy efficient equipment

- Certain gasification projects that separate and sequester at least 75 percent of the carbon dioxide they produce

- The generation or storage of electric power produced from certain qualified facilities that dispose of their carbon dioxide emissions in a defined manner

To the extent Coons' bill fulfills its goal of "leveling the playing field," it seems like good policy. For example, it is hard to argue, other than based on history, that an oil-refining business has a greater claim to the benefits of the MLP structure than a business that produces renewable fuels.

However, it is interesting to point out that some of the proposed qualifying activities in the Coons bill are in direct competition with nonrenewable activities that are not permitted to benefit from the MLP structure under current law. Thus, under current law, an MLP may not be used for electricity generation or plastics manufacturing. Moreover, although the Coons bill provides benefits to coal and natural gas-fired power plants that sequester the carbon dioxide they produce, the bill provides no benefit to nuclear power plants.

On a more practical level, there is some concern that opening the MLP franchise to projects without a strong track record of producing the steady cash flows that MLP investors have come to expect could result in failed projects and cast a pall over the entire investment category.

When bankers consider establishing and marketing an MLP project in a new line of business, they often ask not only whether that project generates the right kind of income to qualify for partnership tax treatment but also whether that project is "suitable" for an MLP. That is, they want to know whether it generates steady and growing cash flows that will be available for distribution to investors on a quarterly basis.

That said, there clearly are renewable energy projects that generate steady cash flows. Solar projects with established technology may be one example. Many of these projects are constructed based upon the expected cash flows from long-term power purchase agreements with utilities and thus have the potential to pay regular cash distributions to investors. Similarly, wind facilities at sites with strong historical data may be good candidates.

In recent years, these projects have also benefited from substantial tax credits or other tax benefits that can be made available to equity investors. Unfortunately, the "tax equity" investor pool, comprised of large corporations with substantial unrelated taxable income, is limited. As a result, these investors have demanded significant returns, resulting in a relatively high cost of capital for these projects.

It is thought, by some in the industry, that if renewable projects could benefit from the MLP structure, they could raise funds from public investors at a reduced cost — making more of these projects viable. It is important to bear in mind, however, that current law largely restricts the use of tax credits and tax losses generated by an investment in an MLP from reducing taxes on an individual investor’s unrelated income.

Consequently, investors in a renewable MLP are likely to be focused solely on the cash distributions they expect to receive from the MLP and not on the tax credits or other tax benefits that tax equity investors may obtain by investing directly in the renewable project. The issue therefore remains whether these projects can generate sufficient cash flow to satisfy investors.

If they can, then Coons’ goal of placing them on a level-playing field with nonrenewable projects makes perfect sense and could support, rather than undermine, the growth of the MLP and renewable energy industries.

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