

# CLEARPATH

## Leveling the playing field with Master Limited Partnerships

ClearPath | April 2016

### Introduction

Policymakers have used the tax code to meet energy policy goals since the 1970's, successfully promoting both the security and affordability of our energy supply.<sup>1</sup> Our energy supply has diversified greatly since then, and it is widely agreed that we should pursue an "all of the above" energy strategy. An important element of an all of the above strategy is technology neutrality, ensuring that the government doesn't give preference to one technology over another.

One prime example of a mismatch in tax treatment between energy sources is access to master limited partnership structure. Master limited partnerships (MLPs) are publicly traded partnerships that are not taxed at the corporate level, avoiding the double taxation issue. Oil and gas midstream companies are able to use this tax structure to access a lower cost of capital and much higher growth. MLPs should be extended to other technologies like hydropower and other renewables. This tax fix also has strong bipartisan support in both chambers of Congress.

### MLP History

A master limited partnership is a special entity that is taxed as a partnership, but whose ownership interest is traded on public exchanges like stock. The partnership structure allows the MLP to avoid corporate income tax while generating significant growth through public trading. Income is distributed through to partnership owners, who are then taxed on the individual income tax schedule.

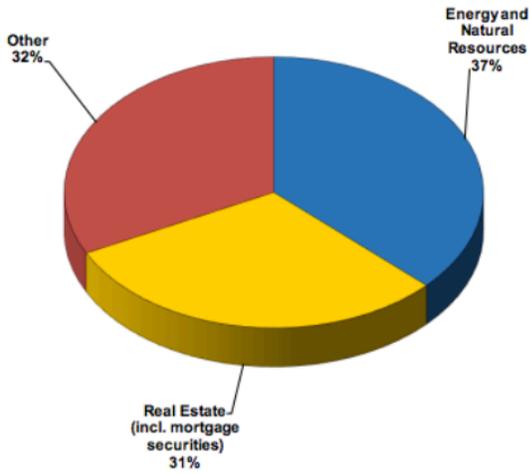
The types of companies that can qualify for MLP structure was limited in 1987 to avoid eroding the corporate tax base. Under section 7704 of the tax code, an MLP must earn more than 90% of its income from certain qualifying sources. Qualifying sources are limited to real estate rental income, commodity investments, and certain natural resources. Qualifying natural resources are limited to oil, coal and gas exploration, development, transportation and refining, but not actual retail sales. The category was later expanded in 2008 to include alternative fuels like ethanol, biodiesel, and hydrogen.

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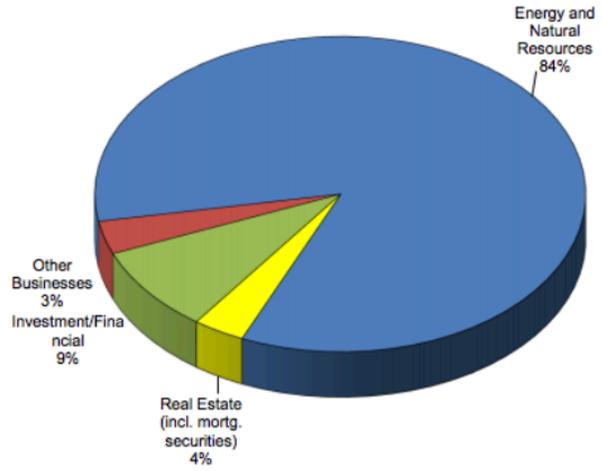
<sup>1</sup> [Issues in the 113th Congress, CRS](#)

Over time the MLP space has grown to be largely dominated by natural resource companies, at a total market cap of \$393 billion dollars.<sup>2</sup>

### MLPs by Industry Group - 1990

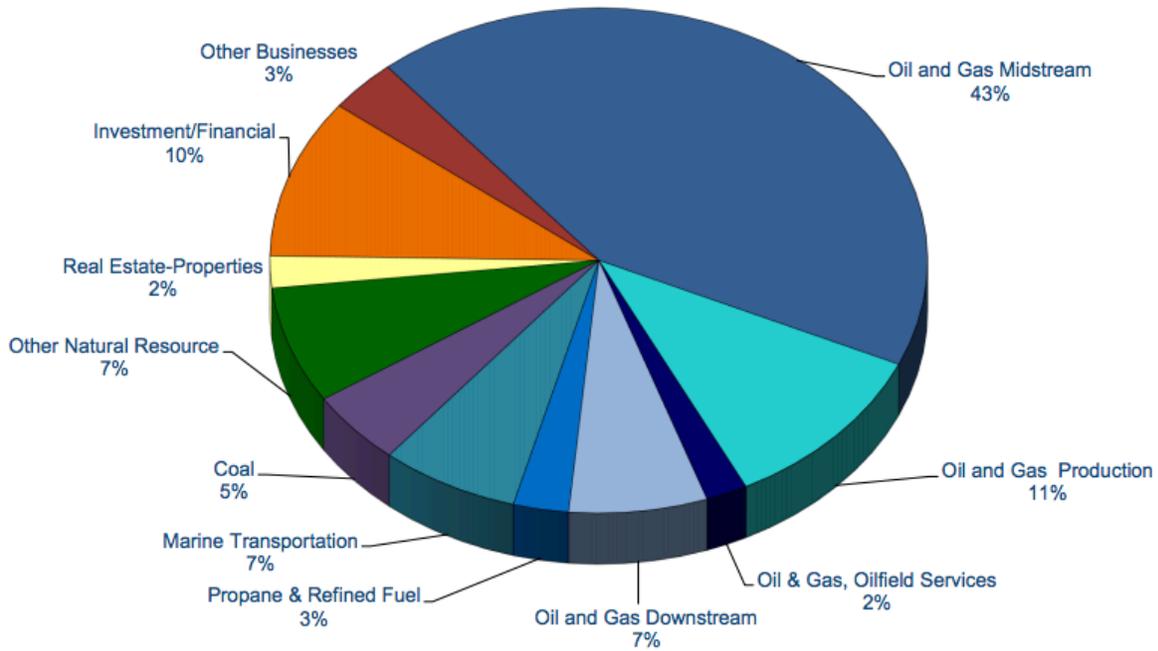


### MLPs by Industry Group - 2015



(Credit MLP Association)

### MLPs by Industry--2015



(credit MLP Association)

<sup>2</sup> [MLP Association](#)

These industries are known as “passthroughs”, enhancing or moving a good, not selling it on the open market. An important element of an MLP eligible passthrough company is that it must provide stable, predictable returns.

MLP structure allows these companies to access lower cost of capital for infrastructure investment. Without corporate taxation, MLP shareholders receive higher returns, significantly lowering the financing costs of capital intensive industries.

### **MLP Structure<sup>3</sup>**

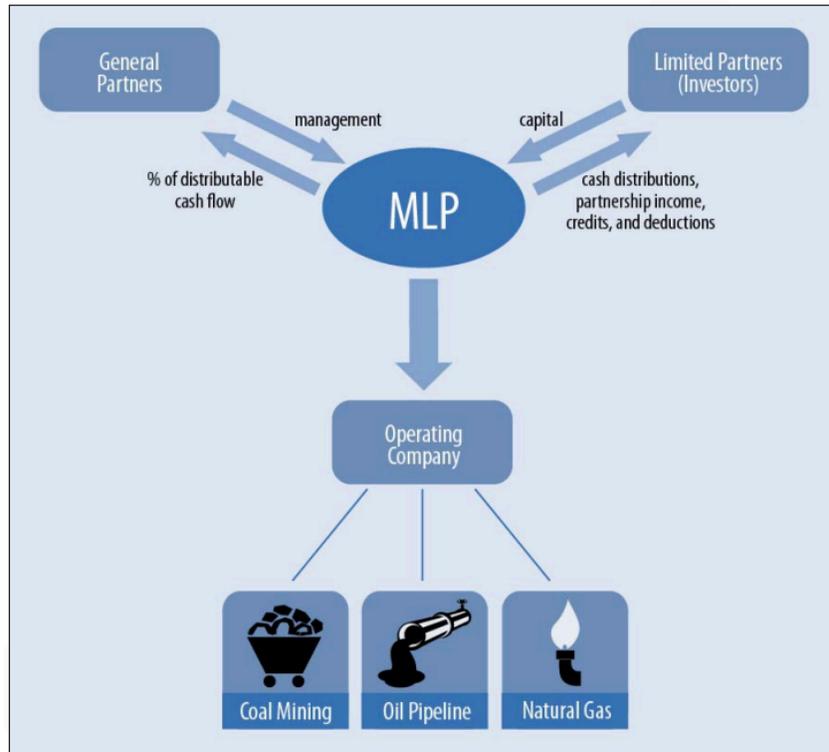
MLPs are composed of at least one general partner and thousands of limited partners. Instead of trading stock like a publicly traded corporation, MLPs issue units to their limited partners, which can then be bought or sold. Similar to stocks, MLP units pay out cash distributions and are traded on public financial exchanges. Unit holders (the limited partners) are issued a proportion of the partnership’s income, credits and deductions in addition to the cash distributions. MLP income is then taxed at the unit holder level under their individual income tax rate. MLP units typically carry both higher returns and higher risk than bonds, and more closely mirror stocks.

The managing general partner receives a baseline percentage of the MLP’s income (usually around 2%). Additionally, the general partner may also receive an increasing percentage of distributed cash flow if the yield on limited partner’s units exceed certain thresholds. This incentivizes the general partner to grow the partnership. The general partner may be another (parent) company or a group of individuals.

There is typically a subsidiary operating company that actually owns and operates the assets. This limits liability across state lines, and also allows the MLP to exclude income from unqualified resources.

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<sup>3</sup> Information for this section drawn primarily from the [CRS](#).



Typical MLP Structure (Credit: Congressional Research Service)

### Applicability to renewables

While oil and gas companies have benefited tremendously from MLP structure, other passthrough energy companies have been unable to benefit. Electricity is a commodity, and companies that generate electricity from renewable sources (and that do not sell retail electricity) have similar financing structures as midstream oil and gas. Similar to midstream oil and gas companies, assets including some clean energy sources (wind, solar, geothermal electricity) generating facilities produce highly predictable revenue streams from their electricity. Moreover, the viability of clean energy relies heavily on access to capital. With no fuel costs, the majority of the cost of energy from solar or wind is from up front capital and financing costs.

Renewable energy is supported primarily through federal tax credits and accelerated depreciation. Only a small portion of the investor community is able to leverage these finance tools effectively, greatly limiting the potential pool of renewable energy investment. Reliance on tax equity finance both limits the number of investors and necessitates complex financial transactions and ownership swaps that drive up the cost of financing.<sup>4</sup>

When combined with two layers of taxation, renewables face significantly higher cost of capital compared with similar oil and gas passthrough companies, lowering their competitiveness in the marketplace.

<sup>4</sup> [Brookings Institute](https://www.brookings.edu/)

There has been a proposal in congress to extend MLP status to additional energy sources beyond oil, gas and coal. H.R.2883, the Master-Limited partnership Parity Act, modifies section 7704 to include renewable energy (wind, solar, hydropower, geothermal), as well as energy storage, biofuels, energy efficient buildings, and carbon capture power generation facilities.<sup>5</sup>

NREL and UCS estimate that access to an MLP structure (without access to current tax credits), will lower the levelized cost of energy of new wind by 16% and solar by 8% (a benefit based to 40% of the PTC for wind).<sup>6,7</sup> Access to tax credits lowers the benefits of MLP structuring, and the full benefit of MLP structuring won't be realized until the tax credits phase out. MLPs would be unable to purchase assets from yieldcos or original owners utilizing the ITC until after each asset's tax benefits had expired (the IC is subject to recapture for 5 years if the owner changes). The PTC however, is not subject to recapture.<sup>8</sup>

### **What's the difference from a YieldCo?**

Over the last few years large renewable energy companies like Abengoa, NRG and SunEdison have introduced a new financing model to emulate the benefits of an MLP structure. Known as "yieldcos", these subsidiaries are publicly traded corporations that bundle low risk assets (often wind or solar installations) to provide a steady stream of dividends to shareholders without entity level taxation, similar to an MLP.<sup>9</sup> Yieldcos attempt to achieve net zero corporate taxation by operating at a loss, for example, through the utilization of favorable tax treatment towards renewable energy projects. Renewable energy projects are eligible for both accelerated depreciation and tax credits that can shelter shareholder returns from taxation. The Entity grows through the acquisition of additional assets. Ultimately, yieldcos are able to access a lower cost of capital than the traditional tax equity model offers by providing low risk steady dividends on public exchanges to a wider pool of investors.

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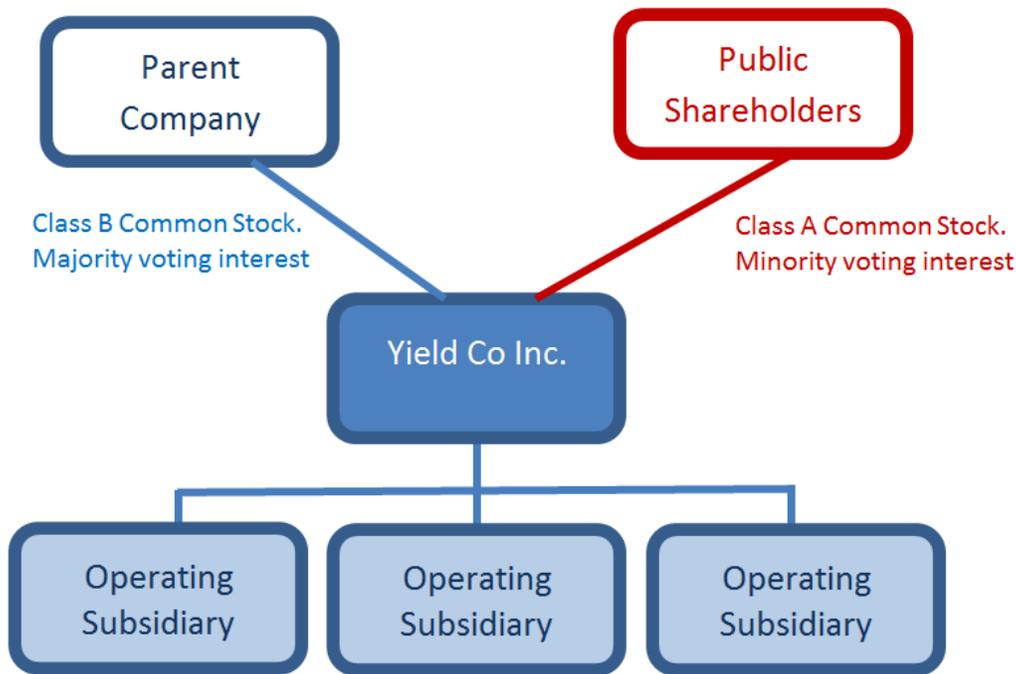
<sup>5</sup> [Congress](#)

<sup>6</sup> [NREL](#)

<sup>7</sup> [UCS](#)

<sup>8</sup> [US partnership for Renewable Energy Finance](#)

<sup>9</sup> [International Financial Law Review](#)



Typical yieldco structure (credit [CleanTechnica](#))

While yieldcos have allowed greater renewable energy project development, the yieldco structure offers several significant disadvantages to an MLP structure that may be unsustainable in the long term.

1. A yieldco requires high levels of asset acquisition. Each asset's positive tax attributes are exhausted between 5 and 10 years after capture, significantly shorter than the lifetime of a typical asset. In order to maintain its low tax liability, a yieldco must grow at a rate of 12-15%, as the tax benefits of new assets must be large enough to shelter revenues from all other assets.<sup>10</sup> As the number of yieldcos increases (each needing to grow at a substantial rate), the available pipeline of high quality, low risk projects becomes increasingly constrained. Additionally, as time goes on, older yieldcos struggle to maintain the growth needed to sustain significant operating losses.
2. The tax benefits necessary to sustain the yieldco model will expire or be significantly reduced. The federal Investment Tax Credit (applicable to solar photovoltaic assets) slowly declines from 30% to 10% through 2022, while the Production Tax Credit expires entirely in 2019.<sup>11,12</sup> Once tax incentives decline, it is likely that new assets will be unable to provide enough tax shelter for the entire portfolio of assets, raising the cost of further development.
3. As interest rates rise, so does the cost of capital. In confluence with declining tax incentive rates and necessary high growth rates, yieldcos will face increasingly difficult challenges providing steady tax sheltered dividends to shareholders.

<sup>10</sup> [International Financial Law Review](#)

<sup>11</sup> [DSIRE](#)

<sup>12</sup> [DSIRE](#)

Given these inherent issues in the structure of yieldcos, it is unlikely that yieldcos will be able to provide access to capital equivalent to oil and gas companies in the long term. Extending access to MLP structuring would make our tax code more resource neutral while promoting economic growth.

### Additional considerations

While MLP parity is worthwhile, there are additional aspects to consider. The first is the concept of “gold plating”. There are concerns that if the tax benefits of investing in renewable energy are too great, investments will be made in renewable energy that are purely for tax reasons, not for energy development. This is particularly a concern if electricity from renewable sources reaches price parity with traditional electricity before the expiration of renewable energy tax credits. However, it is unlikely that the addition of MLP structuring would encourage tax evasion more than currently available through yieldcos.

MLPs are a useful tool to commercialize existing technologies, but not to incent additional innovation in new technologies. Most MLPs depend on highly stable cash flows, and the same philosophy would apply for renewable energy MLPs. It is likely that most of the portfolio of renewable MLPs would be centered around proven technologies like solar and wind development.

### Appendix

#### Simple MLP Finance Example

| <b>Amount per share / unit:</b>  | <b>Corporation</b> | <b>MLP</b>    |
|--|--------------------|---------------|
| Gross Income   | \$4.00             | \$4.00        |
| Deductions   | -\$3.00            | -\$3.00       |
| <b>Taxable Income</b>  | <b>\$1.00</b>      | <b>\$1.00</b> |
| Federal corporate tax  | -\$0.35            | \$0.00        |
| State tax (assumes 5% rate)  | -\$0.05            | \$0.00        |
| <b>Entity's net income</b>   | <b>\$0.60</b>      | <b>\$1.00</b> |
| Shareholder's federal tax (15% rate for dividend, 28% rate for MLP income) | -\$0.09            | -\$0.28       |
| Shareholder's state tax (5%)   | -\$0.03            | -\$0.05       |
| <b>Net income to shareholder</b>   | <b>\$0.48</b>      | <b>\$0.67</b> |

*Credit: MLP Association*