

Master Limited Partnerships: The Case for Parity

Overview

A master limited partnership (MLP) is a business structure that has provided multiple benefits for oil, gas and other “depletable” energy resources over the last 30 years, but has not been available to the renewable energy industry. MLPs are treated like partnerships under the tax code but have tradeable public shares called units. This structure creates tax benefits along with the ability to raise low-cost capital through public markets. While renewable energy assets can provide the steady predictable income necessary for a successful MLP, they do not currently qualify for the designation. Legislation has been introduced with broad bipartisan support to expand MLP eligibility to renewable energy projects. The bill pending in Congress, titled the Master Limited Partnership Parity Act, presents an excellent opportunity to leverage public capital and drive private investment in renewable energy and infrastructure development. Rather than picking winners and losers by providing tax benefits exclusively to fossil energy resources, this act would create a level-playing field for all energy sources alike.

MLP Structure and Fundamentals

An MLP is a publicly traded partnership. This powerful business structure combines the tax benefits of a partnership with the ability to raise the low-cost liquid capital of a public securities market. MLPs have been used since the early 1980s and are designated as pass-through entities under the tax code, allowing income generated by these vehicles to avoid double taxation. As C corporations, these organizations are taxed at both the corporate and shareholder levels; however, as a partnership they do not pay corporate income tax, and generated income passed on to shareholders is only taxed at the individual rate. To receive this beneficial tax status, an MLP must derive at least 90 percent of its income from “qualifying sources,” which is defined to not include renewable energy, energy storage or grid infrastructure.

MLPs are yield-oriented structures that are attractive to investors for their tax incentives and steady long-term income streams. MLP investors typically receive stable quarterly cash distributions through a calculation based on the MLP’s distributable cash flow (i.e., the EBITDA less interest expenses and maintenance capital expenditures). MLP structuring commonly requires at least 80 percent of the available cash flow be distributed to unit holders. In addition to avoiding double taxation on corporate income, investor distributions are also not fully taxed immediately, with 80-90 percent typically classified as a return of capital under the depreciation allowances, which permits investors to compound returns that would otherwise be taxed, while also earning a steady stream of income.¹

¹ This issue brief focuses on a typical MLP arrangement; however, there are many variations and exceptions. Some MLPs, for various reasons, choose to pay both shareholder and corporate income tax. MLPs can have various capitalization structures and distribution policies.

Unfortunately, since the creation of MLPs in the 1980s, the tax code has only considered the exploration, development, mining, transportation, processing, storage, refining and production of depletable mineral or natural resources (oil, gas, coal) as “qualifying sources.” Renewable energy production and electric infrastructure have not been included under “qualifying sources.” While MLPs have also been available to some real estate, financial and other investment instruments, 82 percent of all MLPs in 2017 were depletable natural resource MLPs. Of these natural resource MLPs, the vast majority consist of oil and gas assets.

The favorable tax treatment afforded to MLPs at both the corporate and unit-holder levels gives MLPs a lower cost of liquid capital than is typically available to corporations, allowing the MLPs to pursue projects that might not be feasible for regularly taxable entities. These benefits have helped drive a strong market for depletable natural resource MLPs, which have seen tremendous growth over the last decade. As of February 2018, there are 102 MLPs with a combined market capitalization of \$410 billion and the market has breached the \$500 billion mark in recent years.²

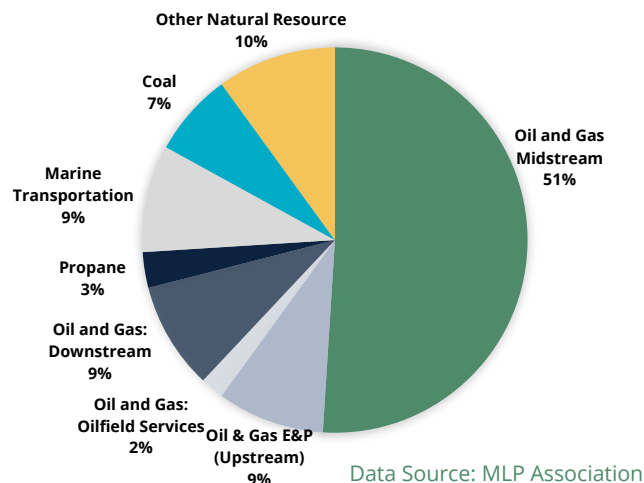
While the MLP tax structure was not changed in the 2017 Tax Cuts and Jobs Act, changes to the treatment of pass-through entities increased the benefits for MLP investors. The new tax law allows for a 20 percent deduction of MLP pass-through income, and enables investors further gain from the sale of MLP interests.

Renewable energy and grid infrastructure projects have demonstrated the ability to provide the consistent cash flows characteristic of successful MLPs. If the MLP structure were extended to such projects, this financing mechanism could help drive additional low-cost private capital to fuel continued growth in the electric power and renewable sector.

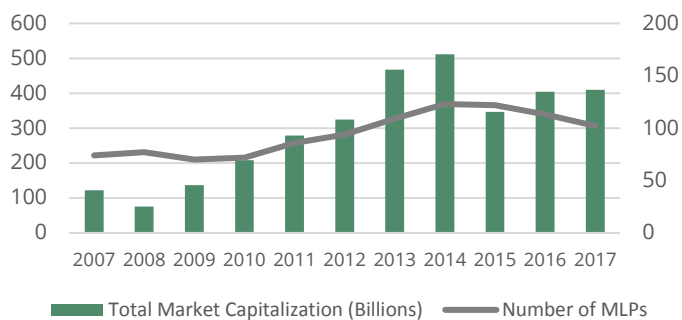
MLP Parity Act

In the fall of 2017, Senator Chris Coons (D-DE) and Senator Jerry Moran (R-KS)³ introduced S. 2006, the “Master Limited Partnership Parity Act” (“MLP Parity Act”). The bill expands the definition of “qualified sources” to include

Natural Resource MLPs By Sector (2017)



MLP Market Capitalization and Number of Partnerships



² Asset Class Overview, Yorkville Capital Management. Available at <http://www.yorkvillecapital.com/asset-class-overview.aspx>. Last retrieved February 23, 2018.

³ Senators Coons (D-DE) and Moran (R-KS) introduced the bill with Senators Stabenow (D-MI), Gardner (R-CO), Bennet (D-CO), Murkowski (R-AL), King (I-ME), Collins (R-ME), and Heinrich (D-NM).

renewable energy resources and limited infrastructure projects. The act would specifically expand the tax treatment to those renewable energy technologies and energy property under Sections 45(c)(1), 45(d)(3) and (7), and 48 of the tax codes.⁴ Additionally the bill includes energy storage property, combined heat and power, renewable thermal energy, waste heat to power, renewable fuel infrastructure, energy efficient buildings, carbon capture and sequestration, and more as qualified sources.

Renewable energy and enabling technologies have been significant drivers of U.S. investment, economic development, and job creation. The sector garnered \$40.5 billion in domestic investment in 2017 and employed hundreds of thousands of American workers. Despite such growth, renewable energy projects, electric grid modernization and infrastructure development still do not have access to the low-cost liquid capital that MLPs can provide.

MLPs can be used as a powerful tool to leverage public capital and attract private investment in renewable energy and infrastructure improvements, especially as the renewable energy tax incentives phase out over the next several years. In 2013, the Joint Committee on Taxation (JCT) scored an earlier version of the MLP Parity Act, estimating a cost of \$307 million over 5 years, while existing fossil energy MLPs were predicted to cost \$6.7 billion over the same period. Notably, JCT scoring does not take into consideration the additional revenue generated through renewable energy deployment and economic development in manufacturing, construction, and other related areas. MLP parity for renewable energy sources would be a relatively low-cost way to drive needed private investment for renewable energy and infrastructure development.

The MLP Parity Act does not currently include transmission and grid modernization as qualified sources. But there are strong reasons to consider such an addition to the bill. U.S. infrastructure was given the grade of D+ by the American Society of Civil Engineers. A major component of this lagging infrastructure is the nation's antiquated electrical grid. Such an expansion of the MLP Parity Act would bring private capital to desperately needed transmission and grid modernization projects and also support renewable energy deployment.

Conclusion

When MLPs were first created, the renewable energy industry was virtually non-existent. Today, it is the nation's largest source of private capital infrastructure investment. The MLP Parity Act would update the MLP structure to recognize the reality of today's energy sector and provide much needed tax parity between renewable energy and fossil energy sources. This bipartisan bill would help drive additional capital into renewable as well as traditional energy development. With a revision to also allow MLP qualification for electric grid infrastructure, the measure could help spur electric power infrastructure upgrades and modernization.

⁴ This includes wind, solar, closed- and open-loop biomass, geothermal, small irrigation power, municipal solid waste, qualified hydropower, and marine hydrokinetic energy technologies, as well as energy property associated with combined heat and power, solar electricity, heating, and fiber-optics, and small wind.