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Master Limited Partnerships for US renewables: panacea or pie in the sky?

Policy-makers are examining alternatives to incentivise renewables in the US, in light of the expiration of the Treasury cash grant programme and uncertainty around extension of tax incentives. One option that has begun to gain traction is to allow renewable energy entities to incorporate as Master Limited Partnerships (MLPs). This Research Note examines the characteristics of MLPs, and their practical and political feasibility, economic returns, and potential market size if they were to be applied to US renewable projects.

- MLPs combine the access to capital of public stocks with the tax advantages of partnerships. Traditionally limited to sectors such as oil and gas, MLPs enable individual investors to avoid 'double taxation' while raising equity to invest in large, capital-intensive projects.
- Clean energy advocates are pushing to extend the benefits of MLPs to renewables, arguing they could provide developers easier access to liquidity and improve investor returns.
- However, exploiting these structures would be a challenge for clean energy. This Note poses potential answers to several critical questions related to implementation: Who would invest in these partnerships? Which technologies would stand to benefit? What roles would MLPs play in the financing process? Who would manage them? Are MLPs compatible with tax equity?
- Specifically, using MLPs in combination with tax equity hinges on changes to key rules. It will be difficult to utilise MLP benefits in tandem with tax equity if investors continue to be barred from flexibly using 'passive losses' or if tax credits are deemed subject to this rule. Three potential workarounds are available though none are straightforward.
- Benefits associated with MLP would lift the economics of renewable projects. For a hypothetical 100MW wind project financed through a typical tax equity structure, incorporation of the developer and the tax equity investor as MLPs would result in an IRR increase of roughly 1.5% (percentage points) and an NPV increase of \$4.0-4.3m, from the perspective of the unit-holders of these MLPs. For the tax equity investor, however, realisation of these benefits hinges on relaxation of the 'passive loss' rule.
- The market size of potential investment into renewable MLPs could be substantial, based on rough proxies. MLP investment in natural gas pipelines amounted to \$29.3bn in 2005-09. The market capitalisation of six companies primarily engaged in renewable project development totals \$28.3bn; barring the introduction of renewable MLPs, purchasing stocks of these types of companies will remain the main avenue for a retail investor looking to gain direct exposure to renewable project development investments.

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Michel Di Capua +1 212 617 7197 mdicapua@bloomberg.net Lobbying to expand MLPs to renewables has ramped, but changing the rules will be an uphill battle, given the poisonous current political climate, deficit concerns, and the looming 2012 election. Changes to the 'passive loss' and other rules are unlikely given that such adjustments would reduce federal tax revenue.

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MLP are taxed like partnerships, but their units trade like shares in corporations.

INTRODUCTION TO MLPS 1.

Master limited partnerships (MLPs) are business structures taxed as limited partnerships, whose ownership interests (called units) are publicly traded on public exchanges or over-the-counter (OTC) markets, just like corporate stock. As with partnerships and unlike corporations, MLPs are not taxed at the corporate level. As with typical corporations and unlike partnerships, ownership interests are highly liquid. Many MLPs operate primarily energy-related businesses; for example, almost all of Kinder Morgan's assets - including natural gas pipelines, CO2 pipelines, and terminals – are owned by Kinder Morgan Energy Partners LP, a large publicly traded MLP.

MLPs must derive 90% of their gross income from 'passive' or 'gualifying' sources. 'Passive' includes dividends, interest, rents from leasing out real property and capital gains from the sale of income-producing capital assets and real property. 'Qualifying' relates to mineral or natural resources, such as exploration, development, mining or production, processing, refining, transportation, storage or marketing of any natural resource (including fertiliser, timber and geothermal energy¹). Other forms of clean energy (hydroelectric, solar, wind, or nuclear power production) or activities related to inexhaustible resources such as water, air, soil and turf do not currently qualify.

Some mutual funds are permitted to own MLPs with certain restrictions.² In 2008, MLP rules were expanded to allow for income from the transportation and storage of certain renewable and alternative fuels such as ethanol and biodiesel.³ The change was intended to equalise tax treatment of biofuel and petroleum pipelines. Taking their cue from that change, lobbyists representing wind, solar, and other renewables have begun pushing to expand MLPs to include their technologies.

1.1. Key characteristics of MLPs

Table 1 summarises key differences between MLPs and C-corporations.⁴ MLPs usually exercise indirect ownership over their assets via a subsidiary (an operating company). Such a structure alleviates the administrative burdens stemming from ownership changes due to trading of units.

An MLP consists of a general partner (GP) and limited partners (LPs). The latter provide capital and receive guarterly required distributions (QRDs - the equivalent of shareholder dividends in a C-corporation). They play no part in the operations of the MLP business. Limited partnerships are also referred to as common unit holders, since ownership interests in MLPs are referred to as 'units' (to differentiate from corporate stocks).

The general partner, on the other hand, manages the MLP's daily operations. GPs could be another company (ie, a parent company) or a group of individuals. The GP typically holds a 2% equity ownership stake in the partnership, in effect retaining control over the asset base, GPs usually receive a percentage, called an 'incentive distribution right', of the MLP's cash flow. LPs may then also appropriate an increasing share of distributable cash flow, if the yield of the LP units exceeds a specific level. Distribution rights can thus have a meaningful effect on GPs' and LPs' economics.

- 3 This broadened definition will come at a cost of approximately \$119 million to the US Treasury for the period 2009-2018, according to the US Congress Joint Committee on Taxation. (U.S. Congress, Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 110th Congress, committee print, 110th Cong., March 2009, JCS-1-09, p. 599.)
- 4 A C-corporation is a business that is legally separate from its owners. The C-corporation is taxed itself and its individual shareholders are taxed on dividends.

Note that while the "marketing" of geothermal energy is considered MLP-eligible, transmission of 1 electricity is not. This likely explains why geothermal power plants are not incorporated as MLPs.

² Mutual funds are allowed to own MLPs as long as they invest less than 25% of the fund's asset value in MLPs, and fund less than 10% of any one MLP.

| Terminology | MLP | C-corporation |
|---|--|-------------------|
| Equity holder | 'Common unit-holder' / 'Limited partner' | 'Shareholder' |
| Unit of ownership | 'Unit' | 'Corporate stock' |
| Periodic pay-out | 'Quarterly required distribution' (QRD) | 'Dividend' |
| Structure comparison | | |
| Corporate level tax | No | Yes |
| Shareholder-level / unit-holder-level tax | Yes | Yes |
| Tax shield on proceeds | Yes | No |
| Tax reporting for IRS | K-1 | 1099 |
| General partners (GPs) | Yes | No |
| Shareholders' / unit-holders' voting rights | No | Yes |
| Incentive distribution rights (IDR) for GPs | Yes | No |

Table 1: MLP vs. standard C-corporation – glossary and structure comparison

Source: Various financial literature primers

1.2. MLP cash distributions, tax treatment and consequences

MLPs can deliver higher after-tax returns for investors compared to other typical corporate structures, making MLP units worth more than C-corporation shares, all else equal. Table 2 provides an illustrative example how the economics of MLPs work, comparing the after-tax returns from an identical entity structured as a C-corporation and as an MLP. The economics are shown per shareholder (in the case of C-corporation) or per LP unit-holder (in the case of MLP).

Table 2: Example - Income and cash distribution comparison, C-corporation vs. MLP

| | o corporation | III EI | | | |
|--|---------------|--------|--|--|--|
| Number of shares / units | 10 | 10 | | | |
| Net income (financial reporting) | | | | | |
| EBITDA | 70.00 | 70.00 | | | |
| (-) Interest expense | 15.00 | 15.00 | | | |
| (-) Depreciation | 20.00 | 20.00 | | | |
| EBT | 35.00 | 35.00 | | | |
| EBT per shareholder (SH) / unit-holder (UH) | 3.50 | 3.50 | | | |
| (-) Corporate tax at 35% | 12.25 | n.a. | | | |
| Corporate tax per SH/UH | 1.22 | n.a. | | | |
| Net income (EBT minus corporate tax) | 22.75 | 35.00 | | | |
| Earnings per SH/UH | 2.28 | 3.50 | | | |
| (-) Tax on distributed income at 35% | n.a. | 1.22 | | | |
| Cash fl | ows | | | | |
| Net income | 22.75 | 35.00 | | | |
| (+) Depreciation | 20.00 | 20.00 | | | |
| (-) Maintenance capex | 10.00 | 10.00 | | | |
| Distributable cash flow (DCF) | 32.75 | 45.00 | | | |
| DCF per share / unit (before GP allocation in MLP) | 3.28 | 4.50 | | | |
| DCF per GP unit ⁽¹⁾ | n.a. | 0.09 | | | |
| DCF per share / DCF per LP unit | 3.28 | 4.41 | | | |
| After-tax investor proceeds | | | | | |
| DCF per share / DCF per LP unit | 3.28 | 4.41 | | | |
| Dividend tax (SH) at 15% | 0.49 | n.a. | | | |
| Tax on distributed income at 35% | n.a. | 1.22 | | | |
| After-tax proceeds | 2.79 | 3.19 | | | |

Source: Bloomberg New Energy Finance Notes: All numbers are illustrative. (1) Distributions available to LPs will vary depending on GP allocation, here assumed to be 2%.

Depreciation

The example assumes both the C-corporation and the MLP can use the Modified Accelerated Cost Recovery System (MACRS) for depreciation purposes (since MACRS is commonly applied in renewable projects). For the five-year MACRS schedule which is applicable for renewable projects, the first-year depreciation is \$20 for an asset with \$100 purchase price and no residual value. The amount of depreciation recognised directly affects net unit-holder returns, as explained later in the section.

Single layer of taxation

The MLP partnership structure eliminates the 'double taxation' usually applied to shareholders of publicly traded C-corporations - ie, the corporation pays taxes on its income, and shareholders pay dividend tax on cash distributions, received out of net income in the form of dividends. Shareholders also pay capital gains tax upon the security's sale. In contrast, with MLPs, income passes directly to the MLP's unit-holders, who are held personally responsible for paying taxes on their individual portions of the MLP's income at their personal income tax rate.

As per Table 2, after factoring the \$20 depreciation and \$15 interest expense, the entity's earnings before tax (EBT) are \$35 in either case. From here, the C-corporation pays \$12.25 of corporate taxes at a 35% rate (per-share effect of \$1.22), which leaves after-tax earnings of \$22.75, or \$2.28 per share. The MLP, in contrast, pays no corporate-level taxes, leaving \$35.00 of earnings to be allocated to unit-holders

Cash flow distributions (QRDs)

Because MLPs pay no taxes at the entity level, the cash flows they can distribute - \$4.50, assuming all cash flows beyond maintenance capex are paid out - exceed those distributable to corporate shareholders (\$3.28) by \$1.22 - the amount the C-corporation must pay for corporate taxes. Note that cash flow distributions - \$4.50 for the MLP and \$3.28 for the C-corporation, after factoring depreciation and maintenance capex - are greater than the recognised earnings per share (\$3.50 and \$2.28, respectively). This is because recognised depreciation (which affects earnings) is greater than maintenance capex (which affects cash flows).

In general, cash distributions in excess of recognised earnings are common for the MLP asset class, traditionally known for solid and predictable stream of cash flow distributions (QRDs). It is generally expected the MLP will continue to distribute cash flows rather than re-invest them; to fund growth, MLPs generally tap into public markets for fresh capital via the issuance of new units. Apart from the absolute amount of distributable cash flows, distribution rights can also impact LP returns. Table 3 assumes that the GP is entitled to 2% of the distribution, leaving 98% of available cash flows to the LPs, or \$4.41.

The excess of the LP QRD over allocated income (\$4.41 less \$3.50 equals \$0.91) remains untaxed in the year of reception. This is referred to as 'tax deferral', since tax is only due on the allocated earnings of \$3.50, at the unit-holder's unique income tax rate. The untaxed portion is 'recaptured' if and when the MLP unit is sold. This recapturing effect is important, as units are liquid and do get traded on the market.⁵

Table 3 assumes a 35% personal income tax rate for comparative purposes, which amounts to \$1.22 due per unit (in reality the tax rate will vary with the unit-holder's unique circumstances). The unit-holder is thus left with net cash inflows of \$4.41 in distribution less \$1.22 tax, or \$3.19. In comparison, corporate shareholders who receive a distribution of \$3.28 (after corporate-tax effect

MLPs eliminate double taxation as income passes directly to unitholders without corporate taxes being applied.

Solid and predictable cash flow distributions (QRDs) are a centrepiece of MLPs' economics; to fund growth, MLPs tap the markets rather than re-investing cash.

MLPs also enjoy the benefits of tax deferral: in early years, cash is greater than income, and this excess is not taxed until later years.

⁵ For more details on recapturing in case of MLP unit sale, see Wells Fargo Securities, "MLP Primer -Fourth Edition: Everything you wanted to know about MLPs but were afraid to ask," Equity Research, 19 November 2010, pp.32-33

of \$1.22 per share) further pay dividend tax rate (assumed 15% but varying with tax-bracket and personal circumstances) of \$0.49, which leaves them with net cash inflows of \$2.79.

In summary, as illustrated in Table 2, higher after-tax investor returns for MLPs than for Ccorporations are driven by (i) greater net cash distributions to owners in the form of QRDs relative to a C-corporation structure, due to a single layer of taxation with no dividend tax on the actual distributions, and (ii) taxable income allocation usually lower than the cash distribution, due to the so-called tax-deferral effect.

1.3. MLPs as an asset class: size and financial performance

MLPs represent a sizeable asset class primarily focused on energy-related industries and natural resources. The total MLP capitalisation at present is approximately \$270bn, of which about 89% (\$241bn) is attributable to energy and natural resources.⁶ MLPs have been a major participant in the build-out of U.S. energy infrastructure. For the period 2005-09, MLPs accounted for 59% of the total domestic natural gas pipeline investments (\$29.3bn), 36% of capacity additions (112bn cubic feet per day), and 53% of the pipeline miles added (11,278 miles).⁷

Predictable recurring cash flows are a key characteristic for the MLP asset class. Since MLPs pay out most of the cash they generate, and since they fund acquisitions and organic investments mostly with external capital in the form of new debt and equity, access to capital is essential for distribution growth and capital expenditure. MLPs generally - and especially MLPs with investment-grade credit ratings - enjoy good capital markets access.

MLPs are usually pitched to investors as an opportunity to reduce portfolio volatility, enhance diversification and expand risk-adjusted returns. The MLP spread over 10-year Treasury bonds has been historically between 200 and 249bps, unprecedentedly widening to nearly 10% (1,000bps) at the height of the financial crisis, before returning back to more familiar levels, around 400bps today. MLPs boast strong historical risk-adjusted performance and low correlation with the overall market (average beta of 0.71 for 2005–09, and 0.65 for 2010).

RELEVANCE OF MLPS TO RENEWABLES 2

2.1. Policy interest

The proposition to introduce MLPs into the renewable sector comes at a time when the policy outlook for renewable energy in the US is uncertain. Section 1603 cash grants expired at the end of 2011, and there is little chance that this incentive will be revived. Looking forward, utility-scale wind projects are eligible for production and investment tax credits (PTCs and ITCs) for projects commissioned by the end of 2012, and solar projects for ITCs until 2016.

In light of this uncertainty, policy-makers and renewable industry advocates have begun to explore alternatives. Extending the benefits of MLPs from the conventional energy sector to renewables is one idea that has gained a bit of traction. Policy-makers at the Department of Energy have raised the possibility of exploiting the MLP structure for renewables; the topic has

National Association of Publicly Traded Partnerships, "Master Limited Partnerships 101: Understanding MLPs," updated 14 October 2011. Over 70% of total MLP market capitalisation is attributable specifically to midstream oil and gas operations. Between 1990 and 2010, the proportion of MLPs engaged in exploration and production as percentage of total MLPs fell from 21% to 10%, and the share of MLPs in oil and gas midstream operations increased from 10% to 44% of all MLPs (from 1994 to 2010, the number of energy MLPs rose from 6 to 72).

⁷ Wells Fargo Securities, "MLP Primer - Fourth Edition: Everything you wanted to know about MLPs but were afraid to ask," Equity Research, 19 November 2010, p.45, based on EIA and partnership data.

surfaced at recent renewable energy conferences; and the Congressional Research Service (CRS) has explored the topic in a recent whitepaper.⁸ Section 7.2 discusses advocacy.

2.2. Benefits for renewables

The expected benefits from allowing renewable energy sources to become qualifying income for MLPs are three-fold: first, they could expand financing availability; second, they could lower financing costs; and third, they could improve returns for clean energy investors. These benefits are of course interrelated.

At present, small, 'retail' investors have limited opportunity to participate directly in renewable project development, apart from holding the stocks of the few public companies that primarily engage in development. MLPs could change that. One aspect of this retail investor opportunity is that local support for community-oriented renewable development could increase, as environmental and socio-economic concerns would then be framed in the context of a potential investment opportunity, which the local community could tap directly.

The MLP structure would likely drive down the cost of capital for US renewable projects for the following reasons:

- Retail investors could arguably accept lower returns than institutional investors
- In the absence of a cash grant, the cost of US renewable financing will be highly dependent on tax equity yields, which tend to be quite high.⁹ Using MLPs in conjunction with tax equity would thus likely reduce the cost of capital.
- Liquidity premiums could also come down, as investors find it easier to trade in and out of positions

Besides reducing the cost of capital, MLPs could drive more M&A and takeover activity in the renewable sector. A more liquid market and a clearer exit strategy might also increase investor appetite for leverage, although this remains a creditor-specific and debtor-specific decision.

3. PRACTICAL CONSIDERATIONS

While MLPs offer potentially superior tax benefits for investors, there are real world considerations to take into account when thinking about launching such vehicles for renewables. Who would back them? What projects would be open to exploiting them? What roles would MLPs play in the financing process? Who would manage such investment vehicles? We explore each of these here.

3.1. Which types of investors would participate in renewable MLPs?

Much of the appeal of current MLPs' lies in the stability of the cash flows they generate, with oil and gas MLPs usually commanding higher yields than pipeline MLPs due to the former's exposure to commodity price sensitivity. While some investors might regard renewable projects as akin to infrastructure projects (low risk, reliable cash flows), others might be concerned about resource intermittency (meaning higher volatility in cash flows) and higher levelised costs of energy. If intermittency and price risk can be mitigated (eg, through solid track record of comparable project performance and secure offtake agreements that lock in guaranteed prices), traditional MLP investors could be amenable to renewable MLPs, given appealing risk-adjusted returns.

- 8 Congressional Research Service, Master limited partnerships: a policy option for the renewable energy industry, Sherlock, M. and Keightley, M. P., 28 June 2011
- In a standard tax equity deal known as a 'yield-contingent' partnership flip, a typical yield would be roughly 9 8-9%. That is, an investor would structure the deal such that his expected after-tax return would be in this range. (Note that, in this case, 'after-tax' means 'after corporate taxes' - but before any taxes paid by individual shareholders on distributions.)

Three potential benefits for renewable projects operating as MLPs: broader financing base, lower cost of financing, improved investor returns

Policy can also threaten revenue stability. In the short and medium term, as different renewable technologies progress toward grid parity, investor appetite for renewable MLPs will be driven by judgment about perceived policy risks such as changes to state renewable portfolio standards or reforms of renewable tax incentives.

Retail vs. institutional investors

Judging from current ownership make-up of the existing MLP market, renewable MLPs would likely initially be geared toward retail investors with institutional investor participation potentially growing as the market grows, subject to applicable restrictions.

Traditionally, MLP investors have been mostly retail and long-term oriented, comprising a combination of family wealth offices, MLP-dedicated funds and newly formed closed-end funds. In 2009, retail investors accounted for the majority of MLP ownership (Figure 1). Institutional ownership has grown particularly since 2009 due to MLPs' attractive yield characteristics relative to alternatives. Since mutual funds were allowed to own MLPs in 2004 under certain restrictions. their exposure has been limited but increasing. Recent industry innovation includes the first MLP mutual fund as a part of the SteelPath Mutual Path Family¹⁰ in 2010, and the first exchangetraded fund by Alerian, the company managing the AMX index.

Tax-exempt investment vehicles such as pension funds, endowment funds, 401(k)s and individual retirement accounts (IRAs) are not typically owners of MLP units, because MLPs generate unrelated business taxable income (UBTI), which is taxable at corporate rates. Even if such hurdles could be overcome through creative structuring (eg, pension funds investing in corporations holding MLPs) at the expense of some traditional MLP benefits - a challenge in itself for the conventional MLP industry - managers would still likely find it hard to identify renewable project investments that would be large enough to be material with respect to the size of the pension fund's assets.

Regardless of their past exposure to other kinds of MLPs, targeting any type of investor - retail or institutional - would likely entail some degree of educational marketing to explain renewable project investments and to compare their economics and risks to other types of MLP investments.

3.2. Which projects would qualify?

As MLPs have traditionally been used to finance mature technologies with stable cash flow streams, their initial adoption in the renewable sector is bound to be geared toward projects employing established low-risk technologies (wind, PV, and proven geothermal). The cash flows of installed renewable projects are generally stable, as revenues are often driven by long-term power purchase agreements (PPAs) with pre-defined offtake prices.¹¹ Even relatively less mature technologies - such as offshore wind and solar thermal - could potentially be within the realm of MLP investor appetite, provided the returns are right.¹²

Renewable MLPs should initially attract interest from retail investors and eventually also institutional investors, though pension funds (among others) may not be a good fit.

Figure 1: MLP ownership by investor type, 2009



Source: Wells Fargo Securities

¹⁰ The American Jobs Creation Act from October 2004 permitted mutual funds to own MLPs as long as they invest less than 25% of the fund's asset value in MLPs, and fund less than 10% of any one MLP. The SteelPath Funds elected to be a corporation paying corporate-level income taxes and allowed to invest more than 25% of its funds in MLPs.

¹¹ This is increasingly true of wind projects, for example. Whereas 2.8GW of the 9.5GW of announced wind projects in 2008 were merchant (ie, no PPA), the portion of merchant projects in 2010-11 was negligible.

¹² The project risk for these less mature technologies is higher than others, but not excessive - a typical term loan spread for offshore wind may be 300bps and for solar thermal may be 325bps, compared to 235bps for wind and solar PV. An example of a technology that may not yet be mature enough for MLP adoption could be marine (tidal or wave), where typical term loan spread may be 500bps. (These spreads come from Bloomberg New Energy Finance Research Note, Levelised cost of energy update: Q3 2011 18 October 2011, Appendix B: Term financing data.)

Extending gualification of MLPs beyond renewable projects and into clean energy infrastructure could garner further interest from investors

Congress could extend MLP eligibility to technologies that meet the criteria for the cash grant or renewable tax incentives. Alternatively, the definition of qualified sources could be expanded to technologies that indirectly support the larger-scale use of renewable energy, such as energy storage and transmission technologies. Since many MLP investments have traditionally been in energy infrastructure, we expect an expanded definition of qualifying sources, which includes storage and transmission, to attract additional investor interest.

3.3. What roles would MLPs play in the financing process?

MLPs could facilitate the financing of renewable in two key ways. They could offer the owner of an existing project a handy way to exit, raise funds, and develop other projects. Or they could simply allow developers of new projects to raise financing.

Exit MLPs

Under an exit MLP, the GP would buy out the original asset owner, who in turn would be able to channel the received capital toward new projects. The GP could purchase an asset (or assets) from a single developer or put together a portfolio of renewable projects by developers of varying size and geographic location – a risk-diversification strategy in effect, and an opportunity for midsize and small-size developers in particular to exit projects in a more liquid market.

Exit MLPs could work in conjunction with tax equity investment during a project's development stage. The sponsor of a wind farm, for example, could use a partner in the form of a tax equity investor to fund the early stages of a project, and then spin off the entity through an MLP, once the tax equity investor's position has been reduced. (Typical tax equity deals often involve the tax equity investor relinquishing partial or full ownership of the project once the tax benefits have been realised.)

Apart from a cleaner ownership structure and active cash flow generation, at this point the asset also benefits from historical operational data, which can mitigate the uncertainty surrounding a revenue model reliant on an intermittent energy source. This makes the project more suitable for an MLP structure. To become attractive clients for public offering work by the investment banks, an MLP would have to reach significant scale. This could initially make large-scale projects more attractive MLP targets.

Development MLPs

There are various ways MLP structures can be combined with traditional renewable project development, given the presence of various tax advantages for which renewables qualify. Developers could incorporate as MLPs and either develop projects independently, or continue to do so in conjunction with tax equity investors. It is possible that investment companies structured as MLPs (investor MLPs) could replace tax equity investors or investment MLPs could fund projects in conjunction with tax equity investors.

Note that many MLPs might be hybrids of the two types above - both acquiring existing projects and developing new ones.

3.4. Who would be in charge?

There are multiple candidates to manage potential clean energy MLPs. Renewable project sponsors, principals from traditional MLPs, or other parties such as financial companies with industry expertise could all potentially do the job.

Those who put a premium on expertise in MLP operations expect the first GPs to be those experienced running such funds focussed on other infrastructure areas. Quickly moving up the managerial learning curve, developers above a certain threshold who already operate a number of renewable projects could also become GPs themselves. Their revenue stream would be in the

Exit MLPs could work in conjunction with tax equity and could draw on historical operational data to bolster investor confidence around cash flow reliability

form of IDRs, redeploying the capital inflows from sales of units to LPs toward future activities. Large diversified companies (eg, BP) could 'drop in' renewable assets into an MLP and remain the corporate parent company. In effect, the MLP assets would remain under control of the GP, whose management could come directly from the parent company (see Figure 5 in the appendix).

INTERACTIONS BETWEEN MLPS AND TAX INCENTIVES 4

4.1. Two rules

The 'passive loss' rule and the 'at risk' rule, particular to MLPs, stand to constrain the use of tax credits and depreciation allocations by MLP investors in renewable project development, particularly for retail investors. An explanation of these rules, and the impact of not changing them, are summarised in Table 3 and elaborated below.

Table 3: Rules constraining usage of tax credits by MLP investors

| Rule | Description | Applicability | Implications if the rules are not changed |
|---------------------|--|---|--|
| 'At risk' rule | Losses can be claimed only up to the amount the unit-holder has invested in the MLP, regardless of the amount of losses generated (which increases with leverage) | Applicable to (ie, rule-bound investors): individuals closely held C-corporations where five or fewer individuals own more than 50% of the stock shareholders of S-corporations partners/members in partnerships/LLCs Not applicable to (ie, rule-exempt investors): C-corporations; S corporations; partnerships/LLCs | Lower unit-holder IRR due to restrictions that prevent the full utilisation of the benefits of leverage in renewable projects Thinner pool of retail investors who could participate in MLPs |
| 'Passive loss' rule | Allocated losses from an MLP can only be used to offset passive income (or active income from that same MLP) | | Lower unit-holder IRR because investor must carry forward, rather than immediately make use of, recognised losses Thinner pool of retail investors who could participate in MLPs |

Source: Bloomberg New Energy Finance

LPs in the same MLP can achieve very different returns, depending on whether they are bound by the 'passive loss' and 'at risk' rules. The entities subject to the two rules are subsequently referred to as 'rule-bound investors' and those not subject to the rules as 'rule-exempt investors.'

MLPs and 'at risk' rules

'At risk' rules were introduced in the mid-1980s to curtail the use of partnerships as vehicles for tax-motivated investments that relied on the allocation of losses to investors as a way of generating returns, often through highly levered activities.

These rules restrict the losses investors can claim to the amount they actually stand to lose.¹³ Hence, leveraging a renewable project through a non-recourse loan cannot provide additional basis against which losses can be taken. For example, if an LP purchases \$1,000 worth of shares in an MLP, and the MLP takes on a \$9,000 non-recourse loan and passes through \$,1,500 of losses to an LP, this LP can claim losses only up to \$1,000. The remaining \$500, disallowed in the current year due to 'at risk' limitations, can be used in subsequent years, but only to the extent the LP's 'at risk' amount increases (ie, use against next year's allocated positive income).

'At risk' rules: implications if the rules are not changed

Under these rules, rule-bound investors would find it harder to fully utilise the benefits of leverage in renewable projects, in relation to the amount of passive losses that can be recognised. This aspect is crucial for renewable projects, since most deals in the renewable sector are usually levered (in the range of 70-80% for solar PV and 65-75% for wind¹⁴).

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'At risk' rules prevent investors from claiming more losses than the amount they invested in an MLP

¹³ IRC Sec. 465

¹⁴ Bloomberg New Energy Finance Research Note, Levelised cost of energy update: Q3 2011, 18 October 2011

MLPs and 'passive loss' rules

Early in the life of a capital-intensive renewable project with front-loaded expenditures and postcommissioning cash flows, an MLP structure would generate negative income - also referred to as a 'passive loss' - for its LPs. This negative income occurs when the MLP passes through tax credits and allowable deductions (including accelerated depreciation) in excess of the income received or accrued for the year.

Under current MLP provisions, rule-bound LPs can use passive losses only to offset passive income, which excludes salaries, wages, retirement income and gains from stocks and bonds (these are all considered "active' income). Thus, rule-bound investors who only have active income would have to carry forward the passive losses, and could only use them to offset the positive income allocations from the same MLP in future periods. In the case of rule-bound investors who hold multiple MLP interests, since MLP rules apply on an entity-by-entity basis, losses from one MLP cannot be used to offset income from a different MLP.

'Passive loss' rules: implications if the rules are not changed

a. Implications for rule-bound unit-holders (eg, individuals):

The 'passive loss' rule thus restricts how LPs can use the benefits associated with MACRs and tax credits. If the LP is forced to carry forward the passive losses, the rule results in lower unitholder IRR, since the benefits are realised further in the future (ie, time value of money). Without changes to the tax code, while it would still be possible to identify a pool of retail investors with passive income, the pool would be much smaller than if the rule were altered.

b. Implications for rule-exempt unit-holders (eg, corporations):

On the other hand, corporations are not bound by passive loss rules by law, and would thus be able to utilise passive losses right away. Corporations would then be in the position to choose between investing in an MLP and pursuing direct involvement as a tax equity investor. Any decision by corporations to invest in development MLPs would involve evaluating the trade-offs between a bespoke tax equity deal tailored to their unique circumstances and a more liquid investment via an MLP.

4.2. Can MLPs and tax incentives work together?

A change in both the 'at risk' and 'passive loss' rules would enable investors, including retail investors, to maximise the joint benefits from a single layer of taxation, leverage, depreciation allocation and tax credits. In such a scenario, instead of relying on a tax equity investor, a developer MLP would be able to use capital raised on public markets, by selling units in which tax benefits and losses pass through to the LPs. These losses could be immediately monetised against the individual investor's own taxable income. An investor MLP could raise capital on similar grounds. The 'tax equity investor' would then in effect be the general public through the MLP vehicle.

Without changes, it is almost impossible for single-project MLPs to fully monetise tax credits and depreciation benefits; this decreases their attractiveness as an investment vehicle for renewable project development.

Workarounds

There are at least three potential ways to circumvent this problem but none are straightforward:

 Focus on exits – as explained in Section 3.3. exit MLPs could work in conjunction with tax equity. The tax equity investor funds the project's early stages; recoups the investment via tax benefits that appear early in the project lifetime, such as MACRS and investment tax credits (ITC); and then the entity is spun off to the MLP investor who harvests the steady stream of

'Passive loss' rules restrict investors' usage of MLP's losses: these can only be used to offset passive income or active income from the same MLP

Changing the 'passive loss' rule could enable developer MLPs to more readily attract interest, as individual investors could then immediately monetise losses against their own taxable income.

There may be three workarounds to address the problem of marrying the MLP passive loss rule with tax incentives

cash flows for the remaining lifetime of the project. In this way, the tax incentives and the MLP incentives are both exploited, but at different periods.

- Split the MLP and the tax investor hypothetically, one could envision a three-party structure featuring a developer, a tax equity investor, and an investor MLP. Most of the investor MLP's returns could come from the project's cash flows (which he would share with the developer); most of the tax equity investor's from the tax benefits. Such a structure could insulate the investor MLP from the complications associated with these rules. However, even if legally feasible, this structure is cumbersome and probably not attractive to either the tax equity or MLP investor, as they would have to share the portion of cash flows that do not flow to the developer.15
- Operate multiple projects in parallel under the same MLP this discussion has mostly assumed a single-project MLP. However, a portfolio approach might circumvent the issue. Changes to passive loss and at risk rules would be less important for MLPs that manage a portfolio of operating cash-generating projects; for these types of MLPs, the losses of one project could offset income of another project, so that on the whole, the losses are effectively absorbed. Again, it is the unit-holder, not the MLP, who is prohibited from employing passive losses from one entity to offset income from another entity. Yet, while a portfolio approach can potentially circumvent the passive loss issue, it requires careful synchronisation, to ensure that some projects are operating profitably when new projects are delivering losses.

5. **RENEWABLE MLP ECONOMICS**

5.1. Assumptions

To estimate the effect of the MLP structure on renewable projects, we created financial models for a hypothetical 100MW wind farm under a typical tax equity deal: an investor participates alongside a developer through a 10-year partnership flip structure using PTCs.¹⁶ We explore the impact on project economics if either the developer or the tax equity investor is structured as an MLP. Table 4 below summarises key assumptions about the project and its financial structure, and Table 5 summarises assumptions specific to MLP modelling.

| Category | Assumptions | | |
|--|--|------------|---------------|
| Nameplate capacity | 100MW | | |
| Electricity price | \$50 / MWh | | |
| Capacity factor | 30% | | |
| Developer fee | \$ 25.9m | | |
| Total investment required | \$ 198.4m | | |
| Equity contribution allocation | 61.5% from tax equity investor, 38.5% from developer | | |
| Developer equity back-leveraged? | Yes (50%) | | |
| Benefits allocation | Years 1-5 | Years 6-10 | After year 10 |
| Cash flow allocation % to developer | 64% | 40% | 95% |
| Depreciation allocation % to developer | 1% | 40% | 100% |
| PTC allocation % to developer | 1% | 1% | 1% |

Table 4: Project assumptions

Source: Bloomberg New Energy Finance Note: Where allocation is less than 100%, the remaining allocation (eg, 99% of PTC and 60% of project cash flows in years 6-10) goes to tax equity investor.

- 15 The 'three-party' and 'exit MLP' structures described in these above two bullet points are similar: both structures involve a developer, a tax equity investor, and an MLP investor. The difference is that whereas the three-party structure has the three parties operating simultaneously, the 'exit MLP' structure has the tax equity investor exiting at the end of some defined period at which point the MLP investor enters.
- 16 This, and other tax equity structures, are explained in more detail in Bloomberg New Energy Finance Whitepaper, "The return - and returns - of tax equity for US renewables", 21 November 2011.

The returns are calculated from the after-tax perspective of a shareholder / unit-holder who owns all shares/units of either the developer or the investor entity. We have considered each entity under the following structures: (1) C-corporation; (2) MLP - no rule changes (ie, no changes to 'passive loss' and 'at risk' rules); and (3) MLP with relaxed rules, which enable unit-holders to take full advantage of tax benefits. In total, then, we produced six different models: two participants (developer and investor) x three structures (C-corporation, MLP with no rule changes, and MLP with relaxed rules).

Table 5: MLP modelling assumptions

| Category | Explanation of assumption |
|--|---|
| Project-based approach and tax-absorption capacity | <u>Developer entity is assumed to be involved only in this project</u> without any additional sources of earning – ie, he does not own a portfolio of projects. Thus, a developer structured as a C-corporation cannot absorb all tax benefits (where such are available) due to insufficient income. |
| | <u>Tax equity investor is assumed to have a sufficiently large pre-tax earnings base,</u> against which to apply all tax benefits – a primary motivation behind tax equity deals. |
| Focus on rule-bound unit-holders | Modelling adopts the <u>perspective of unit-holders who are currently bound by the 'passive</u> <u>loss' and 'at risk' rules</u> (individuals, shareholders of S-corporations, and partners/members in partnerships/LLCs.). The "MLP with relaxed rules" scenario explores the returns if these unit-holders were not bound to these rules. The returns for rule-exempt unit-holders (C-corporations, S-corporations, and partnerships/LLCs) are not avalated borg. (Neto that "rule avamt unit holders" in part |
| | the same as "rule-bound unit-holders with relaxed rules": entities such as C-corporations are subject to different rules than are rule-bound unit-holders regarding the tax exemption of cash distributions.) |
| Applicability of 'passive loss' and 'at risk' rules to PTCs | PTCs are modelled as subject to 'passive loss' rules, unless the rules are relaxed. |
| | The application of 'at risk' rules to PTCs is of minor significance for our modelling since in most cases the total amount of passive losses recognisable is below the 'at-risk' ceiling for passive loss claim recognition, which amounts to the sum of the unit-holder's initial investment and recognised revenues. |
| Monetised passive losses | Monetised passive losses refer to the benefits from applying leftover depreciation against other earnings. <u>Passive losses cannot be monetised unless the 'passive loss'</u> <u>rule is relaxed</u> or unless the unit-holder has passive income. |
| Passive income | Passive income excludes salaries, wages, retirement income and gains from stocks and bonds, and is modelled as zero for rule-bound unit-holders. |
| Pre-tax cash inflows | All cash generated by the project after covering operating costs is assumed to be distributed as dividends or QRDs. <u>No cash is retained within the entity.</u> "Pre-tax cash inflows" refer to cash distributions to shareholders/unit-holders before any corporate, dividend or personal income taxes. |
| Leftover PTCs | Portion of <u>PTCs available to offset other taxes due</u> (corporate or personal income) after PTCs have been used to offset any taxes due by the project itself. |
| Sale of shares/units | Modelling assumes the <u>owner holds on to his shares</u> in the entity, rather than sell them (sale would trigger re-capture of taxes deferred though an MLP structure and would trigger capital gains taxes under C-corporation structure). |

Source: Bloomberg New Energy Finance

5.2. Analysis of returns

Figure 2 presents the NPV breakdowns and IRRs under a 10-year partnership flip tax equity structure from both the developer and investor perspectives, and with each party structured as either a C-corporation or as an MLP. Due to the allocation of structure of PTCS, MACRs and revenues, developer returns are primarily cash-based, and investor returns primarily based on tax benefits.



Figure 2: NPV breakdown and IRR for tax equity wind deal – with each party structured as either C-corporation or MLP

Source: Bloomberg New Energy Finance

Developer perspective

The difference between the NPV of a developer structured as a C-corporation versus as an MLP is solely driven by dividend taxes of \$4.0m, paid by corporate shareholders. Developer returns are identical under either MLP scenario ("no rule changes" scenario vs. "relaxed rules" scenario), since allocated MACRS and PTCs are used in full to offset incoming earnings, and are thus not affected by the applicability of 'passive loss' or 'at risk' provisions.

Investor perspective

Both a corporate structure and an MLP structure with relaxed rules allow the investor entity to take full advantage of available PTCs and depreciation benefits. Shareholder dividend taxes of \$4.3m drive the difference in NPV between the two structures. An MLP without rule changes limits the absorption of all MACRS benefits and of any PTCs, making them virtually unusable. Due to a combination of a limited income stream and large allocation of tax benefits to the investor, the 'at risk' rule also affects investor economics by preventing the recognition of all MACRS allocated from the MLP.

In summary, for this hypothetical project and financial structure, incorporating as MLPs increases IRR for both the developer and the investor by roughly 1.5% (percentage points) and increases NPV by \$4.0–4.3m, from the perspective of the shareholders / unit-holders. Relaxation of the 'passive loss' rule is critical for the tax equity investor to realise the benefits of both tax credits and MLP incentives. Separate modelling that Bloomberg New Energy Finance has conducted (not shown) clearly demonstrates that MLPs alone – without the PTC and MACRS benefits – are insufficient to make typical renewable projects economically viable.

MLP benefits lift IRR and NPV for both parties. Relaxing the passive loss rule is critical to the investor. MLP benefits alone, without tax benefits, cannot make typical renewable projects viable.

6. **MARKET SIZE**

The market size for renewable MLPs is not easy to estimate, particularly in view of policy uncertainty with regard to the formulation of which renewable energy sources would be deemed as qualifying, the decision about whether to amend rules with tax credit implications, and the fate of other policy incentives for the renewable sector.

Nevertheless, below are a few figures to frame an analysis on renewable MLPs' potential market size. The demand for renewable MLPs will depend on investor interest against the backdrop of the current macroeconomic climate, with a possible premium for stable and predictable cash flows in a volatile financial environment.



Figure 3: Selected indicators of potential market size for renewable MLPs (\$bn)

Source: Bloomberg New Energy Finance, Bloomberg terminal data, US Partnership for Renewable Energy Finance Notes: (1) Selected companies included in the 'market capitalisation' column are public companies whose business comes primarily from renewable project development. These include EDP Renovaveis (headquartered in Portugal), Enel Green Power (Italy), China Longyuan Power Group (China), Innnergex Renewable (Canada), Ormat Technologies (US) and Energy Development Corporation (Philippines). (2) 'Tax equity funding available' refers to the amount of tax equity likely to be available in 2012 from established tax equity providers; 'tax equity gap' refers to the shortfall - the minimal amount of incremental tax equity likely to be needed to support growth of US renewable energy project development.

6.1. The need

For renewable project development to maintain growth in 2012 that is in line with 2011 build rates, the industry will require at least \$7.5bn of tax equity. Of this, the established tax equity providers will contribute \$3.6bn, leaving a \$3.9bn shortfall to be addressed.¹⁷ The resultant tax equity gap will have to be filled by the same providers raising their stakes, new players entering the tax equity market or, alternatively, vehicles such as renewable MLPs that can operate as tax equity investors or co-investors.

¹⁷ Both numbers are estimates from the US Partnership for Renewable Energy Finance. A deeper analysis of this topic can be found in Bloomberg New Energy Finance Whitepaper, "The return - and returns - of tax equity for US renewables", 21 November 2011.

MLP investments in natural gas pipelines and the market cap of selected companies focused on renewable project development two proxies for investment appetite in renewable MLPs - were in the \$28-29bn range.

6.2. The supply

Against this identified need, the market size of potential supply is substantial. Figure 3 shows two potential benchmarks of supply - MLP investments in natural gas pipelines and market capitalisation of six companies focused on renewable energy project development: EDP Renovaveis, Enel Green Power, China Longyuan Power Group, Innnergex Renewable, Ormat Technologies and Energy Development Corporation. (Barring the introduction of renewable MLPs, purchasing stocks of these companies will remain the only straightforward way for a retail investor to gain significant direct exposure to renewable project development investments.)

Thinking about market size benchmarks on an even larger scale, the markets for renewable debt and equity worldwide are substantial. There are \$235bn worth of green bonds globally, defined as debt issued by corporations, municipalities and other borrowers to fund clean-energy, energyefficiency or climate change-related project, according to an estimate based on data compiled by Bloomberg New Energy Finance.¹⁸ On the equity side, the total market capitalisation of about 140 large, actively traded public cleantech companies is approximately \$400bn. (As another benchmark, the current total market capitalisation of existing MLPs is the same order of magnitude – \$270bn, of which \$241bn is attributable to energy and natural resources.)

The market size benchmarks explode still more by looking beyond existing investments in the renewable world. Capturing a very small percentage of retail investor funds can deliver substantial financial inflows to the renewable sector. According to data from the US Federal Reserve, the market value of equity shares held by households and non-profit organisations in the US amounted to \$19.2 trillion for the second quarter of 2011.¹⁹ Thus, attracting a minute fraction of the retail investor space with a value proposition which allows retail investors exposure to renewable infrastructure under operation or under development can expand considerably the available sources of financing for renewable projects.

7. **POLITICAL OUTLOOK**

7.1. MLPs under Congressional scrutiny

Any discussions about expanding MLP "gualified income" to include renewable energy activities will be impacted by the ongoing debates in Washington over tax reform and renewable energy support. Both are taking place within the larger context of the 2012 elections and ongoing efforts to slash the federal budget deficit.

Regarding tax reform, Congress and the Administration have begun to scrutinise more carefully the subject of 'pass-through entities'. These entities - which include partnerships, S-corporations, limited liability companies, and sole proprietorships - account for some 90% of businesses and employ more than half the private sector workforce.²⁰ Treasury Secretary Timothy Geithner commented at a Senate Finance Committee hearing in February that Congress should "revisit" rules that permit businesses to choose their organisational structure. Senator Max Baucus (D-MT), Chairman of the Joint Committee on Taxation, has suggested larger pass-throughs could be taxed as corporations as part of a broader corporate tax reform effort. In March, tax expert and law professor at Columbia Law School Michael Graetz drew the attention of the Senate Finance Committee on Tax Reform specifically to partnerships with revenue above \$50m, and to the fact that the increase in pass-throughs since 1990 will shrink corporate revenues by about \$140bn in

18 Bloomberg New Energy Finance, Research Note, "Bond, green bond – licensed to thrill investors." 2 December 2011.

- 19 Federal Reserve Statistical Release, Z.1 Flow of Funds Accounts of the United States, released on September 16, 2011, and available at http://www.federalreserve.gov/releases/z1/current/
- 20 Ernst & Young, "Charting a course on tax reform: how the focus on pass-through entities could shape the debate," July 2011

The politics around **MLPs are fraught: tax** reform and support for renewables are contentious issues, and even more so in an election year.

2015, with only two-thirds of that amount recaptured through individual tax filings.²¹ Given Republican resistance to taxing large pass-throughs as corporations, any discussion is likely to be heated and prolonged.

Such controversy has implications for MLPs, since they fall directly under the 'pass-through' entity category, and will thus be affected by any large-scale changes to the category's tax status.

According to the Joint Committee on Taxation, the provision which currently allows companies participating in "certain energy-related activities"²² to operate as MLPs will lead to projected revenue losses of approximately \$2.8bn for 2010-14.²³ This applies to current MLP eligibility; extending the MLP eligibility to renewables would lead to further losses of federal revenue. (For comparison, the federal revenue losses associated with the MACRS benefits currently enjoyed by renewables is projected to be \$1.1bn for 2010-14.24)

On the other hand, any extreme measures to broaden the tax base, such as requiring all MLPs to structure as C-corporations, while advantageous from a fiscal point of view, "could place greater capital constraints on, and potentially reduce investment in, industries currently able to use the MLP structure," according to the CRS whitepaper. These would likely face intense opposition from powerful private interests representing an asset class with market capitalisation of \$270bn.

Most likely scenario regarding the future tax status of conventional energy MLPs

For conventional energy MLPs, the most likely scenario will be to preserve the status quo. Indeed, in early September, Democrats on the House Ways and Means Committee circulated potential revenue-raising options for submission to the Joint Select Committee on Deficit Reduction (the so-called Super Committee), none of which included any changes to the tax treatment of MLPs or other pass-through entities. According to Bank of America Merrill Lynch's monthly sector presentation on energy MLPs, a change in MLP tax status in the short term is unlikely for "reasons pertaining to policy (energy infrastructure, jobs, lack of revenue raised) and politics (important constituencies in current Congress not inclined to change pass-through taxation)."25

7.2. Assessment of political viability for renewable MLPs

Looking beyond the Treasury cash grant and the tax credits, some renewables advocates have begun lobbying to have MLPs extended to renewables. Third Way, a centrist think tank, will soon be publishing a report advocating for clean energy MLPs.²⁶ The Renewables for Publicly Traded Partnerships Group, an organisation working toward "modification of tax law allowing greater utilisation of renewable energy tax incentives", enjoys wide industry membership including the American Wind Energy Association (AWEA), NextEra, Shell Wind Energy, Vestas, GE, and BrightSource. The group paid lobbying firm Capitol Counsel LLC \$90,000 in the second and third quarters of 2011 to make its case to Congress, according to Senate filings. The efforts are being spearheaded by former Representative Jim McCrery of Louisiana, top Republican on the House Ways and Means Committee in 2007 and 2008, who is now a Capitol Counsel lobbyist.²⁷

25 Bank of America Merrill Lynch, "Energy MLPs: Monthly Sector Presentation," Equity/Americas, 09 September 2011

- 26 Report was not yet published as of 04 January 2011
- 27 According to a lobbying registration in July 2011 filed by Capitol Counsel, a government relations firm focusing on political analysis and advocacy.

²¹ Martin A. Sullivan, "Passthroughs Shrink the Corporate Tax by \$140 Billion," Tax Notes, February 28 2011, pp.987-989.

²² Phrasing in the Joint Committee on Taxation's report is no more specific than this, but we assume that these activities refer to staples of the energy MLP business, such as pipeline and other energy infrastructure operations.

²³ U.S. Congress, Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2010 - 2014, committee print, 111th Cong., 15 December 2010, JCS-3-10, p. 37.

²⁴ Ibid

However, despite these lobbying efforts, given the current political climate, gathering bipartisan support to facilitate advancement of the renewable MLP cause is not likely at least until next year's elections.

Beyond 2012, if a policy to extend MLPs to renewables were implemented, it would be unlikely to actually supplant the tax credit system. Rather, according to a number of sources - including the Bipartisan Policy Center, the Congressional Research Service and a several tax lawyers and investors - renewable MLPs should complement existing incentives.

THE BIOFUELS ANGLE 8.

MLP gualifying income was extended to ethanol and biodiesel storage and transportation in 2008. The consequences of this extension are not indicative of the attractiveness of MLPs for renewables, however, since much of the MLP-funded ethanol investments in the past would have occurred regardless of this extension.

The MLP ethanol players were well established thanks to their involvement in oil and gas. They branched into an activity that requires marginal investment in already existing infrastructure. This infrastructure investment had originally been driven by policy developments such as the federal renewable fuel standard. Pipeline operators structured as MLPs had been installing ethanol storage capabilities well before 2008 and had been fitting these ethanol activities into their 'noneligible income' portion of their MLP business (to preserve their favourable partnership tax treatment, MLPs must derive 90% of their gross income from eligible sources; this thus allows up to 10% of income to come from non-eligible sources).

Ethanol-related investments that have occurred since 2008 and which have qualified as MLP eligible do not constitute a substantial departure from a typical pipeline operator MLP's core business model. In reality, the 2008 extension of gualifying income might have been more of a proactive measure to enable the build-out of Magellan Midstream Partners LP's proposed largescale (\$4bn, 1,800-mile) ethanol pipeline from the Midwest to the Northeast.²⁸ This project is currently on hold due to an inability secure funding from the US Department of Energy.

²⁸ Magellan Midstream investor presentation, UBS MLP Conference, September 2008. Presentation identifies renewable fuels as driver of Magellan's expansion projects and notes that the Renewable Fuel Standard mandate (36bn gallons by 2022) "facilitates the need for dedicated ethanol pipeline... [but] qualifying income and federal loan guarantee are critical for project to proceed." In 2008, Magellan successfully lobbied to update the definition of qualifying income for MLPs to include biofuels. (See http://soprweb.senate.gov/index.cfm?event=getFilingDetails&filingID=5D28D3FC-1409-4CC0-BF94-023731F3710B; and Section 208 of bill HR1424)

Appendix



Source: Congressional Research Service, "Master limited partnerships: a policy option for the renewable energy industry," Sherlock, M. and Keightley, M. P., 28 June 2011. Note: Just as the operating company shown here includes coal, oil, and natural gas subsidiaries, a renewable MLP's operating company could include a portfolio of renewable projects.





Source: National Association of Publicly Traded Partnerships, "Master Limited Partnerships 101: Understanding MLPs," updated 14 October 2011.

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