RENEWABLE FUELS AS QUALIFYING INCOME

Background

As one means of reducing dependence on foreign oil, the Energy Policy Act of 2005 requires that gasoline sold in the United States contain 4.7 billion gallons of renewable fuels, including ethanol and biodiesel, in 2007 and 5.4 billion in 2008, increasing to 7.5 billion gallons in 2012. This year President Bush increased that goal, proposing a mandatory fuels standard to require 35 billion gallons of renewable and other alternative fuels in2017.

There is a significant obstacle to meeting this goal: transportation. Ethanol and biodiesel are currently transported primarily via rail, truck, and barges. Even at conservative estimates, rail and truck transportation results in millions of dollars of overspending when compared to relatively low-cost pipeline transport. Moreover, they are inefficient, using substantial amounts of energy themselves. Most importantly, our rail truck and barge capacity will be insufficient to meet the growing demand for alternative fuels.

The best answer would be to transport these fuels via pipelines, as is done with petroleum-based fuels. However, existing pipelines are viewed as unsuitable for ethanol or biodiesel transport because of several concerns:

- Ethanol is more corrosive than petroleum products and is likely to cause corrosion and possibly leaks in existing pipelines;
- Renewable fuels may pick up water and other impurities along the way;
- Locations of existing pipelines are based on where petroleum production occurs and not close to ethanol and biodiesel production;
- Historical low volumes have made investments in renewable fuels infrastructure cost-prohibitive.

If renewable fuels are to become an important part of the energy mix, research will need to be undertaken to solve the corrosion problem. Then pipelines and storage facilities will have to be retrofitted for ethanol and biodiesel; new dedicated ethanol or biodiesel facilities will have to be constructed to take advantage of efficient pipeline transport—or both. Economic incentives are needed to make it worthwhile for pipeline companies and the alternative fuels industry to make that kind of investment.

The transportation issue was recognized in the 2007 report of the National Commission on Energy Policy, which listed among its recommendations, “Address other hurdles to biofuels

deployment, *including hurdles related to the deployment of critical supporting infrastructures (including gathering systems, distribution systems, and refueling facilities)* and compatible vehicle technologies."[1]

The Potential Role of PTPs

A major portion of the nation's energy pipelines are now owned by PTPs. Almost half of the annual throughput of refined petroleum products and a quarter of crude oil throughput flow through PTP-owned pipelines. The trend towards PTP ownership of pipeline systems shows no sign of abating, as PTPs have shown themselves to be the most efficient vehicle for capital formation and ownership of these assets.

There is clearly great potential for PTPs to assume the same role in providing alternative fuels infrastructure that they have been playing in providing infrastructure for petroleum products. Several Association members are already experiencing increased revenue opportunities associated with ethanol storage, distribution and transportation.

This potential cannot currently be realized, however, because renewable fuels such as ethanol and biodiesel are not considered "natural resources" under the rules governing qualifying income for PTPs. Section 7704 of the tax code, written twenty years ago before renewable fuels were a major consideration in energy policy, allows a PTP to be taxed as a partnership if at least 90 percent of its income comes from, among other things, income and gain from mineral or natural resources activities.

Qualifying natural resources activities include exploration, marketing, mining, processing, production, refining, storage, or transportation of any mineral or natural resource. "Mineral and natural resources" were defined in the Technical and Miscellaneous Revenue Act of 1988 as any product for which a depletion deduction is allowable under section 611, except for a) soil, sod, turf, water, and mosses, and b) minerals from sea water, the air, or similar inexhaustible resources. Since ethanol, biodiesel, and other renewable fuels are derived from products that do not meet this definition, PTPs are foreclosed from undertaking transportation, storage, and distribution of these fuels unless the activity generates such small amounts of income that there is no danger of their failing the qualifying income test.

Proposed Legislation

The Association has worked with Congressional supporters to develop legislation that would resolve this issue and allow PTPs to be full participants in developing infrastructure for renewable fuels. The proposed legislation would amend section 7704 to treat income from transportation and storage of renewable fuels, including ethanol and biodiesel, as qualifying income under section 7704. It is our hope that this legislation can be enacted in 2008.

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[1] National Commission on Energy Policy, *Energy Policy Recommendations to the President and the 110th Congress,* April 2007, p. 8 (emphasis added).

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