Smarter Finance for Cleaner Energy: Open Up Master Limited Partnerships (MLPs) and Real Estate Investment Trusts (REITs) to Renewable Energy Investment

Felix Mormann
Texas A&M University School of Law, mormann@law.tamu.edu

Dan Reicher

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INVEST BUT REFORM

Smarter Finance for Cleaner Energy: Open Up Master Limited Partnerships (MLPs) and Real Estate Investment Trusts (REITs) to Renewable Energy Investment

Felix Mormann and Dan Reicher

Summary

Master Limited Partnerships (MLPs) and Real Estate Investment Trusts (REITs)—both well-established investment structures—should be opened up to renewable energy investment. MLPs and, more recently, REITs have a proven track record for promoting oil, gas, and other traditional energy sources. When extended to renewable energy projects these tools will help promote growth, move renewables closer to subsidy independence, and vastly broaden the base of investors in America’s energy economy. The extension of MLPs and REITs to renewables enjoys significant support from the investment and clean energy communities. In addition, MLPs for renewables also enjoy bipartisan political backing in Congress.

Background

The worldwide race for technological leadership in clean and renewable energy is on. Valued at $2.3 trillion globally over the next 10 years, the clean energy market already employs close to 3 million U.S. workers and continues to grow, making clean energy a key piece of America’s “Next Economy.” In addition to good-paying jobs, victory in the global clean energy race beckons with enhanced energy security and significant environmental benefits, including cleaner air and water. Winning this prize, however, will require an aggressive push to keep up with international competition. Virtually all industrially developed and most developing nations are competing for a slice of the global clean energy pie. In 2011, it took $48 billion of clean energy investment for the United States to reclaim the lead from China ($45.5 billion). But much of this money came from the 2009 American Recovery and Reconstruction Act’s (ARRA) stimulus funding. As these funds run out, America finds itself at a crossroads.

One option is to renew large-scale federal funding for clean energy investment to maintain U.S. leadership in the global clean energy race. Such leadership comes at a price, however, and one that may prove too high amidst a budget crisis with the national debt exceeding $16 trillion. A second option is for the federal government to pull out of the clean energy race or, at least, make significant cuts. Notwithstanding short-term budget benefits, however, such a strategy poses significant risks in the
longer term. Rather than benefit from the global clean energy market’s enormous growth and export potential, America could wind up replacing imported fossil fuels with imported clean energy technology. Hydraulic fracturing and other innovative exploration technologies may help reduce American dependence on imported fossil fuels. But the nation will still also require large-scale deployment of zero-carbon technologies to meet the power sector’s greenhouse gas challenges.

We propose a third option that relies on financial innovation and the power of U.S. capital markets to maintain and strengthen American leadership in clean energy while avoiding undue burden on the federal budget. As the prospects for near-term federal climate legislation remain uncertain, financially innovative tools enjoy mounting bipartisan support on Capitol Hill and are attracting increased attention from the administration.

The Problem
Without the need to pay for fuel, two principal factors determine the overall cost of renewable power projects: the cost of equipment, such as solar panels or wind turbines, and the cost of financing to obtain the necessary capital. Technological innovation has dramatically reduced the cost of panels, turbines, and other technologies. Financial innovation, however, has not kept pace with these technology-related improvements. As a result, the cost of financing today makes up an ever-greater fraction of the total cost of renewable energy projects, raising the cost of generated electricity by as much as 50 percent.

At the same time, most large-scale renewable power generation projects offer stable returns with relatively low risks. “Power purchase agreements” ensure that the “off-taker,” usually an electric utility, will purchase a project’s output. And as solar, wind, and other renewable energy technologies have matured, technology performance risk has also been significantly reduced. So the remaining—but sizable—challenge is the disproportionately high cost of financing that renewables face. Renewable energy projects currently struggle with financing costs of up to 30 cents on the dollar, not because of technology or off-take risks but rather the scarcity of low-cost capital. This dearth of capital for renewables stems from a variety of factors:

- Federal support for renewable energy today comes primarily in the form of tax credits and accelerated depreciation rates. Both tools, however, can only be “monetized” by a tiny fraction of the investment community and therefore cannot leverage broad-scale investment that would increase competition among investors and thereby cut capital costs for renewable power projects. Only a few dozen investors with hefty tax bills to offset, such as big banks and a handful of highly profitable companies, can benefit from these federal tax breaks. This requirement for tax liability has sidelined many interested investors, including tax-exempt pension funds, sovereign wealth funds, and, importantly, millions of retail investors who trade stocks.

- Tax equity investment in renewable energy projects requires complex deal structures that drive up transaction costs. In addition to these transaction costs, the ownership requirements to benefit from federal tax breaks make renewable power projects a relatively illiquid investment where capital may be tied up for five or 10 years to avoid “recapture” or other forfeiture of tax credit benefits. At the same time, the singular focus on tax equity for renewable energy has impeded the development of other investment approaches, including structures primarily financed through debt and other low-cost capital.

- Finally, under current law, renewables must raise equity capital through classic corporate structures that are doubly taxed at both the entity and investor levels. Meanwhile, their conventional energy counterparts have access to MLPs and REITs with only a single layer of taxation.
The bottom line is clear: Technological innovation alone will not be enough to make renewables fully cost-competitive with conventional energy and, hence, subsidy-independent. Instead, sustained technological innovation must be accompanied by critical financial innovation. As long as they lack the same access to large pools of low-cost capital as conventional energy, renewable energy technologies will not be competing on a level playing field and will struggle to deliver cheap and cleaner energy at maximum scale.

Proposal

Given these challenges, we strongly urge Washington to open up MLPs and REITs to investment in renewable energy deployment. Granting the renewable energy industry access to MLPs and REITs will finally provide renewable power projects the same access to low-cost capital that conventional energy sources already enjoy. MLPs and REITs combine the fundraising advantages of a classic corporation with the tax benefits of a partnership. Both structures issue shares to their investors that can be traded like stocks and thereby engage the power of America’s capital markets. Since Apache Petroleum launched the first MLP in 1981, MLPs have grown to reach a total market capitalization of over $350 billion while paying investors average dividends of 6 percent. With over 80 percent of current MLP capital funding oil and gas projects, MLPs have proven a high-impact, cost-efficient driver of energy investment.

REITs, meanwhile, have a total market capitalization of over $440 billion, with recent Internal Revenue Service “private letter rulings” blazing a trail for investment in gas pipelines, power transmission, and other energy-related projects. With average shareholder dividends of approximately 9 percent, REITs raised over $50 billion in 2011 alone, including some for traditional energy and infrastructure projects, and overall more capital than all U.S. clean energy investment for that year.

Allowing renewable energy investment through MLPs and REITs would have a wide range of positive effects:

- MLPs and REITs would give renewable energy projects access to greater pools of capital. As a result, renewable energy would no longer pay scarcity prices for project capital because capital markets would be able to better align risk with return, based on a project’s actual, long-term revenue.
- With current financing charges driving up the cost of a project’s electricity by as much as 50 percent, MLPs and REITs would go a long way in cutting the overall cost of renewable power.
- Granting renewable energy the same access to low-cost capital that conventional energy has enjoyed for decades would help level the playing field. Unlike other leveling approaches, including a pending Senate bill to eliminate MLPs and other conventional energy subsidies altogether, allowing MLPs and REITs for renewables would encourage rather than stifle sustainable growth in America’s energy economy and other sectors.
- From an international perspective, extending MLPs and REITs to renewables would promote American competitiveness in the global clean energy race. Over time, technological innovation brings down the equipment cost of renewable power projects across the globe. However, financial innovation through the extension of MLPs and REITs to renewables would benefit renewable energy deployment in the United States immediately, thereby strengthening America’s clean energy industry at a critical moment.
- MLPs and REITs would also open an attractive secondary market for renewable energy investment by allowing the entry of new investors beyond a project’s initial phase of tax benefits and enhancing liquidity in the renewable power marketplace.
And just as REITs were originally designed to encourage small-scale individual investment in commercial real estate, so would MLPs and REITs enable individual investors to profit from a renewable energy project’s returns. With publicly traded shares, MLPs and REITs could allow millions of Americans to invest in the nation’s energy future.

As these positive effects suggest, opening MLPs and REITs for investment in renewable energy would incentivize economic growth and move renewables closer to subsidy independence, securing U.S. leadership in the global clean energy race in the process.

Budget Implications
MLPs and REITs offer tax benefits with a range of direct and indirect implications for the federal budget. Unlike classic corporations, “pass-through entities” such as MLPs and REITs are exempt from taxation at the entity level: i.e., they do not pay corporate taxes. Only their investors are required to pay taxes for investment-related profits and they do so at their individual tax rates. This single layer of taxation raises concerns over the potential for MLPs and REITs to erode the corporate tax base. The exact budgetary impacts of pending proposals—such as the Master Limited Partnerships Parity Act (S. 3275) in the Senate and a companion bill (H.R. 6437) in the House—await Congressional “scoring.” Whatever the exact number, the loss in tax revenue from single-layer taxation for MLPs and REITs extended to renewable energy should be considered in the overall context of the federal budget, including tax expenditures, budget-relevant alternatives, and economic development.

The Joint Committee on Taxation does not quantify federal budget impacts of REITs. For MLPs, however, the committee has estimated the total tax expenditure from existing MLPs for oil, gas, and other conventional energy. At a total market capitalization of $300 billion, these MLPs are projected to cost the federal government around $1.2 billion from 2011 through 2015. Optimistic forecasts—such as those in a recent study by Southern Methodist University—anticipate that renewable energy MLPs could raise approximately $7 billion in additional capital from 2013 through 2020. Given these estimates, renewable energy MLPs should cost taxpayers significantly less than their conventional energy counterparts in the foreseeable future.

Crucially, any consideration of the budget effects of renewable energy MLPs and REITs should also include gains in tax revenue that result from an increase in renewable power deployment and related economic activity in manufacturing, construction, and other areas. A recent study by the U.S. Partnership for Renewable Energy Finance illustrates this point. The study found that the budgetary burden from investment tax credits for solar energy was more than offset by the tax revenues generated from related leases and power purchase agreements, creating, in effect, a return of 10 percent for the federal government.

State of Play
MLP eligibility for renewable energy investment enjoys widespread support in the investment and clean energy communities and bipartisan backing in Congress. In June, Senators Coons (D-DE) and Moran (R-KS) introduced the Master Limited Partnerships Parity Act (S. 3275), which would make a simple 200-word tweak to the tax code providing renewable energy projects access to the MLP structure. In September, Representatives Poe (R-TX) and Thompson (D-CA) introduced a companion bill (H.R. 6437) in the House. The MLP Parity Act has been endorsed by a number of major trade associations.

The center of action for REITs has been the Treasury Department. A series of recent IRS private letter rulings have allowed REIT investment in a range of energy and infrastructure projects, including natural
gas pipelines and terminals, electric power transmission lines, railroad tracks, cell towers, and even LED-lit billboards. But REITs have not yet been extended to renewable energy.

**Implementation Requirements**

REITs could be opened for renewable energy investment through executive or legislative action. Executive action would require the Department of Treasury to clarify—through project-specific private letter rulings or, preferably, a broadly applicable “revenue ruling”—that renewable power generation equipment qualifies as real property under the tax code and that income from these assets, including from the sale of electricity, is considered REIT-eligible income. The same clarification could also be made through a legislative amendment to the federal tax code.

Use of MLPs for renewable energy projects would require legislative action, such as the amendments proposed by the Master Limited Partnerships Parity Act. Current law specifically prohibits MLP investment in “inexhaustible” natural resources, leaving little room for statutory interpretation that would make renewables MLP-eligible.

A series of signals from Capitol Hill and the administration suggest that MLPs and REITs are emerging as potentially transformative tools to advance renewable energy, with significant economic, security, and environmental benefits. Let’s get the deal done.

**References**


About the Authors
Felix Mormann is Associate Professor at the University of Miami School of Law and Faculty Fellow with Stanford University’s Steyer-Taylor Center for Energy Policy and Finance. Previously, Mormann was a research fellow and lecturer at Stanford Law School and a visiting scholar at the University of California at Berkeley. Mormann has worked as a corporate and energy attorney in Europe and advised international high-tech clients for McKinsey & Company.

Dan Reicher is Executive Director of Stanford’s Steyer-Taylor Center for Energy Policy and Finance, a joint center of the Stanford business and law schools where he holds faculty positions. Reicher previously directed Google’s energy and climate initiatives, was an investor and executive in the clean energy industry, and served as Assistant Secretary of Energy and Energy Department Chief of Staff in the Clinton Administration. He also was a member of President Obama’s Transition Team and, early in his career, a staff member of President Carter’s Commission on the Accident at Three Mile Island.

For More Information
Felix Mormann
Steyer-Taylor Center for Energy Policy and Finance
Stanford University
University of Miami School of Law
mormann@stanford.edu

Dan W. Reicher
Steyer-Taylor Center for Energy Policy and Finance
Stanford University
dreicher@stanford.edu

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For General Information
Metropolitan Policy Program at Brookings
202.797.6139
www.brookings.edu/metro

1775 Massachusetts Avenue NW
Washington, D.C. 20036-2188
telephone 202.797.6139
fax 202.797.2965