Fossil Fuels Get Huge Master Limited Partnership Tax Breaks – "Green" Energy Shut Out

By **Peter Mantius**, on September 22nd, 2014

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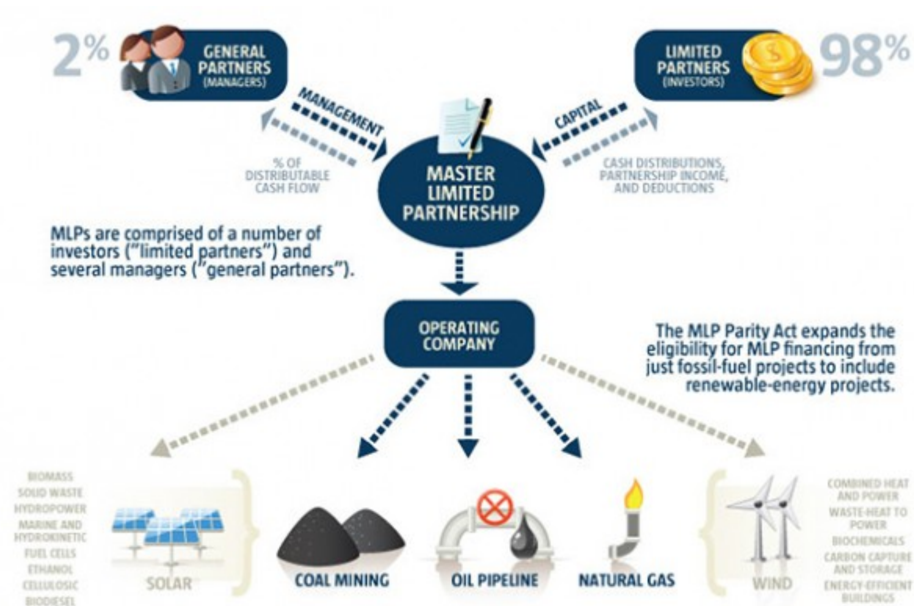


Since 2008, investors have poured several hundred billion dollars into fossil fuel-related master limited partnerships that shield income from virtually all corporate taxation. The MLP tax loophole — a sort of reverse carbon tax — has heavily subsidized the nation's ongoing oil and natural gas fracking boom.

Solar, wind and other renewable energy companies are not eligible for the MLP tax dodge. Although bipartisan support is building in Congress to extend the tax deductions to them, insiders say legislation to do so will most likely have to wait for and be a part of a comprehensive tax reform package, which has proven elusive.

Until then, existing incentives will serve as a drag on the U.S. economy's transition from fossil fuels to renewable energy sources. As long as Congress fails to act, fossil fuels will continue to exploit their government-approved competitive advantage even as mounting evidence shows their use accelerates global warming and prompts calls to tax carbon.

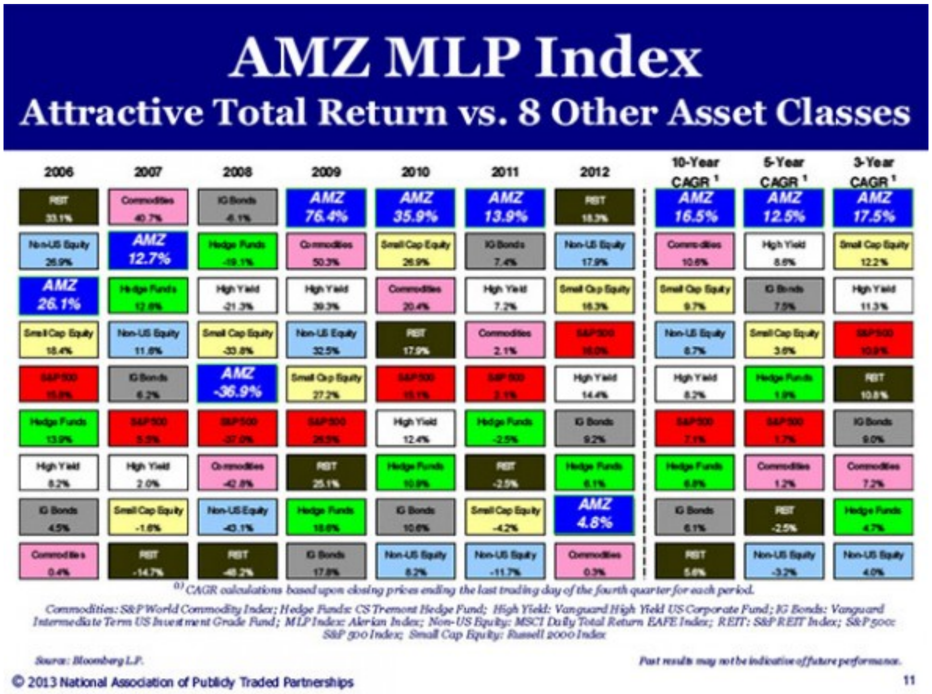
Even from a strictly financial perspective, tilting future U.S. taxpayer-funded energy subsidies toward fossil fuels might be a poor bet. Several major investment banks, including Morgan Stanley and Barclays, have warned that rapidly falling prices for renewable energy pose an existential threat to traditional electric utilities powered by coal, oil and natural gas.

Oil Train

Congress established the MLP option in 1981, and its popularity has been cyclical. The nationwide fracking boom, which caught on just as the country was recovering from the 2008 financial crisis, has spurred — and been spurred by — a flurry of corporate conversions to MLPs, which have grown five times in size during this same timeframe.

An MLP is similar to a traditional corporation in that its shares are traded on major stock exchanges. But while a corporation's income is taxed at both the corporate level and the shareholder level, MLPs are pass-through entities that pay no income tax themselves. The MLP shareholder, called a unitholder, receives distributions of income, which are then taxed at his or her own tax rate.

The tax-advantaged returns are very popular with both retail and institutional investors. Today the roughly 130 MLPs traded on public stock exchanges have a combined market value of more than $500 billion — well over five times the value of MLPs at the end of 2008. Alerian, which compiles an index of MLPs called AMZ, reported on its website that $1,000 invested 10 years ago in MLPs would have a value of $4,924, while $1,000 invested in the Standard & Poors 500 stock index over the same period would be worth $2,116.



More than 80% of existing MLPs shelter fossil fuel-related income. Under industry pressure, the Internal Revenue Service has gradually widened the MLP loophole for businesses ancillary to coal, oil and natural gas production. Pipelines and other oil and gas "midstream" companies in particular have benefited. But so have fracking sand miners, fracking wastewater haulers, rail terminal and rail tank car owners and shipping fleet owners.

In June, Transocean Ltd., owner of the Deepwater Horizon drilling rig that burned in the Gulf of Mexico in 2010 and triggered history's largest oil spill, announced plans for an initial public offering of shares in a master limited partnership that will own three of its 77 offshore drilling rigs. The company's CEO told Bloomberg that Transocean hoped to "grow the MLP over time."

Deepwater Horizon, before (Photo courtesy of Transocean); After (Wikipedia)

MLPs also provide tax shelters for companies moving crude oil from the Bakken field in the Upper Midwest and from the oil sands of Alberta, Canada. TransCanada, operators of the Keystone XL pipeline, formed an MLP to hold its U.S. pipeline assets, while USDGroup LLC, owners of a crude-by-rail terminal in Alberta, recently announced plans for an initial public offering of stock in its new MLP.

The MLP structure has produced or further enriched at least a dozen energy sector billionaires, including former Enron president Richard Kinder, corporate raider Carl Icahn and investment guru Warren Buffet. And it helped Charif Souki, CEO of Cheniere Energy Inc., a potential exporter of liquified natural gas, earn more in 2013 than any other corporate executive in America, according to Forbes.

The Union of Concerned Scientists and dozens of other environmental advocacy groups say it is only fair to extend the MLP tax break to renewable energy companies.

Wind and solar energy companies have long benefited from other federal subsidies, chiefly production tax credits, income tax credits and accelerated depreciation. But those incentives are notoriously fragile politically. And because many are structured to expire in seven to 10 years, the incentives appeal mostly to a narrow band of deep pocket investors, like large insurers and investment banks, which can exit their deals as soon as the incentive periods run out.


Steve Clemmer

Those characteristics make the incentives a less-than-ideal fit for renewable energy companies with long-term capital needs, said Steve Clemmer, director of energy research for the Union of Concerned Scientists.

"Tax breaks for renewables have been on-again, off-again, creating a boom-bust cycle, particularly for wind," Clemmer told DCBureau. "We need longer-term policies …. like the MLP."

Converting to the MLP structure would allow renewable energy companies to tap giant new pools of capital, including the nation's $15 trillion mutual fund market and the $11 trillion defined benefit pension market, Clemmer said. That would help the "green" energy industry meet ambitious government growth targets.

Fresh investments of $50-70 billion a year will be needed to increase non-hydroelectric renewables to 30% of U.S. electricity generation by 2025, according to a 2012 study by the National Renewable Energy Laboratory. That investment will need to grow to $85-125 billion a year after 2030 to reach 80% renewables by 2050, NREL said.

The renewable energy industry invested an estimated $40 billion in 2012, according to Bloomberg. But U.S. financial markets could supply the sector another $50-70 billion per year through renewable energy MLPs, Meister Consultants Group concluded in a report prepared in April for the Union of Concerned Scientists.

For the typical wind project, MLP tax treatment would slash its cost of capital by 40% or more, Meister estimated. The low end of that estimate would cut the project's cost of electricity produced by 17%, the consultants found.

The idea of extending MLP tax breaks to the renewable energy industry moved from theory to proposed federal legislation after a pair of Stanford University professors touted the idea in a June 2012 op-ed in *The New York Times*.

"Congress needs to fix a bizarre distinction in the tax code that bars master limited partnerships from investing in 'inexhaustible' natural resources like the sun and wind, while allowing investments in exhaustible resources like coal and oil," wrote Dan Reicher, executive director of Stanford's Steyer-Taylor Center for Energy Policy and Finance, and Felix Mormann, a faculty fellow at Stanford Law School.


Sen. Chris Coons,

Reicher and Mormann argued that renewables should be eligible for the tax advantages of both MLPs and real estate investment trusts, or REITS. They touted a bill then being drafted by Sen. Chris Coons, D-Del., called the Master Limited Partnership Parity Act.

Coons has since won bipartisan support for his bill, signing up Republican senators Jerry Moran of Kansas and Lisa Murkowski of Alaska as co-sponsors. And the American Petroleum Institute, the fossil fuel's lobbying colossus, and the influential Business Roundtable have endorsed Coons' plan. Plus, there is a companion bill in the House, also with bipartisan support.

Even so, Coons' Senate bill stalled in committee in 2013, and it faces long odds this year. Jamie Serlin, a spokeswoman for Coons, said that while the MLP extension to renewables would be easy to implement, it is probably a long shot as a stand-alone measure.

"(Coons) feels it's urgent that we broaden investments in renewables," Serlin said. "It's one of his top priorities and he's dedicated a significant amount of time to it. But any reform takes time. We are optimistic it will be part of a broad tax reform debate."

That debate is not likely before next year, when many short-term tax credits for renewables are expected to expire, Serlin added. Sen. Ron Wyden, D-Ore., chairman of the Senate Finance Committee, has signaled his willingness to consider Coons' MLP proposal, but only in the context of overall tax reform.


Sen. Ron Wyden

"The United States is stuck with an unsustainable corporate tax rate of 35%," Wyden wrote earlier this month in a column for Politico. "Meanwhile, the average corporate tax rate across the developed world … has fallen to 25%. Comprehensive tax reform must address this gap … and reduce the ability, as well as the incentive, to manipulate the system."

Meanwhile, Sen. Bernie Sanders, an independent from Vermont, favors canceling MLP tax breaks entirely rather than extending them to renewables.

Doug Koplow, founder of Earth Track Inc., a Cambridge, Mass., watchdog group, shares Sanders' skepticism. Koplow argues that the cost of MLP tax subsidies has been vastly underestimated by the only government body that tracks them, Congress's Joint Committee on Taxation.

"Losses over the 2009 to 2012 period for which we have data may have been as high as $13.6 billion, more than six times federal estimates for the same period," Koplow wrote in a July 2013 study titled, "Too Big to Ignore: Subsidies to fossil fuel master limited partnerships."

Koplow goes on to warn that Coons' bill might be a Trojan Horse for greatly expanding the use of MLPs by the fossil fuel industry. He notes that it would, for the first time, extend MLPs eligibility to power generation plants, though only for "green" power. But Koplow argues that would only lay down a challenge for lobbyists for traditional fossil-fuel-powered generation plants.

The same Congressional members and trade groups that have long supported fossil fuels MLPs and backed renewable energy's entry into the sector would be inclined to argue that all power generation — whether "green" or fossil fuel — should qualify for MLP tax treatment, he said. That would dramatically inflate the cost of the tax subsidies, he added.

"The potential fiscal and environmental impact of this extension should not be underestimated," Koplow wrote of the proposed extension to power generators, "even if for the next few years only generally 'green' forms of power are included."

While Congress sets the broad rules for MLP tax breaks, it is the IRS that establishes the specific boundaries of those rules. It interprets the 1981 law that first authorized MLPs, as well as later amendments, by issuing private letter rulings that allow or deny petitions for eligibility on a case-by-case basis.

Under amendments in 1987, any partnership that has publicly traded shares is taxed like a traditional corporation unless it gets at least 90% of its income from "qualified" sources. Then all of the income is tax free for the MLP.

The IRS has felt heavy pressure in recent years to relax its rules on what income "qualifies" for preferential tax treatment. The agency had issued 10 private letters on MLPs in 2011, 21 in 2012 and 30 in 2013. But in April, the IRS said it was suspending all MLP private letter rulings, pending a review of their cumulative effect.

That has not silenced a few aggressive market players. For example, in July the hedge fund Perry Capital said shares of International Paper and Rock-Tenn could rise 50-100% if they created MLPs for their paper mills.

INTERNATIONAL PAPER

RockTenn

In response a few days later, International Paper CEO John Faraci told Bloomberg the idea was not out of the question. "But it is a somewhat theoretical discussion right now because there isn't a letter from the IRS that says you could do this," Faraci added.

The intent of the original law was to help energy companies raise capital from small investors by offering them a tax-advantaged partnership investment in an affordable and highly liquid security, according to the National Association of Publicly Traded Partnerships.

Apache Oil Co. launched the first MLP in 1981, and other oil and gas companies quickly followed suit. Soon other industries jumped in, including hotels and motels, cable TV, investment advisors, amusement parks and even the Boston Celtics of the National Basketball Association.

Before long, Congress grew nervous about the erosion of the corporate tax base. In 1987, it passed legislation to restrict the waiver of income taxes to MLPs that could show that 90% of their income came from "qualified" sources — mainly natural resources. To qualify, even natural resources income had to come from "depletable" sources. Retail sales income did not count, except for propane sales, which did.

The rationale for the "qualified" income rule baffles some, including University of San Diego tax professor Victor Fleischer. "The origin of the MLP loophole is shadowy," Fleischer wrote in a 2013 column in The New York Times. "The legislative history states only that in the case of the energy sector, 'special considerations apply.' As I teach my students, that is code for 'effective lobbying.'"


Victor Fleischer

Although the MLP option continues to attract new converts, one of the oldest and most successful players in the sector, Kinder Morgan Inc., shocked many when it announced in August plans to back away from the MLP structure.

Kinder Morgan (stock ticker symbol KMI) has a market value of about $40 billion, and Richard Kinder owns roughly 22% of the shares. A traditional "C corporation" that pays corporate taxes, KMI said it would acquire its two giant MLPs, Kinder Morgan Energy Partners and El Paso Pipeline Partners. In theory, the combined company will now face the nominal 35% corporate tax rate.


Richard Kinder

But as Fleisher noted in another column for The Times, other factors related to depreciation and amortization rules will allow the parent company to "realize income tax savings of approximately $20 billion over the next 14 years." Unitholders of the MLPs, on the other hand, may face a tax jolt, Fleisher wrote.

Several commentators have speculated that the transaction will pave the way for KMI to go on a buying spree of other energy MLPs.

Those who remain puzzled by the strategy have the opportunity to learn more at a one-day "MLP Investing Conference" scheduled for Sept. 26 in New York City. The exact location of the event is being disclosed only to registered guests, who must pay at least $1,250 to attend.

But a flyer on the conference provides a tantalizing hint: "How the Kinder Morgan deal will usher in a golden age for MLPs tapping into the Great American Energy Boom."

[Peter Mantius]

Peter Mantius is a reporter in New York. He covered business, law and politics at *The Atlanta Constitution* from 1983-2000. He has also served as the editor of business weeklies in Hartford, CT, and Long Island. He is the author of *Shell Game* (St. Martin's Press 1995), a nonfiction book on Saddam Hussein's secret use of a bank office in Atlanta to finance billions of dollars in arms purchases from Western countries before the 1991 Persian Gulf War.

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If there were no subsidies for Nuclear, Coal, Gas, Wind or Solar, it would only make wind and solar get installed faster, since all the rest are even more subsidized than either wind or solar!

Nuclear is the king of subsidies, since the industry does not even pay to guarantee that if a nuke goes bad they will pay for it, since they have already gotten Congress to pass the Price-Anderson Act to limit their ☢ liability.

If you add all the costs and risks, Solar and Wind will win, and soon large scale storage batteries will even make Solar (of all flavors) an even better deal!

Since Solar R&D is just getting started, ratepayers will be really unhappy in the future, since the price of Solar will continue to drop, which will make Nuclear, Coal, Oil and even Gas ever more expensive, and that is if everything goes according to plan, which we all know is not always the case, especially for Nuclear, because all bets are off if ☢ goes BAD, ask the Japanese!

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