THIRD WAY

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A Small Tax Change, Big Clean Energy Results

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Introduction

Almost every one of America's main global competitors—both advanced economies and emerging ones like China, Brazil, and India—are increasing public and private investment in clean energy. [1] For most, the principle reason is not altruistic or environmental, it is economic. The race is on to capture a major share of the $2.3 trillion market in clean energy. [2]

The United States, however, is sliding backwards. As a recent Third Way report found, early investment in clean energy is in decline, and federal investment in clean energy is likely to disappear at the end of 2011. [3] This credit crunch could starve both mature and emerging clean energy companies in America just as the rest of the world races ahead.

It doesn't have to be this way. Congress could unleash significant private capital by reforming the tax code to permit the use of master limited partnerships for clean energy projects. This small change could make financing projects like wind farms and utility-scale solar much less expensive, encourage more development, stimulate economic growth, and reduce energy costs.

Most of the world is racing to develop and deploy clean energy. This will create a $2.3 trillion global clean energy market that is likely to be one of the biggest global economic opportunities of the next several decades. [4] For the winners of this race, competing successfully in this market will generate economic growth (and tax receipts), create jobs, increase energy diversity, and improve the environment.

Other nations understand this opportunity and are moving rapidly to take advantage of this emerging market in the form of direct government involvement in the clean energy sector. By contrast, the United States has taken only halting

and intermittent action in support of clean energy. The loan guarantee program has fallen prey to partisan politics and has ended. The 1603 cash grant program is set to expire at the end of this year. [5] Funds for the 48c manufacturing tax credit have been depleted. [6] These programs invested nearly $12 billion in clean energy over the last two years. [7] It now seems very unlikely Congress will provide any additional funding.

The private equity markets are not able to make up the difference for mature technologies like wind and, increasingly, solar photovoltaic power, and venture capital (VC) is struggling to help new technologies emerge. Investments in clean tech from Q2 2010 to Q2 2011 fell by 44%. [8] New ideas and companies risk being completely shut out of the market place. This makes no economic sense. A recent report from the Brookings Institution concluded that "the domestic clean economy already employs some 2.7 million workers," which is more than the fossil fuel industry. [9] In addition, it noted that newer "cleantech" segments produced "explosive job gains" that "outperformed the nation during the recession" and that the clean economy is "manufacturing and export intensive." [10]

The Problem

American clean energy projects are starved of capital.

As public financing is eliminated for clean energy, companies that want to build out mature technologies are having a hard time finding sufficient private sector capital to build their projects.

Financing clean energy projects is challenging, for many reasons. Among them:

- **They are expensive.** Projects are capital intensive, often involving the manufacturing of large components.

- **They are illiquid.** It's not easy for investors to get a return on their investment, because it takes a long time to build the plants and longer still to pay for them.

- **They are not gold mines**. The power generation projects have known (or knowable) rates of return because most sell their output to utilities on long-term contracts called power purchase agreements. This lowers both the project's riskiness and the profit to investors.

These challenges make financing commercial-scale projects unattractive to most private funding sources. Such investors are looking for projects, like software, which don't require enormous amounts of capital; can be sold or merged quickly; and, if successful, have almost unlimited growth potential.

With much of the VC and private equity markets closed to them, infrastructure and power generation projects generally seek capital from what is known as the tax equity market. [11] But this is expensive for project developers because of high transaction costs. As its name suggests, this is equity; developers have to give up part of their ownership in their projects in order to secure this capital. It is also more difficult to secure capital from lenders using tax equity because the lenders treat it more like debt.

Moreover, the economic downturn that began in 2008 has made it difficult for companies to find tax equity. First, the tax equity market itself has been decimated. The banks and financial institutions that typically provided these funds are themselves in financial straits and no longer need or seek tax equity. A report by the U.S. Partnership for Renewable Energy Finance estimated that, while the tax equity market is beginning to rebound, it is still barely half the size it was in 2007. [12] Second, the lack of consistent federal government policy is making it almost impossible for investors to anticipate what the tax and regulatory environment for tax equity funded projects will be. Understandably, they are reluctant to commit funds that will be illiquid for a long period.

As a result, developers must look to commercial banks and other commercial lenders for "commercial debt." Commercial lenders don't require an equity stake in a project and generally seek lower returns on their funds, but they are

willing to take these lower returns because these projects are much less risky. Typically, debt providers want all the permitting, equity raises, construction plans, intellectual property resolutions, and other legal issues completed and pledged as collateral before they will make their loan. This is, understandably, difficult for innovative energy companies to provide.

So, if commercial scale clean energy projects are not attractive to private sector venture capital or private equity; if they are not attractive to commercial debt providers; if the markets for tax equity have shriveled; if federal government support for the sector has disappeared; and if they are important for the country, then, what can be done to support them in the absence of significant regulatory or legislative changes?

The Solution

Make a minor tax reform to have a major impact on clean energy.

Master Limited Partnerships ("MLPs") offer a serious opportunity to open new, critically needed streams of capital for clean energy projects. At their most basic, MLPs are a subset of publicly traded companies that develop and own specific kinds of assets. Under current law, MLPs are generally infrastructure-related and focus on petroleum, natural gas, and coal extraction and transportation.

MLPs offer tax benefits and liquidity for investors. Because MLPs are partnerships, the income is taxed only once and is not subject to either federal or state corporate income taxes. (In contrast, publicly traded C corporations like Apple or Ford Motor Company are taxed twice, once at the corporate level and once when investors receive dividend income.) In addition, investors in MLP's are able to reduce their tax liability because they receive their share of the partnership's depreciation. Because MLPs are publicly traded, funds can be easily sold and are therefore liquid.

As a result, MLPs have access to capital at lower cost—something that capital-intense clean energy projects in the United States need more than ever. These benefits make MLPs very attractive to many investors.

MLPs have been around since 1980 and have played an important role in the development of energy infrastructure in the United States. Following the energy crisis of the 1970's, Congress sought to increase investment in oil and gas exploration and created the MLP structure specifically to provide tax advantages to investors. Other energy classes were added over time. Between 1994 and 2010, the number of energy MLPs grew by more than a factor of 10. [13] The capital raised from those offerings grew by more than 100 fold, from about $2 billion in 1994 to $220 billion in 2010. [14] With a compounded annual growth rate of 34.1% over the last 16 years, MLPs have outpaced most other classes of investment. [15] MLPs are exceptionally good at attracting private capital to oil and gas energy projects. They could do the same for clean energy.

Open Master Limited Partnerships to clean energy generation projects.

The IRS limits use of the MLP structure to businesses that derive, and then pass through, 90% of their income to their investors. In practice, this means that MLPs must be used for mature assets, like oil and gas extraction. The Emergency Economic Stabilization Act of 2008 expanded the definition of income from qualifying sources to include the transportation of ethanol and biodiesel fuel. Clean energy generation projects still do not qualify.

There is a simple fix. By amending the Internal Revenue Code Section 7704 (d) to include revenues from the generation and sale of electricity produced from clean energy sources as qualifying income, clean energy projects could qualify as MLPs. This could bring substantial private capital off the sidelines to finance these renewable projects and would level the playing field between competing energy technologies. Large-scale electricity generation projects with power

purchasing agreements (PPAs), including utility-scale solar, geothermal, on and off-shore wind, nuclear and, eventually, carbon capture and storage, could all benefit from this reform.

Conclusion

In one of the all-too-rare instances of bipartisanship in Washington today, policymakers from both parties say they support increased private sector investment in clean energy. Unfortunately, many of the policy options that Congress could use to help generate this investment are trapped in partisan gridlock. This is costing America the opportunity to compete in the growing global clean energy market. Making a small change in the definition of Master Limited Partnerships could help rectify this problem and get new clean energy projects built.

Critiques and Responses

Clean energy MLPs are still risky investments.

Inherent in any investment, there is always the chance that the energy output from the source might be less than anticipated. This could, in turn, create issues with the performance requirements under a PPA. However, performance guarantees and risk insurance products can help offset these risks. Equipment and construction risk can, in turn, be offset by reserve funds, warranties, and other risk mitigants.

MLPs are generally used to finance proven technologies with stable cash flows.

Clean energy MLPs will finance proven technologies, such as wind farms and utility-scale solar that typically have long-term revenue streams through power purchasing agreements with established utilities. These clean energy generators are currently struggling to get access to affordable capital because of failures in the capital markets. MLPs would simply

make low-cost capital available so that financing the construction of such projects is affordable.

The single taxation of MLPs will reduce the amount of taxes the federal government takes in.

Changing the taxation of MLPs should bring capital off the sidelines and into clean energy investments. Much of the money being invested in new, clean energy MLPs would not have been generating revenue for the IRS in other circumstances. This will finance more projects than are currently being built, creating more jobs, demand on the supply chain, and, ultimately, expanding the tax base. It is also important to remember that MLPs are a cost-efficient way for government to support clean energy without financing any specific projects. Instead, the federal government simply provides an inducement for the private sector to identify and finance projects with less expensive capital.

Appendix

Key Terms

Capital Markets – Where financial securities, such as stocks and bonds, are bought and sold by institutions and individuals.

Compounded Annual Growth Rate – The year-on-year calculation of interest used to reflect the actual profit/loss of an investment over a specified period time.

Limited Partnership – An ownership structure where two or more people come together to form a partnership to run a privately-held company (companies not listed on the stock exchange). One owner is the "general partner" and all others are "limited partners." The general partner's profits are tied to the fortunes of the company. Limited partners do not earn dividends, and are not liable to provide additional money to the company than they initially invested if the company needs additional investments.

Master Limited Partnership – A publicly traded limited partnership. Companies are typically taxed when they pay out dividends, but because MLP's are partnerships, they don't pay taxes on the dividends, thus reducing their tax burden.

Private Equity – Capital that is invested directly into a company, without going through a stock market or other intermediary. These are often long-term investments that are intended to earn a return based on the overall performance of the company.

Publicly Traded C Corporation – A corporation that is organized to protect its investors from the company's liability. Investors in C corporations are taxed twice, once at the corporate level and again when dividends are distributed to owners.

Reserve funds – A corporate savings account used for unexpected costs.

Securities – Shares of a company that are traded on an exchange.

Tax Equity – When an investor buys a stake in a company (equity) and, in return, receives ownership of a portion of the company, as well as a return on federal and state income tax benefits.

Tax Liability – The amount of taxes owed.

Venture Capital – Money invested in high-risk, high-reward early stage technologies and companies. The companies invested in are typically not yet producing or selling a product, but are seeking capital to develop and commercialize a prototype technology or service.

Warranties – An insurance policy on an investment.

END NOTES

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11. Tax equity investors essentially buy tax benefits from companies that don't have enough taxable income to use those credits on their own. Tax-equity investors get to use those tax credits as part of a strategy to shelter otherwise taxable income and the money they invest allows the project developers to build the projects.

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15. Compounded annual growth rate calculated using data from supra note 21.