

# Byline

October 9, 2014

## Will The Wires REIT Become The Next Midstream MLP?

by Peter K. O'Brien, Mark C. Van Deusen, David C. Wright and Linda L. Walsh

Published in Law360



Since 2009, yield-oriented corporate structures have dominated the energy and power capital markets. There have been over 30 initial public offerings for midstream energy master limited partnerships since 2009. In the power space, the NRG Yieldco initial public offering in 2013 initiated a frenzy among power company executives, assisted by their bankers, to analyze renewable assets in their portfolio in the hopes of forming a yieldco to access the capital markets. Although not possessing certain favorable tax attributes found in MLPs, yieldcos nevertheless are flourishing. As of the third quarter of 2014, five yieldco IPOs have been completed and several more are rumored to be in the pipeline.

As the power industry shifts its focus to the next “new thing”, the financing of transmission assets has become the subject of much discussion. The Edison Electric Institute reports that its member utilities have recently completed or plan to build \$60.6 billion in transmission projects through 2024. Rate-regulated transmission assets that generate a stable annuity-like cash flow would seem like an ideal asset class to serve as a basis for a financing strategy.

Further, the IRS has confirmed that transmission and distribution (T&D) systems can qualify for a tax-advantaged structure that was developed 50 years ago and has been widely utilized in the commercial real estate industry and certain other industries: a real estate investment trust, or REIT.

With the keen interest of power companies to utilize yield vehicles to access the capital markets, a question has arisen as to why the REIT structure has not been more utilized, especially given that the IRS has blessed the ability of REITs to own T&D systems (a “wires REIT”).

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As discussed below, there are currently several possible answers to that question — including tax issues, regulatory uncertainties, credit concerns and even political “hot button” issues. As the utility industry adapts to the changing landscape in which it operates, however, the wires REIT structure — if supported on the regulatory front — could play a pivotal role in fortifying the nation’s electric grid and providing utilities with a growth engine in a fundamentally different utility industry.

## **What is an REIT?**

An REIT is a permanent capital vehicle that generally is not subject to corporate income tax to the extent it distributes its income to its shareholders. The REIT structure was created by statute in 1960 to give retail investors the opportunity to participate in the returns generated by real estate on a tax-advantaged basis. To obtain favored tax status, an REIT must meet certain income, asset, distribution and stock ownership tests. Although the REIT rules are very complex, below is a basic summary of some of the tests that will drive the structure of a wires REIT.

- ***Distribution Test.*** REITs are required to distribute 90 percent of their taxable income each year. Most REITs, however, generally distribute 100 percent of their taxable income so as to avoid paying any corporate income tax.
- ***Income Tests.*** At least 95 percent of the REIT’s gross income each year must come from certain passive sources, and at least 75 percent of an REIT’s gross income each year must come from certain real estate-related sources. “Rents from real property” is “good” income for purposes of those tests. Rent from a “related party” is not “good” income. As a result of the “related party” rent rule, no lessee/operator of a T&D system owned by an REIT could own 10 percent or more of the stock of the REIT. Further, to be “good” income, the rent payments cannot be based on the income or profits of the tenant, but can be based on a percentage of gross revenues or receipts.
- ***Asset Tests.*** Among other requirements, at least 75 percent of the value of an REIT’s assets at the end of each calendar quarter must consist of “real estate assets” and certain other passive assets. “Real property” is included in the definition of “real estate assets.”

## **Development of REITs**

Since their establishment over 50 years ago, REITs have proven to be a popular and enduring investment vehicle. One trade association reports overall real estate assets owned by REITs to be more than \$1 trillion, with REITs paying out approximately \$34 billion in dividends in 2013. Part of the popularity of REITs is that, unlike yieldcos, they generally are not subject to corporate income tax. Also, REITs use 1099s, rather than K-1s, to report income to their investors. Because of the ability to use 1099s, REITs are more attractive to retail investors than MLPs, which issue K-1s.

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Over the years, the REIT structure has experienced much innovation and REITs have invested in a wide variety of types of real estate: office space, multifamily apartments, single-family homes, health care facilities, hotels, malls, billboards, data centers, cell towers and even prisons.

In determining what types of businesses can be owned by a REIT, the key question is often what constitutes “real property” for purposes of the tests described above. REITs have recently expanded into “nontraditional” real estate asset classes, and there has been some controversy regarding whether the IRS was applying the correct definition of “real property.”

Responding to that controversy, the IRS issued proposed regulations earlier this year that address what constitutes real property. These proposed regulations generally expand the current regulations and include many examples that confirm the positions that the IRS has taken in a number of private letter rulings (PLRs). PLRs can be relied upon only by the taxpayer that received the ruling. If finalized, the proposed regulations could be relied upon by all taxpayers.

Under both the current and proposed regulations, real property is defined to include land and improvements to land, including inherently permanent structures (e.g., buildings) and their structural components. Although the current and proposed regulations use different tests to address this issue, assets that are too closely associated with an active business are not treated as “real property.” For example, equipment that generates electricity would not be treated as “real property.”

### **The Sharyland PLR**

In 2007, the IRS issued a PLR holding that a T&D system could be owned by an REIT. The ruling was sought by a new REIT that intended to acquire and indirectly own T&D systems, including the T&D system owned by Sharyland Utilities LP. Sharyland is regulated by the Public Utility Commission of Texas and operates within the Electric Reliability Council of Texas.

The new REIT would lease the T&D system described in the PLR (the “system”) to Sharyland in return for fixed quarterly rental payments pursuant to a “triple-net lease.” Sharyland would own less than 10 percent of the new REIT’s equity and would operate the system, including maintaining required licenses, paying insurance, taxes, operating expenses and utilities, owning the necessary vehicles, tools and equipment, and managing employees.

The IRS concluded that the system was “real property” because it was “an inherently permanent structure that is not an accessory to the operation of a business.” The IRS noted that: “the System is a passive conduit that allows electricity created by a generation source to flow through the System to end-users.” The IRS also stated that the system would not include any machinery or equipment that generates electricity and could be differentiated from the machinery and equipment that does generate electricity.

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The IRS also concluded that the lease payments for the system would be “rents from real property” for the REIT income tests. The system was proposed to be leased under a triple-net lease, pursuant to which the new REIT would receive a fixed rental payment and would provide no services to the tenant. Indeed, the tenant would be solely responsible for operating and maintaining the system, including paying all expenses associated with the system (e.g., insurance, taxes, operating expenses and utilities).

It was also noted that Sharyland would own or lease all the equipment necessary for operating the system. In addition, Sharyland would employ or contract with all the personnel necessary to operate the system. Under these facts, the IRS found that the lease payments constituted “rents from real property.”

Several aspects of the structure used in the Sharyland PLR will be relevant for other wires REITs. Specifically, a wires REIT must comply with the following structural requirements:

- The REIT cannot operate the T&D system. The REIT must lease the T&D system to a lessee/operator.
- The lessee/operator of the T&D system can own only a limited economic interest in the REIT itself (though it may own a larger interest in an “operating partnership” under the REIT). As a result, the lessee/operator will have limited control over the REIT.
- The REIT’s income from the T&D system must be passive rental income. Although a portion of the rental income could be based on the gross revenues of the lessee/operator, no portion of the rent can be based on the net income or profits of the lessee/operator.

Substantially all of the property owned by the REIT and leased to the lessee/operator must be “real property.”

### **Does a Wires REIT Need a PLR?**

Since issuing the Sharyland PLR, the IRS has issued two PLRs concluding that gas pipeline transmission systems would be treated as “real property.” In addition, an example in the new proposed regulations concludes that most components of a gas pipeline transmission system would be “real property.” The analysis in that example would be directly applicable to a T&D system. That example, however, suggests that the IRS’ thinking on the treatment of transmission systems may have changed slightly.

For example, in both the Sharyland PLR and in one of the gas pipeline transmission system PLRs, the IRS concluded that meters would be treated as real property. The example in the proposed regulations reversed course and concluded that meters would not be treated as real property. Even under the analysis in the example in the proposed regulations, most property associated with a T&D system should be classified as “real property.”

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Given the generally favorable IRS posture on the ability of a transmission system to qualify as “real property,” the question arises whether the owner of a T&D utility — to the extent it pursues a wires REIT structure — would need to obtain a PLR with respect to its own factual situation. The public capital markets demand a high level of assurance that an issuer will qualify as a REIT, and a “will” level tax opinion on REIT status is generally required for a public offering.

When considering a wires REIT, management needs to discuss with counsel whether to obtain a PLR based on the specific facts and circumstances applicable to that T&D system. Especially in light of the proposed regulations, a wires REIT may be able to be launched with a “will” opinion of counsel that is not based on a PLR. To the extent a PLR is sought, the timing for a ruling might be up to six to eight months. However, given all the implementation issues for a wires REIT, this time frame should not be an impediment.

### **Regulatory Issues**

In contrast to the favorable IRS precedent, wires REITs are on more uncertain ground in the regulatory arena. In the case of a traditional rate-regulated vertically integrated utility, transmission assets are subject to federal rate jurisdiction and distribution facilities are subject to state public service commission (PSC) jurisdiction. In a scenario whereby the owner of a vertically integrated utility intends to form a wires REIT by extracting the transmission assets from the utility and spinning off such assets to a separate transmission-only REIT (which would be a sister company of the formerly integrated utility), both federal and state approvals would be required for such a “disposition” of assets.<sup>1</sup>

Upon completion of the spinoff, however, the new transmission-only REIT would now be subject solely to Federal Energy Regulatory Commission jurisdiction. Many commentators are quick to point out that it would be very difficult to persuade a state PSC to voluntarily relinquish jurisdiction. Furthermore, there is widespread concern that a state PSC would view any tax benefits achieved through an REIT structure as deserving to go, at least in part, to the ratepayer. These political and economic uncertainties cast doubt as to whether a state PSC would acquiesce to a sponsor’s attempt to establish a wires REIT in such a manner.

The outlook is a little different in a scenario whereby a wires REIT is established as a separate transmission vehicle (or transco) that holds new transmission assets subject solely to FERC jurisdictions. There is little doubt concerning the widespread public policy and FERC support for building new transmission.

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In 2011, FERC promulgated its Order No. 1000 to encourage regional transmission development and enhance the ability of the grid to support wholesale power markets and provide reliable transmission service. As part of this effort, FERC adopted a transmission planning framework that allows for participation by both traditional (“incumbent”) utilities developing within their own service areas and new transmission developers (“nonincumbent”) that include incumbents that create subsidiaries to build outside their service areas and transmission developers not affiliated with a traditional utility.

According to FERC, competition for certain projects can help identify and evaluate the more efficient or cost-effective alternatives to address regional transmission needs. In response to FERC Order No. 1000 reforms, many utilities have formed transcos to participate in this new competitive transmission arena. The transmission assets owned by these transcos are governed under an FERC-jurisdictional tariff with wholesale transmission rates approved by FERC. Transcos are not subject to traditional state PSC rate regulation.

Acknowledging the need for new transmission and a means by which to finance it, as early as 2008, a leading investment bank in the power industry presented to FERC at a technical conference as to the suitability of the REIT structure to finance the development of new transmission. The FERC commissioners at the time showed great interest in the viability of such a structure. When faced with the issue for the first time, FERC approved the transfer of FERC jurisdictional transmission assets to a REIT in a 2010 proceeding, again involving the Sharyland utility.

Despite the clear public policy support at FERC for encouraging new and cost-effective transmission developments, there are several uncertainties. First, given the current political environment, it is unclear if FERC would view any tax benefits afforded from the REIT structure for cost-based transmission assets as benefits that should be shared with ratepayers. Although, as previously mentioned, FERC has already approved a transfer of transmission assets to an REIT, due to the particularities of that proceeding, the issue of sharing tax benefits was not under consideration by FERC. So, despite FERC support for new transmission, FERC policy on the “sharing” of the tax benefits is not yet apparent.<sup>2</sup>

Second, FERC has also not yet opined as to whether its Income Tax Allowance (ITA) policy would apply to REITs. Generally, FERC’s ITA policy permits entities or individuals that own public utility assets a tax allowance on the equity portion of the capital structure of a flow-through entity as long as its owners are “subject to” taxation. An REIT is a taxpayer, but receives a deduction for income it dividends to shareholders. FERC has applied the ITA to MLPs, but not yet to REITs.

Finally, there is also a question regarding the need to adopt a new format for FERC-approved formula rates to accommodate the REIT structure. Until these regulatory uncertainties are clarified, they will complicate the financial analysis of a transco wires REIT.

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## **Rating Agencies**

In March 2014, Moody's Investors Service, in its report titled "Looking to MLPs, Yieldco, and REITs While Keeping Credit Quality Intact," referred to the influx of MLPs, yieldcos and REITs in the energy and power space as "a current financial engineering fad." Moody's went on to conclude that these types of financial engineering strategies are credit-negative.

In the case of a wires REIT, the rating agency cited the fact that such a structure would lead to the payout of some of the utility's most reliable cash flows to a new set of shareholders who get paid dividends before parent-level debt service. In addition, Moody's highlighted that this type of transaction would lead to the structural subordination of parent-level debt to the debt of the new subsidiary and complicate a utility system's capital structure.

Given the importance of an investment-grade credit rating in the utility debt capital markets, these credit rating issues are crucial in an analysis of a wires REIT. To the extent that the formation of a wires REIT would lead to a ratings downgrade, a utility system, especially a lower rated one, would have serious concerns about embarking on such a transaction.

Despite the recent Moody's report, however, MLP and yieldco IPOs are still getting done. Similar to participants in the midstream and renewable sectors, utilities contemplating a wires REIT could take certain steps to neutralize the negative credit impact of such a transaction.

For instance, in the midstream and renewable space, sponsors have used IPO proceeds to pay down debt, fund acquisitions and fund certain general corporate purposes at the sponsor level. The use of proceeds in such manners has been met with favorable rating agency reaction.

Furthermore, to the extent a utility intends to establish a wires REIT by means of a transco developing a portfolio of new transmission assets, in most circumstances, the wires REIT would be a small component of the diversified utility, at least initially. As a wires REIT develops a portfolio of transmission assets with stable cash flows, ratings agencies seemingly would be expected to view such a development in a positive light. So, although the reaction of credit rating agencies will loom large for a wires REIT, a utility should be able to structure its transaction in a manner that remains credit-neutral.

## **Why Hasn't a Wires REIT Phenomenon Hit Yet?**

Several answers have been offered to the above question — such as structural complexity, credit issues, regulatory policy of "sharing" benefits and uncertainty over FERC's Income Tax Allowance policy, among others. There is, however, one answer that no one can dispute: change comes slowly to the utility industry. Given that certainty, one could argue that wires REITs haven't "hit" yet because it's still too soon.

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REITs have been around over a half a century, but the structure's applicability to T&D assets was blessed by the IRS only a few years ago. FERC Order No. 1000 is a relatively new regulation — and only recently survived a legal challenge when it was affirmed by the DC Court of Appeals in August 2014. Although many utilities have set up transcos, most are still in the developmental stage, producing little, if any, taxable income. Given the dividend expectations of its investor base, the REIT structure may be better suited for a mature portfolio of cash-generating transmission assets.<sup>3</sup>

These factors suggest that — except for one or two wires REITs that possess uniquely favorable circumstances — a surge of wires REIT IPOs will not be a 2014 event. One could argue, however, that over the next few years, as the competitive transmission sector heats up and developmental transmission assets mature, as current political controversies over corporate tax “avoidance” die down, as coal-fired generation continues to contract and as (or if) the renewable industry becomes independently viable, the imperative need to build and finance transmission will become readily apparent to all. This confluence of events could serve as the impetus to clarify the current regulatory ambiguity. At that point, the wires REIT would seemingly be ripe for utilization.

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<sup>1</sup> To the extent the utility's assets were subject to the lien of a mortgage bond indenture, such a disposition of assets would present additional complications.

<sup>2</sup> In any event, the benefit-sharing concerns should not be an issue for merchant transmission facilities, which are transmission companies that are participant-funded and authorized to charge market-based transmission rates. Whether a wires REIT investor would accept the risks associated with a merchant transmission facility, however, is another story.

<sup>3</sup> Similarly, merchant transmission entities that are past the development stage may be well-suited for the REIT structure. Again, however, the question arises if the risks associated with merchant transmission facilities would be unsuitable for the wires REIT investor base.