

Transmission REIT Transaction Pending Before FERC

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As those who follow developments in electric transmission issues are aware, a 2007 Internal Revenue Service ("IRS") private letter ruling opened up the possibility of real estate investment trust ("REIT") ownership of electric transmission systems. Given the significant interest in transmission investment throughout the country, facilitating access to a significant pool of public equity capital through an investment vehicle that offers significant tax benefits could be a welcome development. However, until now, we are not aware of any taxpayer relying on the 2007 IRS ruling to form a transmission REIT.

In a proceeding currently pending before the Federal Energy Regulatory Commission ("FERC"), the entities that obtained the 2007 IRS private letter ruling, Sharyland Utilities, L.P. ("Sharyland Utilities") and other associated companies, are seeking FERC approval under Section 203 of the Federal Power Act to transfer legal title to transmission facilities to an entity that could be owned in part by a REIT. That entity would lease the transmission assets to an operator in return for fixed quarterly rental payments pursuant to a triple-net lease. The application states expressly that the purpose of the proposed lease is to "potentially access non-traditional sources of capital," including the REIT market. The deadline for interventions/comments in the proceeding, Docket No. EC10-53-000, resulted in only a single intervention in the proceeding and no opposition.

The Sharyland assets are in Texas and very few FERC jurisdictional assets are actually involved due to ERCOT's jurisdiction over much of the transmission in Texas. Sharyland Utilities is a transmission and distribution utility in ERCOT regulated by the Public Utility Commission of Texas. It built a high voltage DC tie between its service territory in Texas and the Mexican electric grid. Sharyland Utilities is also building transmission in the Texas Panhandle and South Plains regions to facilitate wind resource development for delivery to customers in ERCOT within Texas's Competitive Renewable Energy Zones. As of December 2009, Sharyland Utilities transferred ownership of its ERCOT jurisdictional transmission and distribution assets to Sharyland Distribution & Transmission Services, L.L.C. ("Sharyland D&T") "to enhance Sharyland Utilities' access to capital markets." Sharyland D&T leases such assets back to Sharyland Utilities and Sharyland Utilities continues to operate the assets. The FERC application seeks authority for the transfer of FERC regulated transmission assets, specifically 305 circuit miles of 138 kV transmission lines and 17 substations to establish a similar system lease arrangement for the FERC transmission assets.

Upon completion of the transactions, passive owners for the transmission and distribution assets will be in place with those new owners leasing the transmission assets to another operator. The lease will be "interposed" in order to satisfy the requirement for REIT status that a company must receive passive "rents from real property." The lease is necessary to essentially "convert" the transmission revenue into qualifying rental income to the REIT. As is required in the REIT context, the lessee has the economic risk/reward of operating the transmission assets and the lease provides for a fixed rent, making the lease arrangement essentially a financing on the REIT's assets.

A REIT is a company that owns, and in most cases, operates income-producing real estate, usually properties such as apartment buildings, shopping centers, offices, hotels and warehouses. REITs must have 100 or more shareholders, may not be closely held and may be publicly traded. To qualify as a REIT, at least 90% of taxable income must be distributed to investors on an annual basis (without regard to capital gains). This limits cash flow as a source of funding new development. Instead, funds for new investment must come from debt and equity issuances. A company that qualifies as a REIT is permitted to deduct dividends paid to its shareholders from its corporate taxable income. Thus, REITs remit 100% of their taxable income to their shareholders and therefore owe no corporate tax. As a result, REITs are tax efficient in that a tax on their income is generally only paid by their equity owners.

A REIT must satisfy several income and asset tests. At least 75% of its gross income on an annual basis must be income and gains derived from real property, real property mortgages and other similar sources, and at least 95% of gross income on an annual basis must be income and gain from such real estate investments, and dividends, interest and certain other income. In addition, at least 75% of the value of a REIT's total assets must be represented by real estate assets, cash, cash items, U.S. government securities and certain stock or debt instruments. The 2007 IRS private letter ruling concluded that electric transmission assets may qualify as real estate assets for purposes of such 75% asset test.

The FERC proceeding is of interest because it signifies that at least one company is moving forward with the REIT ownership structure for transmission. The proceeding is not a rate proceeding and will raise few issues under FERC's Section 203 standards so the FERC order itself is unlikely to be groundbreaking. For example, the FERC order is not likely to address accounting treatment of the lease by FERC for ratemaking purposes. The applicants refer to a future rate filing in which they will propose to rely on the financial data of both the lessor and lessee in order to establish transmission rates in the future. But those issues will not be addressed in this particular proceeding which only focuses on the deal approval. The applicants in the proceeding made rate commitments and are not proposing new transmission rates so this particular

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proceeding will not resolve the issue of whether FERC would permit 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. We note that FERC has addressed income tax allocation for limited partners in the master limited partnership or MLP context but this REIT proceeding does not seek such a determination. Also, the FERC application does not discuss GAAP accounting and rating agencies issues that could be associated with the use of the structure and we would not anticipate the FERC order to touch on these issues either.

It is unclear whether REITs would become widely used for new transmission as the uncertainties of construction and timing of project completion may make investors cautious of investing in new transmission companies with only development projects. The development and construction timetable for transmission facilities is generally much longer than the development and construction period for more traditional types of real estate focused REITs. It is also unclear whether the requirement to distribute 90% of taxable income would discourage transmission owners from forming REITs. Nonetheless, it will be interesting to see if other owners of electric transmission facilities, particularly operating projects, will seek to take advantage of the tax advantageous REIT rules to finance a significant portion of their facilities going forward.

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