Master Limited Partnerships Explained

Understanding Energy MLP's

Investors seeking income have historically relied on traditional securities, such as dividend paying common or preferred stocks; corporate, government or municipal bonds; or perhaps REITS. When desiring income with growth potential, the possible field of investments narrows to either just common stocks, or perhaps an asset allocation strategy with a mix of all of these. If tax advantaged income with growth is desired, then all of the options are essentially eliminated, with the possible exception of tax deferred variable annuities. However, in recent years a new option has become increasingly attractive to a number of investors, which combines the potential for income (and a record of increasing that income) with growth and tax deferral.

What Are Master Limited Partnerships?

Master Limited Partnerships (MLPs) have gained the attention of investors because of the high yields they can generate. Many of the MLPs are mid-stream, which means they are neither the energy explorers nor the retail marketers. They are instead the middle men that pump the crude and gas from the ground,

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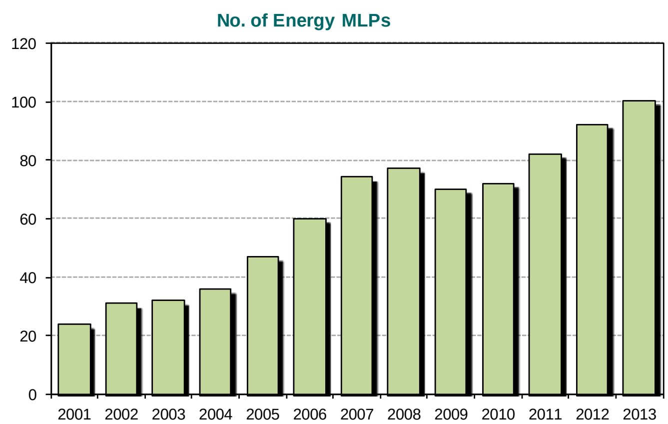
process it and sell it wholesale. Many of the MLPs have low or no debt, which allows them to pass along a high percentage of profits to investors, as well as to increase their distributions and share (or unit) price with some tax advantages.

Master Limited Partnerships are entities structured as publicly traded partnerships which pay no corporate level taxes. Taxes are instead paid at the individual unit holder level. The first MLP was created by Apache Petroleum in 1981, and a few years later the U.S. Congress passed the Tax Reform Act of 1986, which established MLPs' tax treatment as partnerships. The Revenue Act of 1987 restricted the types of companies that can qualify as MLPs to those with at least 90% of their income from energy related businesses. MLPs are a unique class in that they combine the tax benefits of partnerships with the liquidity of equities. Approximately two thirds of MLPs trade on the New York Stock Exchange with nearly all of the remaining trading on the NASDAQ. Their structure as pass through partnerships rather than public corporations allows them to pay no corporate level taxes, which results in higher distributable cash flow to investors.

In the past, most publicly offered limited partnerships were offered under prospectus and closed after the offering period. Limited partner investors had little or no liquidity options. There was also an additional layer of difficulty to getting current valuations on the investment. Energy MLPs, however, have the distinct advantage of trading on major stock exchanges, and potential investors can buy shares just as they can with exchange traded equities. MLP buyers can then track current prices and retain the ability to sell all or part of their investment at any time. While the structure of the entities may appear more complex than listed equities, this may, in fact, offer an advantage for those individuals who have an opportunity to examine them closely. In an inefficient market in which complexity, or some other barrier, makes information about assets less readily available, the rewards for those who have invested time into doing their own research increases. Rather than an arbitrage free environment in which asset prices already incorporate all readily available information, one would expect to see prices which do not reflect available information because of the complexity involved in the analysis of tax effects. This means that fully informed investors have an opportunity to earn above average risk adjusted returns.

The number of Energy MLPs has grown dramatically since 1999 (**Chart 1**).

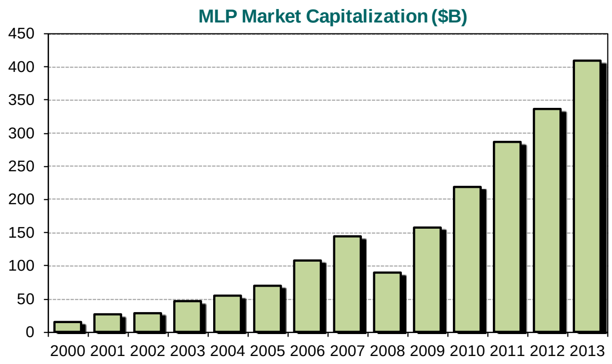
Chart 1



Source: Bloomberg, L.P.

Their market capitalization (number of shares x price/share) has experienced even faster growth (**Chart 2**).

Chart 2



Source: Bloomberg, L.P.

From the previous charts, it is readily apparent that energy MLPs have grown in popularity with investors. While it's true that MLPs pay a relatively steady stream of income and may increase in value over time, why should someone consider purchasing them in place of blue chip, dividend paying stocks with longer track records? The possible answer is their special tax treatment.

We all need energy, and these are very capital intensive industries; however, many of them own relatively low return assets such as rate regulated pipelines. The solution has been to lower their cost of capital by giving them a pass-through tax structure. Therefore, MLPs avoid the double taxation to which corporations are subject. The pass-through status means that distributions are not dividends. They are a combination of earnings plus depreciation, less the amount spent on maintenance. Under the tax code, this equates to a return of capital. Distributions are not fully taxed when received. They are taxed only once, primarily when the units are ultimately sold.

Example

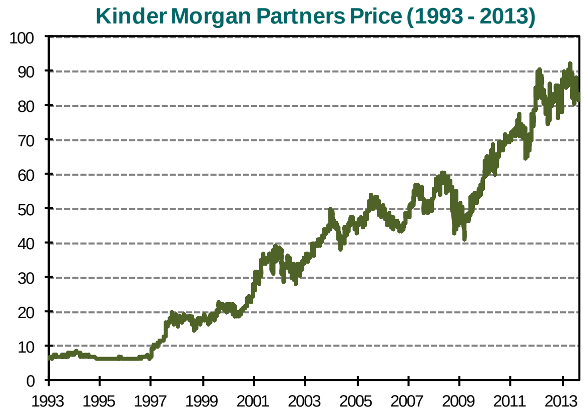
At the first of the year, an investor buys $100,000 of a MLP. Over the following year, quarterly distributions of $6,000 are received. At the end of the year, he learns that these distributions amounted to $6,000 of income and $5,000 of depreciation. Tax is only calculated on the difference of $1,000 on the investor's personal income taxes for that year. The remainder of the $5,000 is considered a return of capital, and is used to reduce the investor's cost basis in the MLP, changing it from $100,000 to $95,000. After a year and a day, he sells his units for $105,000. Since his cost basis has been reduced to $95,000, his gain in this case would be $10,000 - the profit from the purchase and sale, or $5,000 *plus* the $5,000 in gain as a result of the depreciation. The longer the MLP is held, the lower the cost basis sinks as deprecation continues to accrue. Held long enough, the cost basis goes to zero. For this reason a possible strategy is to hold MLPs long term, perhaps even until "death do you part." With the advantage of an estate's adjusted cost basis, the original investor had the advantage of a long stream of tax deferred income, and the estate heir may choose to hold or sell, with no adverse capital gains if sold right away.

Of course, another way to defer taxes and perhaps avoid the depreciation issue with MLPs would be to hold them in qualified retirement accounts. The only caveat to this approach is that under current tax law, if an individual's IRA held MLP investments in aggregate generate more than $1,000 in UBTI (unrelated business taxable income), the amount above $1,000 is subject to tax. For an investor who wants the benefits of MLPs in an IRA without the potential tax headaches, a mutual fund, exchange traded fund or exchange traded note of MLPs can be utilized, such as the Alerian MLP exchange traded fund (ticker: AMLP).

One of the largest energy MLPs is Kinder Morgan Energy Partners (ticker: KMP). Their website describes it as: "*a leading pipeline transportation and energy storage company and one of the largest publicly traded pipeline limited partnerships in America. We own an interest in or operate approximately 46,000 miles of pipelines and 180 terminals. KMP also is one of the largest publicly traded master limited partnerships in the U.S., and has invested over $30 billion in expansions, new build projects, joint ventures and acquisitions since 1997 to grow the company. During that time, KMP has delivered an average annual growth rate of 24% to its unit holders.*"

In 1993, KMP's cash distribution was $.57 per unit, and in 2012 it was $4.85, an income increase of 750% in 20 years.

Chart 3



Source: Bloomberg, L.P.

Risks

While MLPs have attractive features, there are potential risks which should be considered prior to considering this investment:

1. Changes in tax law could make them less attractive.
2. MLPs carry interest rate risk, since yield oriented investors may consider other, more traditional securities in a rising interest rate environment. However, their ability to increase distribution rates may at least partially mitigate this risk.
3. MLPs can be subject to commodity price risk when there is a decline in exploration, transport and processing of energy products related to volatile energy prices.
4. Supply disruptions, including mechanical, environmental accidents and terrorism are always possible.

Outlook

Since Master Limited Partnerships are mandated by law to receive at least 90% of their revenues from natural resource activities, they may be in a position to continue to benefit as the United States develops its energy infrastructure. The MLP market is poised to potentially receive vast additional assets in new forms of energy infrastructure introduced by technological advancements. These assets include liquefied natural gas terminals, gas to liquids technology, biofuel assets, renewable energy assets and coal gasification projects.

Conclusion

MLPs are still a relatively small, narrowly defined and concentrated asset class. Accordingly, it is unrealistic to conclude that they will continue to deliver the dramatic returns of recent years. However, continued investment in energy infrastructure may result in further expansion and accessibility to these investments. Low historical correlations to other asset classes could make them an effective vehicle to improve a portfolio's diversification and risk profile. This in turn may result in the justifiable usage of MLPs as a part of an alternative investment allocation in some investors' portfolios.

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