MASTER LIMITED PARTNERSHIP PRIMER
“MLP 101”

THIRD QUARTER 2009

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What is a Master Limited Partnership (MLP)?

Master limited partnerships (MLPs) are publicly-traded limited partnerships. Although MLPs share many of the same characteristics of a traditional limited partnership, MLPs trade on major exchanges like shares of a public corporation, and thereby provide liquidity not found in most limited partnership investments. As in most partnerships, however, operating earnings of an MLP are allocated among all partners in proportion to their ownership interest in the form of cash distributions and are taxed at the investor level at the investor's applicable income tax rate. This contrasts with corporations, where investors are faced with double taxation at the corporate and personal levels. Further, limited partners have more limited voting rights than do shareholders in a corporation. MLPs are managed by one or more general partners.

MLPs generate income from such sources as the gathering, transporting, processing, storing and distributing of natural gas, crude oil and refined products and coal production, with returns having little or no correlation to commodity prices. The majority of MLPs are engaged in energy businesses because the qualifying income provisions for publicly traded partnerships favor entities involved in mineral or natural resources activities as a way to encourage investment in exploration and production, and infrastructure development. The underlying assets of MLPs are vital to the U.S. economy because they facilitate the movement of natural resources from producing regions to the industrialized and energy-poor regions of the country. As energy demand in the U.S. continues to grow, it will be critical to have the infrastructure in place to meet the increasing demand.

Background of MLPs, 1981-Present

In 1981, Apache Petroleum Company became the first limited partnership to have its equity claims traded on a major stock exchange. The partnership structure provided a way for this asset-intense entity engaged in oil and gas exploration and production to monetize its cash flow stream. The first applications of the MLP structure were primarily exploration and production companies because these entities generally produce substantial cash flow in excess of net income due to large amounts of non-cash charges such as depletion and depreciation. As a result, investors received a cash distribution but had little or no tax liability. However, these entities were directly exposed to commodity price risk and had significant capital expenditure requirements due to depleting oil and gas reserves. These characteristics caused earnings and cash flows to be relatively unpredictable. Consequently, many early MLPs focused on risky oil and natural gas exploration and production, and had trouble maintaining consistent cash distribution levels which ultimately either caused them to fail or to be reabsorbed back into a corporate structure.

The modern MLP was born out of the Tax Reform Act of 1986, which lowered the top marginal tax rate paid by individuals to a level below that paid by corporations. The passage of this legislation caused many companies to change to the partnership structure in order to take advantage of the tax benefits. With many companies, such as Motel 6 and the Boston Celtics, making the switch to the MLP structure, lawmakers passed the Revenue Act of 1987. This legislation required publicly traded partnerships to receive 90% of their income from specific sources. Today, qualifying income for MLPs includes interest, dividends, real property rents, gain from the sale or disposition of real property, income and gain from commodities or commodity futures, and income and gain from mineral or natural resources activities. For these purposes, MLPs are considered to be qualifying sources of income, despite the fact that for tax purposes, MLP distributions are not a taxable event.

According to the U.S. Tax Code, mineral or natural resources activities include exploration, development, production, mining, refining (including fertilizers), marketing, and transportation (including pipelines) of oil and gas, minerals, geothermal energy, or timber that is not generally sold to the ultimate consumer. At the time the 1987 rules were enacted, there were some publicly traded partnerships already trading that did not generate qualifying income. These partnerships were given a transition period of ten years until December 31, 1997 before they would have to either meet the test or be taxed as corporations. The Taxpayer Relief Act of 1997 extended this transition rule indefinitely for grandfathered partnerships electing to pay a 3.5% tax on their gross income from business activities. About a dozen publicly traded partnerships made this election.

On October 22, 2004, the American Jobs Creation Act was enacted effective January 1, 2005. A section of this law allows regulated investment companies (RICs), such as mutual funds, to invest in MLPs by amending the definition of what was considered to be qualifying income for a RIC in the tax code. Largely because MLPs did not exist when the tax rules were written, income from MLPs was not previously included in the list of qualifying sources. This was a deterrent to MLP investment by mutual funds. Section 331 of the American Jobs Creation Act added net income derived from an interest in a publicly traded partnership to the list of sources from which a regulated investment company must derive 90% of its income in order to maintain its RIC tax status. RICs may now invest freely in MLPs as long as such investments do not constitute more than 25% of their assets, and as long as they do not own more than 10% of any one MLP. However, this legislation is still new and many mutual funds are only beginning to consider making major commitments to the MLP asset class.

Tax Advantages

MLPs are considered by the Internal Revenue Service to be pass-through entities, meaning that their operating results and taxable income are passed through to their limited partners for the purpose of tax reporting and tax liability. This eliminates the double taxation found within the traditional corporate structure, giving MLPs a cost-of-capital advantage as they are able to distribute more of their earnings to their limited partners in the form of quarterly cash distributions. Under partnership rules, the payment of distributions is not a taxable event. However, the cash flow generating the distributions may be subject to tax. Usually, an MLP distribution is made up of taxable income, non-cash depreciation and depletion and capital gains or losses, which the unit-holder can claim against MLP income on their schedule K-1. Accordingly, the cash distribution level is generally more a function of cash flow than of a partnership's ability to generate net income. Since cash distributions do not themselves generate a tax liability, the investor will not have a tax liability if an MLP has no income. The amount of the cash distribution that is not tax-deferred is taxed at the taxpayer's ordinary income tax rate. However, when an MLP does generate net income, investors incur a tax liability computed at their individual income tax rate, regardless of whether the income is distributed to investors.

The example in Figure 1 illustrates the hypothetical impact the tax deferral feature can have for an individual investment.

Figure 1. Example of Hypothetical Impact of the Tax-Deferral Feature on Distributions

Assumptions	
Initial Cost Basis:	$20.00
Annual Distribution:	$2.00
Pre-Tax Yield:	10%
Tax Deferral:	85%
Tax Bracket:	35%
Portion Taxable:	$0.30
Portion Tax Deferred:	$1.70
Tax Liability:	$0.11
After-Tax Yield:	9.5%
Adjusted Cost Basis:	$18.30

Source: Kayne Anderson Capital Advisors, L.P.

An investor who purchased a unit of XYZ, L.P., which is estimated to be 85% tax-deferred, will be required to pay taxes on $0.30 (or tax liability of $0.11 per unit at a 35% tax rate) of the $2.00 per unit cash distribution. The remainder will be used to reduce the cost basis to $18.30 per unit. Assuming the unit is sold at the end of the year, a portion of the distribution that was tax deferred may be taxed as ordinary income or loss to the extent that it is attributable to assets giving rise to depreciation recapture. In the event the units are not subject to depreciation recapture, the investor would pay a capital gains(loss) tax on the difference between the reduced cost basis and the sale price, which otherwise would have been taxed at the personal tax rate.

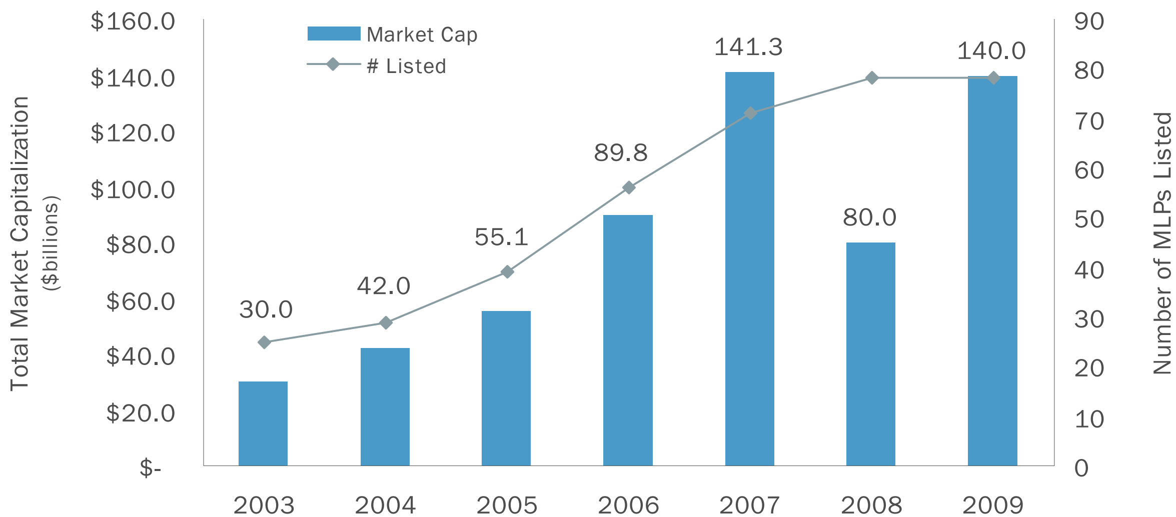
Overview of Energy-Related MLP Sectors

Pipeline, Terminalling and Storage

MLPs owning and operating pipelines, terminalling and storage assets represent the majority the outstanding market capitalization of the asset class. Pipelines are generally considered the lower cost method for transporting natural gas, crude oil, and refined petroleum products. There are three basic pipeline classifications: gathering systems, trunk lines, and distribution lines. Gathering systems are small diameter pipelines that deliver crude oil and natural gas from onshore and offshore wells to trunk lines. Trunk lines are large diameter pipelines that transport natural gas, crude oil, and refined petroleum products across the country. Distribution lines are small diameter pipelines usually owned by local utilities delivering natural gas to customers. Most pipelines do not own the energy products they transport and, as a result, are not directly exposed to commodity price risk. Instead, pipelines charge a tariff for transportation. The tariff charged is determined primarily by distance and volume delivered and is usually regulated by the Federal Energy Regulatory Commission or a local public utility commission.

Storage and terminalling facilities generally complement pipelines. These assets generate revenues through a combination of storage and throughput charges to third parties. Storage fees for handling crude oil and refined products are typically earned by leasing tank capacity. Additional fees can be generated by segregating or custom-blending crude oils for refining feedstocks. Natural gas storage facilities usually provide firm and interruptible services. Firm storage customers pay a monthly demand charge irrespective of actual volume stored and interruptible storage customers pay a monthly charge based on actual volumes stored. Terminalling fees, also referred to as throughput fees, are generated when an operator receives natural gas, crude oil, and refined products from a connecting pipeline and redelivers those products to another connecting carrier.

Figure 2. Growth of MLP Market Capitalization and Number of Energy MLPs Listed, December 2003 – September 2009



Source: FactSet Research Systems

Investment Rationale

From an industry dynamics point of view, midstream MLPs are defensive in nature due to their ownership of real assets and relative insensitivity to commodity price movements. Midstream assets without direct commodity price sensitivity have historically received a higher valuation in the market than those which were exposed to the variability of commodity price cycles. From a structure point of view, midstream MLPs were predominantly owned by retail investors because the size of the asset class and the tax reporting complexities made them unattractive to institutions.

While these same principles still apply today, there are a number of other factors influencing current investment rationale. These factors include: 1) the need for new and/or upgraded energy infrastructure assets, 2) more management teams focused on growing cash distributions through a combination of internal and acquisition-related growth initiatives, 3) a reduced overall risk profile for many MLPs due to recent acquisition activity, 4) the natural aging of the baby-boom generation and their increasing demand for yield-oriented investments, and 5) the institutionalization of the asset class and the potential for demand to outstrip supply. The following section discusses each of these factors.

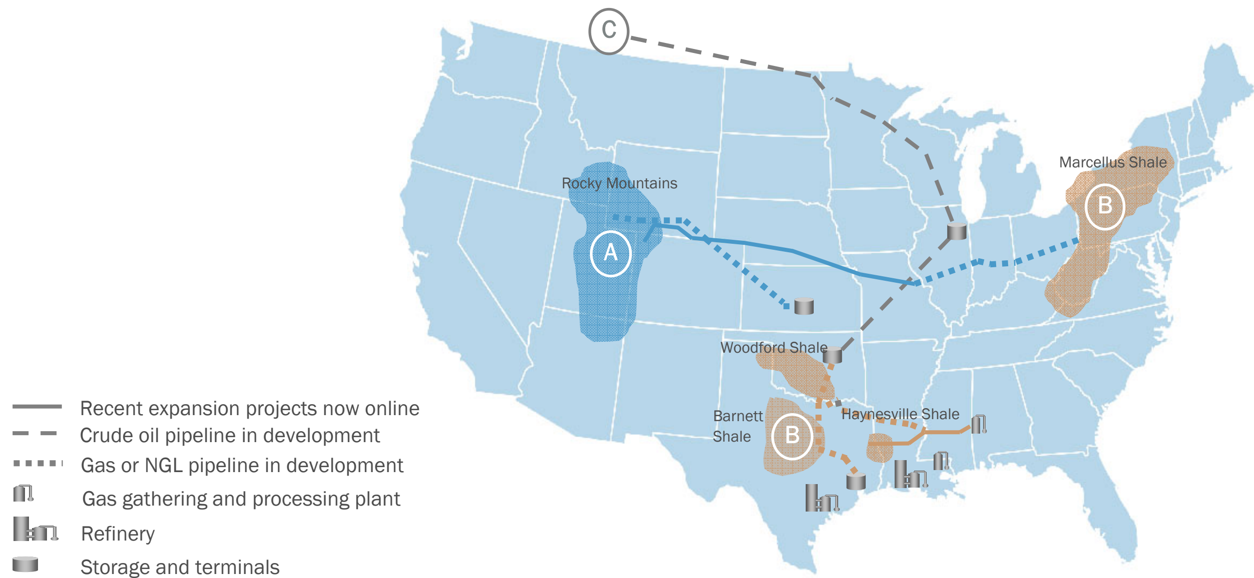
Need for New and/or Upgraded Assets

The demand for energy infrastructure continues to be strong. Shifts in supply sources and end-user demand for energy products are creating new infrastructure requirements. Drilling activity in regions of the United States that were previously thought to be uneconomic has picked up with improvements in drilling technology and higher commodity prices. In these cases, new infrastructure is required so producers can get their oil and gas to market. Figure 3 highlights some of these regions. Likewise, increased imports of Canadian crude oil and LNG have increased the need for new pipelines and storage facilities to handle these energy products. Demographic shifts are also providing growth opportunities as new markets are

developed and energy needs in those areas increase. Growing population centers in Arizona and Colorado are good examples of this trend. For developing markets such as China and India, marine transportation is one of

the most efficient means for transporting large quantities of energy and consumer goods over long distances. This dynamic is driving demand for a variety of vessel types and services.

Figure 3. Growing need for new energy infrastructure

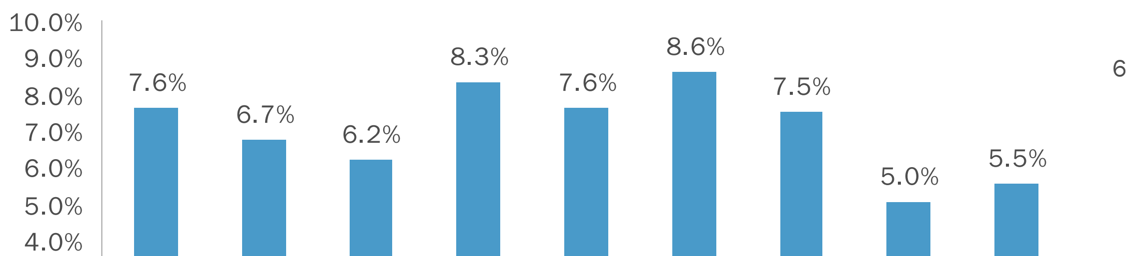


Source: Kayne Anderson Capital Advisors, L.P.

Greater Focus on Cash Distribution Growth

In combination with the pickup in acquisition activity and internal growth projects, more management teams have focused on increasing cash distributions. Part of the reason for this focus is a recognition that cash distribution growth drives unit price appreciation, which in turn reduces cost of capital, potentially making investments even more accretive. In addition, cash distribution growth enables the general partner to realize a greater percentage of distributions under the incentive distribution agreement. In recent years, general partners have increasingly looked at opportunities to go public. Since the thesis for investing in a general partner is largely dependent on the underlying MLPs ability to grow cash distributions, management needs to be constantly evaluating growth opportunities in order to satisfy both investor constituents.

Figure 4. Average MLP Cash Distribution Growth Rates



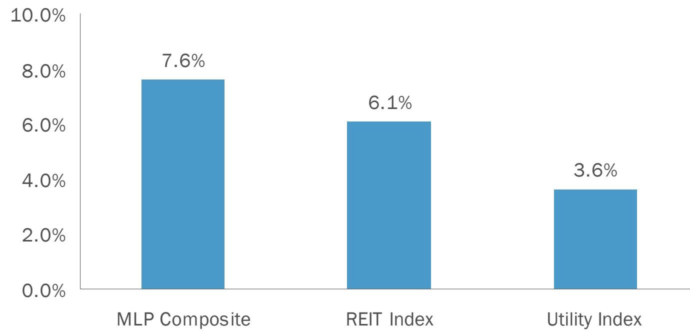
Lower Risk Profile

A period of robust acquisition activity over the past decade has enabled many MLPs to diversify operations to avoid over-dependence on any one business. In many instances these acquisitions have provided geographic diversification benefits that mitigate the effects of regional economic downturns and unfavorable weather conditions on energy consumption. This improved business and geographic diversification also provides increased protection from competitive and regulatory risks. In addition, the experience and knowledge gained by management teams from evaluating and executing deals can reduce integration risks. Finally, liquidity, as defined by publicly traded float and unit volume, has been expanded due to the large amount of equity that has been issued to finance these transactions. As a result, it should be easier for investors to build and liquidate portfolio positions.

Rising Demand for Yield-Oriented Investments

The baby-boom generation (people born between 1946 and 1964) provides a positive backdrop for MLPs because this age group has a strong demand for financial investments. The front-end of the baby boomer generation is now firmly into the very important 46-65 years age group. (The largest and wealthiest segment of the U.S. population falls into this category.) As these investors approach retirement, the demand for yield-oriented investments is anticipated to increase. Kayne Anderson believes that these investors will increasingly find MLPs to be an attractive investment alternative to most fixed income products as a result of the total return characteristics of MLPs.

Figure 5. Average Cash Distribution Yields, data as of September 30, 2009



Source: MLP Index is the average yield of the Alerian MLP Index; REIT Index yield is the average yield of the NAREIT Index; Utilities Index yield is the yield of the Russell 2000 Utilities Index.

Institutionalization of the Asset Class

While the passing of the American Jobs Creation Act in 2004 removed certain hurdles to institutional ownership, MLPs have drawn more attention from Wall Street also because of their attractive total return characteristics and their generally low-correlation to major markets.

The asset class boasts an aggregate equity market capitalization that currently exceeds $140 billion, which should continue to increase as new MLPs are formed and more investments are made. Although the size of the asset class is still relatively small, it is no longer too small to ignore. As more institutional investors “get up to speed” with the investment attributes of MLPs (including administrative requirements they need to integrate in order to handle tax reporting complexities) and the demand for yield-oriented securities accelerates, trading multiples should expand and yields compress.

This report is not a recommendation to engage in MLP transactions, and is provided at no charge, and for educational purposes only. This report is intended give a broad overview of MLPs, and does not contain, or mean to contain, the level of detail necessary to give an adequate basis to an investment decision with respect to any specific security by any one person. Individuals receiving this report should possess sufficient investment knowledge and sufficient ability to make their own evaluation of the report and any investment decisions. Individuals should make their own investment decisions based upon their own financial objectives and financial resources, and they should seek professional advice to the extent that they cannot independently arrive at such determinations. This report is intended to be useful, and as of the date of its first publication, it is believed to be accurate.