

Master Limited Partnerships: Income From a Unique Structure and Industry

An Interview With Kenny Feng, CFA

Article Highlights

- Master limited partnerships (MLPs) are pass-through entities that have different tax structures than corporations.
- Due to steady demand and federally regulated prices, MLPs are able to pay consistent distributions.
- Directly owning an MLP provides more tax efficiency and avoids management fees, while owning the Alerian MLP exchange-traded fund simplifies tax reporting.

Kenny Feng is president and CEO of Alerian. I spoke with him about master limited partnerships and the Alerian MLP exchange-traded fund (AMLP), which is held in our Model ETF Portfolio.

—Charles Rotblut



Charles Rotblut (CR): Could you explain what a master limited partnership (MLP) is and how it differs from a traditional corporation?

Kenny Feng (KF): Sure. Energy master limited partnerships are engaged in four primary businesses, which are the exploration and production, transportation, storage and processing of natural resources and minerals. By confining themselves to these specific activities, MLPs are not subject to entity-level taxation as a traditional C-corporation would be. They are, however, subject to the same reporting requirements (annual reports, filing 10-Ks, filing 10-Qs, filing notices of material changes and complying with the Sarbanes-Oxley act) as publicly traded corporations. It is also worth mentioning that they trade on the public exchanges; about two-thirds of the energy MLPs trade on the New York Stock Exchange and a vast majority of the remaining one-third trade on the NASDAQ.

CR: And with their structure, the earnings flow through, correct?

KF: Exactly. They are pass-through entities.

CR: I know that creates different tax issues for investors than investing in a traditional corporation.

KF: Exactly. If you were to invest in IBM (IBM) or any other publicly traded corporation that pays a dividend,

you would get a Form 1099, and you would report the payments as dividend income.

With MLPs, you are a limited partner, and you get distributions instead of dividends, as well as a proportional share of income and deductions. Your share of income, deductions, and any distributions appears on a Schedule K-1, which is the case for any other partnership in which you would own an interest. Due to the fact that MLPs incur various deductions for things like accelerated depreciation, roughly 70%–100% of the distribution is a tax-deferred return of capital.

CR: With respect to returned capital, one of the issues, particularly with retirement accounts, is that they can trigger the unrelated business income tax.

KF: When you put an MLP into a tax-deferred account (for example, an IRA), if you exceed a certain income limit, you do owe taxes on the excess amount. The limit is \$1,000. The size of your ownership position determines whether or not you're going to trigger that unrelated business income tax. But it does create issues for people who own MLPs in IRAs or other tax-deferred accounts.

CR: How are the revenues affected for MLPs involved in the pipeline industry? Pipeline fees are federally regulated, aren't they?

KF: Pipelines and storage tanks, which are energy infrastructure assets, operate on what we call toll-road business models. If you're driving on a tollway, regardless of whether you drive a Honda Civic or an Aston Martin, as long as it has four wheels, when you go through a toll booth, you'll be

charged the same tariff. In the same way, pipelines and storage tanks do not take title to the commodity itself. Over the past eight or nine years, we've seen oil prices move from \$30 up to \$150 and then back down to \$40, and now we're sitting in the \$80–\$100 range. Pipeline and storage tank businesses have not been directly exposed to those commodity price fluctuations because the way that they make money is a simple revenue equation of price times volume.

On the price side, you have an escalator indexed to inflation. It's called a PPI (producer price index) adjustment. The PPI has moved from –1% in 1995, to +1.3%, to +2.65% today on all interstate oil pipelines. The upward adjustment over time is a function of the fact that the Federal Energy Regulatory Commission (FERC) understands that the financial viability of these companies is very important, as these assets represent the backbone of our nation's energy infrastructure. It's important to be able to recover not just the expenses that are built into operating pipelines and storage tanks, but also increased maintenance requirements over time.

On the volume side, energy demand growth for the United States has averaged roughly 1% per annum over the past 30 years. The consistency of that demand, with some mild fluctuations in between, has really been a function of the fact that President Eisenhower built up the U.S. highway system several decades ago. As a result, we've got suburbia: You're driving your son to football practice, you're driving your daughter to ballet practice, you're driving to the grocery store. The consistency of gasoline demand has been largely inelastic over time. You still have to do those things, regardless of whether the economy is moving one way or the other. Due to the inelasticity of demand on the volume side and, again, the PPI escalator that kicks in every July 1 on the price side, we've got a revenue equation that is very predictable and, as a result, is able to pay consistent distributions.

CR: *In terms of how the MLPs trade, what besides cash flow is influencing their prices?*

KF: There are two sides to how MLPs trade. One is the fundamental side, obviously; the other is the technical side.

On the fundamental side, it really is the consistency of cash flows. MLPs have traditionally traded as a function of price to distributable cash flow. It's important to note that distributable cash flow is net of maintenance capital expenditures. The price-earnings ratio, which is something that a lot of people use for other types of businesses, is not really useful for MLPs, because a lot of times the earnings themselves are going to be negative due to depreciation and other non-cash items. Cash flow is the number that matters, because that is what MLPs use to pay their distributions. Other than that, investors look at the spread to the 10-year U.S. Treasury note. It's not our preferred metric for valuation, but it is something that people look at, and it is consequently important as far as behavioral finance is concerned.

On the technical side, the reality is that this is still an emerging asset class. MLPs have only been around since 1986. If you look at how many partnerships there are today, it is 75 companies and roughly \$250 billion in market capitalization. That is essentially two-thirds the size of Exxon Mobil (XOM) by itself.

Since MLPs are still an emerging asset class, they are going to be subject to growing pains. Some of the smaller partnerships are fairly illiquid, and the price volatility can be significant. We're also seeing higher correlations to the broader equity markets as the asset class becomes more institutionalized. A lot of people like to think of these as bond substitutes, and while that may be true from a yield standpoint, it is worth noting that they can trade like equities, especially in downturns of the broader market.

CR: *In terms of taxes, what is the difference between investing directly in a master limited partnership and investing in your fund?*

KF: The first thing I would say is that if you can invest directly in an MLP, and you're comfortable with the single-security risk and Schedule K-1

filings that come with investing in one, then do it. The reason is simply that there is greater tax efficiency in your distributions and you won't pay any sort of management fee.

There are others who are looking to invest in a basket of securities, because that enables them to get diverse exposure through one vehicle. Similar to an MLP, the Alerian MLP ETF (AMLP) retains the underlying nature of the distributions, which is largely tax-deferred return of capital. You will get a 1099 (but no K-1s, and no state tax filings), in addition to the diversification benefits.

CR: *To clarify: If someone buys Alerian MLP, they're still going to get the tax benefit, meaning they can postpone paying taxes on the return of capital until they sell the ETF?*

KF: Exactly. Alerian MLP has 25 securities in it, and they're all midstream energy infrastructure names. Let's say that if you were to own those 25 MLPs in individual accounts, the average tax-deferred portion of the return of capital would be 80%; the same would be true for owning Alerian MLP directly. The balance—that remaining 20%—would be a qualified dividend, which is another benefit of AMLP's structure.

CR: *If an investor buys the fund in a taxable account, when he sells it, he can actually use the distributions to reduce his basis?*

KF: Right. Your basis comes down over time. You're eventually going to pay the difference because it is tax-deferred, not tax-free. There is a deferral on that account, and you will end up paying taxes on that when you sell. It is this deferral mechanism that delays tax payments, which, thinking about the time value of money, benefits investors.

CR: *What we're talking about is actually reducing the taxable net profit reported to the IRS as a capital gain, correct?*

KF: Right. In the current year.

CR: *Is there anything else about MLPs that should be mentioned?*

KF: One thing that comes up pretty often is, "How does this compare to other yield-oriented equities?" The

Table 1. Alerian MLP ETF Versus Sector Averages

	Total Return				Yield (%)	Expense Ratio (%)
	YTD (%)	2010 (%)	Annual Avg 3 Yrs (%)	Annual Avg 5 Yrs (%)		
Alerian MLP ETF (AMLP)	-0.4	na	na	na	6.5	0.85
Energy ETF Sector Average	-20.5	14.6	-19.6	0.9	1.8	0.94
Real Estate ETF Sector Average	-7.2	30.6	-3.5	-13.7	2.4	1.09
Utility ETF Sector Average	0.0	5.3	11.3	15.0	3.6	0.88

*na = not available. AMLP inception date is August 25, 2010.
Source: Morningstar Inc. Data as of September 30, 2011.*

most common comparisons are going to be to real estate investment trusts (REITs) and utilities, which have also been traditionally thought of as real income-generating equities.

Like MLPs, utilities benefit from inelastic energy demand. But the revenue mechanism for utilities is very different. Let's say an electric utility goes to the local regulatory board and says, "I'd like to install electric meters at the homes of all my consumers." (It's a pretty big initiative that we've seen slowly moving across the entire country.) The utility presents its budget to the regulatory boards and says, "I'm going to have all these cost savings, and I need this amount of capital spending built in to my rate base." The regulatory board comes back to the utility and says, "It's a great idea, it's going to generate a lot of savings, and now I'd like 50% of your savings for my consumers." So you have a naturally antagonistic relationship that's set up between the local regulatory

board and the utility. The regulatory board's job is designed to protect the consumer in a way that often becomes localized and politicized, unfortunately.

With MLPs, you don't have that. Instead, you have overarching benign federal regulation that comes from the FERC on all interstate transportation of natural gas and crude oil. The benefit is that the process doesn't get weighed down in some sort of bureaucracy that eventually becomes really unproductive for both service providers and consumers.

The other comparison that I mentioned is to REITs. A building has a permanent storage value that's associated with it, because of the rent that it generates. We would argue that the pipelines that transport the natural gas to heat that building during the winter and to cool it during the summer have similar permanent storage or hard asset value.

The difference between REITs and

MLPs is that during economic downturns, like the one we saw beginning in 2008, pipeline and storage MLPs don't experience the same kind of cash flow volatility that REITs do.

The building that we used to be in was 90% occupied when we first moved in there in 2007. During the worst part of the economic crisis, it was 50% occupied. You could make the argument to your landlord, "Your building is at a much lower capacity than it was before; there are a number of other buildings that are also empty now, so I'm going to go and shop for the most competitive rate unless you give me a reduction in my rent." Again, with MLPs, you don't see nearly the same level of cash flow volatility to economic activity, because energy demand is pretty inelastic over time. That's why the average MLP distribution growth was still 3%–5% per annum during each of the last three years, and it is on par for that again this year. ▲

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