

**UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION**

**Composition of Proxy Groups for Determining) Docket No. PL07-2-000
Gas and Oil Pipeline Return on Equity**

**POST-CONFERENCE COMMENTS OF THE
CANADIAN ASSOCIATION OF PETROLEUM PRODUCERS
AND THE NATURAL GAS SUPPLY ASSOCIATION**

Pursuant to the procedures established in the Commission's Notice of Technical Conference and Request for Additional Comments, issued November 15, 2007, and the Notice of Extension of Time to File Comments and Rescheduling of Technical Conference, issued December 13, 2007, The Canadian Association of Petroleum Producers (CAPP) and The Natural Gas Supply Association (NGSA) hereby submit their joint initial post-conference comments. CAPP and NGSA fully appreciate the Commission's stated intent to narrow the focus of its inquiry into the technical aspects of growth, and has endeavored to follow that prescription in these comments. In addition to comments on the discrete issue that was the subject of the January 23 conference – how growth of Master Limited Partnerships ("MLPs") might be quantified and translated into a "g" figure for use in a DCF analysis – these comments include several observations addressed to the overall context in which the Commission is addressing the growth issue.

Comments

**MLPs Are Uniquely Vulnerable to the Vicissitudes of Financial
Markets For Purposes of Sustaining Per-Unit Growth. Their Long-
Term Growth Therefore Cannot Reasonably Be Equated With That of
the Economy Generally**

As Commissioner Spitzer observed during the public conference, MLPs are

a reality. However, from the standpoint of finance, they are a highly idiosyncratic reality, which exists in a limited arena, namely, those businesses for which Congress has conferred special tax status as publicly-traded pass-through entities. Unless and until Congress chooses to expand that limited arena, MLPs will remain a small niche in the overall economy, which still overwhelmingly comprises corporate and other forms of business organizations. The unique attributes of MLPs should be given due regard in evaluating their long-term growth prospects. Specifically, the limited ability of MLPs to diversify beyond finite assets within specified businesses as legislated by Congress and their complete inability to employ retained earnings as a financing tool should be given appropriate weight, as should the concomitant vulnerability of MLPs to oversaturation of this limited niche.

In setting out to measure – or to identify a fair proxy for the measurement of – the long-term prospects for growth in per-unit distributions by MLPs, the Commission is taking on a confounding task. It goes without saying that there is no long-term empirical basis for such a judgment because MLPs have not existed in any meaningful numbers over the long-term. Accordingly, much of what has been presented in this docket and in the public conference represents qualified speculation; expert, in some cases, but speculation nevertheless. As the conference emphatically demonstrated, the elements of change and evolution in the MLP “asset class” are at least as numerous as, and in some respects more significant than, the “stable” elements. The uncertainties relating to the “splits” applicable between GPs and LPs (See, e.g, Transcript at 18 and the discussion below), the emergence of private secondary placements as the principal source of MLP financing (see Attachment A), and the relative success or failure of innovations within the MLP structure, such as “I-units”, are all sources of enhanced variability and uncertainty, which have only recently been introduced into the picture, and have different implications today than they had even at the time this docket was initiated. The MLP picture is a kaleidoscope that continues

to rotate.

For the limited purposes of having some policy on pipeline return calculation in place, the Commission should give appropriate recognition to the fact that MLPs do not function in the ways traditional C-corporations or even LLCs do, and that as a result it is an exercise in rumination as to how they can be expected to finance their operations over the long term in an economy that will remain largely structured on the basis of corporate finance. Corporations as an “asset class” have no inherent limitations as to the business enterprises they can develop and have considerable flexibility in how they finance ongoing operations. MLPs do have real limitations on the businesses they can operate, and they have far less flexibility in how they obtain capital. These limitations have important implications, which cannot reasonably be glossed over with observations that the “market” will simply wash them out over the long term.

A clear illustration of even the short-term ramifications is afforded by a recent industry outlook publication: the June 7, 2007 Morgan Stanley “MLPs – Master Limited Partnerships An Overview of an Emerging Asset.”¹ [Attached in its entirety, per the directives of FERC Staff at Transcript page 144-145] Slide 10 of this presentation shows how over past twelve years companies have aggressively moved to utilize the MLP structure in order to exploit its tax efficiencies. Slide 11 shows that a significant backlog has grown as well. Slide 19 cautions that as a result, “The near-term supply of equity could overtake demand without modest institutional interest and as a result MLPs could be negatively affected....The result would make a more challenging environment for secondary offerings necessary to fund organic growth.”

The scenario of reduced demand for MLP equity forecast by Morgan

¹ The Morgan Stanley Overview is only one of many similar publications in which financial advisors have undertaken to explain to investors the many intricacies and unique attributes of MLPs. The very fact that these measures must be taken, and that investors must be educated and apprised of the idiosyncracies of an “emerging asset class” should give the Commission pause in its zeal for incorporating MLPs into the DCF analysis.

Stanley could, in fact, have already arrived for the short-term. Recent MLP offerings have been postponed. For example, Pioneer Natural Resources postponed the initial public offering of its newly planned MLP this February. NAPTP representative Mary Lyman explained to Gas Daily (Thursday, Feb. 7, 2008. pp.6) that there “may be a need for markets to catch up after so many equity offerings last year.” If demand in the equity markets will not support an IPO, it seems unlikely to support an equity issuance from an existing MLP large enough to finance a sizeable growth project. This is an obvious source of volatility in the MLP sector’s externally-dependent growth. Moreover, this limitation is attributable purely to the form of investment, and has nothing to do with the business of owning and operating pipelines.

Such equity-market considerations would have less immediate impact if MLPs could deploy retained earnings as capital, as their corporate counterparts can do. The conference contains numerous optimistic characterizations of MLP prospects. Notably, however, they failed to acknowledge or address the kinds of limitations and constraints on capital formation that the Morgan Stanley piece alludes to. Illustratively, one of the MLP spokesmen, Mr. Vilbert, painted a rosy outlook that minimized the effects of the requirement that an MLP distribute all of its available cash:

MR. VILBERT:First, as I said earlier, I do not believe that distribution policy prevents the MLP, as a whole, from growing every bit as fast as a C-corp. If capital markets -- if they have access to capital markets and you have a good place to put the money, investors will give it to you, if you have a reasonable reputation for using their money efficiently. They will give you the money to invest, so you can grow, if you have the projects to put the money in. A C-corp can do the same thing; they get some of the money by retained earnings, they get some of the money by debt and issuing equity.

[Transcript p. 103] In this passage, the reference to retained earnings was obviously made only in passing, and the critical phrase “if they have access to capital markets” was in fact the critical point in issue. It is a fundamental tenet of

corporate finance, that when equity capital markets become tight, as they inevitably do in cycles both large and small, the availability of retained earnings represents a critical cushion. MLPs have no such cushion. Might the corporate-family GPs weigh in with an equity infusion? It is of course possible, but anything is possible in the realm of speculation. That MLPs have no access to one of the principal sources of finance, internal capital, and must rely exclusively on external capital is a fact. Mr. Siegel of Wachovia summarized the situation succinctly: “The paradox that we are faced with, is, how does an entity grow, if they pay out all their cash in the form of distributions to their unitholders? Well, the answer is simple: They have to rely on accessing external capital.” [Transcript at 33] This different capital structure requires fundamentally different methods of financing growth and the Commission cannot reasonably ignore in forecasting growth rates for MLPs.

If the Commission intends to adhere to the DCF, it should adhere to the rationale implicit in that methodology. As corporations can rely on both retained earnings and external financing to fund growth, a sustainable growth rate for dividends issued by corporations is commonly evaluated in DCF analyses using the following formula:

$$g = br + sv$$

Where:

g = the growth rate of dividends

b = the expected earnings retention ratio

r = the expected earned rate of return on common equity

s = funds raised from the sale of stock as a fraction of existing common equity

v = the fraction of funds raised from the sale of stock that accrues to shareholders

For MLPs, however, which distribute all of their cash flow, $b = 0$ and hence $br = 0$. Indeed, in many instances, the data demonstrate that b is negative, making br a

negative number. Otherwise, for MLPs, the sustainable growth rate would be estimated using $g = sv$. The Commission employs negative sv figures in its DCF analysis in electric utility proceedings (e.g., where share repurchases have resulted in negative cash from stock issuances). If the Commission is to adhere to the DCF methodologically, negative growth rates may simply be what is called for in those instances where the data so indicate. There are various solutions to this basic algebraic issue; ignoring the negative numbers is not one of them.

This again highlights the critical role of new equity in the MLP's ongoing business, one of the few relevant facts that is not in dispute. The only reasonable assumption (or forecast) is for a diminished level of growth in unit distributions relative to that of the economy generally, because 1) MLPs are constrained to external sources of capital to fund growth, a constraint that the economy generally does not confront; and 2) market conditions cannot indefinitely prevail that permit growth to be funded through external sources alone.

Contextual Observations on Growth

A. This Docket Will Not Resolve Growth or Other MLP Issues

As noted above, the public conference highlighted the ongoing evolution of issues relating to the use of MLPs in the DCF proxy group. Recognizing the Commission's interest and intent to narrow those issues, this does not seem to be feasible; indeed, rather than telescoping the issues into a discrete inquiry into growth, the issues appear to be expanding with each successive iteration of this proceeding. This is in part a function of the fast pace at which MLPs as a form of investment are evolving, and in part a function of the fact that as greater detail is introduced into the analysis, the less factual the discussion has become.

There are several fundamental points on which there is no apparent consensus as to the facts and where the available "evidence," in some instances, is anecdotal. Illustrative of such issues are:

1) Whether analysts' percentage growth forecasts represent distributions or earnings, in some cases, all cases, or none; [See, e.g., two statements: Transcript at 19. It "appears" that when MLP analysts report to IBES, "they are likely to be reporting distribution growth, rather than income growth;" and Tr. 33 "the analysts, when asked for EPS growth rates, are more likely than not, talking about distribution growth rate;" these two statements being irreconcilable with the Handout, "Number of IBES Analyst Estimates of Growth Rates, EPS vs. DPS" Thomas Horst on behalf of the State of Alaska, which states "most analysts decline the invitation to provide those [distribution] forecasts and provide only forecasts of earnings per share," Tr. at 54] The seemingly widespread confusion about what is being measured by IBES "growth rates" and, indeed, what the Commission itself seeks to measure with its "short-term growth rate" calls into question the accuracy of the results of the DCF equation when used to calculate MLPs. Traditionally, the IBES growth rates forecast c-corporations' earnings per share (EPS). Mr Siegel, as quoted above, characterized analysts' EPS estimates as "more likely than not, talking about distribution growth rate." In many cases, both forecasts are available and for most MLPs there is significant variation between forecasts of the earnings and the distributions per unit. The conference clearly did not resolve this confusion, nor has the Commission ever specified which it views as appropriate for use in the DCF, or why.

2) Whether it should be expected that the "high splits" that some MLPs have reached or may achieve under their initial partnership agreements will continue in force or if they are more likely to be amended to reduce the GPs share of distributions in response to concerns in the capital markets over the long-term cost of capital to MLPs; [See, e.g., Transcript at 34; "I think it's very, very plausible to think that companies will cut back the IDRs, if it makes sense, to sustain growth. We've seen examples of that."]

3) Whether the current statutory treatment of dividend income should be expected to remain in place, expire, or be renewed. Related directly to this question is the equally speculative prospect that the corporate tax rate may be cut, as is now widely anticipated in a new Congress. The expanding scope of such issues is entirely unpredictable and inevitable, given the novelty and complexity of the MLP form of investment and absence of any theoretical foundation for use of MLPs in a DCF equation. In a practical way, this expansion of issues validates the observations of Mr. Patrick Barry, who appeared on the panel on behalf of the New York Public Service Commission: “Including MLPs in the proxy group will ultimately result in more, rather than less, uncertainty in individual cases, as parties litigate the issues of how and/or whether the Commission’s policy should apply.” [Transcript, at 20-21]

For this reason, CAPP and NGSa urge that the Commission adhere to its well-established approach to formulating policies of general applicability, which was recently reiterated succinctly: “[A] policy statement by itself does not apply to the specific facts of any particular case, nor does it purport to resolve any specific controversy.” Notice Rejecting Request for Rehearing, January 29, 2008, Docket No. PL08-1. The course of the discourse in this proceeding strongly suggests that it may be unworkable to establish anything more than very general parameters for the use of MLP data in a DCF. Absent a specific record on which to resolve some of the fundamental outstanding issues, the viewpoints expressed at the conference – which covered a very broad range – remain just that, views, without any basis for evaluating the legitimacy or reliability of any specific growth figure or any resulting DCF-based cost of equity.

B. The Lower Cost of MLP Equity Cannot Be Ignored Or Lost In a Methodological Shuffle That Disaggregates the DCF Equation

It appears to be beyond dispute that MLPs afford investors a lower cost of capital than that of their corporate counterparts. (See, e.g., The MLP structure

“gives [MLP investors] the opportunity to make acquisitions at a much lower cost of capital” “Gas Daily,” Feb 7, 2008, p. 6, quoting Pioneer CEO Scott Sheffield.) At this juncture of the inquiry in this docket, however, the focus on individual components of the DCF threatens to obscure this reality altogether. There are several layers of assumptions that appear to be built into the analysis and therefore must be accommodated: that the DCF is the preferred methodology, that IBES (Thompson Financial) forecasts are preferred for short-term growth, and now, apparently, that the Commission does not intend to consider imposing a cap on MLP distributions at the level of earnings. Depending on how the long-term growth issue is resolved, it appears likely that if MLPs’ long-term growth is equated with that of corporations, then the result would be a cost of equity for MLPs no lower than that of corporate counterparts and indeed perhaps higher than that of corporations. Indeed, that is the analysis set forth in CAPP’s reply comments in this proceeding. (see Attachment A, tables 2 & 3 to CAPP Reply comments, filed September 19th in Docket PL07-2).

If the Commission adopts a policy in full recognition of this anomaly then it should recognize that the preferred DCF equation is generating results that are at odds with financial realities. Far from conforming to the apparent will of Congress, as Commissioner Spitzer has alluded to, adopting a ratemaking policy that repudiates the lower cost of equity capital for MLPs would appear to repudiate Congress’ intent, to create a lower-cost means of financing businesses that are touched in many instances with a direct public interest.

The DCF formula should function as an instrument for estimating a reasonable outcome, not as the mechanical determinant of the outcome. It should not produce results that are counterintuitive or illogical, particularly in light of the myriad uncertainties that afflict the statistical inputs. As NGSAs has noted, if the Commission finds it necessary to conduct a conference on a single variable, what is the prospect of a reasonable policy of general applicability? If the Commission finds that the DCF is producing results that suggest a higher cost of equity for

MLPs than their corporate counterparts, then it should consider taking the same measure recently adopted by another federal regulator, and replace the DCF with a risk-premium methodology, such as the CAPM. See, Surface Transportation Board, Decision STB Ex Parte No. 664, “Methodology To Be Employed in Determining the Railroad Industry’s Cost of Capital,” January 17, 2008.² As has already been pointed out in this proceeding, the CAPM analysis validates that MLPs have a lower cost of equity capital than their C-corporation counterparts, a finding that is wholly in keeping with the starting point of this dialogue, namely, that MLPs offer a tax-efficient, and therefore lower cost, means of raising capital for the business enterprises for which they qualify.

CONCLUSION

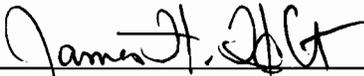
As this proceeding has made abundantly clear, incorporating MLPs into a DCF methodology is a daunting task. Presumably the Commission favors the DCF approach because of its strong theoretical underpinnings. These theoretical underpinnings are seriously jeopardized by ad hoc, unproven tinkering with the inputs to the formula. The theoretical basis of the DCF should not be compromised simply to fortify the proxy group with new candidates such as MLPs. The DCF model specifically recognizes that corporations pay out a portion of their earnings as dividends and a portion are retained to provide a source for future growth. However, if the Commission were to include entities such as MLPs that do not retain any earnings, yet give these entities distribution growth rates the same weight as corporations’ earnings per share growth rates, the theoretical underpinnings of the DCF model will be devalued. Any ROE result derived from such analysis would suspect at best, and arbitrary in many instances. Carte blanche inclusion of MLPs in the Commission DCF approach is not a viable

² Moreover, in its order the STB found that, regardless of capital structure, “the single-stage DCF model estimates a high cost of equity.” The STB found that CAPM provides a more accurate reflection of financial realities than DCF, prompting the Board to shift from DCF to CAPM for rate-making purposes.

option if the Commission wishes to meaningfully and reliably estimate the cost of equity capital.

Respectfully submitted,

THE CANADIAN ASSOCIATION OF
PETROLEUM PRODUCERS

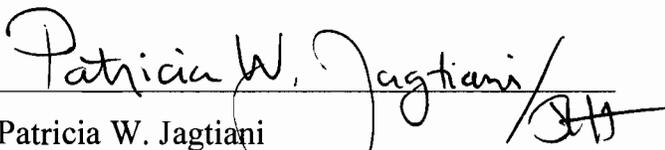


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February 11, 2008

Attachment A

June 7, 2007

Research
North America

MLPs – Master Limited Partnerships

An Overview of an Emerging Asset Class



PRIMER

For Analyst Certification and other important disclosures, refer to the Disclosure Section

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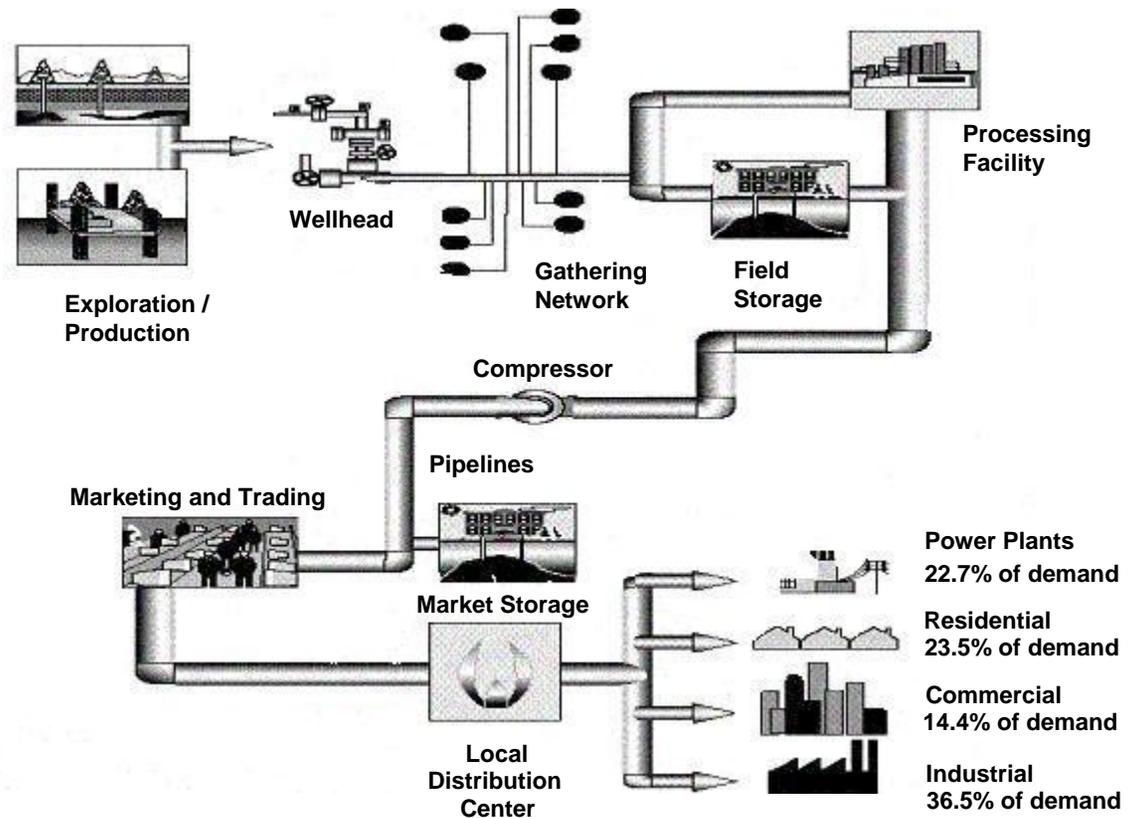
An MLP is an Alternative Structure to Traditional “C-Corps”

Characteristics	Typical MLP (PTP)	LLC	C-Corp
Non-Taxable Entity			
Tax Shield on Distributions			
Tax Reporting for Investors	K-1 Form	K-1 Form	1099 Form
General Partner			
Incentive Distribution Rights (IDR's)			
Voting Rights			

MLPs Traditionally Centered on the “Midstream Portion” of the Energy Value Chains

The Natural Gas Value Chain:
 “From Wellhead to Burner Tip”

Natural gas merchants move the molecule from Point A to Point B and manage the price risk.



Source: Morgan Stanley Research

Note: The breakdown of total demand does not include 2.9% of gas demand from pipeline fuel or lease and plant fuel. It only includes the end users who receive the gas at the end of the pipeline.

Why Structure as an MLP?

- **As mentioned earlier, the tax-driven valuation arbitrage** for MLPs can best be viewed in their market multiples. Recent EBITDA multiples for corporations with pipeline assets have been 9-10x compared with 13x for MLPs.
- Our simplified example walks through the value accretion analysis that must be performed by companies looking to allocate assets into an MLP structure.
- **Issues/Concerns**
 - Depreciation reduces the asset's book basis and can create a large disparity between book and fair market value for assets.
 - Size of the asset (amount of the offering)

Valuation Implications of Asset Transfers				
Tax Implications on Asset Transfer				
	Year 1	Year 2	Year 3	Year 4
Purchase Price (MM)	\$100			
Annual Depreciation	(\$10)	(\$10)	(\$10)	(\$10)
Book Value (MM)	\$90	\$80	\$70	\$60
FMV Transfer Price (MM)				\$150
Taxes Due on Transfer (assuming a 40% tax rate) (FMV - Book Basis) x Tax Rate				(\$36)
Valuation Arbitrage From Asset Transfer				
	Year 1	Year 2	Year 3	Year 4
EBITDA (MM)	\$10	\$10	\$10	\$10
EV/EBITDA C-Corp Value (8.0x multiple)				\$80
EV/EBITDA MLP Value (12.0x multiple)				\$120
MLP Valuation Premium				\$40
Total Value Creation from Asset Transfer				\$4

Source: Company data, Morgan Stanley Research

What Energy/Natural Resource Assets Qualify for MLP Consideration?

Upstream	Midstream	Downstream	Other
<ul style="list-style-type: none"> • Oil Reserves ✓ • Natural Gas Reserves ✓ • Coal Reserves ✓ • Other Exhaustible Ground Mineral and Natural Resources • Drilling Platforms • Drilling Rigs • Other E&P Assets Used to Extract Exhaustible Ground Mineral and Natural Resources 	<ul style="list-style-type: none"> • Interstate Oil and Natural Gas Pipelines ✓ • Intrastate Oil and Natural Gas Pipelines ✓ • Petroleum Product Pipelines ✓ • Gas gathering and processing assets ✓ • Facilities for Gas Compression, Treating, Fractionation, etc. ✓ • Commodity Storage Facilities ✓ • Compressor Stations ✓ • Coal Preparation and Transloading Facilities ✓ • LNG Tankers and Carriers ✓ • LNG Regasification Facilities 	<ul style="list-style-type: none"> • Transportation to “Bulk Distribution Centers” such as a terminal or refinery by: <ul style="list-style-type: none"> • Rail Cars • Refineries ✓ • Trucks and Trailers • Barges and Tugboats ✓ • Propane Delivery and Service Vehicles ✓ 	<ul style="list-style-type: none"> • Timber • Geothermal Energy Sources • Fertilizer • Nitrogen and Sulfur product Manufacturing Plants

✓ = Existing MLP

How Does an MLP Work?

Master Limited Partnership (MLP): A limited partnership whose ownership is divided between the general partner (GP) and the limited partner (LP). An MLP retains partnership tax treatment; it does not have to pay entity level tax and all tax items flow through to the partners as long as it derives at least 90% of its income from “qualifying sources.” (A complete definition for qualifying sources is included on the next page.)

General Partner (GP): A limited partnership can have one or more general partners, which may be corporations, individuals, or other partnerships that manage the partnership. The GP typically owns a 1-2% stake in the MLP and can extract a higher percentage of the partnership’s take as distributions increase through the distribution tier system.

- 1) Is responsible for the operations of the MLP and has the authority to make decisions.
- 2) Owns a 1-2% stake in the MLP and is eligible to receive incentive distribution rights (IDRs)

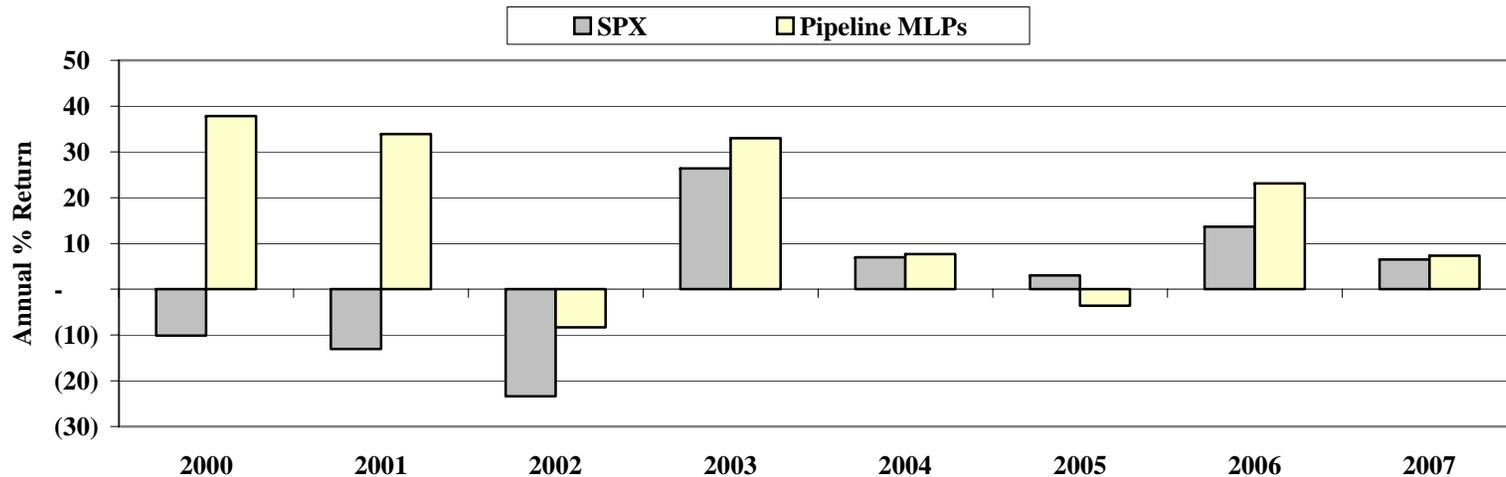
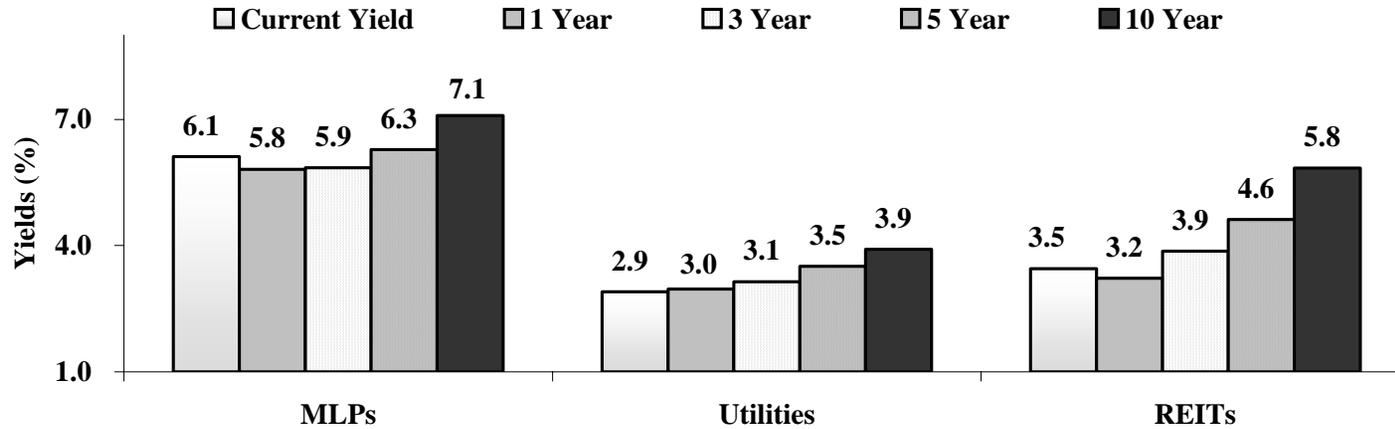
Limited Partner (LP): An LP provides capital to the partnership and receives a majority of the initial cash flows generated by the partnership through distributions. LP holders do not have a role in the partnership’s ownership or operations (unless they secure a definitive majority — e.g., 66%, but it can vary), and their liability is limited up to the amount of capital invested.

- 1) Provides capital and owns a majority of the partnership’s assets.
- 2) Does not have decision making authority for the partnership’s ownership and operations.
- 3) Receives regular distributions from the partnership.

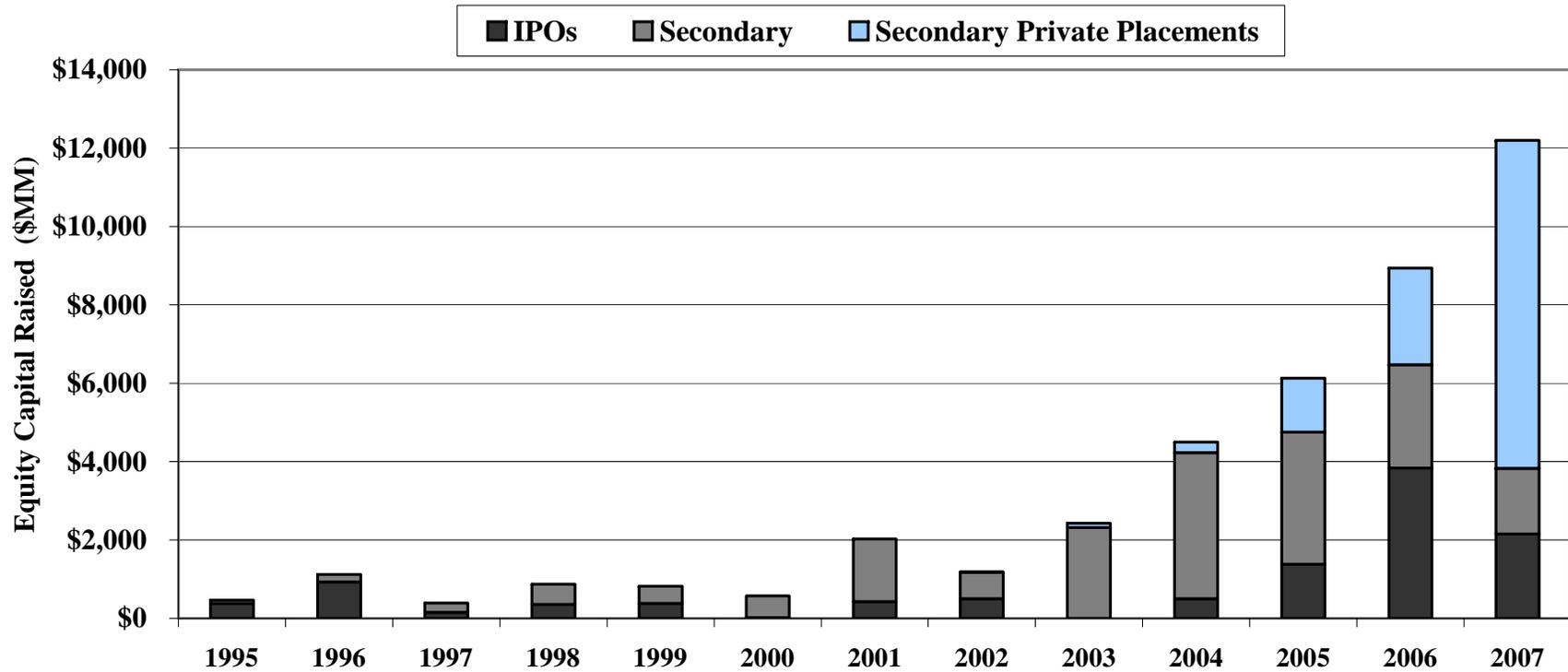
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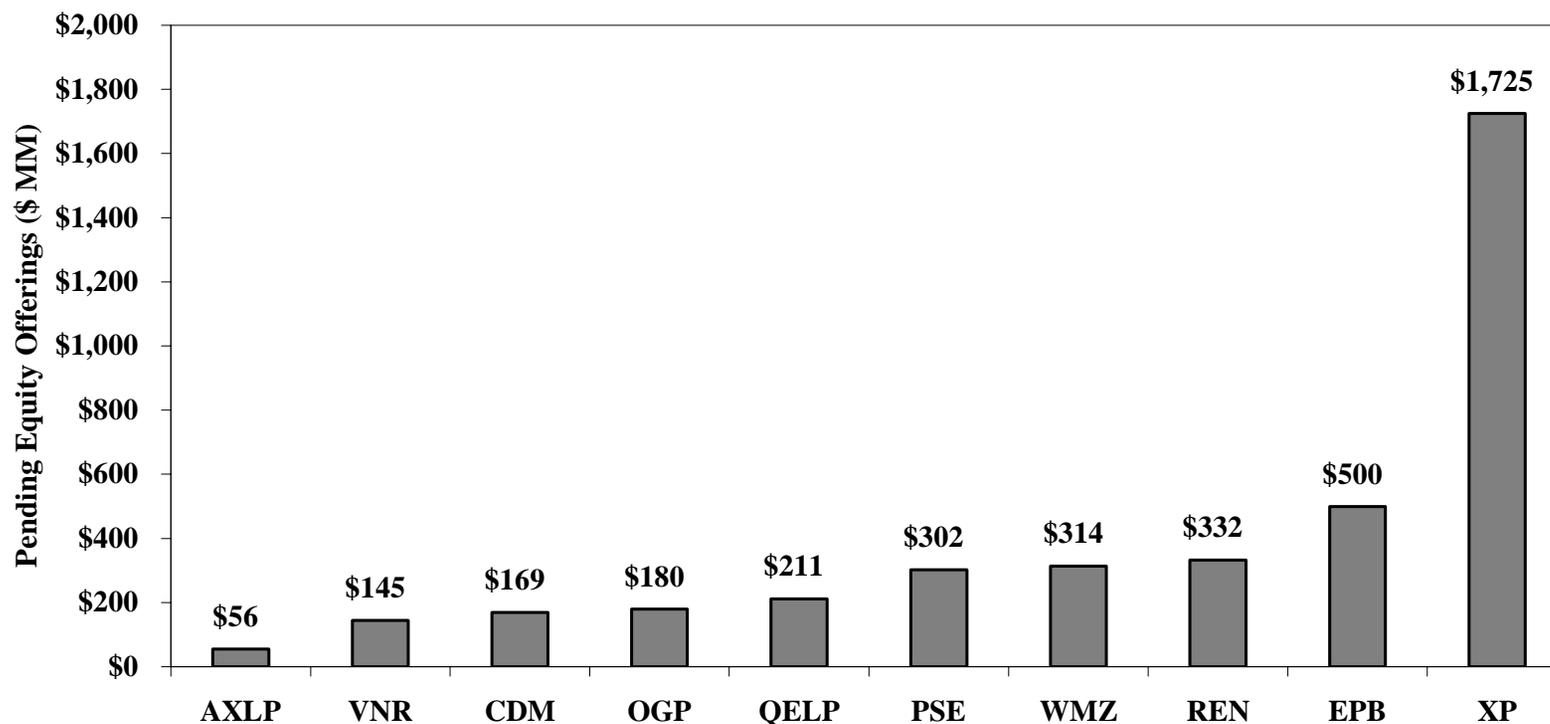
Why Investors Like MLPs?



Companies Have Aggressively Moved to Utilize the MLP Structure



With a Significant Backlog Growing as Well



Companies Utilize the LP Structure to Leverage Long-Term Cash Flow

- **Split Structure Dictates Cash Flow Allocation; Whether Due to Split, or Amount**

- The higher the split, the more money is paid to the GP. If in the high-splits, then the GP is paid at either a 1:1 (50/50) ratio or 1:3 (75/25) ratio. The higher the payout, the more money is paid to the GP and the higher the cost of capital.
- Company A represents a company with a 25/75 max GP/LP split, while Company B represents a 50/50 split structure

	% Interest			\$5.00		\$6.00		\$7.00		
	LP	GP	Limit	LP	GP	LP	GP	LP	GP	
Company A										
Tier 1	98%	2%	\$2.00	\$2.00	100%	2%	100%	2%	100%	2%
Tier 2	85%	15%	\$3.00	\$1.00	33%	6%	33%	6%	33%	6%
Tier 3	75%	25%	\$5.00	\$2.00	40%	13%	50%	17%	57%	19%
Total										
Current				85%	15%	83%	17%	82%	18%	
Company B										
Tier 1	98%	2%	\$2.00	\$2.00	100%	2%	100%	2%	100%	2%
Tier 2	85%	15%	\$3.00	\$1.00	33%	6%	33%	6%	33%	6%
Tier 3	75%	25%	\$4.00	\$1.00	25%	8%	25%	8%	25%	8%
Tier 4	50%	50%	\$5.00	\$1.00	20%	20%	33%	33%	43%	43%
Total										
Current				76%	24%	70%	30%	66%	34%	

Source: Morgan Stanley Research

What Are Incentive Distribution Rights (IDRs)?

Incentive Distribution Rights (IDRs): The general partner (GP) is allocated an increasing share of cash distributions as certain targeted levels of cash distributions to the unit holders are achieved.

Rationale: The incentive distribution structure is intended to encourage the GP to operate the MLP in a manner that maximizes cash distributions to the unit holders. The GP is financially motivated to improve performance and ratchet up the distributions to the partnership.

Function: The incentive distribution provision creates a very favorable scenario for the GP. The GP's 2% stake earns an incrementally higher percentage of distributions as the partnership progresses through its distribution tiers (receiving up to 50% in some cases).

Below we highlight the distribution rights status for the 14 partnerships in our coverage universe.

Distribution Status for our MLP coverage

		Current LP/GP	Maximum LP/GP	% Cash to LP	% Cash to GP	Cost of Equity Today
Boardwalk Partners	BWP	98/2	50/50	98%	2%	4.8%
Copano Energy	CPNO	NA	NA	NA	NA	3.8%
DCP Midstream Partners	DPM	85/15	50/50	96%	4%	3.9%
Enbridge Energy Partners	EEP	75/25	50/50	90%	10%	7.3%
Enterprise Products Partners	EPD	75/25	75/25	87%	13%	6.7%
Energy Transfer Partners	ETP	50/50	50/50	66%	34%	7.5%
Holly Energy Partners	HEP	75/25	50/50	95%	5%	5.6%
Kinder Morgan Partners	KMP	50/50	50/50	57%	43%	8.3%
Magellan Midstream Partners	MMP	50/50	50/50	72%	28%	7.0%
NuStar Energy, LP	NS	75/25	75/25	79%	21%	5.9%
Plains All American Pipelines	PAA	50/50	50/50	84%	16%	5.8%
Regency Energy Partners	RGNC	98/2	50/50	97%	3%	6.8%
Teppco Partners	TPP	75/25	75/25	90%	10%	7.2%
Williams Partners	WPZ	75/25	50/50	96%	4%	3.9%

Source: Company data, Morgan Stanley Research

How Is the MLP LP Investor Taxed?

- An investor pays tax on his/her allocated share of partnership income and not on the cash distribution.
- An investor's basis is calculated by taking the initial basis **Plus** (allocated income less depreciation) **Less** the cash distribution.
- In our example, 67% of the allocated share of income is tax-deferred due to the depreciation tax shield. Taxes are paid on the non-shielded portion (\$1.00) of income at the ordinary tax rate. The deferred portion is taxed upon sale at the ordinary tax rate.
- The tax breakdown is as follows:

Annual Taxes: This is the portion of allocated income that is not covered by the depreciation shield. The cumulative amount of annual taxes paid was \$1.40/unit (\$0.35 * 4 years).

Deferred Taxes: This is the \$8/unit of cumulative depreciation shield (\$2.00 * 4 years) multiplied by the investor's ordinary tax rate of 35% to yield ordinary income taxes of \$2.80/unit.

Capital Gains: The balance of the taxable gain (defined as sales price less basis) after considering ordinary income is allocated to capital gains. In our example, the sales price (\$65) less basis (\$42) yields our taxable gain (\$23). Of the taxable gain, \$8 is allocated to ordinary income at 35%, and the \$15 balance is taxed at the capital gains rate of 15%.

Taxation Example

Schedule of Taxes Paid Annually on MLP Distributions

	Year 1	Year 2	Year 3	Year 4
Purchase Price: (A)	\$50.00			
Sale Price:				\$65.00
Income/Share (B)	\$3.00	\$3.00	\$3.00	\$3.00
+ Depreciation/Share (C)	(\$2.00)	(\$2.00)	(\$2.00)	(\$2.00)
+ Annual Distribution (D)	(\$3.00)	(\$3.00)	(\$3.00)	(\$3.00)
Basis: (A+B-C-D)	\$48.00	\$46.00	\$44.00	\$42.00
Taxable Income (B-C)	\$1.00	\$1.00	\$1.00	\$1.00
Current Taxes (@ 35% Tax)	\$0.35	\$0.35	\$0.35	\$0.35
Tax Deferred Income (C-(A-B))	\$2.00	\$2.00	\$2.00	\$2.00
Def. Tax Liability (@ 35% Tax)	\$0.70	\$0.70	\$0.70	\$0.70
% of Taxes Deferred (Tax Shield)	66.7%	66.7%	66.7%	66.7%

Taxes Paid

Ordinary Income	\$8.00
Annual Taxes	\$1.40
Deferred Taxes	\$2.80
Total Taxes	\$4.20
Capital Gains	\$15.00
Taxes Due	\$2.25
Total Taxes Paid on Holding	\$6.45
Annualized Post-Tax Return	8.66%

Source: Company data, Morgan Stanley Research

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2. Section 2: Why Companies & Investors Like the MLP Structure
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MLP FAQs

What are MLPs? Master limited partnerships (MLPs) are passive investment vehicles in which 85-90% of operating profits and losses are usually passed through the ownership structure to the limited partners. This pass-through creates passive income or losses, along with dividend and investment income. MLPs typically pay out most of their distributable cash flow to unit holders. Distributable cash flow is calculated as net income plus depreciation and other noncash items, less maintenance capital expenditure requirements.

How is an MLP typically structured? The MLPs that we follow comprise a general partner (GP) and multiple limited partners (LP holders). The GP is responsible for the operations and the maintenance of the partnership's businesses, while the LPs assume economic risk up to their level of investment. The GP typically has a 1-2% stake in the MLP and typically can extract a higher percentage of the partnership's take as the MLP's distributions increase. This serves as an incentive to the GP to grow the LPs' distributions.

How do MLP units differ from corporate stock? MLPs are not common stock, although in some ways they are very similar. Both may be bought and sold on the NYSE, the AMEX, or the NASDAQ, and most of them pay a regular dividend, known as a "distribution." The biggest difference between the two is that because MLPs are not corporations (C-corps), so they do not pay corporate taxes. This allows MLPs to pay out more of their cash flow generated (distributable cash flow) directly to investors. Also, the majority of the time that an investor owns MLP units, he/she does not pay taxes on the distributions the way he/she would on corporate dividends. The MLP distribution is considered a return of capital (a payback of investment). The investor is, however, responsible for paying taxes on his/her share of the partnership's taxable income. However, most MLPs pay cash distributions that are well in excess of any taxes owed.

What types of energy companies operate as MLPs? Generally, the companies in our coverage universe focus on pipeline assets, gas processing assets, and bulk and liquids storage facilities that transport energy products (crude oil, natural gas, and refined products) to consumer markets of the commodities. These companies typically derive their growth through acquisitions, cost reductions, system expansions, and more efficient operations of the assets than the prior asset owners achieved.

MLP Basic Q&A

What are the categories of energy MLPs? There are various energy MLPs. The broad categories of energy MLPs are pipeline MLPs, and propane MLPs (such as Amerigas and Ferrellgas). Also, many of the energy MLPs own assets across two or more of these categories.

Who manages the energy MLPs, and how do the partners share quarterly cash distributions? Each pipeline MLP is managed by a general partner (GP) that is responsible for the operations and maintenance of the business, while the limited partners (LPs) assume economic risk up to their level of investment. Each MLP has a standard distribution schedule for the percentage of cash that gets distributed each quarter to the LPs and to the GP. The GP typically has a 1-2% stake in the MLP and typically can extract a higher percentage of the partnership's take as the distributions increase. Put another way, the GP has an incentive to grow the LPs' distributions, as the GP gets to keep more of the cash as the GP grows the payout to the LPs. Once the LP distribution gets to the highest tier, known as the "high splits," the GP generally takes 50% of the incremental cash available for distribution.

Source: Morgan Stanley Research, FactSet, Company data

MLP Basic Q&A

What valuation framework should be used to value MLPs? We generally use cash flow multiples (Price / Distributable Cash Flow, Enterprise Value / EBITDA), yields (distribution yields, yield spreads over treasuries and across comparable classes like Municipal Bonds, Utilities, and REITs), asset value work (sum-of-the parts, net asset value), and intrinsic valuation methodologies (discounted cash flows and dividend discount models).

Do MLPs generate free cash flow and how is this determined? MLPs use “cash flow available to LP holders” as a proxy for free cash flow. The basic definition is Net income + Depreciation – Sustaining Capex – GP’s interest. Sustaining capex is defined as the amount of capital reinvestment needed to maintain current operating assets. The investor must deduct growth capital expenditures (capital investment or acquisitions that will drive future operating profits) as well in order to bridge the gap to “true” free cash flow from available cash flow.

What advantages do small MLPs have over their large counterparts? Smaller MLPs that are earlier in the distribution tiers have better acquisition economics (i.e. lower cost of capital) because the LP holders receive a greater percentage of the accretion. For example, consider two MLPs are planning on issuing equity to finance an acquisition. One is a mature MLP in the high splits (40% of CF to GP) and the other is a young MLP early in the tiers (10% of CF to GP). The young MLP can bid more competitively for assets because the GP’s drain on cash flow is a much smaller percentage than the mature MLP.

What is the difference between “Return-of-Capital” versus “Return-on-Capital”? Return-of-capital measures the return from an investment that is not considered income (i.e. dividends and share repurchases). Dividends are considered a direct repayment of capital and share repurchases are considered an indirect repayment of capital. In the case of MLPs, the non-shielded portion of the distribution is considered a return of capital which reduces the investor’s initial basis in the partnership. Return-on-capital measures the operating profitability of a firm. In the case of MLPs, return-on-capital is measured from the income generated off of the partnership’s operating assets. The shielded portion of the distribution is considered a return on capital.

What Are Investors Asking Today?

- **What is a publicly traded GP?**

Publicly traded GP IPOs have become popular recently. The GP's cash distribution growth is a result of the GP's incentive distribution rights (IDR) received from the underlying LP. Therefore, as the LP grows its cash distribution, the payout to the GP through the IDR increases at a greater rate than cash payments to the LP. However, the value of the GP and its growth is directly predicated on the ability of the underlying LP to grow and increase its distribution.

- **Are GPs good for the market?**

Publicly traded GPs offer an attractive growth characteristic in a traditionally income-oriented investment vehicle. However, this same caliber of growth is generally attainable through low split peers (e.g, BWP, DCP, TGP, and WPZ). Furthermore, the abundance of MLP equity in the form of GPs could make it difficult for larger MLPs to attract new equity (e.g., EPE vs. EPD, MMP vs. MGG).

- **What are the advantages/disadvantages of private placements?**

Private placements are advantageous for the space over the near/intermediate term, we think. The advantages include the ability to fund organic growth programs without immediate equity dilution. Furthermore, private placements will ultimately enhance overall liquidity as they are sold into the market.

- **What does the IPO backlog look like? What is the impact?**

There are a number of potential or filed IPOs and three announced GP IPOs. The near-term supply of equity could overtake demand without modest institutional interest and as a result MLPs could be negatively affected (a similar dynamic unfolded in early 2005). The result would make a more challenging environment for secondary offerings necessary to fund organic growth.

Glossary

MLP Glossary

Cash Available to Limited Partners (also known as distributable cash): This is calculated as net income plus depreciation and other non-cash items, less maintenance capital expenditure requirements, and less the general partner's incentive distribution payment.

Cash Distributed to Limited Partners (also known as dividends): Quarterly dividend payments made to limited partner investors. These amounts are set by the general partner and are typically supported by an MLP's operating cash flows.

Coverage Ratio: Calculated as cash available to limited partners divided by cash distributed to limited partners. It gives an indication of an MLP's ability to make dividend payments to limited partner investors from operating cash flows. MLPs with a coverage ratio of in excess of 1.0 times are generally able to meet their dividend payments without external financing.

General Partner (GP): Corporate sponsor that typically owns a 2% interest in the MLP. Through this 2% interest, the GP has the responsibility for the operations and maintenance of the MLP and the authority to make decisions. To align the interests of the GP with the limited partners, MLPs have an incentive distribution schedule that rewards the GP for increasing the cash distributions to the limited partners.

High Splits: Increases in cash distributions entitle the general partner to a higher percentage of the incremental distributed cash flows. The high splits specifically refer to the levels of increased cash distributions on the incentive schedule that give the general partner a larger percentage of the incremental dollars.

Limited Partner (LP): Owners of the limited partner units that are entitled to receive the majority of the cash flows generated by the partnership through a quarterly distribution. LPs cannot participate in making decisions regarding the operation of the MLP unless they secure a definitive majority (e.g., 66%, but it can vary) in a proxy vote.

MLP Glossary

K-1 Statement: This is the form that an MLP investor receives each year from the partnerships that shows the investor's share of the partnership's income, gain, loss, deductions, and credits. The K-1 is similar to a Form 1099 that is received from a corporation. The investor will pay tax on the portion of net income that is allocated at his or her individual tax rate. Net income is calculated as the cash distribution less any deductions and credits like depreciation.

PTP: or "Publicly Traded Partnership" is a master limited partnership or a limited liability company that has chosen to be taxed as a partnership, which is publicly traded. There are roughly 50 publicly traded partnerships and the majority are involved in energy-related activities. Energy related PTP's comprise approximately 85% of total PTP market cap, with REITs making up the majority of the 15% balance.

Qualifying Income: In order to be taxed as a partnership, 90 percent of a PTP's income must be "qualifying income" every year that it is a publicly traded partnership. Qualifying income can include **1)** interest **2)** dividends **3)** real property rents **4)** gains from the sale or other disposition of real estate **5)** income and gains from the exploration, development, mining, or production, processing, refining, transportation, or marketing of any mineral or natural resource **6)** Any gain from selling or disposing of a capital asset held for the production of any of the types of income in numbers 1-5 **7)** Income and gains from commodities, if buying and selling commodities is the PTP's principal activity **8)** Any income that would be qualifying income for a regulated investment company (RIC) or real estate investment trust (REIT).

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(as of April 30, 2007)

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