



Midstream Master Limited Partnerships The Past and Future

By
Pipeline Knowledge & Development

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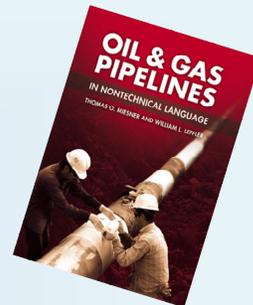
Presented by
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Instructor – Tom Miesner

- Principal Pipeline Knowledge & Development
 - Pipeline Education and Training
 - Strategy and Project Development
 - Expert Testimony and Arbitration
 - Appraisals and Independent Opinions
 - Management and Improvement Consulting
- Chairman of the Board of LineStar Services
- Over 35 years of Midstream experience
- President Conoco Pipe Line Company
- Numerous JV Boards and Committees
- Author
 - *Oil and Gas Pipelines in NonTechnical Language*
 - *The Role of Pipelines and Research in the U. S.*
 - *A Practical Guide to US Natural Gas Pipeline Economics*
 - *The Interstate Natural Gas Transmission System: Scale, Physical Complexity, and Business Model*
 - *Pipeline Engineering for McGraw Hill's Transportation Engineering Handbook*
 - *The Final Mile, Natural Gas Distribution Pipelines in NonTechnical Language* will be released in 2006



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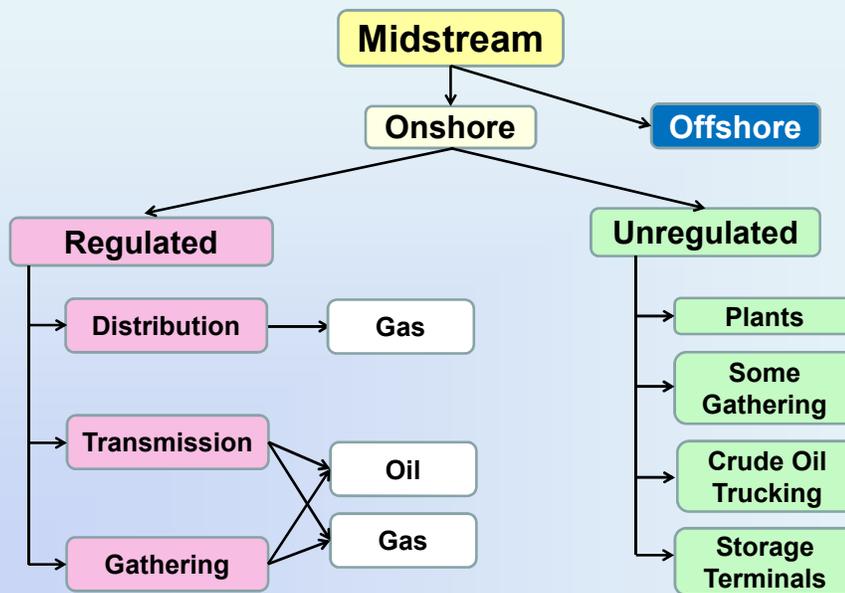


Session Outline

- What is Midstream Anyway?
- Why build new pipelines and other midstream assets?
- MLP History and Structure
- Project Economics
- Motivations of the Limited and General Partners (LP & GP)
- Incentive Distribution Rights – IDRs
- Limited Partner Returns and Cost of Capital
- Dropdowns
- One Unique Arrangement
- Challenges for the Future

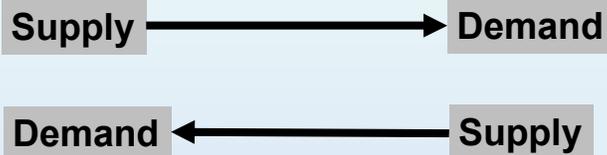


What is Midstream Anyway?





Why Build Pipelines?



Supply

- Crude oil
- Natural gas
- NGL

Demand

- Refined products
- Natural gas
- Crude oil
- Chemical feed stocks

Demand has not changed much but supply sources has.

Some midstream entities are more exposed to supply changes than others.



The Birth of MLPS

1981 - Apache Petroleum is formed as the first MLP

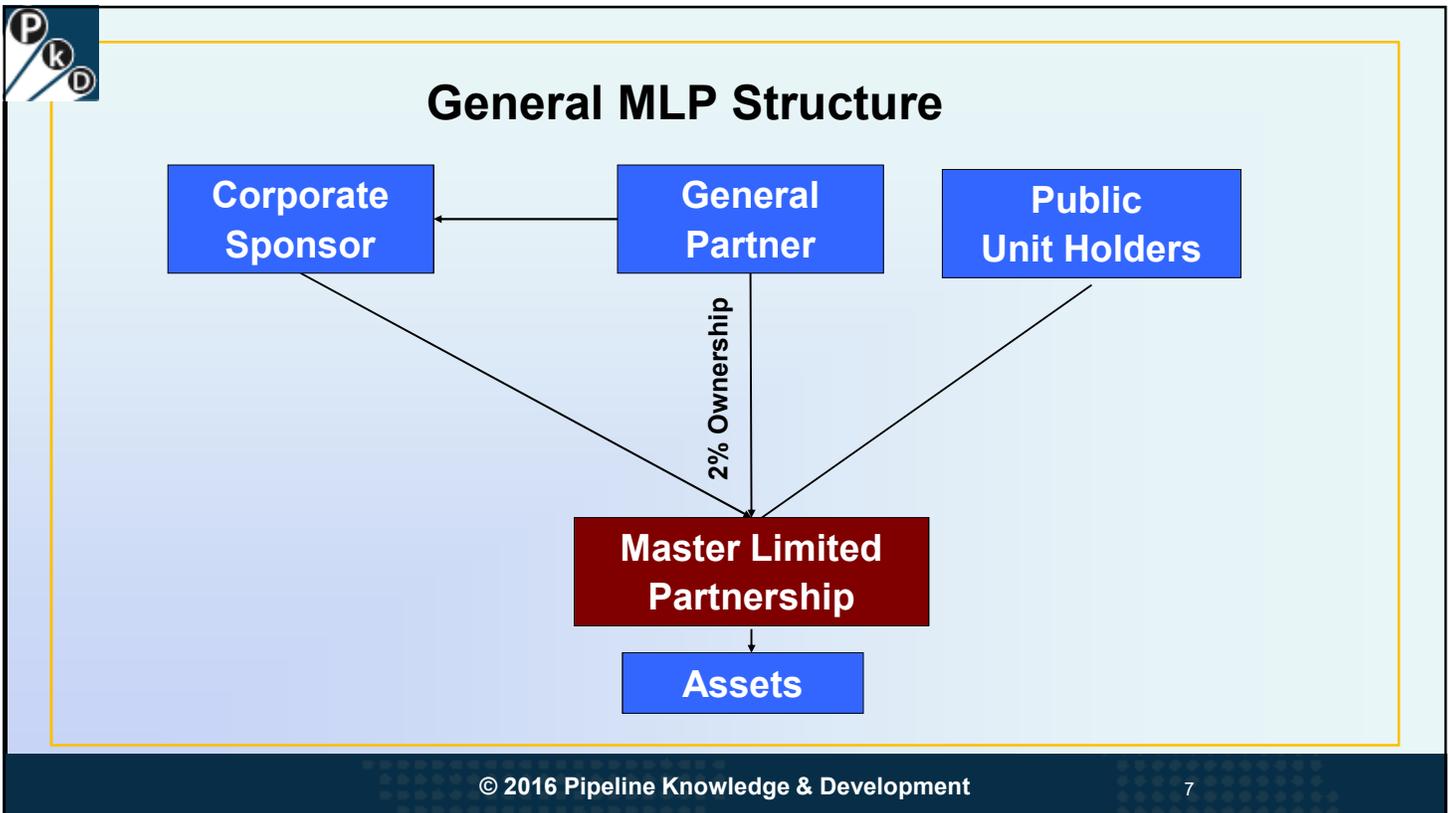
1986 - The Tax Reform Act

- enabled companies organized under the MLP structure to pass all income, losses, gains, and deductions on to limited partners without corporate taxation.
- reduced some individual tax rates.

1987 - The Revenue Act

- limited the MLP structure to companies where at least 90% of their income was considered "qualifying income".
- qualifying income is defined as "income and gains derived from the exploration, development, mining or production, processing, refining, transportation, or the marketing of any mineral or natural resource including fertilizer, geothermal energy, and timber."

2015 - 70% of MLP market cap is in oil and gas midstream – Association of Publically Traded Master Limited Partnerships

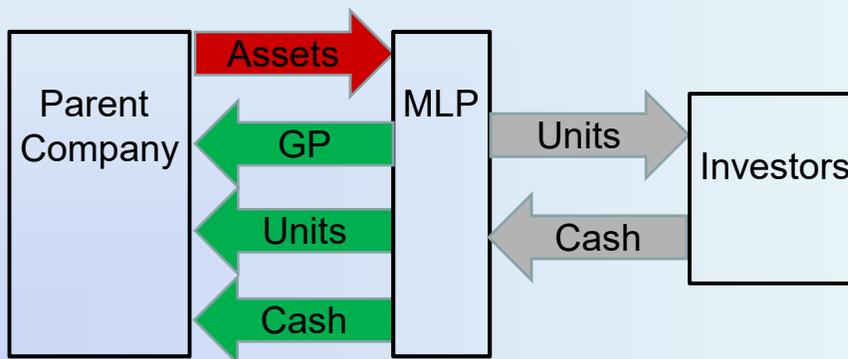


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- MLP Acronyms and Terms**
- MLP – Mater Limited Partnership
 - Units – Shares
 - GP – General Partner
 - LP – Limited Partner
 - Distribution – Dividends
 - DCF – Distributable Cash Flow
 - DPU – Distribution Per Unit
 - Coverage – Ratio of DCF to DCU
 - MQD – Minimum Quarterly Distribution
 - IDR – Incentive Distribution Rights
 - Drop Down – Acquisition from Parent
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IPO Formation

- Form corporate entity
- Transfer assets to the entity
- Transfer GP, units and cash to the parent
- IPO the MLP



IRR Calculations – The “Old Way”

Investment	10,000									
Pretax Income	1,351	1,421	1,621	1,834	2,060	2,300	2,166	2,028	1,886	1,739
Income Tax	<u>473</u>	<u>497</u>	<u>568</u>	<u>642</u>	<u>721</u>	<u>805</u>	<u>758</u>	<u>710</u>	<u>660</u>	<u>609</u>
Earnings	878	924	1,054	1,192	1,339	1,495	1,408	1,318	1,226	1,131
Depreciation	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Cash flow	1,878	1,924	2,054	2,192	2,339	2,495	2,408	2,318	2,226	2,131
IRR	17%									

IRR - Present value of discounted cash inflows = value of investment



Limited Partner Economics

Limited partners typically are looking for:

Income

- Normally distribute pretax income less ongoing maintenance capex needs
- Typically trade at a spread to the 10 year T bill

Tax Savings

- Portion of distribution shielded from current tax
- Return of capital lowers tax basis and taxes

Growth – Purchases and new investment opportunities



General Partner Economics

The GP owns 2% of the company and makes all decisions

- As long as distributions are below a certain amount per unit the GP receives their proportionate share of the distributions (2%).

As distributions grow the GP receives increasingly larger percentages of the incremental distribution (Incentive Distribution Rights – **IDR**)

Example IDR Chart				
Tier	DPU (\$)	LP (%)	GP (%)	IDR (%)
1	0 - .60	98	2	0
2	.61 - .72	85	2	13
3	.73 - .93	75	2	23
4	.94+	50	2	48

From what is the IRR?
To
Is this project accretive?
Can we increase distributions?



Distribution Accretion

	1	2	3	4	5	...	9	10
Cash flow	1,878	1,924	2,054	2,192	2,339	...	2,226	2,131
At \$10,000 Interest @ 8%	800	800	800	800	800	...	800	800
Accretion	1,078	1,124	1,154	1,392	1,539	...	1,426	1,331
At \$20,000 Interest at 8%	1,600	1,600	1,600	1,600	1,600	...	1,600	1,600
Accretion	278	324	454	592	739	...	626	531

Accretion: The value created after a transaction. If the transaction **adds to distributions**, it is accretive to distributions, that is distributions can be increased after the deal or project.

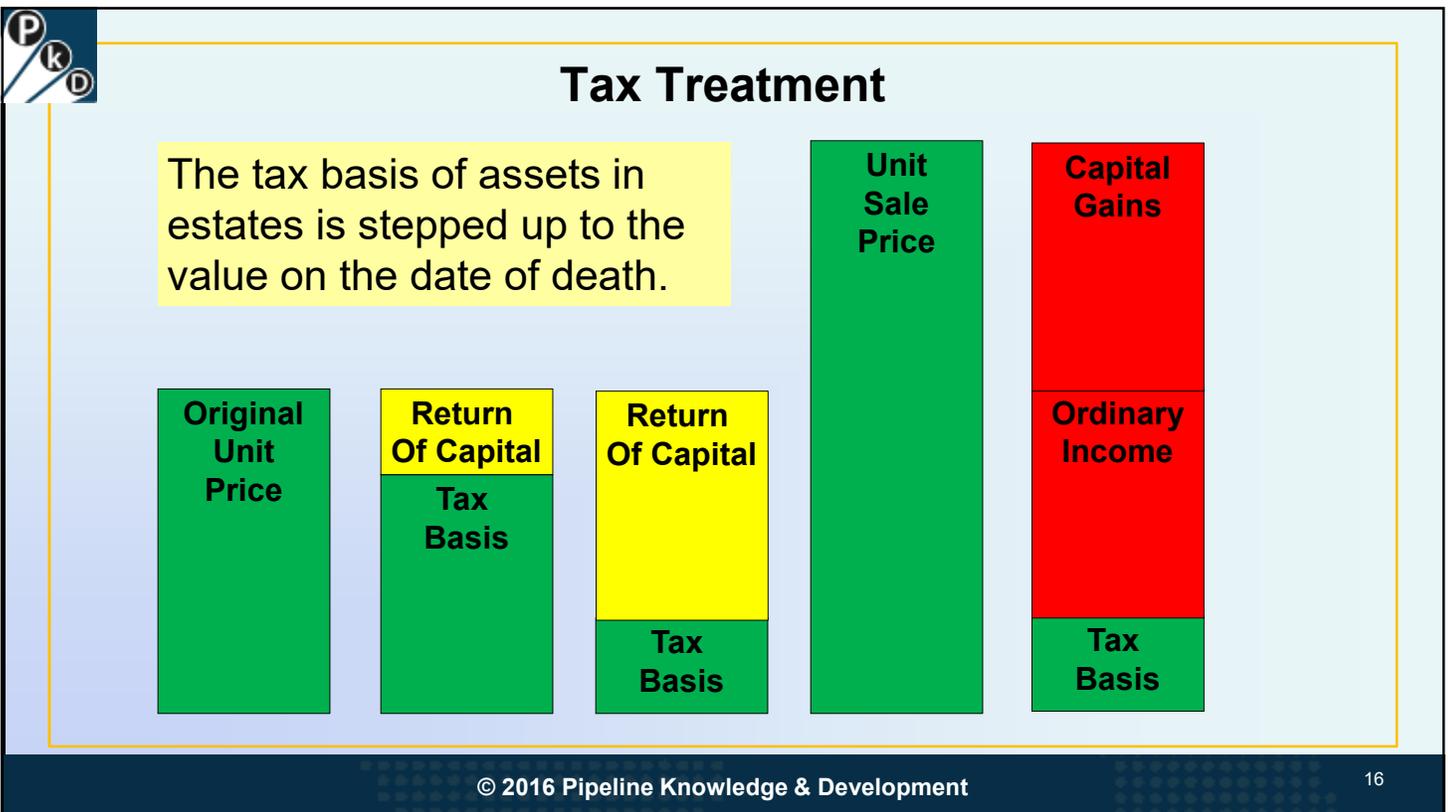
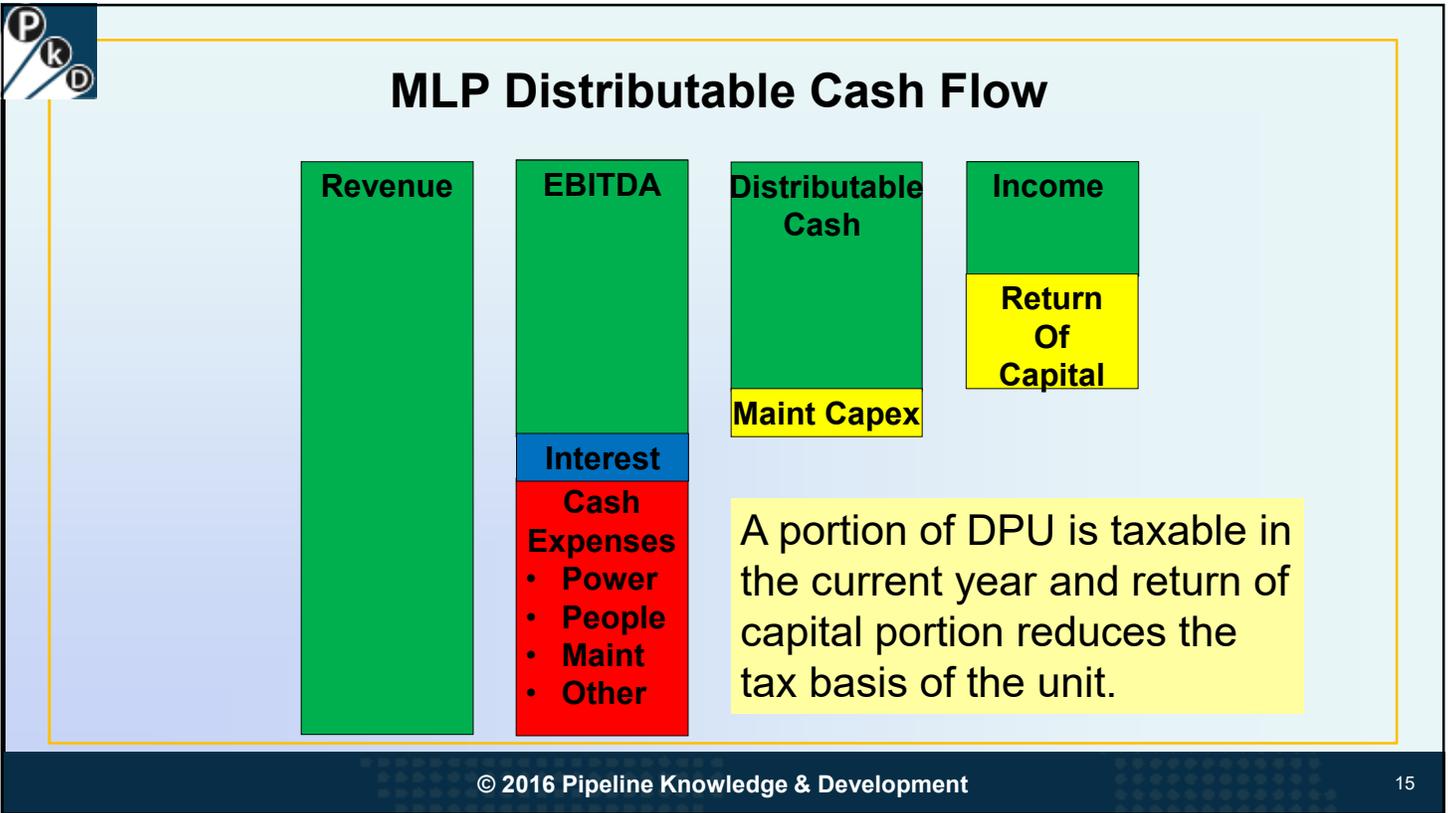


Game Changer Summary

- Partnership agreements give GPs **tremendous incentive to increase distributions**
- Pipeline MLP's have a **lower cost of capital** than do pipelines owned by integrated majors
 - These two factors have **driven a rotation of ownership** to MLPs from integrated majors
 - Purchase multiples have about **doubled over the past 20 years**

As IDRs grow the GP receives a larger percentage of the distribution

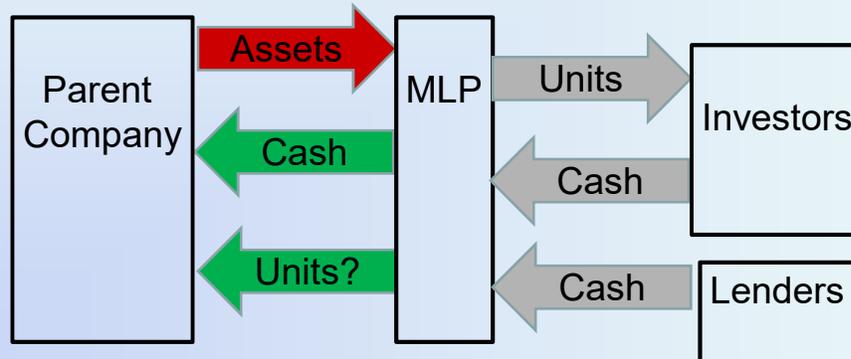
This drives the return to the LPs down and the cost of capital up meaning it is more difficult to justify new projects.



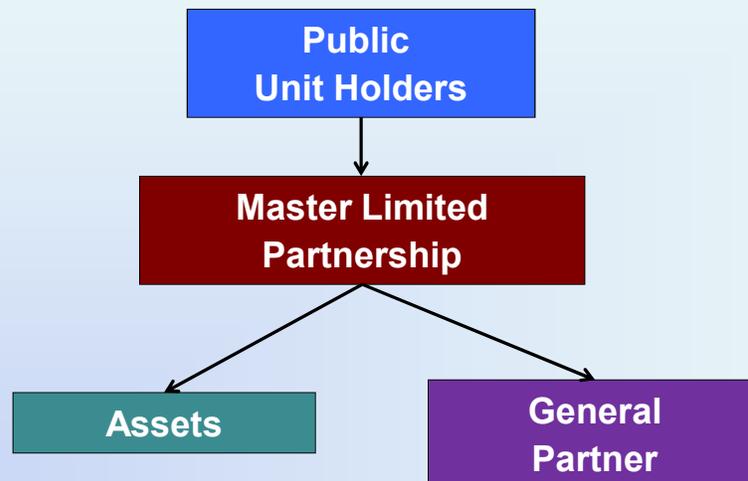


Asset Drop Down

- Transfer additional assets from parent to MLP
- Transfer asset value to the parent
- Must be at fair market value



Potential MLP Structure



This form keeps the **incentive distributions** inside the limited partners.



Headwinds

- Rising IDRs reduce the LP percentage from new projects increasing the cost of capital to the entity.
- Conversions from MLPs to corporations create a taxable event triggering unexpected tax consequences.
- Shipper financial problems may result in renegotiating contracts which provide for “committed service”.
- The cost of operating failures continue to increase.
- Rising interest rates could increase yield expectations and negatively impact price.



Tailwinds

- Oil and gas midstream will be a vital part of the economy for many years.
- Transportation infrastructure expansion and renewal will be required for the foreseeable future.
- Steady fee based revenues.
- Capital intensive business generating cash flow.
- Combination of yield plus growth (maybe).
- Deferred taxes (return of capital) is not taxed when units pass into an estate.
- Potential move for MLPs to purchase the GP.



Questions or Comments?

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