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Master Limited Partnership Overview

August 2013

What is a Master Limited Partnership?

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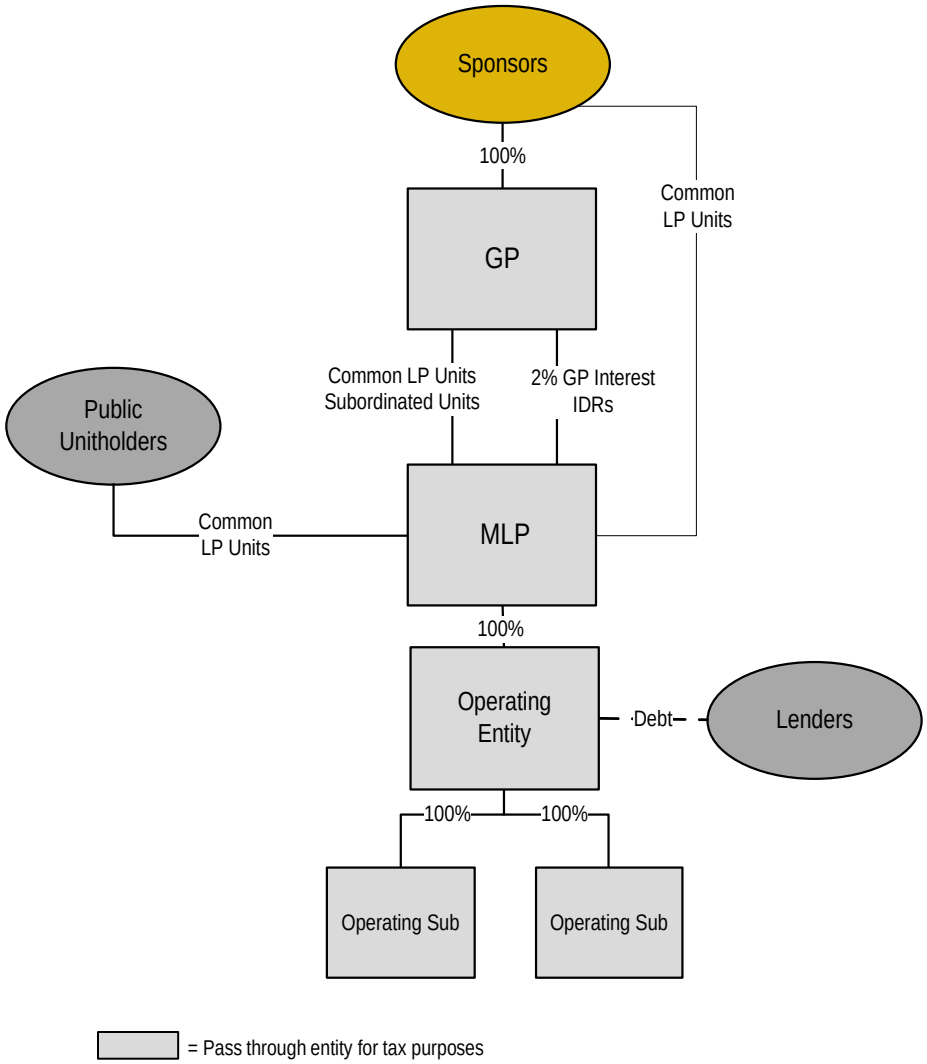
- A Master Limited Partnership ("MLP") is a state law entity that can be treated as "pass through" for tax purposes and that has publicly traded equity securities
  - Common units are listed on major exchanges
  - Public unitholders are generally retail (not institutional)
- Most MLPs are limited partnerships, but they can also be limited liability companies or business trusts
- The tax code restricts the benefits of the MLP structure to businesses that generate "qualifying income" under section 7704 of the Internal Revenue Code



History of the MLP Structure

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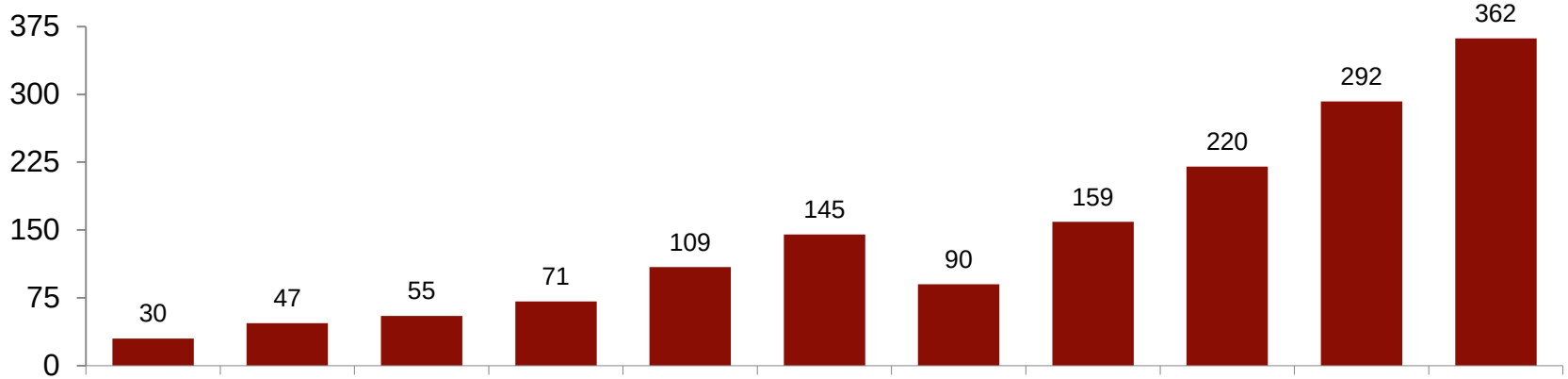
- Apache Corp. formed the first MLP in 1981 to consolidate 33 oil and gas drilling program limited partnerships
- MLPs became extremely popular in the mid-1980s, but their use waned after 1987 federal tax legislation restricted the MLP structure to businesses generating "qualifying income"
- Growth of the modern MLP structure was driven by the interaction between (i) tax requirements, (ii) Delaware partnership and LLC law, (iii) market expectations based on precedent transactions and (iv) the unique business characteristics of issuers utilizing the structure

1996		2012
15	Public MLPs	86
676	Avg. Market Cap. ($m)	4,215
10,143	Total Market Cap. ($m)	362,489
43,000	Avg. Daily Trading Vol. (units)	253,000

Aggregate MLP Market Capitalization Over Past 10 Years ($ billions)



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
# of MLPs	31	32	36	47	60	74	77	70	73	81	86

Market Capitalization by Subsector as of 2012

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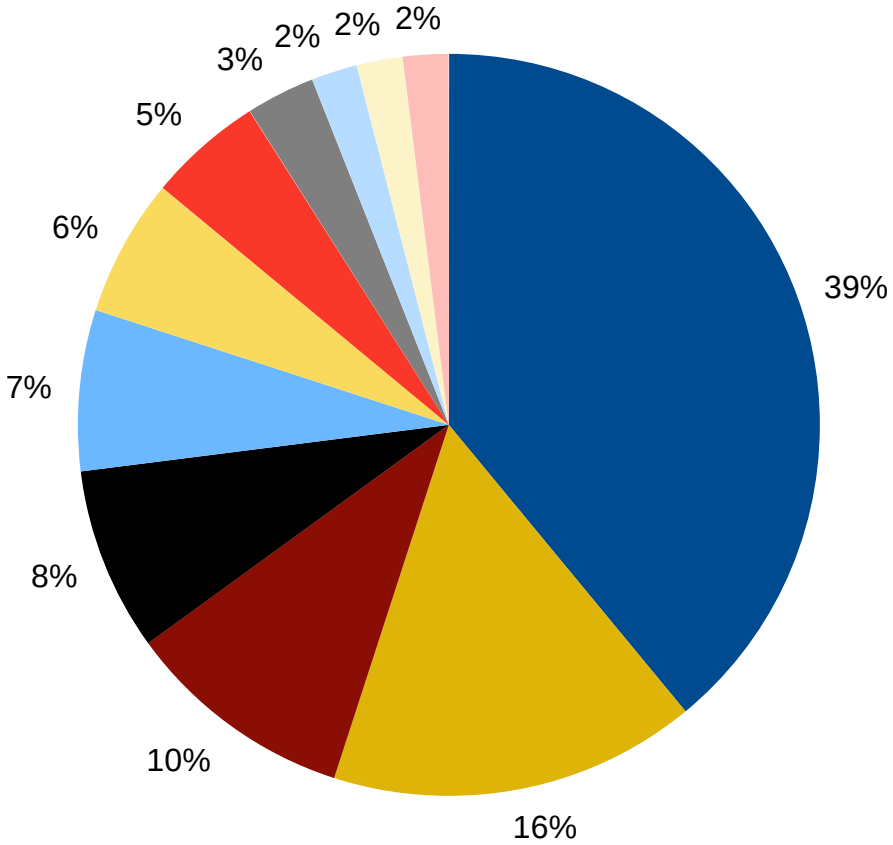

- Diversified (39%)
- GPs (16%)
- Gas G&P (10%)
- Liquids T&S (8%)
- Gas T&S (7%)
- Upstream (6%)
- Other (5%)
- Propane (3%)
- Coal (2%)
- Variable (2%)
- Shipping (2%)

What are the benefits and drawbacks of forming an MLP?

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Sponsor Benefits

- Monetization of assets at fair market value
- Higher value of assets in separate company
- Lower cost of capital
- Tax benefits—upon contribution and ongoing
- Retain control over assets
- Incentive distribution rights ("IDRs")
- Ability to limit fiduciary duties to public unitholders
- Eventual sale of GP

Potential Sponsor Drawbacks

- Creation of an additional public company (with all associated periodic reporting requirements)
- Creation of intercompany agreements
- Reduction of business integration
- Risk to credit profile
- Valuation can be impacted if growth prospects decline

LP Investor Benefits

- High-yield security with reliable distributions
- One level of taxation, so more cash available for distribution
- Expected increases in distributions
- Potential appreciation of units
- Limited liability similar to corporate common stock
- Tax shield typically equivalent to 80-90% of cash distributions
- Tax deferred portion not taxable until unitholder sells securities

MLP Performance and Valuation

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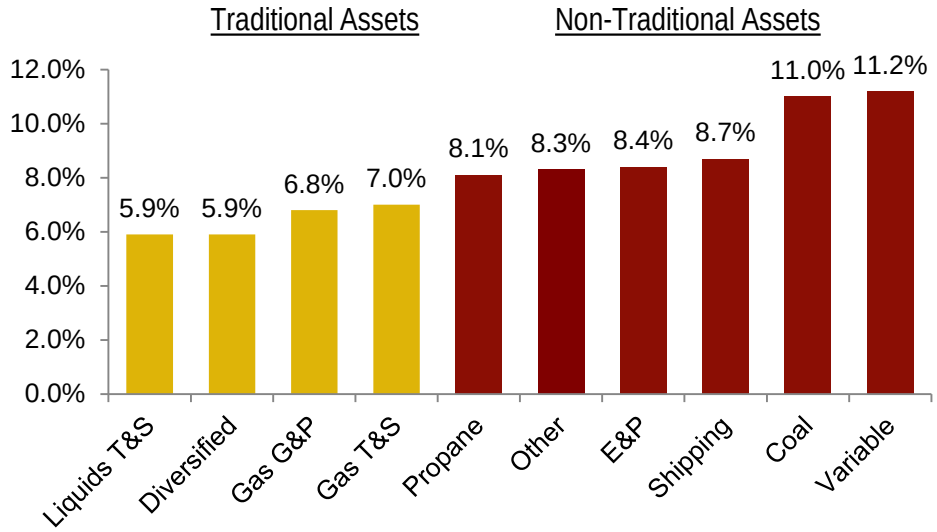
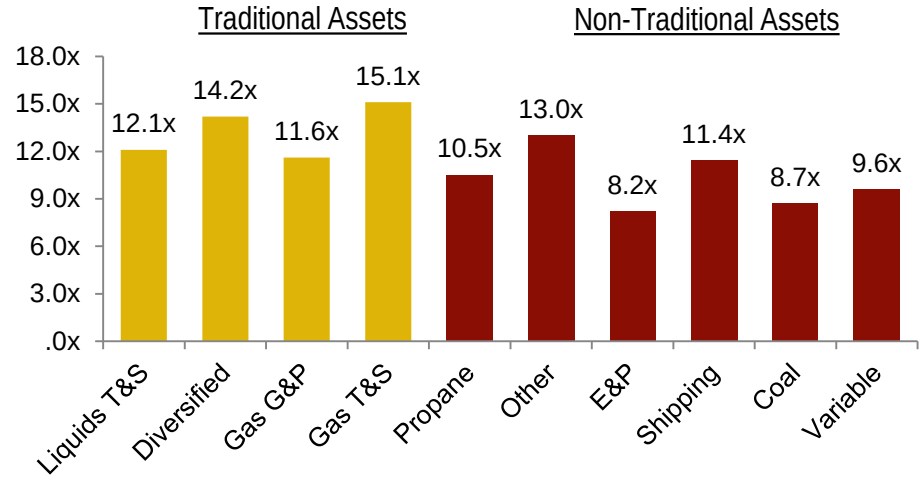
- Investors favor stability and growth, so certain subsectors are more in favor
- The Alerian MLP index has outperformed the S&P in each of the last ten years

2012 MLP Yields (%)



EV / 2013E EBITDA (x)



How do the sponsors form the MLP?

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Pre-IPO

- The sponsors form the general partner ("GP"), usually a wholly owned limited partnership or limited liability company
- The sponsors or one of their affiliates (acting as the organizational limited partner) and the GP form a limited partnership that will become the MLP
- All assets must be in a tax pass through or ignored entity (like a partnership or limited liability company) to realize the benefits of the MLP structure
  - The MLP may have corporate subsidiaries to own non-qualified assets
- The MLP is capitalized with a nominal amount of cash
  - The GP typically receives a 2% general partner interest in the MLP
  - The sponsors receive the remaining 98% limited partner interest in the MLP
- The sponsors contribute qualifying assets to the MLP and cause the MLP to assume related liabilities
- The MLP moves the assets and liabilities down to the operating subsidiaries

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IPO and Post-IPO

- Common units are offered to the public in an initial public offering
- The GP maintains its 2% general partner interest
- The sponsors or an affiliate of the sponsors (usually the GP) receives cash, common units, subordinated units and the right to receive a greater portion of the MLP's incremental cash flow in the future ("incentive distribution rights" or "IDRs")

How much does it cost to form an MLP?

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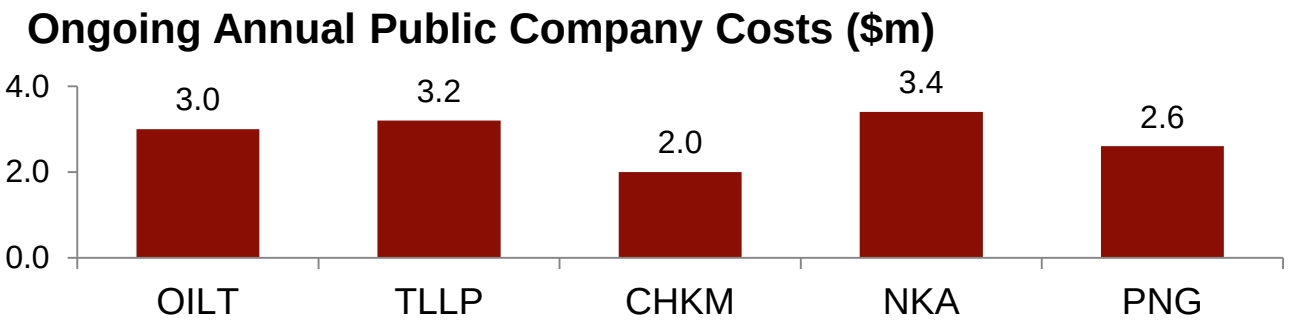
Recent MLP IPO Costs

	Oiltanking Partners	Tesoro Logistics	Chesapeake Midstream Partners	Niska Gas Storage	PAA Natural Gas Storage
SEC registration fee	$ 28,038	$ 35,048	$ 34,849	$ 31,569	$ 17,219
FINRA filing fee	24,650	30,688	49,375	44,775	24,650
Printing and engraving expenses	650,000	725,000	750,000	400,000	500,000
Fees and expenses of legal counsel	1,515,000	5,173,596	2,100,000	3,000,000	1,100,000
Accounting fees and expenses	990,000	1,015,000	250,000	1,500,000	500,000
Transfer agent and registrar fees	20,000	4,800	25,000	20,000	25,000
New York Stock Exchange listing fee	200,000	156,032	250,000	250,000	250,000
Miscellaneous	148,000	189,167	40,776	103,656	183,131
Advisory Fee	-	2,020,000	-	-	-
Total	$ 3,575,688	$ 9,349,331	$ 3,500,000	$ 5,350,000	$ 2,600,000



What tax issues arise with forming an MLP?

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- Asset contributions can be **taxable** or **tax deferred**, depending on sponsors' objectives
- A sponsor's contribution of assets generally will not trigger tax to the extent that the sponsor receives MLP units
- Generally, the receipt of cash (including the assumption by the MLP of certain liabilities) is treated as a taxable disguised sale
- Alternatives exist to avoid disguised sale treatment that allow cash or other value to be received on a tax-deferred basis

Keys to Structuring a Tax-Deferred MLP

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- Keys to structuring a tax-deferred MLP
  - The proceeds from any new debt incurred by the MLP is recourse to the sponsors, directly or through the GP
  - The proceeds from new borrowings are distributed to the sponsors
  - IPO proceeds are used to retire "qualified" debt and capital expenditures made within the two years prior to the closing of the IPO
  - The amount of qualified debt retired cannot exceed a sponsor's tax basis in the MLP
- Any deferred gain will generally be taxable to the sponsor over the life of the assets contributed to the MLP because of allocations under Section 704(c) of the Internal Revenue Code

Who owns and manages the MLP?

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Sponsors	• Own GP units and some LP units • Elect Board of Directors of GP • Contractual relationship with MLP • Limited fiduciary duties to the limited partners
General Partner	• Wholly owned by sponsors (although sometimes publicly traded) • Manages and operates day-to-day business of MLP • Acts on behalf of MLP • Board of Directors, senior management and employees are at GP level
Board of Directors	• Minimum of three independent directors (does not need to be a majority of the Board) • Typically have conflicts committees to review conflicts of interest between the GP, on one hand, and the MLP or LPs, on the other • Must have an audit committee, a corporate governance committee and compensation committee
Limited Partners	• Passive investors with very limited voting rights • No annual meetings • Vote only on "Material Events" (*e.g.*, sale of substantially all of the assets, removal of GP and material amendments to partnership agreement)

What corporate governance provisions apply?

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- The Board of Directors of the GP is considered to be the Board of Directors of the MLP
- The GP is not elected by the MLP's unitholders and will not be subject to re-election on a regular basis in the future
- The MLP's unitholders are not entitled to elect the directors of the GP—directors are elected by the sponsors
- The GP must comply with the corporate governance requirements of the federal securities laws and the securities exchange on which the MLP's securities are listed even though it is a private entity
- The MLP must have three independent directors—one at the IPO, a second within 90 days of the IPO and a third within 12 months of the IPO
- The MLP's audit committee must have at least three members and must be composed entirely of independent directors

What types of conflicts of interest arise with the MLP structure?

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- The GP is empowered to resolve conflicts of interest and may, but is not required to, seek the approval of the conflicts committee regarding such resolution
- An independent third party is <u>not</u> required to evaluate the fairness of the resolution by the GP or conflicts committee

Conflicts of interest are inherent in the MLP structure due to the relationship between the GP and its affiliates, on one hand, and the LPs and MLP, on the other hand:

- The directors and officers of the GP have fiduciary duties to manage the GP in a manner beneficial to its owners (the sponsors), but the GP also has a fiduciary duty to manage the MLP in a manner beneficial to the MLP and its unitholders
- Fiduciary duties owed to unitholders by the GP are prescribed by law and the MLP's partnership agreement
- Delaware limited partnerships may, in their partnership agreements, expand, restrict or eliminate the fiduciary duties otherwise owed by a GP to the LPs and the partnership
- The standard MLP partnership agreement contains various provisions modifying and restricting the fiduciary duties that might otherwise be owed by the GP
- These provisions allow the GP (and its affiliates) to:
  - engage in transactions with the MLP that otherwise would be prohibited by state-law fiduciary standards and
  - take into account the interests of other parties in addition to those of the MLP when resolving conflicts of interest.

What is a typical economic structure?

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- Substantially all MLP governing documents include an agreement to distribute 100% of "available cash"
  - Not a tax requirement for MLPs, but rather market driven
  - Because MLPs are not subject to entity-level federal income tax, they have more cash to distribute to unitholders
- In its governing documents, the MLP states its intention to distribute a specified minimum level of distributions on a quarterly basis
  - This is called the "minimum quarterly distribution" or "MQD"

Typical definition of "available cash":

- All cash on hand at the end of a quarter;
- <u>less</u> reserves established for the operation of the MLP, compliance with applicable laws, any debt instruments and other agreements of the MLP and provide funds for distribution to unitholders and the GP for any one or more of the next four quarters;
- <u>plus</u>, at the election of the Board of Directors, all cash on hand on the date of determination of available cash for the quarter resulting from working capital borrowings made after the end of the quarter for which the determination is being made.

How does the MLP ensure that it has cash to distribute to public unitholders?

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- Most MLPs have an "**internal**" support mechanism to provide greater certainty of cash distributions:
  - The MLP has two classes of LP Units—common units and subordinated units
  - Sponsors retain all subordinated units and any common units not offered to the public in the IPO
  - Common units have a priority distribution of the MQD over subordinated units each quarter, providing more certainty of distribution to public unitholders
  - Common units are also entitled to arrearages in subsequent quarters if the MQD is not met
  - The subordination period generally lasts five years, but there is a potential for early conversion (25% of subordinated units convert to common units in each of years three and four) if certain cash distribution and financial tests are satisfied
- MLPs can also have an "**external**" support mechanism for cash distribution:
  - Sponsors may agree to cover any distribution shortfalls with cash contributions in exchange for additional partnership interests
  - An external support mechanism would be created in lieu of subordinated units
- The GP determines the amount of available cash to be distributed—in a typical structure, the LPs are initially entitled to 98% of distributions, and the GP is initially entitled to 2% of all distributions, subject to adjustment for IDRs

How does the MLP decide between "internal" and "external" distribution support?

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"External" Distribution Support

- Requires a strong balance sheet, but is more favorable to the sponsors
  - Sponsors retain smaller LP interest in MLP since no subordinated units are issued
  - Allows for the sale of more than 50% of the partnership to the public
  - Assuming compliance with applicable law and no agreement to the contrary, the sponsor is free to sell the common units it holds following expiration of the IPO lock up
  - Increased cash distribution to sponsor at IPO
- Requires the sponsors to inject cash, rather than just forego distributions
- Could generate additional disclosure obligations for certain sponsors

"Internal" Distribution Support

- Has been the standard since 1993
- Attractive to a larger number of sponsors
  - Balance sheet largely irrelevant
  - Majority of sponsors want to retain larger ownership interest at IPO
- More favorable to the LPs
  - Sponsors retain sizeable LP interest in MLP
  - Terms of subordination incentivize sponsor to maintain and grow distributions
  - Not dependent on sponsor's credit worthiness

Midstream MLP IPO Distributions

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	EQT Midstream Partners, LP	Inergy Midstream	Rose Rock Midstream	American Midstream	Oiltanking Partners	Tesoro Logistics	Chesapeake Midstream Partners	Niska Gas Storage	PAA Natural Gas Storage
Date	6/26/2012	12/15/2011	12/8/2011	7/26/2011	7/13/2011	4/20/2011	7/28/2010	5/11/2010	4/29/2010
Size ($m)	301.9	313.7	160.8	90.6	247.4	313.5	511.3	412.5	289.6
% of Company Sold	40.6%	24.8%	47.0%	46.7%	29.0%	48.0%	17.3%	29.2%	23.1%
MLP Subsector	Gas Transportation	Gas Transportation and Storage	Liquids Transportation and Storage	Gas Gathering and Processing	Liquids Transportation and Storage	Liquids Transportation and Storage	Gas Gathering and Processing	Gas Transportation and Storage	Gas Transportation and Storage
Market Cap at Offering ($m)	743.6	1,265.0	342.3	194.1	853.2	653.1	2,955.6	1,412.6	1,253.7
Common Units Interest	49.0%	100.0%	49.0%	49.0%	49.0%	49.0%	49.0%	49.0%	54.3%
Subordinated Units Interest	49.0%	n/a	49.0%	49.0%	49.0%	49.0%	49.0%	49.0%	43.7%
GP Interest	2.0%	n/a	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Min. Subordination Period	1 year	n/a	1 year	1 year	1 year	1 year	1 year	3 years	3 years
Dividend Yield at Pricing	6.7%	8.7%	7.3%	7.9%	6.3%	6.4%	6.4%	6.8%	6.3%
MQD per Unit	$0.35	$0.37	$0.3625	$0.4125	$0.3375	$0.3375	$0.3375	$0.3500	$0.3375
GP Incentive Distribution Rights (IDRs)	• Up to $.4025; 2%	• Up to $.37; 0%	• Up to $.416875; 2%	• Up to $.47438; 2%	• Up to $.38813; 2%	• Up to $.388125; 2%	• Up to $.388125; 2%	• Up to $.4025; 2%	• Up to $.3375; 2%
	• Above $.4025 up to $.4375; 15%	• Above $.37; 50%	• Above $.416875 to $.453125; 15%	• Above $.47438 to $.51563; 15%	• Above $.38813 to $.42188; 15%	• Above $.388125 to $.421875; 15%	• Above $.388125 to $.421875; 15%	• Above $.4025 to $.4375; 15%	• Above $.3375 to $.37125; 15%
	• Above $.4375 to $.525; 25%		• Above $.453125 to $.54375; 25%	• Above $.51563 to $.61875; 25%	• Above $.42188 to $.50625; 25%	• Above $.421875 to $.50625; 25%	• Above $.421875 to $.50625; 25%	• Above $.4375 to $.5250; 25%	• Above $.37125 to $.50625; 25%
	• Above $.525; 50%		• Above $.54375; 50%	• Above $.61875; 50%	• Above $.50625; 50%	• Above $.50625; 50%	• Above $.50625; 50%	• Above $.5250; 50%	• Above $.50625; 50%

What are Incentive Distribution Rights ("IDRs")?

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- IDRs are incentives to the GP to grow the MLP's business and increase its cash flow, as well as compensation for subordination
- Substantially all MLPs have included IDRs in their structure at the time of IPO
- The GP is entitled to an increasing share of cash distributions as benchmarks for limited partners are achieved
- The thresholds and "splits" vary, but many deals provide the GP with 15%, 25% and 50% of the incremental cash generated above certain target levels
- As more MLPs enter the highest split level, there has been increased scrutiny of IDRs
- Some MLP agreements permit the GP to "reset" the splits by exchanging the IDR for a number of LP units with a distribution equal to the foregone GP distribution
- Established MLPs may elect to reduce or eliminate IDRs to improve the MLP's cost of capital and facilitate continued growth

Typical IDR Structure

GP Incentive Tiers	Quarterly Distribution (US$)	% Above MQD (%)	Cash Flow Split to	
			LPs (%)	GPs / IDRs (%)
MQD	0.300	n/a	98%	2%
Tier 1	≤0.345	15%	98%	2%
Tier 2	>0.345 - ≤0.375	25%	85%	15%
Tier 3	>0.375 - ≤0.450	50%	75%	25%
Tier 4	>0.450	50%	50%	50%

What is Qualifying Income?

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- To receive "pass through" tax treatment for a publicly traded partnership, qualifying income must be 90% of the MLP's gross income for the relevant taxable year and all prior taxable years.
- Is it qualifying income?
  - For income related to natural resources:
    - Is the item a "natural resource or mineral"?
    - Is the activity directed at that natural resource or mineral one of the activities listed under Section 7704(d)(1)(E)?
  - For income not related to natural resources:
    - Is the item one of the enumerated items under Sections 7704(d)(1)(A), (B), (C), (D), (F) or (G)?

Example Qualifying Natural Resources

- Oil, gas and petroleum-related products (including certain alternative fuels)
- Coal, timber and other minerals
- Other resources that are depletable under Section 613 of the Internal Revenue Code

Example Qualifying Natural Resource Activities

- Exploration, development and production
- Gathering and Processing
- Storage, marketing and distribution
- Transportation
- Refining
- Compression
- Mining
- *But*, does not include marketing to retail end users or processing natural resources into finished products

Example Qualifying Income Sources

- Income from commodity investments
- Capital gains from sale of assets used to generate the prior mentioned types of income
- Income and capital gains from natural resource activities
- Interest, dividends and capital gains
- Rental income and capital gains from real estate

What types of qualifying-income assets are currently held by MLPs?

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- Petroleum products pipelines
- Crude oil pipelines
- Natural gas pipelines
- CO2 pipelines
- Crude oil and natural gas gathering
- Refineries
- Deathcare (land plots)
- LNG tankers
- Natural gas processing facilities
- NGL fractionating facilities
- Coal reserves
- Coal transportation and handling facilities
- Retail propane sales
- Timberlands
- Petroleum products tankers and barges
- Crude oil tankers

What types of businesses lend themselves to the MLP structure?

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- Businesses that expect growth, whether organic growth or acquisition opportunities.
- Businesses with predictable levels of cash, for example:

Long-term contracts (shipping, pipelines, terminals)

Long-lived reserves or royalty payments (coal)

Margin businesses (propane)

Oil and gas companies with steady production, slow decline curves, relatively low finding costs and low exploratory risk

Fee-based businesses (pipelines, terminals)