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White Paper

DiMeo Schneider & Associates, L.L.C.

Energy Infrastructure Master Limited Partnerships (MLPs)

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An Attractive Diversifying Asset Class?

What are Master Limited Partnerships (MLPs)?

MLPs are publicly traded partnerships that were largely born out of tax-friendly legislation in the 1980s. The *Tax Reform Act of 1986* enabled companies organized under the MLP structure to pass all income, losses, gains, and deductions on to limited partners without corporate taxation. Fearing that many corporations would rush to adopt the tax-friendly MLP structure, Congress followed up with *The Revenue Act of 1987*. The Act limited the MLP structure to companies where at least 90% of their income was considered “qualifying income”, defined as “income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or similar products), or the marketing of any mineral or natural resource including fertilizer, geothermal energy, and timber.” As a result, the vast majority of modern day MLPs own and operate energy infrastructure assets like pipelines that transport crude oil, natural gas and other petroleum products. Exceeding \$77 billion in total market cap, there are 52 publicly traded MLPs today.

MLPs are traded like shares of corporations on public exchanges and are regulated by the Securities and Exchange Commission. However, unlike ownership interests in traditional corporations, MLP ownership interests are divided into two segments: a general partner (GP) and limited partners (LP). The general partner typically has a 2% stake, manages the partnership and has unlimited liability. On the other hand, the limited partners provide the capital and receive cash distributions from the partnership and are only liable to the extent of their invested capital. Also, unlike traditional corporations, the limited partners’ ownership interest is structured as “units” rather than as “shares” and the cash flows to the LP are called “distributions” rather than “dividends”.

How the Modern MLP Market Evolved to its Present Form:

In the 1980s, MLPs were involved in a variety of businesses, including risky oil and natural gas exploration and production companies. These exploration and production MLPs fell prey to falling energy prices and depleting reserve bases which relied heavily on exploratory drilling to sustain cash flow. Without reinvestment, many of these MLPs were self-liquidating partnerships and were ultimately unable to sustain their distributions.

In the late 1980s and early 1990s, MLPs were reinvented when large energy companies began transferring their low growth physical assets (e.g. pipelines) that generated “*qualifying income*” to the more tax-efficient MLP structure. As a result, MLPs were reborn, largely as midstream energy infrastructure assets that transported, processed, and stored natural gas, crude oil, and refined petroleum products. So unlike the exploration and drilling MLPs of the prior era, today’s MLPs focus on energy transportation, refining and storage and have little exposure to volatile energy prices.

Beginning in the late 1990s, MLPs started making significant acquisitions, pursuing growth projects and aggressively raising distributions. This change in focus was largely due to the continued availability of midstream energy transportation assets as the large diversified energy players divested their mature assets to redeploy their capital to higher-returning investments. MLPs were able to take advantage of their tax-exempt structure, which affords them a lower cost of capital and allows them to achieve higher returns compared to traditional corporations.

Today, there are 52 MLPs traded on public exchanges. 38 are energy related, 2 are in the timber and minerals category, 5 in real estate, 3 in mortgage securities, and 4 fall into a miscellaneous class. The market cap of MLPs has grown to about \$78 billion from \$2 billion in 1994 (when there were only 7 MLPs).

Alerian MLP Index Weights as of May 31, 2006

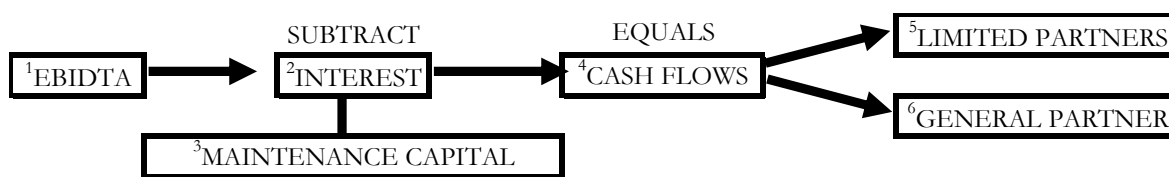
Company Name	Ticker	Price	Market Cap	Weight
Kinder Morgan Energy Part LP	KMP	\$47.20	\$7,662,103,440	13.61%
Enterprise Product Partners LP	EPD	\$25.20	\$9,960,950,160	11.98%
Energy Transfer Partners LP	ETP	\$45.24	\$3,360,997,224	6.79%
Plains All American Pipeline LP	PAA	\$48.50	\$3,747,750,200	5.49%
TEPPCO Partners LP	TPP	\$37.64	\$2,633,429,904	5.13%
Magellan Midstream Partners LP	MMP	\$34.64	\$2,298,731,184	4.65%
Northern Border Partners LP	OKS	\$49.70	\$4,119,990,840	4.61%
Kinder Morgan Management	KMR	\$43.47	\$2,561,078,520	4.47%
Enbridge Energy Partners LP	EEP	\$43.52	\$2,344,444,160	4.39%
Valero LP	VLI	\$51.48	\$2,409,763,356	3.88%
Buckeye Partners LP	BPL	\$43.46	\$1,713,579,994	3.30%
AmeriGas Partners LP	APU	\$29.00	\$1,647,115,900	1.89%
Pacific Energy Partners LP	PPX	\$31.30	\$1,230,121,300	1.82%
Suburban Propane Partners LP	SPH	\$29.23	\$886,078,220	1.81%
Ferrellgas Partners LP	FGP	\$21.83	\$1,320,236,923	1.81%
Alliance Resource Partners LP	ARLP	\$37.02	\$772,803,606	1.58%
Sunoco Logistics Partners LP	SXL	\$42.95	\$1,213,590,905	1.41%
Penn Virginia Resource Partners LP	PVR	\$25.81	\$1,074,831,640	1.35%
Copano Energy LLC	CPNO	\$46.66	\$855,408,448	1.32%
Inergy LP	NRGY	\$26.45	\$965,194,885	1.30%
Energy Transfer Equity LP	ETE	\$26.70	\$3,645,212,160	1.15%
Crosstex Energy LP	XTEX	\$34.36	\$912,275,180	1.03%
TC Pipelines LP	TCLP	\$32.59	\$570,325,000	1.01%
Magellan Midstream Holdings LP	MGG	\$21.64	\$1,355,681,080	0.98%
Atlas Pipeline Partners LP	APL	\$40.99	\$534,878,510	0.95%
Enbridge Energy Management	EEQ	\$42.42	\$515,958,532	0.88%
Enterprise GP Holdings LP	EPE	\$35.50	\$3,155,385,550	0.88%
Dorchester Minerals LP	DMLP	\$25.10	\$708,834,040	0.83%
Markwest Energy Partners LP	MWE	\$43.00	\$553,840,000	0.79%
Natural Resource Partners LP	NRP	\$54.78	\$921,673,500	0.76%
Boardwalk Pipeline Partners	BWP	\$23.17	\$2,348,279,500	0.70%
Teekay LNG Partners LP	TGP	\$30.73	\$1,074,709,350	0.69%
Holly Energy Partners LP	HEP	\$40.12	\$646,232,900	0.66%
Regency Energy Partners LP	RGNC	\$22.30	\$861,344,190	0.63%
Alliance Holdings GP LP	AHGP	\$22.09	\$1,322,373,670	0.55%
DCP Midstream Partners LP	DPM	\$28.42	\$497,350,000	0.52%
Martin Midstream Partners LP	MMLP	\$31.22	\$396,047,554	0.49%
Linn Energy LLC	LINE	\$20.09	\$558,702,900	0.49%
Natural Resource Partners LP	NSP	\$52.55	\$447,463,250	0.41%
Calumet Specialty Products Partners LP	CLMT	\$32.00	\$836,224,000	0.38%
Star Gas Partners LP	SGU	\$2.64	\$200,043,360	0.37%
K-Sea Transportation Partners LP	KSP	\$31.10	\$308,480,900	0.36%
Williams Partners LP	WPZ	\$34.52	\$483,487,120	0.35%
Hiland Partners LP	HLND	\$42.29	\$355,574,320	0.33%
Genesis Energy LP	GEL	\$12.01	\$165,550,644	0.31%
US Shipping Partners LP	USS	\$20.80	\$287,040,000	0.25%
Inergy Holdings LP	NRGP	\$32.68	\$653,600,000	0.24%
TransMontaigne Partners LP	TLP	\$30.54	\$222,783,192	0.21%
Global Partners LP	GLP	\$20.66	\$233,148,100	0.20%
Rio Vista Energy Partners LP	RVEP	\$5.01	\$9,574,110	0.01%

Total: \$77,560,273,421

How MLPs Generate Investment Returns:

Modern day MLPs mainly own midstream energy infrastructure assets like pipelines that generate “tariffs” for the transportation of crude oil and refined petroleum products (e.g. jet fuel, gasoline and/or distillate fuel oil). These tariffs charged for the transportation of petroleum products generate fee income, similar to that of a toll road. Most pipelines that cross state lines are regulated by the FERC (Federal Energy Regulatory Commission). The FERC regulates the rates that pipelines can charge, usually building in annual inflation adjustors (e.g. PPI +1.3%). Therefore, the fees generated are usually not tied directly to changes in the price of the transported commodity, but rather simply to the quantity (and distance) of the good transported. As a result, this fee income tends to be fairly stable over time, regardless of changes in the commodity’s prices. As the volume of the commodity transported increases with demand growth (and growth in inflation), the fee revenues increase.

Diagram of MLP Cash Flows



¹ EBITDA = Earnings generated from fee income before interest, depreciation, taxes and amortization.

² Interest = interest paid to owners of debt.

³ Maintenance Capital = expenditures to maintain/ repair the asset.

⁴ Distributable Cash Flow = Remaining cash flows to distribute to LPs and GPs.

⁵ Limited Partners = Owners of "Units".

⁶ General Partners = Entity that manages the business.

The General Partner (GP) usually starts out receiving a 2% share of the cash flow, but the split can increase if the GP is able to generate revenue growth. The split can usually grow up to a 50% marginal rate over time if the GP is successful. Since the GP receives an increasing split as cash flows grow, the GP’s interests are aligned with those of the Limited Partners (LP) to grow overall revenues.

Returns

Example of Percentage Allocation to GP & LP

Target Distribution	Annual LP Distribution Per Unit	LP % of Incremental Cash Flows	GP % of Incremental Cash	GP % of Total Distribution
Minimal Annual Distribution	\$2.00	98%	2%	2.0%
First Target Distribution	above \$2.00 up to \$3.00	85%	15%	2.1% - 6.3%
Second Target Distribution	above \$3.00 up to \$4.00	75%	25%	6.4% - 11.0%
Thereafter	above \$4.00	50%	50%	11.1% - 18.8%

Source: Kayne Anderson Capital Advisors, L.P.

Because MLPs distribute virtually all available cash to unit holders, they must access the capital markets to finance growth. This dynamic can cause MLPs to be disciplined acquirers, at least compared to traditional corporations, because management teams must demonstrate to unit holders that acquisitions and projects are immediately accretive to earnings.

MLP Sub-Sectors:

Many types of businesses have historically been structured as MLPs. For example, the Boston Celtics were once owned by an MLP. However, most of the non-natural resources sector MLPs that exist today were grandfathered when tax laws changed in 1987 (and currently represent a very small part of the MLP market). Today, there are several major sub-sectors of the dominant energy infrastructure MLP market that are readily identifiable.

Pipeline and Terminalling: Pipeline assets transport crude oil, natural gas and refined petroleum products. They generate their income through tariffs that are tied to quantity and distance transported (rather than value transported) so they are not directly exposed to changing commodity prices. The FERC (Federal Energy Regulatory Commission) regulates the interstate transmission rates, serving to limit the returns pipeline operators can earn and to stabilize earnings.

Retail Propane Distribution: Retail propane assets transport propane to rural areas where natural gas service is not available. Most of the retail propane distribution base consists of residential homeowners who rely on propane for home heating, cooking, water heating and clothes drying.

Coal Mining and Marketing: The electric utility industry relies on coal combustion to fuel about 52% of the electricity generated in the United States annually. In so doing, the utility industry consumes more than 90% of the coal produced every year. While the new electricity capacity built over the coming decades is likely to be primarily fueled by natural gas, coal will likely retain a dominant share because it is a less expensive source of energy.

Marine Transportation: 28% of domestic refined products are transported by waterborne vessels that are frequently owned by MLPs. Marine transportation is also a critical link for liquefied natural gas. While pipelines are the most efficient way to transport refined petroleum products, there are no pipelines connecting the major refining areas in the Gulf Coast with the consuming areas in California, the Pacific Northwest and Florida.

MLP Risks

Interest Rate Risk: Currently, the MLP market is yielding ~6.7%. If buyers of MLPs suddenly demanded 7.7% yields (or a 1% increase), the market price of MLPs would fall about 13%. If government bond yields suddenly jumped from 5% to 7%, for example, investors could own a risk free asset with similar yields, making MLPs less attractive. Therefore, MLPs can have interest rate risk. However, this risk has declined in recent years as the market has begun pricing MLPs based on their growth potential (as well as their yield).

Regulatory/Tax: The majority of MLPs assets are regulated by the FERC, which has historically been a highly politicized organization. However, from 1992 to 2006, there has been only one substantive change to the pipeline inflation indexing methodology, and it was a positive for the pipeline owners. Prior to July 2003, the FERC capped tariff increases at PPI minus 1%. In 2003, the FERC raised this to PPI + 0%. In 2006, this again was raised to PPI +1.3%. While these regulatory changes have been beneficial to MLPs, it is possible that future regulatory changes could be detrimental. It is also possible there could be changes to the 1986 Tax Act that could alter the MLP structure and eliminate the ability to pass through tax liabilities. However, this may be politically unlikely because such a change would raise the cost of capital for energy infrastructure, which is already widely viewed as being undercapitalized.

Demand Reduction for Energy: Since the oil crisis of the 1970s, demand for refined petroleum products has increased about 1.5% per year. Leveraging this modest growth has been a major source of MLP distribution growth. If energy demand were to decline, MLP pipeline assets could suffer.

Terrorism: While terrorists could destroy segments of pipelines, it would be very difficult to destroy an entire pipeline (just as it would be difficult to destroy an entire highway). Most MLPs do not carry terrorism insurance because it is a relatively simple and inexpensive task to replace a pipeline segment that has been damaged. In reality, terrorists would be more likely to target downstream infrastructure (refinery complexes that supply pipelines) which could adversely effect MLPs. However, virtually all MLPs carry business interruption insurance, which could mitigate the risk of such occurrences.

The Current MLP Value Proposition

From 1991 to 2005, MLPs generated compound total annual returns of 18%¹. During the time period, distributions (or yields) of the MLP market averaged 9-10%, while annual distribution growth averaged 8% - 9%².

Looking forward, the value proposition for MLPs are distributions (or yields), plus the potential for growth. Currently, the MLP market's average yield is ~6.7%³. While the 8-9% historical growth rate for the last 10 years may be difficult to duplicate over the coming decade, a 3-5% growth rate may be sustainable in the foreseeable future due to the continued growth in demand for energy in the U.S. (historical growth of 1.5%) and the inflation adjustments in some MLP contracts. Moreover, there are a significant amount of non-core qualifying assets available for divestiture (spurring additional accretive growth) within the major oil companies and energy merchants⁴ (estimated to be between \$50 - \$100 billion⁵). There are also opportunities for MLPs to grow their distributions organically by connecting existing pipelines and building new ones.

Combining the current 6.7% yield with a potential 3-5% growth rate, expected total annual returns of 9.7% - 11.7% do not seem unreasonable. In an era of low interest rates and relatively low equity risk-premiums (e.g. current DiMeo Schneider & Associates, LLC 10-year US equity forecast of 8.2%), a potential 9.7% - 11.7% annual return appears compelling.

¹ Source: Atlantic MLP Index

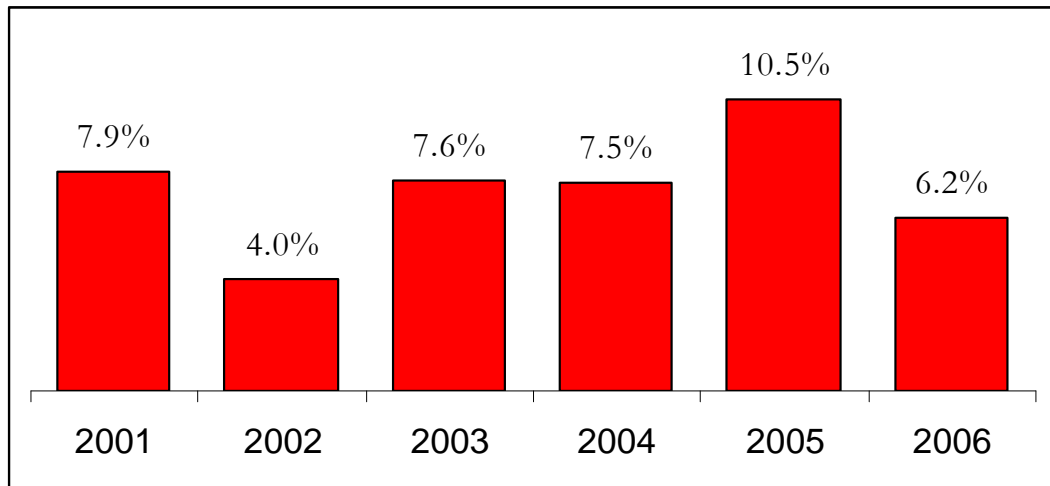
² Source: Alerian Capital Management

³ As of 5/3/2006: Source: Citigroup Investment Research, Bloomberg and Kayne Anderson Capital Advisors, L.P.

⁴ Source: Kayne Anderson Capital Advisors, L.P.

⁵ Source: Kayne Anderson Capital Advisors, L.P.

Average Historical MLP Distribution Growth (2001-2006)⁶



Alerian MLP Index Return History, 1996-Present

Calendar Year	Price Appreciation	Distributions	Total Return
1996	8.2%	8.4%	16.6%
1997	17.9%	8.9%	26.8%
1998	-9.4%	6.5%	-2.8%
1999	-13.8%	6.2%	-7.6%
2000	34.1%	12.9%	46.9%
2001	34.4%	9.2%	43.6%
2002	-9.8%	6.7%	-3.1%
2003	35.4%	9.5%	44.9%
2004	8.3%	7.1%	15.4%
2005	1.5%	5.2%	6.7%
<i>Mean</i>	<i>10.7%</i>	<i>8.1%</i>	<i>18.7%</i>
<i>Median</i>	<i>8.2%</i>	<i>7.7%</i>	<i>16.0%</i>
<i>High</i>	<i>35.4%</i>	<i>12.9%</i>	<i>46.9%</i>
<i>Low</i>	<i>-13.8%</i>	<i>5.2%</i>	<i>-7.6%</i>
<i>St. Dev.</i>	<i>19.1%</i>	<i>2.2%</i>	<i>21.0%</i>

Statistical Properties of MLPs' Historical Returns:

Returns & Risk

From 1991 to 2005, the Atlantic MLP Index generated a total return of 18% annually with an annual standard deviation of 18.9%. Over the same period, US Stocks returned 11.5% annually with an 18.0% annual standard deviation, and US Bonds returned 7.3% annually with a 5.8% annual standard deviation.

⁶ Data through 4/30/06. 5-Year distribution growth from 2000-2006 YTD. Source: Kayne Anderson Capital Advisors, L.P.
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Historical Return Comparisons

Calendar Year	¹ US Bonds	² US Stocks	Atlantic MLP Index	50% US Stocks, 50% US Bonds	23% US Stocks, 38% US Bonds, 39% MLPs
1991	16.0%	30%	14%	23.2%	18.6%
1992	7.4%	8%	26%	7.5%	14.7%
1993	9.8%	10%	33%	9.9%	18.9%
1994	-2.9%	1%	-14%	-0.8%	-6.1%
1995	18.5%	38%	27%	28.0%	26.2%
1996	3.6%	23%	26%	13.3%	16.7%
1997	9.7%	33%	40%	21.5%	27.0%
1998	8.7%	29%	-1%	18.6%	9.7%
1999	-0.8%	21%	-5%	10.1%	2.6%
2000	11.6%	-9%	44%	1.3%	19.4%
2001	8.4%	-12%	39%	-1.7%	15.5%
2002	10.3%	-22%	2%	-5.9%	-0.6%
2003	4.1%	29%	42%	16.4%	24.3%
2004	4.3%	11%	14%	7.6%	9.7%
2005	2.4%	5%	4%	3.7%	3.7%
AVE RET	7.4%	13.0%	19.4%	10.2%	13.3%
GEO RET	7.3%	11.5%	18.0%	9.8%	12.9%
ST DEV	5.8%	18.0%	18.9%	10.0%	10.0%

¹ *Lehman Aggregate Bond Index*

² *S&P 500 Index*

While history is not destiny, adding a 39% allocation to MLPs would have increased annual returns by over 3% at the same risk level (vs. a 50% Stock & 50% Bond portfolio). *Past performance is no guarantee of future returns.*

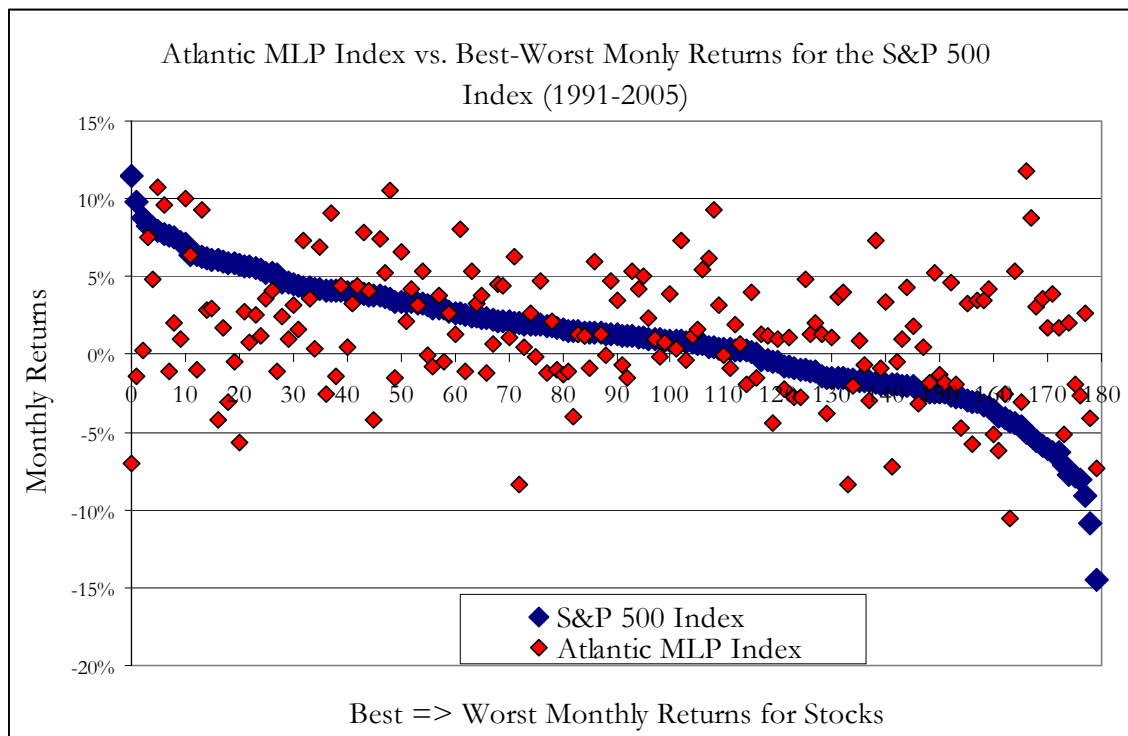
Correlations

From 1991 to 2005, the correlation between Large Cap US Stocks (S&P 500) and MLPs was 0.24. Coincidentally, the correlation between US Bonds (Lehman Aggregate Bond) and MLPs was also 0.24. So, overall, the correlation of MLPs to US Stocks and US Bonds has been quite low when compared to most other asset classes. The asset classes with the highest correlations to MLPs have been High Yield Bonds (0.43), REITs (0.30), and Small Cap Stocks (0.29), although those are still quite low in relative terms. Interestingly, the correlation to Commodity Futures (*Dow Jones - AIG Commodity Index*) has been quite low (0.17). As previously discussed, pipeline MLPs charge tariffs on the quantity and distance of the good transported so they are not usually directly exposed to the price fluctuations of oil and other energy commodities.

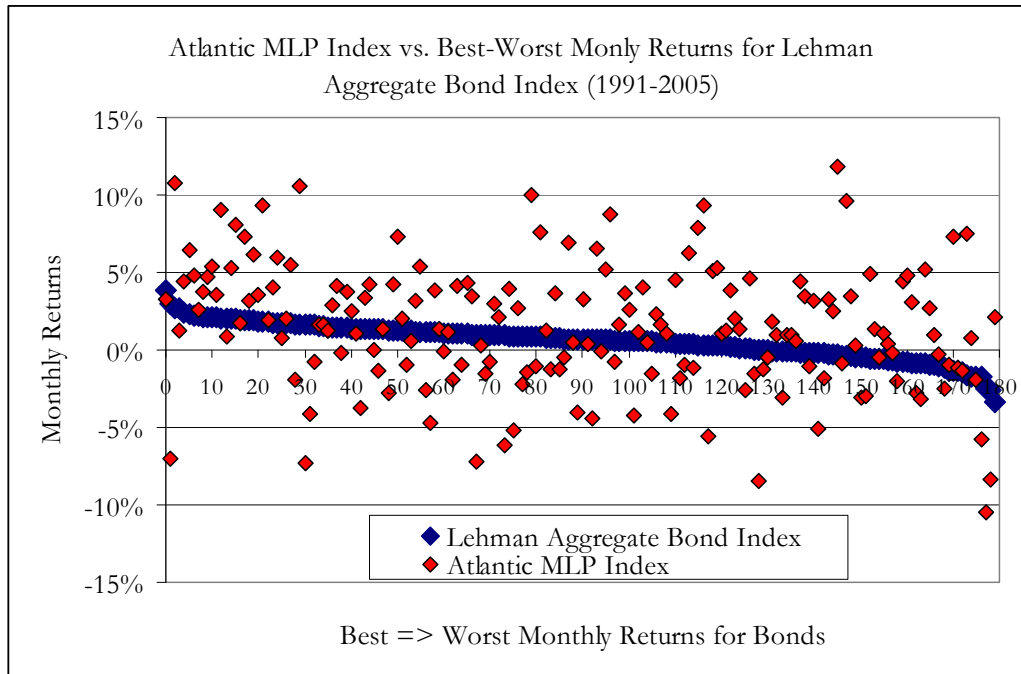
Correlation Matrix (1991-2005)

	Cash	TIPS	US Bonds	Foreign Bond (50% hedged)	HY Bond	Large US	Mid US	Small US	REIT	Foreign Equity	Em. Mkts.	Commod Futures	Atlantic MLP Index
Cash	1.00												
TIPS	-0.04	1.00											
US Bonds	0.10	0.76	1.00										
Foreign Bond (50% hedged)	0.06	0.53	0.47	1.00									
HY Bond	-0.01	0.05	0.33	0.08	1.00								
Large US	0.02	-0.18	0.24	0.00	0.50	1.00							
Mid US	-0.01	-0.13	0.24	-0.03	0.55	0.93	1.00						
Small US	-0.01	-0.15	0.14	-0.08	0.55	0.80	0.93	1.00					
REIT	-0.02	0.12	0.23	-0.01	0.43	0.56	0.67	0.69	1.00				
Foreign Equity	-0.04	-0.16	0.17	0.43	0.36	0.57	0.55	0.51	0.38	1.00			
Em. Mkts.	-0.04	-0.11	-0.05	0.00	0.43	0.59	0.63	0.63	0.37	0.57	1.00		
Commodity Futures	-0.05	0.17	-0.05	0.05	-0.08	0.07	0.08	0.09	0.07	0.13	0.10	1.00	
Atlantic MLP Index	0.07	0.18	0.24	0.12	0.43	0.24	0.28	0.29	0.30	0.18	0.25	0.17	1.00

Low Correlation to US Stocks



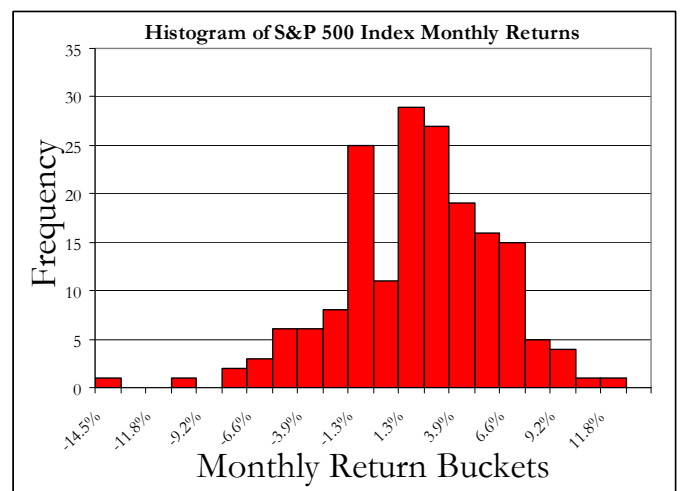
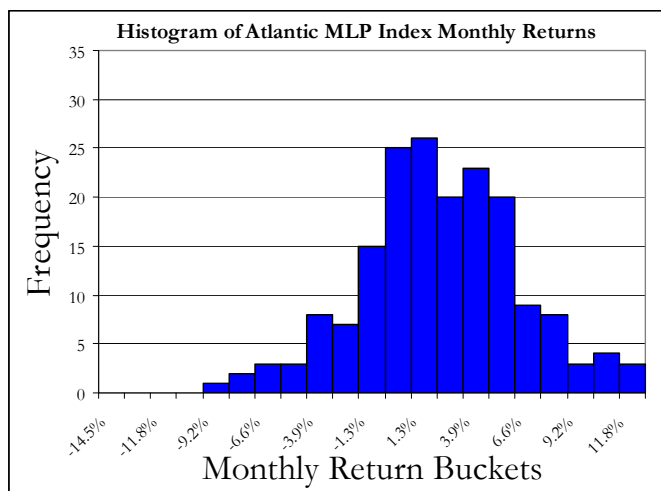
Low Correlation to US Bonds



Skewness & Kurtosis

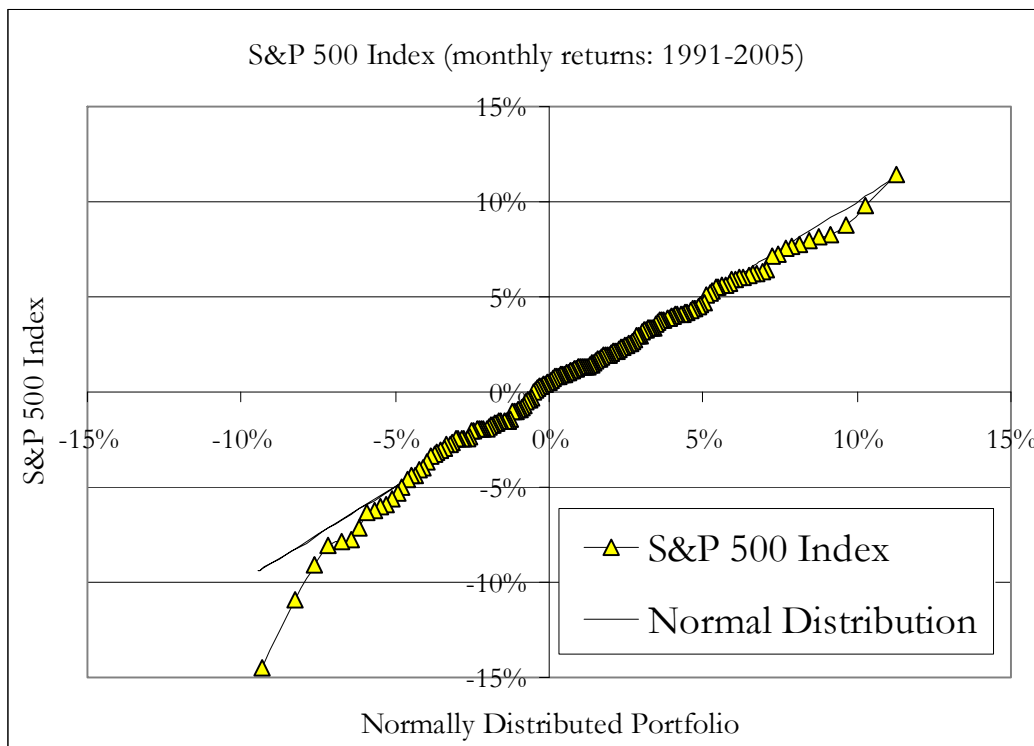
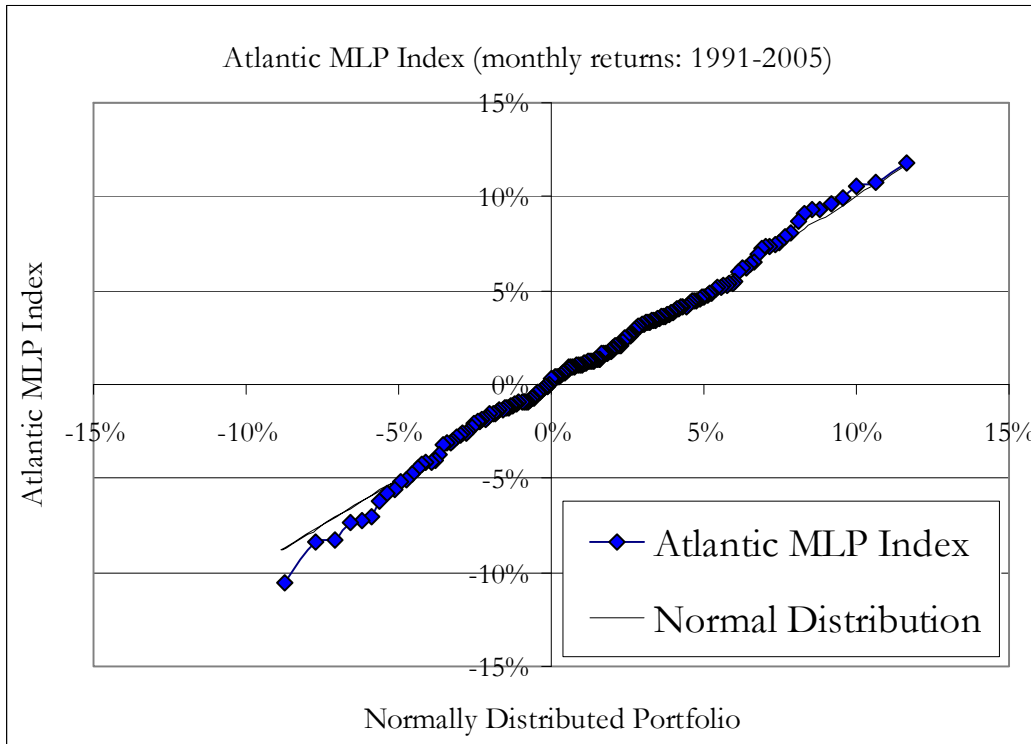
MLPs have had fewer large negative monthly returns than the S&P 500 (less skewness) and have had fewer extreme returns in general (lower kurtosis) since 1991.

MLPs vs. S&P 500 Histograms of Monthly Returns



When compared to US Stocks (S&P 500 Index), monthly returns of MLPs have also been closer to what would be predicted by the normal distribution. Therefore, the proverbial “fat-tails” for MLPs have been “thinner” than for US Stocks.

MLPs & US Stocks versus what is predicted by the normal distribution

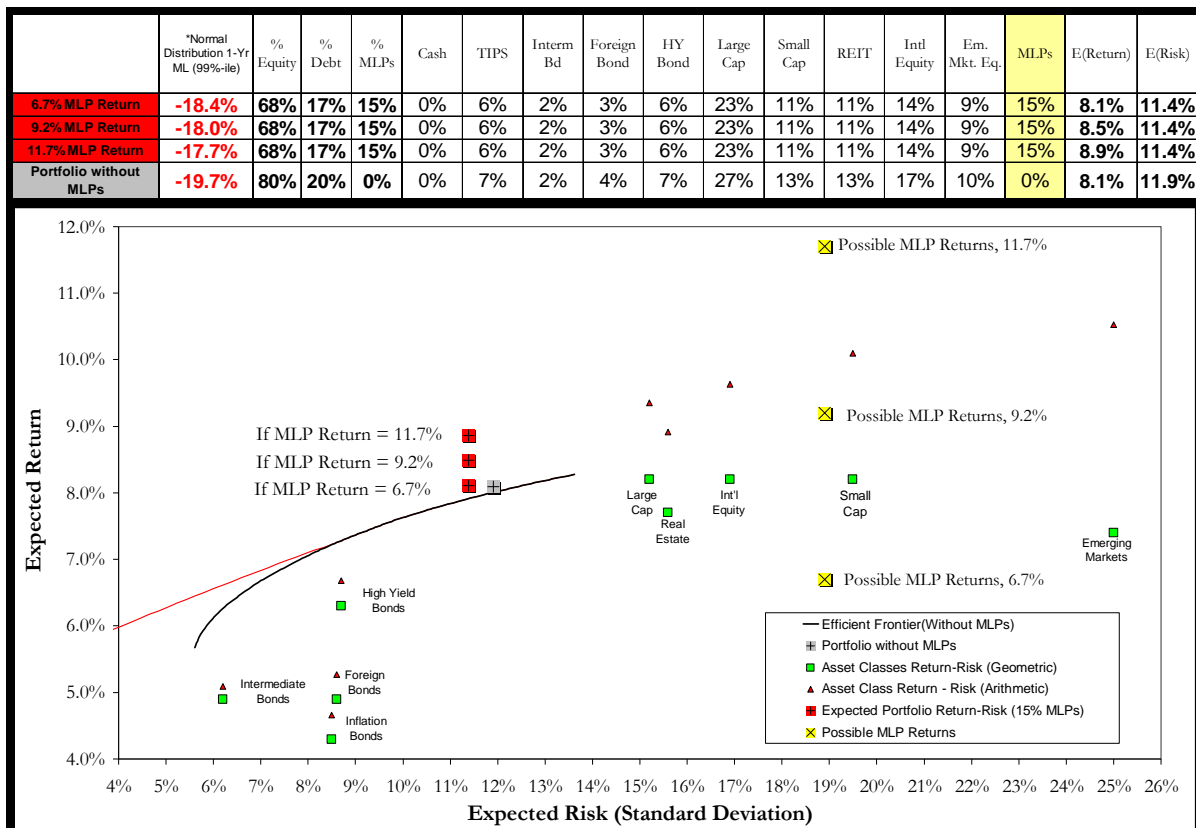


MLPs in a Modern Portfolio Theory Framework

The following asset allocation study examines the potential diversification benefits of MLPs within a diversified 80% equity & 20% fixed-income portfolio (*that has 7% TIPS, 2% Intermediate US Bonds, 4% Foreign Bonds, 7% High Yield Bonds, 27% Large Cap US Stocks, 13% Small Cap Stocks, 13% REITS, 17% Developed Foreign Stocks and 10% Emerging Markets Stocks*). Using DiMeo Schneider & Associates, LLC 10-year capital market forecasts (*expected return, risk & correlations*), this analysis models the expected return & risk of the same diversified portfolio, but with a 15% pro-rata allocation to MLPs. Using historical standard deviation and correlation assumptions for the Atlantic MLP index, the following analysis shows what would happen to the expected return & risk of the portfolio if MLPs returned 6.7% (no distribution growth), 9.2% (2.5% growth) or 11.7% (5% growth). Since the yield on MLPs is currently ~6.7%, 6.7% represents a theoretical “no growth” scenario.

Efficient Frontier Analysis

With & Without MLPs



*Normal Distribution 1-Yr ML (99%-ile): Represents theoretical worst case annual return (with 99% confidence) in any given year. Assumes returns are normally distributed.

If MLPs are expected to generate 6.7% annual returns, the portfolio’s expected return would remain unchanged, but the expected volatility (or standard deviation) would decline (from 11.9% to 11.4%). On the other hand, if MLPs generate an 11.7% return, the aggregate portfolio’s expected return would increase 0.80% (from 8.1% to 8.9%) and would still have lower volatility. If the mid-point assumption occurs (a 9.2% annual return), the expected return of the portfolio would increase ~0.40%. Because MLPs have low correlation to most other asset classes, one does not have to be a wild-eyed optimist about the asset class’ return prospects to see the potential value they can bring to a diversified portfolio (as either a risk reducer or a return enhancer).

Taxation: The Good, the Bad and the Ugly⁷.

The Good.....

Considered pass-through entities by the IRS, MLPs do not pay tax at the corporate level, which allows them to avoid the double taxation of most corporations (similar to *Real Estate Investment Trusts*). And while distributions are paid in cash, each partnership unit is also entitled to its share of the expense deductions associated with running the business. These deductions include non-cash items like depreciation and amortization. These deductions reduce taxable income on the distribution. Most new MLP issues have more than 80% of their cash distributions allocated as “tax-deferred”. Therefore, only 20 cents of every dollar distributed is taxed at the unit holder’s income tax rate (in this example). This can make MLP units a very attractive after-tax asset. For example, assume an MLP generates an 8% yield (e.g. \$0.80 distribution on \$10 unit price). If 80% is deferred income, only 20% (\$0.16 of the \$0.80 distribution) will be taxed at the ordinary income tax rate. So if the income tax rate is 35%, the after tax yield is 7.4% (\$0.74/ \$10.).

MLP Tax Example

MLP Unit Price	\$10.0
Distribution	\$0.80
Effective Yield	8.0%
Taxable Yield	1.6%
Tax Deferred Yield	6.4%
Taxable Income	\$0.16
Deferred Income	\$0.64
Tax Owed (35% rate)	\$0.06
After Tax Distribution	\$0.74
After Tax Yield	7.4%

⁷ DiMeo Schneider & Associates, LLC does not provide tax advice. We strongly encourage you get consultation from a tax advisor prior to purchasing MLPs.

MLPs can be an especially attractive asset for estate planning purposes. To demonstrate how, the above example is carried forward for the next 5 years. Over the next five years, we assume the deferred income is \$3.20 (or \$0.64 X 5). Now assume that the price rises 3% per year from \$10 to \$11.59. When the owner of the asset passes away, the heir(s) would receive a “step-up in basis,” eliminating capital gains **and** the recapture of ordinary income!

The Bad.....

The above 5-year example assumed that the asset was transferred upon the owner’s death. If the investor sells the MLP prior to passing, the investor must pay income tax on the \$3.20 deferred income (at their marginal tax rate) and capital gains on the \$1.59 gain. While the deferral of taxation can be a good thing, the chickens eventually come home to roost if the asset is not held until death.

and the Ugly.....

MLPs can kick off an obscure tax called UBTI (unrelated business taxable income). If the MLP is held in an IRA, any UBTI generated greater than \$1,000 is subject to federal taxation. This can make tax filing a difficult and impractical endeavor if the MLP is held in a tax deferred account (e.g. pension plan or IRA account).

There can also be additional administrative burdens related to state filing requirements. Because MLPs often do business (e.g. manage pipelines) in many states, an owner of an MLP may be required to file income tax returns in every state in which the MLP conducts business, even when no taxes are owed, which creates administrative burdens.

Barriers to Institutional Ownership:

Approximately 55% of total outstanding MLP units are held by retail investors, 4.1% are held by insiders and 21.3% are held by general partner interests⁸. While hedge funds and other institutional investors have recently begun investing in MLPs, only about 19% of MLPs are presently held by institutions. The “ugly” potential tax considerations for tax-exempt and tax qualified investors have largely prevented institutions from owning MLPs directly. For example, most pension funds and endowments avoid UBTI like the plague. And until recently, mutual funds were prevented altogether from owning MLPs. This changed when the American Jobs Creation Act of 2004 added MLP income to the list of acceptable sources of income for mutual funds as long as the mutual fund does not invest more than 25% of total assets in MLPs or own more than 10% of any one MLP. However, while the legal barriers for mutual fund ownership have been reduced, structural barriers still exist. For one, MLPs issue K-1s (rather than 1099s) that usually do not come out until after the January 31 mutual fund deadline for issuing 1099s.

In recent years, some offshore MLP hedge funds have cropped up. To avoid both the UBTI tax issues and the FIRPTA tax (Foreign Investment in Real Property Tax Act), which is a major barrier to foreign ownership for real U.S. assets, at least one offshore hedge fund invests solely in total return swaps that are tied to specific MLPs. Another way for tax-exempt institutions to own MLPs is to form a tax-paying corporation for the sole purposes of owning the MLPs. This corporation, owned by the institution, pays the taxes (including UBTI taxes), which allows the institution to avoid the UBTI issues at the plan or endowment level. These are just a couple of ways in which some institutional investors have found end-runs around some of the legal and structural barriers of MLP ownership.

Recently, Alerian Capital Management launched an MLP index (ticker: AMZ), which has led to speculation about the eventual creation of an exchange traded fund (ETF). However, how the potential ETF would deal with taxation issues is still unclear.

⁸Source: Partnership reports, Bloomberg, and Wachovia Capital Markets, LLC estimates

Closed-End MLP Funds:

There are several closed-end funds that invest solely in MLPs. These closed-end funds are structured as corporations (rather than as regulated investment companies) and are not subject to the restrictions related to qualifying income and UBTI. These closed-end funds typically pay a dividend that is meant to track the underlying MLP investments themselves. They can also engage in private market transactions that are not available to the general public.

The closed-end fund structure effectively eliminates the UBTI and K-1 barriers because investors receive simple 1099s. Most of these funds also employ some degree of leverage in order to increase returns (and, consequently, risk), help pay for their management fees, and create a deductible interest expense to offset some of the taxable income generated by owning and/or selling the MLPs at a gain (which can trigger the deferred income tax and lead to double taxation).

At first glance, closed-end funds look to be a viable way for institutions (e.g. mutual funds, pensions, endowments, etc.) to invest in MLPs and avoid the UBTI and K-1 headaches. However, they are too thinly traded for large institutions to take meaningful positions (without seriously moving the share price). For example, the largest of the closed-end funds managed by Kayne Anderson (Ticker: KYN) has a market capitalization of ~\$950 million and has an average daily trading volume of 71,000 shares. With a current price of around \$26 per share, only ~\$1.8 million worth of shares trades hands on average every day. For large institutional investors seeking \$10 - \$50 million investments in MLPs, this can be an insurmountable barrier to ownership. And even if the institution manages to gradually build a large position over time, it could be equally difficult to divest it.

At the end of the day, closed-end MLP funds may be a viable way for small institutions and individual investors to own MLPs, but large institutional investors will likely be squeezed out for the time being.

Closed-End Fund (Ticker), Market Capitalization⁹:

- Kayne Anderson MLP Investment Company (KYN), \$950 million
- Tortoise Energy Infrastructure Corporation (TYG), \$425 million
- Fiduciary/Claymore MLP Opportunity Fund (FMO), \$350 million
- Energy Income and Growth Fund (FEN), \$125 million (managed by Fiduciary)
- Tortoise Energy Capital Corporation (TYY), \$325 million
- Kayne Anderson Energy Total Return Fund (KYE), \$700 million
- Tortoise North American Energy Corporation (TYN), \$100 million

⁹Source: Alerian Capital Management LLC

Closed-End Fund Tax Treatment

For investors who own MLP closed-end fund shares in IRAs or other tax qualified accounts, taxes are a non-issue (and UBTI is avoided). However, for those who own the closed-end funds outside a tax qualified account, there are some additional potential tax benefits as compared to owning the MLP units outright. For one, the vast majority of the income paid out to investors is considered a “non-dividend distribution” and is not taxable. In 2005, for example, the Kayne Anderson MLP Investment Company (KYN) paid a \$1.495 per share dividend (~6% of the January 1, 2005 share price). Only 9% of this dividend (or \$0.1309) was considered a qualified dividend (making it taxable at the 15% rate). The remaining 91% of the dividend (or \$1.3641) was not taxable, but reduced the cost basis for an eventual capital gains distribution when sold (currently 15% long term capital gain tax upon sale). Had one owned the underlying MLPs outright, the non-taxable component of the dividend would be treated as deferred income, meaning that it would eventually be taxed when sold at the income tax rate (potentially 35%).

The Tax-Deferred Liability – A Potential Headwind for Closed-End Funds

The vast majority of the distributions closed-end funds receive from their MLP holdings is considered “return of capital” and is not currently taxable. However, it is considered “deferred income,” which means a tax-deferred liability is recorded on the books for accounting purposes and is subtracted from assets when calculating the published NAV. So long as the closed-end fund never sells the MLP, the tax-deferred liability is never paid. However, if sold, it becomes taxable at the closed-end fund’s income tax rate (for KYN, this was ~42% in 2005). As time passes, the tax-deferred liability will likely grow as deferred income accrues, which means the published NAV could dramatically understate the actual assets of the fund that are “at work” generating returns. This has several potential consequences. First, closed-end funds are frequently bought and sold based on their premium and/or discount to their published NAV. If the published NAV understates the assets of the fund that are “at work” generating returns, the share prices could remain close to the published NAV, regardless of the assets at work. Another implication is that the managers of the closed-end fund must carefully consider the tax consequences before selling an MLP. For example, they may think an MLP holding has become grossly overvalued and want to sell it (for whatever reason), but may be forced to hold onto it because the fund would have to pay an enormous deferred income tax.

This is partly why some closed-end MLP funds employ leverage. The debt payments (from the leverage) create an expense that can be netted against taxable income. So instead of holding a portfolio of 100% MLPs and no debt, a closed-end fund might own ~130% MLPs (and -30% debt). If the interest on the debts is 7%, for example, this can create a tax-deductible expense equivalent to 2.1% of the NAV (2.1% = 7% X 30%). So long as the MLP holdings return at least 7%, the leverage is not detrimental to returns.

Conclusion:

While MLPs certainly have unique risks and their own brand of tax considerations, their low correlations to most asset classes make them a potentially attractive diversifying asset. In the coming future, it is likely that institutional investors will continue to increase their ownership of MLP assets. If this does indeed occur, MLPs could begin trading more like REITs (which currently yield ~4%), creating a potentially profitable revaluation for investors. If it doesn’t happen, owning a 7% yielding asset with a 3-5% potential growth rate does not sound too bad either.

For additional information about MLPs, please contact your consultant at DiMeo Schneider & Associates, LLC or Matthew Rice at 312-853-1000.