

The MLP journey



Building a better
working world



As master limited partnerships (MLPs) continue to grow in popularity, many energy companies are considering the MLP structure for a variety of strategic reasons. Making the decision to enter the market as an MLP should be thoughtfully considered.

In its simplest form, an MLP is a publicly traded limited partnership, or a limited liability company, that pairs the tax benefits of a partnership with the fundraising ability and liquidity of a public company. The rise in popularity of MLPs in recent years, particularly in the energy space (in oil and gas, hard rock minerals, as well as in the chemical and other industries), mirrors the rapid growth in domestic energy production.

The MLP structure itself has been around since 1981, when the first MLP, Apache Oil Company, was formed. From 1981 through 1986, a number of energy and non-energy MLPs entered the public markets, providing unit holders with flow-through benefits on income and deductions while also providing the market liquidity typically enjoyed only by corporations (whose income is subject to a corporate-level tax). In 1986, concerned with the ability of corporations to distribute appreciated property to shareholders tax free, Congress enacted certain income tax provisions that curtailed the ability of corporate entities to distribute appreciated property to shareholders on a tax-deferred basis. In response, numerous companies discovered that the MLP structure allowed them to escape corporate-level taxation and retain the ability to distribute property tax free to their owners (subject to certain restrictions).

Concerned that corporate-level taxation could become elective, Congress added Section 7704 to the Internal Revenue Code in the Omnibus Budget Reconciliation Act of 1987. Under Section 7704, a partnership that is publicly traded (an MLP, generally) is classified as a corporation for US federal income tax purposes, denying the entity flow-through taxation treatment and the ability to make tax-deferred property distributions; however, as an exception to this general rule, an MLP can be classified as a partnership for US federal income tax purposes (and thus achieve flow-through treatment on its income and losses) if 90% or more of the MLP's gross income consists of "qualifying income."

The effect of the rule change was to curb the use of the MLP structure for activities that were not passive-type investments or activities that were not historically structured via joint venture arrangements (e.g., natural resource activities). "Qualifying income" includes, in part, interest, dividends, real property rents, gains from the sale or other disposition of a capital asset, income and gains from commodities, and income and gains derived from natural resources (such as the exploration, development, mining or production, processing, refining, transportation, or the marketing of any mineral or natural resource).

The number of energy MLPs on the market remained fairly steady from 1988 through 2004, despite the continued qualification for certain energy-based MLPs. In spite of a track record of successful midstream MLPs (mostly pipelines), the MLP structure was historically viewed as an appropriate vehicle for entities with low operational and commodity risk and predictable, stable cash flows, as opposed to a capital structure that would allow companies to unlock value and provide a strategic growth alternative. That has changed, thanks to a couple of key factors:

- ▶ The thirst for yield by individual investors (and, recently, certain institutional investors), who have experienced low interest rates on savings, CDs and other investment vehicles for several years, as well as a volatile stock market. With the average energy MLP providing a yield of more than 5% (varying according to structure, equity risk, and certain other factors), investors who have a long-term investment horizon and are looking for an investment with a strong yield have flocked to invest in MLPs.
- ▶ The increase in drilling activities across the United States, which is boosting production in multiple regions and requiring substantial investment in new pipelines and other infrastructure.

Since January 2013, more than 30 new MLPs have entered the market, bringing the total number of publicly traded energy MLPs to over 100, with many more in various stages of consideration. Additionally, in the past couple of years, the Internal Revenue Service (IRS) has issued a number of private letter rulings that have clarified the types of activities that could generate "qualifying

income," including certain activities that MLPs have historically not been engaged in. While the IRS has announced a "moratorium" on certain "qualifying income" private letter rulings, many companies are currently evaluating and proceeding with entering the market via the MLP structure. Certain nontraditional MLPs, with variable earnings and payouts, are unlike their conventional counterparts, which featured stable cash flow and predictable distributions. These nontraditional MLPs, however, represent a new opportunity for companies with assets throughout the energy supply chain. Further, a variety of newly implemented structures may allow companies with variable earnings and payouts to structure their activities and cash distributions in the "traditional" MLP format.

With interest in MLPs at an all-time high, many energy company executives and board members are pondering the "MLP journey" for their own companies. Additionally, in the current economic environment, investors often pressure companies to evaluate the availability and benefits of an MLP. Yet the decision to move forward isn't always a simple one; a thorough, unbiased evaluation is critical.

Six strategic reasons for an MLP

Historically, a traditional energy MLP often involved an exploration and production company that owned midstream assets. Creating the MLP was a way to conduct a "synthetic spin-off," allowing the E&P company to unlock the value of its transportation and processing assets, without sacrificing operational control.

Today, companies (both in the energy and non-energy sectors) are evaluating MLPs for a wide range of strategic reasons, most of which fall into one of the following six categories:

- ▶ The potential for lower cost of capital
- ▶ The desire to improve stock valuation of the sponsor
- ▶ The ability to set a valuation for the sponsor's retained assets
- ▶ The opportunity to create a strategic growth platform – i.e., funding strategic growth via an alternative source of acquisition capital
- ▶ The desire for a capital raise alternative – the monetization of certain assets (partial liquidity)
- ▶ The potential to access a different class of investors

At the same time, there are definite challenges to implementing and managing an MLP. To start with, an MLP initial public offering (IPO) is a time-consuming process and takes away management's time and attention from core business operations. Further, there are costs associated with filing, preparation and implementation,





with the typical MLP IPO costing between roughly US\$3-55 million (exclusive of investment banking fees).

Once the IPO is complete, the sponsor's management team typically manages the MLP, reporting to a board with its own directors and committees. An MLP, similar to a regular publicly listed entity, also requires significant time spent on investor relations, reporting and disclosure, and there is complexity around accounting for shared services and the allocation of expenses.

Importantly, since MLP investors expect distribution growth, the MLP will need to illustrate a long-term strategy for consistent growth. Often, the need to consistently "feed the beast" requires an ongoing mergers and acquisitions effort, with attendant management focus and staffing requirements.

The potential for conflicts of interest between the sponsor company and the new MLP cannot be overlooked. For the MLP to thrive, the sponsor typically must provide new prospects, either through continued asset drop-downs or new business opportunities. This can create a natural tension between the two entities, especially with respect to valuation of assets. Improperly managed, this tension can distract from – or even harm – the overall strategy of the sponsor company. In other words, the strategic intent of the MLP – growing distributions via cash flow – can be at odds with the business objectives of the sponsor company, which may need to invest cash in long-term projects that offer good returns down the road.

These challenges may not be deal-breakers, but they do warrant discussion and consideration, and a clear strategic direction is needed so companies enter the MLP market with complete understanding of the challenges and future expectations.

For senior managers and executives of publicly held companies, the transition to a dual role – leading both the sponsor organization and the MLP – requires focus and patience. Leaders of privately held firms may have an even bigger learning curve, because they must also adjust to the complexities associated with a publicly held entity.

The transition to two separate yet connected organizations is often challenging for board members as well. The MLP IPO process must include the recruitment of a certain number of independent board members for the MLP so that both boards can focus on strategy as well as issues of governance and conflicts of interest. The boards are responsible for ensuring that transactions and cost allocations are fair to shareholders/unit holders of both entities and that the strategic needs for both are met.

With proper management focus, most MLPs develop their own "rhythm" over time, and the two organizations – along with their managers and boards – learn to work in tandem.

Planning for the long term

To fully understand the impact of an MLP IPO – and to properly anticipate and prepare for the challenges involved – senior management must undertake a thorough study that tests assumptions (best case and worst case, as well as iterations in between) and validates approaches.

Because of the wide range of options available to sponsor companies related to which assets are transferred to the MLP, the analysis should include detailed modeling of various tax, valuation and capital structure scenarios, as well as identification of a strategy for the ultimate downside: how will you unwind or otherwise exit the MLP if changing conditions require it?

A major element of this strategic decision-making process is determining which sponsor assets will be contributed to the MLP. There are a number of factors to consider:

- ▶ Which company assets qualify for placement in an MLP?
- ▶ Which assets fit strategically in the MLP?
- ▶ What are the tax advantages/disadvantages of each asset under consideration – (up-front and long-term tax costs)?
- ▶ Which assets are (and what operational structure is) most marketable to investors?
- ▶ Should all applicable assets be dropped down initially, or should some be held back initially? If some are held back, in what order will they be dropped down (and when)?
- ▶ Is it advantageous (from a tax and operational perspective) to restructure the legal-entity structure related to the assets prior to the formation of the MLP?

Understanding the tax implications of dropping down various assets is critical to the IPO's success and the MLP's ongoing viability. The types of assets included and the timing of drop-downs and acquisitions can have significant tax consequences. For example, seeding an MLP with fully depreciated assets can reduce the overall internal rate of return to the sponsor due to certain tax rules requiring the sponsor to pick up certain items of notional income.

In evaluating the tax implications, proper modeling can take into account future income streams, expansion plans and other variables. A flexible model can allow management to understand the implications of various scenarios and, combined with proper tax planning, can allow management to choose tax-efficient methods to monetize assets and grow the MLP.

An objective third-party tax and advisory consultant, with experience in helping companies understand and manage the MLP process, can map out various options and provide a "proof of concept" analysis that is critical for a board-level decision to pursue an MLP. Tax professionals can also work hand-in-hand with the executive team, investment bankers and legal counsel to enhance the overall value of the offering.

A typical energy company considering an MLP IPO may have hundreds of applicable assets that must be identified and modeled. Because of the complexity of determining each asset's tax "DNA" and its impact on the overall IPO, bringing in tax professionals early in strategic planning process is critical. The earlier that they are involved, the more effective they can be in maximizing the sponsor's ability to extract cash from the IPO and maximize tax deferral.

Implementation requires resources

If the decision is made to pursue an MLP IPO, a host of other activities may require outside assistance. Operationally, the MLP will need to assess a number of critical components, including, in part:

- ▶ Current shared services
- ▶ Shared organizational structure
- ▶ Third-party agreements for change of control impacts or ongoing seller liability
- ▶ IT systems that must be separated and replicated to operate in a stand-alone manner
- ▶ Required interim services (TSAs) and long-term operating agreement requirements
- ▶ Possible stranded costs and their ability to be eliminated

The allocation of employee/shared services costs is not always a straight-forward exercise, especially when assets transferred to the MLP are pulled from various legal entities within the sponsor's organizational structure. Determining costs, creating inter-company agreements and developing carve-out financial statements can be a complex, time-consuming exercise that requires deep knowledge and experience.

These are just a handful of the tasks and responsibilities that are required when a sponsor company decides on an MLP IPO. It is a serious undertaking that should be planned and managed with a strategic approach and the proper allocation of resources.

Timing and execution are important

Successful IPO candidates will begin the transformation process well before the public launch, due to the numerous activities to be completed in an IPO timeline. Overall, the key activities should be determined and monitored closely throughout the MLP journey by a project management office (PMO). The establishment of a PMO has served many IPO-bound companies well. PMOs are responsible for coordinating the IPO process and liaising between management, bankers, attorneys, underwriters, tax advisors, accountants and other involved parties.

Your selection of highly experienced advisors will carry significant weight in the IPO process as they will be instrumental in identifying and addressing potential "roadblocks" throughout the MLP journey. The human dynamic can be crucial, and it will be important to look for advisors that have a reputation for working well together. The choice is not only about reputation and track record. Relationships with existing service providers may need to be evaluated to confirm that they have the resources and expertise to meet those various challenges.

It is in your best interest to have an experienced professional services firm with broad resources and a comprehensive understanding of your business and industry to serve as your business advisor – while you prepare for the IPO process and long after you join the public markets. A full-service accounting firm is often the ideal candidate, with a range of auditing, tax, transaction and business advisory service offerings.

Trusted business advisors will provide information to help you evaluate the advantages and disadvantages of going public and, if appropriate, explore alternative routes to monetization. They can provide guidance related to the filing of your Securities and Exchange Commission (SEC) registration document (e.g., Form S-1) to help streamline the SEC registration and related comment letter process, which is crucial to accessing the capital markets in the most efficient manner. If you have not done so already, you should select a firm with a strong reputation and demonstrable know-how in IPO tax and accounting issues, securities offerings and SEC reporting.



Considerations in forming the MLP and reporting its financial information in an SEC registration statement include, but are not limited to:

- ▶ Determining the legal structure
- ▶ Assessing market expectations/tax shield
- ▶ Identifying the predecessor and determining the appropriate historical carve-out financial statement presentation for the MLP
- ▶ Evaluating and drafting appropriate dividend policy disclosures given the MLP's focus on providing cash distributions to its investors Understanding the required presentation of pro forma financial statements in accordance with Article 11 of Regulation S-X
- ▶ Assessing the disclosure of historical and forward-looking "pro forma" cash distribution tables

Numerous complexities can arise in the financial statement and registration statement preparation, and a parallel path must be taken with tax planning to accelerate the speed to market.

Taking the first step of the journey

The MLP has a unique role in today's energy marketplace. It offers a wealth of benefits to both sponsor companies and individual investors, while providing a low-cost, alternative form of capital for expansion and growth.

For many energy companies, an MLP IPO can be an important step to unlocking current value and creating future value. But it must fit strategically and be planned and implemented properly. The "MLP journey" – from concept to execution – is a multistep process that involves:

- ▶ Strategic evaluation – is this right for our company?
- ▶ Preparation and planning
- ▶ Execution of the IPO
- ▶ Ongoing transactions and growth
- ▶ Compliance, reporting and governance

Along the way, numerous complexities can strip value from your offering and hamper your MLP's ability to prosper. Avoiding those pitfalls takes focus, resources and knowledge. Many companies turn to EY for impartial, experienced guidance and counsel throughout each step of the MLP journey.

Can we help you with your company's journey?

Learn more

To learn more about our experience advising global, national and local oil and gas companies, please contact one of the following Ernst & Young LLP Oil & Gas professionals.

Key contacts

Strategic Analysis and Tax Structuring

Greg Matlock +1 713 750 8133 greg.matlock@ey.com	Deborah Byers +1 713 750 8138 deborah.byers@ey.com
---	---

Financial Accounting Advisory Services

David Zaozirny +1 713 750 8148 david.zaozirny@ey.com	Karen Brooks +1 713 750 4888 karen.brooks1@ey.com
---	--

Valuation

Mitch Fane +1 713 750 4897 mitch.fane@ey.com	Michael Hoyt +1 713 750 8196 michael.hoyt@ey.com
---	---

Tax Compliance and Reporting

Tim Gowens +1 713 750 8458 timothy.gowens@ey.com	Ray Fossett +1 918 560 3610 ray.fossett@ey.com
---	---

Assurance

Elaine Pickle +1 713 750 8132 elaine.pickle@ey.com	Anita Holloway +1 918 560 3619 anita.holloway@ey.com
---	---

Divestiture Advisory Services

Regina Balderas
+1 713 750 1232
regina.balderas@ey.com

Operational Transactions Services

Alicia Lohman
+1 713 750 5103
alicia.lohman@ey.com

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

How EY's Global Oil & Gas Center can help your business

The oil and gas sector is constantly changing. Increasingly uncertain energy policies, geopolitical complexities, cost management and climate change all present significant challenges. EY's Global Oil & Gas Center supports a global practice of more than 10,000 oil and gas professionals with extensive experience in providing assurance, tax, transaction and advisory services across the upstream, midstream, downstream and oilfield service sub-sectors. The Center works to anticipate market trends, execute the mobility of our global resources and articulate points of view on relevant key sector issues. With our deep sector focus, we can help your organization drive down costs and compete more effectively.

© 2014 EYGM Limited.
All Rights Reserved.

1411-1354633

ED 0115

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com/oilandgas