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Are Master Limited Partnerships for you?

By JONATHAN FAHEY AP Energy Writer, 05/29/2013 01:41:20 PM MDT

NEW YORK—Investors searching for income-generating investments are finding opportunities in the oil and gas pipelines that crisscross the country.

Many of the pipelines, holding tanks and other equipment that help get fuel to consumers are owned by firms called Master Limited Partnerships. They typically generate high income and tax benefits for investors because the firms are required by law to “pass through” much of their income and deductions to shareholders. In return, the partnerships pay no corporate tax.

These partnerships are very similar to more popular real estate investment trusts, but they own energy infrastructure instead of real estate. They trade on exchanges like stocks or exchange-traded funds.

Many financial advisors recommend them because of their high payouts to investors and because many let investors benefit from the booming energy industry without having to worry about oil or gas prices fluctuating. Most pipeline owners charge a set price for delivery that doesn’t change with the price of fuel.

“It’s a great way to invest in this massive resource in the U.S. without the commodity risk,” says Ethan Bellamy, an MLP analyst at Robert W. Baird & Co.

An index of the 50 most prominent energy MLPs yields 5.7 percent, according to Alerian, a market research and analysis company that focuses on MLPs. The S&P 500 yields 2 percent.

MLPs GROW UP

MLPs can hold wells; small pipelines that gather oil and gas from wells and funnel it to processing plants; big interstate pipelines; refineries and fuel distribution companies. The most popular, and safest, are so-called “mid-stream” MLPs that focus on delivering energy from place to place, according to financial advisors. By avoiding oil and gas drilling and selling refined products, these mid-stream MLPs are more insulated from volatile commodity prices.

Congress established the rules for MLPs in 1986 and 1987. Energy companies were reluctant to establish them until Richard Kinder and William Morgan figured out how to make them more attractive to investors starting in 1997 when they formed Kinder Morgan Partners.

Until Kinder Morgan, MLPs were generally collections of assets that were generating some cash, but were approaching the end of their lives or had no hope for growth.

Kinder Morgan showed that MLPs could also grow. Kinder realized it would be cheaper to raise money in a partnership structure than through a corporation because partnerships don’t pay taxes at a corporate level and because they pass their profits through to investors. With that cost advantage, Kinder was able to buy more pipelines, improve old ones, build new ones—and grow distributions to investors.

“Slowly people started to realize that pipelines weren’t boring old assets,” Bellamy says.

Investors may soon also get to choose “green” MLPs. There is a bi-partisan movement in congress supported by both the renewable industry and the oil and gas industry to allow companies to create renewable energy MLPs that include assets such as solar farms, wind farms and collections of rooftop solar systems.

ARE MLPs TOO HOT?

MLPs have gotten very popular in recent years. Interest rates fell to extraordinarily low levels, boosting demand for investments that generate income. And soaring U.S. oil and gas production has filled pipelines and created the need for more of them.

New partnerships have sprung up and energy companies are spinning off parts of their companies into MLPs. The refining company Marathon Petroleum Corp. created an MLP with 1,800 miles of pipeline called MPLX in October. The partnership's shares have risen 52 percent since then, to $38.63.

Alerian's index of MLPs has outperformed the S&P 500 index for 12 of the last 13 years.

That strong performance highlights one of the risks of buying MLPs now. Investors are so enthusiastic for them that they have bid prices up relatively high. Financial advisors say it's a risk, but it's the same risk facing just about every income-generating investment, including bonds, dividend stocks and REITs. If interest rates rise, investors may start to abandon these investments and prices may fall.

But the growth of the U.S. energy industry and the need to move that energy around gives advisors confidence that these investments can still pay off.

"There's still a lot of value out there," says Nathan Kubik, a principal at Carnick & Kubik, a financial advisory firm in Colorado Springs, Co.

Kubik says investors should pick larger MLPs that cater to a diverse group of oil and gas companies so their payouts are not dependent on the strength of one or two oil and gas drillers. Kubik recommends Kinder Morgan Partners, Williams Partners and ONEOK Partners. Baird's Bellamy says Enterprise Products Partners is also a strong, stable MLP.

TAX ISSUES

MLPs offer big tax advantages—and they can create some big tax headaches, too. Because MLPs pay no corporate taxes, it leaves them more cash to distribute to investors, but it also puts the responsibility for paying tax onto investors.

MLP cash distributions come in two categories, each of which is taxed differently.

The bigger portion of the cash generally represents a deduction for the depreciation of the assets in the partnership. Investors don't have to pay taxes on that part of the cash distribution until they sell their shares in the MLP—creating a potentially useful tax deferral for the investor—because it is considered a return of capital instead of income.

Investors do have to pay tax right away on the smaller, income, portion of the distribution, and that's where the headache comes in. The rate is usually lower than what a corporation would have paid. That's good, but investors have to pay income taxes in every state the partnership operates. For a pipeline partnership, that can be a dozen or more, enough to create a mountain of paperwork.

"For some individual investors, it becomes a tax nightmare," warns Kubik.

Investors can get around the tax headache—and sometimes lose some of the advantages—by owning a mutual fund or an exchange traded fund that invests in MLPs or securities that track the performance of MLPs.

The Alerian MLP ETF, for example, pays corporate taxes. That reduces the tax benefit to investors but it also eliminates the need to pay income taxes in several states.

The Eagle MLP Strategy Fund I, recommended by Kubik, has found a way to provide the best of both worlds, although for a higher management fee. It avoids paying corporate tax by restricting its direct ownership of MLPs to less than 25 percent of the portfolio. It then uses other financial instruments to mirror the performance of an MLP index. That way the tax benefit remains intact and investors don't have to face the extra paperwork.

"We believe MLPs belong in most portfolios," Kubik says. "It's been a good place to be."

For more information on MLPs, visit a useful primer compiled by The National Association of Publicly Traded Partnerships here: http://www.naptp.org/PTP101/BasicFacts.html.

http://www.denverpost.com/businessbreakingnews/ci_23346294/are-master-limited-partnerships-you