

Stability just a few feet below

How to access genuinely stable income in today's fraught investing environment? **Jeffrey E. Fulmer** of Tortoise Capital Advisors explains why energy master limited partnerships, with their core oil and gas pipeline assets, demand consideration

GIVEN THE DYSFUNCTIONAL relationship investors have had with their portfolios over the past couple of years, it's no wonder that ever-elusive stability is sought by nearly all. This hunger is increasingly taking the form of a quest for inflation-beating income. Even soothsayers of high-risk/reward are quietly attempting to balance their portfolios with a measure of income, but the hunt is akin to looking for black truffles with the assistance of a trained-farm animal.

Over £5.2 billion¹ (€6.1 billion; \$8.1 billion) in 2010 investor income has been wiped out by the frailties of a complex offshore drilling operation alone. BP is keeping its head above the Gulf waters, but its strategy for now includes eliminating dividends. Several billion more has been stripped from investors' pockets through the paring back of dividends in the financial sector generally.

Recent years have also seen institutional investors battered and bruised by hefty expenditure on due diligence and legal fees as investors vie for US infrastructure – an exercise fraught with public sensitivity and, ultimately, inaccessibility. Americans are loath to turn over public assets to profit-seeking companies, especially foreign entities. Infrastructure projects that have made it through the finish line are almost entirely in the realm of toll roads and parking lots.

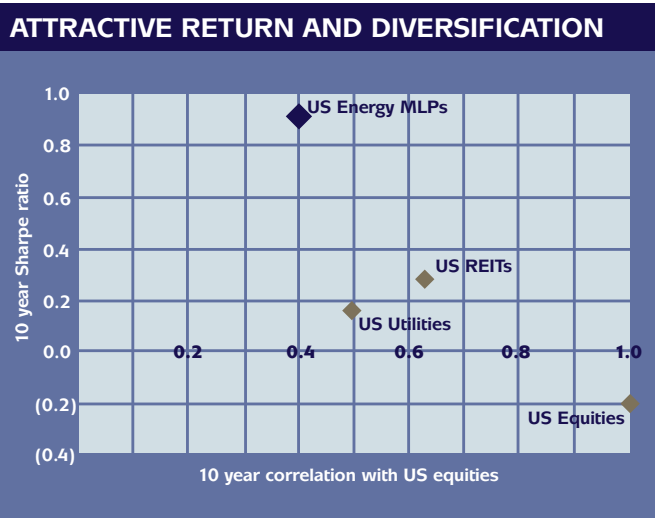
Perhaps if investors could look beyond the underbrush and dig a little deeper, say four or five feet, they would uncover what they are truly seeking: inherently stable and attractive income. Income derived from natural gas and oil pipelines.

One method of getting pipelines in your portfolio is to competitively bid on assets as they are offered for sale. But, as one engaged investor says: "There are usually five to ten bidders on any one asset, which makes it tough to come out on top without over-paying." In addition to necessary expertise, bidders need to devote substantial time and be in possession of a weighty pocket-book to out-bid their competition. These relatively scarce opportunities usually represent limited points of revenue compared with buying into geographically dispersed networks with sources of revenue all over the map. Furthermore, it can be argued that long-lived gas and oil pipelines may be unsuitable for fixed-life funds, and more certainly a bad fit for aggressive gearing.

US gas and oil pipelines are the core assets of energy master limited partnerships (MLPs). MLPs are tax-advantaged, publicly traded companies that own over 50 percent of the interstate and intrastate networks that fuel the American economy. There are 305,000 miles of natural gas and 165,000 miles of crude oil and refined product interstate and intrastate pipelines² serving the voracious energy appetite of 308 million citizens. That equates to eight feet of pipeline per American. With population projected to grow by 90 million within the next 40 years, a required build-out of about 3,400 miles of pipeline per year is implied. MLPs are likely to be the chief beneficiaries of these build-outs, whether by constructing assets directly or having assets dropped down into their tax-efficient structures by their corporate energy parents.

Pipeline MLPs have limited direct commodity exposure, receiving fee-based revenue tied to long-term contracts. Unlike much of the world where ownership of major pipelines and the commodities flowing through them go hand-in-hand, US pipeline owners transport and store the commodities without taking title to them. They collect their tariffs regardless of whether oil is selling for \$40 or \$140 per barrel. In the case of gas contracts, they often collect full fees from their customers even when only a portion of the contracted capacity is being used.

Over the last 10 years, energy MLP total returns have averaged 18 percent³. By contrast, REITs and utilities (also sought by income-oriented investors) produced 11 percent and 5 percent returns⁴, respectively. Given the excess return of MLPs, surely there must be excess risk? To the contrary, MLPs displayed a 10-year Sharpe ratio of 3x to 5x that of REITs and utilities. Moreover, MLPs provided less correlation to equities than the better known asset classes. →



→ A substantial portion of MLP total return is yield, which currently is averaging 6 to 7 percent. This income is far from fixed, as MLP distributions have achieved average annualised growth of 5.7 percent over the last 12 years. Interstate pipeline regulation administered by the Federal Energy Regulatory Commission (FERC) sets tariff limits charged to customers. Petroleum pipelines have their tariffs adjusted to account for inflation annually. The FERC allows adjustment of rates by a Producer Price Index escalator. Gas pipeline tariffs can also be bolstered to account for inflation through a FERC rate filing process that recognises an MLP operator's actual cost and permits a reasonable return on their investment. Besides inflation, distribution growth is significantly driven by accretive projects; both build-outs and acquisitions.

PLENTIFUL RESERVES

Market capitalisation for the 72 energy MLPs is approximately \$180 billion, and some estimates project that these companies will invest over \$50 billion in the next three years making acquisitions and connecting new natural gas and oil supplies with demographic demand. As recently as 2003, worries were rampant about the US running low on natural gas reserves. In June of that year, then Federal Reserve chairman, Alan Greenspan, warned Congress about short supplies and rising costs of natural gas leading to the erosion of the economy³.

What a difference a few years make! The US is now awash in natural gas stemming from enhanced drilling and completion technologies applied to unconventional accumulations, including shale reservoirs. America now has an estimated 100 years of natural gas reserves⁶. These hydrocarbons cannot be moved around onshore in meaningful quantities without the use of pipelines. By owning and operating the monopolistic assets and critical right-of-ways, MLPs should be well positioned for many years to come.

For investors, accessing MLPs is another story. MLPs trigger what are arguably the most dreaded of all Internal Revenue Service (IRS) tax forms, the infamous Schedule K-1. MLP investors are limited partners and, as such, have to report their pro-rata share of income, gains, losses, expenses and earnings. Since most MLPs derive revenue from multiple states, investors may also be required to file and pay taxes in a myriad of states. Many investors tolerate these administrative headaches to avail themselves of attractive returns and tax advantages (80 to 100 percent of the income received from MLPs is typically tax deferred). The hefty depreciation MLPs are able to expense commonly results in their distributions exceeding taxable income. Due to their tax treatment, the IRS limits their inclusion in tax-deferred retirement accounts.

DURABLE DISTRIBUTION GROWTH



Non-US MLP investors are viewed by the IRS as having Effectively Connected Income (ECI) which subjects their associated income to a 35 percent withholding. Depending on their level of investment, it is also possible that an investor could be subject to Foreign Investment Real Property Tax (FIRPTA). Even then, several large non-US institutional investors allocate sizable investments into the sector.

Recognising the appeal of steady and growing MLP income, Tortoise Capital Advisors committed to developing an investor solution, and in early 2004 went public with the first MLP closed-end fund. The fund was structured as a corporation to selectively invest in energy MLPs, process Schedule K-1s and provide investors with a simple IRS Form 1099. The same tax deferral benefits are retained and concerns about inclusion in retirement accounts are eliminated. Tortoise has since gone public with five additional NYSE-listed funds and has also structured and developed tax-efficient MLP prospective products well suited for non-US investors.

“MLP” may not yet be a household acronym outside the US, but given their solid fundamentals, attractive current income and growth, this relatively unknown sector is expected to rise in global cognizance. Investors just need to look below the surface a few feet. ■

(1) Reuters

(2) Energy Information Administration and American Petroleum Institute

(3) Tortoise MLP Index, TMLPT

(4) Dow Jones Average Utility Index and FTSE Equity NAREIT Index

(5) The *New York Times*, 11 June 2003

(6) NaturalGas.org, 1 September 2010

Jeffrey E. Fulmer is a senior advisor at Tortoise Capital Advisors, a Leawood, Kansas-based investment manager serving individual and institutional investors and specialising in listed energy infrastructure