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Energy Resources UPDATE

MLPs to Fund Shale Exploration and Development: Know Your Risks

Master limited partnerships (MLPs) are an increasingly attractive structure for funding the significant investments required for the exploration and development of shale plays across the U.S. There are approximately 100 MLPs on the market, the majority in industries related to energy and natural resources, according to the National Association of Publicly Traded Partnerships. Reports indicate that another 15 prospective MLPs have submitted S-1 forms to the U.S. Securities and Exchange Commission in 2012.

Proponents of these investment vehicles tout their tax benefits, predictable returns and stable cash flow. Record low interest rates and poor equity markets further enhanced their appeal in recent years. However, their complexity has increased in tandem with their popularity. Not all MLPs are created equal – there are varying levels of volatility to consider. It's important to understand the advantages and risks these vehicles offer.

A changing mix of MLPs

What's past is not necessarily present. Traditionally, most MLPs were investment structures used by midstream companies. The nature of the pipeline business meant that the pipeline was always relatively full; meaning, yields were also fairly stable and predictable. Investors had low exposure to fluctuating commodity prices.

Today, there are a growing range of MLPs coming to market; many include exploration and production (E&P) companies seeking higher levels of capital to finance exploration opportunities. Both the risks and benefits in this sector are much more volatile. The potential upside is clearly enormous – The Energy Information Administration (EIA) estimates there are around 37 tcm of recoverable reserves in the U.S., two-thirds of which is shale gas and the rest tight gas and coal-bed methane. However, the costs of drilling a single gas well can be upwards of $10 million. Add to that the fact that the odds of striking oil or natural gas are only about one in three, and it comes as no surprise that more E&P companies are entering into MLP structures to help make drilling economically feasible and mitigate some of the risks for owners. Upstream MLPs are also more exposed than midstream ones to commodity prices, which adds more fluctuation to cash flow and distributions.

The Internal Revenue Service (IRS) has been slowly expanding the definition of publicly traded partnerships, as defined under section 7704 of the IRS Revenue Code. It issued a record number of private letter rulings in 2011 regarding "qualifying income" to offer taxpayers better guidance. One of those rulings expanded the definition of the list of fluid handling activities that generate qualifying income to include the "supply and transportation of fracturing fluid and removal, treatment and disposal of fracturing flowback from a well and acid mine discharge." Expect to see more transportation MLPs coming to the fore, as the industry's need for distribution and transportation to handle the uptick in domestic production continues to rise.

Most recently, U.S. Senators Chris Coons (D-Del.) and Jerry Moran (R-Kan.) introduced new legislation, known as the MLP Parity Act, that would expand MLP eligibility to renewable energy projects and alternative transportation fuels such as cellulosic, biodiesel and algae-based fuels.

There is also the introduction of the variable pay MLPs, relatively new structures that were used most recently by oil refiner Northern Tier Energy in its initial public offering (IPO). It brings in another new element of volatility with the promise of a potentially higher yield. Low pricing following its market debut has raised questions about this type of structure. ML Ps to Fund Shale Exploration and Development With the MLP market offering more dynamic options, investors need a clear understanding of the cash flow of the type of business in which they are investing. The relatively

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straightforward pipeline MLP models don't necessarily apply anymore. Read the fine lines of the prospectus and consider the management team's experience in running this type of asset.

Tax advantages and risks

A primary draw of MLPs is tax benefits – they avoid both federal and state corporate income tax because they pay out most of the cash flow to shareholders. The MLP's assets are a critical part of the balance and require a constant "feeding of the beast" to maintain a desirable tax shield for investors. As its assets depreciate, the MLP needs to absorb new assets in order to benefit from continued tax deductions. This may be an easier balance to maintain for midstream companies that have hard assets and a strong market demand for building out infrastructure, but grows more volatile with other types of companies, like E&P ones.

The major X factor that could drastically alter the MLP landscape is a fundamental shift in the tax code. Intangible drilling costs (IDC), a tax benefit to attract capital to the high risks of natural gas and oil production, has long been a target of President Obama's administration. Geological and geophysical (G&G) amortization, costs that are associated with developing new resources, currently allow companies that are not considered major integrated oil companies to amortize these expenses over 24 months. However, the Obama administration has pushed to eliminate this completely or expand the scope of companies required to use a seven-year amortization period. Eliminating these and other tax provisions for oil and gas companies would challenge some of the current tax deductions enjoyed by MLPs.

A rosy outlook

MLPs have outperformed the S&P 500 for the last decade and a half, reaching cumulative gains of 650 percent versus 130 percent for the broader market, with the exception of a sharp sell-off in 2008, according to J.P. Morgan. Most experts continue to have a positive outlook on MLPs and their potential returns for investors.

The midstream market, in particular, will continue to be a hotbed for MLPs. A 2011 report from the Interstate Natural Gas Association of America said $200 billion will be spent on energy infrastructure through 2035 and those investments are expected to contribute an additional $218 billion of added value to the economy. MLPs, in large part, will support this upsurge in infrastructure development.

The energy future of the U.S. relies heavily on exploiting shale formations for oil and natural gas. It's in the country's best financial interest to identify and support ways that make it more economically feasible for companies to take on the high risks required for exploring and drilling.

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