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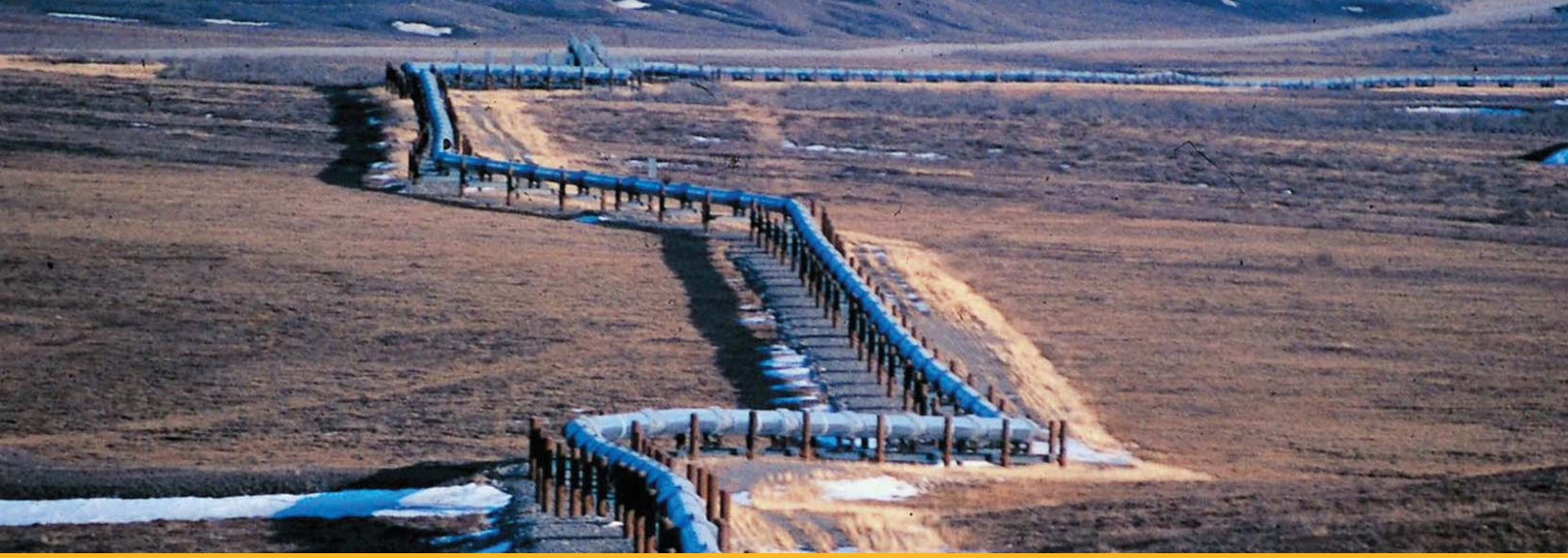
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Mastering the MLP

Considerations When Forming Master Limited Partnerships





Master Limited Partnerships

Mastering the MLP

For energy companies seeking new avenues toward growth, the master limited partnership (MLP) has become a powerful tool in today's business landscape. Promising tax advantages, improved cash flow and a lower cost of capital, the MLP structure has experienced a meteoric rise in popularity, with the last decade witnessing the birth of dozens of new entities comprising more than \$130 billion in market capitalization. What's more, the sector continues to grow, as upstream players are discovering how to assert themselves in a space that has, until now, been almost exclusively occupied by midstream pipeline operators.

Amid the frenzy of recent MLP activity, more energy companies are undoubtedly plotting to get in on the action. But despite the steady stream of new MLPs entering the market, forming and launching an MLP is by no means a process that can be approached without significant planning.

Key Accounting Considerations at Every Stage

From an accounting and reporting perspective, each MLP involves complexities that, without careful navigation, could stifle the company's progress and impair its marketability. Moreover, it seems that no two MLPs are alike. With each new amalgamation of assets comes a diverse history and unique issues, none of which

can be appropriately addressed by a one-size-fits-all set of financial solutions. As in any sensitive and intricate business dealing, unique challenges must be met with proactive solutions, and careful research and preparation is essential at every step. By giving proper consideration to these issues early in the planning stages, companies can accelerate the MLP formation process and tip the odds of success in their favor.

An Introduction to MLPs

An MLP is a limited partnership organization whose limited partnership units are available to investors and traded on public exchanges, just like corporate stocks. MLPs usually consist of a general partner (GP), which typically holds a small percentage (commonly 2 percent) of the outstanding units and manages the operations of the partnership, and limited partners (LPs), who provide capital and hold most of the ownership, but have limited influence over the operations.

Energy companies that form MLPs typically do so to take advantage of the special tax treatment of the partnership structure (although MLPs may also provide an attractive exit strategy for owners of private equity assets). MLPs do not pay federal corporate income taxes. Instead, each partner includes its distributive share of net income in computing its federal income tax. Subsequent distributions of cash from the MLP to the partners are not

again subject to tax. This process enables MLPs to avoid the double taxation generally applied to traditional corporations and their shareholders. These benefits create increased free cash flow and a lower cost of capital for the MLP.

To qualify for the tax benefits, 90 percent of an MLP's income must be derived from activities in natural resources, real estate, or commodities, thus the explosive growth of the structure in the energy industry.

First introduced in 1981, the MLP structure gained favor among midstream and E&P oil and gas companies, as well as various other industries. But due to adverse economic conditions, most did not last past the late 1980s. The surviving MLPs were able to thrive due in large part to three factors: their assets (pipelines, gathering systems, processing plants, and storage facilities) cost relatively little to maintain; they offered minimal exposure to volatile commodity prices; and they had relatively stable revenue flows. The same criteria, along with new legislation and mass divestiture of midstream assets after the collapse of Enron, led to the MLP resurgence that took hold in the early 2000s.

As the earliest pipeline MLPs proved, assets with slow growth and high cash flow best lend themselves to the MLP's goal of maintaining and/or increasing cash distributions to unit holders.

Master Limited Partnerships (cont'd)

Following those guidelines, other subsets of the oil and gas industry can also work well in the MLP structure, such as natural gas processing plants, some coal production facilities, and fully developed and slowly declining crude oil or natural gas-producing assets. The low cost of capital of the MLP, once formed, then gives it a competitive advantage in the acquisition market, which is essential to fueling the MLP's growth strategy.

An aging U.S. population seeking high-yield investments, along with increasing demand from institutional investors, is driving continued growth in MLPs. And the strong commodities market, low interest rates, and favorable regulatory environment also suggest a bright future.

Accounting Along the MLP Journey

The MLP is a business structure like no other, pairing the tax benefits of a partnership with the fundraising ability and liquidity of a public company. The opportunity is promising for energy companies, to be sure, but MLPs also present their own set of accounting challenges that may veer from the issues faced by traditional corporations.

Perhaps the most orderly way to highlight the accounting challenges of an MLP is to think in terms of two stages: first, the historical period and formation/IPO phase; and second, the ongoing transactions and management after the IPO.

In each stage, accounting issues unique to the individual MLP inevitably surface and demand analysis and resolution by experienced professionals. A few of

the more common issues are discussed below. Companies aspiring to enter the MLP market have the option to address them proactively or risk setbacks that can undermine the go-to-market strategy – and its results.

Get Organized, Prepare for Changes

As a plan to form an MLP begins to materialize, the importance of identifying and resolving the accounting and reporting issues cannot be overstated. Launching an MLP can involve a considerable amount of technical research and an extensive process of collecting and preparing historical, as well as forecasted, financial information. The earlier consideration is given to these requirements, the more efficient this process will be.

A logical place to begin is to determine whether the company will need to prepare carve-out financial statements. Carve-outs generally relate to special purpose financial statements of a division, which usually is not a separate legal entity, and therefore must be carved-out of a larger entity. Other times financial statements of an existing legal entity may be available. However, issues may still arise depending on whether the entire legal entity will be contributed to the MLP or whether the entity will be combined with other entities or assets in the MLP.

Those overseeing the MLP formation process must also consider how a number of other accounting matters will be handled in the MLP's financial statements, such as how to account for shared services, allocation of expenses, and push-down of debt and related interest expense.

Common IPO/MLP Accounting Issues – by Industry Sector

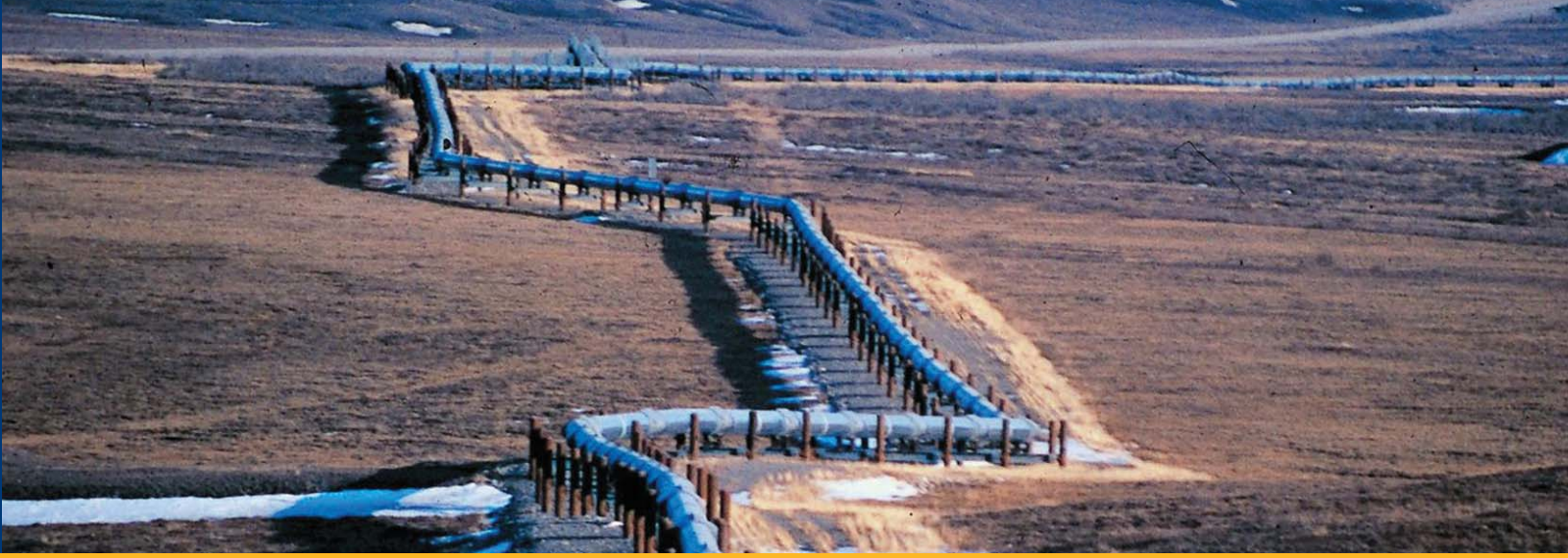
Midstream/Pipeline MLPs:

- Environmental issues/reserves
- Capitalization versus expense treatment for pipeline integrity costs
- Accounting for linefill/linepack
- Asset retirement obligations
- Regulatory issues/disputes

Upstream/E&P MLPs:

- Reserves estimates and disclosures
- Derivatives and hedge accounting
- Successful efforts vs. full cost method of accounting
- Ceiling test/impairment
- Asset retirement obligations
- Environmental issues/reserves

Companies should consider seeking “pre-clearance” from the SEC staff on the reporting issues surrounding the financial statements to be included in the MLP registration statement. Obtaining pre-clearance helps to address and resolve issues up-front, potentially avoiding the costly and time-consuming process of redrafting financial statements and pro formas following the SEC's review, and delaying the offering itself.



Simultaneous with preparing the historical financial statements and registration statement, general partners should be putting plans in place for the changes that will occur at or near the time of the IPO. For example, corporations earmarked for inclusion in the MLP will be required to change to non-taxable entities (limited liability companies or partnerships). Moreover, the original makeup of the MLP often changes, as some assets are transferred out at the time of the IPO while others are added.

By taking the proactive steps to evaluate and plan for the accounting issues in the formation and IPO stage of the MLP process, the public offering will be more efficient and expedient.

Settle in, Embrace Frequent Acquisitions

The MLP going public and taking its place on the exchange marks the beginning of what will be an ongoing management process replete with all the corporate governance, reporting, regulations, and other responsibilities of the public markets. As such, general partners should plan for a robust accounting operation throughout the life of the MLP.

Following the IPO, the MLP will have additional accounting issues related to the presentation of the multiple classes of equity, allocation of earnings, earnings per unit calculations, and cash distributions.

Furthermore, the MLP will need to grow. Keeping in mind that an MLP's primary goal is to maintain and/or increase cash distributions to its unit holders, building upon the MLP's existing asset portfolio is, in most cases, a continual objective. Whether through internal growth, acquisitions, or additional contributions of assets from the parent company, every transaction requires the expertise not only to bring the deal to fruition, but also to successfully assimilate and account for the transaction.

Put simply, reporting will become more complex and acquisition and integration must become core competencies for the MLP.

Parent Company Considerations

In addition to the accounting challenges at the MLP level, the parent company to the general partner will also face a separate set of issues related to the IPO and ongoing accounting for their investment in the MLP. Thus, companies planning to launch an MLP will want to analyze and forecast the accounting ramifications of the MLP on the parent company's financial statements. Common issues a parent company must address include, for example, accounting for minority interests and potential gains on the sale of MLP units.

Paving the Way

In the current economic environment, both corporations and investors stand to benefit from the growing utilization of MLPs. Midstream participants continue to

outperform the markets, while E&P players are entering the market at a fast pace. As more energy companies evaluate and plan MLPs, they must keep in mind that the significant accounting decisions related to the MLP depend heavily on the particular facts and circumstances involved. As one would expect, a firm knowledge of accounting guidance and SEC requirements is necessary for MLPs and their parent companies to accelerate the time to market and reduce obstacles along the way.

Master Limited Partnership Accounting and Reporting Guide – A Primer

Following this paper is our publication *Master Limited Partnership Accounting and Reporting Guide – A Primer*, which covers a variety of common accounting and reporting considerations associated with the formation of and ongoing operations of an MLP. We have developed this Primer to assist companies in understanding many of the technical financial accounting and reporting issues that must be addressed when forming an MLP. This Primer can be used as a resource for understanding the issues associated with an MLP and the related authoritative financial accounting and reporting guidance. However, it is not intended to be, and it is not, an all-inclusive discussion of every issue or every aspect of an issue that may be encountered relating to an MLP.