

Value Creation in the Energy Value Chain: Spinoffs, MLPs and Shareholder Returns

Betty J. Simkins, Ph.D.

Williams Companies Chair and Professor of Finance
Oklahoma State University

Email: betty.simkins@okstate.edu

Phone: 405-744-8625

Webpage: <http://spears.okstate.edu/~simkins>



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Image from Deloitte



Outline

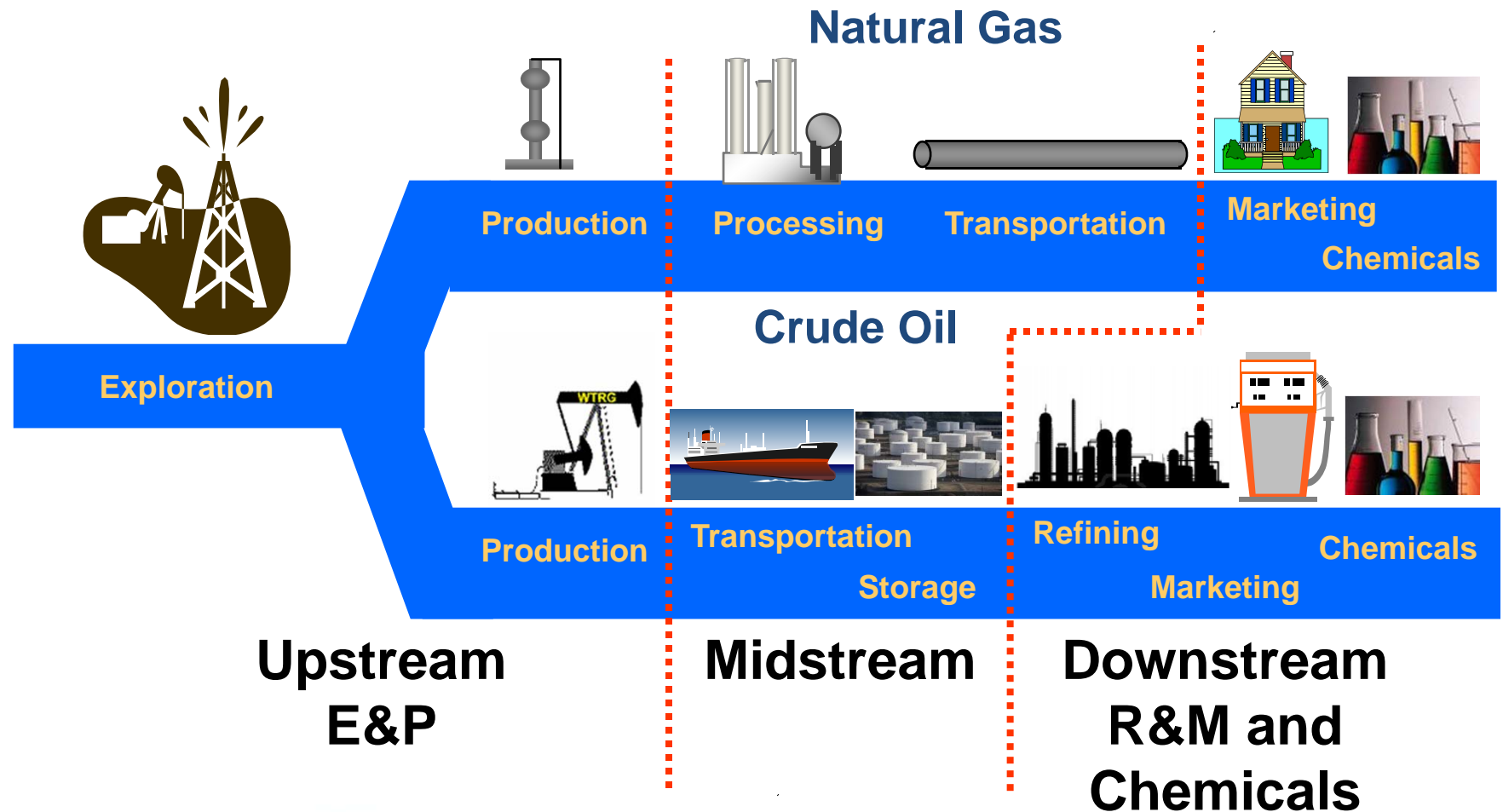
- A little background and history
- Value creation in the energy value chain and strategies to unlock value
- Midstream growth and need for capital
- MLPs: What, Why, and How
- Future trends



A Little Background and History



What is the Energy Value Chain?



A Little Background and History

“Drill for oil? You mean drill into the ground to try and find oil? You’re crazy.”

- Drillers who Colonel Edwin Drake tried to enlist for his project in 1859.

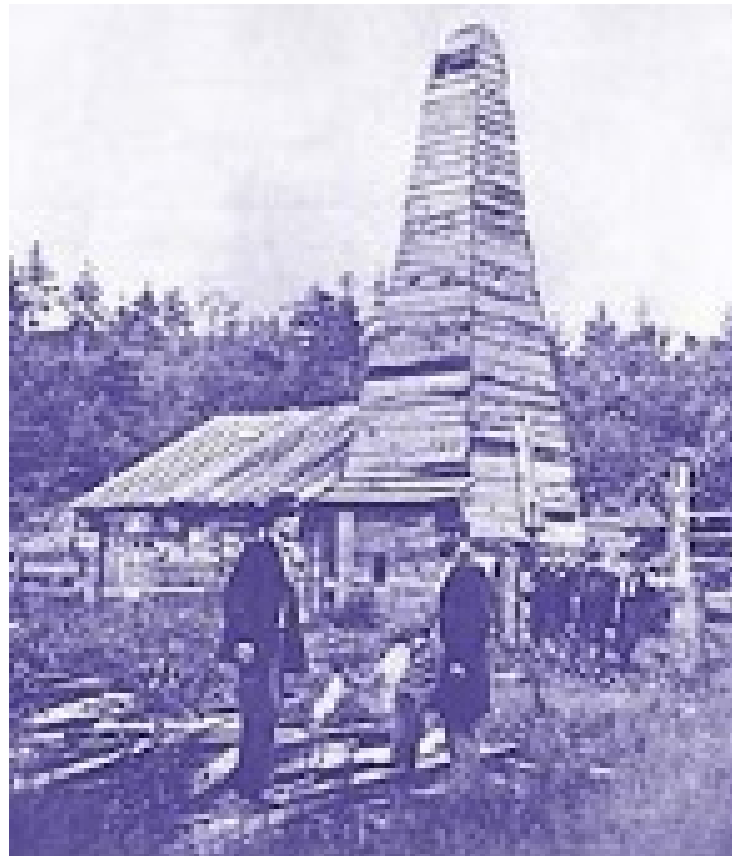


Photo courtesy of Drake Well Museum



What is this?
Spindletop (Texas)

When is this?

1901

Why is it important?

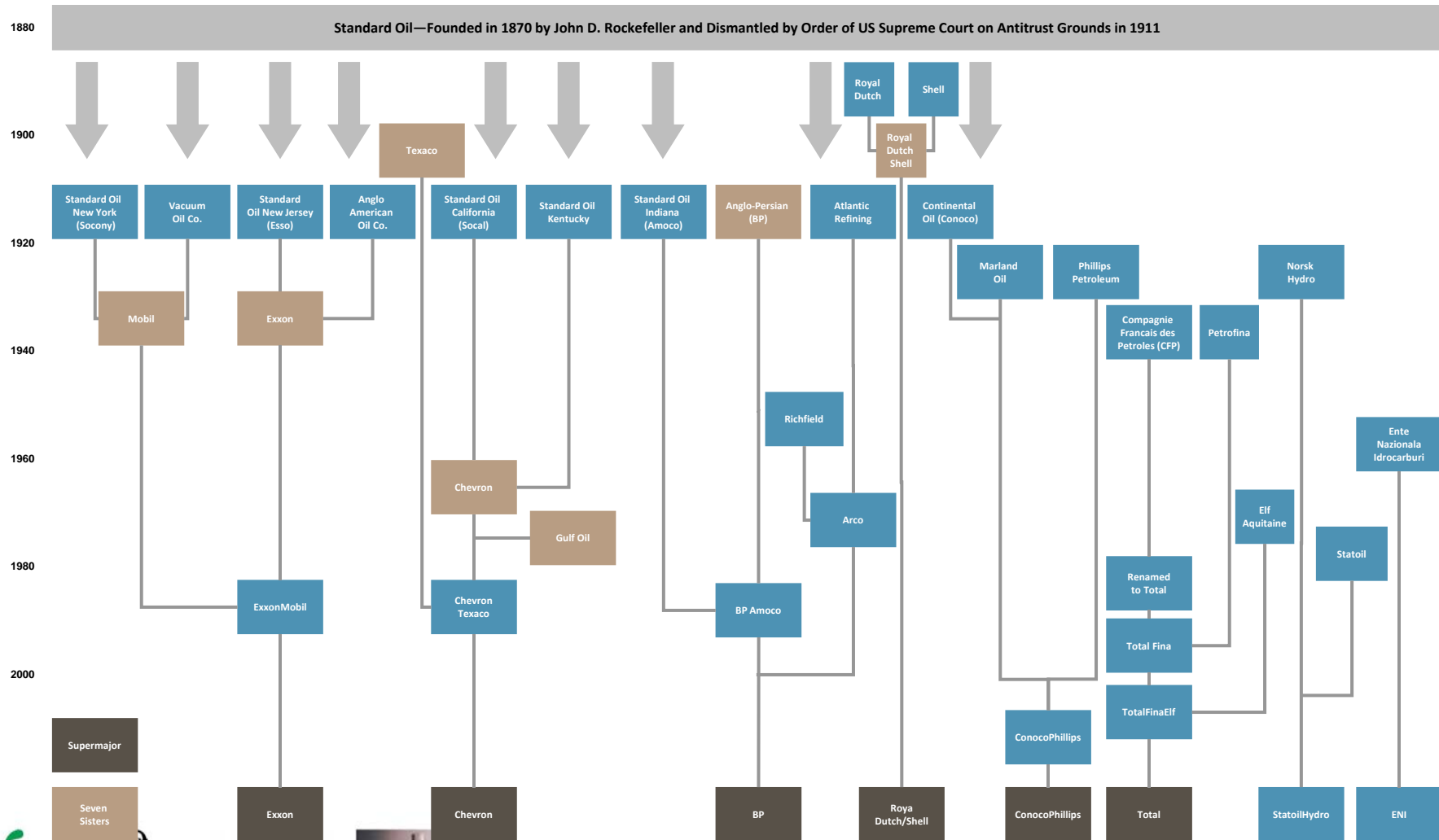
The first true gusher ushers in the beginning of the modern petroleum industry. It is known as the Lucas Well

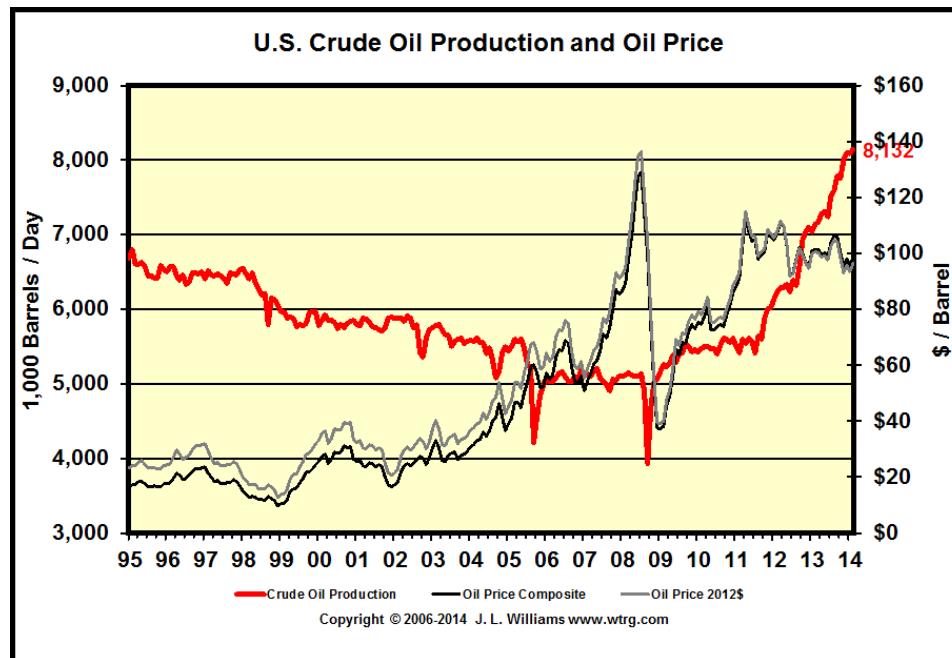


The Lucas well is estimated to have flowed about two million gallons (8,000 cubic metres) of oil per day.



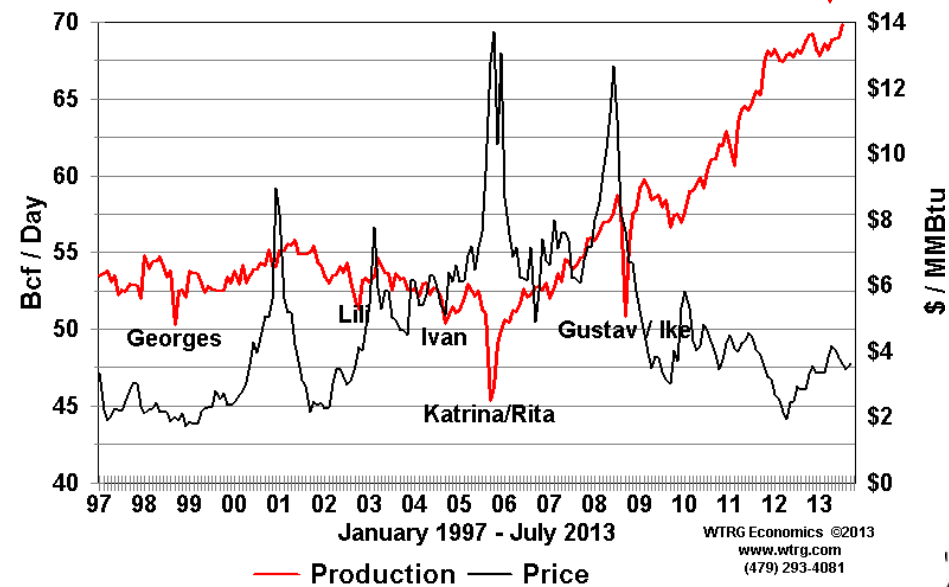
The Major IOCs Family Tree





***We are not
running out
of fossil
fuels.***

**Marketed Gas Production
Lower 48**



ARS
F BUSINESS

Value Creation in the Energy Value Chain and Strategies to Unlock Value



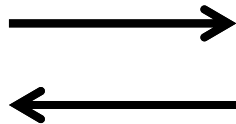
Strategy and Competitive Benchmarking

Type of Comparison

1. Comparison between companies



Sales Growth



Sales Growth

2. Comparison over time



2013

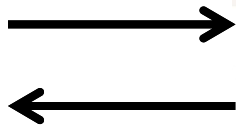


2012

3. Comparisons to Industry



Company Risk



Industry Risk

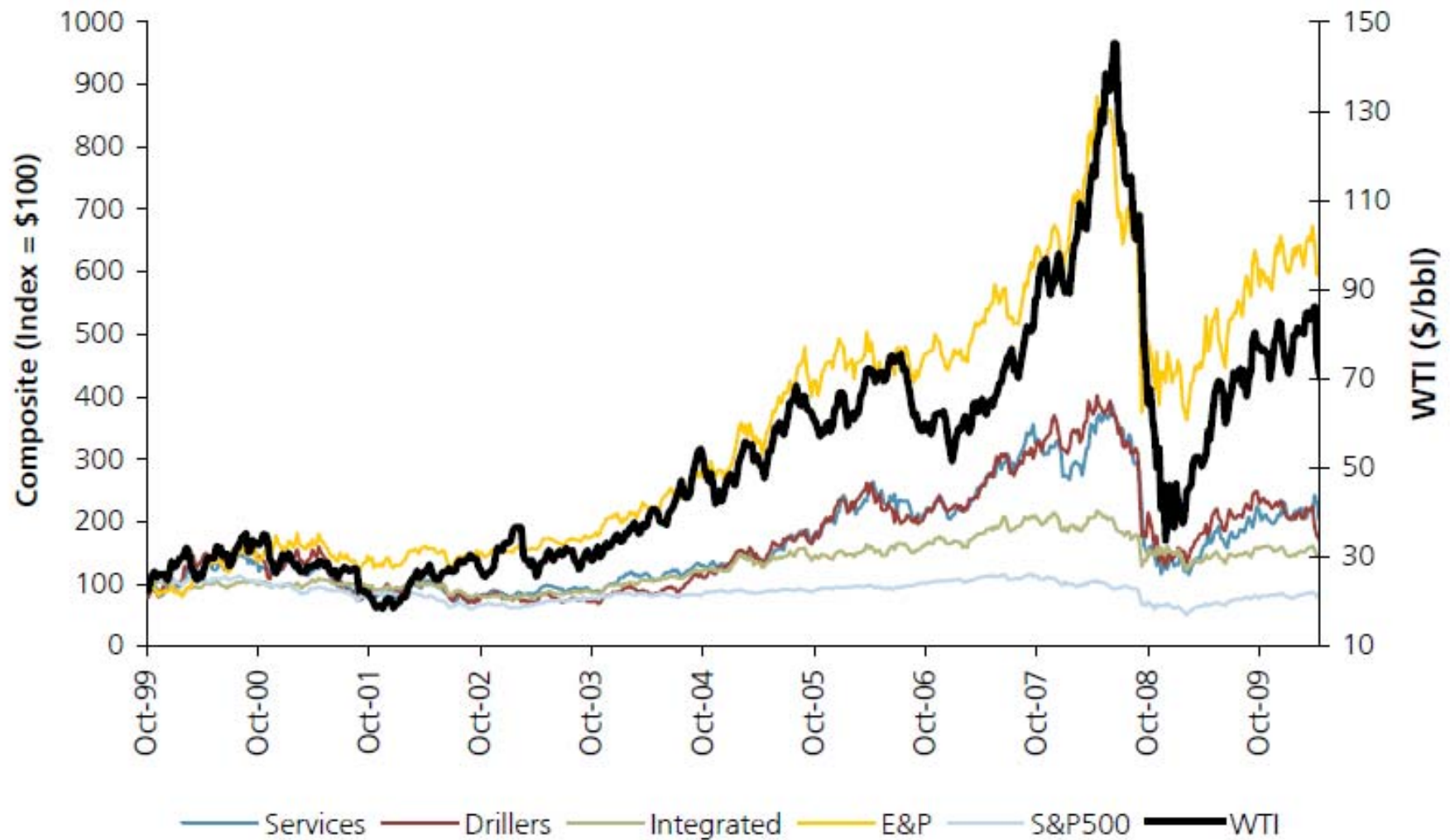
Example

- Compare performance for **OSU** with performance for **OU**.
- Compare **OSU** this year with last year.
- Compare **OSU's** performance with the average performance for the entire Big 12 Conference.



Stock Price Performance vs. Stock Price

Ten-year indexed sector performance



Rules for Oil Price Forecasting

- **Never mention a price & a date in the same talk**
- **If you can't forecast well forecast often**
- **If you are ever lucky enough to get it right, don't let anyone forget it**

Jim Williams, WTRG



POP QUIZ

Since 2006, what has been the fastest growing sector of the oil and gas industry?

- A. Upstream
- B. Midstream
- C. Downstream
- D. Oilfield services



Strategies to Unlock Value

- Integrated operating model for oil companies (IOC) has been the predominant and most successful operating model of the 20th century.
 - Ultimate integrated oil company: Standard Oil (created by John D. Rockefeller) as a way to protect against volatility in business.
 - By owning the entire supply chain, oil prices were less transparent, thus providing major tax benefits to Rockefeller.
 - Logic of a natural hedge. Integration allows a company to optimize value chain.
 - Midstream and downstream could be seen as source of long-term cash flow and financial stability to balance risky upstream activities. Integration balanced segments – reducing risk and volatility.
- Recent trends are seeing this model being challenged.
- New models emerging
 - Players focusing on specific industry segments.



Why are IOCs Vertically Integrated?

- Very few industries have traditionally had this degree of vertical integration.
- Some characteristics of vertical relationships that support this:
 - Small number of firms
 - Market transactions subject to taxes
 - High uncertainty about costs, technology, demand
 - Similar scale of operations in the stages
 - Similar strategies between stages
 - Limited need for entrepreneurial behavior
 - Predictable market demand
 - Controllable risk to other elements of value chain



Why are Many Vertically Integrated?- NOW

- Some characteristics of vertical relationships that support this:
 - ~~Small number of firms~~
 - Market transactions subject to taxes
 - High uncertainty about costs, technology, demand
 - ~~Similar scale of operations in the stages~~
 - ~~Similar strategies between stages~~
 - ~~Limited need for entrepreneurial behavior~~
 - ~~Predictable market demand~~
 - Controllable risk to other elements of value chain

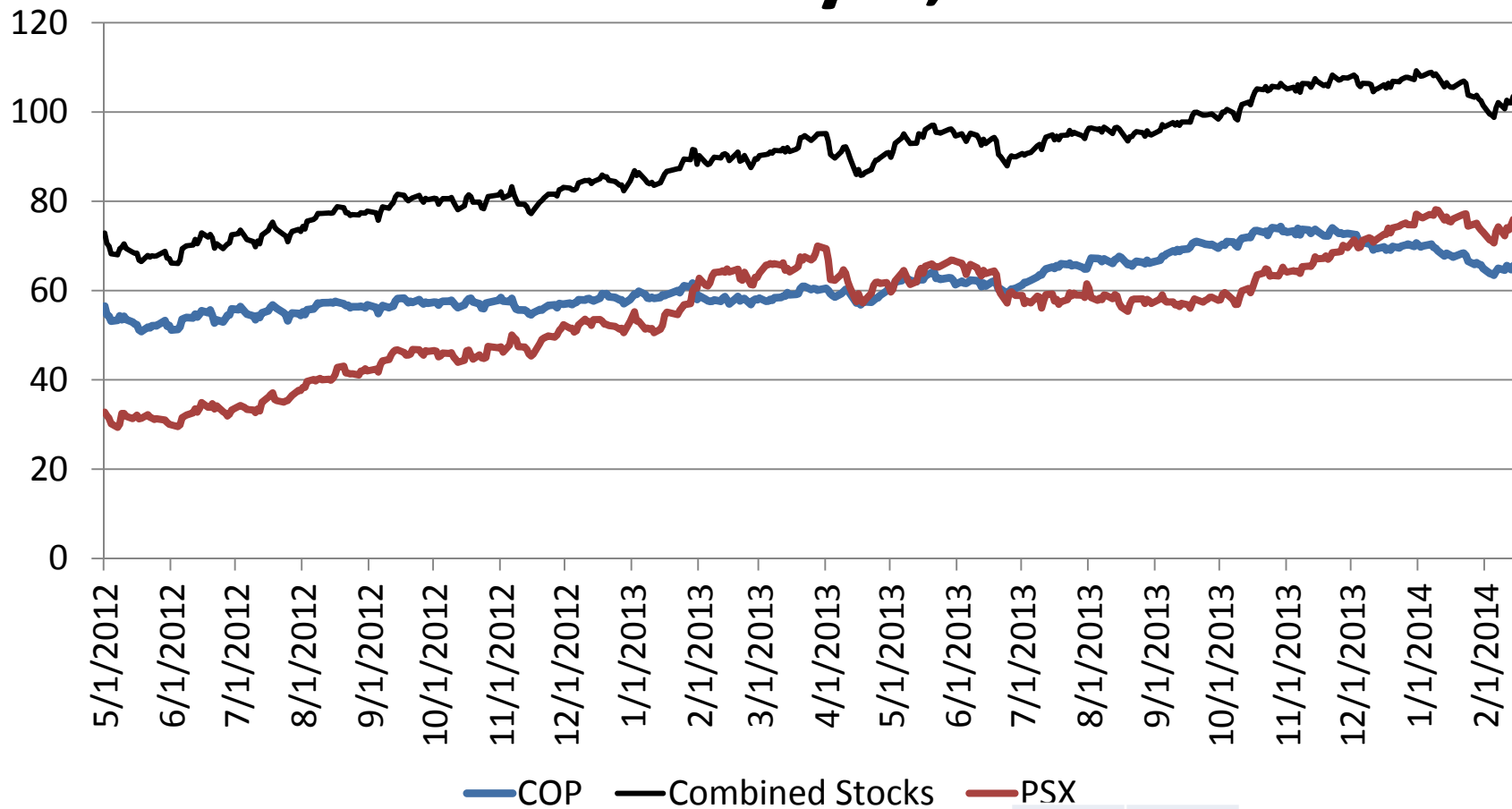


Vertically Challenged?

- IOCs underperforming
 - Very different today since Rockefeller's day
 - Captive suppliers have no incentive to innovate
 - Too much complexity and a lack of skills to run multiple businesses (i.e., focus on what you are good at)
 - With transparent pricing at every point in supply chain, integration holds little value
 - IOCs produce crude but do not necessarily sell it to themselves
 - IOC refineries will buy much of their crude on the open market
- Analysts comments:
 - *Majors are unloved dinosaurs*
 - *Investors to Big Oil: We Need to Talk (Wall Street Journal)*
- *Some companies are listening – a few examples*



ConocoPhillips Spin-off of Phillips 66, Share Price Performance since Effect Date of May 1, 2012

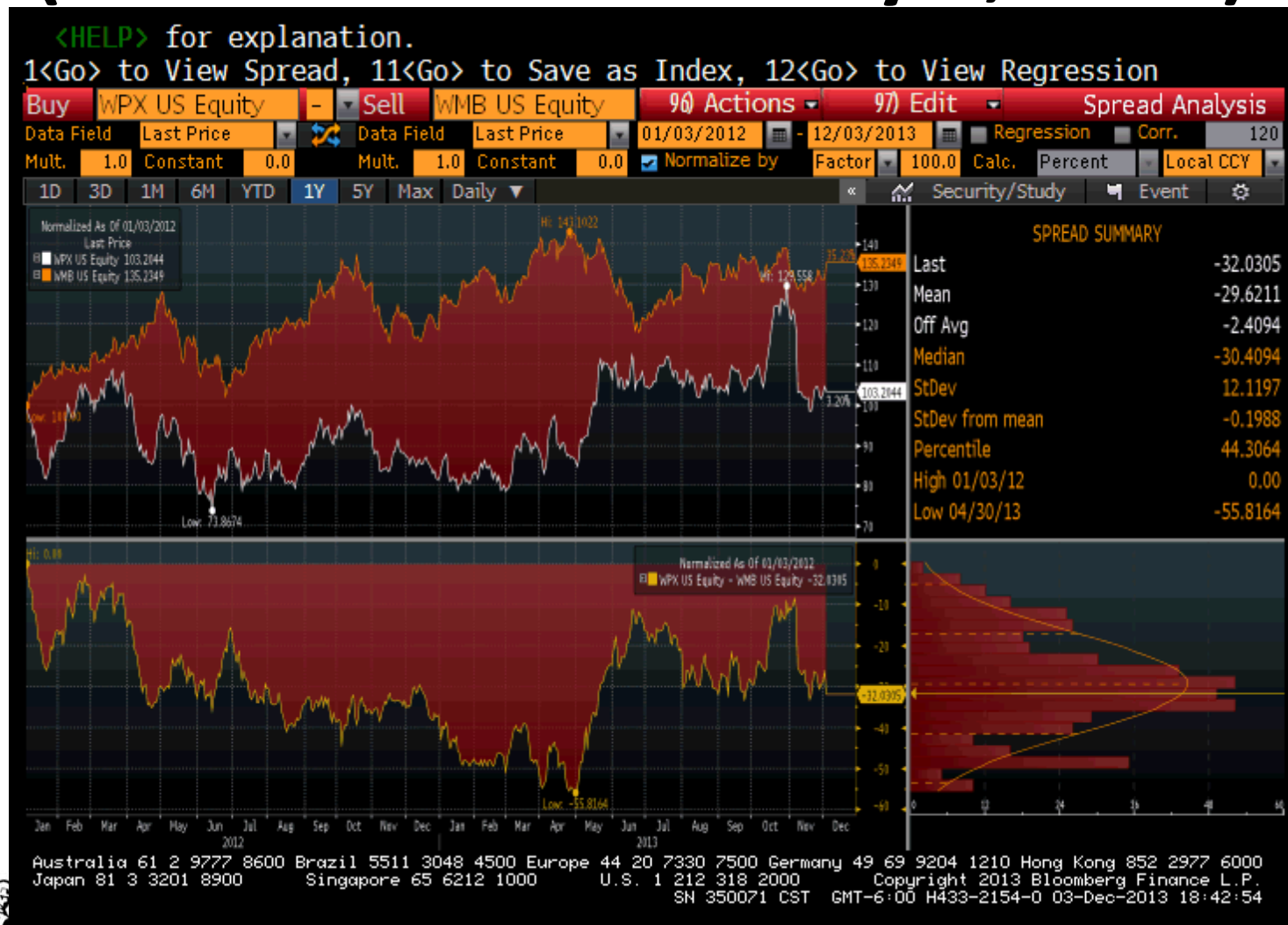


— COP — Combined Stocks — PSX

COP	15.96%
PSX	131.78%
Combined	41.99%
S&P 500	31.11%

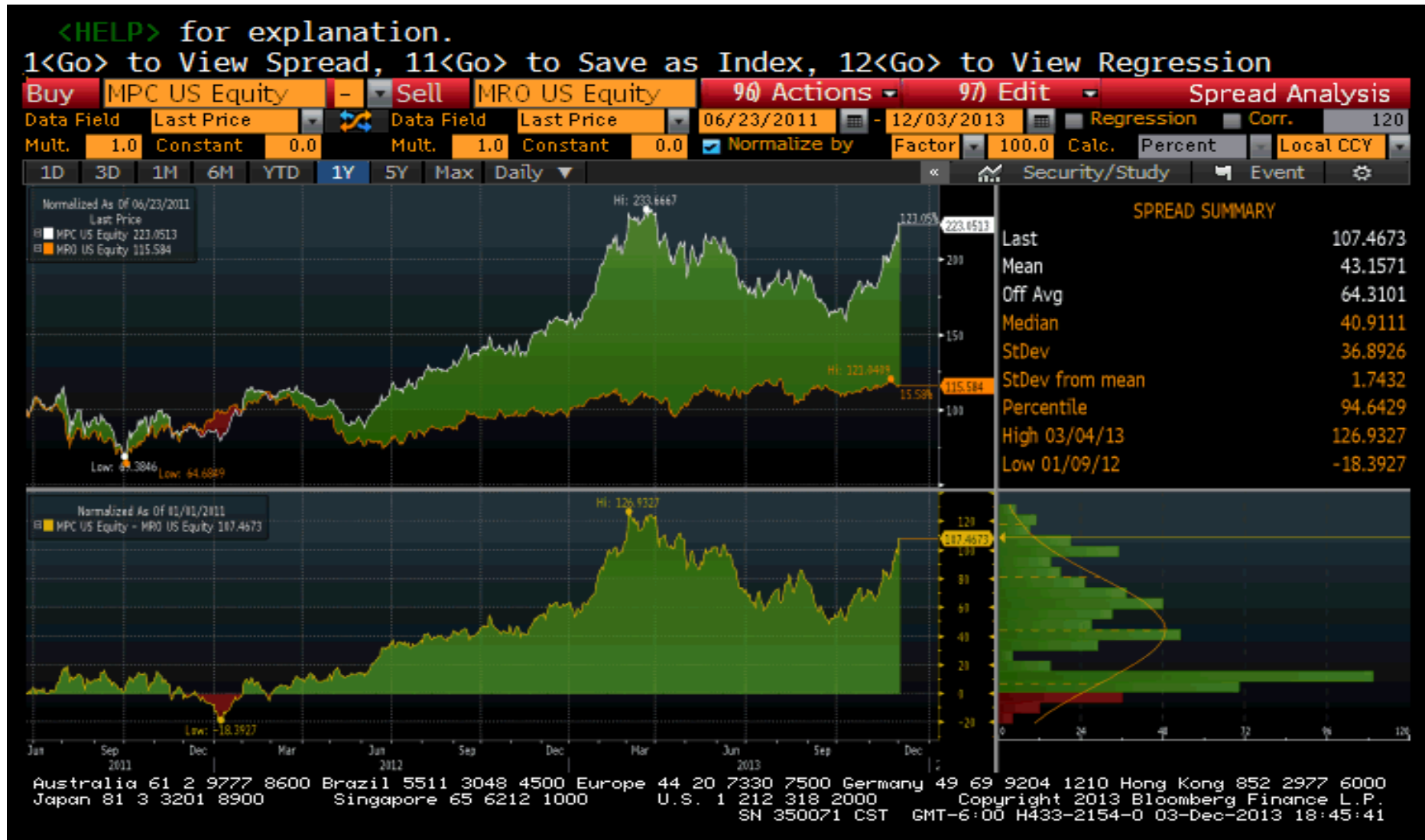


Williams Companies Spin-off of WPX (effective date January 3, 2012)



Marathon Oil (MRO) and Marathon Petroleum (MPC)

Split June 30, 2011. MRO (Upstream) and MPC (Mid/Downstream)



Spinoffs: What Part of Value Chain Performs Best Currently

- A. Upstream
- B. Midstream
- C. Downstream



Midstream Growth and Need for Capital and MLPs: What, Why, and How



Rise of the U.S. Midstream Industry: U.S. Midstream Capex, 1992-2012

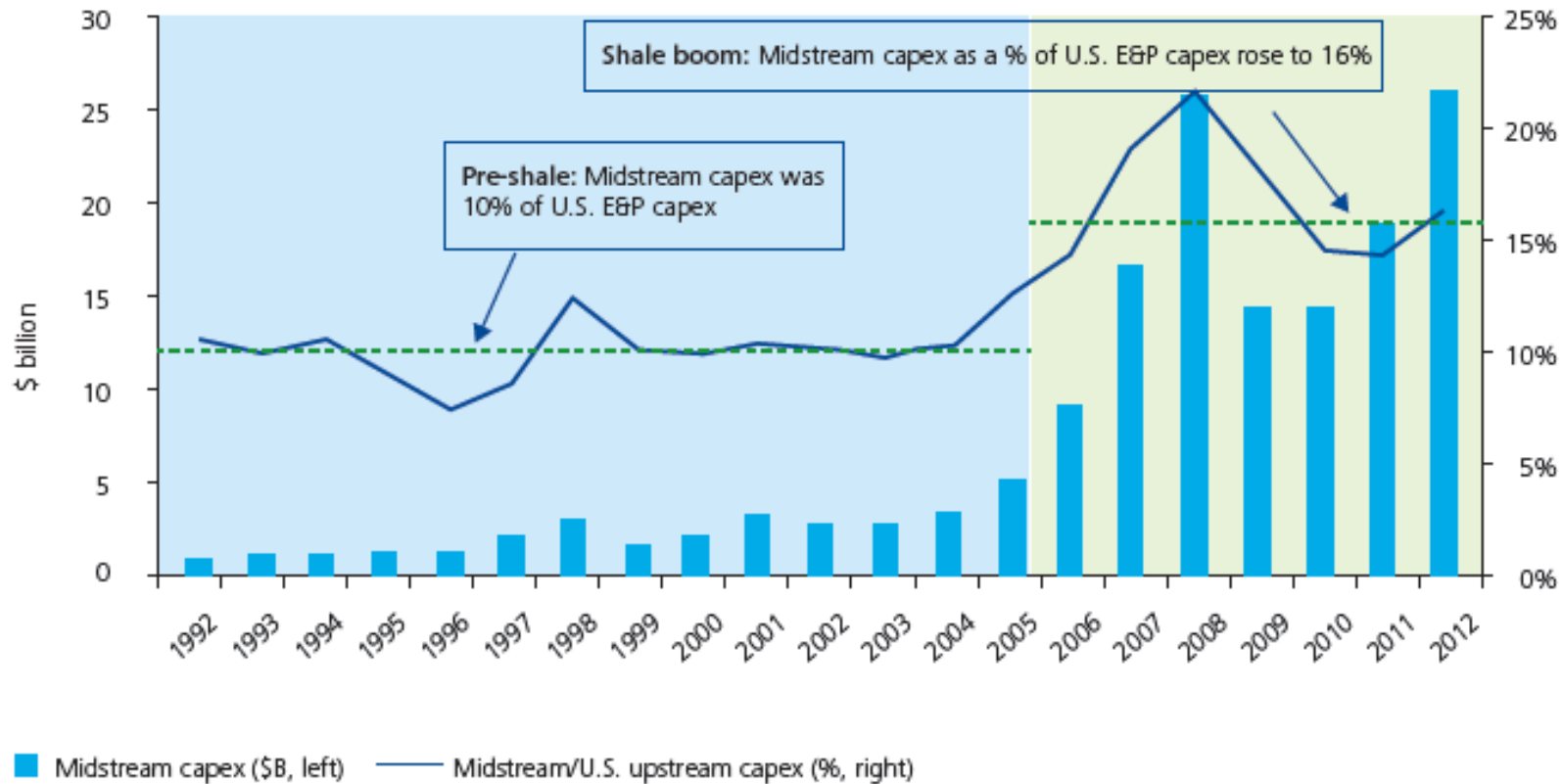


Figure from Deloitte Midstream Report, 2013

Master Limited Partnership (MLP) Overview

An MLP is a partnership, or a limited liability company (LLC) that has chosen partnership taxation, that trades on a public exchange (NYSE, NASDAQ, etc.) or over the counter market.

- General Partners and Limited Partners
- Pass Through Organization
 - Tax flows through to unit holders
 - No double taxation
- Allows companies to build and operate low-return assets while providing sufficient return to investors
 - Necessary new infrastructure
- Low Risk / Stable Markets
 - Pipeline revenue on transportation fees
 - Not commodity prices
- Allows investment from a broader range of Investors
- 90% revenue - Qualifying Natural Resource Activities

Examples of MLP Qualifying Assets (not a complete list)			
Upstream		Midstream	
- Oil reserves		- Interstate oil and natural gas pipelines	
- Natural gas reserves		- Intrastate oil and natural gas pipelines	
- Coal reserves		- NGL pipelines	
- Other exhaustible ground mineral and natural resources		- Petroleum product pipelines	
- Drilling platforms		- Gas gathering and processing assets	
- Drilling rigs		- Facilities for gas compression, treating, fractionation, etc.	
- Other E&P assets used to extract exhaustible ground mineral and natural resources		- Commodity storage facilities	
		- Compressor stations	
		- Coal preparation and transloading facilities	
		- LNG tankers and carriers	
		- LNG regassification	
		- Transportation and storage of biofuels	
Downstream		Other	
- Refineries		- Timber	
- Transportation to "bulk distribution centers" such as a terminal or marketing outlet by:		- Geothermal energy sources	
- Rail cars		- Fertilizers	
- Trucks and trailers		- Nitrogen and sulfur product Manufacturing plant	
- Barges and tugboats		- Aggregates	
- Propane delivery and service vehicles			

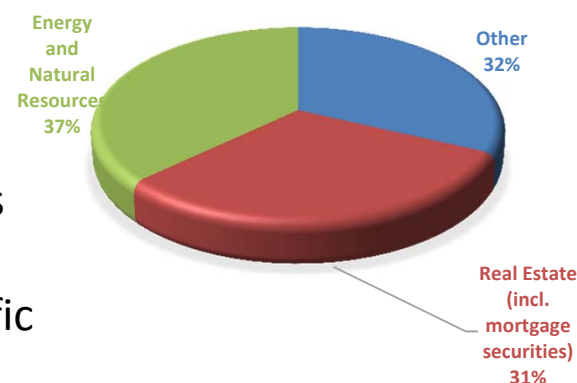


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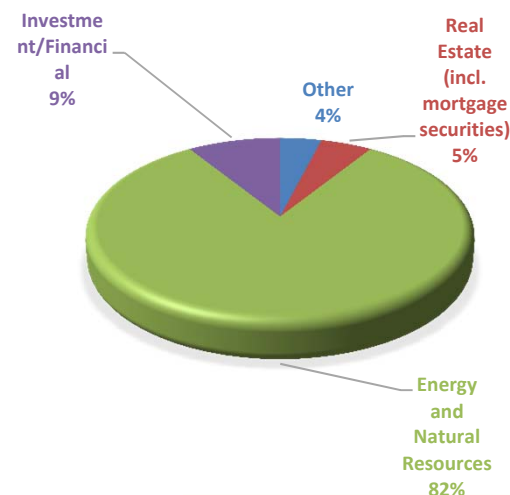
Master Limited Partnership (MLP) Overview

- **1981 - Apache Oil Company**
 - Raise capital from smaller investors by offering a partnership investment in an affordable and liquid security
- **1980s** -MLP grew rapidly and spread to other industries
- **1987** – Congress passed legislation to define and limit MLP's
 - Created section 7704 of tax code
 - MLPs had to earn greater than 90% income from specific sources; Existing MLP's under 90% income were grandfathered (3 remain)
- **Late 1980s-1990s** – Many Original Oil and Gas MLPs left market as oil and gas prices dropped
 - Integrated energy companies began spinning off “Midstream” assets to focus on their core business
 - Most of the original real estate MLPs converted to REITs
- **2000s** – The number of MLPs in the oil and natural gas Midstream businesses steadily increased
- **2008** – Qualifying income was expanded by Congress
- **2013** – Close to 130 MLPs are trading publicly

MLPS BY INDUSTRY GROUP - 1990



MLPS BY INDUSTRY GROUP - 2013



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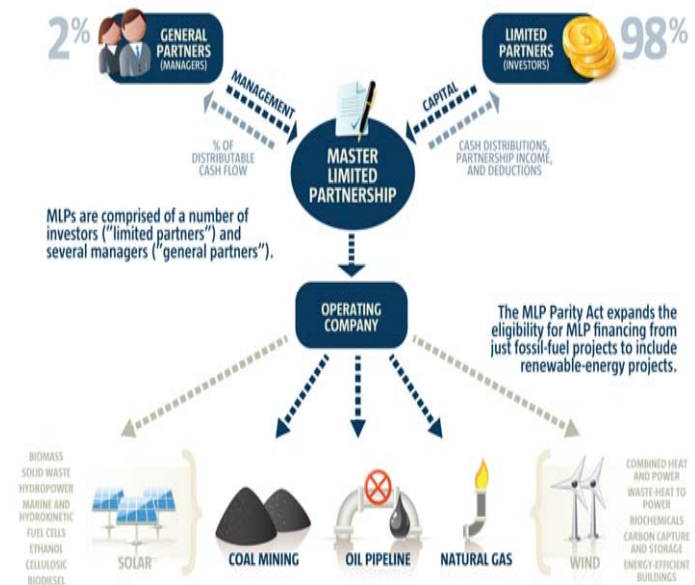
Master Limited Partnership (MLP) Overview

Limited Partners

- Purchase Units in a public market
- No Voting Rights
- Provide Capital
- Distributable Cash Flows (quarterly)
 - Net Earnings
 - Personal Tax Rate
- Depreciation and Depletion Expenses
 - Return on Capital
 - Deferred and Capital Gains Tax
- K-1 Statement

General Partners

- Generally has 2% ownership stake
- Operates and Manages
- One or more GP
- Incentive Distribution Rights (Tiered)
 - Incentive to Grow Business
- Can purchase additional units



	Distribution to LP	Total Distribution	GP IDR's
Tier 1	\$0.27500	\$0.27500	0.0000
Tier 2	\$0.04250	\$0.04885	0.0064
Tier 3	\$0.09500	\$0.12338	0.0284
Tier 4	\$0.48125	\$0.92548	0.4442
Totals	0.8937500	1.3727080	0.4789580



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Master Limited Partnership (MLP) Overview

Corporations - Dividends

- Corporation pays tax on earnings
- After-tax earnings paid to shareholder as dividend
- Shareholder pays tax on dividend

	C-Corp	MLP
Taxable Income	\$100.00	\$100.00
Corporate Tax	(\$35.00)	\$0.00
Net Income	\$65.00	\$100.00
Shareholder's Marginal Tax Rate (30% assumed)	(\$19.50)	(\$30.00)
Net Income to Shareholder	\$45.50	\$70.00

MLP - Distributions

- Partnership does not pay tax; income and deductions flow through to partners
- Partners pay tax on net earnings (regardless of cash received)
- Cash distribution exceeding net income treated as tax deferred return of capital; lowers basis and is taxed on sale.



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Master Limited Partnership (MLP) Overview

General Partner

- Maintain control

- Free up capital

- Participate in midstream growth through IDR's

Limited Partner

- Cash flow security

- Low risk/stable market

- Ideal tax structure

Midstream Space

- High growth due to the natural gas boom

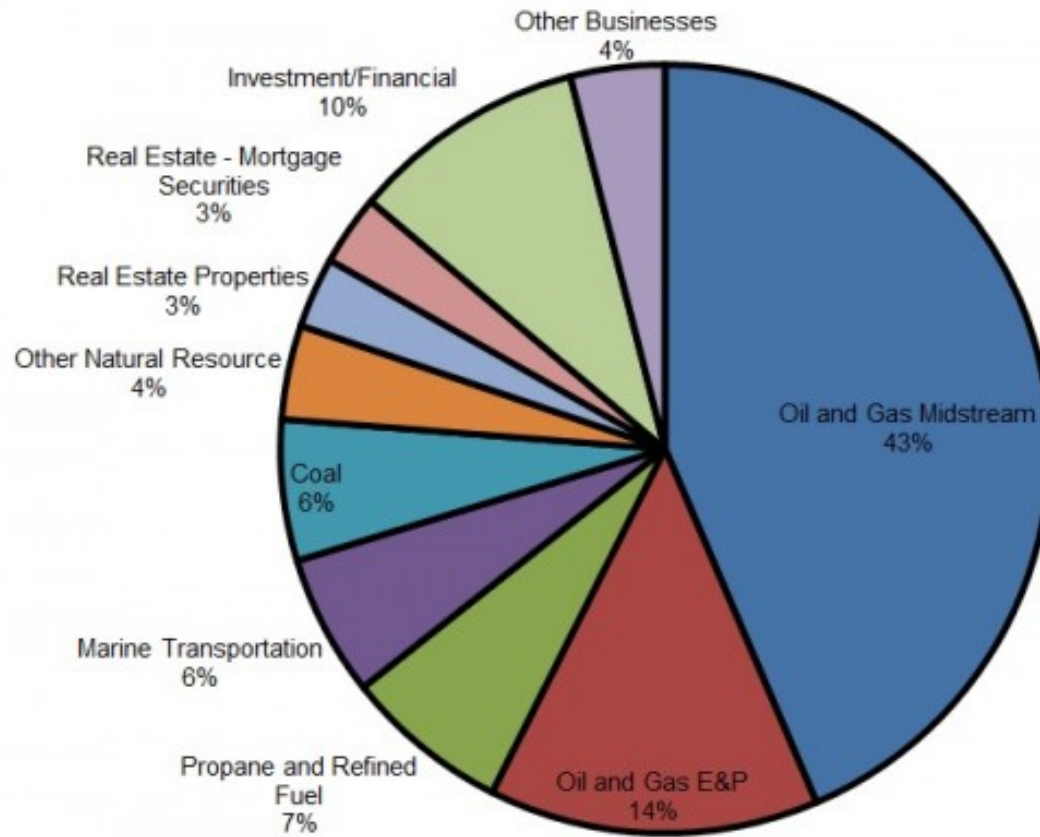
- Stable/low-risk market

- Necessary new infrastructure



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MLPs by Industry Type (2012)

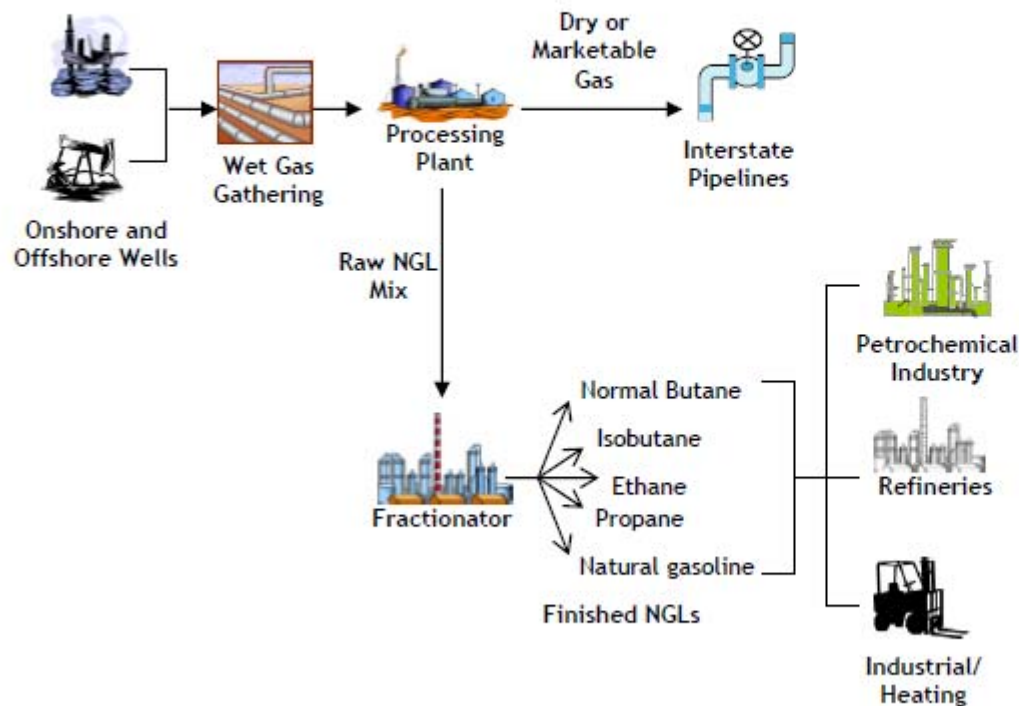


Source: National Association of Publicly Traded Partnerships



Midstream Primer

Midstream Overview



■ There are four primary segments within the Midstream business:

1. Gathering - transports and often compresses natural gas and removes water and other contaminants;
2. Processing - extracts NGLs, resulting in dry/marketable natural gas and a raw NGL stream
3. Fractionation - splits raw NGLs into finished product
4. Marketing - stores, transports and markets finished NGLs

Image Source: Tudor, Pickering, Holt & Co.



POP QUIZ

Which of the following are advantages of MLPs?

- A. An MLP is a way for the sponsoring entity to “monetize” its investment in a group of assets while retaining control over those assets (by owning the general partner)
- B. Due to lack of corporate level income tax, MLPs generally have a lower cost of capital than corporations, which makes MLPs more competitive in the acquisition marketplace
- C. The sponsor often can defer significant amounts of taxation upon formation of the MLP
- D. Incentive distribution rights entitle sponsor to increasing distributions
- E. All of the above



Similarities and Differences with other Structures

Tax advantages are a big plus; tax reporting and lack of voting rights can be a minus

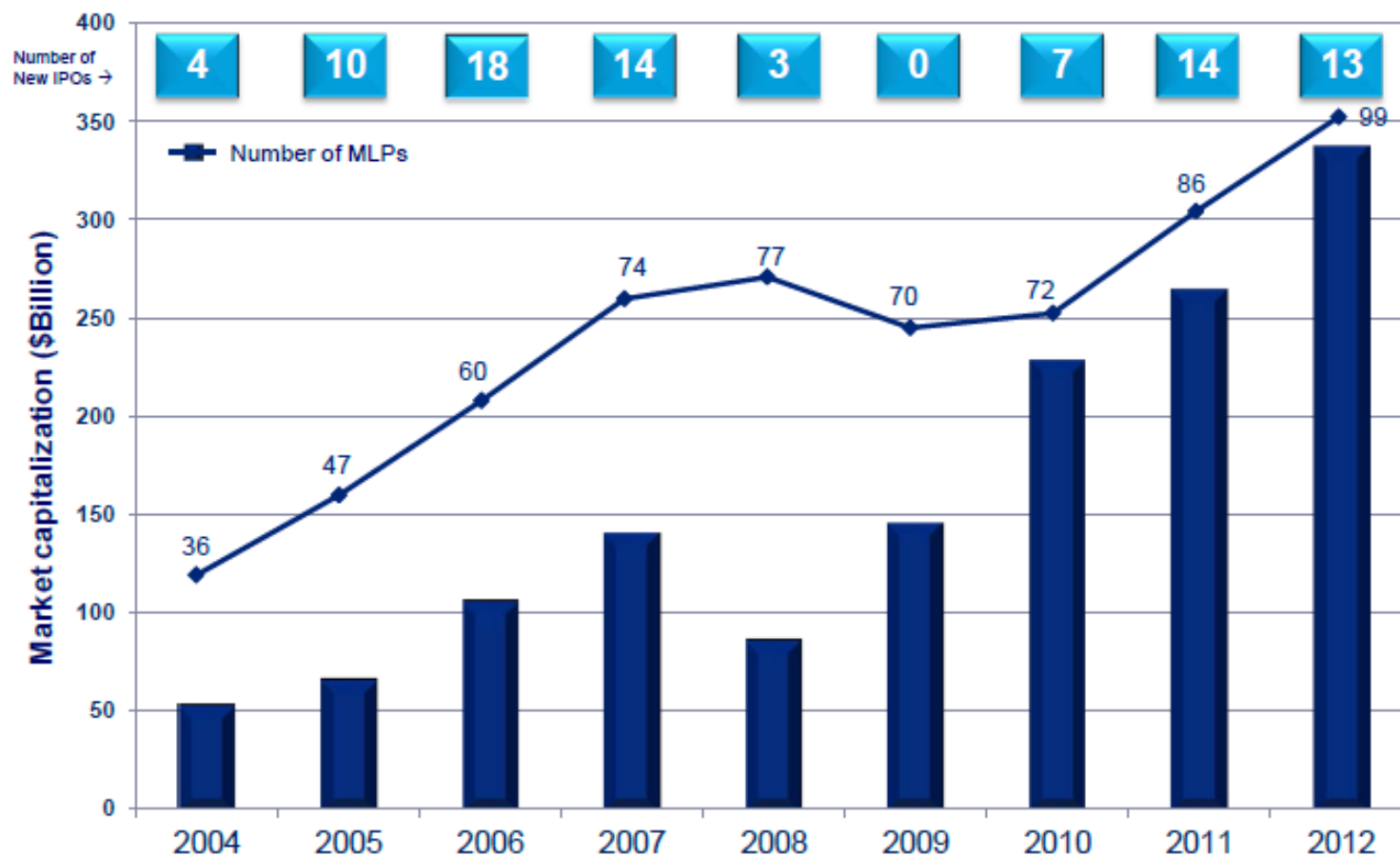
Structure Comparison	MLP	LLC	C-Corp
Non-taxable (at entity level)	Yes	Yes	No
Tax items flow through (to investor)	Yes	Yes	No
Distribution tax shield (to investor)	Yes	Yes	No
Tax reporting	K-1	K-1	1099
General Partner (GP)	Yes	No	No
Incentive Distribution Rights (IDRs)	Yes	No	No
Voting Rights	No	Yes	Yes

Source: Morgan Stanley Research



What is the size of the MLP market?

There are ~100 trading MLPs with total market capitalization of ~\$325 billion.



Source: Wells Fargo Securities, LLC & Simmons & Co. International

SOURCE: DELOITTE BRIEFS



POP QUIZ

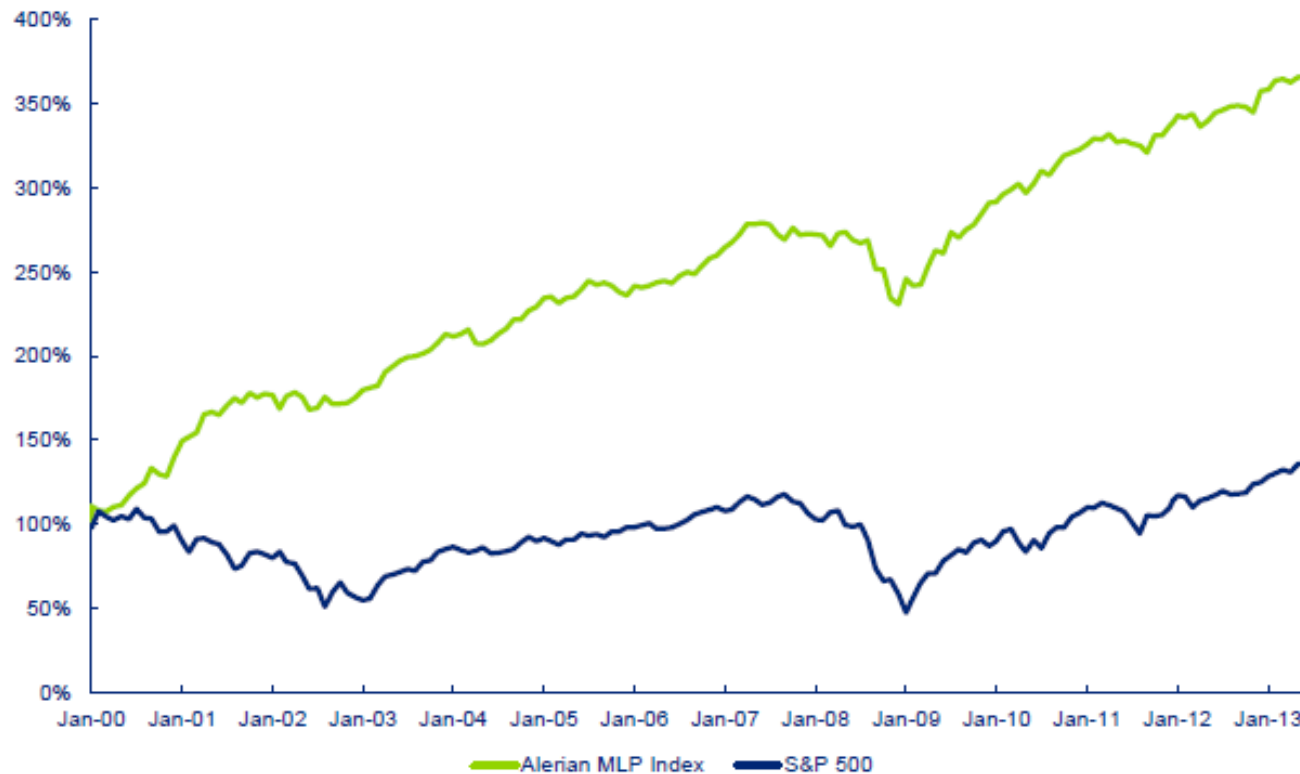
Which of the following is true regarding a tax shield?

- A. An MLP unit holder is not subject to tax
- B. A tax shield is a defensive weapon
- C. An MLP unit holder may receive an amount of cash distributions from the MLP which exceeds the amount of taxable income recognized by the unit holder from the MLP
- D. All of the above



Return on Midstream/MLPs have outperformed the broader market

MLPs have significantly outperformed the broader S&P market index due to favorable tax structure, consistent yields, and tremendous growth in the energy sector.



Source: Alerian Index, Yahoo Finance



Some Examples of C-Corps with MLP Interests

Numerous C-Corps have MLP subsidiaries

C-Corp (Ticker)	MLP
Anadarko Petroleum (APC)	WGP / WES
CenterPoint / OGE Energy	Newly Announced
Crosstex Energy Inc (XTXI)	Crosstex Energy. L.P. (XTEX)
DCP Midstream LLC*	DCP Midstream Partners (DPM)
Enbridge Inc. (ENB)	Enbridge Energy Partners (EEP)
EQT Corporation (EQT)	EQT Midstream Partners LP (EQM)
Kinder Morgan Inc. (KMI)	KMP / EPB
Loews Corporation (L)	Boardwalk Pipeline (BWP)
Marathon Petroleum Corp (MPC)	MPLX LP (MPLX)
ONEOK Inc. (OKE)	ONEOK Partners (OKS)
SemGroup Corp (SEMG)	Rose Rock Midstream LP (RRMS)
Spectra Energy Corp. (SE)	Spectra Energy Partners (SEP)
Targa Resources Corp. (TRGP)	Targa Resources Partners (NGLS)
TransCanada Corp. (TRP)	TC PipeLines (TCP)
Williams Co. (WMB)	Williams Partners (WPZ)

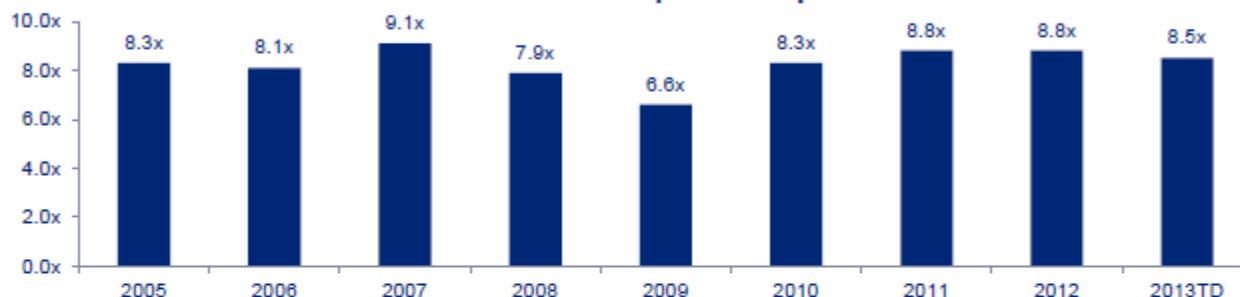
Source: Morgan Stanley Research. * DCP Midstream is a 50/50 private joint venture between Spectra Energy Corp. and ConocoPhillips



Transaction multiples – EV/EBITDA

Transaction multiples have been trending higher and reflect consolidation in the sector. Gathering and Processing companies are receiving greater multiples due in part to potential growth in NGLs.

Forward EBITDA Multiple for Acquisitions



Forward EBITDA Multiple by Sub-Sector

	2005	2006	2007	2008	2009	2010	2011	2012	2013 TD
Pipelines	8.3x	8.4x	13.9x	9.3x	8.2x	9.5x	10.9x	11.0x	10.4x
Storage	11.6x	9.2x	10.0x	8.3x	8.8x	9.9x	11.3x	8.9x	-
Gathering/Processing/Fractionation	9.7x	9.2x	9.9x	10.0x	6.7x	9.1x	10.6x	11.7x	9.8x
Upstream	-	5.0x	6.5x	5.0x	5.4x	6.8x	6.0x	6.9x	6.2x
Marine Transportation	-	9.1x	9.0x	9.1x	6.0x	7.1x	7.8x	6.7x	8.5x
Coal	4.6x	-	7.3x	-	5.8x	-	7.3x	-	-
Propane	7.4x	7.5x	6.3x	5.5x	6.4x	-	7.8x	7.5x	-
Other	-	-	9.6x	-	5.3x	7.3x	9.1x	9.0x	7.6x
Total	8.3x	8.1x	9.1x	7.9x	6.6x	8.3x	8.8x	8.8x	8.5x

Source: Wells Fargo Monthly MLP Report July 2013

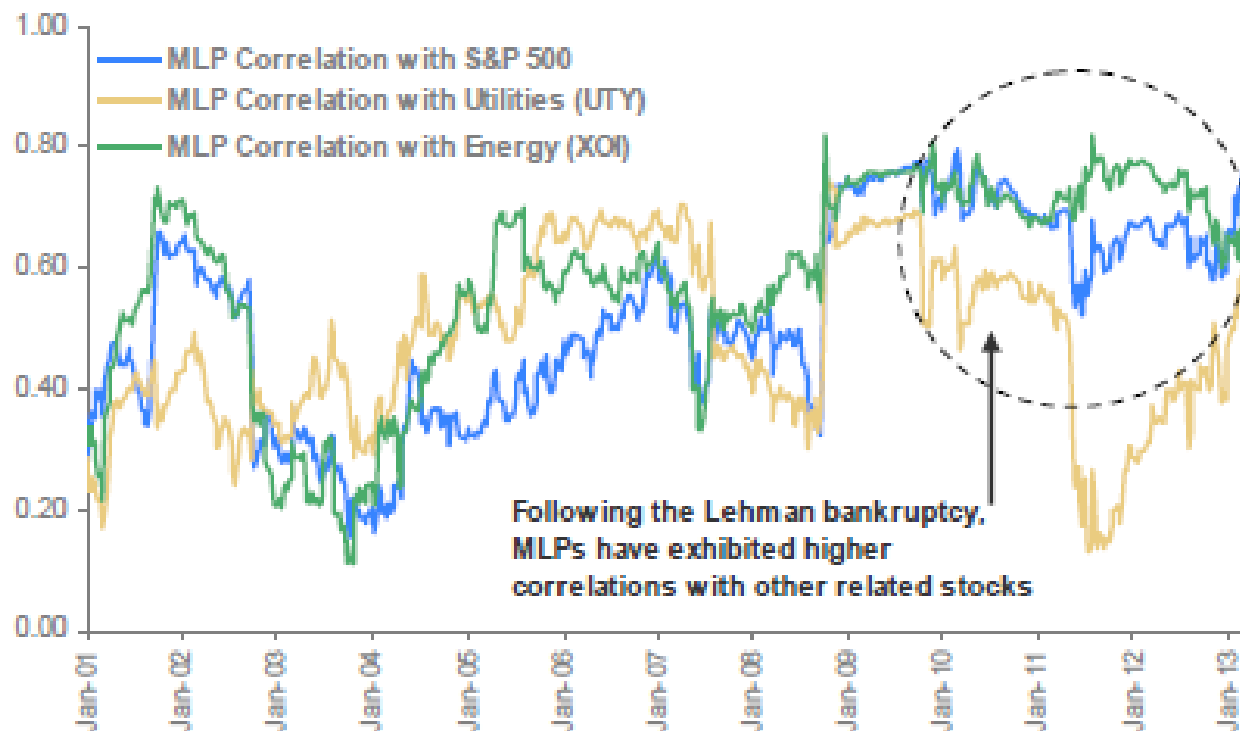
SOURCE: DELOITTE BRIEFS



Why Invest in MLPs? A Few Reasons

MLPs Have Low Correlation with Other Stocks

However, it has increased in recent years



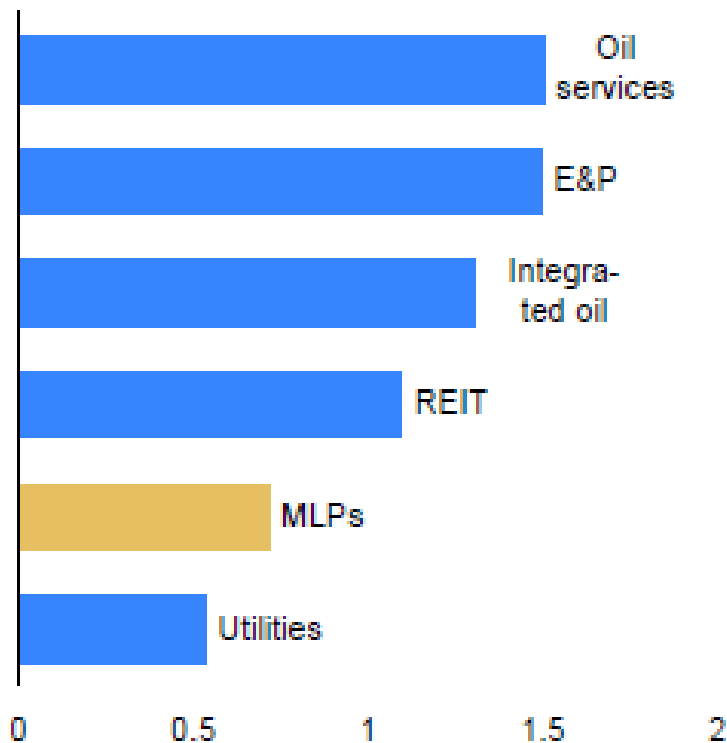
Source: Thomson; Morgan Stanley Research



Why Invest in MLPs? A Few Reasons

A Lower Beta Industry (chart 2)

MLPs have a lower risk profile than other sectors



Source: Company data; Morgan Stanley Research



POP QUIZ

Which sector has the highest valuation multiples for MLPs?

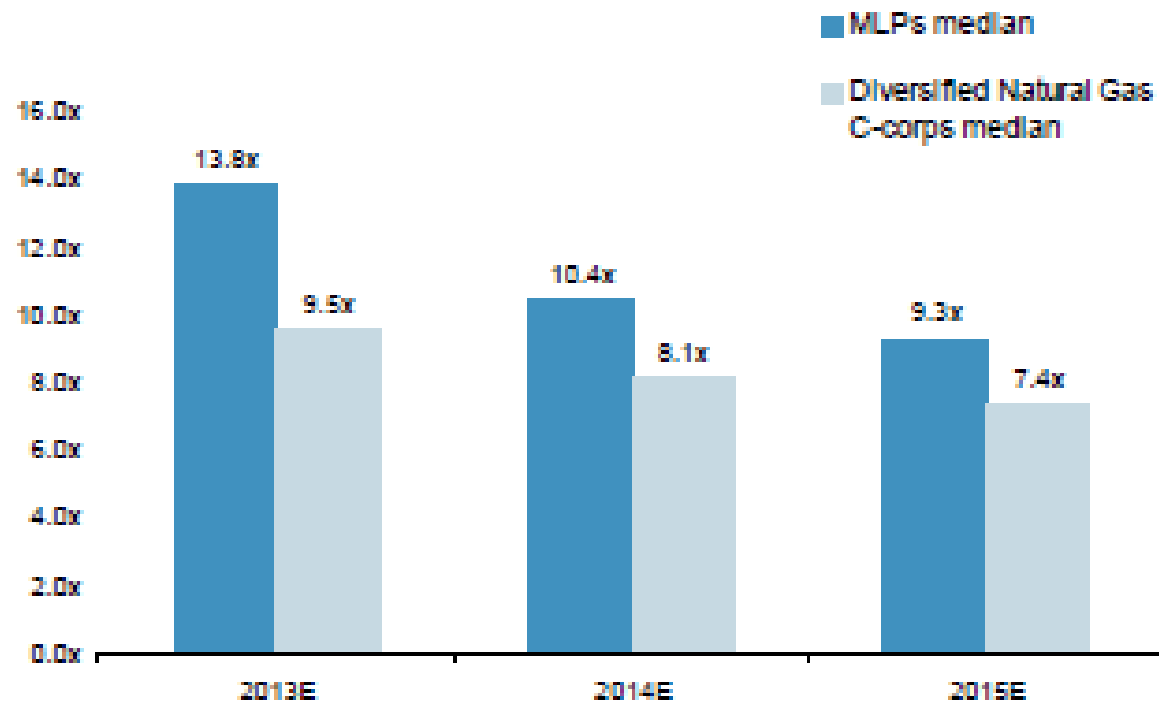
- A. Upstream
- B. Midstream – all areas have similar multiples
- C. Midstream – gathering and processing
- D. All of the above



Exhibit 3

EV/EBITDA Uplift for MLPs vs. Midstream C-Corps

Significant valuation step-up for traditional midstream assets held within the MLP structure



Source: Company Data, Morgan Stanley Research

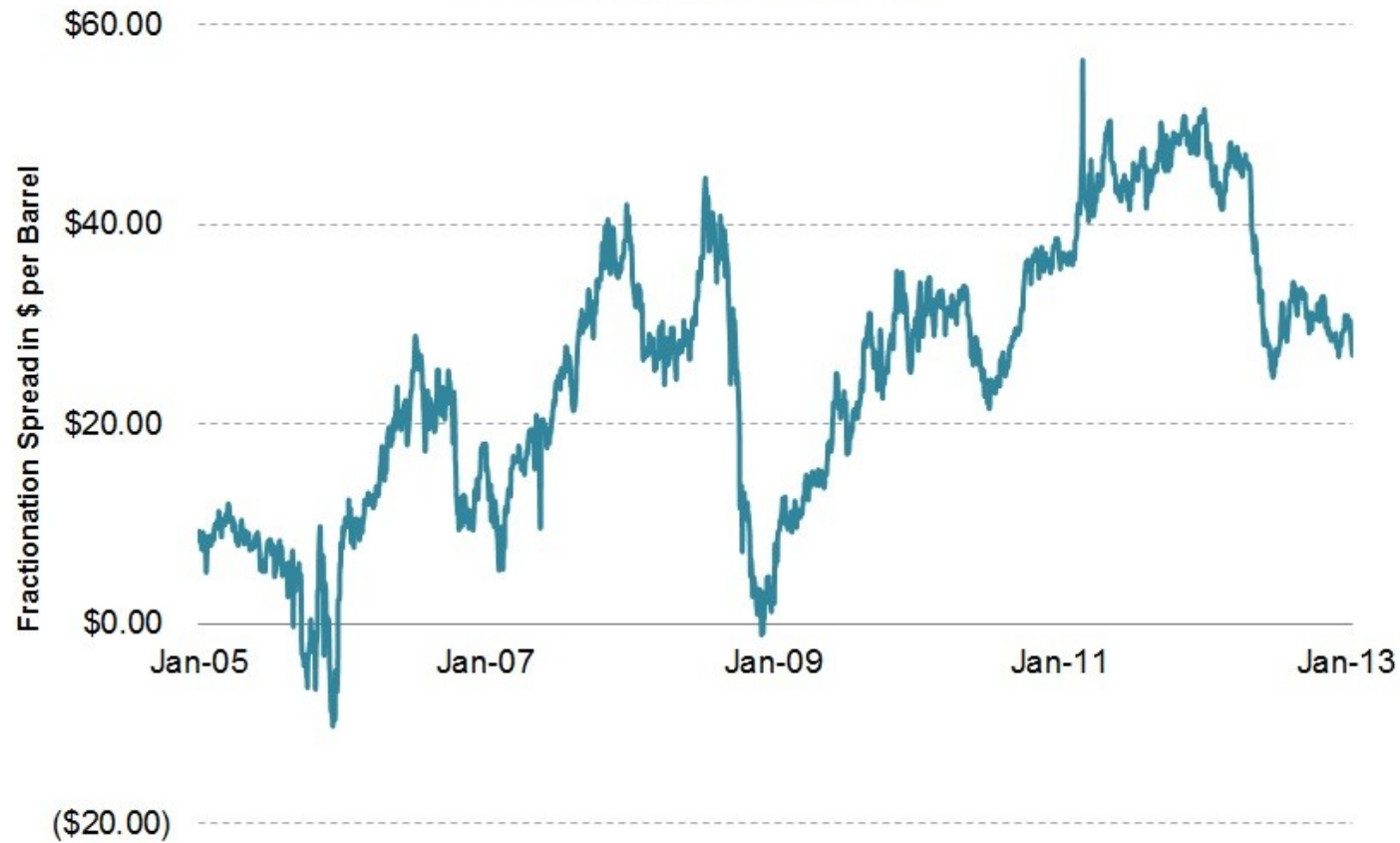


Frac Spreads and MLP Performance

- As frac spreads fall, this can be negative for MLPs with exposure to gas processing.
- Companies with significant gas processing operations include (but are not limited to) DCP Midstream ([DPM](#)), Enterprise Products Partners ([EPD](#)), Williams Partners ([WPZ](#)), and Targa Resources ([NGLS](#)).
- Many companies in the gas processing space are MLPs and fall into the Alerian MLP ETF, an ETF which tracks a cap-weighted index of 50 energy MLPs.
- Note: Frac Spreads are simply the value received on the sale of natural gas liquids (NGLs) such as ethane, propane, butane and pentane less the cost of the natural gas used to extract the NGLs.



Fractionation Spread




Source: NYMEX, LPG, Ceritas



Despite significant capex and volatility in commodity prices, the industry's growth has been profitable. Further, the industry has maintained its leverage ratio and increased distribution to its unit holders.

	2006	2007	2008	2009	2010	2011	2012
EBITDA Margin	9.0%	9.8%	8.9%	15.4%	13.6%	13.2%	13.5%
Return on Assets (Adjusted)	4.2%	3.8%	4.3%	3.7%	3.1%	4.5%	3.4%
Interest Coverage Ratio	2.9	2.7	2.7	2.8	2.7	3.2	3.0
Net Debt/Capital	52%	54%	56%	53%	53%	52%	51%
Dividends per Unit	\$2.1	\$2.2	\$2.8	\$2.6	\$2.5	\$2.7	\$2.8

Note: ROA is adjusted for non-operating and unusual expenses and income.
Source: FactSet, Market Insights Analysis




SOURCE: DELOITTE BRIEFS



Poll Question

Which area of the midstream sector do you think will have the highest growth over the next 10 years?

- Gathering and processing
- Natural gas pipelines
- Liquids pipelines and logistics
- Gas storage and terminals (costal)



Good Sources for Analysts Views on MLPs

- <http://marketrealist.com/2013/01/master-limited-partnership-mlp-basics/>
- http://www.standardandpoors.com/spf/upload/Events_US/US_CO_Event_WebcastMidstream102913.pdf
- <http://www.morganstanleyfa.com/public/projectfiles/4735a09e-c35d-4545-a059-8873c8d057f0.pdf>



Future Trends



What will the industry look like in 5 years? 10 years? 20 years?

- We are now seeing the rise of diversification – breaking apart of the vertical integration.
- No shortage of supply
- M&A in upstream
- Rise of the U.S. midstream industry
- More focus on unconventional hydrocarbons (horizontal and directional drilling; deep water; oil sands; tight oil)
- Unconventional drilling around the world next? Russia, Australia, Saudi Arabia, China?
- Case for peak oil consumption as opposed to peak oil supply
 - Unconventional gas supply allowing gas to replace oil in transport, petrochemicals, power and heating
 - Engine and vehicle design
 - Emerging markets will not exactly replicate the path of the developed economies in how they consume oil



Thank you for your attention!

Questions or Comments?

