P: 312.263.2610
T: 800.338.8214
F: 312.876.1028

March 19, 2018

Duff & Phelps' Insight on the recent MLP regulatory ruling

Master Limited Partnerships (MLPs) and stocks of midstream energy companies fell sharply intra-day on March 15, 2018. The downward move was caused by the Federal Energy Regulatory Commission – also known as "FERC" - announcing that it would no longer allow MLPs to include a corporate income tax allowance in the contractual rates charged to certain customers. The Duff & Phelps MLP/Energy team provides their insight on this development below.

After the recent regulatory announcement and subsequent selloff, many midstream energy companies indicated that they would be unaffected by this development or were still evaluating what the impact would be but projected it would be immaterial. Within 24 hours the share prices of many companies had partially recovered.

The FERC's decision was very surprising as there have been numerous challenges and court cases regarding this technical topic going back to the 1990s, and the FERC has always expressly confirmed the right to include the tax allowance. Furthermore, while the industry was expecting tax-related guidance from the FERC, the expectations only pertained to receiving clarifications about the new tax law and the lowering of the corporate tax rate from 35% to 21%. The surprise announcement sent share prices down, with the benchmark Alerian MLP Index finishing down 4.6% on March 15, 2018.

It should be noted that this FERC ruling only impacts a limited swath of the midstream energy sector. Specifically, it only applies to FERC-regulated interstate gas and oil pipelines owned by MLPs and operating under what is known as a "cost-of-service" revenue model. Pipelines not meeting this definition are not expected to be impacted. Exclusions include intrastate pipelines, pipelines owned by C-Corps, pipelines using a negotiated revenue model, and other non-pipeline gathering/processing assets considered to be part of the midstream energy sector.

Nevertheless, given the unexpected nature of the announcement and the complexity in determining how it may affect each company, investors took a "shoot first and ask questions later attitude" as midstream-energy related share prices tumbled. Our view from the outset of the episode was that investors were overstating the impact of the FERC ruling across the sector and painting the industry with too broad of a brush.

We acknowledge that the profitability for certain MLPs will be affected, potentially setting in motion a process whereby those MLPs' look to new corporate structures. However, the sector had already been engaged in an era of soul-searching over the last year about the need for the partnership structures to co-exist with their corporate parents, as the economics of some MLPs were perceived—sometimes rightly so—as being tilted in favor of the corporate sponsors instead of the partnership investors. Accordingly, the proportion of midstream energy assets held within C-Corps rather than MLPs was already on the rise before the recent FERC ruling.

Amidst the noise, it is important to remember that the prospects for the midstream energy sector are bright. Oil and natural gas production in the U.S. remains robust. Voluntary production cuts by Russia and OPEC member nations, combined with Venezuelan political upheaval, have curbed production elsewhere in the world, ushering an era of major oil and natural gas exportation opportunities for the U.S. These products will need to be transported from the production basins to the refineries and export terminals (and within the U.S. to satisfy our own domestic consumption needs) via midstream energy pipelines. The sector undertook significant capital expenditures in recent years that will result in major new projects coming online in 2018. And we expect lower levels of dilutive equity issuance in 2018 than in the past, removing another headwind.

There is no question that the FERC ruling was a setback for the midstream energy sector as it introduces more uncertainty and volatility to a sector that has already had way too much of it. That said, at current levels we continue to see MLPs and energy infrastructure C-corps as being very attractively priced. A key component of their return potential is their attractive yield which typically ranges in the mid-to-high single digits. This robust level of yield is appealing in an environment where bonds and other yield-oriented instruments are paying out comparatively modest distributions. Against the positive economic backdrop, with attractive yields, and strong growth prospects, we are hopeful the day will soon arrive when performance of the stocks reflects the fundamentals of the sector.

Midstream Energy Investment Team

David Grumhaus
Senior Portfolio Manager

Charles Georgas, CFA
Portfolio Manager