

Master Limited Partnership (MLP) Overview

ENERGY SECTOR REPORT

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Investment Guidance

We believe that Master Limited Partnerships (MLPs) are not the right investment for everyone. There are risks and tax-reporting issues that need to be fully understood before an investor considers owning an MLP. MLPs can make sense for some investors who might benefit from the tax deferral that comes with owning MLPs. Many MLPs can provide a yield higher than the market; however, understanding how this yield differs from corporate dividends is important.

Important Items to Consider

- While the yields are relatively high on MLPs, much of the distribution an investor receives is a return **of** capital versus a return **on** capital. The portion that is a return of capital will reduce the investor's tax basis.
- In most cases MLPs are not suitable for tax-deferred accounts.
- Upon the sale of MLP units, an investor must recapture the previously deferred income as ordinary income, which will be subject to the taxpayer's prevailing tax rate.
- We believe that MLPs are not right for everyone. Investors should be aware of the risks related to this structure and the tax and governance differences between partnerships and companies structured as corporations.

MLPs Have Underperformed the Broader Market

Over the past five years, the MLP sector has significantly lagged the broader U.S. equity market. This underperformance has been driven by a change in investor preferences for self-funded capital-spending plans, which is contrary to the typical MLP model that relies on continual equity and debt issuance to fund growth capital. In addition, distribution cuts by several MLPs have negatively impacted investor sentiment toward MLPs.

What Should Investors Do?

We do not currently cover any individual MLPs; however, if investors understand the inherent risks and tax consequences and seek exposure to MLPs, it is our view that investors' best prospects are to buy MLPs with:

- Stable long-term assets (such as pipelines) that are positioned to grow;
- Cash flows that are less directly tied to commodity prices; and
- A solid track record of stable returns and distribution increases (historical performance is no indication of future results).

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Please see important disclosures and analyst certification on page 7 of the report.

What is an MLP?

An MLP is a limited partnership that is publicly traded. Shares in an MLP are called "units" and shareholders are referred to as "unitholders." Per the Revenue Act of 1987, as long as 90% of an MLP's income is derived from qualified sources, an MLP is treated like a partnership for U.S. federal income tax purposes.

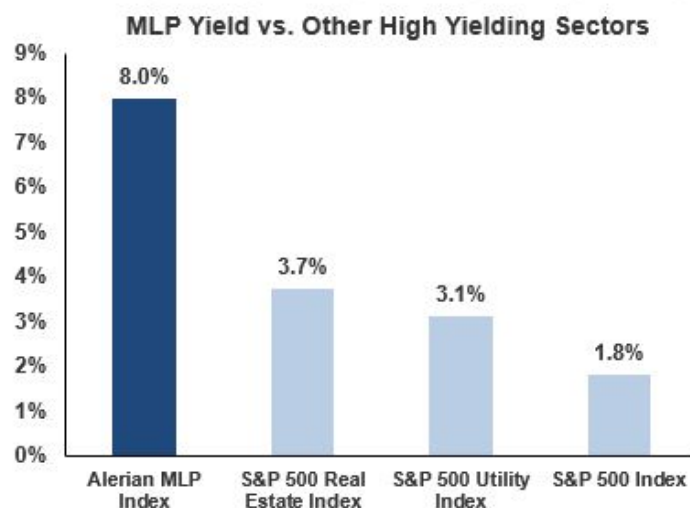
- Assets.** Qualified sources include income from the transportation, processing, storage and production of minerals or natural resources. A large portion of MLPs operate oil, natural gas and refined product pipelines and storage facilities, which provide stable cash flow that support steady distributions that can be increased over time. Other types of MLPs include more volatile natural resource companies that have greater exposure to commodity prices, such as exploration and production and refining. Some of these MLPs have a variable distribution since cash flow can be unpredictable.
- Distributions.** MLPs pay quarterly distributions (similar to a dividend for a C corp) to both the general partner and limited partners based on the amount of distributable cash flow ("DCF," which is a non-GAAP financial measure generally defined as net income plus depreciation less capital expenditures required for maintenance activities). Unlike real estate investment trusts (REITs), which are required to distribute a certain percentage of their cash flow each quarter, the MLP partnership agreements determine the level of distributions. Generally, as DCF rises, the general partner receives an increasing percentage of DCF (typically up to 50%) through what is referred to as incentive distribution rights, or IDRs. On average, MLPs pay out between 80%-100% of DCF in distributions.
- Ownership.** Unlike corporations owned by shareholders, MLPs are owned by general and limited partners. General partners manage the partnership but have a very small ownership percentage (usually around 2%), whereas limited partners (i.e., the MLP unitholders) provide the majority of the capital but have no management role and have no voting rights.
- Tax Structure.** The major difference between a corporation and an MLP is the tax structure. A corporation is subject to income tax and when corporations pay dividends to shareholders, these dividends are taxed again at the shareholder level. MLPs, on the other hand, are not subject to corporate level taxation. Instead, income is passed through and

taxed at the individual income level. Because MLPs do not pay corporate tax, they have more cash flow available to distribute to unitholders. This is a key advantage for MLPs and is a contributing factor to their above-average yield. However, that advantage has decreased somewhat since the tax rates for C corps have been lowered.

Advantages of MLP Ownership

1) Yield -The Alerian MLP index yield is approximately 8.0% (as of January 3, 2023). This relatively high yield (**chart 1**) is a result of weakening demand for investment in oil and gas companies as investors look to address climate change and move toward a low-carbon future. It is important to note that this yield differs from a dividend yield because, for tax purposes, a portion of the yield is a return of the original investment. The portion of the distribution that is a return of capital will reduce the investor's tax basis (ultimately investors must recapture the previously deferred income as ordinary income, generally less a 20% deduction). Over time, yield can make up a large portion of total return. As shown on **Chart 2**, income makes up almost all of the total return for the Alerian MLP index and has underperformed both the sector and the broader U.S. equity market.

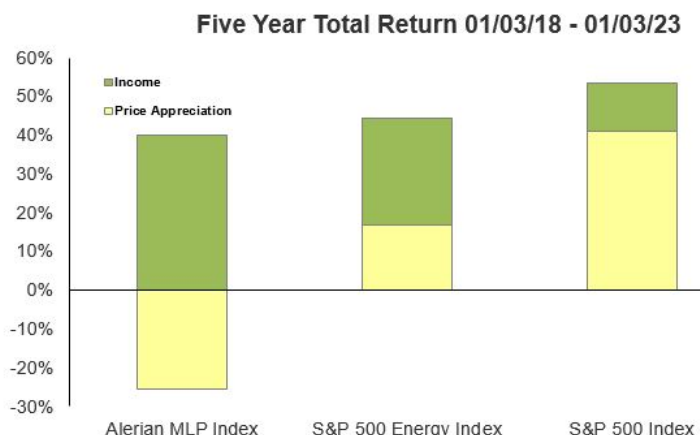
Chart 1



Source: FactSet data as of 01/03/23.

The Alerian MLP Index is a composite of approximately 30 MLPs weighted by market capitalization. The S&P 500 Index is based on the average performance of around 500 widely held common stocks. The S&P Real Estate Index consists of 32 REIT companies within the S&P 500 Index. The S&P Utility Index consists of 29 utility companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

Chart 2



Source: FactSet

The Alerian MLP Index is a composite of approximately 30 MLPs weighted by market capitalization. The S&P 500 Index is based on the average performance of around 500 widely held common stocks. The S&P Energy Index consists of around 30 energy companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

2) Partial Tax Deferral - Usually the majority of the distribution a unitholder receives is deferred for tax purposes until the MLP units are sold. The pass-through of partnership earnings increases the units' cost basis, while the cash distribution received is treated as a return of capital and lowers the units' cost basis. Typically, cash distributions exceed the pass-through of partnership earnings because high depreciation expenses lower partnership earnings. This results in a net reduction in the cost basis and a tax deferral on a significant portion of the cash distributions (on average 80%) along with a continuously declining cost basis. The table below shows an example assuming the investor buys one MLP unit for \$25 at the beginning of Year 1.

Table 1

MLP Example Assuming an Investor Buys an MLP Unit for \$25				
	Year 1	Year 2	Year 3	
Purchase 1 MLP Unit for \$25				
Cost Basis at Beginning of the Year	\$ 25.00	\$ 23.80	\$ 22.60	
Receive cash distribution of \$1.50/unit (assuming 6% yield)	\$ (1.50)	\$ (1.50)	\$ (1.50)	
Pass-through partnership earnings allocated to unitholder	\$ 0.30	\$ 0.30	\$ 0.30	
Net Change in Cost Basis	\$ (1.20)	\$ (1.20)	\$ (1.20)	
Adjusted Cost Basis at End of Year	\$23.80	\$22.60	\$21.40	

Source: Edward Jones

3) Estate Planning Advantages - From an estate-planning perspective, as is the case with other securities, the cost basis of an MLP is “stepped up” to fair market value upon the death of the unitholder.

Neither the estate of the unitholder nor the heir of the MLP units has to pay tax on the tax-deferred cash distributions received over time. While this is compelling, it is important to note that an acquisition of an MLP by another company could spoil one's plans to use the MLP units for estate-planning purposes.

4) A Possible Addition to a Diversified Portfolio- Many different asset classes are strongly correlated with the broader market. In the relatively short history of MLPs, MLP returns have revealed insignificant correlations with the market. Some MLP types have cash flows with the ability to remain consistent barring a physical product shortage. We believe that in some cases, adding an MLP allocation to a portfolio can help to reduce the overall risk of that portfolio.

Disadvantages of MLP Ownership

1) Fewer Governance Protections Compared With C Corps - There are several key governance differences between MLPs and C corps. MLPs are controlled by the general partner, which has a board of directors appointed by the entity that owns the general partner. Unlike C corps, there is no requirement for the board to have a majority of independent directors, and an annual meeting of unitholders is not required. Unlike shareholders of a corporation, limited partners do not elect the directors nor have approval rights on the issuance of additional equity. Unlike C corps, MLPs are not required to have compensation or governance committees. The management team and board of directors of a corporation have a fiduciary duty to shareholders. For MLPs, the partnership agreements state that no fiduciary duty is owed to unitholders. We think it is important for investors to be aware of this key difference between MLPs and C corps. While the general partner has no legal fiduciary duty to the limited partners, there is an alignment of interests between the two because both are incentivized to see distributions increase over time.

2) Part of Distribution Is a Return of Capital- While the yield on MLPs appears higher when compared with other equities, it is important to note that this yield differs from dividend yield. For tax purposes, a portion of the yield is a return of the original investment. The portion of the distribution that is a return of capital will reduce the investor's tax basis (if the investor sells shares, he/she would then have to recapture the previously deferred income and pay a

tax at his/her ordinary income tax rate). As long as the investor's cost basis remains above zero, taxes on the return of capital portion are deferred until the sale of units. If an investor's basis reaches zero, then future cash distributions will be taxed as capital gains in the current year.

3) Tax Complexity - When it comes to tax time, MLPs are complex. MLP investors receive a K-1 instead of the 1099 C corp investors receive, and may be required to file state tax returns in each of the states in which the MLP operates. Complexity is also added from the need to adjust the investment's cost basis from distributions. MLPs provide annual tax information packages to lessen the tax compliance burden, but tax preparation can still be complex, and we would suggest consulting a tax professional before investing in MLPs.

4) Taxed as Ordinary Income Upon Sale of MLP - Tax regulations require that, at the time of sale, the investor recapture the previously deferred income as ordinary income, which will be subject to the taxpayer's prevailing tax rate. This rate is usually higher than the long-term capital gains tax rate. Continuing our previous example, let's assume an investor purchased an MLP unit for \$25. At the end of year three, the cash distributions reduced the investor's cost basis to \$21.40, and the investor then sold the MLP for \$30. The investor would have \$5 of capital gain (the \$30 sale price less the \$25 original cost basis). In addition, the investor would have \$3.60 of ordinary income recapture on the previously deferred income (the \$25 original cost basis less the current cost basis of \$21.40). While there are current tax benefits, over a longer period of time these benefits may be partially offset by higher tax preparation expenses and the higher tax rate on ordinary income recapture upon sale of the investment. Tax laws allow for a deduction to individual MLP unitholders generally equal to 20% of the MLP's domestic income through 2025.

Table 2

Sale of MLP Units: Simplified Example	
Year 3: 1 MLP Unit Sale Price	\$30.00
Year 3 Adjusted Cost Basis (see table 1 above)	\$21.40
Total Gain (sale price less adjusted cost basis)	\$30.00-\$21.40 = \$8.60
Taxed at Capital Gain Rates (sale price less purchase price)	\$30.00-\$25.00 = \$5.00
Income Recapture taxed at Ordinary Income Rates (purchase price less adjusted cost basis)	\$25.00-\$21.40 = \$3.60

Source: Edward Jones

5) Investors Should Consult a Tax Advisor Before Buying MLPs in Tax-Deferred Accounts - MLPs

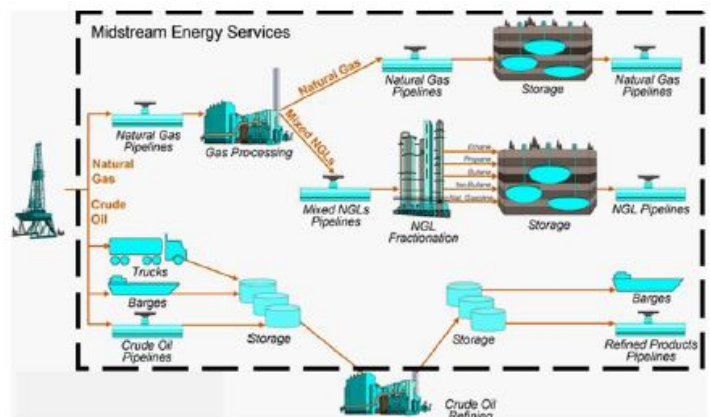
are allowed in tax-deferred accounts like IRAs, but we believe in most cases the tax restrictions make this undesirable. When held in tax-exempt accounts, tax regulations label income (not cash distributions) generated from MLPs as unrelated business taxable income (UBTI), and annually allow only the first \$1,000 to be tax-free with any remainder subject to tax. For this reason, and because MLPs already receive partial tax deferral, MLPs can be inappropriate in many cases for tax-deferred accounts like IRAs. **NOTE:** At Edward Jones, investors can no longer purchase MLPs in a retirement account.

Types of Energy MLPs

We believe that when purchasing MLP units, an investor should look for MLPs that own stable, long-term assets that can grow over time and have cash flow that is less directly exposed to commodity prices. MLPs that own midstream assets fit this profile. We are less favorable from a risk standpoint on MLPs whose underlying businesses include upstream operations, propane, shipping and coal.

Midstream. The most common types of MLPs are those involved in midstream activities. These activities primarily include the gathering and processing, transportation and storage of crude oil, natural gas and natural gas liquids and/or refined products (see Figure 1).

Figure 1 - Midstream Services



Source: Enterprise Products Partners LP

Pipeline and Storage - MLPs engaged in pipeline and storage activities are generally considered to have relatively stable revenues. Natural gas pipelines generally receive natural gas from gathering systems and deliver the gas over long distances to utility companies, industrial users or storage facilities. In

most cases, shippers must pay the pipeline owner for its reserved capacity regardless of usage. Because of this, natural gas pipelines often generate consistent cash flow. These pipelines are regulated businesses and are allowed to earn a predetermined return on investment to cover their costs plus a reasonable return.

Storage assets generally charge a fee to reserve capacity for a customer. While oil, refined products and natural gas liquids are stored above ground, natural gas is stored below the ground in depleted reservoirs or salt caverns.

Pipeline and storage earnings are not directly tied to commodity prices. However, there is indirect commodity price exposure because lower commodity price cycles can lead to lower demand for new capacity. Therefore, often times these types of MLPs may still move in line with commodity prices.

Gathering and Processing - Another type of MLP involved in the midstream process are those with gathering and processing as their primary businesses. Gathering pipelines are smaller pipes that move natural gas from wells to larger pipelines that transport the commodity over larger distances. Before the raw commodity is put into the long-haul pipelines, it is processed to remove impurities to meet requirements to travel in longer distance pipelines. Gathering and processing systems' cash flows are driven more by natural gas prices, which drive drilling activity.

The processing business is more sensitive to fluctuations in commodity prices, and there are several ways to structure the processing contracts. Fee-based contracts are based on the total amount of throughput and not the fluctuating price of the commodity. In a percent-of-proceeds contract, the MLP gathers and processes the natural gas on behalf of the producer and then sells the processed liquids at market rates. Based upon the agreed-upon contract, the processing plant keeps a percentage of the revenue and returns a percentage to the producer. The third type of contract is a keep-whole contract. In this case, the MLP gathers gas from the producer, processes it and sells the liquids. The processor then returns to the producer the original amount of natural gas or a cash value equivalent. Keep-whole contracts are the most profitable when natural gas liquid prices are high compared with natural gas prices, but are used less frequently by MLPs given the commodity price risk.

Other types of MLPs - Exploration, production, refining and propane MLPs are more directly sensitive to commodity prices. Because of this, the cash flow streams are more volatile than for more stable pipeline and storage businesses. Some of these MLPs have a variable distribution since cash flow can be unpredictable.

Rate-Making Policy Changes

In 2018, the Federal Energy Regulatory Commission (FERC, which regulates pipelines in the U.S.) revised a long-standing policy by announcing it would no longer allow pipelines held in a master limited partnership structure to recover an income-tax allowance for interstate pipelines with cost-of-service rates. This unfavorable ruling did not impact all MLPs to the same degree. However, those MLPs with a significant amount of cost-of-service rates potentially face the issue of lower cash flow from the policy change.

The FERC later softened its stance and the revised ruling stating a pipeline organized as an MLP is not required to eliminate its income-tax allowance, but instead can reduce its rates to reflect the reduction in the maximum corporate tax rate from 35% to 21%, if the MLP's income is consolidated on the federal income-tax return of a corporate parent. Alternatively, the MLP pipeline can eliminate its income-tax allowance along with its accumulated deferred income-tax (ADIT) balance used for rate-making purposes.

High Cost of Capital Leading to Restructurings

The majority of an MLP's cash flow is paid out in distributions to unitholders. Because of this, access to external capital is extremely important for an MLP. Acquisitions as well as organic investment are dependent on the MLP's ability to raise debt and equity from the capital markets. MLPs with investment-grade credit ratings have generally been able to access capital at a much lower cost, and that can lead to higher returns.

Over the past five years, the unit prices of many MLPs have significantly lagged the overall market as well as the broader energy sector. The MLP underperformance has been driven by a change in investor preference for self-funded capital-spending plans, which is contrary to the historical MLP model that relies on continued equity and debt issuance to fund growth in capital spending. In addition, distribution cuts by several MLPs have negatively impacted investor sentiment.

Given the underperformance, the yield of the Alerian MLP index is more than 600 basis points (6%) higher than the broader U.S. equity market. This higher cost of equity makes the MLP model less attractive as a source of funding, and, as a result, we have seen numerous transactions where MLPs are consolidated into their C-corp general partners or the MLP eliminates the general partner's incentive distribution rights in exchange for limited partnership units. Given the risk of lower cash flow and, in turn, rising leverage and lower distribution coverage from the 2018 FERC rate-making policy changes, we expect more MLPs either cut distributions, eliminate incentive distribution rights, or be acquired by the general partner.

While we expect additional restructuring in the MLP sector, there is no one solution that fits every MLP. We have seen several C-corp general partners acquire their underlying MLPs over the past several years. Others have eliminated their general partners' incentive distribution rights, which helps to address the high cost of equity capital. Some MLPs bought out their general partners years ago, which reduces the pressure to address the recent market weakness. In addition, MLPs that do not own interstate pipelines and are instead focused on natural gas and natural gas liquids gathering and processing, or refined product transportation and storage, are not impacted by the FERC policy change and may be less compelled to restructure. In addition to addressing the high cost of equity capital, benefits of restructuring include simplification and typically a stronger credit profile.

MLPs and Inflation

We believe that individual investors desire an increasing distribution from MLP holdings just as they do for utility stock holdings. A distribution that is increased consistently every year can help offset the impact of inflation over time. In addition, many pipelines have contracts that include inflation adjustments based on annual Producer Price Index (PPI). These types of investments should not be affected negatively due to inflation. While it has been stated by some that MLPs can act as defensive holdings in the face of inflation, we believe that it is difficult to tell exactly how MLPs react in high or low inflation environments because they have not been around long enough to live through many high inflation periods.

Major Risks in Owning MLPs

Like all investments, MLPs suffer from common potential risks like terrorism and a downturn in the economy; however, MLPs face many specific risks of their own. MLP-specific risks include legislative and tax changes affecting MLPs favorable tax status, a potential conflict between general and limited partner interests, permitting delays for new projects, environmental risk from pipeline spills, and the loss of access to capital markets, limiting the growth of MLPs. We also believe a rising interest rate environment could negatively affect MLPs. All of these risks have the potential to affect a partnership's ability to raise the distribution which we believe is the main driver for share performance.

Rising Interest Rates – As with most higher-yielding sectors, MLP units can be sensitive to interest rate increases and can decline in price with a rise in interest rates. Over the long term, inflation-adjusted tariffs as discussed above and distribution growth could mitigate the impact of higher interest rates.

Cash Distribution Cut - MLP distributions are not guaranteed and should not be viewed as a steady source of income as fixed-income securities. Cash distributions could be severely impacted by disruptions to business operations, lack of access to capital markets, or the inability of the MLP to find additional investment opportunities. Distribution cuts would not only significantly reduce the income stream, but also negatively impact the value of the MLP unit price, since its value is typically based on the amount of cash distributions. From 2014 through 2020, approximately 45 MLPs cut their distributions.

Guidance

There are many different types of MLPs. Broadly speaking, we believe MLPs are differentiated between those that have investment-grade debt and those with either noninvestment-grade debt or no debt rating. In our opinion, investors who want to invest in MLPs should be selective. We believe MLPs are more suitable for investors in higher income-tax brackets who are willing to assume the risks along with the tax-reporting burden. Additionally, given tax regulations, we do not believe MLPs are appropriate for tax-deferred accounts like IRAs in most cases.

We believe that investors who understand the risks and tax consequences involved and still seek exposure to MLPs would be best served to buy an

MLPs with stable midstream assets, less exposure to commodity prices, and a history of solid returns and distribution increases.

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