

**Statement of Bruce Heine, Director of Government Affairs, Magellan Midstream Partners
on behalf of the
National Association of Publicly Traded Partnerships**

**on
Energy and Tax Policy**

**Submitted to the
Subcommittee on Select Revenue Measures
of the House Committee on Ways and Means**

The National Association of Publicly Traded Partnerships (NAPTP) is pleased to have this opportunity to submit a statement for the record of the hearing on Energy and Tax Policy held by the Subcommittee on April 19, 2007. NAPTP, formerly the Coalition of Publicly Traded Partnerships, is a trade association representing publicly traded partnerships (commonly referred to as “master limited partnerships” or MLPs) and those who work with them.

Background

Publicly traded partnerships, for those unfamiliar with the entity, are exactly what their name suggests: large partnerships, or in some cases limited liability companies that have elected partnership taxation,¹ which are traded on stock exchanges. They were originally formed in the 1980s as a way for the energy and real estate industries to access capital from individual investors accustomed to the affordability and liquidity of publicly traded stock. Today they serve as the most efficient way of attracting capital to energy infrastructure such as pipelines, storage terminals, and processing plants.

In 1987, wanting to restrict the availability of PTPs to industries which had traditionally operated via partnerships, Congress enacted section 7704 of the tax code, which treats PTPs as corporations for tax purposes unless they earn primarily “qualifying” income. Qualifying

¹ Because the group includes publicly traded LLCs which are not, technically, master limited partnerships, we prefer to use the more inclusive term publicly traded partnerships (PTPs) rather than MLPs.

income under section 7704 includes real property rents, gain from the sale or disposition of real property, income and gain from commodities or commodity futures, and income and gain from mineral or natural resources activities, gain from the sale of stocks, interest, and dividends. It is the qualification for mineral and natural resources activities that has proven to be the most important.

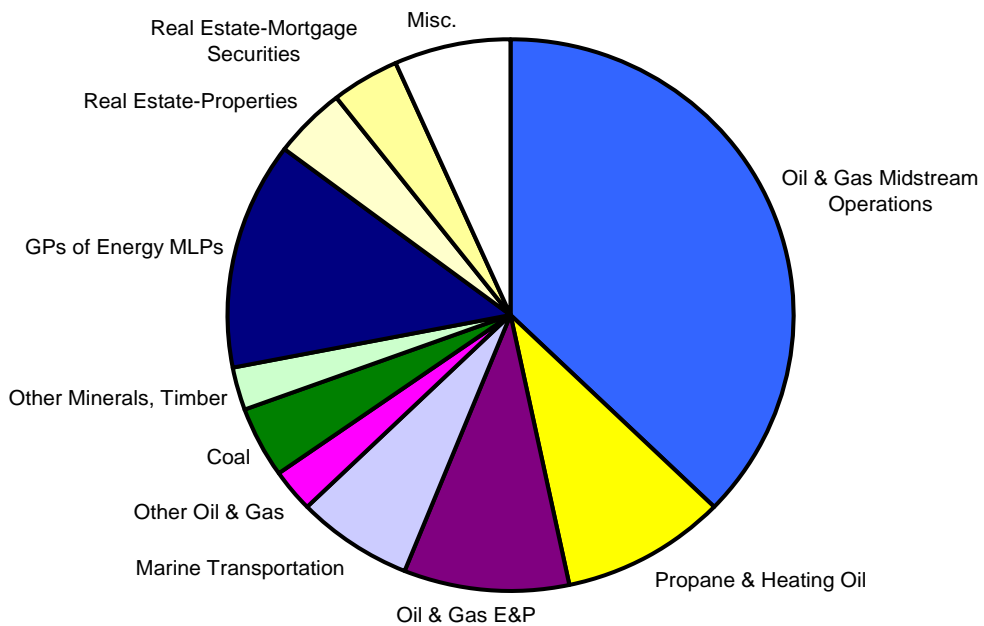
Qualifying natural resources activities include exploration, marketing, mining, processing, production, refining, storage, or transportation of any mineral or natural resource. “Mineral and natural resources” were defined in the Technical and Miscellaneous Revenue Act of 1988 as any product for which a depletion deduction is allowable under section 611, except for a) soil, sod, turf, water, and mosses, and b) minerals from sea water, the air, or similar inexhaustible resources.

As can be seen, the types of income that are qualifying are primarily those earned in energy and real estate activities. This was because companies in these industries had traditionally operated through partnerships and Congress felt that they should not make it more difficult for these industries, which are important components of the American economy, to raise capital.

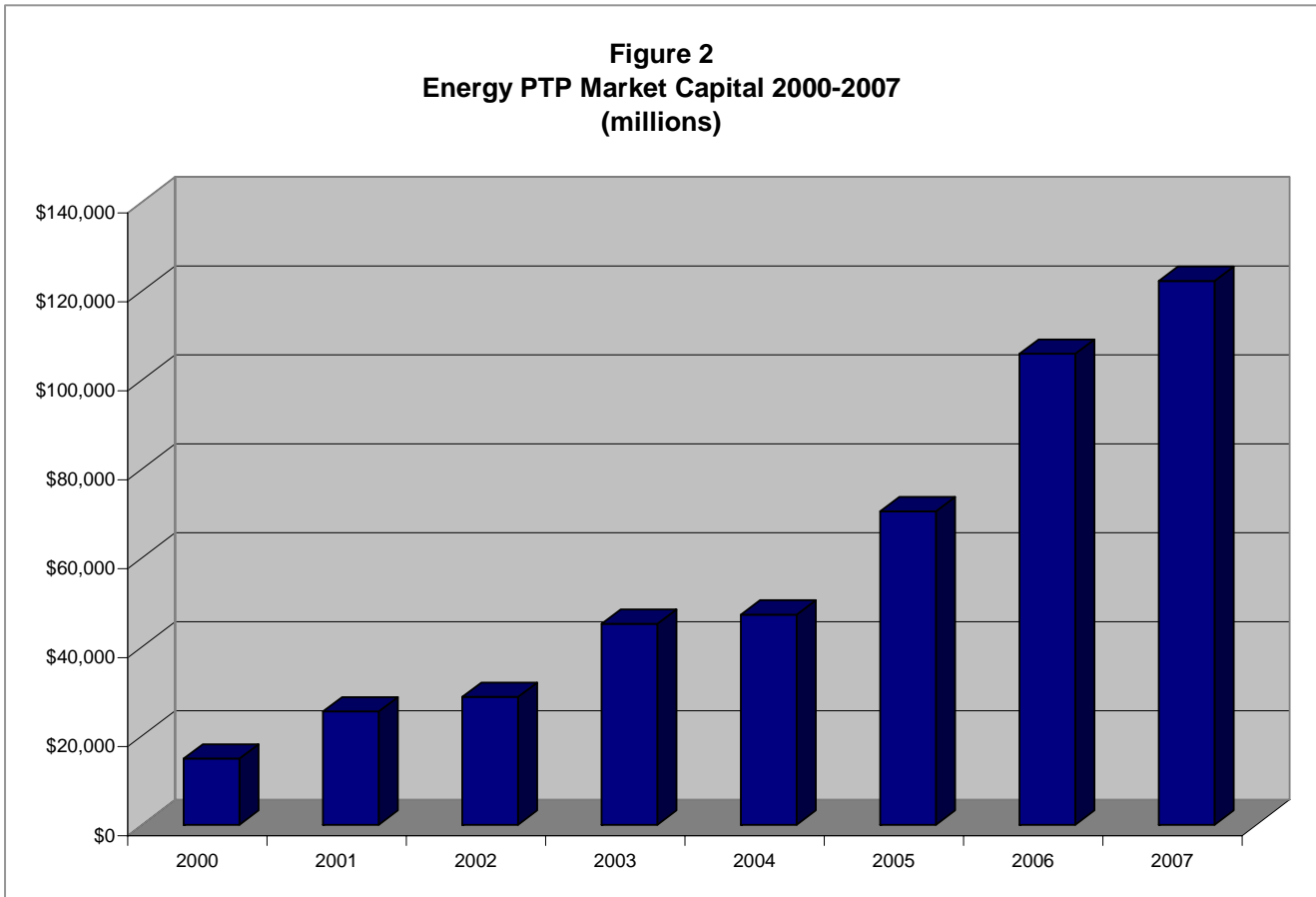
In the intervening years, as can be seen in Figure 1 below, the use of PTPs has largely shifted away from real estate and towards the energy industry, particularly midstream energy operations. Midstream operations are those occurring between the extraction of oil and gas from the ground and its delivery to the consumer: gathering, processing, refining, pipeline or marine transportation, etc. As this is written there are 75 PTPs trading on the New York, American, and NASDAQ exchanges. Some others trade over the counter or on pink sheets. Of the 75 traded on major exchanges, 52 are directly involved in energy (including coal) activities; another ten are

general partners of energy PTPs. Of these energy PTPs, 28 are engaged in gathering or long distance transportation of oil, gas, and refined products via pipeline; seven distribute propane and heating oil (one of the propane companies, Energy Transfer Partners, also owns pipelines); five are engaged in marine transportation of petroleum products; seven are engaged in exploration and production of domestic oil and gas; two perform other energy related services (refining and natural gas compression); three own coal properties; and ten are general partners of energy PTPs.

Figure 1
Publicly Traded Partnerships by Sector



Market capitalization of energy PTPs has grown from under \$5 billion in 1995, to \$15 million in 2000, to \$122 billion today, as shown in Figure 2.



PTPs and the Pipeline Industry

As noted earlier, the largest segment of the PTP universe consists of PTPs which own and operate energy pipelines. Over the past decade, the PTP share of the pipeline industry has steadily increased. According to Lehman Brothers, 48% of annual throughput of refined petroleum products goes through pipelines owned by PTPs. For crude oil, the figure is 25% and for interstate natural gas transportation, 18%--but transactions currently under consideration could raise that figure to over 60%. NAPTP estimates that today over 210,000 miles of intra-

and interstate gathering and transportation pipelines are owned and operated by PTPs.

Therefore, any consideration of pipeline transportation of energy products needs to take PTPs into account.

Why are pipeline assets moving into PTPs? In essence, because a number of corporations have concluded that in the current economic and regulatory environment investment in pipeline construction and maintenance is not the best use of their limited capital. The constraints on return imposed by rate regulation are part of the equation, but not the only part. Pipeline construction and acquisition require large amounts of capital which many energy companies, faced with decisions on how to best allocate limited resources, feel they could put to more profitable use. In addition, pipelines carry with them a number of environmental risks – mishaps can lead to expensive fines and litigation – which tip the risk-reward balance towards other investments. Therefore, a number of corporate energy companies—both major oil companies and smaller oil and gas producers--have divested themselves of their pipeline assets in order to focus their capital investment on assets that they feel will be more rewarding.

PTPs have moved to the forefront because they have proven to be an ideal vehicle for overcoming the downside of pipeline ownership and attracting investors to pipeline assets. Between rate regulation and market competition, the pre-tax return that pipelines can generate is limited, making after-tax return critically important. PTPs' flow-through taxation allows a sufficient after-tax return to make pipeline ownership a sound investment. Without PTPs, many pipelines would not be economically viable. With PTPs, pipelines can be very attractive to investors.

Pipeline PTPs pay reliable quarterly cash distributions, providing investors, particularly those looking for an income stream, with a higher return than they would receive from many

corporate stocks. Distributions are substantial not only because taxation occurs after the distribution of income to the investor rather than before, but also because the investor is considered to “earn” and must pay tax on his share of the PTP’s earnings regardless of whether they are distributed to him in cash. Partnership agreements therefore require that available cash be paid out to the partners. In addition, the cash distributions are very reliable because they are based on a steady stream of transportation fees and are largely insulated from the ups and downs of commodities markets. Whether the price of oil and gas goes up or down, the pipelines will receive their contracted fees.

There are other factors pointing to PTPs as a good location for pipeline assets. PTPs, unlike corporate energy companies, are limited by the tax code in the type of income-producing assets that they can hold. While corporations can diversify into a number of other, more lucrative investments if they wish, pipeline revenues are one of the very few types that a PTP can receive if it wishes to be taxed as a partnership. In addition, the PTP structure creates management discipline. Because PTPs must pass through their earnings to their unitholders, they do not have the option, as corporations do, of retaining earnings for future capital investment. Rather, they must go to the equity or debt markets for each major acquisition, which requires transparent public filings and provides added assurance that such transactions have been thoroughly scrutinized and make economic sense.

Need for Legislation

In 2004 Congress recognized the increasing importance of PTPs in building and operating the infrastructure needed to transport petroleum-based energy sources by making PTPs a qualifying investment for mutual funds.² Since then, it has become increasingly clear that we

² Section 331 of the American Jobs Creation Act of 2004.

need to build infrastructure not only to serve petroleum products but also to transport and store alternative energy sources such as ethanol and biodiesel.

The Energy Policy Act of 2005 required the United States to use 4 billion gallons of renewable fuels, including ethanol and biodiesel, in 2006, increasing to 7.5 billion gallons of renewable fuels in 2012, in order to reduce dependence on foreign oil. This year President Bush increased that goal, proposing a mandatory fuels standard to require 35 billion gallons of renewable and other alternative fuels in 2017. Like petroleum-based energy sources, these fuels will need to be transported from where they are produced to where they are consumed. This was recently recognized by the National Commission on Energy Policy, which listed among its recommendations in the area of biofuels “Address other hurdles to biofuels deployment, *including hurdles related to the deployment of critical supporting infrastructures (including gathering systems, distribution systems, and refueling facilities)* and compatible vehicle technologies.”³ [emphasis added]

Ethanol and biodiesel are currently transported primarily via rail, truck, and barges. Even at conservative estimates, rail and truck transportation results in millions of dollars of overspending when compared to relatively low-cost pipeline transport. Moreover, they are inefficient, using substantial amounts of energy themselves. Most importantly, our rail truck and barge capacity will be insufficient to meet the growing demand for alternative fuels. Pipelines are the obvious answer, but at this time there are some problems. Existing pipelines are viewed as unsuitable for ethanol or biodiesel transport because of several concerns:

- Ethanol is more corrosive than petroleum products and is likely to cause corrosion and possibly leaks in existing pipelines;

³ National Commission on Energy Policy, *Energy Policy Recommendations to the President and the 110th Congress*, April 2007, p. 8.

- Renewable fuels may pick up water and other impurities along the way;
- Locations of existing pipelines are based on where petroleum production occurs and not close to ethanol and biodiesel production;
- Historical low volumes have made investments in renewable fuels infrastructure cost-prohibitive.

If renewable fuels are to become an important part of the energy mix, this will have to change. First, research must be undertaken to solve the corrosion problem. Then pipelines and storage facilities must be retrofitted for ethanol and biodiesel; or new dedicated ethanol or biodiesel facilities must be constructed to take advantage of efficient pipeline transport—or both. Economic incentives are needed to make it worthwhile for pipeline companies and the alternative fuels industry to make that kind of investment.

One very simple way to provide such an incentive would be to amend the definition of qualifying income for PTPs in section 7704, which as noted earlier now includes only depletable resources, to add the transportation and storage of renewable fuels to the “natural resources activities” which qualify. This would be entirely within Congress’ intent of providing an incentive for desirable energy-related activities and will help address a critical issue that must be overcome if we are to meet our goals for the use of renewable fuels.