

A guide to investing in master limited partnerships

What you should know before your buy

Wells Fargo Advisors wants to help ensure that you are investing in the master limited partnerships that best suit your investment objectives, risk tolerance, time horizon, and diversification needs. This guide will help you better understand the features and costs associated with master limited partnerships, as well as how your financial advisor and Wells Fargo are compensated when you invest in them. As always, if you have any questions about your master limited partnership investments, please contact your financial advisor.

What are master limited partnerships?

Master limited partnerships (MLPs) are limited partnerships that are publicly traded on a securities exchange (i.e., NYSE, Nasdaq, and NYSE MKT) just like shares of corporate stock. However, MLP ownership interests are referred to as “units,” in contrast to corporate equity shares. The cash generated by MLPs is paid out to unit holders in the form of “distributions,” instead of dividends (which are paid out by corporations). In essence, MLPs combine the tax benefits of a limited partnership with the liquidity of publicly traded securities.

The limited partnership structure generally results in favorable tax treatment by avoiding the corporate income tax. Instead, taxes are paid (on a partially deferred basis) by the limited partner unit holders (i.e., MLPs are pass-through entities). Thus, unlike corporate stock, MLPs are not subject to double taxation on dividends.

To qualify as an MLP and to not be taxed as a corporation, a partnership must earn at least 90% of its income from qualifying sources as set forth in Section 7704(d) of the Internal Revenue Code of 1986. These qualifying sources include natural resource based activities such exploration, development, mining or production, processing, refining, transportation, storage, and marketing of any mineral or natural resource. The majority of MLPs operate in the energy sector, particularly in energy infrastructure industries such as pipelines.

Units in an MLP are offered through an initial public offering (IPO). In addition, the MLP may issue new partnership units via a follow-on offering under the shelf registration process. The net proceeds received are typically used for acquisitions, funding capital expenditures, repaying debt, providing working capital, or general corporate purposes.

Like individual stocks, MLPs can be bought and sold throughout the trading day at the current market value, which continuously fluctuates and reflects the value of each unit at any particular time.

Investment and Insurance Products are:

- Not Insured by the FDIC or Any Federal Government Agency
- Not a Deposit or Other Obligation of, or Guaranteed by, the Bank or Any Bank Affiliate
- Subject to Investment Risks, Including Possible Loss of the Principal Amount Invested

Classes of ownership

MLPs generally have two classes of owners, the general partner (GP) and limited partners. The general partner may be structured as a private or publicly traded corporation or other entity, typically controlling the operations and management of the MLP through an equity interest in the MLP (usually up to 2%), in addition to ownership of common and subordinated units. The limited partners provide capital through ownership of common units and have no role in the partnership's operations and management.

MLPs are typically structured such that common units and general partner interests have first priority to receive quarterly cash distributions. If the partnership agreement includes a clause for incentive distribution rights (IDRs), the general partner may be eligible to receive incentive distributions if the general partner operates the business in a manner which results in distributions paid per common unit surpassing specified target levels. As the MLP increases cash distributions to the limited partners, the general partner receives an increasingly higher percentage of the incremental cash distributions. IDRs have become less common in MLP structures as many partnerships have discontinued this practice due to a perceived conflict of interest between general partners and unit holders.

Types of MLPs

Due to the requirements of the tax code, the great majority of MLPs are in energy-related businesses. The vast majority of MLPs reside within the midstream sub-industry which gathers, processes, transports, and stores oil, natural gas, and refined petroleum products. There are also MLPs engaged in refining (downstream) and in the marketing and/or distribution of refined products including propane, as well as MLPs involved in coal leasing and mining, and marine transportation of petroleum products. In addition to Energy MLPs, there are some publicly traded partnerships in real estate, the investment industry, and various other businesses. For the purpose of this guide we focus on Energy MLPs.

Energy MLPs

Energy MLPs are engaged primarily in the production, processing, transportation, storage, refining, and marketing of energy-related natural resources. The assets owned by these MLPs include midstream, shipping, refining, marketing, and coal.

Midstream — Midstream MLPs encompass all aspects of the energy value chain except the production of oil and gas and the refining, marketing, and distribution of energy products to end markets. Midstream includes all types of commodities and encompasses the gathering and processing, transportation, and/or storage of crude oil, natural gas, natural gas liquids (NGLs), and/or refined petroleum products. Midstream MLP assets can be further categorized based on their position in the value chain. Integrated MLPs typically have broad exposure across the value chain while other MLPs are concentrated around a specific function. The three primary categories are:

- **Pipeline MLPs** — Pipelines can be interstate or intrastate, and either gathering or transportation of crude oil, natural gas, NGLs, and/or refined petroleum products. Pipelines can range in diameter from as small as four to six inches, to as large as 42 inches. Natural gas gathering pipelines consist of a network of small-diameter (four to six inches) pipelines that collect and transport raw natural gas to a central delivery point for transport to a processing and treating facility or directly to the pipeline system. Onshore domestic crude oil production is collected via gathering lines. Transportation pipelines receive supply from gathering systems and/or other pipelines, and deliver it to industrial end users, utility companies, storage facilities, or other pipelines. Interstate and intrastate pipelines transport commodities via larger pipeline systems (pipelines as big as 42 inches in diameter).
- **Natural Gas Gathering and Processing** — plants typically receive nonpipeline quality natural gas via a gathering system. They separate pipeline quality natural gas for transportation on interstate and intrastate natural gas pipelines from raw NGL product mix for transportation on NGL pipelines to fractionation facilities and ultimately, petrochemical plants. NGL fractionation is the process of separating raw NGL mix produced by natural gas processing plants into discrete NGL purity components.
- **Storage/Terminals** — MLPs storage operators handle various commodities including natural gas, crude oil, refined products, and NGLs. They typically derive a majority of their revenue from fee-based contracts, while a smaller amount is generated by throughput fees and optimization businesses. Terminal operators provide storage, distribution, blending, and other ancillary services to pipeline systems. Cash flows generated by terminals are typically affected by the amount of products stored/handled.

Shipping — Shipping MLPs transport bulk commodities via tankers, barges, and dry bulk vessels. Products shipped on tankers typically include crude oil, as well as refined petroleum products and by-products such as gasoline, heating oil, diesel fuel, jet fuel, lubricants, asphalt, fuel oil, sulfur, petrochemical and commodity specialty products, and liquefied natural gas (LNG). Dry bulk vessels primarily carry iron ore, coal, grains, and minor bulk commodities such as steel, fertilizer, and potash. Shipping partnerships are subject to various governmental and industry safety regulations, depending on the type of vessel and location.

Shipping and marine transportation services are typically performed under spot and term contracts set under a competitive bidding process. The rates charged under these contracts can be based either on a daily basis or on a volume-transported basis. Shipping contracts can vary in length depending upon the type of ship and operating market.

Coal — Coal MLPs consist of coal-producing or coal royalty businesses. The royalty-oriented partnerships enter into long-term leases that provide the coal operators the right to mine coal reserves on the partnerships' properties in exchange for royalty payments. The coal-producing MLPs actually mine raw coal, negotiate contract terms, and/or own the reserves.

Features and characteristics

The majority of MLPs are involved in the energy industry. Most own assets that handle various commodities for a fee. Because of this fee-based nature of their businesses and lack of corporate-level taxes, MLPs may pay out the majority of cash flow to limited partners in the form of quarterly distributions. However, some MLPs are involved in more commodity-sensitive or cash flow-variable businesses, such as oil and gas production, processing, refining, shipping, and coal — which may have an impact on the variability of the distributions paid.

MLPs also offer the following features to investors:

Structure — The partnership structure of most MLPs results in favorable tax treatment due to the avoidance of double taxation. In addition, the regular quarterly cash payments MLPs pay out are known as distributions rather than dividends. For tax purposes, the MLP distributions are reported to investors in a Schedule K-1 in lieu of a Form 1099 (as is the case when companies elect corporate status).

Form 1099 vs. Schedule K-1 — However, a small number of MLPs, namely Marine MLPs and publicly traded general partner MLPs, choose to be taxed as corporations instead of as MLPs and hence will issue a Form 1099 instead of a Schedule K-1. By choosing to be taxed as corporations, these companies forgo the “qualifying sources” requirement. In the case of the Marine MLPs, classifying as a partnership and/or limited liability company provides the entity a tax exemption within the country of domicile (for the most part, the Marshall Islands).

Income — For investors seeking current income, MLPs may offer an attractive yield relative to alternative investments.

Buying and selling flexibility — You can typically buy or sell MLPs on a stock exchange much like the purchase or sale of any other listed stock.

Risks

An investment in MLP units involves certain risks which differ from an investment in the securities of a corporation. Holders of MLP units have limited control and voting rights on matters affecting the partnership. In addition, there are certain tax risks associated with an investment in MLP units and conflicts of interest may exist between common unit holders and the general partner, including those arising from incentive distribution payments. The risks associated with an MLP are outlined in the prospectus. You should carefully consider the risk factors listed below.

Not all MLP assets are created equal — A large-diameter pipeline (30 inch pipelines) transporting product across the United States is generally a consistent cash flow generating asset due to inherent advantages; lowest cost, not easily replaced, not dependent on commodity prices, etc. A small-diameter (4 inch) pipeline connected to a natural gas processing plant is a more risky asset because production is subject to natural declines and commodity prices.

Conflicts of interest with the general partner — For certain MLPs, the GP of the partnership and the parent company that owns the GP are controlled and run by the same management teams. Some potential areas of conflict include the price at which the MLP is acquiring assets from the GP, as well as the potential incentive to raise the distribution in the near term (through IDRs), possibly with long-term negative implications. In addition, in many instances the investment banks sponsoring a new MLP deal may have made direct investments in the MLP at either the GP or LP level. These direct equity investments (especially at the GP level) could potentially create a conflict between the sponsor's due diligence obligations as an underwriter and their financial interests as an investor. Furthermore, offering proceeds are frequently applied to repaying loan obligations to the underwriting firms. This use of proceeds creates a similar potential for conflicts of interest.

Interest rate risk — A rising interest rate environment could adversely impact the performance of MLPs. Rising interest rates could limit the capital appreciation of equity units of MLPs as a result of the increased availability of alternative investments at competitive yields with MLPs. Rising interest rates also may increase an MLP's cost of capital. A higher cost of capital could limit growth from acquisition/expansion projects and limit MLP distribution growth rates.

Investment and market risk — The value of an MLP may increase or decrease in value, sometimes rapidly and unpredictably. The units at any point in time may be worth more or less than the original investment, even after taking into account distributions.

Legislative risk — One of the most attractive characteristics of MLPs is the tax treatment of this asset class. The tax advantage is based on partnership avoidance of double taxation of dividends. If MLPs were no longer able to pass through taxes to limited partners a large benefit of investing in MLPs would be removed. Moreover, discussion around carried interest, derivative legislation, and cap and trade could also result in headline legislative risk.

Regulatory risk — Many pipelines are regulated by the Federal Energy Regulatory Commission (FERC), which sets tariff rates on these systems. The FERC also hears all tariff disputes arising between pipeline operators and shippers. If the FERC rules against pipeline MLPs or lowers tariff rates, MLPs' cash flow performance over the long term could be adversely affected. Stricter laws, regulations, or enforcement policies could be enacted in the future which could potentially increase compliance costs and may adversely affect the financial performance of Energy MLPs.

Commodity price risk — Energy MLPs may be directly affected by commodity prices, especially those which own the underlying energy commodity or receive payments for services that are based on commodity prices. Such impact may be a result of changes in the price for such commodity or a result of changes in the price of one energy commodity relative to the price of another energy commodity (i.e., the price of natural gas relative to the price of natural gas liquids). In addition, a prolonged depressed commodity price environment could trigger lower volumes pushed through the midstream infrastructure as a result of commodity price-driven production cuts at oil wells.

Field Decline Rate Risk — Energy MLPs may be affected by an unexpectedly steep decline rate of oil and natural gas fields serviced by its pipelines. As such, fee-based pipeline contracts, based on the amount of oil and gas produced, are still subject to volumetric risk.

Access to capital markets — Because MLPs pay out virtually all of their cash to unit holders, they must continually access the debt and equity markets to finance growth. A dislocation in either of these markets could reduce a partnership's ability to increase distributions, as their cost of capital would become more expensive on the margin.

A severe economic downturn — Energy demand is closely linked to overall economic growth. A severe economic downturn could reduce the demand for energy and commodity products, which could result in lower earnings and cash flow.

Environmental incidents and terrorism — Many MLPs have assets that have been designated by the Department of Homeland Security as potential terrorist targets, such as pipelines and storage assets. A terrorist attack or environmental incident could disrupt the operations of an MLP, which could negatively affect cash flow and earnings in the near term.

Tax treatment

Because most MLPs are treated as a partnership and not a corporation for federal income tax purposes, an MLP incurs no income tax liability and does not pay corporate-level federal income taxes. Partners in an MLP (the limited partner unit holders and the general partner) are required to take into account their allocable share of the partnership's income, gains/losses, deductions, and other factors. The amount of taxes a limited partner unit holder pays is determined by several factors, including the investor's percentage ownership in the partnership, the date of the investment, and the price paid.

Because most MLPs are partnerships, investors receive Schedule K-1s instead of 1099s for tax reporting. The K-1 is prepared by the entity to distribute to owners/shareholders to outline their portion of the income, loss, and deductions. Each separate MLP investment will generate its own K-1. The investor pays tax on the portion of net income allocated to him or her at his or her ordinary income tax rate. If the partnership reports a net loss (after deductions), it may be considered a "passive loss" under the tax code and may not be used to offset income from other sources. However, the loss can be carried forward and used to offset future income from the same MLP. Generally, K-1s are distributed between mid-February and early April. K-1s may also be available on an MLP's website.

Since MLPs generate unrelated business taxable income (UBTI), tax-exempt investment vehicles such as pension accounts, 401Ks, individual retirement accounts (IRAs), and endowment funds do not typically own MLP units.

As previously mentioned, there are a small number of MLPs, namely Marine MLPs and publicly traded general partner MLPs, which choose to be taxed as corporations. Investors should determine the entity's tax treatment before investing in MLPs.

Neither Wells Fargo Advisors nor your financial advisor can offer tax, legal, or accounting advice. As a result of potentially complex tax-reporting requirements, investors should consult with their tax advisor or attorney before investing in MLPs.

Costs of investing in MLPs

You will pay a commission (or sales concession) each time you buy or sell shares in an MLP. In the primary market, a sales concession is built into the purchase price. When you buy or sell an MLP in the secondary market, you incur a commission as a cost of processing each transaction.

Advisory accounts are fee-based accounts in which clients may be charged a fee on the underlying assets. It is also possible to own MLPs through discretionary and nondiscretionary investment advisory programs. Instead of paying a sales charge or commission on each transaction, you may pay an annual fee, billed quarterly in advance, that is based on a percentage of the account's value.

MLP ETPs carry investor fees not associated with an individual MLP and are subject to the same risks associated with MLPs. Contact your financial advisor or reference *A Guide to Investing in Exchange Traded Products* at wellsfargoadvisors.com/guides for more details regarding risks, costs, and compensation on exchanged traded products.

Investor characteristics

MLPs are not appropriate for all investors. Like all investments, MLPs have their own risk/reward propositions. Investors should consider their risk-tolerance level and make investments accordingly. Selecting an MLP for your investment objectives involves a number of factors unique to each MLP being considered. You should review an MLP's prospectus to fully evaluate your options. You should also talk with your financial advisor, so that together you can make the choices most appropriate for you.

Diversification — Wells Fargo Advisors believes that investors should diversify their investments. Investors should observe an asset allocation strategy and not concentrate their overall portfolio in any one class, or sector of securities. Although asset allocation can be an effective investment strategy, it cannot eliminate the risk of fluctuating prices, yields, and uncertain returns.

How your financial advisor and Wells Fargo Advisors are compensated on MLPs

For helping you invest in an MLP, Wells Fargo Advisors and your financial advisor are compensated in ways that vary depending on the selected investment. Your financial advisor will receive compensation in the form of a commission from most transactions.

For most purchases, a financial advisor's compensation is based on the dollar amount purchased or sold in the MLP transaction. In certain fee-based accounts, a financial advisor's compensation is based on a percentage of assets in the account. The compensation formula that determines the amount of payment to your financial advisor is generally the same for all MLPs.

Additional information

To learn more about MLPs, ask your financial advisor or visit the following websites:

Wells Fargo Advisors
wellsfargoadvisors.com

Financial Industry Regulatory Authority
finra.org

U.S. Securities and Exchange Commission
sec.gov

Securities Industry and Financial Markets Association
sifma.org

In addition to receiving compensation, your financial advisor may receive internal credits in the syndicate allocation process for sales in MLPs and other products. Financial advisors may receive allocations of new syndicate deals based on the number of internal credits accumulated. For example, a financial advisor accumulating a large number of internal credits based on past sales of those transactions may receive a greater allocation of a new syndicate issue than a financial advisor with fewer credits.

Within the division that operates in Wells Fargo financial centers and some Wells Fargo stores, a licensed banker may refer you to a financial advisor, as they generally work as a team. In this case, the licensed banker will be compensated through a referral arrangement with the financial advisor.

Wells Fargo Securities, LLC (WFS) may receive compensation for making a market and keeping an inventory in the common stock of select MLPs. WFS or its affiliates may receive compensation for investment banking services of select MLPs.

Talk to your financial advisor

Determining whether MLPs are an appropriate investment strategy for you requires an in-depth evaluation of your individual financial situation and the objectives you want to achieve. Talk to your financial advisor today about how MLPs may help you work toward your investment goals.

We have a responsibility to consider reasonably available alternatives in making a recommendation. We do not need to evaluate every possible alternative either within our products or outside the firm in making a recommendation. We are not required to offer the “best” or lowest cost product. While cost is a factor that we take into consideration in making a recommendation, it is not the only factor.

You should consider factors such as those below prior to accepting a recommendation:

- The potential risks, rewards, and costs in purchasing and in the future selling of a security.
- Your age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance.
- The security’s investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions.
- For complex products, you should consider whether less complex or costly products achieve the same objectives.

By accepting a recommendation, you acknowledge that you have considered the above factors to your satisfaction.

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