

THE EFFICIENCY OF MASTER LIMITED PARTNERSHIPS
AS INVESTMENT VEHICLES RELATIVE TO
THEIR PARENT COMPANIES

by

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ABSTRACT

This study focuses on the performance of oil and gas MLPs and their parent companies. MLPs are a unique asset class in the investment space due to their unique structure as well as their connection to their sponsor, or parent company. While these companies have a relationship, shares of both companies are separately traded in equity markets. The goal of this study was to analyze how these two asset classes performed comparatively, how various MLPs and their corresponding parent companies performed relative to each other, and whether investors would have been better off investing in MLPs or the C-Corporations.

This study will use historical returns, dividend distributions, as well as various statistical and financial metrics to address these questions. This study will examine five MLPs and their five corresponding parent companies, in order to measure performance of the two groups as well as the performance of the individual MLP-parent company “pairs”.

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INTRODUCTION

Master Limited Partnerships (“MLPs”) are a limited partnership structure commonly used by oil and gas companies. This structure of MLPs creates a limited partner and general partner relationship between the parent company and the MLP. As a result, shares of both the MLP and the parent company are able to be publicly traded, and investors are able to invest in the MLP and/or the larger corporation. MLPs exist in a variety of industries; however, one of the most common, and the focus of this study, will be oil and gas MLPs. In the oil and gas industry, the MLP owns assets or business lines that are dropped down by the parent company. When valued and selected correctly, MLPs can provide investors with significant income as well as various tax benefits which makes these securities intriguing to investors. Thus, it is important to be able to understand the overall structure of this asset class as well as how to properly evaluate these securities, especially in relation to their parent companies.

The MLP structure was initially created by the U.S. Government in an effort to stimulate additional investment into energy infrastructure. Currently, MLPs are utilized by companies to allow investors to invest through public markets in a specific portfolio of assets the larger company owns, but drops down to the MLP. The parent company often drops down assets that they feel will realize additional value outside of the parent company or that they view as having significant stand-alone growth potential.

Since the genesis of MLPs in 1981, the structure has been utilized by many companies in the oil and gas industry as well as other industries. However, this increased use also brought increased regulation to the industry and has caused MLPs to evolve since their creation. Market views on MLPs have fluctuated over the years, primarily corresponding with expectations of crude oil production and natural gas production, as these are key drivers of cash flow for MLPs.

The outlook for the MLP market is positive for the next two to three years, which makes this asset class especially interesting to study in the coming years. MLP EBITDA is expected to increase to roughly \$50 billion in 2019 and \$54 billion in 2020, representing a 10% compound annual growth rate (Goldman Sachs Asset Management, 2019, p. 6). Because this asset class is expected to perform well in the coming years, I wanted to analyze how MLPs performed relative to their parent companies historically.

According to The Tax Magazine, by “using this hybrid structure, investors in a natural resources MLP really can have ‘the best of both worlds’” (Henzler & Milani, p.56). While this structure sounds very attractive, investors’ primary consideration when evaluating equity investments are returns and performance. Consequently, in this study I focused on the performance of MLPs over a given time period relative to their parent companies in order to determine if there was a distinct financial benefit to investors provided by the properties and structure of MLPs.

LITERATURE REVIEW

MLP Structure

In order to understand and invest in MLPs it is important to understand the various structural features of this unique asset class. The overall structure of MLPs feature components of common equity issued by a corporation as well as a partnership. The partnership is formed between the general partner (the corporation or parent company that forms the MLP) and the limited partner. The general partner typically owns a small percentage of the MLP (usually 2%) and the rest of the MLP is owned by the limited partners in the form of “common units”

(Ciccotello & Muscarella, 1997). The limited partners are individual or institutional investors who have purchased units of the MLP, as well as the parent company through its 2% stake (Maresca, Santiago, Kad, & McIntosh, 2011, p. 3). The first MLP was created in 1981, but due to the tax benefits that this structure provided in comparison to a traditional corporation, many companies across a wide spectrum of industries formed MLPs. To combat this problem, the U.S. introduced the Revenue Act of 1987, which restricted the formation of MLPs, with a few exceptions. Section 7704 (c) states “a partnership meets the gross income requirements for any taxable year if 90% or more of the gross income of such partnership for such taxable year consists of qualifying income” (Cornell Law School Legal Information Institute). Furthermore, subsection (d) (e) of this act clarifies that the income generated by the MLP must be “derived from the exploration, development, mining, or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource” (Cornell). These subsections created the legal framework of today that MLPs operate under that at least 90% of the entity’s income must be generated from one of the specified activities (Pickle, 2009, p. 9).

As a result of the revenue generating activity restrictions of the Revenue Act of 1987, companies within the energy sector make up the vast majority of MLPs today. This is evidenced through the continued high concentration of energy focused MLPs within the MLP universe; 80% of the roughly 90 publicly traded MLPs generate income from natural resources (Maresca, Santiago, Kad, & McIntosh, 2011, p. 3).

Oil and gas MLPs own a variety of assets, the most common of which are midstream pipelines and infrastructure. In addition, MLPs also own exploration & production assets, as well as downstream transportation infrastructure (Goodgame, 2005). Because MLPs generate

income passively, they acquire their portfolio assets through drop-downs from the parent company. These transactions are initiated when the parent company and the MLP decide to engage in the drop-down of a specific asset. The asset is then sold at an agreed upon price, often requiring a fairness opinion performed by an independent valuation firm. The MLP then finances the transaction usually through a combination of either cash, equity, or debt and pays the parent company (Alerian, 2018). Drop-down transactions are viewed favorably by investors, as this drives additional growth for the MLP in addition to its organic growth. Additionally, these transactions allow the MLP to realize the value of the asset, while the parent company is able to maintain control and will likely reap the benefits through the future distributions that they receive (Rutenberg & Greenblatt, 2015, p. 50).

Tax Treatment of MLPs

One of the benefits that makes investing in MLPs attractive to investors is the advantageous tax policies they benefit from. As previously stated, an MLP combines features of both a corporation and a partnership. The primary benefit related to the partnership features of this structure derive from its status as a flow-through entity. As a unitholder of an MLP, you are required to pay taxes based on your income and distributions from the investment, but the organization does not pay taxes on its own income. This allows MLP's to eliminate the double taxation investors in a C-Corporation experience, which occurs when the corporation pays taxes on its income and the individual shareholders pay taxes on their capital gains and dividends (Terando & Omer, 1993, 23). As a flow through entity, the tax obligations flow through to the unitholders. The result of this is that MLPs are able to pay larger distributions because they are not being taxed on their income. For unitholders, cash distributions from the MLP are classified

as “return on capital”, which means that that they reduce an individual’s tax basis, but do not qualify as gross income for federal income taxes (Henzler & Milani, 2005, p. 56).

The benefit of the tax laws applicable to MLPs in comparison to a corporation are easily displayed through the following cash flow calculations for a shareholder of a corporation and a unitholder of an MLP (Collins & Bey, 1986, p. 7)

Shareholder Cash Flow:

$$CF_S = [EBT(1-t_c) - RE](1 - t_p)$$

Unitholder Cash Flow:

$$CF_u = EBT(1-t_p) - RE$$

Although the cash flow to the shareholder or unitholder depends on the corporate tax rate as well as the marginal tax rate for the individual, these equations show the presence of double taxation for shareholders of corporations and the potential tax-related advantage investors can obtain from investing in an MLP.

Incentive Distribution Rights

One of the primary benefits for general partners in forming an MLP is the cash flow they receive through incentive distribution rights (IDRs) paid by the MLP to the sponsor. Because MLPs recognize the importance of this to investors, most MLPs pay out a high percentage of their cash flow to investors and hold small cash balances. IDRs are similar to dividends paid by a public corporation to its shareholders, but differ slightly in structure. As the MLP increases its cash flow the general partner has the right to a higher share of the distributable cash flow through

a defined structure (Ciccotello, 2011, p. 87). Consequently, as the limited partner’s incremental cash flow increases, the GP begins to take a higher percentage.

This structure creates “tiers” or “splits” that create various thresholds for the MLPs distributions to its unitholders. The “tier” that an MLP’s quarterly distribution falls into determines how much of the distribution the general partner is entitled to. At the lowest tiers (if the MLP pays a small distribution) the vast majority of the distribution is paid to the common unitholders; however, if the MLP pays a higher distribution, the general partner is paid a greater percentage of the incremental increase in distribution from one tier to the next. It is important to emphasize that the general partner’s share of the distribution only grows as the company reaches higher tiers, and this higher percentage only applies to the the incremental increase in distribution from one tier to the next (Moreen, Walter, Morris & Brazinski, 2003, p. 10)

Because this can be difficult to visualize, below I have included a diagram showing an example of the IDR structure between a hypothetical LP and GP using hypothetical distribution thresholds of \$.5 for simplicity and LP/GP distribution percentages that are common within the industry. For MLPs on the market, the tier levels and distributions percentage between GP and LP are distinct to each company and outlined explicitly when the MLP is initially formed.

	Distribution to Common Unitholders			GP	Total
	LP Share	GP Share	Distribution	Distributions Paid by MLP	
Minimum Quarterly	\$0.50	98%	2%	\$0.01	\$0.51
Tier 1	\$1.00	98%	2%	\$0.01	\$0.51
Tier 2	\$1.50	85%	15%	\$0.09	\$0.59
Tier 3	\$2.00	75%	25%	\$0.17	\$0.67
Tier 4	\$2.50	50%	50%	\$0.50	\$1.00
Totals				\$0.78	\$3.28

The above example displays the general partner's increased share of distributions as the company reaches a higher distribution to its common unitholders. At the bottom tiers, the general partner's distribution is very small, but increases rapidly once they reach Tier 4 and are entitled to 50% of the incremental increase in distribution. One of the primary reasons for this structure is to ensure that the interests of the GP and LP are aligned. The GP is paid a higher distribution when the MLP is able to pay a higher distribution to its common unitholders, so the GP is incentivized to manage the MLP as efficiently as possible.

MLP Valuation

Due to the differences in structure and investor preferences between C-Corporations and MLPs, these assets should be valued slightly differently. One valuation difference between MLPs and their parent companies is that MLPs often have a lower cost of capital than their parent (Congressional Research Service, 2011, p. 2). Also, a study conducted by David Denis and Atulya Sarin, concluded that the net tax advantage of S Corporations (MLPs) must be accounted for when valuing an MLP relative to a C-Corporation. Additionally, the valuation of these assets is affected by the company's payout ratio, the marginal corporate tax rate, the capital gains realized by the investor, and the marginal tax rate of an individual investor. Based on their study, they concluded that the value of an MLP would be greater than the valuation of a C-Corporation if the two companies were similar in performance, capital structure, and dividend payout. Additionally, they found that the primary reason for this premium on MLPs came from the net tax advantage they possessed relative to C-Corporations (Dennis & Sarin, 2002, p. 14).

MLPs are also valued differently than C-Corporations for individuals based on their individual marginal tax rates. Because of the tax laws enacted in 2017, investors in MLPs are able to defer a portion of their income from the MLP to a later year (Gordon, 2018, p. 20). However, an investor's evaluation of an investment in an MLP will depend on his or her personal preference for the timing of their tax payment (Saporoschenko & Stowe, 2012, p. 11). As previously stated, because MLP distributions are classified as "return on capital", they are deducted from an investor's costs basis (the amount they initially paid for the shares) then taxed as capital gains when the investment is sold (Hetherington & Hurley, 2015, p. 12). If an investor holds the MLP shares until the cost basis become zero, then a majority of the deferred tax is taxed at long-term capital gains rates and some will be taxed at ordinary income rates. Because the long-term capital gains tax rates are lower than ordinary income tax rates, the investor is able to pay less from a monetary standpoint in the long run through holding the MLP shares for a significant amount of time (Toolson, 2016, p. 41). However, an investor may decide that they would rather pay taxes on distributions gradually to avoid a larger tax obligation in the future; thus, making a C-Corporation a more valuable investment (Shaw, 1991, p. 756).

DATA AND METHODOLOGY

My goal of this study is to determine how MLPs and their parent companies performed during the sample period and whether investors were better off investing in a portfolio of MLPs or a portfolio of their corresponding parent companies over a certain period of time.

Methodology Process

- Calculate weekly price returns for MLPs and their parent companies
- Calculate the difference between the price return of the MLP and the parent company
- Calculate total returns (including dividends) of individual MLPs and parent companies
- Create equal weighted portfolios of MLPs and parent companies
- Analyze total return of the MLP portfolio and the parent company portfolio
- Examine other metrics to compare the two sets including dividend yields, correlation, and a t-test
- Formulate conclusion

Sample

In order to create a sample to compare the returns and efficiency of MLPs relative to their parent companies, I created a set of MLPs and a set of their corresponding parent companies. Because MLPs have currently and historically been predominantly utilized by oil and gas companies in the midstream and downstream sectors, I focused on these subsectors for my sample. In order to ensure that these companies were comparable, I selected companies of similar scale and analyzed them over a consistent time period. Because oil and gas companies commonly create an MLP then later repurchase its shares, it was important to select companies that had MLP shares outstanding for a significant amount of time. Additionally, it was important that the MLPs and their parent companies operated in the same sector and were similar in terms of scale and competition. Based on these parameters, I created the following peer sets:

MLP Set

- Valero Energy Partners (VLP)
- Phillips 66 Partners LP (PSXP)
- Holly Energy Partners (HEP)
- MPLX LP (MPLX)
- Shell Midstream Partners LP (SHLX)

C-Corporation Set

- Valero Energy Corporation (VLO)
- Phillips 66 (PSX)
- HollyFrontier Corporation (HFC)
- Marathon Oil Corporation (MPC)
- Royal Dutch Shell (RDSA)

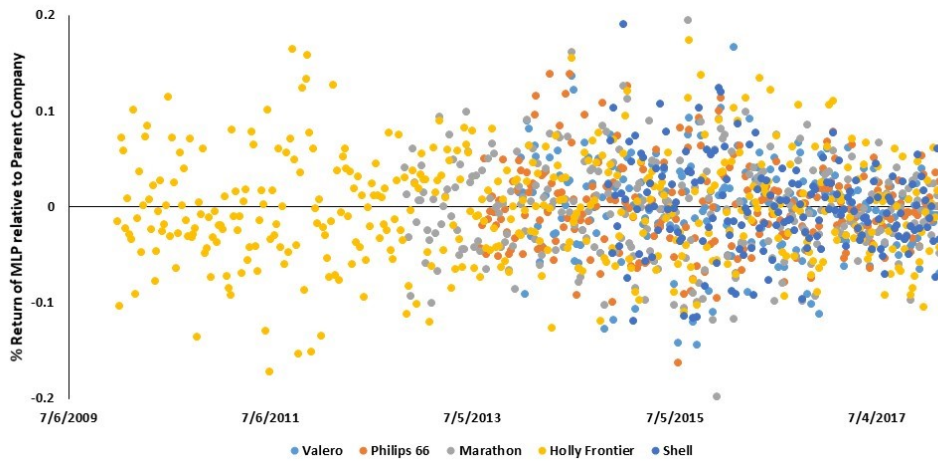
Data Results

For the data I collected, I analyzed it both on a set and pair basis, meaning I compared the results of the MLP set to the C-Corporation set as well as each “pair” of individual MLPs and their corresponding parent companies. I first calculated the weekly stock price returns for all of the MLPs and the C-Corporations in the two sets in order to examine how the stocks performed. I included stock returns for the MLPs and C-Corporations over the last ten years in my data set; however, because companies within both sets began trading in public markets at different times, I compared the data during the period that all of the equities were publicly traded to ensure consistency with the data.

Relative Performance of MLP-Parent Company Pairs

After computing the weekly returns of the MLPs and the C-Corporations, I compared the weekly performance of the MLPs relative to their corresponding parent companies. The results

of the relative weekly returns of MLPs and C-Corporations are shown in the following scatter plot:



The above graph shows the percentage of outperformance or underperformance of the MLP in comparison to its parent company. Each data points represents the relative weekly return of the MLP-parent company pair, with the Y-axis measuring the percent return of the MLP relative to the parent company. Consequently, data points above 0 signify that the MLP outperformed the parent company in that week and data points below zero represent an outperformance by the parent company. Because this data is comparing the performance of the individual MLP-parent company pairs and not the performance of the sets, I included data from the past ten years, even though not all of the MLPs had IPO'd at this time. Consequently, data for each pair begins at the time that both the MLP and the parent company were publicly traded. This explains why the early data (2009 – 2012) only contains data from Holly Frontier. Through this data, I was hoping to see whether a pattern of outperformance by either the MLP or the parent company existed over a certain period of time for both the pairs and sets. However, because the data points were randomly distributed, there didn't appear that there was any MLP-

parent company pair that showed consistent outperformance by either the MLP or the parent company. Additionally, there weren't any periods where the MLP set consistently outperformed the parent companies, or vice versa.

Portfolio Returns of MLP and C-Corporation Sets

The next step of my analysis was to create two equal weighted portfolios worth \$1,000, one composed of companies in the MLP set and another with the companies from the C-Corporation set. I then tracked the total return of both to see whether investors would have realized higher returns if they invested in the MLP portfolio or the C-Corporation portfolio. The time period for the stock price and dividend data used for this analysis was from the week of 10/31/14 to the week of 1/11/19, as this was the duration over the last ten years in which all of the MLPs and their parent companies were publicly traded.

C-Corporation Portfolio

The portfolio composed of the parent companies generated a total return of 45.69% over the period analyzed. Consequently, an investor in a \$1,000 equal-weighted portfolio composed of the stocks in the C-Corporation set would have had a portfolio value of \$1,456.90 at the end of the period.

Total Return Comparison (Weekly - 10/31/14 - 1/11/19)			
	Price Change	Total Return	Annualized
Valero	53.74%	83.55%	15.63%
Philips 66	15.72%	34.76%	7.40%
Marathon	35.64%	61.51%	12.15%
HollyFrontier	13.97%	35.81%	7.60%
Shell	-15.61%	12.82%	2.93%

The above chart shows a breakdown of each company in the C-Corporation portfolio's performance over this time period, including price change percentage, total return percentage, and annualized return percentage. Valero experienced both the highest price appreciation and the highest total return among these companies, which was a significant driver of the portfolio's positive performance. Shell was the only company within the set whose price depreciated over the period.

MLP Portfolio

The portfolio composed of MLPs had a total return of -12.37% over this period. Accordingly, an investor with a \$1,000 equal-weighted portfolio composed of the companies in the MLP set would have experienced a loss of \$123.70, yielding a portfolio value of \$876.30 at the end of the period.

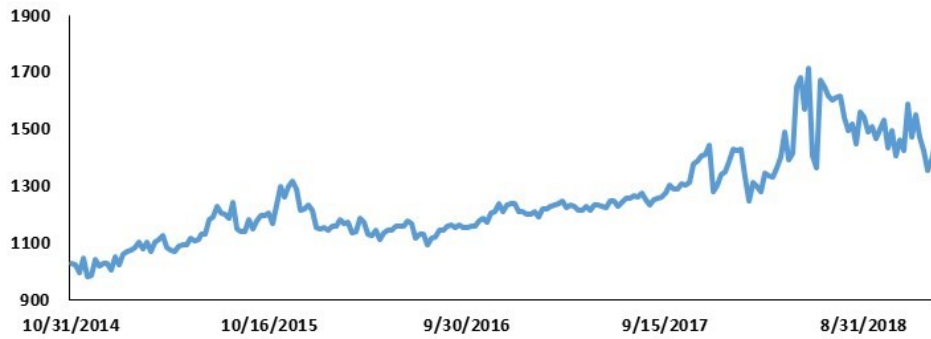
Total Return Comparison (Weekly - 10/31/14 - 1/11/19)			
	Price Change	Total Return	Annualized
VLP	-1.08%	15%	3.30%
PSXP	-31.14%	-18.90%	-4.86%
MPLX	-50.27%	-37.64%	-10.63%
HEP	-11.18%	19.75%	4.38%
SHLX	-44.73%	-35.64%	-9.96%

The above chart displays the price change percentage, total return percentage, and annual return percentage for the companies in the MLP portfolio. Interestingly, all of the companies in the MLP set experienced negative stock price returns over the period. This is a significant contrast from the stock price performance of the C-Corporation set, in which only one of the companies had a negative stock price return. Although the stock price returns for this portfolio were a negative factor for the portfolio's value, the high distribution yields paid by these

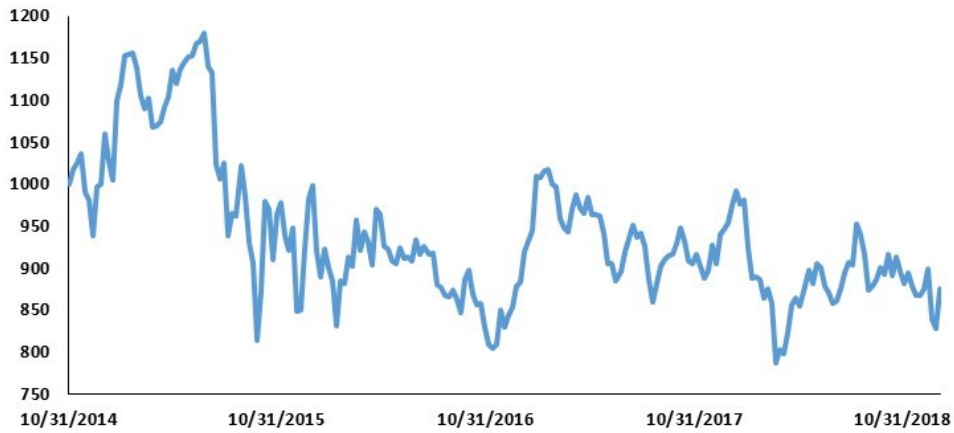
companies acted to counteract the depreciation of the stock price. Consequently, an investor in this portfolio's loss was lessened by the cash flow they received from distributions by these companies.

Portfolio Values

C-Corporation Portfolio Value



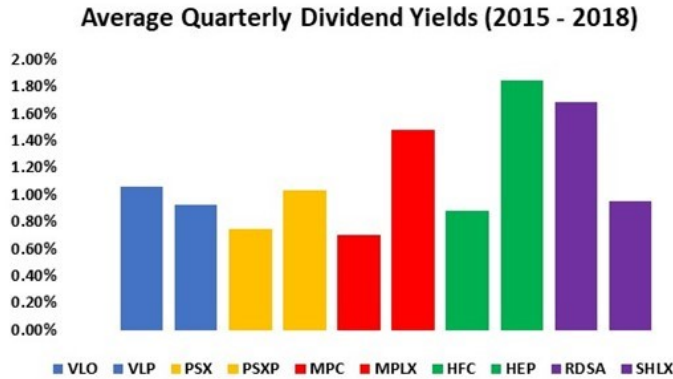
MLP Portfolio Value



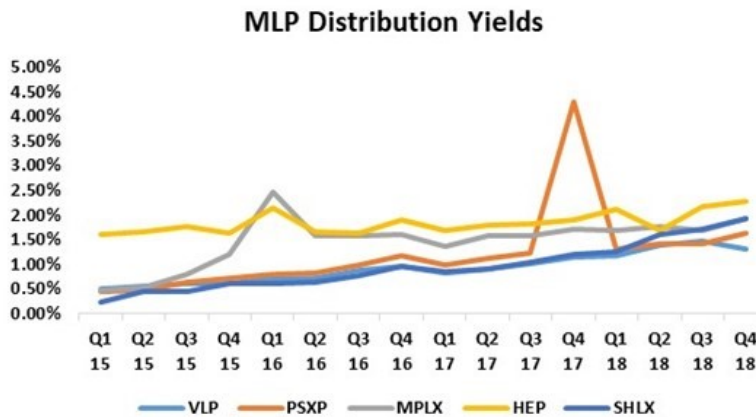
The above graphs show the portfolio values for the MLP and C-Corporation sets, with the Y-axis displaying portfolio value and the X-axis showing the date. The difference in the returns generated by the two portfolios over the period is evidenced by the ending portfolio values on 10/31/2018. This graph provides clarity on how each portfolio performed by showing the progression of the portfolio value over the course of the period of analysis. Interestingly, the MLP portfolio outperformed the C-Corporation portfolio during the first 8 months, appreciating 18.02% to a portfolio value of \$1,180.24 from 10/31/14 to 6/26/15. However, after this the portfolio value rapidly declined and was never able to return to its peak levels. I was unable to find any information on the specific event that caused MLPs to drop off dramatically after their initial outperformance. Overall, an investor would have realized higher returns by investing in the portfolio of C-Corporations instead of the portfolios of MLPs.

Dividend Yields

Because the total return of the MLP set was significantly less than the return of the C-Corporation set, I examined the dividend yields for both sets of companies to see if the results provided additional clarity on why the C-Corporations performed better. One of the most attractive features of MLP equities for investors is the high dividend yield, so MLPs would be expected to pay a higher dividend yield than their parent companies. However, despite paying a lower dividend yield the C-Corporations generated a higher total return.



The above graph shows the average quarterly dividend yields from 2015 to 2018 for each MLP-parent company pair, with the dividend yield of the parent company shown first and followed by the dividend yield of the corresponding MLP. In three of the pairs, the MLP paid a higher average distribution than the parent company, and in two of the pairs the parent company paid a higher dividend. This graph shows that despite the expectation that MLPs would pay a higher dividend yield than their parent companies based on the increased value investors in MLPs place on dividend income over stock price appreciation, this is not always the case.

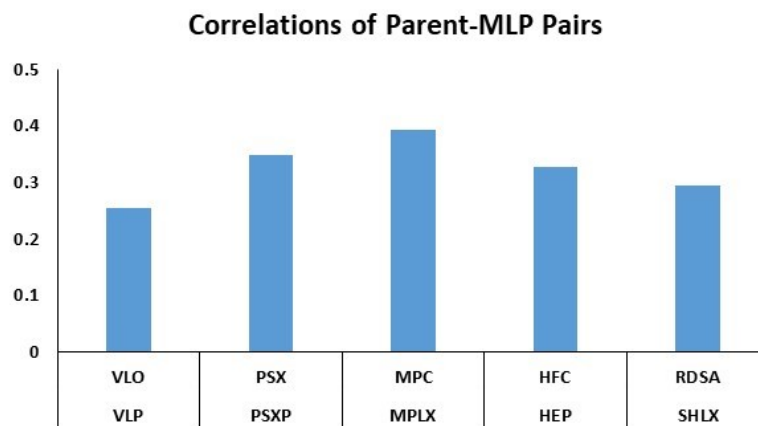


In order to further examine the distribution trends paid by MLPs, I examined the trend in distributions paid by each of the MLPs from 2015 to 2018. This graph shows an upward sloping

trend in the distribution yields paid by MLPs over the period. Although some MLPs did decrease their distribution (likely due to fluctuations in their available cash flow to distribute) from one quarter to the next, all of the MLPs increased their dividend yield over the span of the four years.

Correlation

Because the stock price performance of the MLPs and the parent companies differed significantly, I analyzed the correlation of weekly price returns between the parent company-MLP pairs. I was also interested in the correlations in stock price of the MLP-parent company pairs due to the related nature of the companies.



The correlations between the MLPs and the parent companies were all relatively low, with all of the correlations falling between the range of .25 and .4. This result is not particularly surprising given the significant difference in stock price performance of the MLP and C-Corporation sets, but it shows that although the MLP-parent companies are related through their structure this does not result in a high correlation in their stock prices.

T-Test

Lastly, I performed a two-sample t-test of weekly returns for MLPs and their parent companies in order to analyze whether or not my results were statistically significant using the following inputs:

MLP Mean: -.07%

Parent Company Mean: .19%

MLP Standard Deviation: .03086

Parent Standard Deviation: .03349

N: 220

T-Statistic: 1.1686

Because the t-test yielded a t-statistic of 1.1686, this shows that the outperformance by the parent companies relative to the MLPs was not statistically significant. Consequently, over this period there was not a statistically significant in the total returns of the two portfolios.

DISCUSSION AND CONCLUSION

This study focused on examining the performance of MLPs and their parent companies and whether the various tax and structural features of MLPs correlated to higher returns to investors. The data I analyzed suggested that investors were better off investing in C-Corporations rather than MLPs over this time period. Although the findings from this study are helpful in further understanding MLP and parent company performance, they are not conclusive due to a couple of reasons. Because this study only examined a specific segment of time and only included five parent company-MLP pairs, the results cannot be extrapolated to all MLPs

and C-Corps. Additionally, the difference in the performance of the two portfolios was found to be not statistically significant by the t-test. In order to formulate a more comprehensive conclusion on MLP and C-Corporation performance, more companies would need to be included over a broader span of time.

Based on the time period and companies that I analyzed, the parent companies outperformed the MLPs. Consequently, an equal weighted portfolio of the C-Corporations would have generated higher returns for an investor than an equal weighted portfolio of the MLPs. While the total return for the C-Corporations was primarily driven by stock price appreciation, the MLPs returns primarily came from distributions. The MLPs in the study all increased their distribution yields over the years; however, not all of the MLPs paid higher distribution yields than their corresponding parent companies.

Conducting this study allowed me to not only gain knowledge about the relationship between MLPs and their parent companies and formulate conclusions based on the data I studied, but also raised further questions about this asset class. Because the decline in the portfolio of MLPs was largely driven by declines in the stock price, what led to the valuations of the MLPs dropping dramatically? Additionally, why did some producers with successful MLPs to repurchase the shares of their MLPs and bring them back under the umbrella of the corporation? Lastly, because the MLP portfolio performed well over latter half of 2014 and early part of 2015, outperforming the C-Corporation portfolio, before dropping off dramatically, I would like to know what event or market news drove the sharp decline in the MLP sector. I look forward to continuing to research this topic and examine these questions.

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