Kayne Anderson FERC Announcement Takeaways

Houston, TX – March 19, 2018

The following is a summary of the FERC's recent announcement and its likely impact to the midstream space. To the extent you have questions, please contact us at 1-877-657-3863.

Executive Summary

We expect the vast majority of the midstream universe to see little financial impact from the Federal Energy Regulatory Commission's (FERC) recent announcement regarding cost-of-service rates for MLPs (described below). We expect less than 5 MLPs to see a material impact to cash flows as a result of the FERC's proposed changes (with these companies representing less than 5% of the market cap of the North American Midstream universe). Our view is being confirmed by the companies themselves, with the majority of major MLPs and midstream corporations issuing press releases indicating that the proposed rule change will not have a material impact on their financial results.

In our opinion, the market was caught off guard by the FERC's announcement. There was reactionary selling at first (the AMZ was down almost 10% on March 15th shortly after the news was released), which appeared to be indiscriminate. While most MLPs have recovered from their intra-day lows (as of March 16th, the AMZ was down approximately 3% from levels immediately prior to the FERC's announcement), we expect a further recovery in equity prices as investors continue to digest this news and better understand the potential impact of these proposed changes. Put simply – we believe the sector is trading at overly discounted valuations that are not reflective of industry fundamentals.

Our team of analysts continues to review the potential impact of the FERC's announcement. Thus far, we have had extensive conversations with management teams, individuals at the FERC, legal experts and political consultants. This process continues, and we will provide updates on our views as appropriate.

FERC's Announcement

On March 15th, the FERC announced that it will no longer allow MLPs to recover an income tax allowance (ITA) in the cost-of-service calculation for interstate natural gas and crude oil pipelines. This ruling is a departure from prior rulings (in particular, the 2005 Policy Statement for Recovery of Income Tax Costs) and is in response to a Court of Appeals ruling in 2016 (United Airlines vs. FERC) that remanded the matter to the FERC for reconsideration. That court's ruling indicated that the FERC had failed to demonstrate there was no "double recovery" of income tax costs when permitting an MLP to recover both an ITA and a return on equity determined using a pre-tax rate of return when making the cost-of-service calculation.

The FERC's decision turned on the question of whether or not under its methodology there is a so-called double recovery of income tax costs in setting cost-of-service rates for MLPs given that MLPs are not themselves taxed, but rather the tax payment obligation flows to their investors (i.e., the limited partners and general partner). Prior to this change, MLPs were being allowed to, in effect, include the impact of taxes paid by their investors in determining costs for rate-setting purposes.

While the industry was aware that the FERC was again evaluating the ITA issue as a result of the Court of Appeals ruling, the general belief was that the FERC would again rule in favor of the status quo. Further, the general belief was that any changes would be phased in over time, so the announcement came as a surprise to the industry and investors.

Please note that this change does not impact the ability of midstream companies formed as corporations to include an ITA in the determination of their cost-of-service rates.

Scope of Impact to MLP Cash Flows

This ruling will negatively impact those MLPs that operate interstate pipelines charging cost-of-service rates at or near maximum levels allowable under the FERC calculation. It's important to understand that this represents a relatively small sub-set of the MLP universe:

- The ruling applies only to FERC-regulated pipelines, excluding much of the MLP universe (gathering & processing, terminals, intrastate pipelines, fractionation, export and LNG are generally not regulated by FERC)
- Within FERC-regulated pipelines, it will not affect pipelines operating under negotiated or market-based rates (which includes the majority of newly built assets)
- Within FERC-regulated pipelines charging cost-of-service rates, this should only materially affect pipelines charging rates at or near maximum allowable levels
- Among this small subset of assets, only those owned by MLPs will see the more significant reduction in cost-of service rates (as a result of excluding ITA); corporate midstream companies are not impacted by the ruling (although they will see a more modest reduction as a result of lower corporate tax rates)
- Only natural gas pipelines that fit these criteria would experience any near-term impact. Oil and liquids pipelines will not have rates re-evaluated until 2020, and under a different mechanism.

The limited scope of impact of this ruling is evidenced by statements publicly released by the majority of major MLPs and midstream corporations stating that they anticipate minimal impact to revenues as a result of the FERC announcement. This list includes companies with significant FERC-regulated natural gas pipeline assets that simply are not impacted by the decision because they do not meet the criteria listed above. Overall, we estimate that less than five MLPs could see a material impact to cash flows as a result of this announcement, representing, in our estimation, less than 5% of the market cap of the North American midstream universe.

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This press release contains "forward-looking statements" as defined under the U.S. federal securities laws. Generally, the words "believe," "expect," "intend," "estimate," "anticipate," "project," "will" and similar expressions identify forward-looking statements, which generally are not historical in nature. Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ from the either company’s historical experience and its present expectations or projections indicated in any forward-looking statements. These risks include, but are not limited to, changes in economic and political conditions; regulatory and legal changes; MLP industry risk; leverage risk; valuation risk; interest rate risk; tax risk; and other risks discussed in each company’s filings with the SEC. You should not place undue reliance on forward-looking statements, which speak only as of the date they are made. The companies undertake no obligation to publicly update or revise any forward-looking statements made herein. There is no assurance that either company’s investment objectives will be attained.

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