THE OKLAHOMA MLP QUARTERLY

Colleagues and Friends,

It is with great pleasure that we circulate to you the inaugural edition of *The Oklahoma MLP Quarterly*–a publication focused on master limited partnerships, or MLPs, in our great state.

As you know, a growing number of MLPs now call our state home. In an effort to celebrate this business for our state, our firms, leaders in taxation, law and investment advisory services with respect to MLPs, collaborated to form *The Oklahoma MLP Quarterly*.

The Oklahoma MLP Quarterly will be circulated electronically after the close of each calendar quarter. The publication will focus on changes in taxation, law and capital markets during the prior quarter that affect MLPs who have headquarters located in, or significant contacts with, Oklahoma.

As the publication remains in its infancy, we welcome any suggestions you might have to enhance the publication. Please do not hesitate to contact any of the editors listed below with your comments.

We look forward to the future success of *The Oklahoma MLP Quarterly* and bringing deserved attention to our great state.

Enjoy,

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THE OKLAHOMA MLP QUARTERLY

THIRD QUARTER 2013

TAX UPDATE

Sponsored by Ernst & Young LLP

We begin our first Tax Update column by providing a high level survey of the large number of private letter rulings ("**PLRs**") issued to date in 2013. We anticipate that subsequent columns will provide appropriate updates of the PLR environment and will also discuss potential changes in income tax regulations that may impact MLP sponsors as they plan for initial public offerings or drop-down transactions.

As most of our readers know, in order for a publicly traded partnership to be treated for federal income tax purposes as a non-taxable pass-through entity, rather than as a taxable corporation, the partnership must satisfy a gross income based test. More specifically, a publicly traded partnership is subjected to income tax as a corporation unless 90% or more of the publicly traded partnership's gross income consists of "qualifying income." For this purpose, qualifying income includes certain portfolio type income (e.g., dividends and most types of interest income), real property rent, gain from the sale of real property, and certain income derived from natural resources. Most Oklahoma-based MLPs satisfy the qualifying income test by deriving gross income from natural resources, including (in the language of the applicable federal income tax statute) "income and gains derived from the exploration, development, mining or production, processing, refining, transportation . . . or the marketing of any mineral or natural resource."

Maintaining partnership tax status is critical for MLPs, yet there is a very small body of authority that MLPs may rely on as precedent for determining whether particular types of income constitute qualifying income. Accordingly, many MLPs will obtain a PLR from the Internal Revenue Service in order to obtain certainty that certain types of income are, in fact, qualifying.

//ABOUT THE OKLAHOMA MLP QUARTERLY

The Oklahoma MLP Quarterly highlights changes in taxation, law and capital markets that affect master limited partnerships who have headquarters located in, or significant contacts with, Oklahoma. The publication is circulated electronically following the end of each calendar quarter and is the product of a collaboration among Ernst & Young LLP, GableGotwals and Pinnacle Investment Advisors, leaders in taxation, law and investment advisory services with respect to MLPs in Oklahoma.

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From January 1, 2013 through this column's publication date, the IRS issued 22 PLRs. Although not all of the PLRs may be readily categorized, many of the rulings have common features. Broadly, in many PLRs, the IRS appeared to evaluate whether an MLP's gross income was "derived from" natural resources based upon the necessity of the goods or services provided by the MLP to the exploration and production activities conducted by the MLP's customers. Examples of this concept include:

Support for the hydraulic fracturing process. Although water is generally not considered to be a natural resource for purposes of the qualifying income rules, the IRS issued several rulings (see, e.g., PLR 201330023, PLR 201330024, etc.) indicating that gross income derived from supply, transportation, and storage of fractionation fluid and other fluids constitutes qualifying income.

Removal and treatment of flowback water. Much like the hydraulic fracturing related rulings, the IRS issued rulings (see, e.g., PLR 201336006, PLR 201338035, etc.) that gross income from the removal, treatment, and disposal of fracturing fluid and produced water constitute qualifying income.

While many PLRs issued in 2013 fall into these broad categories, the IRS also issued a variety of other PLRs regarding qualifying income. These rulings include PLRs related to an MLP's interest rate hedging activities (see, PLR 201315008), rulings related to specific types of commodities, products, or services (see, PLR 201314038, PLR 201315015, PLR 201324002, PLR 201328005, etc.), and rulings related to the issue of when bulk sales to end users constitute non-qualifying retail type sales (see, PLR 201301010 and PLR 201308004).

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// TAX UPDATE

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LEGAL **UPDATE**

Sponsored by GableGotwals

Thomas J. Hutchison and Brandon M. Watson, GableGotwals

As Delaware is the preferred state of formation for MLPs, changes in Delaware law are critically important, even to Oklahoma-based companies. This quarter, the Delaware Supreme Court and the Delaware General Assembly reaffirmed the right to contractually waive certain fiduciary duties, both in the context of limited partnerships and limited liability companies.

Limited Partnerships

Following a recent line of Delaware cases interpreting contractual fiduciary duties in limited partnership agreements, on July 22, 2013, the Delaware Supreme Court affirmed the Delaware Chancery Court's dismissal of a class action complaint challenging the merger of Encore Energy Partners LP, a publicly traded Delaware limited partnership ("Encore"), with its general partner's controller, Vanguard Natural Resources, LLC, a publicly-traded Delaware limited liability company ("Vanguard").

In *Allen v. Encore Energy Partners LP*, the plaintiff, representing a class of Encore's common unitholders, alleged that the defendants (including Encore, its general partner, the members of the general partner's board

// LEGAL UPDATE

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of directors and Vanguard) breached their contractual duties to the class members by proposing, approving and consummating a merger between Encore and Vanguard, which the plaintiff alleged was unfair, unreasonable, and undertaken in bad faith. Before the merger, Vanguard owned Encore's general partner, Encore Energy Partners GP LLC ("Encore GP"), and 46% of Encore's outstanding common units. Additionally, four of seven members of Encore GP's Board of Directors (the "Board") were Vanguard employees.

On March 24, 2011, Vanguard announced its initial merger offer to Encore: to convert each Encore common unit into 0.72 Vanguard common units, resulting in a valuation of $23.20 per Encore unit—a 0.2% premium to Encore's pre-announcement closing unit price. In response to this offer, Encore GP's Board delegated to its Conflicts Committee (comprised of three independent directors) the authority to negotiate and evaluate the merger and recommend a proposal to the entire Board, if appropriate. After conducting diligence, and engaging independent legal and financial advisors, the Conflicts Committee proposed a higher exchange ratio, which Vanguard subsequently accepted. Due to price decreases in Vanguard's units after the time of the presentation of the initial offer, however, the counteroffer actually presented a discount to Vanguard's initial offer. When the merger closed on December 1, 2011, due to continued declines in the price of Vanguard units, the exchange ratio resulted in an implied value that was even further below Vanguard's initial offer.

The plaintiff alleged that the proposal, approval and consummation of the merger violated the defendants' fiduciary duties, as set forth in Encore's limited partnership agreement (the "LPA"). As is common for MLPs, the LPA eliminated the common law fiduciary duties of care and loyalty owed by Encore GP and its affiliates (including the Board and Vanguard) to Encore's limited partners. In place of the common law duties, the LPA provided that actions or inactions by Encore GP, the Board and Vanguard were guided by a "good faith" standard—defined in the LPA as a "belief that the determination or other action is in the best interests of the Partnership."

The LPA also provided that if the Conflicts Committee approved a transaction containing a potential conflict of interest through the LPA's Special Approval process (i.e., the approval of a majority of the Conflicts Committee acting in good faith), the LPA would deem the transaction approved and deem that Encore GP and its affiliates did not breach their duties owed under the LPA, or any other duty they might owe. The LPA further provided that in making a Special Approval, there was a presumption that the Conflicts Committee acted in good faith.

In reviewing the merger and the duties created in the LPA, the Delaware Supreme Court determined that the LPA's good faith standard required only that the Conflicts Committee members form a "subjective belief that the Merger was in Encore's best interest"—unlike prior cases, a purely objective view of the Conflicts Committee actions was not appropriate. To sufficiently plead that the Conflicts Committee breached its duty of good faith in approving the merger, the court required the plaintiff to show either that the Conflicts Committee (i) subjectively believed it was acting against Encore's best interests when approving the merger or (ii) consciously disregarded its duty to form a subjective belief that the merger was in Encore's best interests.

The court held that even though the Conflicts Committee members "may have negotiated poorly," that did "not permit a reasonable inference that they subjectively believed they were acting against Encore's best interests." Additionally, the Court held that "[a]llegations that the Conflicts Committee should have started with a higher counteroffer, should have negotiated more forcefully, and should thereby have achieved a better result do not support a reasonable inference that the Conflicts Committee consciously disregarded a duty to *form a subjective belief* that a transaction was in Encore's best interest."

The *Allen* case shows the continued importance of carefully drafted limited partnership agreement provisions with regard to fiduciary duties and the benefit of these provisions to MLP management. The case also highlights the ability to contract for a subjective good faith standard.

Limited Liability Companies

The Delaware Chancery Court has repeatedly held that there are certain default fiduciary duties owed by a manager of a Delaware limited liability company ("LLC") to the LLC's members. The Delaware Supreme Court, however, has not definitively ruled on this issue and, in 2012, issued an opinion bringing into question its view of these implied duties for LLCs. In response to this seeming conflict, effective as of August 1, 2013, the Delaware General Assembly amended the Delaware Limited Liability Company Act (the "Act") to clarify that, absent contrary language in an LLC operating agreement, default fiduciary duties do exist.

The Delaware General Assembly specifically amended Section 18-1104 of the Act to read as follows (new language underlined): "In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern."

The legislative synopsis explained that "[the amendment] confirm[s] that in some circumstances fiduciary duties not explicitly provided for in the limited liability company agreement apply. For example, a manager of a manager-managed limited liability company would ordinarily have fiduciary duties even in the absence of a provision in the limited liability company agreement establishing such duties. Section 18-1101(c) continues to provide that such duties may be expanded, restricted or eliminated by the limited liability company agreement."

Through this amendment, the Act now provides the same conceptual framework found in the Delaware Revised Uniform Limited Partnership Act—that default fiduciary duties exist, but may be modified by express language in an entity's governing documents. This amendment is especially noteworthy for management of publicly-traded LLCs, who will be subject to these default fiduciary duties, and the related potential liability to managers, in the absence of provisions in the LLC agreement restricting or eliminating these duties.

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CAPITAL MARKETS **UPDATE**

Sponsored by Pinnacle Investments Advisors

The strong price appreciation in July and September allowed many MLPs to raise additional equity capital through secondary offerings. The additional supply weighed on the sector, leading to slightly negative returns for the quarter while the S&P 500 Index rose more than 5% and small company stocks rose 10%. Additionally, yield-oriented sectors were pressured by the rise in Treasury yields leading into the Federal Reserve meeting in September. The ten year Treasury Note yield reached the psychologically important level of 3% just before the Fed met. In the two weeks after the Fed announcement market yields fell by 0.30%. There is a wide disparity in yields in the MLP sector, with rapidly growing MLPs priced at distribution yields below 4% while slow growing MLPs with some risk of not being able to maintain their distribution yielding over 9%. The average yield for the sector is approximately 5.80%, which is 1% higher than the lows reached in 2007, and the yield premium versus Treasuries is close to its long term average as shown in the graphs below. The yield premium gives us some comfort that MLPs are not expensive in this environment since we expect robust growth in distributions over the next year to offer additional protection against higher interest rates.

// CAPITAL MARKETS UPDATE

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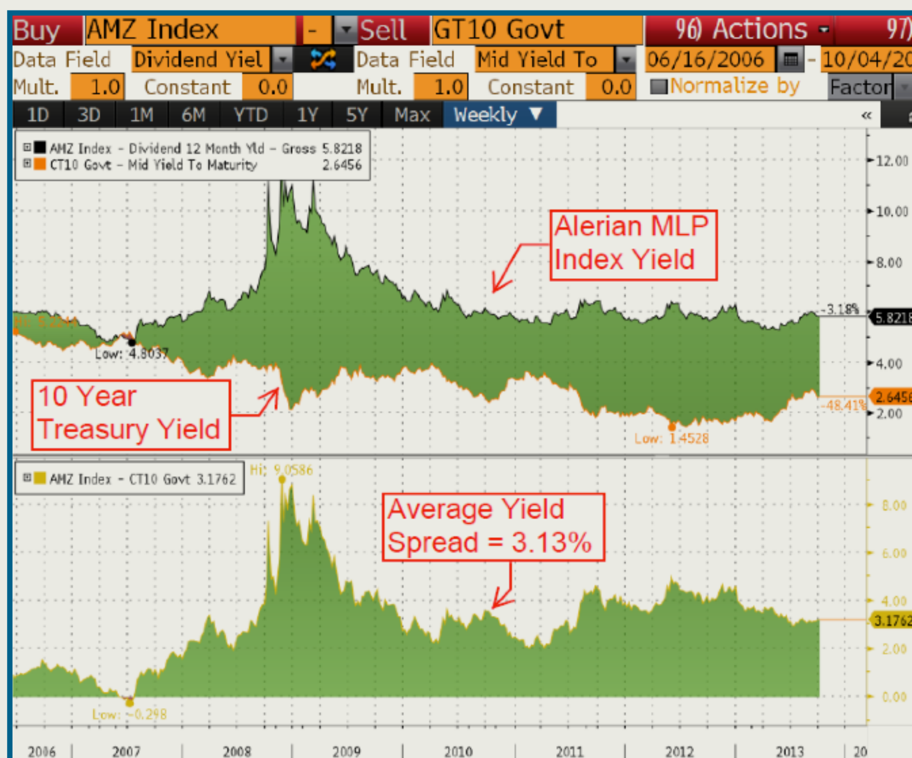


Graph 1. Yield Spread History, Alerian MLP Index Versus Treasury Note, *Source Bloomberg*

Our approach to managing MLP portfolios has been to invest in fast growing small MLPs that are just starting their growth trajectory so they are not paying a high proportion of their cash flow to their general partner. We also prefer MLPs that have capped their payout to their general partner or have acquired their general partner, so their cost of capital is advantageous versus other MLPs with general partners. However, if a general partner is involved, we typically look to invest in the MLP through ownership in the general partner since it will benefit disproportionally as the MLP grows. We owned the general partner of Markwest Energy, Magellan Midstream, and Penn Virginia before they were acquired by their limited partnership. We currently own Alliance Holdings, the general partner for Alliance Resources and Williams Companies, the general partner for Williams Partners. We added one general partner to our funds this quarter after ONEOK Inc. announced their intent to spin off their regulated natural gas utility operations into a new company. The remaining assets of ONEOK will be their ownership of units of ONEOK Partners and the general partership interest in ONEOK Partners. The typical general partnership payout structure incentivizes the general partner to grow the limited partnership and increase the quarterly distributions. For example, at the initial minimum quarterly payout, the general partner receives 2% of the cash flow available for distribution at the limited partnership. Once the limited partnership raises their quarterly payout and reaches certain target levels, the general partnership receives 15%, then 25%, then 50% of the additional cash flow. These "incentive distribution rights," or IDRs, give the general partnership a higher potential growth rate than the limited partnership. For example, we own Alliance Holdings in our funds. Alliance will increase their quarterly distribution 50% faster than Alliance Resources because they own the incentive distribution rights and have reached the 50% split on additional cash flow.

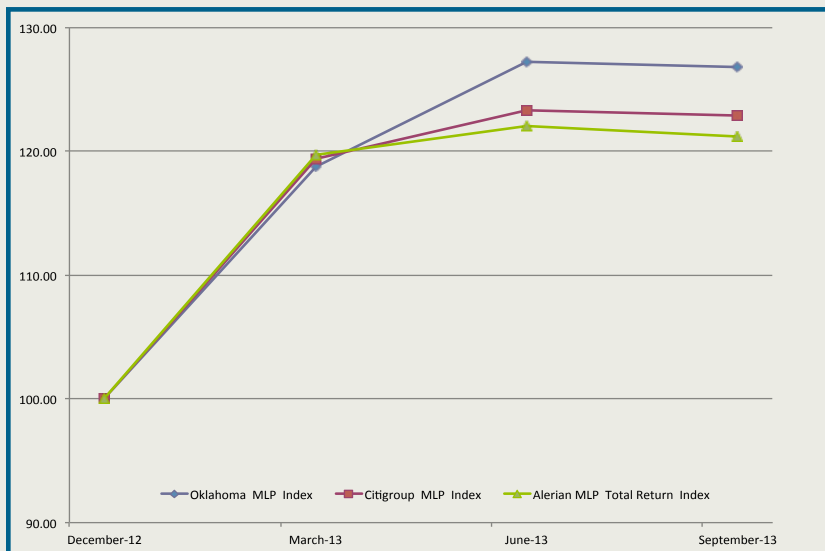
Crude logistics MLPs have been strong performers over the last few years as oil production from the shale regions grew rapidly. Natural gas focused MLPs lagged in performance because of the glut of domestic natural gas and the weak prices for natural gas liquids. That could be starting to change. Natural gas in storage is close to historical levels and exports of propane are alleviating the pressure on fractionation spreads. New LPG export facilities are operating and others are under construction. Exports have increased by more than 100% over the last twelve months. Higher international natural gas liquids prices that are more correlated to crude oil prices are supporting demand for domestically produced NGLs.

Graph 2. U.S. Produced Propane Exports, *Source: Bloomberg*

Graph 3. Propane Price History, *Source: Bloomberg*

Propane exports are helping the frac spreads for natural gas gathering and processing MLPs while the expansion of domestic chemical plants to use the growing supply of propane and ethane will boost their outlook in 2015 and beyond. The U.S. recently surpassed Russia as the largest producer of crude oil and natural gas. This is a huge competitive advantage for our economy and our manufacturers.

The following graph shows unit performance for a hypothetical index comprised of Oklahoma MLPs compared to the Citigroup MLP Index and the Alerian MLP Total Return Index:



Note: Oklahoma MLP Index includes Publicly Traded Partnerships only with headquarters or major operations in Oklahoma.

// DEVON MIDSTREAM

***OCT 21**, Devon announced a significant restructuring in its plan to monetize its U.S. Midstream Assets.*

MLP IN THE **SPOTLIGHT**

// Devon Midstream

Sponsored by GableGotwals

Brandon M. Watson, GableGotwals

In the final days of the third quarter, Devon Midstream Partners, L.P. ("Devon Midstream Partners"), a MLP formed by Devon Energy Corporation ("Devon"), filed a Registration Statement on Form S-1 with the SEC. As disclosed in the S-1, at the closing of the offering, Devon Midstream Partners would own, through a wholly-owned subsidiary, a 20% interest in Devon Midstream Holdings, L.P., which would own substantially all of Devon's U.S. midstream assets (the "U.S. Midstream Assets"). Over time, Devon Midstream Partners would aim to acquire, through its subsidiary, the remaining 80% in Devon Midstream Holdings, L.P. from Devon, pursuant to a right of first offer.

On October 21, Devon announced a significant restructuring in its plan to monetize its U.S. Midstream Assets. Under the new plan, Devon will combine its U.S. Midstream Assets with the assets of Crosstex Energy, Inc. and Crosstex Energy, L.P. to form two new publicly-traded companies.

In order to effect the transaction, Devon will contribute its U.S. Midstream Assets to its subsidiary, Devon Midstream Holdings, LP ("Devon Holdings"). Devon will then contribute all of its equity interests in Devon Holdings in equal parts to two new publicly-traded companies, for purposes of this article, the "General Partner" and the "Master Limited Partnership." Devon will also contribute $100 million to the General Partner and the general partner interest in Devon Holdings to the Master Limited Partnership.

General Partner – In exchange for the contribution of 50% of the outstanding interest in Devon Holdings and $100 million in cash, Devon will receive 70% of the outstanding common units in the General Partner. In exchange for each share of Crosstex, Energy, Inc., Crosstex Energy, Inc. shareholders will receive one unit of the General Partner and a one-time $2.00/share distribution, constituting the remaining 30% of the outstanding common units in the General Partner. As a result:

OWNERSHIP OF THE GENERAL PARTNER:

- Devon (70%)
- Crosstex Energy, Inc. shareholders (30%)

ASSETS OF THE GENERAL PARTNER:

- 50% ownership interest in Devon Holdings
- $100 million cash
- 7% limited partner interest in the Master Limited Partnership
- 100% of the general partner interests in the Master Limited Partnership
- 100% of the incentive distribution rights of the Master Limited Partnership
- Crosstex Energy, Inc. (merged)

Master Limited Partnership – In exchange for the contribution of 50% of the outstanding interest in Devon Holdings, and the general partner of Devon Holdings, Devon will receive 53% of the outstanding common units of the Master Limited Partnership. In exchange for each unit held, Crosstex Energy, L.P. unitholders will receive one unit of the Master Limited Partnership, constituting 40% of the outstanding common units of the Master Limited Partnership. The General Partner will own 7% of the outstanding common units of the Master Limited Partnership and the general partner interests. As a result:

OWNERSHIP OF THE MASTER LIMITED PARTNERSHIP:

Limited Partner Units

- Devon (53%)
- Crosstex Energy, L.P. unitholders (40%)
- General Partner (7%)

General Partner Units

- General Partner (100%)

ASSETS OF THE MASTER LIMITED PARTNERSHIP:

- 50% ownership interest in Devon Holdings
- 100% ownership of the general partner of Devon Holdings
- Crosstex Energy, L.P. (merged)