Miller/Howard INVESTMENTS

MAY 22, 2019

An Open Letter to MLP/Midstream Management Teams from Miller/Howard Investments, Inc.

IT'S BEEN ONE YEAR SINCE WE WROTE OUR OPEN LETTER TO MLP/MIDSTREAM MANAGEMENT TEAMS, and we thought now would be a good time for an update. In the original letter, we wrote about how we believed management teams needed to address three issues to become better aligned with investors, and to transition the sector from a good investment opportunity—based on solid long-life assets with an essential economic need—to a very good investment opportunity.

1. Eliminate incentive distribution rights (IDRs)

As long-term investors in MLPs for 20 years, we urged all MLPs to eliminate IDRs immediately. Thus far, we are encouraged by the progress. Last year, of the 17 holdings in our strategy, six had IDRs. The percent of cash flow going to the general partners ranged from a low of 10% to a high of 37%. One year later, only two of our 17 holdings have IDRs, with the percent of cash flow for those two in the +30% range. Other MLPs that we do not own have also eliminated this unnecessary burden.

While we cheer the progress, we would be remiss in not pointing out that we are disappointed in the two companies we own that still have IDRs—as well as those we do not own. The sector as a whole continues to evolve, with some companies speaking about more traditional metrics that C-corps historically use, and some companies also targeting lower leverage and limiting or even eliminating equity issuances. But if the sector really wants the attention of a larger investor base and wants more investment dollars from long-term holders, IDRs must go. We will repeat what we wrote last year: As one of your partners, we implore you to take action.

2. Increase disclosures about operations

Of the three issues we wrote about in our first letter, this one garnered the most pushback—which we found quite telling, given that we also asked energy companies to be more environmentally aware! The question we received the most was: What do you want? Our answer: We don't want the secret sauce, but at least reassure us that you will be able to make the secret sauce for years to come. As an example, competition to build midstream assets out of the Permian has heated up to the point of boiling over. How can we be sure that legacy pipelines will not see significant declines in volumes and tariffs? Will projects really generate low to mid-teen returns on capital invested? Put another way, will assets with low announced construction multiples continue to generate attractive cash flows for decades to come?

And perhaps the Holy Grail: We'd like these companies to better define the difference between growth and maintenance capital expenditures (capex). It appears to us that some of that "growth spending" must be used to offset declines on legacy assets. So is that really growth or maintenance capex? We realize that maintenance is the investment required to maintain the partnership's existing assets. But if assets are no longer being utilized as they were previously, then some of the growth spending must be to offset those declines. So isn't that really maintenance?

3. Address shareholders' environmental concerns

This is the issue we thought would cause the most controversy. However, we've seen great success. Our ESG team has had many constructive conversations with managements, and those dialogues have led to change. For example, several companies that we engaged took action to release inaugural disclosures on their websites (and more committed to doing so in the near term). During our conversations, companies told us they realize that "[social] license to operate is very much in play these days" and transparency is "good for the company and for investors."

While we are happy with the ESG progress so far, there could still be improvement. Some companies, inexplicably to us, have even refused to have a short phone call. Some continue to pay minimal attention to environmental issues. To the companies who listened and have taken or committed to take action, we commend you for your leadership. Norms are changing in the industry as expectations are changing among investors; laggards will fall further behind unless they take action. We are not going away. There needs to be more transparency around environmental and governance concerns. We believe having more information will help investors be more comfortable with their investments.

It has been an active year. With many positive developments. IDRs are disappearing. We believe there is much better awareness and disclosure around corporate governance issues from energy companies. Progress has been made. There needs to be more. IDRs need to be completely eliminated. Companies need to help us better understand where the risk resides in their businesses through better disclosures. Corporate governance needs to be a core concern and one of the drivers of compensation for management.

At Miller/Howard Investments, we have always been, and continue to be, big believers in the economic role of midstream companies.

~ Miller/Howard Investments Portfolio Team

Disclosure

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Risk Factors to Consider When Investing in Master Limited Partnerships (MLPs)

- Cash distributions are not guaranteed and may fluctuate with the MLP's operating or business performance.
- MLPs typically have a General Partner. Unit holders will have limited voting rights and do not own an interest in, vote with, or control the General Partner. The General Partner often cannot be removed without its own consent, and the General Partner has conflicts of interest and limited fiduciary responsibilities, which may permit it to favor its own interests to the detriment of unit holders.
- The MLP may issue additional common units, diluting existing unit holders' interests.
- Unit holders may be required to pay taxes on income from the MLP even if they do not receive cash distributions.
- The IRS could reclassify the MLP as a taxable entity, which could reduce the cash available for distribution to unit holders.

Tax Considerations of MLPs

The tax treatment for investors in MLPs is different than that of an investment in stock, including (a) the investor's share of the MLP's income, deductions and expenses are reported on Schedule K-1, not Form 1099, **(b) because of the possibility of unrelated business taxable income, charitable remainder trusts should not invest in this strategy, and other non-taxable investors (such as ERISA and IRA accounts) should carefully consider whether to invest in this strategy,** (c) investors may have to file income tax returns in states in which the MLP's do business and (d) MLP tax information is sent directly from the partnership, which generally has until April 15th to provide this information. You should discuss these and any other tax implications with your tax advisor.

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