The Trading Risk Confronting Some MLPs

Barron's has one of their by now regular articles on MLPs this weekend as they interview their "MLP Roundtable". These write-ups are invariably constructive, and the most recent one is no exception. As well as noting the many opportunities offered to build out infrastructure in support of America's shale boom, General Partners (GPs) received a mention. Roundtable member Douglas Rachlin of Neuberger Berman pointed out that, "GPs are not required to contribute capital to the organic-growth projects or acquisitions their MLPs make; yet they benefit in a disproportionate manner through their ownership of distribution rights."

Becca Followill of U.S. Capital Advisors added, "Some MLPs don't have a general partner, which makes them easier to take out and can make a deal more accretive more quickly."

These are both features of MLPs that we've long identified and reflected in our own MLP strategy.

Quite a few names reported quarterly earnings last week. The numbers were generally good and MLPs are overwhelmingly reporting increases in future capital investment which for GPs at a minimum assures continued growth in distributed cashflow received and therefore in dividends paid. But not everything was good. Buckeye Partners (BPL) issued a surprisingly disappointing report which included losses in their Merchant Services division. We're investors in BPL and have been for years.

The most attractive businesses for MLPs are fee-based whereby they earn recurring income from storage and pipeline assets. BPL largely does this, but like a handful of other MLPs they also have a marketing division which incurs basis risk on its underlying products on behalf of customers, often in exchange for quite narrow margins.

These activities can be quite tricky to manage. MLPs face a principal-agent problem here, in that their desire is to generate a return through using their inside knowledge and control of product to charge more than the cost of the basis risk incurred. However, there is inevitably judgment involved, and while the MLP wants to exploit an additional element of its franchise, if not properly managed the traders involved will seek to make money from the risk taking side of this. In fact, risk-averse basis trading maximizes the firm's franchise value and minimizes the value added of the trader. The trader's incentive can therefore be to minimize the apparent value of the franchise so as to maximize the apparent value of his skill-based activities. It can lead to excessive risk-taking, since profits from properly exploiting the MLP's position in the middle of all kinds of information about supply and demand can appear to value the trader less than trading profits generated through his own skill/judgment.

It's not only banks that can get themselves into trouble with risk. And in BPL's case, it appears that a poorly constructed hedging strategy went wrong during the 2Q, causing the Merchant Services unit to swing to an operating loss.

Positions were liquidated, people fired and a more modest business model adopted. But it shows that unwelcome surprises can come from units that appear to offer steady if unspectacular returns, if the principal-agent conflict described isn't carefully managed.