June 2008

S&A Oil Report

How A.O.P. Will Pay for Your Retirement – No Matter What the Price of Oil

Stansberry & Associates
Investment Research

How A.O.P. Will Pay for Your Retirement – No Matter What the Price of Oil

By Matt Badiali

It's no secret there's a ridiculous amount of oil wealth in the United States…

But typically – unless you're the federal government… an executive at an oil company… or have a major oil field directly on your property – you'll never see a single penny of it.

Luckily for folks like you and me, the American Oil Pension (A.O.P) allows you to cash in on the gallons of gas American drivers pump each day.

Here's how it works:

A.O.P businesses receive revenue from oil-producing fields around the country and legally must distribute this money to you… and others enrolled.

Just to be crystal clear, A.O.P. businesses are NOT corporations or trust funds, but rather master limited partnerships (MLPs).

MLPs trade on major exchanges, and you can buy them just as easily as a corporate stock or trust fund...

But there are a few notable differences.

First, unlike a corporation, MLP ownership is split into two segments: There is the *general partner*, who manages the partnership's operations, and the *limited partners*, who provide the capital and receive cash distributions from the partnership each quarter.

Secondly, MLP earnings are far more stable than your typical exploration company because earnings are less dependant on the price of oil and gas and reflect the volume of petroleum and products the business handles.

And lastly, as an MLP investor, you only have to pay taxes on 10%-20% of the cash you collect. Taxes on the remaining 80%-90% are deferred until you sell your shares, or "units."

How is this possible?

Because every time you receive a check from an MLP, a portion of your initial investment is returned to you.

As a result, the IRS does not consider these MLP payments as "taxable income," but rather a "return of capital." As a result, it doesn't tax your quarterly income checks until you sell your units.

The A.O.P. is a collection of the most stable, income-generating pipeline partnerships available. The companies own and operate pipelines that are used to transport oil and gas, and make their money based on the volume of oil and gas they transport.

Each MLP owns thousands of miles of pipeline, most of which have been in the ground since before World War II.

According to *Financial Planning*, "these pipelines require little maintenance and if properly maintained will be in the ground for at least another 75 years."

Pipeline partnerships are simple businesses. They put oil or gas in one end, take it out the other, and get paid for the privilege.

These partnerships grow by acquiring other pipelines, expanding existing pipelines, or building new ones.

While these companies provide for a great investment with steady dividend income, you still need to do your homework before you invest in any individual MLP…

You can think of these pipelines as toll roads. Toll takers don't care about the price of the cars that drive on them. All the toll takers care about is the volume of cars on the road. And if you haven't noticed, it's rush hour for oil right now, and the toll roads, these MLPs, will make a lot of money.

I think a lot of institutional investors are going to come around to my way of thinking soon – and that will spell additional gains for us in the near future.

According to *Oil and Gas Investor*, many of the hedge funds that were invested in MLPs bailed out during the August 2007 market correction. Many of these funds had to liquidate good positions with bad just to get the cash out. That drove down the prices of the MLPs.

However, as the funds come back, they will drive the price up much higher. We currently have the perfect setup for that to happen. That's because while all the MLPs raised their dividends over the last few quarters, the yield on the 10-year Treasuries has fallen to 4.2%. So as the funds move to re-establish positions, they'll be drawn to the MLPs high yields (more than twice Treasuries) and relative safety (oil demand).

The share prices of our MLPs would double for the yields to equal Treasury yields. That means we have little downside risk and potentially triple-digit gains as our upside.

Initially, many of these pipeline companies can seem similar. Pipes are pipes. The networks are fixed structures with known volumes of oil and gas.

So to sort them out, you want companies that pay healthy-but-sustainable yields and ones that have some sort of edge over the competition. The edge can take many forms – the biggest operation in a high volume area, the only pipe leading to a critical area, exclusive international pipelines, etc.

I've found what I think are the four best A.O.P. plays.

These A.O.P. businesses each pay four quarterly distribution checks to their shareholders each year. If you decide to purchase shares of all of the businesses, you could receive up to 20 checks a year.

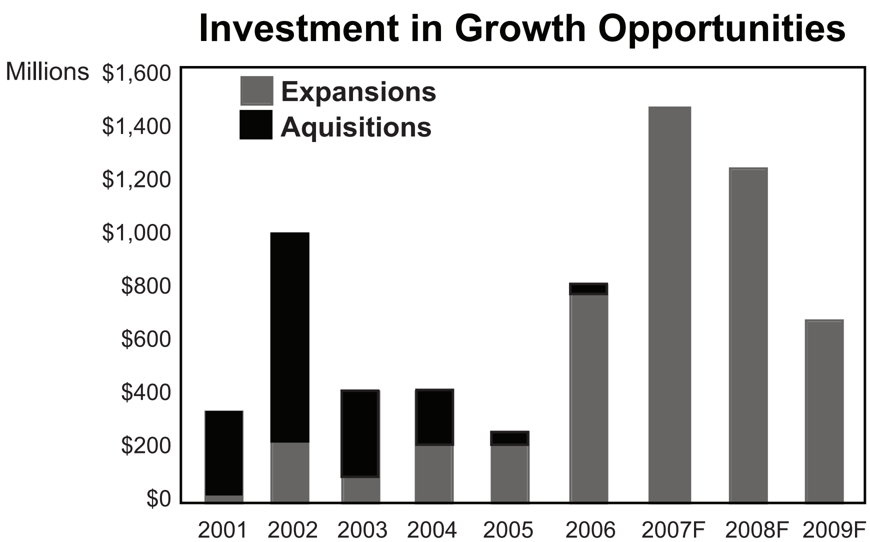
We have provided you with a brief summary at the end of each section noting the next ex-dividend dates.

If you are searching for a source of stable, conservative 6%-7% dividends, with the potential of a few more points through growth, look no further…

MLPs Poised For Huge Returns… Again

If the past is the key to the future, MLPs are poised to rise over 200%.

As you can see from the chart, in January 2003, the dividend yields of MLPs exceeded the yield of the 10-year Treasury Bonds by more than 4%. Over the next three years, investors seeking a higher return on their investments sent MLP share prices up and up and up.



Source: EEP reported and forcast investment in growth initiative.

Thanks to Ben Bernanke and the Federal Reserve board cutting interest rates, the difference is again greater than 4%. In addition, the price of oil is 300% higher today than back in 2003. Those are ideal conditions for a strong rise in the MLPs.

As you will see below, the current market favors our MLPs. For example, Enbridge's earnings grew by 65% from last year, Magellan's earnings grew by 88%, and Buckeye paid its 85th consecutive dividend. It's time to buy now, before the share prices begin to climb.

Enbridge Energy Partners L.P.

Enbridge Energy Partners L.P. (NYSE: EEP) is a major owner of oil and gas infrastructure in the U.S. It gathers and transports oil through three main regions: Lakehead, North Dakota, and Mid-Continent systems. It handles natural gas onshore and offshore and manages a series of distribution lines. The company's focus is building the plumbing to carry Canada's oil into the U.S.

If you look at an aerial image of Alberta, you'll see a series of long, straight pipelines connecting Canada's giant tar-sand basin to the U.S. These pipes carry Canada's low-grade crude oil to the U.S. refiners that turn it into vital fuels.

Enbridge built and owns many of those pipelines.

Without Enbridge's pipes, tar-sand crude is worth a whole lot less money. I think Canada's crude oil will become increasingly important to the U.S. over the next four years or so. That's why Enbridge is such a great investment.

Lakehead

The Lakehead system is the world's longest liquid petroleum pipeline. Its 12- to 48-inch-wide pipes stretch from Alberta oil fields to near Neche, N.D., where they cross the Canada-U.S. border. The system then winds through the Great Lakes and Michigan's Upper Peninsula before reaching terminals in the Buffalo, New York, region.

The 55-year-old network encompasses roughly 3,500 miles of pipe, running 1,900 miles from western Canada to the United States. It supports 59 pumping stations and 62 crude oil storage tanks that can hold approximately 10.8 million barrels.

The Lakehead System connects to all the major refineries in the Midwestern United States, and Ontario, Canada. In 2007, Lakehead pipes averaged 1.54 million barrels per day, which should grow to 1.69 million barrels per day this year. That represents about 67% of all the crude oil delivered from western Canada to the U.S.

The company recently completed the first phase of a southern expansion project that will carry about 190,000 barrels per day to Chicago. The new pipes will add about $100 million in earnings in 2008. The next stage, which will add 210,000 barrels per day of capacity, should be complete in a year.

Hardisty-Superior

A new pipeline, scheduled to come on line in 2010, will carry 450,000 barrels per day from Hardisty, Alberta, to Superior, Wisconsin. This will be a significant link in the plumbing between Canada and the U.S.

North Dakota

Enbridge's North Dakota System gathers crude oil and ships it through 620-miles of interstate pipes. The North Dakota pipes transport oil from 36 fields in the Williston Basin in North Dakota and Montana. It delivers oil to regional refineries or connections with other pipelines (like the Lakehead system).

A recent upgrade to the North Dakota pipeline increased its capacity from 80,000 barrels per day to 110,000 barrels per day. Additional upgrades should be done in 2010 and will add another 51,000 barrels per day capacity.

Mid-Continent

The Mid-Continent System is 480 miles of pipe that combine the Ozark and West Tulsa crude oil pipelines. In 2007, those two lines delivered 236,000 barrels per day. The pipes run from Cushing, Oklahoma, to refineries in Oklahoma and Wood River, Illinois. This line incorporates one of the largest aboveground storage facilities in North America. Crude oil terminals in Cushing and El Dorado, Kansas, can hold 11.9 million barrels of oil. Enbridge upgraded the terminals in 2005 with the addition of four 575,000-barrel tanks.

Natural Gas Pipes

Enbridge runs three onshore interstate gas distribution systems that serve customers in Alabama, Kansas, Louisiana, Missouri, and Tennessee. It has a total of 1,820 miles of pipe and a combined capacity of 560 million cubic feet per day.

Enbridge is a partner in 12 pipelines that run along six major corridors in the Gulf of Mexico. The pipes transport about half of all deepwater Gulf of Mexico natural gas production, or 3 billion cubic feet of natural gas per day on average.

In February 2008, the company upgraded its Weatherford natural gas processing plant. The work added about 195 million cubic feet per day of natural gas capacity to the system.

As I've said many times in the *S&A Oil Report*, Canadian oil will be vital to U.S. needs throughout the coming decades. Our demand for Canadian oil jumped from 1.59 million barrels per day in 2005 to 1.85 million barrels per day today.

Canada's exports will grow with new oil sand production scheduled to come on line in the next five to 10 years. In fact, exports to the U.S. could almost double by 2014.

Enbridge recognized this growth and began positioning itself to meet the need. It proposed expansion projects designed to streamline Canadian crude supplies coming to the U.S. I'm all in favor of Canadian crude over OPEC crude, and I don't think I'm alone. Enbridge is poised to have a very profitable decade!

The first quarter 2008 earnings report shows Enbridge's capital investments are paying off. Sales rose from $124.9 million in the first quarter of 2007 to $380.3 million in the first quarter of 2008. That beats the management's forecast and was mainly due to higher volumes of oil and gas filling up expansion capacity faster than projected.

Enbridge currently pays a 7.28% dividend per share. It made its most recent payment May 15, and its next dividend is due in August.

Recommendation: Buy Enbridge Energy Partners (NYSE: EEP) up to $56 per share, use a 30% trailing stop.

Note: Enbridge Energy Management (NYSE: EEQ) is a much smaller company that owns shares of Enbridge Energy Partners. It is an alternative investment in the same pipelines. It mirrors the price performance of EEP in all respects and can be treated as the same company. But I recommend buying shares of Enbridge Energy Partners rather than Energy Management.

If you already own shares of Enbridge Energy Management, don't sell them unless they hit the trailing stop. But I no longer recommend them here because of their similarity to the company we already own, Enbridge Energy Partners.

Buckeye Partners L.P.

Buckeye Partners (NYSE: BPL) is one of the largest shippers of gasoline, jet fuel, and diesel fuel in the U.S. It owns approximately 5,350 miles of pipeline that run between 110 terminals. Of those, 60 are in Illinois, Indiana, Massachusetts, Michigan, Missouri, New York, Ohio, and Pennsylvania.

Buckeye also operates 60 refined product storage terminals that hold up to 21 million barrels. And the company can store 22 billion cubic feet of natural gas in northern California. Finally, Buckeye maintains approximately 2,100 miles of pipeline for major oil and chemical companies.

Standard Oil created Buckeye in March 1886 to gather crude oil in northwestern Ohio. Buckeye went public in 1911, when Standard Oil dissolved.

During the 1950s, the company expanded its operations into transporting petroleum products. It built a new products system that carried refined products from New York Harbor into New Jersey, New York, and Pennsylvania.

Over the next five decades, Buckeye grew mainly through acquisitions of other pipelines. Its largest acquisition in company history came on October 1, 2004. Buckeye purchased five refined product pipelines and 24 petroleum products in the Midwest from affiliates of Shell Oil Products. The purchase more than tripled Buckeye's throughput.

More recently, the company had a surprisingly lackluster first quarter. The company's sales soared to $380.3 million from $124.9 million in the first quarter of 2007. But earnings grew to $42.8 million up from up from $37.7 million in the first quarter of 2007.

Recent acquisitions ate into the earnings a bit. But those new operations are contributing higher sales that should be reflected in earnings before long. Lodi Gas Storage, acquired in January 2008, brought in $11.5 million in sales and $4.9 million in earnings for the quarter. Farm & Home Oil Co., acquired in February 2008, added $235 million in sales but only $1.7 million in earnings in the first quarter.

The company paid its 85th consecutive quarterly dividend. That makes more than 21 years of consistent paychecks.

Buckeye made its most recent 7.69% dividend payment on May 30. It should distribute its next dividend in August.

Recommendation: Buy Buckeye Partners (NYSE: BPL) up to $52 per share, use a 30% trailing stop.

Magellan Midstream Partners

Magellan Midstream Partners (NYSE: MMP) is a gasoline pipeline company with assets concentrated in the Midwest, stretching in a line from Minnesota and Wisconsin south to Texas' Gulf Coast. Its network includes 8,500 miles of refined product pipes and 45 terminals. The terminals consist of seven marine facilities. Magellan also owns an 1,100-mile ammonia pipeline.

Magellan can store and blend ethanol at 25 terminals. It collects unusable refined products (due to contamination or improper mixing) for reprocessing at a Des Moines, Iowa, facility. And it has a facility for reclaiming tank bottom material and water.

The company also has more than 20 million barrels of storage capacity at its Corpus Christi, Texas; Galena Park, Texas; Marrero, Louisiana; and New Haven Connecticut, facilities.

Magellan's business model is growth through smart acquisitions that complement the existing portfolio.

The company plans to invest $240 million in a direct connection to the refining hub of Port Arthur, Texas, by 2011. This huge, 16-inch-diameter, 150,000-barrel-per-day pipeline will carry gasoline and other refined products from Port Arthur refineries to Magellan's terminal in Houston – the origin of the company's 8,500 miles of pipes to the rest of the United States.

Magellan's assets generate stable cash flows, with little exposure to commodity fluctuations. Its cash flows have enabled the company to increase its distributions every quarter since it went public in 2001.

Magellan is on a tear right now. It just reported a stupendous first quarter 2008. Operating profits soared to $105.3 million – 63% higher than the first quarter 2007. The company set operating profit records for both pipelines and terminals. As you would expect, net profits rose as well – they grew by 88% over the first quarter of 2007.

The company currently trades at a 52-week high. Its shares are heading steadily upward, disrupted only by slight corrections of 50¢ to a maximum of $2. If you can get it on a low ebb, do so. However, I wouldn't suggest waiting too long. It's averaged 5% gain per month in January and February.

The company's leadership increased the dividend to 67¢ for the first quarter this year. That's a 9% raise over the first quarter of 2007 and is the 28th consecutive increase.

Magellan currently pays a 7.11% dividend per share. Its last payment went out May 15, and its next dividend is due in August.

Recommendation: Buy Magellan Midstream Partners (NYSE: MMP) up to $47.50 per share, use a 30% trailing stop.

TC PipeLines

TC PipeLines (Nasdaq: TCLP) is a natural gas distribution MLP and subsidiary of TransCanada Pipelines Ltd. The company owns part of three major natural gas pipelines between Canada and the U.S.

Its three chief assets are Northern Border Pipeline Co., Tuscarora Gas Transmission Co., and the Great Lakes Gas Transmission LP. Together, these pipelines transport more than 5.5 billion cubic feet of natural gas per day.

TC PipeLines owns 50% of the Northern Border Pipeline Co., which in turn owns 1,249-mile pipeline that runs from the Minnesota/Saskatchewan border to the midwestern U.S. The pipe transports about 2.2 billion cubic feet of natural gas from Montana to Indiana.

In addition, TC PipeLines owns 100% of Tuscarora, a smaller pipeline that runs 240 miles from

Oregon to Nevada. The pipe carries about 100 million cubic feet of natural gas per day.

Finally, the company owns 46% of the Great Lakes Gas Transmission, which company operates a 2,115-mile pipeline from Emerson, Manitoba, to St. Clair Michigan. It can carry 2.5 billion cubic feet of natural gas per day.

Also, TC PipeLines is in a great position to build a new pipeline, the Bison Project, to serve companies in the Bakken Shale. The Bakken is a giant oil and gas deposit that lies under Wyoming, Montana, and the Dakotas. New horizontal drilling technology has the region booming, and TC PipeLines will channel out that oil and gas.

TC PipeLines raised its quarterly distribution by 22% since October 2006. Its first quarter dividend of 70¢ per share was a 5.3% increase over the fourth quarter 2007. The company's annual dividend is about $2.66 per share. That's a current yield of 7.74%. It paid its most recent dividend on May 15, and its next will go out in August.

Buy TC PipeLines (Nasdaq: TCLP) up to $45 per share, use a 30% trailing stop.

S&A Oil Report
1217 St. Paul Street
Baltimore, MD 21202
1-888-261-2693

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