April 12, 2011

Mike Isbell
Oklahoma Tax Commission
Ad Valorem Division
P.O. Box 269060
Oklahoma City, OK 73126-9060

Re: Preliminary 2011 Capitalization Rate Study, Pipeline MLP Industry

Dear Mike:

Thank you again for organizing this year's cap rate meeting with industry and for posting the OTC's Preliminary 2011 Capitalization Rate Study online. After reviewing the Pipeline MLP Industry section, I have a couple of comments that I would like to share.

1. **More weight should be given to the DCF Model in the calculation of the cost of equity:** Master Limited Partnership (MLP) structure creates additional filing requirements and complications with flow through tax issues. Therefore, MLP units tend to be less liquid than corporate shares that are generally owned and traded by a broader set of investors. This means that the trading pattern for MLP units is different when compared to corporate shares. Consequently, MLP beta estimates tend to be biased on the low side. As a result, the estimated returns of MLP companies may be understated when using a CAPM model to estimate the cost of capital. We feel that a more accurate estimate of the cost of equity for the MLP pipeline industry is the DCF Model. This model focuses on the current dividend yield plus consensus earnings growth estimates which better reflects MLP returns. Therefore, weighting should be higher on the DCF Model (minimum 80%) and lower on the CAPM (maximum 20%). By weighting the equity calculation at 80% - 20% accordingly, the equity rate would increase from 13.00% to 13.99%, resulting in a new capitalization rate of 11.45%, as can be seen in Exhibit 1.

2. **OTC's DCF Model:** One of the company's equity rates used in the OTC's DCF model, Energy Transfer Partners, L.P. (4.6%), is below the typical cost of debt selected by the OTC for use in their Band of Investment. We feel that an equity rate that falls below the cost of debt should be excluded from the study. Equity holders have more risk and require a higher rate of return than debt holders because in the event of default by a company, debt holders are paid first. By excluding equity rates that fall below the cost of debt, the DCF model "Equity Rate Earnings" would increase from 15.50% to 17.06%. This in turn would lead to a new Equity Rate of 14.62% and a new capitalization rate of 11.87%, illustrated in Exhibit 2.

3. **Liquidity Adjustment:** It has long been established that smaller stocks offer returns in excess of that calculated by the CAPM, and some of this difference can be attributed to their illiquidity. An adjustment must be made to the discount rate used to discount the cash flows of an illiquid investment by adding a premium to the cost of capital estimated from liquid securities. Several studies have estimated a liquidity premium based on various measures of illiquidity. For companies similar to NuStar Logistics, LP, Ibbotson Associates suggest a premium of 2.94% be added to the equity rate, as can be seen in Exhibit 3.

We appreciate the opportunity to provide input for the cost of capital process this year. Please feel free to contact me if you have any questions regarding our recommendations or if you have any additional questions or concerns.

Sincerely,

Tillman Davis

NuStar Logistics, LP

# Industry Equity Rate Summary

| Pipeline MLPs | Current Rate | Current Weighting | Current Rate | Recommended Weighting | Adjusted Weight |
|---|---|---|---|---|---|
| CapM Ex Post Equity Rate | 9.84% | 22.00% | 2.16% | 10% | 0.98% |
| CapM Ex Ante Equity Rate | 11.55% | 22.00% | 2.54% | 10% | 1.16% |
| DCF (Dividend) Equity Rate | 14.13% | 28.00% | 3.96% | 40% | 5.65% |
| DCF (Earnings) Equity Rate | 15.50% | 28.00% | 4.34% | 40% | 6.20% |
| Earnings Price Ratio | 6.77% | 0.00% | 0.00% | 0% | 0.00% |
| **Adjusted Equity Rate** | | **100.00%** | **13.00%** | **100%** | **13.99%** |

**Current Capitalization Structure**

| | Capital Structure | Cost | Weighted Average |
|---|---|---|---|
| Debt | 32.26% | 6.11% | 1.97% |
| Equity | 67.74% | 13.00% | 8.81% |
| **Total** | **100.00%** | | **10.78%** |

**Change to the Equity Weighting**

| | Capital Structure | Cost | Weighted Average |
|---|---|---|---|
| Debt | 32.26% | 6.11% | 1.97% |
| Equity | 67.74% | 13.99% | 9.48% |
| **Total** | **100.00%** | | **11.45%** |

## Discounted Cash Flow (Gordon Growth)

| Industry | Company | Value Line Strength | Market Capitalization d | Dividend Yield e | Growth Estimate Dividends f | Growth Estimate Earninggs g | Equity Rate Dividend (e+f) | Equity Rate Earnings (e+g) |
|---|---|---|---|---|---|---|---|---|
| **Pipeline MLPs** | | | | | | | | |
| | Boardwalk Pipeline Partners, L.P. | B+ | 6,000,000,000 | 6.80% | 6.00% | 9.00% | 12.80% | 15.80% |
| | Buckeye Partners, L.P. | B+ | 3,500,000,000 | 5.80% | 4.00% | 6.50% | 9.80% | 12.30% |
| | El Paso Pipeline Partners | B | 4,600,000,000 | 5.00% | 24.50% | 27.50% | 29.50% | 32.50% |
| | Energy Transfer Partners, L.P. | B++ | 9,700,000,000 | 7.10% | 4.50% | -2.50% | 11.60% | 4.60% |
| | Enterprise Products Partners, L.P. | B+ | 26,800,000,000 | 5.80% | 10.00% | 12.50% | 15.80% | 18.30% |
| | Kinder Morgan Energy Partners, L.P. | B+ | 22,000,000,000 | 6.50% | 7.50% | 9.50% | 14.00% | 16.00% |
| | Magelllan Midstream Partners, L.P. | B+ | 6,300,000,000 | 5.30% | 4.00% | 12.00% | 9.30% | 17.30% |
| | Plains All American Pipeline, L.P. | B+ | 8,400,000,000 | 6.20% | 4.00% | 1.00% | 10.20% | 7.20% |
| | Williams Partners, L.P. | B+ | 13,200,000,000 | 6.30% | 0.00% | 0.00% | | |
| **Median** | | | 8,400,000,000 | | | | 12.20% | 15.90% |
| **Arithmetic Mean** | | | 11,166,666,667 | | | | 14.13% | 15.50% |
| **Arithmetic Mean without Energy Transfer Partners** | | | | | | | | 17.06% |

## Industry Equity Rate Summary

| **Pipeline MLPs** | | **Current Rate** | **Current Weighting** | **Current Rate** | **Recommended Weighting** | **Adjusted Weight** |
|---|---|---|---|---|---|---|
| | CapM Ex Post Equity Rate | 9.84% | 22.00% | 2.16% | 10% | 0.98% |
| | CapM Ex Ante Equity Rate | 11.55% | 22.00% | 2.54% | 10% | 1.16% |
| | DCF (Dividend) Equity Rate | 14.13% | 28.00% | 3.96% | 40% | 5.65% |
| | DCF (Earnings) Equity Rate | 17.06% | 28.00% | 4.78% | 40% | 6.82% |
| | Earnings Price Ratio | 6.77% | 0.00% | 0.00% | 0% | 0.00% |
| **Adjusted Equity Rate** | | | **100.00%** | **13.44%** | **100%** | **14.62%** |

**Current Capitalization Structure**

| | Capital Structure | Cost | Weighted Average |
|---|---|---|---|
| Debt | 32.26% | 6.11% | 1.97% |
| Equity | 67.74% | 13.00% | 8.81% |
| **Total** | **100.00%** | | **10.78%** |

**Capital Structure with Change to Equity Weighting and Removing Companies that are not applicable**

| | Capital Structure | Cost | Weighted Average |
|---|---|---|---|
| Debt | 32.26% | 6.11% | 1.97% |
| Equity | 67.74% | 14.62% | 9.90% |
| **Total** | **100.00%** | | **11.87%** |

# Rate Change Summary Page

**Current Capitalization Structure**

| | Capital Structure | Cost | Weighted Average |
|---|---|---|---|
| Debt | 32.26% | 6.11% | 1.97% |
| Equity | 67.74% | 13.00% | 8.81% |
| **Total** | **100.00%** | | **10.78%** |

**Change to the Equity Weighting**

| | Capital Structure | Cost | Weighted Average |
|---|---|---|---|
| Debt | 32.26% | 6.11% | 1.97% |
| Equity | 67.74% | 13.99% | 9.48% |
| **Total** | **100.00%** | | **11.45%** |

**Capital Structure with Change to Equity Weighting and Removing Companies that are not applicable**

| | Capital Structure | Cost | Weighted Average |
|---|---|---|---|
| Debt | 32.26% | 6.11% | 1.97% |
| Equity | 67.74% | 14.62% | 9.90% |
| **Total** | **100.00%** | | **11.87%** |

**Liquidity Adjustment**

| | Capital Structure | Cost | Weighted Average |
|---|---|---|---|
| Debt | 32.26% | 6.11% | 1.97% |
| Equity | 67.74% | 17.56% | 11.90% |
| **Total** | **100.00%** | | **13.87%** |