MAGELLAN MIDSTREAM PARTNERS LP
Form 10-Q
August 02, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2017

OR

£ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File No.: 1-16335

Magellan Midstream Partners, L.P.
(Exact name of registrant as specified in its charter)

Delaware	73-1599053
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

One Williams Center, P.O. Box 22186, Tulsa, Oklahoma 74121-2186
(Address of principal executive offices and zip code)
(918) 574-7000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No £

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No £

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer £ Non-accelerated filer £ (Do not check if a smaller reporting company)

Smaller reporting company £ Emerging growth company £

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. £

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes £ No x

As of August 1, 2017, there were 228,024,556 outstanding limited partner units of Magellan Midstream Partners, L.P. that trade on the New York Stock Exchange under the ticker symbol "MMP."

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PART I
FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

MAGELLAN MIDSTREAM PARTNERS, L.P.
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per unit amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2017	2016	2017
Transportation and terminals revenue	$392,240	$433,239	$762,315	$825,910
Product sales revenue	123,689	182,004	270,251	427,624
Affiliate management fee revenue	2,968	4,197	6,147	7,980
Total revenue	518,897	619,440	1,038,713	1,261,514
Costs and expenses:				
Operating	134,183	145,294	257,096	276,886
Cost of product sales	95,703	145,975	209,288	318,851
Depreciation and amortization	43,302	48,896	87,056	96,194
General and administrative	34,554	43,393	75,230	83,674
Total costs and expenses	307,742	383,558	628,670	775,605
Earnings of non-controlled entities	15,339	25,576	32,967	47,022
Operating profit	226,494	261,458	443,010	532,931
Interest expense	48,686	51,546	92,410	102,758
Interest income	(404)	(256)	(765)	(548)
Interest capitalized	(7,130)	(3,183)	(13,266)	(7,380)
Gain on exchange of interest in non-controlled entity	(1,244)	—	(28,144)	—
Other expense (income)	(1,958)	2,043	(3,710)	3,213
Income before provision for income taxes	188,544	211,308	396,485	434,888
Provision for income taxes	685	908	1,556	1,752
Net income	$187,859	$210,400	$394,929	$433,136
Basic net income per limited partner unit	$0.82	$0.92	$1.73	$1.90
Diluted net income per limited partner unit	$0.82	$0.92	$1.73	$1.90
Weighted average number of limited partner units outstanding used for basic net income per unit calculation(1)	227,952	228,192	227,889	228,151
Weighted average number of limited partner units outstanding used for diluted net income per unit calculation(1)	227,983	228,245	227,921	228,202

(1) See Note 10–Long-Term Incentive Plan for additional information regarding our weighted average unit calculations.

See notes to consolidated financial statements.

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MAGELLAN MIDSTREAM PARTNERS, L.P.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited, in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2017	2016	2017
Net income	$187,859	$210,400	$394,929	$433,136
Other comprehensive income:				
Derivative activity:				
Net gain (loss) on cash flow hedges[1]	(8,631)	(2,802)	(21,109)	(1,507)
Reclassification of net (gain) loss on cash flow hedges to income[1]	388	739	776	1,479
Changes in employee benefit plan assets and benefit obligations recognized in other comprehensive income:				
Amortization of prior service credit[2]	(974)	(46)	(1,947)	(91)
Amortization of actuarial loss[2]	1,292	1,983	2,693	3,211
Settlement cost[2]	—	361	—	1,726
Total other comprehensive income (loss)	(7,925)	235	(19,587)	4,818
Comprehensive income	$179,934	$210,635	$375,342	$437,954

(1) See Note 8–Derivative Financial Instruments for details of the amount of gain/loss recognized in accumulated other comprehensive loss (“AOCL”) for derivative financial instruments and the amount of gain/loss reclassified from AOCL into income.
(2) See Note 6–Employee Benefit Plans for details of the changes in employee benefit plan assets and benefit obligations recognized in AOCL.

See notes to consolidated financial statements.

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MAGELLAN MIDSTREAM PARTNERS, L.P.
CONSOLIDATED BALANCE SHEETS
(In thousands)

	December 31, 2016	June 30, 2017 (Unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,701	$ 5,471
Trade accounts receivable	105,689	113,233
Other accounts receivable	25,761	12,636
Inventory	134,378	119,451
Energy commodity derivatives contracts, net	—	4,250
Energy commodity derivatives deposits	49,899	4,492
Other current assets	39,966	66,123
Total current assets	370,394	325,656
Property, plant and equipment	6,783,737	7,048,502
Less: Accumulated depreciation	1,507,996	1,592,035
Net property, plant and equipment	5,275,741	5,456,467
Investments in non-controlled entities	931,255	976,456
Long-term receivables	23,870	22,532
Goodwill	53,260	53,260
Other intangibles (less accumulated amortization of $2,136 and $1,228 at December 31, 2016 and June 30, 2017, respectively)	51,976	52,925
Other noncurrent assets	65,577	43,426
Total assets	$ 6,772,073	$ 6,930,722
LIABILITIES AND PARTNERS' CAPITAL		
Current liabilities:		
Accounts payable	$ 77,248	$ 103,100
Accrued payroll and benefits	45,690	40,181
Accrued interest payable	65,643	65,459
Accrued taxes other than income	50,166	43,409
Environmental liabilities	10,249	6,466
Deferred revenue	101,891	115,023
Accrued product purchases	51,600	46,803
Energy commodity derivatives contracts, net	30,738	—
Energy commodity derivatives deposits	—	119
Other current liabilities	48,431	36,015
Total current liabilities	481,656	456,575
Long-term debt, net	4,087,192	4,231,912
Long-term pension and benefits	71,461	68,444
Other noncurrent liabilities	25,868	27,137
Environmental liabilities	13,791	12,385
Commitments and contingencies		
Partners' capital:		
Limited partner unitholders (227,784 units and 228,025 units outstanding at December 31, 2016 and June 30, 2017, respectively)	2,193,346	2,230,692

Accumulated other comprehensive loss	(101,241)	(96,423)
Total partners' capital	2,092,105	2,134,269
Total liabilities and partners' capital	$ 6,772,073	$ 6,930,722

See notes to consolidated financial statements.

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MAGELLAN MIDSTREAM PARTNERS, L.P.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

	Six Months Ended June 30,	
	2016	2017
Operating Activities:		
Net income	$394,929	$433,136
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	87,056	96,194
Loss on sale and retirement of assets	3,263	5,331
Earnings of non-controlled entities	(32,967)	(47,022)
Distributions of earnings from investments in non-controlled entities	31,080	46,754
Equity-based incentive compensation expense	10,059	10,717
Settlement cost, amortization of prior service credit and actuarial loss	746	4,846
Gain on exchange of interest in non-controlled entity	(28,144)	—
Changes in operating assets and liabilities:		
Trade accounts receivable and other accounts receivable	(10,703)	2,681
Inventory	(25,562)	14,927
Energy commodity derivatives contracts, net of derivatives deposits	(17,121)	10,538
Accounts payable	9,125	13,132
Accrued payroll and benefits	(14,937)	(5,509)
Accrued interest payable	10,998	(184)
Accrued taxes other than income	(6,463)	(6,757)
Accrued product purchases	(8,858)	(4,797)
Deferred revenue	16,935	13,132
Current and noncurrent environmental liabilities	(2,695)	(5,189)
Other current and noncurrent assets and liabilities	(9,673)	(9,519)
Net cash provided by operating activities	407,068	572,411
Investing Activities:		
Additions to property, plant and equipment, net(1)	(310,133)	(281,504)
Proceeds from sale and disposition of assets	4,756	4,886
Investments in non-controlled entities	(109,933)	(55,273)
Distributions in excess of earnings of non-controlled entities	1,942	11,152
Net cash used by investing activities	(413,368)	(320,739)
Financing Activities:		
Distributions paid	(361,605)	(393,912)
Net commercial paper borrowings (repayments)	(255,966)	146,885
Borrowings under long-term notes	649,187	—
Debt placement costs	(5,408)	—
Payments associated with settlement of equity-based incentive compensation	(14,376)	(13,875)
Net cash provided (used) by financing activities	11,832	(260,902)
Change in cash and cash equivalents	5,532	(9,230)
Cash and cash equivalents at beginning of period	28,731	14,701
Cash and cash equivalents at end of period	$34,263	$5,471
Supplemental non-cash investing and financing activities:		
Issuance of limited partner units in settlement of equity-based incentive plan awards	$7,092	$1,669

(1) Additions to property, plant and equipment	$(321,085)	$(289,570)
Changes in accounts payable and other current liabilities related to capital expenditures	10,952	8,066
Additions to property, plant and equipment, net	$(310,133)	$(281,504)

See notes to consolidated financial statements.

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MAGELLAN MIDSTREAM PARTNERS, L.P.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization, Description of Business and Basis of Presentation

Organization

Unless indicated otherwise, the terms “our,” “we,” “us” and similar language refer to Magellan Midstream Partners, L.P. together with its subsidiaries. Magellan Midstream Partners, L.P. is a Delaware limited partnership and its limited partner units are traded on the New York Stock Exchange under the ticker symbol “MMP.” Magellan GP, LLC, a wholly-owned Delaware limited liability company, serves as its general partner.

Description of Business

We are principally engaged in the transportation, storage and distribution of refined petroleum products and crude oil. As of June 30, 2017, our asset portfolio, including the assets of our joint ventures, consisted of:

- our refined products segment, comprised of our 9,700-mile refined products pipeline system with 53 terminals as well as 26 independent terminals not connected to our pipeline system and our 1,100-mile ammonia pipeline system;

- our crude oil segment, comprised of approximately 2,200 miles of crude oil pipelines, our condensate splitter and storage facilities with an aggregate storage capacity of approximately 27 million barrels, of which approximately 17 million barrels are used for contract storage; and

- our marine storage segment, consisting of five marine terminals located along coastal waterways with an aggregate storage capacity of approximately 26 million barrels.

Terminology common in our industry includes the following terms, which describe products that we transport, store and distribute through our pipelines and terminals:

- refined products are the output from refineries and are primarily used as fuels by consumers. Refined products include gasoline, diesel fuel, aviation fuel, kerosene and heating oil. Collectively, diesel fuel and heating oil are referred to as distillates;

- liquefied petroleum gases, or LPGs, are produced as by-products of the crude oil refining process and in connection with natural gas production. LPGs include butane and propane;

- blendstocks are blended with refined products to change or enhance their characteristics such as increasing a gasoline’s octane or oxygen content. Blendstocks include alkylates, oxygenates and natural gasoline;

- heavy oils and feedstocks are used as burner fuels or feedstocks for further processing by refineries and petrochemical facilities. Heavy oils and feedstocks include No. 6 fuel oil and vacuum gas oil;

- crude oil and condensate are used as feedstocks by refineries and petrochemical facilities;

- biofuels, such as ethanol and biodiesel, are increasingly required by government mandates; and

- ammonia is primarily used as a nitrogen fertilizer.

Except for ammonia, we use the term petroleum products to describe any, or a combination, of the above-noted products.

MAGELLAN MIDSTREAM PARTNERS, L.P.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Basis of Presentation

In the opinion of management, our accompanying consolidated financial statements which are unaudited, except for the consolidated balance sheet as of December 31, 2016, which is derived from our audited financial statements, include all normal and recurring adjustments necessary to present fairly our financial position as of June 30, 2017, the results of operations for the three and six months ended June 30, 2016 and 2017 and cash flows for the six months ended June 30, 2016 and 2017. The results of operations for the six months ended June 30, 2017 are not necessarily indicative of the results to be expected for the full year ending December 31, 2017 for several reasons. Profits from our butane blending activities are realized largely during the first and fourth quarters of each year. Additionally, gasoline demand, which drives transportation volumes and revenues on our pipeline systems, generally trends higher during the summer driving months. Further, the volatility of commodity prices impacts the profits from our commodity activities and, to a lesser extent, the volume of petroleum products we transport on our pipelines.

Pursuant to the rules and regulations of the Securities and Exchange Commission, the financial statements in this report do not include all of the information and notes normally included with financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2016.

Use of Estimates

The preparation of our consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities that exist at the date of our consolidated financial statements, as well as their impact on the reported amounts of revenue and expense during the reporting periods. Actual results could differ from those estimates.

New Accounting Pronouncements

In March 2017, the Financial Accounting Standards Board (“ FASB”) issued Accounting Standards Update (“ASU”) 2017-07, Compensation-Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. This ASU requires companies that offer postretirement benefits to present the service cost, which is the amount an employer has to set aside each period to cover the benefits, in the same line item with other employee compensation costs. Other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations. Additionally, only the service cost component will be eligible for capitalization when applicable.

Public companies must comply with the new requirements under ASU 2017-07 for fiscal years that start after December 15, 2017, and the amendments must be applied retrospectively except for the capitalization change, which should be applied prospectively. Early adoption is allowed, and we elected to adopt ASU 2017-07 as of January 1, 2017. Prior to adoption, we expensed all components of pension expense through salaries and wages, which impacted operating income. We are now recording only the service component of pension expense to salaries and wages, with the remainder of the expense being recorded to other income and expense below operating profit. Comparative prior periods have been restated for this change. The changes were not material to our financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). This ASU requires lessees to recognize a right of use asset and lease liability on the balance sheet for all leases, with the exception of short-term leases. The

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MAGELLAN MIDSTREAM PARTNERS, L.P.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

new accounting model for lessors remains largely the same, although some changes have been made to align it with the new lessee model and the new revenue recognition guidance. This update also requires companies to include additional disclosures regarding their lessee and lessor agreements. Public companies are required to adopt the standard for financial reporting periods that start after December 15, 2018, although early adoption is permitted. We are currently in the process of evaluating the impact this new standard will have on our financial statements.

In July 2015, the FASB issued ASU 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory. Prior to this update, reporting entities were required to measure inventory at the lower of cost or market. Market could be replacement cost, net realizable value or net realizable value less an approximately normal profit margin. Under this update, inventory is to be measured at the lower of cost or net realizable value, which is defined as the estimated selling price in the ordinary course of business, less reasonable predictable costs of completion, disposal and transportation. This ASU became effective for fiscal years beginning after December 15, 2016 and interim periods within those fiscal years. We adopted this standard on January 1, 2017, and it did not have a material impact on our results of operations, financial position or cash flows as we have historically measured our inventory at the lower of cost or net realizable value, as described above.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. This ASU amends the existing accounting standards for revenue recognition and is based on the principle that revenue should be recognized to depict the transfer of goods or services to a customer at an amount that reflects the consideration a company expects to receive in exchange for those goods or services. We will adopt this ASU as required on January 1, 2018, using the full retrospective method of adoption. We do not expect the adoption of this ASU to have a material impact on our consolidated financial statements.

2. Product Sales Revenue

The amounts reported as product sales revenue on our consolidated statements of income include revenue from the physical sale of petroleum products and mark-to-market adjustments from exchange-based futures contracts. See Note 8 – Derivative Financial Instruments for a discussion of our commodity hedging strategies and how our futures contracts impact product sales revenue. All of the petroleum products inventory we physically sell associated with our butane blending and fractionation activities, as well as the barrels from product gains we obtain from our operations, including tender deductions, are reported as product sales revenue on our consolidated statements of income.

For the three and six months ended June 30, 2016 and 2017, product sales revenue included the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2017	2016	2017
Physical sale of petroleum products	$135,459	$167,790	$266,039	$384,730
Change in value of futures contracts	(11,770)	14,214	4,212	42,894
Total product sales revenue	$123,689	$182,004	$270,251	$427,624

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MAGELLAN MIDSTREAM PARTNERS, L.P.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Segment Disclosures

Our reportable segments are strategic business units that offer different products and services. Our segments are managed separately as each segment requires different marketing strategies and business knowledge. Management evaluates performance based on segment operating margin, which includes revenue from affiliates and external customers, operating expenses, cost of product sales and earnings of non-controlled entities.
We believe that investors benefit from having access to the same financial measures used by management. Operating margin, which is presented in the following tables, is an important measure used by management to evaluate the economic performance of our core operations. Operating margin is not a GAAP measure, but the components of operating margin are computed using amounts that are determined in accordance with GAAP. A reconciliation of operating margin to operating profit, which is its nearest comparable GAAP financial measure, is included in the tables below. Operating profit includes depreciation and amortization expense and general and administrative ("G&A") expense that management does not consider when evaluating the core profitability of our separate operating segments.

	Three Months Ended June 30, 2016 (in thousands)				
	Refined Products	Crude Oil	Marine Storage	Intersegment Eliminations	Total
Transportation and terminals revenue	$247,842	$101,340	$43,058	$ —	$392,240
Product sales revenue	122,311	(28)	1,406	—	123,689
Affiliate management fee revenue	124	2,486	358	—	2,968
Total revenue	370,277	103,798	44,822	—	518,897
Operating expenses	98,513	20,555	16,278	(1,163)	134,183
Cost of product sales	94,392	1,016	295	—	95,703
(Earnings) losses of non-controlled entities	38	(14,711)	(666)	—	(15,339)
Operating margin	177,334	96,938	28,915	1,163	304,350
Depreciation and amortization expense	24,971	9,062	8,106	1,163	43,302
G&A expense	20,506	9,149	4,899	—	34,554
Operating profit	$131,857	$78,727	$15,910	$ —	$226,494

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