Midstream Movements

March 8, 2019 Kim Mai

PRACTICES Energy, Power and Natural Resources, Midstream, Oil and Gas

Following several tumultuous years, the midstream oil and gas industry is making strides to stabilize the business model by de-risking corporate structures and rethinking capital sourcing. As the forecast for commodity prices in 2019 remains uncertain, there are several midstream developments worth following.

Restructuring and Improved Financing Prospects

To improve their appeal to investors, many midstream companies restructured in 2018 by eliminating incentive distribution rights (IDRs) of general partners with "simplification transactions," improving leverage metrics or self-funding expenditures with cash flow.[1]Midstream companies have also continued to divert resources from less attractive prospects to the more attractive Marcellus, Permian and Utica basins. Some, like Enbridge Inc. and EnLink Midstream have consolidated through mergers and acquisitions and others, like Brazos Midstream, Noble Midstream Partners LP, and SemGroup have pursued joint ventures. The reduction of the U.S. corporate tax rate, which was implemented in 2018 in connection with the Tax Cuts and Jobs Act, motivated a number of midstream MLPs (which are treated as pass-through entities for tax purposes) to convert to C-Corps (which are taxed at the entity level), including ONEOK Partners, Targa Resources Partners and Williams Partners. In the long run, the midstream oil and gas industry hopes these different efforts will lead to a lower cost of capital, improved returns on capital and better market perception.[2]

The shift from a distribution growth focused industry to a more balanced model of reduced leverage and increased coverage ratios and cash flow is a positive development for not only investors, but lenders providing credit facilities. In midstream credit facilities, asset values are predominately determined by either a cash flow multiple, with a typical valuation range between 8x to 12x historical cash flow, or a discounted cash flow analysis.[3] The standard leverage covenant (total funded debt to EBITDA) in current credit facilities will range from 4x to 6x, with step-ups in the leverage covenant of 0.25x to 0.50x following an acquisition. Credit facilities ordinarily also include an interest coverage ratio (EBITDA to interest expense) that currently ranges from 2.5 to 3x. The calculation of EBITDA is heavily negotiated, with borrowers pushing to include open-ended addbacks and pro-forma adjustments to material project EBITDA, while lenders are aiming to set parameters around such add-backs, including limiting any pro forma EBITDA to no more than 20-35 percent of total EBITDA and ensuring that any add-backs are certain and quantifiable.

Sabine Case Aftermath

In addition to organizational and financing restructurings, several large midstream companies have modified their form gas gathering agreements in response to the U.S. District Court's decision that gas gathering contracts entered into by Sabine Oil & Gas Corporation with two midstream service companies were personal obligations, and not real property "covenants running with the land" under Texas law and could be rejected under the bankruptcy code. The decision was later affirmed by the United States Court of Appeals for the Second Circuit on May 25, 2018.[4] To create horizontal privity (and thus real property attributes), some midstream companies have added provisions conveying, or granting a security interest in, not only the hydrocarbons of the producer but also the producer's leases and lands. The broad conveyances and grants of security interest are often problematic for producers who have credit facilities that restrict them from transferring producing oil and gas properties or granting liens thereon. The Sabine decision, and its fallout, has created a tension between producers that need to comply with the terms of their credit facilities and midstream companies that need to clearly demonstrate the creation of horizontal privity to pass the scrutiny of potential investors and midstream lenders.

New Competition from a Familiar Face

In a quest to increase operational efficiency, some oil and gas companies are investing in their own midstream assets by building infrastructure, acquiring midstream assets, entering into joint ventures or consolidating with companies that have midstream assets. Investing in midstream assets enables producers to design and develop a system that would allow for the most efficient development of the entire field and ensures that producers have timely access to downstream markets. The strategy also allows producers to move production through longer-haul pipelines to areas where they can sell production for a higher value or to create leverage for better contractual terms by gathering production from multiple sources to a central collection point located in an area with multiple midstream providers. Beyond creating operational efficiency, oil and gas companies can slowly build-out a valuable midstream company.

LNG Exports

LNG (liquefied natural gas) exports remain a hot topic in the midstream industry. The U.S. Energy Information Administration projected in its Annual Energy Outlook that U.S. LNG exports will continue to surge as LNG exports hit record levels in November and December 2018. Despite ongoing trade wars with China, LNG growth shows no sign of slowing as more LNG projects recently have been announced, including Exxon Mobile's joint development of its Golden Pass terminal with Qatar Petroleum on the Texas coast. Major LNG export terminals expected to come on line by the end of 2019 include Cameron (majority owned by Sempra Energy), Corpus Christi (the second facility of Cheniere Energy), Freeport (majority owned by Freeport LNG) and potentially Golden Pass, which will involve the conversion of an existing import terminal to send gas in the opposite direction. Other LNG Export terminals either currently or imminently operating are at Elba Island (Kinder Morgan, Southern Company), Cove Point (Dominion Energy), and Kenai (ConocoPhillips), all with a combined export capacity of 1.3 Bcf/d. As long-term demand for LNG grows, there will be an immediate need for midstream infrastructure to connect regasification facilities to users. The midstream industry is poised to remain a key player in sustaining LNG growth.[5]

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[1] The shift to self-funding was a result of a decline in the public equity market's appetite for the issuance of new equity. *See also* Alerian Insights, "Back to Basics: The MLP and Midstream Investment Thesis." *Seeking Alpha*. Jan. 9, 2019 (noting that corporation and MLPs, including Enterprise Production Partners and Kinder Morgan, have either repurchased units or are discussing buybacks).

[2] Chicksaw Capital

[3] See guidance provided by "Midstream Lending in the Oil and Gas Industry." Risk Management Association. 2018.

[4] Ellen Conley and Jeff Nichols, "Sabine Decision Affirmed" (May 30, 2018).

[5] See Gregory DL Morris, “Last Mile Is Key To Global LNG Growth.” *Oil and Gas Investor*. January 22, 2018.