Midstream Energy

Midstream companies' resiliency will be tested as headwinds approach

What's changed?

Heightened counterparty risk. The precarious financial health of many companies in the upstream sector could result in cash flow pressure for the midstream gathering and processing companies.

Slowing production growth. We assume low natural gas prices will persist unless there is a significant supply response by the upstream industry.

Take-private transactions and private equity money is creating uncertainty. Private equity firms and infrastructure funds have filled funding gaps, which in some cases has resulted in more complex organizational structures and higher financial leverage.

What to look for in the sector in 2020?

Lower capital spending and high-grading project backlogs. We assume that the midstream industry will scale back on capital spending by 15%-20%.

Increased regulatory and environmental risk. Permitting delays and heightened social opposition to new pipelines has in some cases affected timing and construction costs.

A move toward consolidation and asset rationalization. We think there is an opportunity for some consolidation between larger diversified companies and their smaller peers.

What are the key medium-term credit drivers?

The demand for hydrocarbons and U.S. exports. Growth in North American LNG capabilities, the strength of U.S. producers, and more disciplined production are the key drivers to watch for natural gas supply and demand.

Financial discipline and portfolio optimization. Balancing capital spending, shareholder needs, and growth strategies will be key differentiators.

Scale, scope, and diversification. Increased scale and geographic and asset diversification are becoming more important credit drivers as companies look to compete in high-growth areas or for access to export markets along the U.S. Gulf Coast.
Ratings trends and outlook

Global Midstream Energy

Chart 1
Ratings distribution

Chart 2
Ratings outlooks

Chart 3
Ratings outlook net bias

Source: S&P Global Ratings. Ratings data measured at quarter end. Data for Q4 2019 is end October, 2019
Our 2020 outlook for the midstream sector is stable, but we believe there is increased negative bias in ratings because of the drivers that we've outlined above: weaker counterparties, slower production assumptions, and heightened environmental and regulatory risk. Our view is based on a modest uptick in the negative outlooks on companies to 18% from 13% in May 2019. That said, most of the portfolio have stable ratings (79%), which is little changed from May (81%). We expect midstream companies to continue to fund most of their organic growth projects with retained cash flow, with minimal use of incremental debt. We forecast that the investment-grade companies will have average debt-to-EBITDA ratios of about 4.2x in 2020, while their speculative-grade peers will have ratios in the 4.75x area. Our forecast assumes capital spending to be down 15%-20%, but we think this could be revised lower given weaker industry and investor sentiment, coupled with the rising risk of a global recession.

### Key assumptions

#### 1. Commodity Prices

Our base-case price assumptions for West Texas Intermediate (WTI) and Brent crude oil is $60 per barrel (bbl) and $55/bbl, respectively, for 2020. We then have Brent decreasing to $55/bbl for 2020 and beyond, which is in line with our assumptions for WTI. Our price assumption for natural gas is $2.50 per million British thermal unit (mmBtu) in 2020, $2.75/mmBtu in 2021, and $3.00/mmBtu in 2022 and beyond. We are forecasting that natural gas liquid (NGL) prices average about 50 cents per gallon. Under these price assumptions, we don’t expect commodity prices to substantially change our forecast assumptions or harm midstream companies’ credit profiles because most already have largely fee-based contract profiles.

#### 2. Slower Production Growth

We expect U.S. E&P companies to scale back production, which has been factored into our midstream growth forecasts. We believe companies with exposure to the Permian Basin and Bakken Shale regions will perform the strongest in 2020, while companies with exposure to areas of the SCOOP/STACK basin and Marcellus and Utica Shales may somewhat underperform based on our revised forecasts.

#### 3. Generally Flat Financial Performance, Lower Capital Spending

We assume that midstream credit measures will modestly improve, depending on the use of excess cash flow. We forecast that investment-grade midstream companies will achieve average debt EBITDA of about 4.2x, while their speculative-grade peers will have a debt-to-EBITDA ratio closer to 4.75x in 2020. We assume that midstream spending will decline 15%-20%, and credit measures could be stronger if companies allocate capital for debt repayment, which we think is less likely.
Key risks and opportunities

1. Regulatory Risk
We believe opposition to large pipeline projects will continue to be a significant risk for midstream companies, even if the Atlantic Coast Pipeline and Mountain Valley Pipeline projects receive a favorably ruling by the U.S. Supreme Court. We also believe that the 2020 presidential election holds some risks for midstream companies, such as the fracking ban on federal land some Democratic candidates have proposed.

2. Counterparty Risk
Producer credit quality is under pressure from financial and operational restructurings, and in some cases bankruptcies. Although the effects of the last downturn in the upstream sector were mostly benign for midstream credit quality, we nevertheless think that weak upstream credit quality and lower volumes could affect midstream cash flows this time.

3. Disciplined Growth Can Lead To Strong Balance Sheets
We think most midstream companies will stay on a more disciplined financial path and focus only on the highest return projects, while scaling back capital spending. The strategy of partnering on larger capital projects not only shares the risk but preserves some balance sheet flexibility, in our view. We think selective acquisitions are possible but the acquiring company would need to be provided with an asset that is viewed as strategic to the integrated model and would not add significant commodity or volume risk that we’d view as dilutive to the credit profile.

U.S. Crude Oil And Natural Gas Production Growth Will Slow In 2020
The Energy Information Administration (EIA) expects U.S. crude oil production growth (excluding Gulf of Mexico) will slow, increasing by about 870,000 barrels per day to 13.2 million barrels per day and that natural gas production growth will average about 2% in 2020 to 93.5 billion cubic feet per day (Bcf/d.) We believe slowing production and the precarious health of the upstream industry could have profound effects for some companies in the midstream industry.

We believe gatherer and processors (G&P) are the most vulnerable, while new crude oil pipeline operators that have capacity to fill could confront a more challenging competitive landscape depending on location and the strength of the assets’ strategic relationships. We believe the natural gas pipelines that have been placed into service and new additions expected in the next 12-24 months are in a good position to transport excess natural gas production and associated gas to demand and export markets. We think NGL logistic providers and their assets, when part of an integrated network that can provide redundancy and operational flexibility for its customers, are best positioned. The smaller peers that have disparate groups of regional assets will remain the most challenged from a credit perspective.

Regionally, we believe the Permian Basin and Bakken Shale areas will provide the best opportunities for midstream companies in 2020, while the midcontinent regional and Marcellus and Utica Shales will be somewhat challenged. With the prospects of crude oil production reaching 5.7 million barrels per day and natural gas production hitting 13 Bcf/d, the Permian Basin will continue to see significant activity and capital projects. That said, the risk of an overbuild, particularly on the crude takeaway, is possible, in our view, because we’ve already seen new operators cut transportation rates to remain competitive. The Bakken will continue to require associated natural gas processing from
the crude production, which is expected to grow to more than 1.5 million barrels per day in 2020.

U.S. rig activity continued its downward trend, averaging 932 rigs in October 2019—a 5.2% monthly drop. Within the major eight basins, rigs fell most heavily in the SCOOP-STACK, down by 14.5% in October compared to September. Natural gas production is expected to be flattish in the basin, while crude oil production could post modest single-digit growth in 2020.

We also believe midstream companies with significant exposure to the Marcellus and Utica Shales will feel pressure. Although natural gas production in Marcellus will grow in 2020, production growth will slow to the mid-single-digits. Average monthly dry gas production in Utica will drop by 3% to an average of 6.4 Bcf/d in 2020. The region's expected production is driven by low natural gas prices, which have incentivized E&P companies to focus on well completion rather than drilling.

Private Capital Is Available For Funding But Raises Uncertainty For Credit Quality

Midstream companies’ stubbornly low equity prices have opened the door for financial sponsors and infrastructure funds to invest capital in the industry. Take-private deals or changes in a company’s financial policies after a private capital investment could lead to negative rating actions across our rated portfolio. Over the past few years, private equity investors, infrastructure funds, and investment management companies have made compelling bids to take private several midstream partnerships, such as Boardwalk Pipeline Partners, TransMontaigne Partners, Buckeye Partners L.P., and Tallgrass Energy Partners L.P. We believe that financial investors will be the leading candidates for any future transactions largely due to the steep price and the contracted nature of their cash flows, including the potential sale of Western Midstream Partners or Energy Transfer L.P.’s interest in Rover Pipeline. Large diversified energy companies such as Energy Transfer L.P., Kinder Morgan Inc., TC Energy Corp., Enbridge Inc., and MPLX L.P. have executed and may consider divesting certain noncore assets to financial sponsors to bridge the funding needs of their capital spending initiatives, maximize shareholder value, or reduce leverage.

Our take on some of the recent transactions:

- **Tallgrass Energy Partners**: The partnership announced that the board of directors of its general partner received a nonbinding proposal from Blackstone Infrastructure Partners, its partners, and respective affiliates to pursue a take-private deal. The proposed transaction would lead us to consolidate the debt at its holding company and could lead to a lower rating.

- **Boardwalk Pipeline Partners**: A take-private transaction by majority owner Loews—an investment holding company—didn’t affect the ratings because we did not expect any change to the company’s financial policy or credit measures.

- **Western Midstream Operating L.P.**: Currently for sale and while no buyer has emerged, the expectation is that private equity will likely buy and control these assets if sold by Occidental Petroleum (OXY). Given OXY’s public comments, we now assess Western Midstream as nonstrategic to the company. The outlook is negative given the increased likelihood that the partnership is sold to a more aggressive owner over the next 12–24 months.

These transactions usually lead us to take negative rating actions due to the sponsors’ more aggressive financial policies, which often involve using leverage to partially finance the transactions. In our view, financial sponsors are generally more willing to use debt or debt-like instruments to boost equity returns and sell within a shorter time period than an infrastructure fund. A sponsor’s track record could also influence how we assess a company’s financial profile and lead to lower ratings. In certain cases, we could look at holding company financial leverage separately from the operating company’s leverage,
but will likely consolidate credit ratios in a take-private scenario, which often leads to significantly weaker credit metrics. That said, if the new owner commits to no dividend and allows the private operating company’s excess cash flow to pay down debt, it could mute the harmful impact on the credit rating. We would expect financial sponsors to pay themselves a distribution rather than repay debt, but infrastructure funds are more cognizant of leverage levels. This was reflected in the recent transaction involving IFM Global Infrastructure Fund’s take-private of Buckeye Partners L.P., which we expect will use internally generated cash flow to fund capital requirements and repay debt for the next several years.

**Weakened Credit Quality For Upstream Companies Could Affect Midstream Issuers**

Sustained low gas prices, heavy debt burdens, high cost structures, and other contractual obligations have hurt many U.S. E&P companies’ credit quality. We took several negative rating actions on upstream issuers that focus on the Marcellus and Utica Shales, including Antero Resources, EQT Corp, CNX Resources, and Range Resources. The rating actions at Antero Resources and CNX Resources led to subsequent actions at their respective midstream operating subsidiaries, Antero Midstream and CNX Midstream, because they derive most of their cash flow from their parent companies. CNX Midstream receives 70%-80% of its revenues from CNX Resources while Antero Midstream gets all of its cash flow from Antero Resources.

Even if commodity prices do not fall further, producers’ credit quality could keep deteriorating because of financial and operational restructurings and bankruptcies, which could affect contracts with G&P companies. G&P companies concentrated in the Northeast U.S. with high exposure to natural gas producers are the most vulnerable, but we also see some vulnerabilities in the midcontinent region and other dry gas areas like the Haynesville Shale or Powder River Basin. Weaker credit quality for the midstream industry’s customers could result in a replay of contract renegotiations, or the amend-and-extends that proliferated in 2016 and 2017. However, most producers are living within their current cash flow, and in our view it may be harder for midstream companies to maintain strong financial profiles if things get worse for producers. Separately, we expect low natural gas prices to result in lower growth profiles for Northeast-focused G&P companies than we previously expected. These companies have some flexibility, including the ability to scale back capital spending, which may preserve some balance sheets and credit measures.

**Regulatory Challenges For Large Capital Projects Will Persist**

Regulatory challenges to large-scale pipeline projects plague the industry and we expect this trend to continue in 2020. The harmful effect on the credit quality of some midstream issuers and has led the industry to share the risk among multiple joint venture partners on many of these large oil and natural gas transportation projects. Most notably, EQM Midstream Partners L.P.’s Mountain Valley Pipeline (MVP) project continues to face headwinds, with permit issues stopping the completion of the last 10% of construction. The most recent legal challenge comes from environmental groups who sued the U.S. Fish and Wildlife Service to reevaluate the pipeline project’s impact on the environment and endangered species along the pipeline’s route. Additionally, EQM is waiting on the Supreme Court to hear arguments on Dominion’s $7.5 billion Atlantic Coast Pipeline project, agreeing to rule on a permit that would let the pipeline cross under the Appalachian Trail. The court’s decision, expected in June or July 2020, will affect EQM’s MVP project and its ability to cross the Appalachian Trail, allowing completion of the project. Due to the many regulatory hurdles MVP’s in-service timing has been pushed back from the original date of 2018 to year-end 2020 and the budget has increased to between $5.3 billion and $5.5 billion from the original budget of $3.7 billion. EQM is responsible for approximately $2.7 billion of the total MVP budget.
Even pipeline operators in Texas, one of the most energy-friendly states in the country, are not immune to regulatory speed bumps. Due to slower-than-expected regulatory authorizations, Kinder Morgan has pushed back the in-service date for its Permian Highway Pipeline Project. While this does not affect Kinder Morgan's credit quality, it demonstrates the regulatory hurdles the industry faces. We expect environmental groups to continue pursuing action in the courts, which will affect large-scale pipeline projects. The results of the Democratic primary and 2020 election could create further regulatory headwinds for the industry, including a possible fracking ban on federal lands, stricter rules for water use, and the inability to obtain permits.

**Canadian Midstream Is Looking For A Clear Path Among Bumps In The Road**

The Canadian energy sector generally remains challenged due to political uncertainty, a difficult regulatory environment, persistent infrastructure constraints, and weak oil prices. Alberta’s curtailment quotas and U.S. sanctions on Venezuelan heavy crude have supported Western Canadian Select (WCS) prices this year, with differentials versus WTI crude now close to $20/bbl, which primarily reflect rail transportation costs to U.S. refineries and markets, particularly the Gulf Coast where demand for heavy oil is the most favorable. We believe Canadian oil sands producers could ship up to 200 million barrels per day of heavy oil by rail above the provincially imposed caps in 2020, which will likely keep the differential in a $15-$20/bbl discounted band from WTI and help U.S. refiners’ profitability.

Despite the Alberta government’s decision to ease curtailment quotas, the curtailment program has been extended to December 2020 in response to the lack of export capacity. The midstream industry’s ability to provide some relief to producers has been challenging. The egress solution that Enbridge’s Line 3 replacement project was to provide has been delayed until the second half of 2020 due to permitting issues with Michigan. As such, we believe a costlier and riskier rail solution will be the answer for producers in 2020, at the expense of midstream cash flow and credit quality.

The availability of liquids-rich gas in the Montney region, cheap natural gas, and incentives offered by the previous Alberta government have made large-scale petrochemical projects economically attractive. That said, several large petrochemical plants that are under construction have weakened credit measures and could add commodity risk to cash flows, which may pressure ratings. The capital spending and construction risk associated with Pembina Pipeline Corp.’s integrated propane dehydrogenation plant and polypropylene upgrading facility and Inter Pipeline Ltd.’s Heartland Petrochemical Complex will be a key risk factor for both companies’ credit profiles.

Regulatory risk has also increased in Canada, with several bills passed in 2019. Bill C-69, which Parliament passed in June 2019, overhauls the federal environmental assessment process for major construction projects. The bill also replaces both the National Energy Board Act with the Canadian Energy Regulator Act and the Canadian Environmental Assessment Agency Act with the Impact Assessment Act. Therefore, the Canadian Energy Regulator is now the primary authority responsible for federally regulated oil and gas pipelines and power lines. Though the bill is aimed at improving trust and transparency in the review process, we believe it adds some complexity and uncertainty to the project approval process, making it more difficult for midstream companies to receive construction approval for future oil and gas pipelines. Additionally, Bill C-48 also received Royal Assent in September 2019 and aims to limit the movement of large oil tankers (those carrying more than 12,500 metric tons of oil) at ports or marine installations located along British Columbia. Critics call the bill an effective ban on oil tankers. We believe the legislation is somewhat inconsistent with the federal government’s commitment to increase tidewater access for the export of Canadian natural resources after its purchase and intention to expansion the Trans Mountain Pipeline. The Alberta government has pledged to launch a constitutional challenge against both bills.
Related Research

- Credit FAQ: Our Approach To Holding-Company Leverage In The U.S. Midstream Energy Sector, Nov. 7, 2019
- IMO 2020: The Coming Storm, Oct. 7, 2019
- S&P Global Ratings Lowered Its Henry Hub Natural Gas Price Assumption For The Rest Of 2019 And For 2020, 2021; Long-Term U.S. Natural Gas, Canadian AECO, And Crude Oil Price Assumptions Unchanged, July 30, 2019
- ESG Industry Report Card: Midstream, July 3, 2019
- Issuer Ranking: North American Midstream Companies, Strongest To Weakest, May 2, 2019
- Issuer Ranking: Global Oil Refining And Marketing Companies, Strongest To Weakest, March 9, 2019

This report does not constitute a rating action.
Industry forecasts

Global Midstream Energy

Chart 1
Revenue growth (local currency)

Chart 2
Capex growth (adjusted)

Chart 9
Debt / EBITDA (median, adjusted)

Chart 10
FFO / Debt (median, adjusted)

Source: S&P Global Ratings. Revenue growth shows local currency growth weighted by prior-year common-currency revenue-share. All other figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.
Cash, debt, and returns

Global Midstream Energy

Chart 11
Cash flow and primary uses

Chart 12
Return on capital employed

Chart 13
Fixed versus variable rate exposure

Chart 14
Long term debt term structure

Chart 15
Cash and equivalents / Total assets

Chart 3
Total debt / Total assets

Source: S&P Global Market Intelligence, S&P Global Ratings calculations