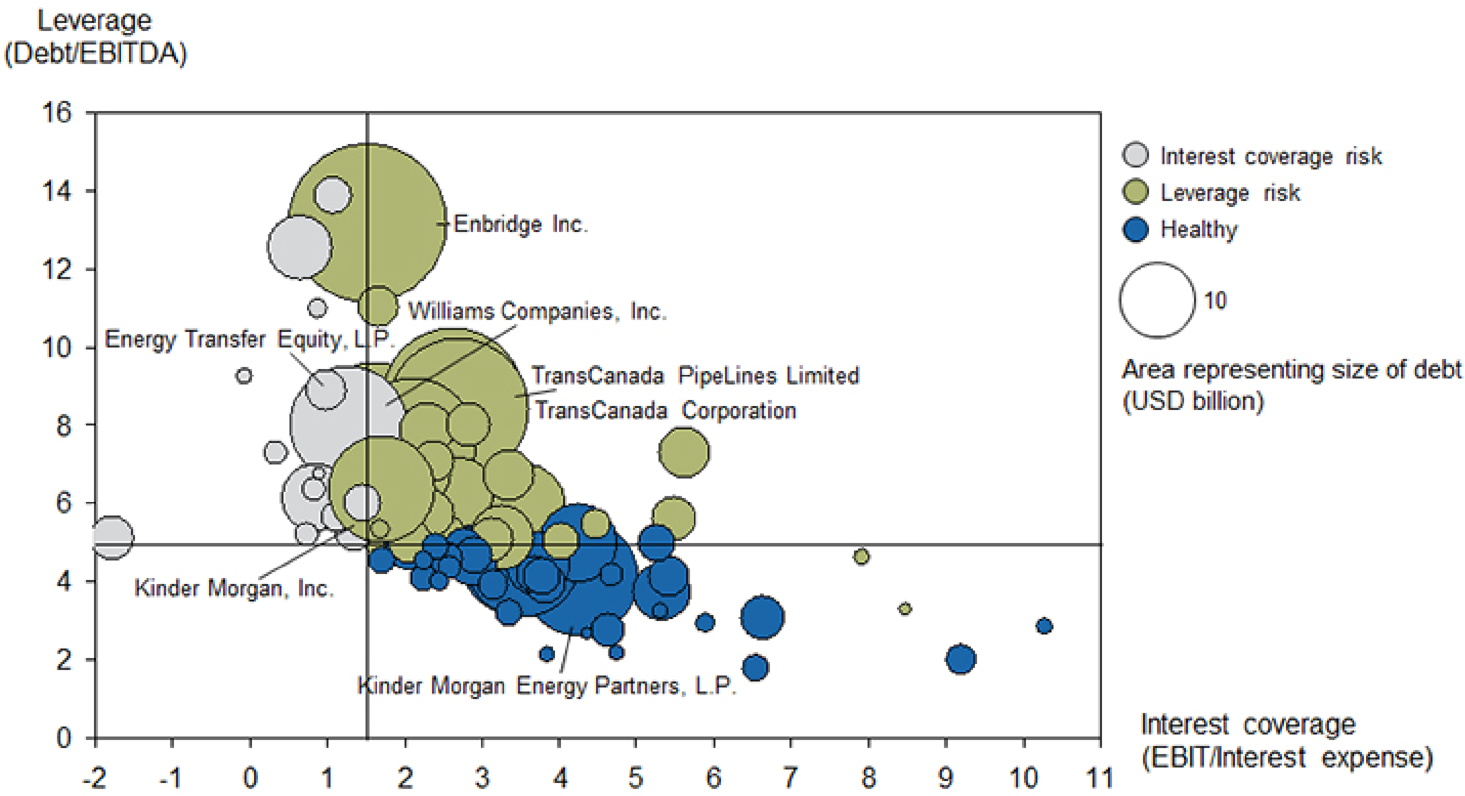
Trouble Comes to the Midstream

The mix of troubled cash flows and mounting debt woes affecting many exploration and production (E&P) companies continues to roil through the global oil and gas industry, and it's becoming apparent that the North American midstream sector could soon face similar pressures. The drop in oil prices is beginning to squeeze pipeline, processing, storage, and transportation companies as well. Liquidity issues are rapidly becoming a concern at many midstream companies, gaps in their operating cash flows are widening, and rate pressures are starting to squeeze transportation companies.

Liquidity issues start bubbling up

E&P liquidity issues are already well documented, but the midstream sector appears more vulnerable than expected, as growing interest coverage and leverage risks continue to crop up at many companies (figure 1).

Figure 1: North American midstream debt levels, March 2016



Sources: Bloomberg, Capital IQ, AlixPartners

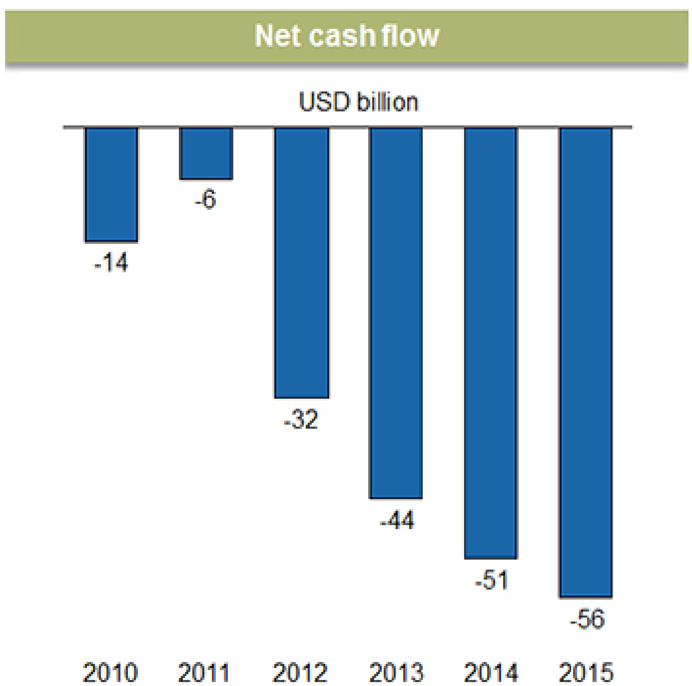
Conventional wisdom is that many midstream investments are recession proof because they're mostly infrastructure investments in transportation or processing assets. But closer inspection reveals that many midstream companies are loaded up with significant debt. Now that revenues have peaked and lower prices are affecting the entire sector, some companies may have to struggle to make future interest payments.

There are clear signs those challenges are affecting the market. The proposed acquisition of pipeline operator Williams Cos. by Energy Transfer Equity, first announced in September 2015, with an estimated value of $33 billion, might be a preview of the woes in store for the market segment at large. The stocks of both companies have plunged more than 70% since the deal was first proposed,[1] and recent company filings with the US Securities and Exchange Commission cut the estimated benefits of the deal to less than one-tenth of the original forecasts.[2] The deal is still on, but it could face renegotiation.

Cash flows start to sputter

The low-price environment means many midstream companies focused on growth are outspending operating cash flows at faster rates (figure 2). The stress on their balance sheets means these companies will have to curtail spending and stretch future capital programs in order to survive.

Figure 2: Gaps emerge in North American operating cash flows



Sources: Capital IQ, AlixPartners

Midstream companies' total cash shortfalls reached $56 billion in 2015, an almost 10% increase from the year before and a more than ninefold jump from 2011, when lower spending levels created a gap of only $6 billion. The recent bankruptcy of Peregrine Midstream Partners and its Ryckman Creek gas storage facility is an example of capital expenditures and interest risks overwhelming revenues in a low-price environment.[3]

Midstream's E&P customers demand lower rates

Lower oil and gas prices also mean that pressure is mounting on transportation rates, as financially stressed E&P companies try to renegotiate and lower their own costs. In many cases, former bottlenecks—wherein producers were desperate to find routes for getting their hydrocarbons to market—have given way to a wealth of often cheaper options. The trend indicates customers are flexing their muscles and trying to renegotiate transportation and processing rates. A recent federal bankruptcy court ruling allowing Sabine Oil & Gas to jettison expensive pipeline contracts doesn't set a binding precedent, but similar contract disputes appear likely.[4]

Conclusion: Responding to the squeeze

Conditions are challenging, but midstream companies that take the following pragmatic actions should become better positioned if low oil and gas prices persist.

- Reduce or suspend dividends to preserve cash. High-grade the project portfolio and defer all nonessential projects.
- Aggressively attack costs, and source all third-party expenditures. Rates have declined by as much as 30% or more across many categories, making it vital to capture a fair share of the deflation dividend.
- Eliminate overtime and all nonproductive time to save precious cash amid soft conditions. Provide as much cushion as possible, because project pipelines will take a while to get replenished when the recovery comes.
- Aggressively attack selling, general, and administrative expenses, and implement zero-based budgets to reflect current and anticipated reduced workloads, which will be an industry feature until prices recover.

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3 Stephanie Gleason, “Peregrine Midstream Partners Files for Bankruptcy Protection,” *Wall Street Journal*, February 2, 2016, http://www.wsj.com/articles/peregrine-midstream-partners-files-for-bankruptcy-protection-1454431752.

4 Alison Sider and Tom Corrigan, “Sabine Oil & Gas May Reject Pipeline Contracts,” *Wall Street Journal*, March 13, 2016, http://www.wsj.com/articles/sabineoil-gas-may-reject-pipeline-contracts-1457469841.