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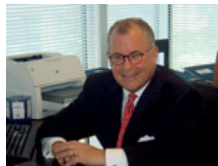
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CAPITAL ATTENTION TAKES NOTICE OF MIDSTREAM

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RBC Capital Markets' Joe Cunningham notes that a lot of new capital is being invested in midstream infrastructure, such as pipelines, gas-gathering systems and processing plants, to support the expansion of drilling activity in the U.S.

There's a domino effect under way today in the energy sector that may be getting overlooked by investors. No, it's not increased capex spending by E&P companies and oil-service suppliers, in turn, building more rigs to take advantage of the drilling boom being spawned by \$60 oil and \$7-plus gas.

Rather, it's the next step in the energy-supply chain—the midstream sector—that's drawing a flood of capital from investment banks, lenders, private-equity firms, and even corporations that haven't been traditional investors in the midstream.

The domino effect they see: as more and more drilling takes place in new areas of the U.S., such as in unconventional gas-resource plays, there's inevitably going to be increased demand for more midstream

infrastructure. This includes gas-gathering pipelines, gas-processing plants and storage facilities, in addition to regasification plants to handle the expected swell of liquefied natural gas (LNG) imports into the U.S.

Given this burgeoning need for midstream facilities, it's no small wonder that so many publicly traded midstream master limited partnerships (MLPs)—with attractive tax-sheltered cash distributions and total returns—have emerged in this decade, and are continuing to parade to the IPO market.

Indeed, one investment banker observes that the market cap of mainly midstream MLPs has grown from \$8 billion in 2000 to more than \$125 billion today.

In addition, billions of dollars in credit facilities are pouring into the midstream MLP space, while private-equity capital—such as the new \$1.5-billion NGP Midstream & Resources LP fund—is also flowing into midstream energy projects.

Why the rising investment in the midstream sector of the energy space? One leading market-maker and two private-equity players that are heavily committed to midstream investments describe their view here.

Crossborder innovator



Haddington Ventures' J. Chris Jones estimates that the overall investment opportunity in the midstream today for private-equity players, MLPs and non-traditional corporate investors is in the billions of dollars.

RBC Financial Group, with \$470 billion in assets, is one of the largest financial institutions in North America, with a worldwide energy-loan portfolio of \$27.6 billion, \$5.9 billion of that in the U.S. Meanwhile, its corporate and investment-banking arm, RBC Capital Markets, has in the 2005-07 period lead-managed in the U.S. energy space equity financings totaling \$2.5 billion and debt financings worth an aggregate \$2.4 billion.

What's notable is that RBC Capital Markets since 1992 has grown an extensive practice within the MLP arena, establishing client relationships with 33 of the 50 most prominent energy-related MLPs, mainly those in the pipeline/midstream sector.

"Since 2004, we've lead-managed \$1.7 billion worth of public equity and debt financings for mainly midstream MLPs, and currently have \$1.3 billion worth of credit commitments to that sector," says Joe Cunningham,

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managing director and co-head of the U.S. energy group for RBC Capital Markets in Houston.

Why the fascination for this sector? "Very simply, this is a high-growth business that has soared from \$8 billion in market capitalization in 2000 to more than \$125 billion today," he says.

A lot of new capital is being invested in midstream infrastructure, such as pipelines, gas-gathering systems and processing plants, to support the expansion of drilling activity in the U.S., which has mushroomed in this decade as the result of strengthening commodity prices.

Originally geared to retail investors, the MLP format now also has a big institutional following. The reason: these partnerships have demonstrated an ability to provide not only an attractive level of tax-sheltered income, but also fairly high growth in cash distributions, he says.

Cunningham cites the Alerian MLP Index, a composite of the 50 leading energy MLPs that tracks unit-price performance and total returns. Formed last year by New York-based Alerian Capital Management LLC—an investment advisor that manages portfolios exclusively focused on midstream MLPs—this index shows that, in 2006, these MLPs sported an average annual total return of 25.8% versus 15.8% for the S&P 500.

"If you've got 4.5% available on a 10-year Treasury bond and entities in the energy MLP space are offering 7% yields—80% of that tax-sheltered—that's pretty attractive to investors and explains why the MLP Index has outperformed the S&P 500 on an annual total return basis for seven consecutive years."

Innovative in partnership structures, RBC Capital in 2004 was sole book-runner on the \$115-million IPO for Copano Energy LLC, a Houston gas-gathering and -processing company. Of note, it was the first limited liability company (LLC) in the midstream.

The advantage of this structure: Copano doesn't have a general partner (GP), thus unit-holders aren't burdened by the incentive distribution rights that GPs have in conventional MLP structures. Typically, those rights allow a GP, which may have a 2% economic interest in an MLP, to receive up to 50% of the partnership's incremental cash flows after certain growth targets are met in terms of distributions. Absent those rights in an LLC, more dollars are available for distribution to unit-holders and to grow the entity.

Since its IPO, Copano's annual distribution to investors has risen from \$1.60 per unit to \$3.20 for 2006 while its unit price has shot up from \$20 to a recent level of \$66.

In January 2006, RBC Capital applied the same structure to the upstream space as lead book-runner on the \$261-million IPO of Houston-based Linn Energy LLC. Linn's performance since then: its annual distribution has risen from \$1.75 per unit to \$2.08, while its unit price has jumped from \$22 to \$33.

Back to the broader MLP theme, the investment-banking firm has managed to combine capital-markets underwritings with M&A advisory and lending capabilities—often multiple times for the same client.

Case in point: in July 2004, RBC Capital provided Denver's MarkWest Energy Partners LP—a midstream MLP—with a \$315-million bridge loan to purchase American Central's midstream assets in East Texas. Next, in September 2005, it advised the MLP on its \$355-million buy of Texas gas-processing assets from El Paso Corp. In that case, the capital provider was the sole underwriter of a \$500-million bridge loan to MarkWest.

Then, in June 2006, it acted as lead book-runner on a \$131-million equity offering and a \$200-million high-yield debt offering for the MLP, the proceeds of which were used to pay down the earlier bridge loan.

With crossborder understanding of MLPs in both the U.S. and the Canadian income-trust market, RBC Capital in August 2005 also advised Terasen Inc., a Canadian midstream player, on its \$5.6-billion sale to Kinder Morgan Inc., and in May 2006, EnCana Corp., on the \$1.5-billion sale of its gas-storage business to Carlyle/Riverstone, a private-equity group. (All figures are U.S. dollars.)

Looking ahead, Cunningham stresses that pending legislation in Canada that would adversely affect the tax flow-through status of Canadian income trusts would create acquisition opportunities not only for U.S. midstream companies, including MLPs, but also private-equity firms.

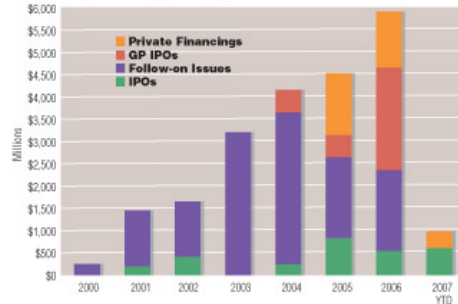
"Previously, U.S. buyers of Canadian assets were looking at paying taxes on those assets whereas Canadian income trusts were not," he explains. "However, if Canadian income trusts also become taxpayers, they'll no longer have that relative advantage—plus U.S. buyers generally have lower costs of capital. Thus, we see a real shift in the market for Canadian assets away from those trusts toward U.S. buyers."

Cunningham says his firm, with its crossborder expertise, is currently working with U.S. buyers looking at Canadian midstream opportunities. Meanwhile, in the U.S. MLP market, RBC Capital expects to participate in some of the planned \$1-billion-plus worth of midstream IPOs. Those that have been announced include Tulsa's SemGroup Energy Partners LP, Houston's Spectra Energy Partners LP, and still others coming out of both El Paso Corp. and Southern Union Co.

This explosion in the MLP market aside, Cunningham cautions investors to be wary of the commodity-price and interest-rate risks to which this sector is exposed.

"If the prices of oil and natural gas liquids go down, processing fees also go down," he says. "Also, if the yield on the 10-year Treasury rises, for instance, climbs to 6%, you'll see value destruction in the MLP sector. Why? If an investor can get 6% on a 10-year Treasury, he's going to want 8.5% to hold onto a higher-risk MLP security—and unit prices would have to fall to create that higher yield."

MLP Equity Financing Activity



MLP equity financing surged in 2006 to \$5.8 billion. That included \$541 million in initial public offerings, \$1.8 billion in follow-on issues, \$2.3 billion in IPOs of general partners and \$1.2 billion in private financings. So far in 2007, some \$626 million has been raised in IPOs and another \$360 million in private financings. Source: RBC Capital Markets

New midstream fund

A private-equity provider to the energy sector since 1988—committing \$3.5 billion to more than 100 E&P, midstream and oil-service companies—Irving, Texas-based Natural Gas Partners (NGP) Energy Capital Management is currently in the process of closing a new \$1.5-billion private-equity fund. It is called NGP Midstream & Resources LP, a Dallas-based entity with a Houston presence, which will be led by managing partner and chief executive John Raymond.

The fund will be focused primarily on the North American midstream sector, making investments in crude oil, natural gas and refined-products logistical supply and distribution systems, as well as coal-production, mining and mineral-related infrastructure.

Raymond knows a thing or two about the energy sector. Formerly, he was a midstream equity-research analyst for Howard Weil, an executive within Kinder Morgan's corporate development group, president and chief operating officer of Plains Exploration & Production, chief executive of Plains Resources and a director of Plains All American Pipeline.

"Prior to launching this effort last year, we realized that the majority of the midstream energy sector that processes, transports and stores natural gas, crude oil, refined products and coal was running at virtually full capacity," says Raymond. "We further recognized—against the backdrop of an aging system—that as demand for these energy sources continues to grow and supply sources continue to change, there will be increasingly a need to reconfigure and expand midstream-infrastructure systems globally, particularly in North America."

The legacy producing basins in this country are mature, with some in steep decline, he notes. In the case of natural gas, this has forced the industry to look at unconventional gas-resource plays in the U.S.—in the Rockies and the Midcontinent especially—where there's at least 100 trillion cubic feet (Tcf) of proven gas reserves that can be economically developed at current prices.

"Right now, however, these remain largely stranded reserves; the challenge for the industry is to have the requisite infrastructure in place to move those molecules to market—and therein lies the opportunity in the midstream part of the natural gas business."

A similar need exists in the case of crude oil and refined products, Raymond adds. "Increasingly, new oil and refined-products supply is coming from foreign markets, so we as an industry are going to have to develop more midstream infrastructure to handle additional imports along the Gulf Coast, the Northeast and Canada in the case of oil."

No less a midstream investment opportunity resides in the coal business, with the need to develop terminals, washing and blending facilities, he notes. "Today, coal provides more than 50% of the electricity that gets consumed in this country every day."

There is, however, no shortage of supply. The U.S. has more than 250 billion tons of coal reserves and consumes about 1.1 billion tons annually, resulting in a reserve life of more than 200 years. "In fact, 85% of the Btus in the ground in the U.S. are in the form of coal—more than Saudi Arabia and Kuwait combined have in the form of crude oil."

There are yet two other drivers behind the fund's creation—simple demographics and consumer demand. Forty years ago, the population of the U.S. was 200 million; today, it's 300 million. Yet,

Raymond notes, the build-out of the nation's midstream infrastructure systems hasn't kept pace. "This has resulted in the vast majority of the systems vital to our economics growing increasingly old and, in turn, requiring ever-increasing maintenance-capital programs."

In the next 25 years, it's expected that the population of the U.S. will grow by another 100 million people, with roughly half of them living in five states—California, Arizona, Nevada, Texas and Florida. "So not only will energy demand continue to rise by virtue of population growth, but also the regional concentration of where people live will increase as well, requiring all sorts of incremental midstream infrastructure across all functional segments of the energy complex."

NGP Midstream & Resources continues to evaluate an active set of midstream-investment opportunities in natural gas, crude oil, refined products and coal, and in the mining and minerals sectors.

"Generally, we're looking at projects that require multi-year investment cycles between capital deployment and cash flow, with funding in the range of \$50- to \$250 million within the context of a typical private-equity investment cycle," says Raymond.

"However, we have deliberately structured the fund to make longer-term commitments as warranted on a project-specific basis. For this level and term of equity investment, we're seeking risk-adjusted returns consistent with those of the legacy NGP funds."

No midstream stranger

Since 1998, Haddington Ventures LLC, a Houston-based private-equity firm, has raised more than \$320 million for the energy industry, with a focus on investing in the midstream sector, including gas-storage, -gathering and -processing infrastructure, as well as electricity-generation, -transmission and -distribution companies.

With the backing of institutions, commercial banks and high-net-worth individuals, its current Haddington Energy Partners III LP closed in May 2006, raising \$182 million.

"Our interest in the midstream centers around the changing nature of energy supply sources in this country, particularly in the area of natural gas where there has been a broad decline in supply in the Gulf of Mexico, particularly on the shelf, which in all likelihood will be replaced by significant quantities of imported LNG during the next five to 10 years," says J. Chris Jones, managing director for Haddington Ventures.

"This event, just by itself, will create the need for additional midstream infrastructure."

No stranger to the midstream, Jones and his partners in 1986 started a gas-gathering, -processing, -storage and -marketing company with just \$1 million of venture capital and in 1997 sold that NYSE-traded company when its equity value was nearly \$300 million.

"Also, new plays are developing in the deepwater Gulf of Mexico that will prompt the need for more midstream facilities, whether floating production systems or pipelines," he adds. "In addition, new domestic gas supplies are being found in unconventional-shale and coalbed-methane plays in the Rockies, Texas, Louisiana and Arkansas. That production, too, will need additional midstream facilities to move gas in new directions to get it to the highest-value markets."

Jones estimates the overall investment opportunity in the midstream today—for private-equity players, MLPs and non-traditional corporate investors—is in the billions of dollars. He cites the Rockies Express Pipeline, which is expected to cost about \$5 billion.

Meanwhile, he notes that regasification terminals along the Gulf Coast can cost anywhere from \$500 million to \$1 billion each—and at least six to nine of those will likely be built. "In short, the demand for incremental midstream capital is growing significantly."

Case in point: Haddington Ventures in August 2005 made an initial \$25-million private-equity investment in the Bobcat gas-storage project in St. Landry Parish, Louisiana—45 miles from Henry Hub and 12 to 15 miles from five interstate pipelines.

To help advance the construction of the planned project, which will initially have 13.5 billion cubic feet of working-gas storage capacity, Haddington sold a 50% preferred-equity interest in the project for \$65 million to GE Energy Financial Services this February.

Royal Bank of Scotland was advisor to Haddington on that sale and arranged \$185 million in senior secured credit facilities to be used for project construction, development and long-term financing.

The private-equity firm has also provided an initial \$15.8 million to Houston-based Gulf Coast LNG Partners, which is developing a regasification terminal at Port Lavaca, Texas, in the Matagorda Bay region.

Says Jones, "Ultimately, construction of the terminal and pipeline infrastructure will require a total investment approaching \$800 million, which we'll fund through our own private-equity, non-recourse

project financing and third-party equity, either from a corporate investor, another private-equity firm, an MLP, a local distribution company or utility.”

More recently, Haddington has made two other midstream equity investments. One is an initial \$10-million commitment to Dallas-based IACX Energy, which has developed a new technology to remove nitrogen and/or CO2 from gas-well streams in order for that gas to meet pipeline-quality specifications; the other, an initial \$5-million commitment to Houston-based Tristream Energy, a gas-gathering and -processing company.

The initial investment in IACX should allow it to build as many as 20 portable, mini-gas-processing plants that will allow it to treat historically uneconomic, often shut-in gas wells, says Jones. “The investment in Tristream, to which we could well bring another \$30- to \$40 million of private equity plus commercial-bank debt or project financing, could do opportunistic acquisitions.”

However, given the high costs of midstream acquisitions in today’s market, the company will more likely grow organically through grass-roots development, providing midstream infrastructure to unconventional gas-resource operators that need to connect their production to further downstream, larger-diameter, intra- and interstate pipelines.

At the moment, Haddington Ventures is in the process of backing midstream management teams that overall are building or developing about \$1 billion worth of grass-roots projects. For those investments—which typically run four to five years—it seeks 20% to 25% net returns, after compensation.

-- Brian A. Toal

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