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Special Report
COVID-19's Impact on Midstream Energy Infrastructure and
A Prognosis for the Future

It was an absolutely devastating quarter for the energy sector and with it the performance of midstream infrastructure assets, as the COVID-19 contagion continued its spread across the globe leaving countries, their social systems, and economies in virtual hibernation.

As we all know, energy is a demand-pull commodity. As world economies came to their current standstill the demand for oil, petroleum products, gasoline, jet fuel, natural gas and natural gas liquids naturally came to a screeching halt, effectively a demand-based shock! To add insult to injury, the Saudis and Russians failed to agree on further production cuts at their OPEC+ meeting in early March, following which the Royal Kingdom in retribution reversed course to flood world oil markets in an attempt to drive out competition and regain market share. Timing is everything and with that, the price of a barrel of crude oil precipitously fell to single digits: at one point as low as $5.00 per barrel. It was at this point, that energy and MLP shares basically halved in price value.

Unfortunately, unlike previous oil-related calamities - 2014, 2015-16 - the current situation is much more difficult to digest given it was, in the first order, caused by an unknown world-gripping pandemic of indeterminable length, exacerbated by the cartel's untimely failure to extend production cuts and then frivolous actions to intentionally flood already oversupplied markets.

As we try to compare this crisis with those of the past, it is worthwhile to first recognize that much of the US energy landscape has changed. Since mid-decade, the United States, through its advances in shale technology, has grown to become the world's largest oil producer and a net exporter. It now also exports natural gas and NGLs. Back then, US oil production stretched to just over 9mil barrels per day. Today, it has easily closed in on 12.5mil bpd. Just before the COVID-19 outbreak, US production was forecast to increase robustly through 2020-21 to help meet a global demand forecast of some 100mil bpd. In its early days, shale drilling was conducted by numerous relatively marginal "pioneer types" on small tracts of leased land. Since then, industry consolidation and corporate opportunism has led many of the oil majors (Exxon, Chevron and Occidental) to replace these small companies and secure ownership rights to huge land tracts with promising reserves. And finally, in its formative years shale technology was very nimble, i.e. able to start and stop production on a dime. Today it is better characterized as a manufacturing process - unfortunately less responsive now, but also owned by major players with deep pockets.

Against this backdrop, let us discuss what changes have occurred in the midstream energy space. Several years ago, midstream energy was characterized as an emerging asset class and it surely behaved like one. Midstream companies were independently springing up overnight or they were being "dropped down" by their oil major sponsors. The industry mantra was to capture third party capital, irrespective of the cost of that capital (debt or equity) to achieve capital expansion and internal growth, so they could deliver huge and growing cash flow distributions to GP sponsors and investors. Most MLP structures also included incentive distribution rights (IDRs), which accelerated expansion and materially and disproportionately increased distributions to their GPs.

Following the 2014-15 energy bust, the "rodeo days" of the midstream MLP came to an abrupt end. As always there was an industry cleansing, ushering in improved governance and financial accountability among those who survived. Call this MLP version 2.0. No longer would MLPs rely solely on outside capital for organic growth. IDR structures were abandoned. In many cases, distributions and project capex were cut to help stabilize balance sheets and/or accumulate reserves for new down-the-line projects. In fact, the group had finally matured to become the more conservative businesses they are today - so much more “utility-like”.

So where do MLPs as a group stand against this current COVID-19 precipitated demand-shock, where world oil consumption is now projected to slip by some 25-30%, or an estimated 75-80mil bpd over the next year, thereby exacerbating an already bad inventory overhang?

Well first, some recent good news! On April 9th, OPEC+ reconvened and quickly reversed itself, agreeing to cut 10mil bpd of production through May and June and further to keep another 8mil bpd from reaching oil markets for the balance of 2020. This should help and further demonstrates that there is global concern among producers over accumulating inventories. Before OPEC’s reversal, the US itself was destined to cut back production by some 2+mil bpd. Despite significant independence among our producers, a headwind to a swift and effective outcome, the glut remains so dire that our producers will very likely also do their part as a measure of good faith.

OK, so as for the MLPs themselves, we already know from headline news that there is little or no storage capacity remaining. In some few instances, even the pipelines themselves are becoming surrogate storage facilities as refineries have curtailed operations on the collapse of gas and jet fuel consumption.

Despite this bad news, the silver lining is that most if not all of the MLPs transport and store fuels are on a multi-year fixed fee or cost of service contract basis. These contracts were judged to be iron clad in the 2014-15 crisis and so there is little doubt they will remain so. Further, while many of the larger MLPs are in fact more heavily involved in natural gases, most are diversified or “integrated”. That is to say their revenue streams are sourced from oil and natural gas activities, the latter of which have not experienced the same operational deterioration witnessed in the oil markets. As to their ability to absorb the current conditions, most of these version 2.0 MLPs became financially sound well prior to this crisis. Whether it was by any combination of means: reducing overall leverage well below lender standards, paring back or deferring project capex, or becoming more judicious in distributing cash flows, even at the expense of minimizing distribution growth rates. All steps were taken with a view toward shoring up their financials and deliberately focusing on organic growth in a responsible way. Many of these same levers will likely be employed again to help these partnerships weather the current crisis.

In all of this conversation, there’s no doubt that the recovery of our MLPs - or for that matter the healing of world economies, financial markets and our global population - are all wholly dependent on the timeline to COVID-19’s demise. We suspect that as soon as world economies are confidently able to reopen, pent-up demand for energy will be quickly unleashed, overhanging reserves will start to dwindle and global consumption projections will once again reach 100mil bpd.

At the end of the day, if we all still believe that fossil fuels will remain a core world energy source over the next 10-20 years, it is these very infrastructure assets that are and will remain critically needed to gather and process, transport, store, refine and distribute energy now and into that future, both within the US and to the world at large.