S&P Global Ratings

Midstream Energy

Industry credit profile strong as future challenges await

January 9, 2024

This report does not constitute a rating action.

What's changed?

Canadian midstream challenges/opportunities. Canada's two largest midstream companies have pressured credit metrics from project cost overruns and a large acquisition. Their path to credit improvement is a reflection of how the broader industry could position itself.

U.S. Gulf Coast infrastructure development. New pipeline infrastructure is needed to provide for liquid natural gas projects and the growing supply of natural gas liquids out of West Texas.

M&A and asset rationalization. Small tuck-in acquisitions and asset divestitures will continue as the industry positions itself for future growth and energy transition opportunities.

What are the key assumptions for 2024?

Higher spending to support Permian growth. Capital spending will be focused on processing and logistics infrastructure to move natural gas, NGLs, and crude out of the Permian region.

Financial discipline. Companies will continue to lower leverage targets and build free cash flow.

Greater focus on shareholder returns. We expect most companies to use more excess free cash flow to reward shareholders.

What are the key risks around the baseline?

Lower demand for hydrocarbons could worsen volumes for midstream companies.

Capital markets and banking access. Refinancing maturing debt will require new capital if capital markets close or banks are unwilling to lend to the sector.

Increased regulation and renewables growth. Permitting has become increasingly difficult for new pipeline projects, GHG emissions reduction, and renewables penetration.

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Ratings Trends: Midstream Energy

Chart 1

Ratings distribution

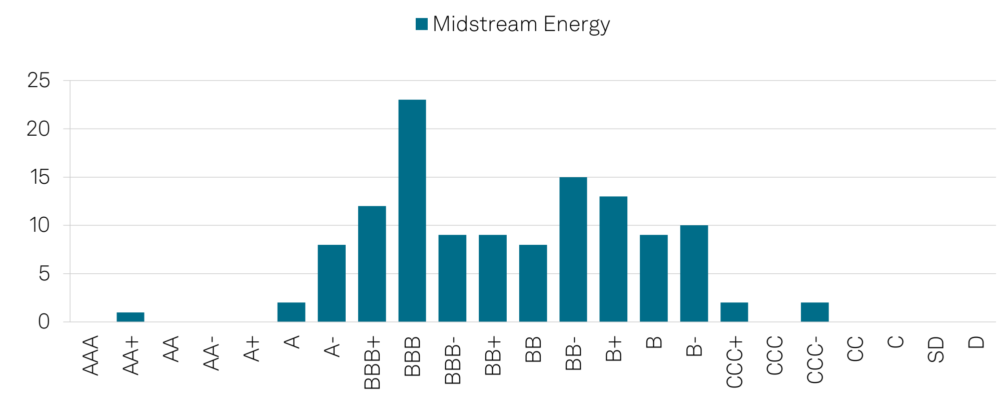


Chart 2

Ratings outlooks

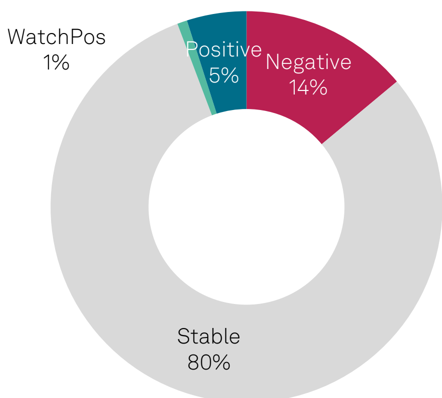
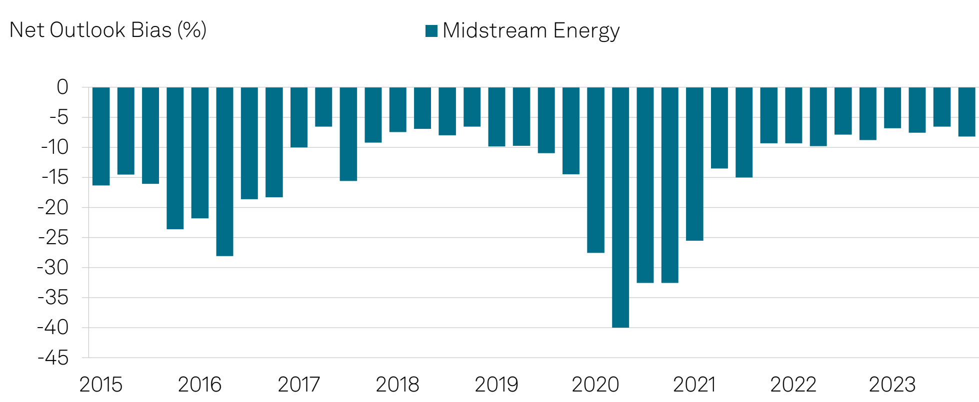


Chart 3

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

The midstream industry's financial discipline and focus on maintaining strong balance sheets and credit measures continued in 2023; most companies maintained financial flexibility by retaining excess cash flow to fund growth initiatives and address upcoming maturities and revolver borrowings, before rewarding shareholders. While we expect this trend to continue, we expect companies to allocate more capital to tuck-in transactions that are strategic for their existing asset base, before giving cash flow to shareholders in the form of buybacks or dividend increases. Equity and debt holders have been aligned for several years, which we believe has resulted benefits to all the company's constituents: better credit quality along with a consistent return for equity holders.

Investment grade companies, which account for about 40% of our ratings, continued to benefit from their size, scale, and geographic and asset diversity. These companies generally have more organic opportunities and can provide their customers with more optionality to end markets. We've seen investment-grade companies leverage their operations in the Permian and near the Gulf Coast to sanction new natural gas projects for liquified natural gas (LNG) facilities and increase egress for natural gas liquids (NGLs) and crude out of the region for export. Balance sheets remain strong and credit measures have improved, with some companies lowering long-term leverage targets, which is supportive of ratings.

Most speculative-grade issuers have strengthened their credit profiles, with some ratings improvement particularly among companies in the 'B' category. These companies have focused on improving their contract profiles and using cash flow to reduce debt, forgoing dividends to their sponsor companies or limiting distributions or share repurchases. We believe lower-rated issuers could see more ratings upside in the coming year given our outlook on hydrocarbon demand, or they may become takeover candidates by their larger competitors.

Currently about 80% of midstream rating outlooks are stable, 5% are positive, and about 14% are negative. Ratings improvement occurred for both investment-grade and speculative-grade companies, mainly due to improved credit profiles related to strong prices and demand, coupled with meaningful debt reduction. The sector's ratings and outlooks were relatively similar to the beginning of 2023, when 81% of ratings were stable, 9% were positive, and 16% were negative.

Main assumptions about 2024 and beyond

1. New infrastructure is needed to support growth in West Texas and the U.S. Gulf Coast

Infrastructure development for LNG and egress out of West Texas will be the main focus of the industry for the next several years. Growing gas-to-oil ratios and the richness of the associated natural gas coming out of Permian crude oil production will be addressed through strategic partnerships between midstream companies, upstream companies, and financial parties. Export facilities, dock space, and the need for natural gas as a feedstock for LNG capacity will accelerate in the next 12 months.

2. Companies continue to prioritize balance sheets as they set strategic goals

We expect companies to continue to keep long-term leverage targets at or below current levels as they shape strategic plans in an industry that is becoming increasingly bifurcated between large and small. Maintaining strong credit measures gives investors greater comfort with the specific company narrative, and companies more access to the capital markets.

3. Shareholder returns could increase absent other growth opportunities

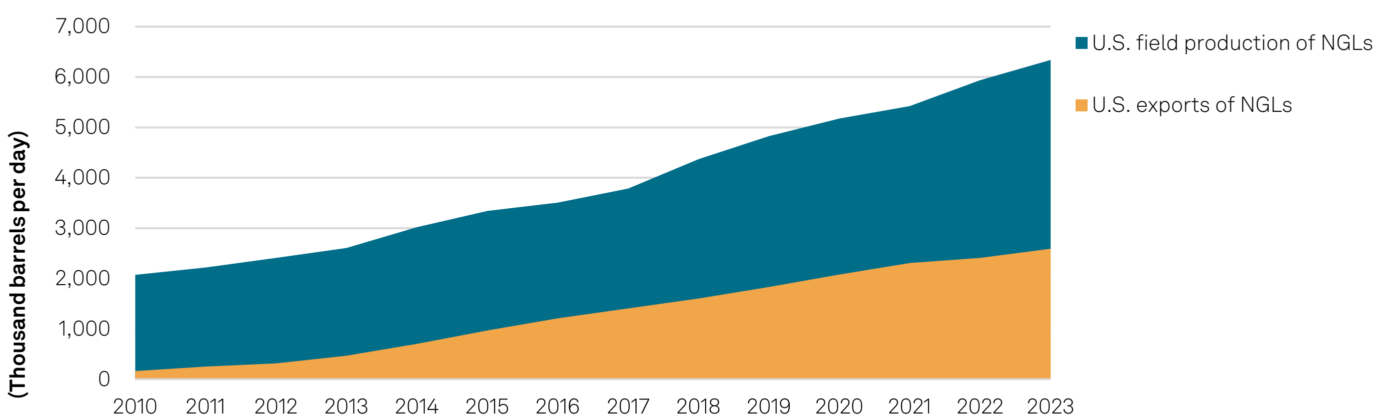
After several consecutive years focusing on debt reduction, the midstream industry could pivot to returning cash flow to equity holders. That said, we do not believe this pivot, if it occurs, is mutually exclusive of maintaining creditworthiness. Companies will increasingly have to compete with alternative energy investments for new capital as renewables and other alternative energy projects' costs fall and yields for investors improve. This should keep a more conservative bent on midstream financial policy.

The focus will be on infrastructure for Permian egress and LNG exports. Midstream companies are responding to the call for additional natural gas feedstock to supply about 10 billion cubic feet per day (Bcf/d) of LNG export capacity currently under construction in the U.S.; more than 20 Bcf/d of pipeline capacity is currently in progress. While this capacity is being built in regions that historically has been amenable to the industry in terms of permitting and right-of-way, it could become more difficult and take longer to build these assets as opposition to such projects grows. The pipeline capacity currently being contemplated is more than required, but we believe it will be filled as more LNG trains are built in the next few years. Given the long-term supply contracts from the various LNG projects, we expect the pipeline capacity under consideration will be contracted under similar long-term arrangements to ensure a consistent supply of natural gas feedstock.

We expect additional NGL transportation will also be required for consumption at Gulf Coast chemical complexes and for global export. The majority of growth in natural gas and NGLs is coming in the form of associated gas as upstream producers drill for crude oil. The gas content in wells being drilled for crude oil in the Permian and Bakken is increasing, as is the concentration of NGL content. Through Sept. 30, 2023, U.S. field production of NGLs increased by almost 7% (see chart 4). Unlike natural gas, NGLs cannot be flared and as NGL production increases, infrastructure needs become more important to support drilling activity. With a number of fractionation plants in construction and over 40% of U.S. NGLs exported, there is a growing need for takeaway capacity.

Chart 4

U.S. natural gas plant field production



Source: U.S. Energy Information Administration.

A number of large, integrated midstream energy companies are progressing on expansions of existing processing plants and new greenfield projects (see table 1). As of October 2023, Enterprise Products Partners (EPD) began converting its Seminole Red Pipeline from crude oil service to NGL service, with an expected completion of year end. The 210,000 barrel per day (b/d) crude oil pipeline, which was in NGL service prior to 2019, will retain the flexibility to convert back to crude oil service. The flexibility of being able to convert the pipeline back into crude service provides some flexibility should there be an overbuild of NGL takeaway capacity in the next few years. Based on our current expectations of production growth and the projects currently announced, we believe there will be sufficient capacity to meet the industry's needs through 2025. The only new build outside of the recently operational BANGL Pipeline is EPD's 550 mile Bahia Pipeline, which will have 600,000 b/d of capacity.

Table 1

NGL pipeline projects

NGL pipeline	Expected startup/expansion	Project
Seminole	Q4 2023	Conversion
Daytona NGL	Q4 2024	400,000 bpd expansion
BANGL	Q1 2025	200,000 bpd expansion
Shin Oak Pipeline	Early 2025	275,000 bpd expansion
Bahia Pipeline	2025	600,000 bpd new build

bpd—Barrel per day. Source: S&P Global Ratings.

Financial policy remains a key ratings driver. We view the midstream industry as mature with more limited organic growth opportunities, especially given the regulatory difficulties of completing new pipelines. This has created an environment in which midstream companies are growing modestly and largely internally funding capital spending. As a result, they use substantial free cash flow for share buybacks and dividend increases, while being deferential to debtholders; 2023 saw an increase in companies publicly communicating lower long-term leverage targets. Two examples are EPD's announcement on its fourth quarter 2022 earnings call that it was lowering its leverage target to 2.75x-3.25x and Plains All American Pipeline LP's (PAA's) announcement during its 2023 third quarter earnings call that it was lowering its leverage target to 3.25x-3.75x. Shortly thereafter, we upgraded EPD to 'A-' and PAA to 'BBB' due to improved financial policy. We also upgraded Energy Transfer L.P. (ET) to 'BBB' as a result of improved financial policy, with the expectation that ET will maintain leverage of about 4x over the next 12 to 24 months.

In 2024, we expect the trend of lower leverage targets to continue for midstream companies because of less opportunity to grow as well as equity and debt investors' desire for less leverage. In addition, we expect the industry to continue to grow dividends and distributions at a moderate pace. We expect larger midstream companies to make acquisitions but believe they will be largely tuck-in transactions that will use company equity as the main currency to transact. In general, we expect credit metrics in the midstream industry to modestly improve in 2024, which could result in further positive rating actions, especially if accompanied by public messaging that companies will operate at lower leverage over the long-term.

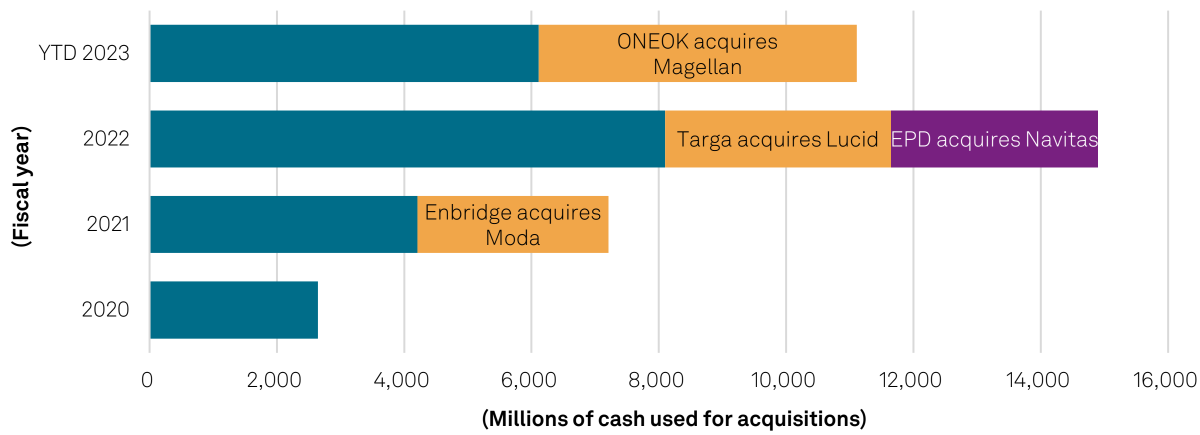
Boosting shareholder returns could come in many forms. Returning value to shareholders has generally meant dividends and share repurchase programs in the midstream sector, but we think an increase in mergers and acquisition (M&A) activity could be another path. M&A activity is hard to predict, though there has been significant consolidation in the upstream industry, which include many of the customers and shippers that use the assets owned by the midstream companies we rate. While this has "high-graded" the credit profiles of some of the counterparties, it also raises longer-term questions on surety of volumes that are now controlled by multinational energy majors. The risk is that these companies can shut down wells more easily than small private drillers if basin economics become unfavorable. These changing industry dynamics will lead some smaller midstream companies to think about getting bigger and more diversified.

Accordingly, since 2020 we have seen significant consolidation of small sponsor-owned issuers being acquired by large strategics (see chart 5). Examples are EPD buying Navitas Midstream Partners and Enbridge Inc. buying Moda Ingleside, in 2022 and 2021, respectively. In March 2020 we had around 20 issuers owned by financial sponsors or infrastructure funds; as of Dec. 8, 2023, that number is 14. The declining pool of available assets has resulted in bigger deals, like that of Energy Transfer's acquisition of Crestwood and ONEOK's acquisition of Magellan, both of which closed in 2023.

Overall, acquisitions have been supportive of credit quality by increasing scale and diversity without pressuring leverage metrics substantially. They have also contributed to an increase in average credit quality since sponsor- and infrastructure-backed issuers are typically rated in the 'B' or low 'BB' categories.

Chart 5

Cash spent on acquisitions



Sources: S&P Global Ratings, company filings.

Large scale mergers could continue in 2024, though regulatory risk, specifically FTC review, will likely be a factor. We also expect bolt-on acquisitions and individual asset sales to continue. Notable transactions in 2023 include The Williams Cos. Inc.'s acquisition of MountainWest Pipeline from Southwest Gas Holdings Inc. and Gibson Energy Inc.'s acquisition of South Texas Gateway from Buckeye Partners and other minority investors (see table 2). Plains All American has pursued small bolt-on acquisitions in its crude gathering joint venture with Oryx Midstream which could continue in 2024.

Table 2

M&A transactions 2021-2023

Acquirer	Target	Seller	Amount (Mil. $)	Funding
2021				
Enbridge Inc.	Moda Ingleside	Encap Flatrock	3,000	Cash - revolver
Energy Transfer, LP	Enable Midstream Partners LP	Public	7,000	Equity
2022				

Acquirer	Target	Seller	Amount (Mil. $)	Funding
Targa Resources Corp.	Lucid Energy Group II Borrower LLC	Riverstone Holdings	3,550	Cash - notes, TLB, revolver
Enterprise Products Partners L.P.	Navitas Midland Basin, LLC	Warburg Pincus	3,250	Cash - cash on hand & revolver
Energy Transfer, LP	Woodford Express, LLC	Quantum Energy Partners	485	Cash
The Williams Cos.	Trace Midstream	Quantum Energy Partners	950	Cash
Delek Logistics Partners LP	3Bear Delaware	3Bear Energy LLC	625	Cash
2023				
ONEOK Inc.	Magellan Midstream Partners L.P.	N/A	18,000	Cash & equity
Gibson Energy Inc.	South Texas Gateway	Buckeye (50%), Phillips (25%), Marathon (25%)	1,100	Debt & equity
The Williams Cos.	MountainWest Pipeline, LLC	Southwest Gas Holdings, LLC	1,500	Cash & assumed debt
Energy Transfer, LP	Crestwood Equity Partners L.P.	Public	7,100	Equity

Source: S&P Global Ratings.

Credit metrics and financial policy

We believe our current hydrocarbon price assumptions, production forecasts in Canada and the U.S., and expectations of growing global demand will support ratings strength and stability across North America broadly in 2024. Most companies continue to drive financial leverage lower, and we believe capital spending will be at or modestly above levels in 2023, which should allow most companies to generate positive free cash flow before dividends and share repurchases. This could lead to further ratings upside.

In contrast, the Canadian midstream industry had a more difficult year. In 2023 we saw heightened rating activity in the region, with noteworthy rating actions for both TC Energy Corp. and Enbridge Inc., which saw revisions to their respective outlooks to negative. These rating actions belied pressured metrics as a result of a significant capital program along with cost overruns at Coastal Gas Link (for TC) and a $17 billion acquisition (for Enbridge). The higher leverage at both companies was somewhat out of step with the broader North American midstream industry, which, as we noted above, continues to reduce debt. Still, some of the actions taken by TC and Enbridge may indicate how each company is positioning itself in the face of changes in the future energy mix. Both companies have made natural gas a strong focus, with Enbridge buying three regulated natural gas utilities and TC divesting its liquids business. As the industry evolves we anticipate more players will begin to align with changes in global perspective on hydrocarbon usage.

We believe growing crude oil and natural gas volumes in the Western Canadian Sedimentary Basin (WCSB) should continue to drive steady operating performance and better credit metrics in 2024. Pipeline companies are taking advantage of strong prices and growing volumes to lock in more favorable contracts, both in length and pricing. Newly commissioned projects and recent acquisitions also added to the operating margin.

Key risks or opportunities around the baseline

1. Developing economies and decisions by OPEC+ are a key demand driver.

Crude oil prices depend on the continuation of supply cuts by OPEC+ and growing demand in developing nations. Weaker commodity prices could result in production cuts that could flow through the midstream assets. An economic slowdown rather than a soft landing in developed nations could dampen demand.

2. Continued capital markets access and supportive banks are needed for growth.

Access to capital remains crucial for both refinancing existing debt and funding growth. A focus on debt reduction and strong excess cash flow has been credit-supportive, but companies with weak credit profiles or smaller operations could see some near-term challenges for a more selective pool of capital.

3. Climate change is a long-term headwind.

Global regulation to address climate change and emissions continues to be a significant headwind for the industry.

We believe global demand growth for crude oil will slow to 1 million b/d in 2024, from about 2.4 million b/d in 2023, on the heels of a strong demand recovery after the pandemic. Any significant demand weakness in developing nations like China or India could lead to weaker crude oil prices absent any action by OPEC+. It appears likely that a continuation of 1 million b/d supply cut by Saudi Arabia and additional announced cuts by Russia will be needed to balance production growth out of the U.S. We see little upside in natural gas prices if the U.S. experiences another mild winter and with European gas storage levels generally full in anticipation of the coming winter. There is likely limited risk to midstream cash flow given the industry's contract structure, but any significant price volatility could harm volume-dependent cash flow if it lasts for several quarters.

Debt levels for most issuers will be stable through 2024, particularly given the focus on conservative financial policies we have observed in the last 12 months. The exception to this is a small subset of investment-grade companies that have larger capital spending programs on specific projects. Enbridge, Energy Transfer, TC Energy, and Venture Global LNG Inc. collectively account for virtually all of the forecasted increase in midstream sector debt in the next 12 months. We think the market will largely remain open for most investment-grade companies in 2024, given investor confidence on their strong credit profiles. If debt markets are choppy, speculative-grade issuers could have a more difficult time refinancing or funding new projects, and may have to wait for a better window if they have the liquidity to do so.

That said, we see a relatively limited near-term needs for speculative grade companies to access the markets, with minimal debt in capital structures coming due over the next 18 months (less than 10% of total rated debt outstanding). However, improved market conditions and tightening high yields spreads could lead to a flurry of activity early in the year to take advantage of open capital markets. We see a significant increase in maturities as we look to late 2025 and 2026, with roughly 25% of speculative-grade issuance coming due. While companies could wait till 2025 to address these, a good amount could be pulled forward into 2024. Companies will need to weigh the potential to secure lower rates on financing by waiting until late 2024 and 2025 against the certainty of execution by addressing this earlier. Companies appear to have come to terms with rates likely remaining high through the year (S&P Global economists anticipate potential declines only in the second half of 2024), and we anticipate interest expense for the sector to increase.

The midstream industry has delivered several consecutive years of credit improvement, which we believe will continue in 2024. Companies were generally very resilient through the cycle in the past few years and self-funding model has given them significant flexibility to adapt to the risks and uncertainties in the global energy markets. We believe there is significant financial cushion in most company's credit measures to withstand a U.S. recession or significant shock without significantly impacting ratings. Renewables and the energy transition is a long-term threat for the industry, we believe the intermittency of alternative energy needs to be solved before it becomes a more significant threat. We also think that this solution is not going to occur in the next several years. We think that midstream companies will continue to adapt and look to seek greater participation in technologies such as carbon capture and sequestration, renewable natural gas, hydrogen, and the transportation and storage of renewable fuels as the returns on such technology becomes more attractive.

Regulation to address climate change is a long-term headwind. Increased government regulation around the globe to address climate change and greenhouse gas emissions are a significant headwind for the industry. While we believe a phase out of hydrocarbon use is decades away, the industry must remain vigilant in reducing emissions and hitting their long-term net-zero targets.

Related Research

- S&P Global Ratings Has Raised Its Henry Hub Natural Gas Price Assumptions For 2024 And 2025, Nov. 7, 2023
- Credit Considerations: The North American Midstream Energy Sector's Momentum Has Slowed, July 5, 2023
- Clear LNG Outlook Could Turn Murky Near End Of Decade, June 27, 2023
- Carbon Capture, Removal, And Credits Pose Challenges For Companies, Jun 08, 2023
- Investment-Grade Midstream Issuers Weathered Pandemic-Related Volatility By Focusing On Leverage Reduction, May 2, 2023
- Credit FAQ: What Would It Take To Upgrade Energy Transfer L.P. To 'BBB'?, April 26, 2023
- Issuer Ranking: North And South American Midstream Energy Companies, Strongest To Weakest, March 31, 2023
- How We Assess Hybrid Replacement Decisions When Credit Quality Improves: A Focus On Midstream Energy, March 6, 2023

Industry Forecasts: Midstream Energy

Chart 6

Debt growth (adjusted)

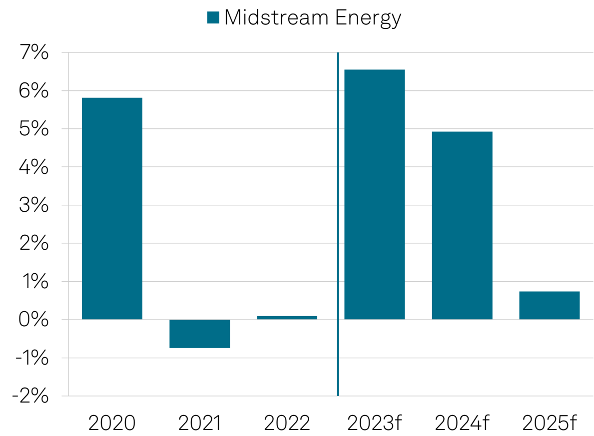


Chart 7

Capex Growth (adjusted)

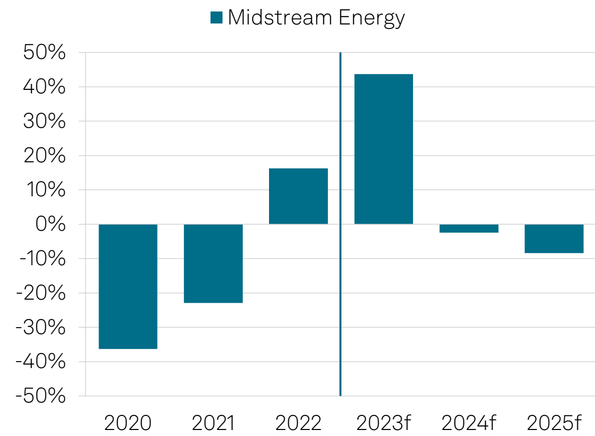


Chart 8

Debt / EBITDA (median, adjusted)

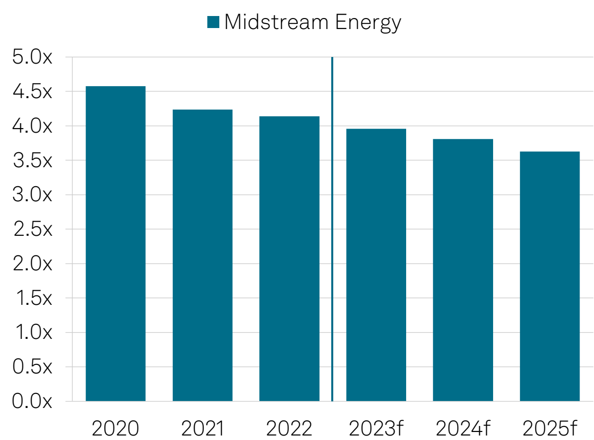
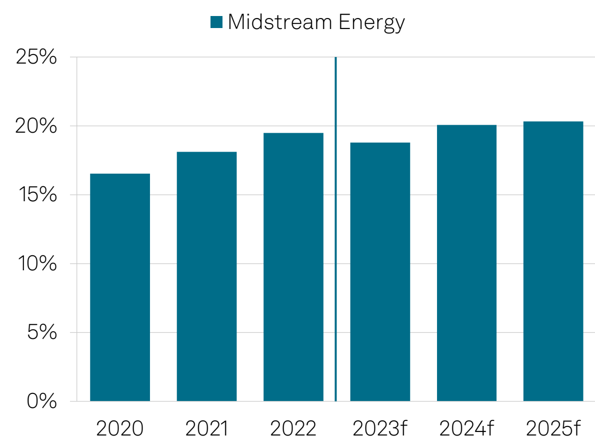


Chart 9

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: Sector

Chart 10

Cash flow and primary uses

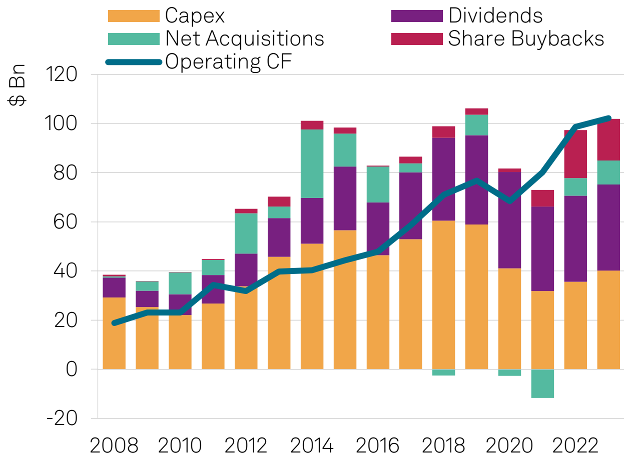


Chart 11

Return on capital employed

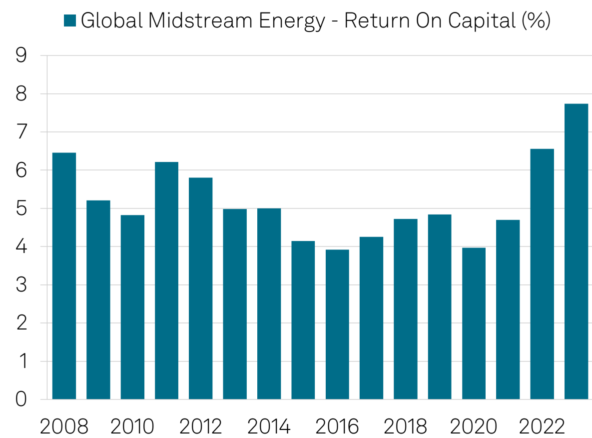


Chart 12

Fixed- versus variable-rate exposure

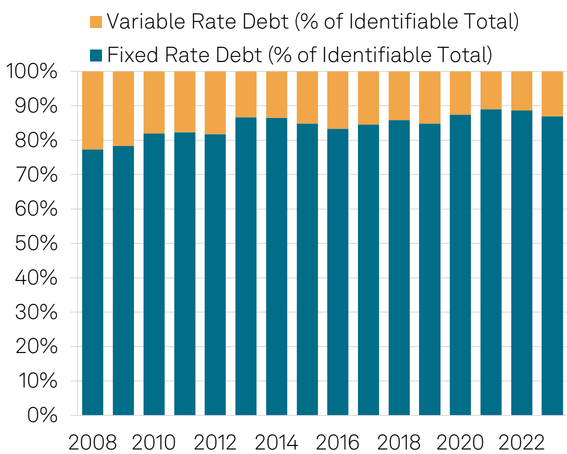


Chart 13

Long-term debt term structure

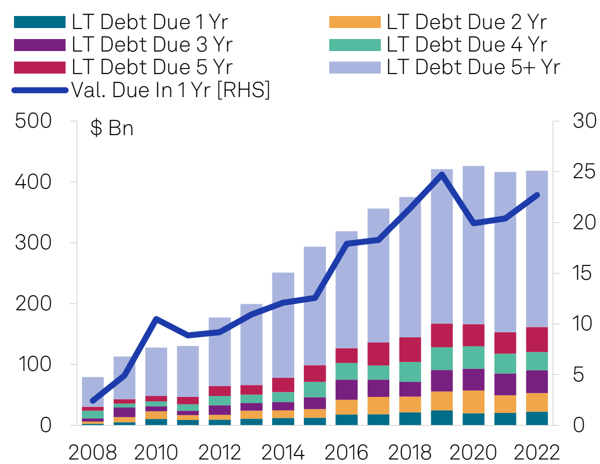


Chart 14

Cash and equivalents / Total assets

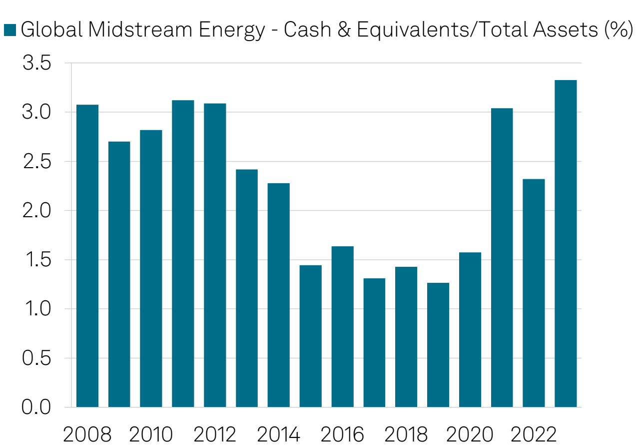
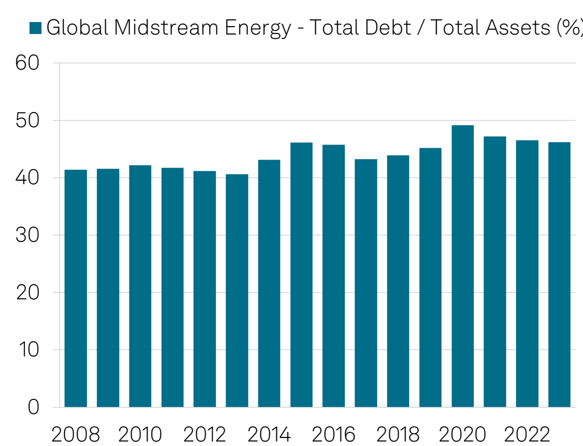


Chart 15

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.