The Changing Landscape Of U.S. Midstream Energy Credit

At the beginning of the fourth quarter of 2009, the credit landscape may seem a strange and foreboding place to investors in the U.S. midstream energy sector compared with the optimistic outlook many had in 2007 and early 2008. Although the credit market turmoil that began with the demise of Lehman Brothers in September 2008 has moderated, Standard & Poor's Ratings Services believes that the enduring effects of the credit crisis will continue to define the risks and opportunities for the midstream sector in 2010. Credit quality could be volatile over the next 12 to 18 months, depending on the speed of economic recovery and the supply and demand balance for natural gas, crude oil, and natural gas liquids (NGL). Two key factors for the midstream sector—commodity pricing and capital market conditions—may present perils and opportunities for investors. But despite market uncertainty, the storm clouds that might lie ahead could have a few silver linings.

Lower Commodity Prices Could Have An Upside

Commodity prices were an almost immediate casualty of the credit crisis. As fears of a protracted economic slowdown took root, all three key commodities for the midstream energy sector lost nearly half their prior value. Oil prices fell from a high of $145 per barrel on July 3, 2008, to a low of $31 only six months later. Although crude has rebounded to about $70 in recent months, it remains down 30% in year-on-year comparisons. Similarly, average natural gas prices using the Henry Hub benchmark in 2009 have been an anemic $3.80 per million Btu (mmBtu) versus $8.90 per mmBtu in 2008. NGL pricing has fared no better, with prices for a composite barrel declining to about 73 cents per gallon in 2009 from about $1.40 in 2008.

The forward price curves for these three commodities suggest higher future prices in 2010. Nevertheless, Standard & Poor's has a relatively bearish outlook on commodity market fundamentals for natural gas. We believe that commodity prices for natural gas and NGLs in particular are likely to remain depressed as the weak economy continues to hinder industrial demand, leading to oversupply in end markets. *(See "How Standard & Poor's Arrives At Natural Gas Liquids Pricing Assumptions," on p. 24).*

Lower commodity prices are likely to hurt almost all midstream companies in some fashion. The impact on speculative-grade (rated 'BB+' or lower) midstream issuers is likely to be the most obvious and immediate, given that these companies typically have cash flows that depend on market prices for natural gas, NGLs, and, to a lesser extent, crude oil. To date, unhedged cash flows at gathering and processing companies have declined almost 65% in quarter-over-quarter comparisons, although relatively favorable hedge positions for some partly mitigate the impact of those sizable declines. We expect this trend to continue through the end of 2009.

Even for investment-grade (rated 'BBB-' and above) companies that usually have less than 25% of their total cash flow directly exposed to commodity prices, we anticipate that financial performance will decline over the next year. The probable causes of this are less upstream production, which reduces volume throughput in fee-based gathering and processing systems and intrastate pipelines, which earn less revenue when they handle less fuel. Furthermore, the natural gas surplus has led to lower basis differentials between production areas and end markets, which imply less near-term commodity price volatility and a diminished opportunity for companies to optimize unused storage and pipeline capacity for additional profit.

In short, lower commodity prices are likely to lead to fewer—and less profitable—growth opportunities in 2010. We are already seeing companies scaling back capital spending in response to these dynamics *(see chart 1)*. Lower growth is generally bad for credit quality, and capital programs and debt financing to meet the infrastructure needs of the industry have added considerable debt to balance sheets over the last two years. In fact, we estimate that the midstream companies we rate spent roughly $30 billion on new infrastructure that went into service in 2008 and 2009, which, at 12% to 15% average unlevered cash returns, suggests that companies could generate between $3 billion and $4.5 billion of incremental cash flow in 2010 that could benefit bondholders. If capital spending continues to decline, we would expect the balance sheets deterioration of the last several years to at least partly revive as cash flows from already completed projects improve the companies' financial profiles.

Chart 1 Capital Spending—U.S. Midstream Energy Companies

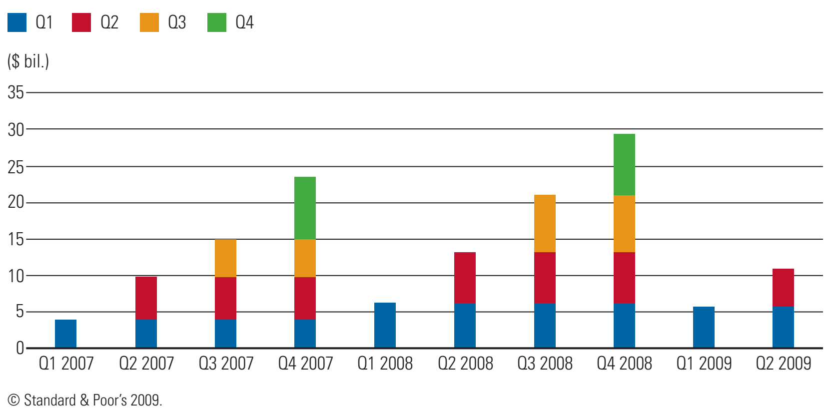
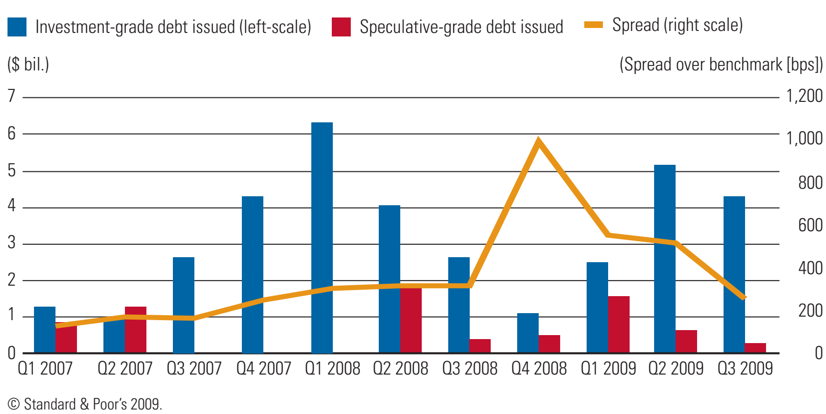


Chart 2 Debt Issuance And Spreads—U.S. Midstream Energy Companies



In 2010, the degree to which the impact that weaker near-term macroeconomic conditions will have on financial profiles balances the positive effects prior capital investments will have on cash flow is uncertain. Our research broadly suggests that even with a sustained downturn in economic activity, many segments of the midstream industry will be well positioned to ride out market conditions. Ratings are most likely to decline for gathering and processing companies, propane companies, and, if the weak economy persists through the end of 2011, a few diversified midstream companies. *(See "2010: U.S. Midstream Energy's Prospects For A Brighter Future," on p. 32).*

Capital Market Conditions Are Likely To Ease

Because of the upheaval in capital markets and lower growth prospects, we continue to emphasize the importance of liquidity in midstream companies' credit profiles. Although liquidity concerns dominated many of the negative ratings actions in late 2008 and early 2009, we now believe that market conditions have eased substantially for most of the midstream sector. If the robust equity and debt issuance of the past 12 months is an accurate indicator of market sentiment, investors are well-disposed toward the midstream sector going into 2010, which will help support ratings and liquidity at current levels.

U.S.-dollar denominated debt issuance by midstream companies in 2009 is not much lower than it was in 2008 *(see chart 2)*. As of Sept. 30, 2009, Standard & Poor's rated about $12.4 billion in debt in the midstream sector versus $14.7 billion for all of 2008. This suggests that the market continues to view midstream energy as a sector with relatively good long-term credit fundamentals despite weaker near-term economic conditions. Likewise, spreads on fixed-income securities have narrowed substantially, to year-end 2007 levels, indicating much more positive sentiment about credit risk in the sector.

On the equity side, the midstream master limited partnership (MLP) equity market, which the Alerian MLP Index tracks, has yielded solid returns for investors in 2009. The index has increased by about 35% for the year after about a 45% decline in overall value between September and August of 2008. Rated midstream companies have issued about $3.2 billion in equity through June 30, 2009, which is essentially on-par with pre-crisis equity issuance of about $3.5 billion in the second quarter of 2008 *(see chart 3)*. Equity yields have also dropped about 600 basis points through September 2009.

Although equity issuance has not substantially abated in year-on-year comparisons, distribution coverage levels for MLP issuers are declining as weaker market conditions erode distributable cash flow for many companies. Certainly, well-publicized distribution cuts at Atlas Pipeline Partners L.P. (B-/Negative/—) and CrossTex Energy Partners (not rated) have elevated equity investor concerns about distribution growth prospects for gathering and processing companies. Lower-rated companies have more restricted access to equity markets. The total percentage of equity market issuance by speculative-grade midstream companies has declined from about 32% of total issuance in 2007 (which is roughly equivalent to the share of speculative-grade ratings in the midstream sector) to only 5% through the first half of 2009. To date, concerns about companies' ability to support current equity distributions seem mostly focused on speculative-grade processing companies, whereas larger, more diversified issuers have consistently demonstrated their ability to issue stock even under very unfavorable market conditions.

The easing of financial conditions in the debt and equity markets for many midstream companies is good news for a sector that will need to refinance significant maturities beginning in 2012 and 2013. Relatively good access to external funding markets will help support credit for companies at 'BBB' and 'BBB-' levels that continue to have sizable capital spending requirements that may require additional liquidity. For the lower end of the credit spectrum, absolute levels of liquidity continue to be a key ratings factor.

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The 12-Month Ratings Outlook Is Mostly Stable

The average credit quality of the midstream sector is 'BBB-', as it has been for the past three years. And 76% of outlooks are stable *(see chart 4)*. Nevertheless, weak near-term fundamentals contribute to our opinion that a handful of companies will see their credit quality slip in 2010.

That most outlooks are stable indicates that we do not expect material deterioration in the overall sector's financial performance over the next year. But our bias is negative for those companies we believe have a better than 30% chance of a ratings change in the next 12 to 18 months. However, we have not placed any midstream issuers on CreditWatch, which implies that any future changes will likely stem from longer-term market developments.

Our negative bias toward the sector has persisted for the last 11 quarters *(see chart 5)*. But the intensity of our negative sentiment did not peak as a direct result of the credit crisis (although the absolute number of companies with a negative outlook or CreditWatch did peak during this period). It actually became apparent two quarters sooner. This was primarily because of our concerns about the risk of longer-term balance-sheet deterioration in the industry resulting from high capital spending programs that entailed substantial leverage and execution risk. Liquidity and capital access concerns at the end of 2008 exacerbated this negative trend, which the sustained downturn in commodity prices has prolonged.

We still believe higher capital spending will test the sector's credit profile. Although infrastructure spending so far this year is lower than in past years, many large diversified companies continue to develop big projects that should create negative free cash flow over the next two years. A company's ability to successfully follow through on these construction programs is important, particularly because current commodity prices are unlikely to offset losses from material cost overruns. However, lower materials and labor costs should help. Balancing the short-term risks of infrastructure construction programs against the longer term cash flow profile of these assets will remain a key credit concern for the industry. *(For more information on our approach to the risks of capital spending, see "Methodology For Examining Capital Spending Program Risk For U.S. Midstream Energy Companies," on p. 17.)*

Chart 3 Equity Issuances—U.S. Midstream Energy Companies

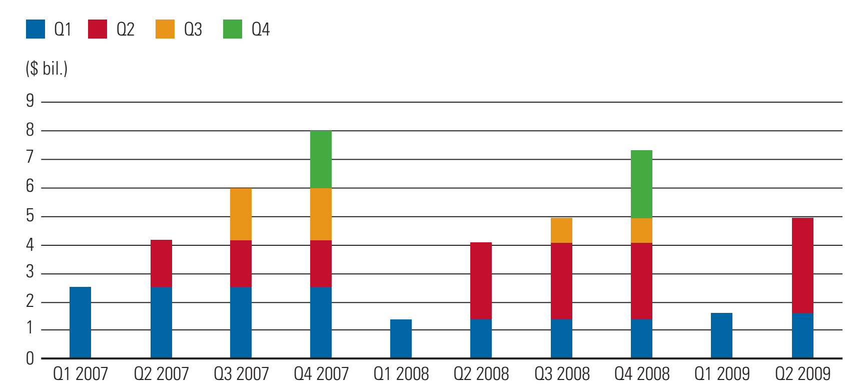


Chart 4 Outlook Distribution For U.S. Midstream Energy Companies

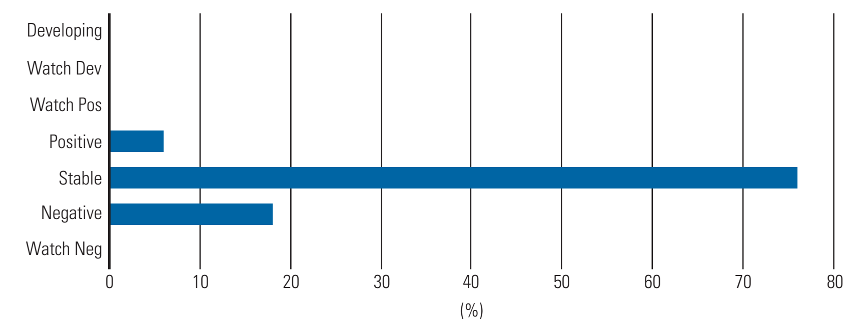
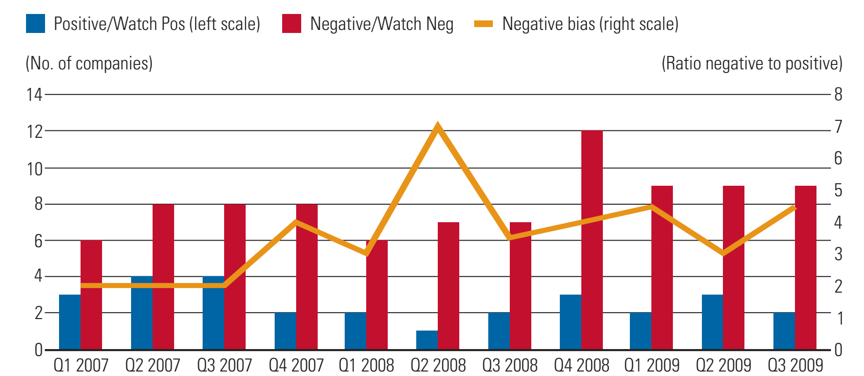


Chart 5 Outlook Trends



2010 Will Be A Year Of Transition

Midstream energy companies generally appear well positioned to manage lower commodity prices, lower profitability, and lower growth in 2010, but roughly one in five are at risk for a downgrade. Although capital markets and liquidity are becoming secondary issues for the sector's investment-grade companies, speculative-grade gathering and processing companies will likely continue to wrestle with uncertain access to debt and equity markets and low commodity prices that will leave very little margin for error. Capital spending and execution risk will remain key ratings factors for all issuers. And while 2010 is shaping up to be a year that might hold a few surprises for bondholders, major changes in credit quality are unlikely. **CW**

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