As seen in the November/December 2012 issue of MIDSTREAM Business

Nuevo Midstream LLC has significantly increased gathering and processing capacity of its Ramsey plant in the Delaware basin near Orla, Texas. The expansion was to be finished by the first of November.

Source: Nuevo Midstream LLC

Exciting Times Ahead For Midstream

Moving into the new year, the midstream consensus is that continued strong drilling in North American shale plays will keep gathering, processing, transmission and storage demands strong in 2013 and beyond.

By Jennifer Postel

For many in the midstream sector, 2012 has been a game of catch-up. Increased oil and natural gas production, volatile natural gas prices and a shift of focus to liquids-rich areas has left the midstream industry scrambling to alter previous plans. However—despite the compounded difficulties—the sector surges on, giving many industry insiders a positive outlook for the future.

According to one midstream executive, wherever a strong upstream economy exists, midstream investments are sure to follow. During the past few years, oil and natural gas production has exceeded expectations thanks to vast improvements in drilling and completion techniques and technologies that have left exploration and production companies with increasingly shorter drill times and higher initial production. Therefore, liquids-rich areas like the Bakken, Eagle Ford, Marcellus and even historical Midcontinent basins like the Permian in West Texas have seen a burst in infrastructure build-out.

The future appears brighter than the past, according to *North American Midstream Sector: Booming Demand for New Oil and NGL Infrastructure Trumps Weak Natural Gas Price*s, a mid-year report released by Moody's Investor Services, which concluded that the midstream sector should see an increase in infrastructure demand into late 2013, all in spite of plummeting gas prices.

"Growing production of oil, natural gas and natural gas liquids (NGLs) and higher margins are driving increased earnings and distributable cash flow for pipeline operators and gathering and processing (G&P) systems," the report noted. "Oil, gas and NGL production growth will keep driving demand for new midstream infrastructure. Strong oil and NGL prices have sustained high drilling activity by North American exploration and production companies, outpacing the decline in natural gas directed drilling."

Midstream Business interviewed a handful of midstream executives for a review of 2012 and a look ahead at what is in store for their companies as well as the burgeoning midstream industry.

Shift in focus

Crestwood Midstream Partners LP has been one of the most active midstream services providers in the industry since changing management in 2010. Beginning with an early focus in Texas' Barnett shale, Crestwood has quickly expanded its midstream holdings with acquisitions in the Avalon, Fayetteville, Granite Wash and Haynesville/Bossier regions. In addition, this past March, the company amplified its midstream presence with the acquisition of gathering assets in the prolific Marcellus shale.

In March, Crestwood and its general partner, Crestwood Holdings, formed Crestwood Marcellus Midstream to complete a $375 million acquisition from leading Marcellus shale producer Antero Resources. The gathering assets are in the liquids-rich area of the Marcellus shale play located in the West Virginia counties of Harrison and Doddridge. Like many in the industry entering 2012, Crestwood saw a decline in dry-gas activity and turned its focus—successfully—in the other direction.

"It's been a good year despite lower natural gas prices as, we've been able to make acquisitions in a couple of rich-gas plays to drive our growth," Robert G. Phillips, chairman, president and chief executive of Crestwood Midstream Partners tells *Midstream Business*. "In 2011 and 2012, we largely acquired and built assets in the dry gas plays but because of the natural gas price decline from late 2011 through April 2012, there's been a slowdown in activity in those areas.

"But, that's been offset by a big increase in activity in our rich-gas areas such as the Marcellus, and the Granite Wash and a timely acquisition in the rich-gas Barnett shale area. So, 2012 is turning out to be a good year for us from a growth standpoint, and it sets the stage for more growth in 2013," Phillips adds.

According to a *Bloomberg* report, shale-gas production is up more than 25% from the previous year and, the report noted, the Marcellus shale has represented the biggest supply gain. Despite a drop off in active rigs and—again—low gas prices, Phillips expects to see increased output from the area.

"Having just come back from a field visit to our Marcellus operations, I am more excited today than I have been in years. Producer drilling activity in the rich-gas portion of the Marcellus is off the charts," Phillips says. "The producers are aggressively developing their acreage, and the wells in all the areas are turning out to be much better performers than we thought."

Although the refocus of producers from dry gas to wet gas might have left many midstreamers in a bind, the industry, according to Phillips, has been able to adjust to any of the issues the shift may have caused.

"I think the midstream sector has done well matching the needs of producers," Phillips says. "As producers moved their drilling activity out of those dry gas areas, it simply increased, or super sized, the level of activity in the rich-gas areas. It also put a lot more pressure on midstream players to move faster to build out infrastructure in concentrated areas like the Marcellus, the Eagle Ford,

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—Robert G. Phillips, chairman, president and chief executive, Crestwood Midstream Partners

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—Bill Waldrip, managing partner and founder, EnCap Flatrock Midstream

the Niobrara, which is an emerging play, and the Bakken for oil. So, as producer activity shifted from to dry to rich gas, the midstreamers have had to recalibrate their plans to shift their activity as well.

"The midstream sector is scrambling to catch up with the infrastructure needs of our producers. It's a great time for us. It is exciting that we have aggressive producers that are developing their properties. And, we're building gathering systems, processing facilities and compression stations as fast as we can. I think 2013 is going to be a really big year for the midstream industry," he says.

Over the next year, Phillips expects Crestwood to spend more time focusing on business and greenfield development projects in new areas like the Niobrara and the Utica "where we are at the beginning phase and working on some exciting potential projects to build out infrastructure in those rich gas plays," he adds.

The future of MLPs

Crestwood, like a majority of midstream companies, is a publicly traded master limited partnership (MLP). With consistent tax-advantaged distributions, MLPs have become a popular business structure in the energy industry, and, as Phillips notes, Crestwood has capitalized on the program.

"We think the MLP financial structure aligns very well with the long-term growth profile of the infrastructure business we are in," Phillips says. "We spent the past two years acquiring operating assets in key shale plays with growth potential—Crestwood is totally shale-play focused—so we are well positioned with access to public capital markets to raise long-term capital and invest in midstream infrastructure. Now as we go forward with our business-development strategy, a key to our success will be to access the public equity and the public debt markets through our MLP."

In addition, as the industry progresses into the new year, the popularity of the MLP structure should continue to grow and face challenges, according to Phillips.

"There's always a concern, from a taxation standpoint, that given the state of our country's budget issues and the presidential election that there is going to be the potential for a massive structural tax change, but we don't think so, and our industry sector doesn't think so," says Phillips. "I think most of the publicly traded partnerships are fairly confident that we will maintain our tax-deferred, tax-preferred structure under the U.S. tax code.

"With that said, investors are still looking for yield, and from that standpoint, investors will continue to support MLPs because of the high-yield nature of our equity and our debt. Underlying all that is the fundamental need for MLPs to build the nation's vitally important energy infrastructure, and I think we are in a 10- to 15-year window where we are going to build out more energy infrastructure than ever. I think MLPs are well positioned to attract investor capital to continue this historic build-out of midstream infrastructure to bring new shale-based energy supplies to end markets," he adds.

Private equity heats up

Private equity-backed midstream investments flooded the market in 2012. According to an article from Deloitte *Show Me the Money: Private Equity's New Role in Shale Gas Infrastructure*, private equity-backed midstream companies have become increasingly attractive due to "reliable annuity streams and five- to 15-year investment horizons …"

San Antonio's EnCap Flatrock Midstream is a key player in this private equity revolution. Formed in 2008, through a partnership between Flatrock Energy Advisors and EnCap Investments LP, EnCap Flatrock Midstream's singular focus is "identifying, investing in and enhancing the value of great businesses and attractive assets in the midstream sector of North America's oil and gas industry," according to the company.

The private equity firm continued that undertaking this year, announcing in July the final closing of it second private equity fund, EnCap Flatrock Fund II, with total capital commitments of $1.75 billion, well in excess of its $1.25 billion target. The firm has nearly $3 billion in investment commitments from institutional investors across Funds I and II and has, to date, backed 10 midstream teams.

"For us 2012 was really a continuation of what we tend to do, which is going out and backing the very best management teams in the midstream business," Billy Lemmons, one of EnCap Flatrock's three managing partners, tells *Midstream Business*. "We think we are very fortunate to be able to provide those teams with venture capital for midstream projects."

With more than 30 years experience in the midstream industry, Lemmons, Managing Partner Dennis F. Jaggi and Managing Partner and Founder Bill Waldrip lead EnCap Flatrock's investment team.

"I would say part of what we saw in the last year is continued migration of activity to areas with strong upstream economics. So, where crude oil and NGL production have evolved, you saw our midstream investments follow," says Waldrip. "Even though we've been through some volatile periods in 2012, certainly with natural gas liquid prices, the liquids-rich sector is still a very economic side of the business."

Despite the capricious atmosphere, the industry remains resilient and, according to Waldrip, the outlook appears strong.

"From our standpoint we have a fundamental belief that there's somewhere between a 15% to 30% need for midstream capital for every upstream dollar that is spent," he says. "As long as you continue to see a very healthy upstream domestic capital program, there will be a very healthy midstream capital program. We continue to see very strong upstream spending, and as we head into the new year, you'll continue to see very strong demand for midstream infrastructure to support that development."

The Permian push

According to Lemmons the liquids-rich plays will continue to be the focal point heading into 2013 and, like many others, Lemmons and Waldrip believe the Marcellus and the Utica will be pivotal areas, but the Permian basin has also caught the group's attention.

"Approximately 25% of the rigs running in the U.S. right now are working in the greater Permian and Delaware basins." says Waldrip. "Even though it's an area with a very rich history in oil and gas development, the midstream infrastructure needs—spurred by the kind of development that is going on today—continue to be very high, even in mature areas such as West Texas."

One of the EnCap Flatrock-backed teams working in the Permian is Houston-based Nuevo Midstream LLC. Backed by an initial $65 million commitment from EnCap Flatrock Midstream and Torch Energy Advisors Inc., Nuevo focuses its gathering and processing efforts in the Delaware basin where producers are drilling the Avalon shale, Bone Springs and Wolfcamp formations in southeastern New Mexico and West Texas. At the end of 2011, Nuevo announced that the company would expand its Ramsey plant near Orla, Texas, and add cryogenic processing capacity of more than 100 million cubic feet per day.

"There's been a tremendous evolution of new technology in the Permian," Nuevo's President and Chief Executive, Jay Lendrum, tells *Midstream Business*. "With that, though, there was a real lack of midstream infrastructure on the west side of the basin, where our operations are focused. The area is incredible. It hasn't been fully defined, but the basin has several targets that are stacked on top of each other, so from an upstream economic standpoint, the potential for producers is incredible."

Lendrum expects a healthy and active new year for Nuevo Midstream. "We see 2013 as a growth period. We just set our second processing plant, and we are in the process of finalizing and making the decision to put another plant at the Ramsey site in 2013 or 2014," he says.

The EnCap Flatrock team has also turned their focus toward the region with a $75 million equity commitment to Lucid Energy Group this past February. Led by company President Michael Latchem, Lucid, according to a press release, plans to bring "a full range of midstream services, including crude oil and natural gas gathering, gas compression, treating, processing and transmission" to the area.

"We've been pursuing a couple of different opportunities in emerging plays," says Latchem in a *Midstream Business* interview. "Lucid's background and focus has been and will be organic development of grassroots facilities. Our focus has been in those newly emerging plays where infrastructure is lacking."

According to Latchem, the construction of some major NGL and crude transmission systems has dominated 2012 but, despite the build-out, he says there is still more work to be done in 2013, and that is where Lucid comes in.

"Where I see the infrastructure lacking significantly is on the gathering side," he says. "And, predominately where we see more opportunity now is crude gathering rather than gas gathering, and I think that is going to be a focus for 2013 and beyond.

"You've got some major expansions going on to create capacity for downstream, but the upstream capacity still needs to be created and serviced. Historically, trucking was sufficient because oil production was not enough to make it viable for pipeline connection, now it makes sense for pipeline systems to take care of larger volumes rather than trucks. This also reduced congestion and road traffic on the surface, which is a desirable result for land owners and local communities," Latchem adds.

Winning strategies

It becomes essential that those within the industry develop a clearly defined direction for the year ahead as the year ends. For veteran companies, sometimes sticking to what has worked in the past is the best strategic path.

"It [the winning strategy] comes down to the same model that we have been using for the last several years. It all starts with the people," says EnCap Flatrock's Lemmons.

"As a capital provider, having the confidence of the very best teams in the business, that if they partner with you then you will add value to their ability to be successful drives everything." ■