



# CRA Insights: Energy

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## Migration to midstream: strategic considerations for utilities investing in midstream assets

### Introduction

The transformation of the natural gas industry has created midstream growth opportunities for utility holding companies in North America. Shale gas exploitation in the Marcellus and Utica as well as the growth of natural gas end uses across the continent and abroad have dramatically shifted gas flows and increased the need for new midstream infrastructure. As large buyers of natural gas, utilities may be uniquely positioned to invest in this burgeoning space. Yet, the competition from traditional upstream and midstream competitors is significant. To be successful, utility holding companies will need to consider the unique value they bring upstream of the local distribution company (LDC), even outside their own geography, and then develop a strategy for growth.

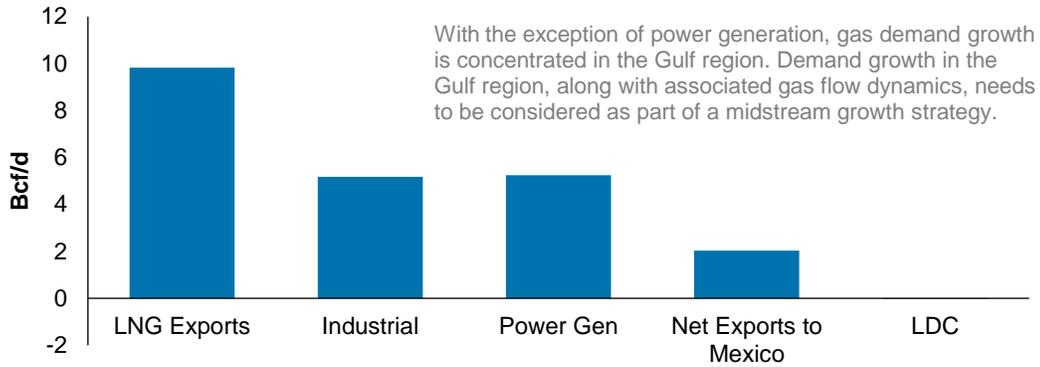
### Market trends support investment in midstream assets by utilities

While all investor-owned utilities seek earnings growth, most are experiencing little to no sales growth within their service territories. This is particularly acute in the electric sector, where energy efficiency and distributed generation have led to load growth that is largely flat to negative in most of the country. While utilities may be able to rate base their way to earnings, a strategy that relies on retail rate growth for earnings growth is inherently risky.

Utilities seeking growth, beyond what is provided by distribution system upgrades, may need to look beyond their traditional service territories. The Energy Information Administration (EIA) is forecasting significant natural gas production growth in the US fuelled by export and industrial and power generation uses (see Figure 1). This production growth will be the primary driver for midstream natural gas infrastructure additions which are outside of the traditional distribution service areas.

We see a unique opportunity for utilities to participate in these midstream projects to support their earnings growth targets.

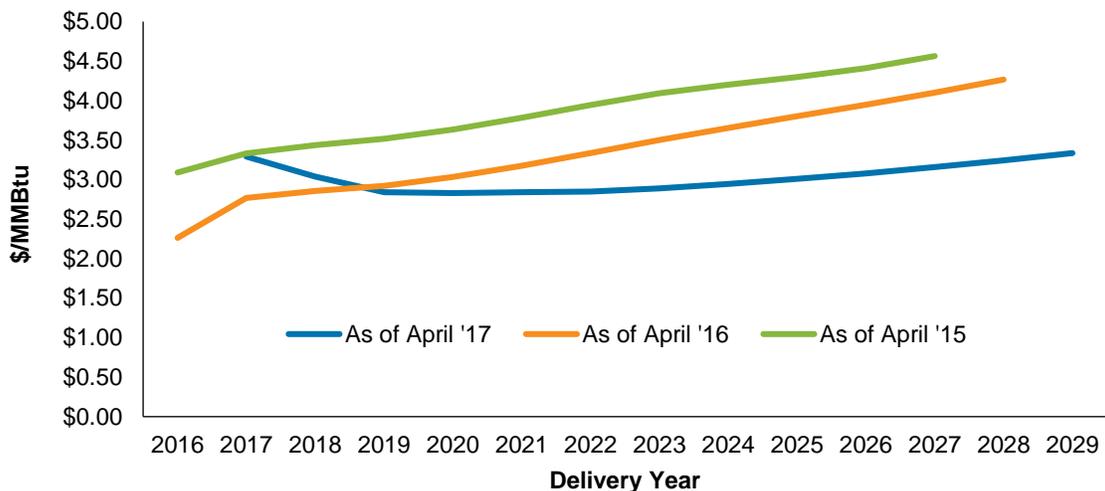
**Figure 1: Gas demand growth (2016–2025)**



Source: CRA analysis; EIA, AEO 2017 Forecast. Power generation figures based on new gas generation builds, implied capacity factor.

Another factor supporting utilities investing in midstream assets will be the expectation that gas prices will remain low for an extended period of time. Low prices will encourage midstream companies to partner with utilities to improve cash flow and support capital spending programs. The current NYMEX forward curve shows gas prices trading ~15% lower in 2019 than they are in 2017. This extremely bearish sentiment is a significant departure from previous forecasts (see Figure 2) and is driven by continued shale production growth in a low gas price environment.

**Figure 2: Henry Hub futures by trade date**



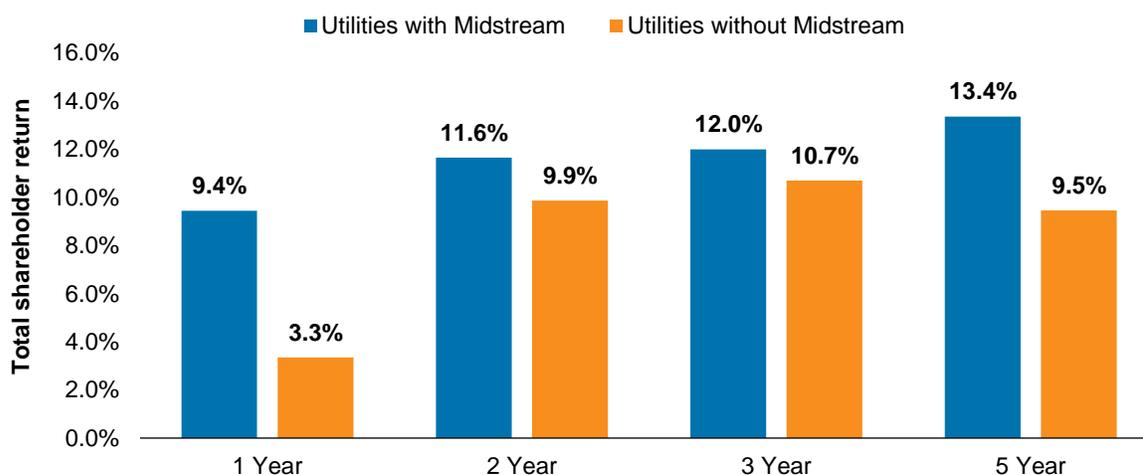
Source: Ventyx

While we have seen some utilities investing in pipeline projects, we believe the current demand growth and pricing trends can support a broader midstream investment thesis. However, we expect valuations of natural gas assets (both utility and midstream) to remain robust. Thus, utilities will need well thought out midstream growth strategies to support the high prices being paid for these assets.

## Midstream strategic considerations

Utilities investing in midstream assets have seen positive responses from research analysts and many have performed better on a total shareholder return (TSR) basis relative to utilities that have not invested in midstream (see Figure 3).

**Figure 3: Total shareholder return, utilities with and without midstream**



Source: Capital IQ. Total Shareholder Return equal to share appreciation + dividends. Utility sample made up of 28 utilities, 14 with material midstream assets, and 14 without material midstream assets.

The first movers into the midstream space have supported critical pipeline infrastructure in the market areas. These investments were made possible by the growth in shale production and supported by utility markets desiring access to this new cheap and abundant supply. Utilities underpinning pipeline projects with their native demand quickly realized, however, that this approach, by itself, would not support long term sustained growth given the modest sales growth in their service territories. Complicating things, utilities building pipelines to their market areas have faced serious headwinds given local and state opposition to these projects. Most have experienced considerable delays and some have had required state permits denied, such as the Constitution Pipeline and National Fuels' Northern Access Project.

Utilities need to fully consider their market influence along the entire value chain in order to realize sustainable growth. We believe investing in projects or operating assets away from the market areas and closer to the basins may face less regulatory uncertainty.

The question now is: how far can a utility reasonably move upstream to capture value?

## Realizing valuation improvements through contracting strategies

The value utility markets bring to infrastructure development is evident. Utilities have supported the development of billions of dollars of new "market pull" pipelines in recent years. Utility markets may provide even greater value supporting infrastructure builds further upstream and replacing "producer push" contracting structures with "market pull" contracting structures. This is due to the fact that upstream "producer push" (unregulated gathering) contracts are structured in a manner where the asset owner bears both volume risk and, at times, commodity price risk,

whereas “market pull” (regulated pipeline) contracts provide for firm revenues and no commodity price exposure. In addition, contracts with utilities provide higher value to midstream assets than contracts with producers and marketers. This is due to a utility’s superior credit quality and likelihood of contract renewal. This point has been proven in the marketplace where assets predominantly supported by utility contracts (pipelines) have experienced valuations 30% higher than assets (gathering and processing) supported by producers.

CRA recognizes that the regulation of a midstream asset, be it state or federal, has an impact on an asset’s valuation as well, but notes that within the Marcellus many assets have changed their status between state and federal regulation in the past few years.

The question is whether a utility can participate in a broader collection of midstream assets than is currently the practice, and by doing so increase the value of that asset. There are many existing midstream assets (laterals and header systems) in the various shale plays that that would qualify for federal regulation (FERC) which is more desirable from a utility perspective for participation. While these opportunities will be situational rather than generic in nature, they represent the greatest opportunity for value appreciation and should be considered as part of a utility’s midstream strategy.

## Conclusion

As the utility industry has transformed and restructured over the last two decades, many utility companies have transitioned to a more purely-regulated portfolio, exiting riskier commodity, merchant or international businesses. However, in the wake of flat/declining load and other industry changes, the regulated model is increasingly facing a new set of risks as energy efficiency and distributed generation limit capital growth opportunities and increases the risk of stranded capital investments. Utilities facing these pressures must now look beyond their traditional base for growth. A well-designed midstream investment strategy can support a utility’s need for sustainable growth and enhance value while managing risk.

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