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Midstream Energy Industry Headed For Merger Mania

By Keith Goldberg

Law360, New York (June 27, 2013, 6:07 PM ET) -- With soaring U.S. oil and gas production fueling demand for pipelines and other infrastructure, attorneys say recent deals such as the $7 billion tie-up between Crestwood Midstream Partners LP and Inergy Midstream LP signal a consolidation wave is poised to hit the midstream energy sector.

In what's been a generally lackluster 2013 for global energy and power M&A activity, some of the year's biggest deals have come from the midstream sector. Before Crestwood and Inergy **announced last month** that they were tying the knot, there was the **$11 billion joint natural gas venture** entered into by CenterPoint Energy Inc., OGE Energy Corp. and ArcLight Capital Partners LLC in March, as well as Kinder Morgan Inc.'s **$3.3 billion all-stock deal** for Copano Energy LLC that closed last month.

Blake H. Winburne, the global head of McDermott Will & Emery LLP's energy practice group, said he expected the consolidation trend to continue given the tremendous growth in U.S. natural gas, shale oil and natural gas liquid markets because of increased production.

"Not only have they grown, but they've grown in areas that haven't been historic basins for production," Winburne, whose firm represented ArcLight in the JV with CenterPoint and OGE, told Law360. "All of that creates a need for midstream infrastructure, from pipelines to storage facilities. There's a lot of capital that's needed to put that to work."

And there are plenty of investors out there eager to sink capital into those midstream projects, according to Akin Gump Strauss Hauer & Feld LLP partner J. Vincent Kendrick.

"When you combine those two things, you see deals," Kendrick, whose firm represented Crestwood in the deal with Inergy, told Law360.

Unlike the upstream oil and gas sector, which is dominated by a handful of major oil and gas producers, there aren't many majors in the midstream sector. Kinder Morgan, the U.S.' fourth-largest energy company thanks to a $38 billion merger with El Paso Corp. finalized last year, is an exception.

Historically, the midstream sector has been dominated by publicly traded master limited partnerships, and their market capitalizations generally don't come close to the levels enjoyed by the major oil and gas producers as a result of upstream consolidation, according to Winburne.

Midstream projects such as pipelines and refineries also often carry billion-dollar price tags — a lot of capital for MLPs that are under the gun to provide steady returns to investors, attorneys say. Consolidation is the logical next step for many of these MLPs, whether it's to create a company that has the financial muscle to develop new projects or to combine assets to expand their overall reach, according to attorneys.

"With the economies of scale, it would make a lot of sense for these public companies to increase their size, ... expand their geographic reach and diversify asset classes," Winburne said.

That thinking played into the CenterPoint-OGE-ArcLight deal, which created one of the largest MLPs in the U.S. The venture will own and operate 8,400 miles of interstate pipelines, nearly 2,300 miles of intrastate pipelines,11,000 miles of gathering lines, more than 90 billion cubic feet of natural gas storage capacity and 11 major processing plants.

Most of Kinder Morgan's assets are housed in its MLP, Kinder Morgan Energy Partners LP, of which Kinder Morgan Inc. is the general partner. When Kinder Morgan's MLP snapped up Copano, it got access to the company's 6,900 miles of pipeline, pumping 2.7 billion cubic feet of natural gas per day. Copano also owns nine processing plants across Texas, Oklahoma and Wyoming.

"There is a tremendous amount of infrastructure that is ripe for consolidation," Kendrick said. "If you look at Kinder Morgan-El Paso, Kinder Morgan acquiring Copano — it's happening all over."

There's another factor fueling the desire of MLPs to join forces, according to Paul Hastings LLP corporate partner Steve Tredennick: The demand for midstream assets is so high that it's driving up the price of those assets.

"If you look at the private assets or private deals space, there's such a demand for midstream assets and those midstream assets are being sold on very high multiples of future earnings expectations," Tredennick told Law360. "Given the competitiveness of the landscape and the high multiples, it's almost more effective and less expensive for an existing MLP to buy another existing MLP."

Yet MLPs that make acquisitions that have the potential for organic growth — i.e., new projects — can potentially earn more than MLPs that simply acquire existing assets, according to Kendrick.

While attorneys expect the midstream merger market to gather steam, they don't foresee megadeals on the scale of the Kinder Morgan-El Paso. Instead, large public companies will gobble up smaller public companies or private assets, or there will be combinations of MLPs with market caps in the single-digit billion-dollar range, they say.

"I think private capital, particularly private equity, will increasingly acquire and develop projects with their access to capital and perhaps when they reach commercial operation or thereafter, sell or drop down those assets to a MLP," Winburne said. "You have a lot more players in the lower half of the market — I would expect there to be more activity toward the midmarket area."

And with such high demand for new infrastructure, the midstream market still has plenty of room to grow, making megadeals less likely in the near future, attorneys say.

"It's not like we're talking about 15 MLPs that have 85 percent of the market contracting down to four," Kendrick said. "Every day, there's a new midstream company that's out there. It's going to be very dynamic."

--Additional reporting by Liz Hoffman. Editing by Elizabeth Bowen and Katherine Rautenberg.