East Daley Midstream Guidance Outlook

2021 Midstream Guidance Outlook – Fight or Flight: Taking Stock of the Midstream Report

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Questions?
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As we approach the New Year, midstream companies will release 2021 guidance, providing investors a first look into expectations for the coming year. In East Daley's fourth annual installment of our *Midstream Guidance Outlook*, we combine commodity fundamentals with asset-level financial modeling to identify themes and trends that will affect the midstream sector next year.

Key Takeaways

- Reduced associated gas growth and rising gas demand will create a call on natural gas supply from the Marcellus-Utica and Haynesville. Williams (WMB), MPLX (MPLX), Antero Midstream (AM), and EQT Midstream (ETRN) should benefit given their leverage to these drier gas basins.
- We expect Permian gas production growth despite lower drilling activity, which should benefit Energy Transfer (ET), Targa (TRGP), Altus Midstream (ALTM), MPLX (MPLX), and Western Midstream (WES) that have significant underutilized gathering & processing (G&P) capacity in the basin.
- Midstream companies have largely transitioned to living within cash flow. This new, more conservative financial strategy improves the sustainability and health of midstream companies without significant future legacy asset declines.

Building on the themes from the *2021 Midstream Guidance Outlook*, East Daley will release the first section of our annual ***Dirty Little Secrets* report, "Fight or Flight: Taking Stock of the Midstream"** in December. We will release the midstream company sections of *Dirty Little Secrets* at the end of January, analyzing near- and long-term risks for every midstream company in East Daley's coverage.

It Is Not *All* Bad – 2021 Midstream Themes

Most midstream companies will be relieved to shut the door on 2020, which has been among the most challenging years ever in the energy space. Our *2020 Midstream Guidance Outlook* focused on themes ranging from crude pipeline overbuilds and Permian production concerns to the need for additional natural gas supply rationalization. The 2Q2020 collapse of global economic activity and commodity prices due to the COVID-19 pandemic exacerbated some of these issues and completely reversed others. Heading into 2021, significant headwinds remain because of an overbuild of midstream infrastructure in many basins. We will focus on several of these overbuilt basins in *Dirty Little Secrets.* However, there are some positive trends for the midstream sector amid challenging industry conditions, which we explore here.

- Theme 1: Gas Basins Resurrected – Increasing Demand, Lower Associated Gas, and Discipline
- Theme 2: Permian Gas Infrastructure – It's Not Dead Yet
- Theme 3: The Focus on Free Cash Flow – Midstream Finally All Grown Up?

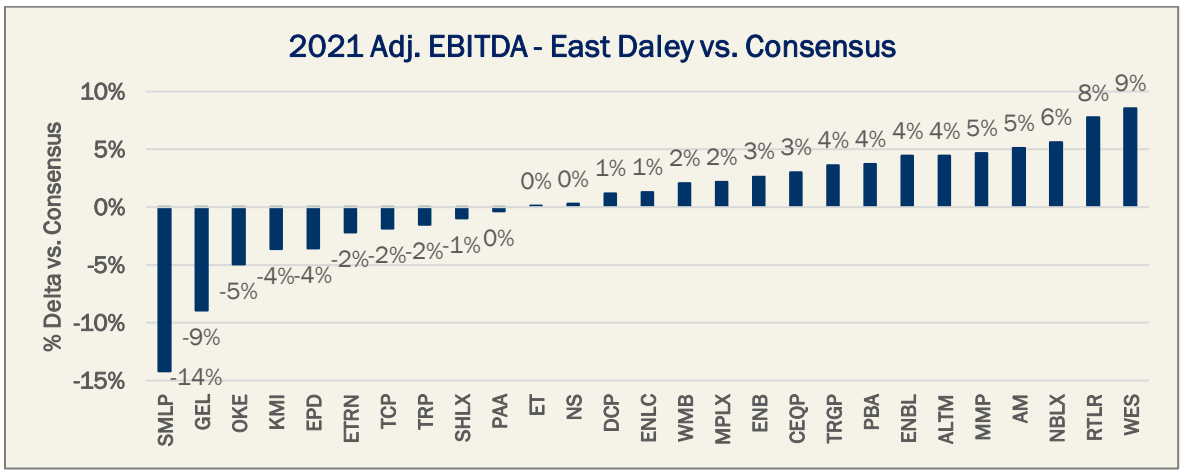

Figure 1: East Daley vs. Consensus 2021 Adj. EBITDA (East Daley Consensus Comparison Report)

Theme 1 - Gas Basins Resurrected: Increasing Demand, Lower Associated Gas, and Discipline

The COVID-19 pandemic caused widespread disruptions in the energy space that slashed demand and cratered commodity, equity, and debt prices. The downturn ushered in significant changes for the sector, foremost a lower long-term demand outlook for liquids and a sharpened focus by E&Ps on positive cash flow and investment returns. These impacts will undoubtedly weigh on production growth and volume throughputs for midstream assets that gather and transport liquids. However, the story for U.S. natural gas demand growth is still largely intact and supported by inelastic demand from residential, commercial, and industrial uses, and growing exports as waterborne LNG or piped supplies to Mexico. The prospects for lower associated gas production from liquids-rich basins means the market will require more supply from dry gas basins to meet future demand. Thus, some midstream companies levered to dry gas basins could see material upside in our models because of a shift toward drier gas.

East Daley's forecast for 3.9 Bcf/d natural gas demand growth in 2021 (based on current forward prices) underpins the need for natural gas supply growth, as shown in Table 1. We project the biggest demand change will be a 3.0 Bcf/d increase in LNG exports, which faced significant headwinds into the late summer of 2020 due to the warm 2019-20 Northern Hemisphere winter and global COVID demand effects. Gas prices in Europe have rebounded more quickly than in the U.S. and currently trade over $5/MMBtu for the 2020-21 winter and above $4 for the balance of 2021. This premium makes U.S. LNG exports profitable once again, as illustrated by our netback calculations in Figure 2 below. As a result, we expect U.S. LNG exports to ship near capacity in 2021.

U.S. Natural Gas Demand				
Demand (Bcf/d)	2019	2020	2021	2021 vs. 2020
LNG Exports	5.0	6.4	9.4	3.0
Industrial	23.1	22.5	23.3	0.8
ResCom	23.4	21.9	22.6	0.7
Mexico Exports	5.1	5.4	5.9	0.5
Processing/Pipe/Other	7.9	7.6	7.9	0.3
Canada Exports (Gross)	2.7	2.5	2.7	0.2
Power	30.9	31.2	29.6	-1.6
Total Demand	**98.1**	**97.5**	**101.4**	**3.9**

Table 1: Historical and Projected U.S. Natural Gas Demand (EIA, PointLogic, East Daley Research)

We also forecast industrial demand will increase next year because of waning COVID headwinds, which shut down or reduced industrial activity for parts of 2020. We forecast ResCom demand assuming a normal winter, which yields a moderate demand bump compared to last season's unseasonably warm temperatures. Exports to Mexico should also be higher because of the completion of the Wahalajara pipeline system that allows Permian gas to displace LNG imports along Mexico's Pacific Coast. Mitigating these upsides, we project higher gas prices in 2021 will reduce power demand at the margins as more utilities switch from gas to coal.

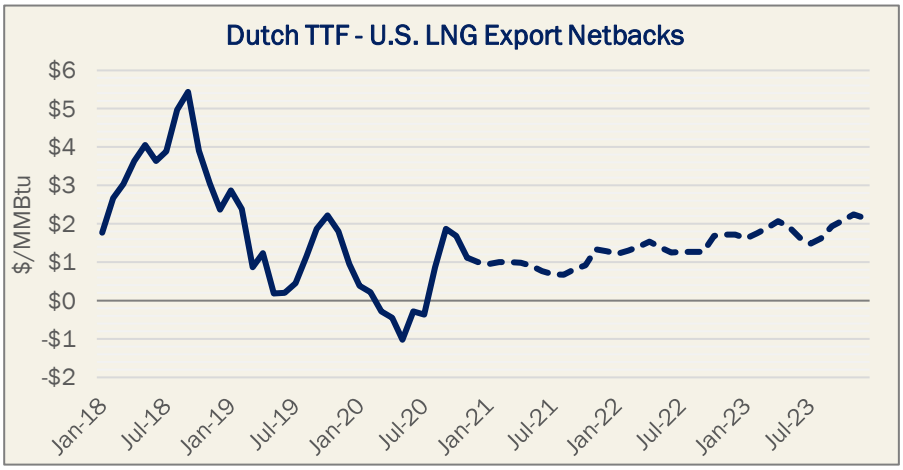

Figure 2: Netbacks for U.S. LNG Cargoes to Europe (Bloomberg, East Daley)

East Daley in March published a report, "Gas Production in a Low Oil Price World," in which we found that 2021 natural gas prices would need to increase to $2.50-$3.00/MMBtu in order to incentivize rig additions and balance the market. Our price predictions were accurate, as the forward Henry Hub curve shifted notably higher in the ensuing eight months and now averages $2.83/MMBtu for 2021 (Figure 3). However, our prediction for more rig activity has not come to fruition as the natural gas rig count has stayed stubbornly depressed since April (Figure 4). Persistently low drilling levels appear to be a product of newly established E&P discipline in which producers prioritize free cash flow and investment returns over supply growth. Thus, more drilling requires even higher gas prices. Most major Northeast producers have provided preliminary guidance for flat production in 2021, stating that regional prices were too low to add additional rigs.

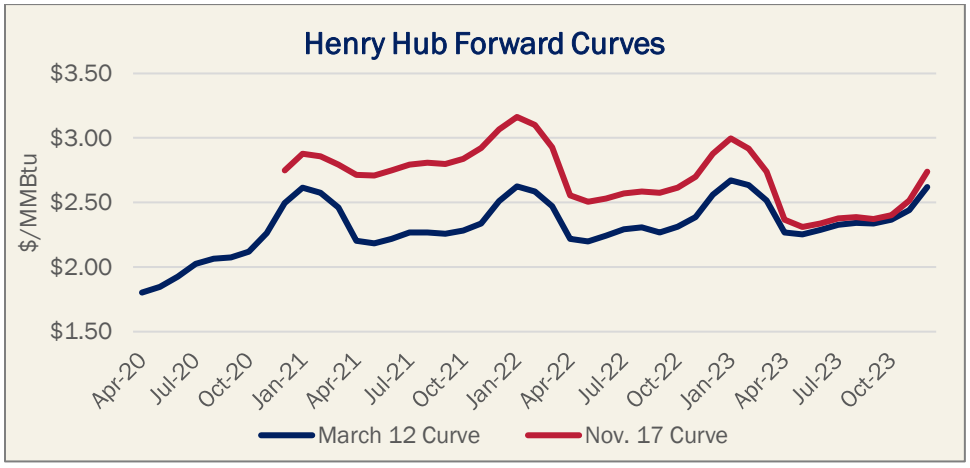

Figure 3: Henry Hub Forward Curve in March vs. November 2020 (Bloomberg)

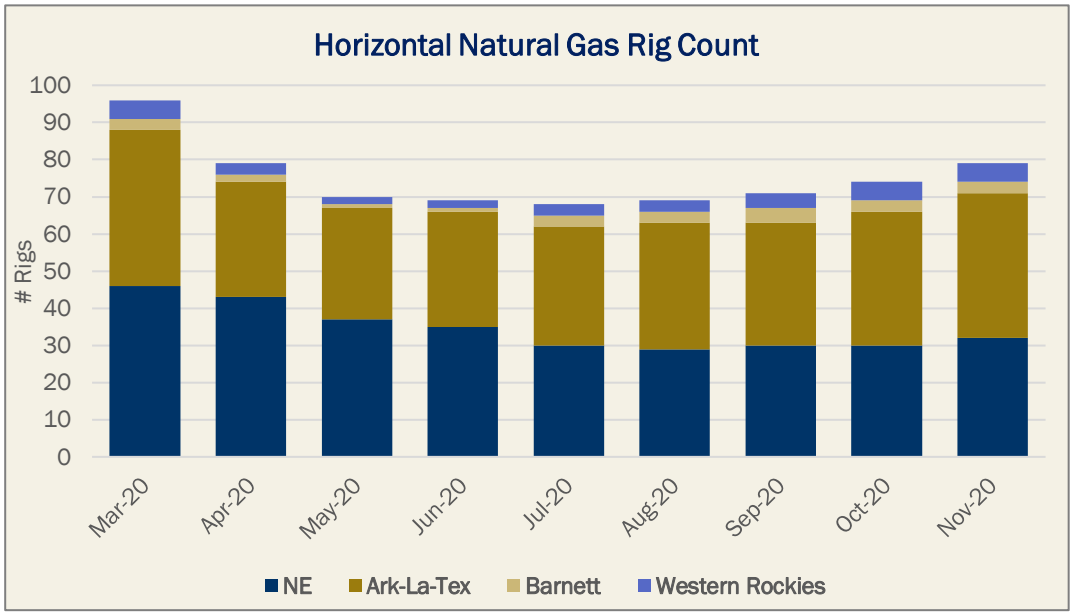

Figure 4: U.S. Horizontal Gas Rig Count, by Basin (East Daley Midstream Activity Tracker)

We outline our U.S. natural gas supply forecast (based on current forward strips) in Table 2 below. We estimate a net 1.0 Bcf/d production decline in 2021. We forecast a 1.0 Bcf/d drop in associated gas production from the oil basins (Permian, Bakken, Anadarko, Eagle Ford, Gulf, DJ) and 1.2 Bcf/d less production from lower-tier gas basins like the Barnett, Western Rockies, and others. Expected growth of 1.1 Bcf/d in the Ark-La-Tex region mitigates this downside as producers have added a handful of rigs over the last few months and several operators have guided to increased production in 2021. We also forecast 0.5 Bcf/d of supply growth in the Northeast due to abatement of shut-ins and slightly higher E&P activity.

U.S. Natural Gas Supply (Bcf/d)				
Basin	2019	2020	2021	2021 vs. 2020
Ark-La-Tex	11.6	12.3	13.4	1.1
Permian	10.6	11.6	12.2	0.6
Northeast	30.6	31.4	31.9	0.5
Bakken	1.7	1.8	1.8	0.0
Gulf of Mexico	2.5	2.5	2.4	-0.1
Barnett	2.7	2.4	2.2	-0.2
DJ	2.3	2.5	2.3	-0.2
Canada Imports (Gross)	7.4	6.9	6.5	-0.4
Western Rockies	7.5	6.7	6.3	-0.4
Anadarko	8.1	7.0	6.5	-0.5
Other	7.8	7.1	6.5	-0.6
Eagle Ford	7.0	6.1	5.3	-0.8
Total Supply	**99.8**	**98.3**	**97.3**	**-1.0**

Table 2: U.S. Natural Gas Supply (EIA, East Daley Research)

By combining our supply and demand forecasts, we expect demand will outstrip supply by ~5 Bcf/d next year, as shown in Figure 5. The imbalance suggests prices will need to increase to foster either of higher supply or lower demand, but more likely increased supply given producers' view of breakeven economics at or below $2/MMBtu in basins such as the Haynesville. East Daley's adjusted natural gas price model estimates Henry Hub prices will need to average ~$3.35/MMBtu in 2021 in order to balance the market. We forecast that higher prices primarily will incentive supply growth from the Northeast and Ark-La-Tex in 2021 and 2022, leading to volume upside for G&P systems in these basins. However, as shown in Table 3 below, we expect lukewarm midstream EBITDA growth in the Ark-La-Tex versus the Northeast because of fierce competitive pressure on rates. We believe lower competition better positions Northeast midstream companies for EBITDA growth.

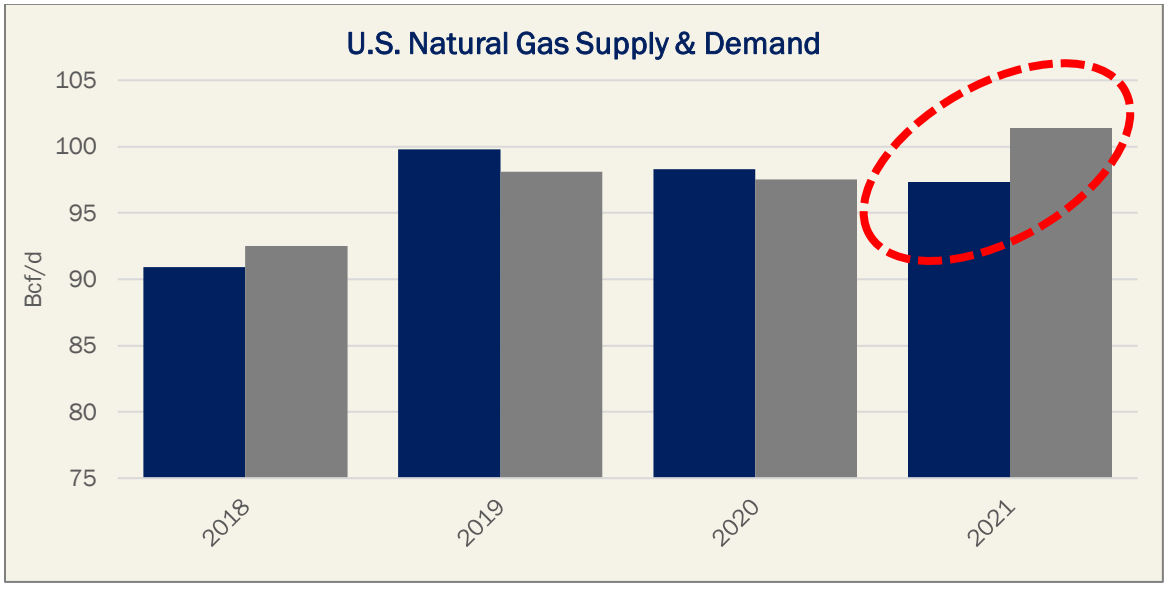

Figure 5: U.S. Natural Gas Supply and Demand (EIA, PointLogic, East Daley)

Estimated Adj. EBITDA – G&P Segment ($MM)				
Company	Basin	2020	2021	2022
Williams (WMB)	Northeast	$1,506	$1,584	$1,819
MPLX (MPLX)	Northeast	$1,289	$1,341	$1,459
Antero Midstream (AM)	Northeast	$862	$890	$987
EQT Midstream (ETRN)	Northeast	$793	$863	$961
Williams (WMB)	Ark-La-Tex	$158	$154	$177
Enable (ENBL)	Ark-La-Tex	$176	$178	$197
Kinder Morgan (KMI)	Ark-La-Tex	$97	$97	$101
Energy Transfer (ET)	Ark-La-Tex	$135	$139	$135
Enterprise (EPD)	Ark-La-Tex	$63	$64	$64
Total EBITDA		**$5,079**	**$5,310**	**$5,900**

Table 3: Adj. EBITDA Estimates for Gathering & Processing, by Company (East Daley Blueprint Model)

Theme 2: Permian Gas Infrastructure – It's Not Dead Yet

Last year's *Midstream Guidance Outlook* focused on the severe overbuild of crude oil pipeline capacity out of the Permian and impacts to legacy pipelines, a theme that while much discussed deserves continued scrutiny because of the COVID black swan that has strangled crude oil demand, pricing, and production growth. The Permian Basin will soon have over 8 MMb/d of crude oil takeaway capacity paired with production of only ~4.5 MMb/d, a gap that producers likely won't fill in the next decade under any but the most optimistic price recovery scenarios. While the market is now clearly aware of the magnitude of the overbuild, it may still underestimate the long-term downside for some crude oil pipelines under current oil price expectations. East Daley's upcoming *Dirty Little Secrets* will analyze thoroughly the potential downside for Permian crude oil pipelines as legacy minimum volume commitments (MVCs) roll off and pipelines compete for a shallow pool of uncommitted volumes.

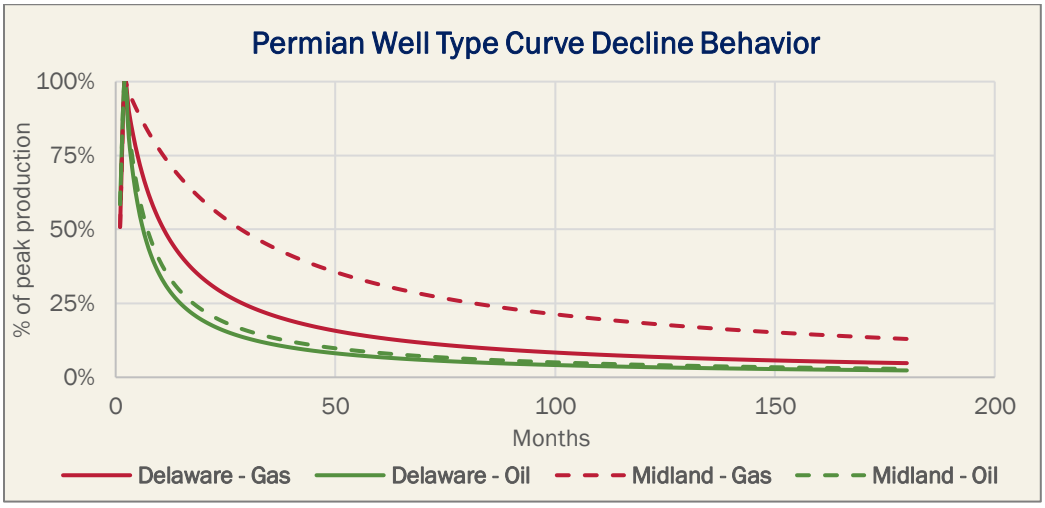

Figure 6: Type Curve Decline Behavior of Permian Wells (East Daley Research)

The overbuild of Permian infrastructure is not limited to crude as NGL pipelines, gas processing, and natural gas takeaway will all have significantly more capacity than supply heading into 2021. However, the degree of overbuild in each of these midstream chains varies, as do the dynamics of future growth into this capacity. Natural gas production has a built-in supply boost in the form of previously flared production. With Waha prices regularly trading at $1-$2/MMBtu discounts to Henry Hub, weak gas prices haven't produced an economic incentive to connect each new well. That may change in 2021. With new capacity for long-haul takeaway from Kinder Morgan's Permian Highway Pipeline and MPLX's Whistler Pipeline, coupled with larger producers' internal drive to limit flaring, natural gas supply from the Permian stands to outpace crude

oil. Additionally, both the Midland and Delaware have characteristically shallower declines for gas when compared to oil, which is illustrated in Figure 6. Thus, production of associated natural gas grows faster than oil in the Permian, which may allow latent capacity of gas infrastructure to fill much faster than with oil.

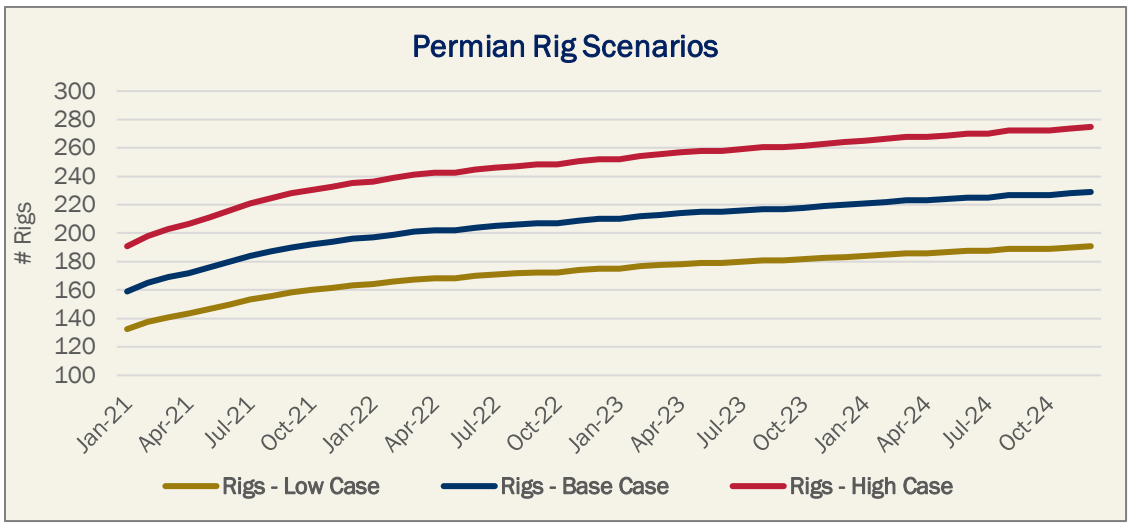

Figure 7: Permian Rig Scenarios (East Daley Research)

East Daley uses the forward curve for our base production modeling in the Permian. However, significant uncertainty underlies drilling activity heading into the future given the possibility of either a strong economic rebound or continued malaise from COVID. Thus, we created high and low scenarios that contemplate a 25% increase or decrease in rig counts from our base forecast, which is shown in Figure 7. We then feed these production scenarios into our constraint models for each type of midstream infrastructure.

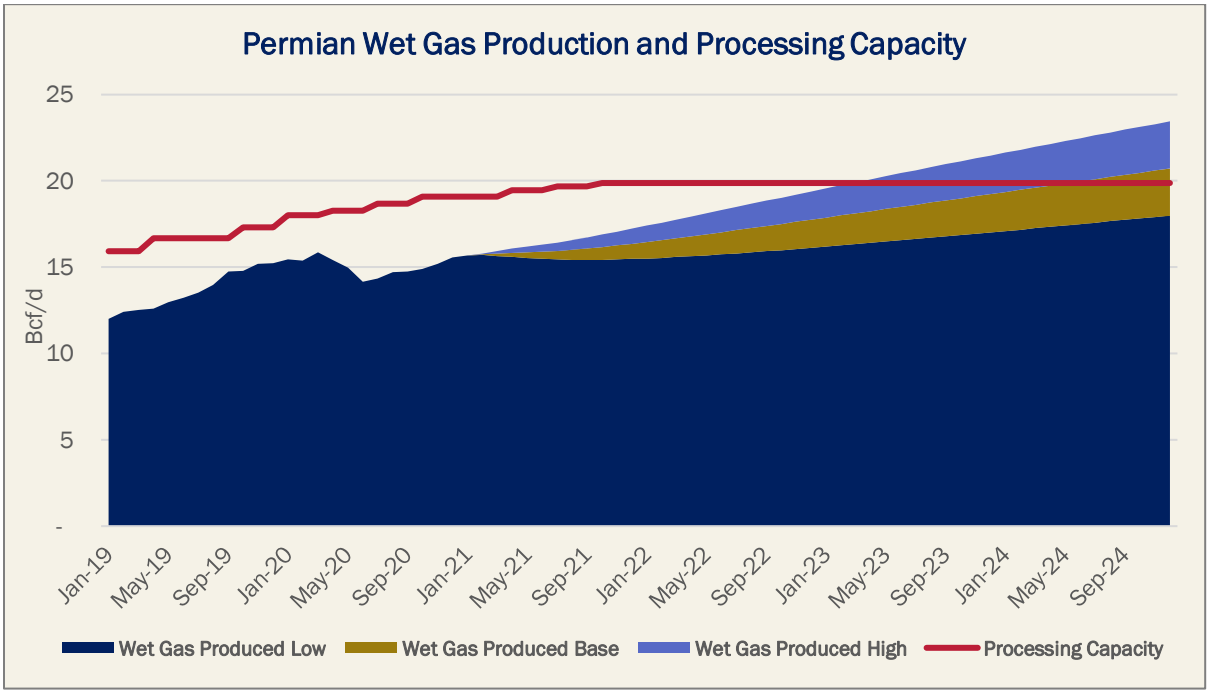

Figure 8: Permian Basin Wet Gas Production and Processing Capacity (East Daley Production Scenario Tool, East Daley Research)

As shown in Figure 8, gas processing capacity becomes constrained by late 2022 in our high case forecast and in late 2023 in our base case forecast. Contrary to the general oil industry malaise from poor prices, the consolidation underway in the upstream industry appears to benefit the Permian Basin midstream sector. Recently, for example, Pioneer (PXD) and Parsley (PE), the father-son E&P combination in the Delaware and Midland, each added two rigs to Targa's West Texas system. Consolidation of oil-centric drilling capital in the Permian in either our base or high scenarios should drive upside for midstream companies with latent processing capacity as they increase asset utilization with limited new capital expenditure required. We outline the latent capacity available for companies under East Daley's coverage in Table 4. Companies like Energy Transfer (ET), Targa Resources (TRGP), Altus Midstream (ALTM), MPLX, and Western Midstream (WES) have material underutilized capacity at their plants they could fill if natural gas production rose. A tighter balance of production and processing capacity would also firm up rates as competition for processing services would decline.

Permian Basin Gas Processing – 3Q2020 (MMcf/d)			
Company	Throughput*	Capacity**	Latent Capacity
Energy Transfer	1,694	2,825	1,131
Targa***	2,965	3,664	699
Altus	524	1,000	476
MPLX	372	800	428
Western Midstream	970	1,300	330
DCP Midstream	975	1,260	285
Enterprise	1,400	1,605	205
EnLink	930	1,085	155
Enterprise/WES JV	260	400	140
Crestwood	184	255	71
Rattler	13	40	27
Summit Midstream	34	60	26
Total	**10,321**	**14,294**	**3,973**

*As reported by Company/Texas RRC or estimated by East Daley.

**Includes capacity under construction.

***Includes Pioneer JV capacity.

Table 4: Permian Basin Gas Processing Capacity and Throughput in 3Q2020, by Company (East Daley Research)

The residue gas takeaway picture is not as bullish as G&P; however, there is still the potential need for another large-scale pipeline by late 2024 or into 2025 in our high and base case scenarios (see Figure 9). Kinder Morgan (KMI) has been vocal about its ability to deliver their third Permian egress pipeline when needed and has hinted at having already lined up partner support. However, KMI will expect aggressive competition from other midstream companies, private equity, and LNG export terminal owners given the lack of large-scale infrastructure projects in the backlog. Depending on the timing of a new pipeline, marketing arms could also benefit. Energy Transfer (ET), Enterprise (EPD), DCP Midstream (DCP), and KMI all have benefited from wide Waha-to-Gulf Coast spreads the past few years and could benefit again if egress becomes constrained.

In summary, while oil egress profitability appears ominous, even more subdued Permian growth should lead to increased asset utilization and greenfield infrastructure requirements in natural gas and gas processing. If the legacy of the COVID shock lingers in the form of more judicious capital deployment and downside scenario planning, then Permian gas and NGL logistics have an attractive five-year window for growing and sustainable profitability.

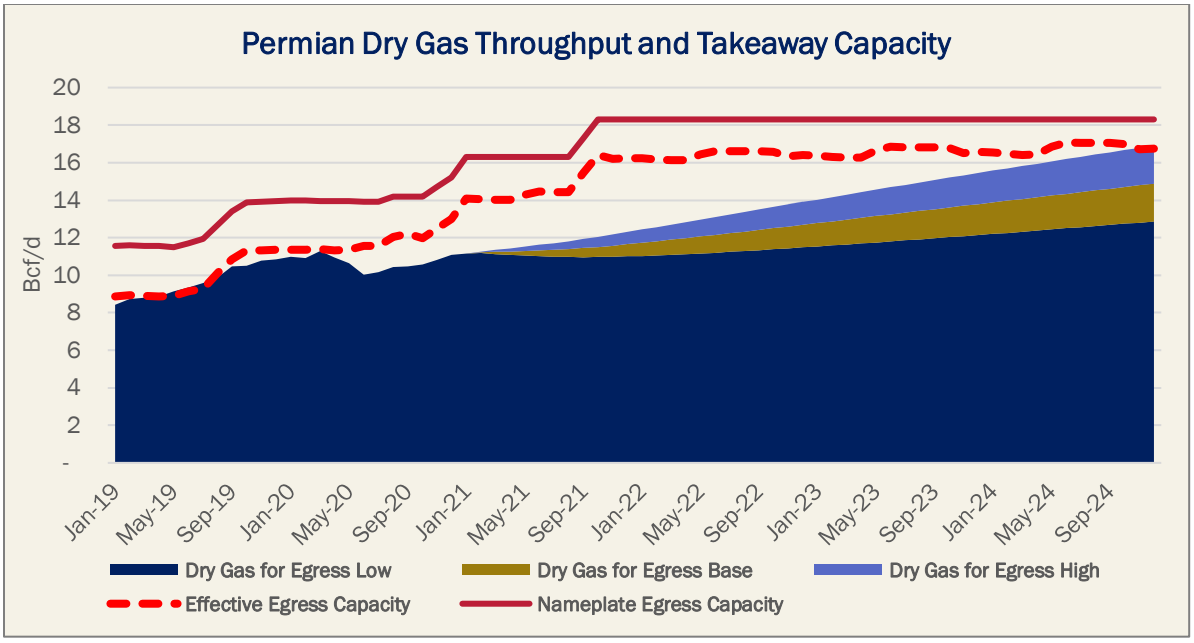

Figure 9: Permian Basin Dry Gas Throughput and Egress Capacity (East Daley Production & Constraint Forecast, East Daley Research)

Theme 3: The Focus on Free Cash Flow - Midstream Sector All Grown Up

The midstream sector appears to have found religion in a newfound focus on free cash flow. It took one pandemic, two commodity price crashes, and years of overspend, distribution cuts, and poor returns, but midstream names in 2020 are demonstrating unprecedented capital discipline. As shown in Figure 10, our models show most companies under our coverage will fund all their capital spending plus distributions and still have cash left over in 2021 and 2022. This cash can pay down debt, finance additional projects, or be distributed to equity holders via additional distributions or stock buybacks. The ability to fund capital expenditures from cash flow is in sharp contrast to the past decade when midstream companies distributed almost all operating cash flow to equity holders and issued debt and/or more stock to fund massive capital spending programs.

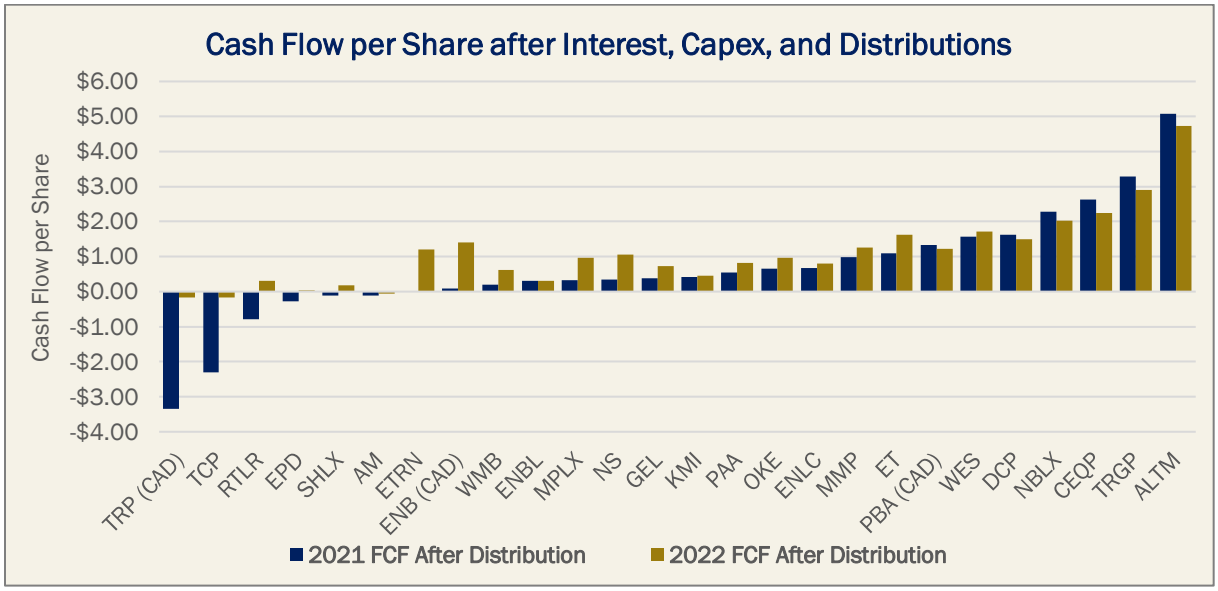

Figure 10: Estimated Cash Flow per Share after Interest, Capex, and Distributions (East Daley Research)

Living within cash flow is probably an appropriate policy for a sector that experiences massive cyclical price swings and potential long-term headwinds from renewable energy and regulatory risks. The potential downside to this strategy is that lower capital spending does not create enough new cash flow to offset declining cash streams from legacy assets. Indeed, some of the companies we cover have struggled to keep cash flow flat the past few years, even with massive capital budgets. East Daley refers to this effect as "the treadmill". We publish a quarterly Treadmill Incline Intensity (TII) index that shows which midstream companies face the largest risk of future declines in cash flow generated from legacy assets.

Figure 11 shows East Daley's latest TII index for our midstream coverage group. The TII forecasts legacy asset EBITDA declines (as a percent of EBITDA) from 2020 to 2024. Positive TII scores indicate companies we expect to experience declining EBITDA from legacy assets. A negative TII score indicates a declining treadmill, or companies with legacy assets that we project will see higher EBITDA over the forecast period. Negative TII scores – a healthy financial indicator – are mathematically possible via rate increases or increased utilization of legacy assets.

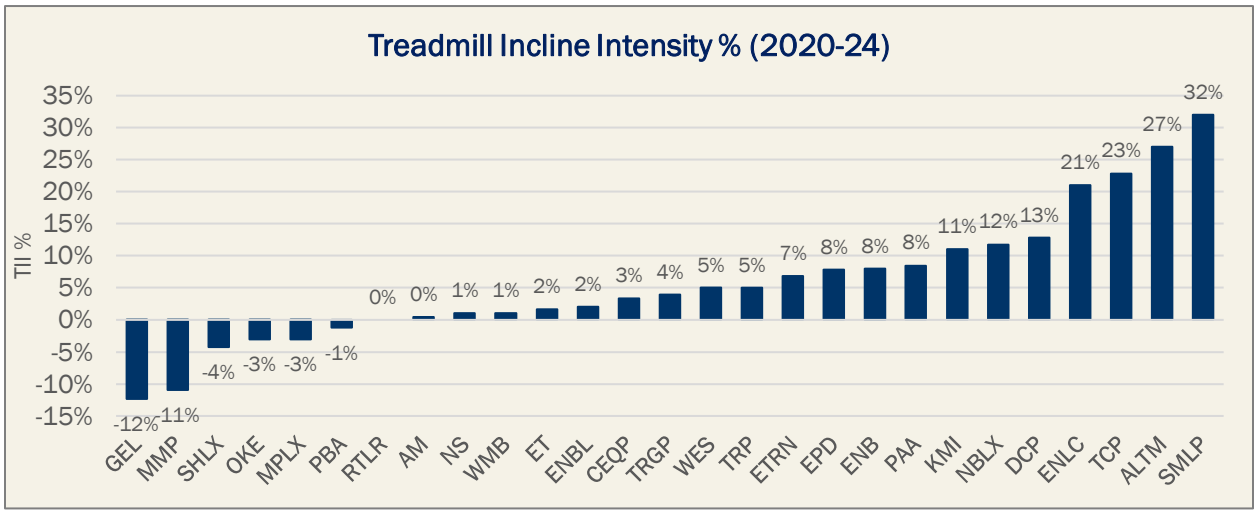

Figure 11: Treadmill Incline Intensity from 2020 to 2024, by Company (East Daley Blueprint Model)

As midstream transitions to a higher focus on free cash flow, our models too will evolve. Starting with our 3Q2020 post-earnings models, we will publish both FCF/share to equity as well as the CF/share after interest, capex, and distributions, as shown in Figure 10 previously. The FCF/share to equity is particularly useful metric in that it provides a decent proxy for the cash flow per share that could be captured by equity holders after all other obligations are paid (e.g. interest, taxes, capital expenditures).

In Figure 12, we plot average FCF to equity yield from 2021 to 2024 against current leverage. This plot creates some interesting insights when analyzing equity valuations for midstream companies. For example, Energy Transfer (ET) has the highest Avg. FCF to Equity Yield on the plot but also is among the most levered. A recent distribution cut by the company implies the partnership will reallocate cash flow to lower leverage.

Another interesting company is TC Energy (TRP), which in our scatter plot has one of the lowest returns and is among the most levered names. However, TRP's higher leverage and lower returns are justified by the safety of its massive footprint of highly regulated assets that face little competition. Finally, Shell Midstream (SHLX) is well positioned on the scatter plot showing a relatively high Avg. FCF to Equity Yield and relatively low leverage. The company also has a rare negative TII score, which shows we expect EBITDA to grow from its legacy assets over the forecast period. However, the market may be discounting the terminal value of some of the company's offshore assets because of potential regulatory headwinds in Federal leasing, a discount which our forecast period would not capture.

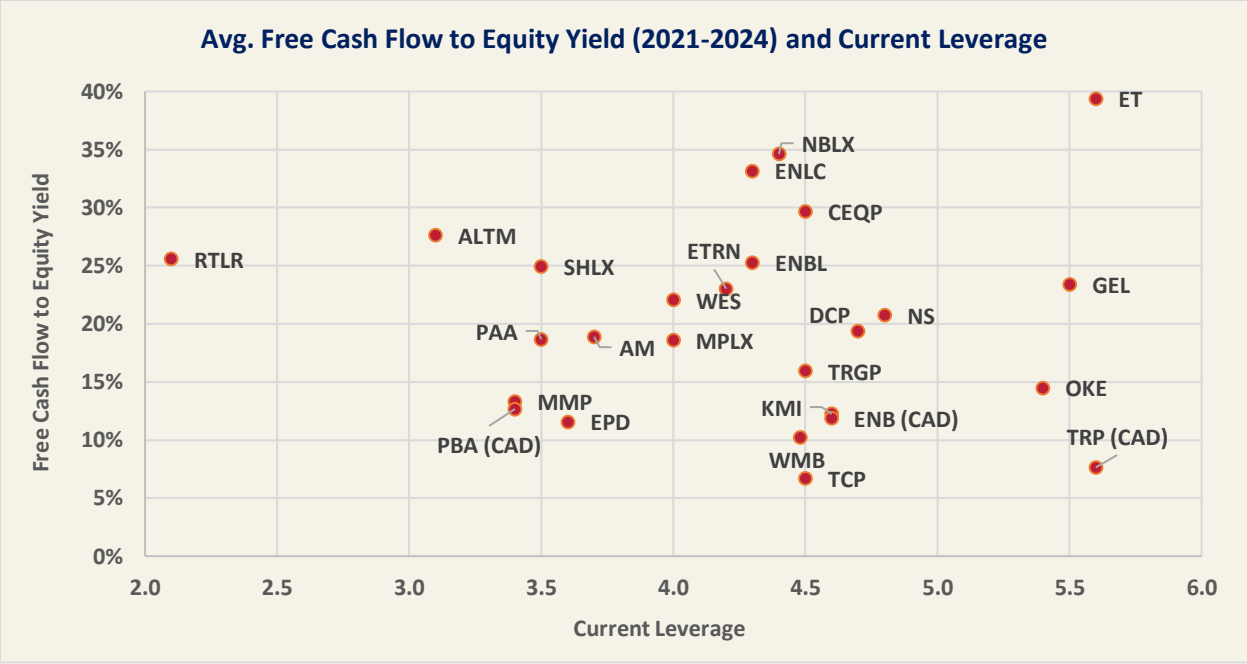

Figure 12: Average Free Cash to Equity Yield from 2021 to 2024, and Current Leverage (East Daley Research)

COVID exacerbated headwinds from the self-inflicted wounds of overbuilt midstream infrastructure and will continue to weigh on asset returns across the space. Additionally, the push for renewables and rising regulatory hurdles create additional long-term challenges. However, investors have fled the midstream and energy more broadly over the last eight months, which may create upside opportunities. Not *everything* is doom and gloom for the midstream sector heading into 2021. First, we forecast companies with significant asset leverage to competitive gas basins will enjoy upside from higher activity as the market calls on more supply from these areas. Companies like Williams (WMB), MPLX (MPLX), Antero Midstream (AM), and EQT Midstream (ETRN) are best positioned to benefit from this shift. Second, despite lower activity, we still forecast gas production in the Permian would increase significantly. This could benefit midstream companies with latent G&P capacity like Energy Transfer (ET), Targa (TRGP), Altus Midstream (ALTM), MPLX (MPLX), and Western Midstream (WES). Finally, most midstream companies are shifting to a conservative strategy of focusing on, and living within, free cash flow. This strategy seems more prudent given the cyclicality of the business and the potential headwinds facing the sector. This more disciplined approach to management could yield more resilient business models, more stable income, and a recovery in investor interest.

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Afterword: Midstream Asset Database Now Available on Amazon Web Services

As part of our ever strengthening and expanding client solutions, East Daley recently rolled out our proprietary Midstream Asset Database, the industry's largest and most comprehensive aggregation of financial and operational data for North American midstream assets and the first one available on Amazon Web Services. The database, fed by fundamental research from our Commodity and Capital Markets teams, provides access to over 1,100 North American midstream assets with asset-level information such as owner, location, throughputs, rates, revenues, expenses, and more. The Midstream Asset Database combines East Daley's proprietary modeling capabilities with metadata tagging and organizes each line item from the models into a searchable format by owner, basin, commodity type, asset type, and origin/destination. Queries that once took weeks to assemble – such as competitive in-basin rates, asset-level comparable data, and M&A target comparisons by financial and operating statistics – now take just minutes to scan, sort, and review. We plan quarterly revisions and expansion of our data set as we grow our coverage, additional metadata tags, and enhanced flexing of our own intelligence and capabilities in our upcoming *Dirty Little Secrets* report. For more information, contact data.distribution@eastdaley.com.

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