Investors look to existing pipelines as new projects face major hurdles

TARA WEBER

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There's no denying it – getting a major pipeline project built is becoming a lot more difficult.

New pipelines are facing increasingly savvy environmental activists and are getting caught up in political gamesmanship, resulting in many project delays and cancellations. As a result, investors are taking a greater shine to existing pipeline infrastructure that is already in the ground and moving product.

"It is tough to get any pipelines done, in particular oil pipelines," Dan Tsubouchi, chief market strategist at Stream Asset Financial LP, told BNN Bloomberg in a phone interview.

"I will take the value of the asset today because you know what? It's probably going to have more scarcity value as we go forward."

Christopher Blumas, vice president and portfolio manager at GlobeInvest Capital Management Inc., echoed this sentiment.

"There is more contract certainty with the existing assets because you know the volumes are going to be high because there are no competing alternatives," he said in a phone interview. "And in theory, if you make something like the cash flows of a business more certain, like a utility, then people are willing to pay more."

This past week has been full of hurdles for pipeline projects in North America. On Monday, a U.S. judge ordered the Dakota Access pipeline (DAPL) to be shut down and emptied while it awaits an environmental review. On the same day, the U.S. Supreme Court upheld a lower court decision blocking a permit needed by TC Energy Corp. to continue construction south of the border on its long-delayed Keystone XL pipeline (KXL) project.

Both announcements followed the outright cancellation of the US$8-billion Atlantic Coast Pipeline by Dominion Energy Inc. and Duke Energy Corp.

It's a familiar story for the Canadian energy industry that has watched the cancellation of both Energy East and Northern Gateway pipelines, and is still awaiting completion of KXL. There are also constant challenges confronting both the federally-owned Trans Mountain expansion project and Enbridge Inc.'s Line 3.

That's not to say in-service pipelines aren't facing their own share of challenges. For example, DAPL had been running since 2017 when ordered to shut down by next month and Enbridge's Line 5, in operation since 1953, is facing political and environmental hurdles in Michigan.

Nevertheless, market watchers are quick to note the value for in-service pipelines is more of a strategic play as they enable producers with access to the lines to get their product to the market and ensure market value. The physical assets won’t necessarily extract greater economic value for shareholders because of how highly controlled they are, according to Blumas.

“A lot of these pieces of infrastructure are regulated with fixed-rate agreements on them, so it’s not necessarily a case that the owners of those resources are able to adjust the price based on demand,” Kevin Birn, vice president of North American crude oil markets at IHS Markit, told BNN Bloomberg in a phone interview.

“In a lot of these situations, pipelines are regulated because there is the potential for a natural monopoly to occur. If you had one big pipeline, it could address the entire region’s need to move product, so that’s why a lot of these pipelines are regulated or have a fixed-rate agreement in place.”

But that doesn’t mean strong pipeline companies won’t try to leverage their positions in the market.

“As E&P [exploration and production] companies increase production, their demand for pipeline capacity also increases,” Teal Linde, president and founder of Linde Equity, said in a phone interview.

“Therefore, in an environment where pipeline capacity remains constrained due to lack of new infrastructure, the existing pipelines will become more valuable as the producers have to increasingly compete for limited access. This situation also gives the pipeline companies the upper hand during re-contracting negotiations.”

Linde points to the moves Enbridge has undertaken to change the tolls shippers pay on its Mainline pipeline system. Companies including Suncor Energy Inc. and Canadian Natural Resources Ltd. have fought back, arguing that Enbridge is abusing its monopoly and that they’re being forced into contracts at a time when options on other pipelines are limited. The matter is before the Canada Energy Regulator.

“Longer-term contracts from investment grade counterparties are better than shorter-term contracts in increasing the value of an oil and gas infrastructure company,” Linde said. “Thus, Enbridge’s attempt to secure more longer-term contracts from their customers would be an example of a value adding move for the company.”

But even with the pipeline contracts as they stand, Blumas says there are opportunities for investors in existing infrastructure.

“There are really, really durable cash flows and there are great dividend yields right now,” he said. “The sentiment is already negative. I don’t think multiples will compress anymore. If sentiment were to change down the road, you’d get a lift in the multiple, so that’s a bonus, but you don’t want to bank on it.”

It’s a bet the Oracle of Omaha is willing to make. This past week, Warren Buffett’s Berkshire Hathaway Inc. snapped up Dominion Energy Inc.’s natural gas assets in a deal worth US$9.7 billion.

“It’s a testament that it’s a really inexpensive way to buy cash flow,” Blumas said of Berkshire’s acquisition. “That’s the same thesis I have on pipelines. Even if you were to go into the public market and buy them, it’s a very inexpensive way to get cash flow with really attractive dividends.”

Stream Asset Financial’s Tsubouchi says there may be another factor at play that further increases the importance of pipeline infrastructure for some time: COVID-19.
“The world is not spending anywhere near enough money and at the pace that’s required,” he said. “So all these aspirations that the world has for the clean energy transition, they’re not going to have it.”

Tsubouchi believes Buffett and others expect fossil fuels and the accompanying infrastructure will be needed for longer than many had hoped.

“I don’t think [Buffett] believes that the clean energy transition happens as smoothly as possible,” he said.

“And it’s not just him: the [International Energy Agency] reports have written about it, [Royal Dutch] Shell says it. It’s not going smoothly and more importantly, they’re not spending enough money on time to make it happen.”