TAKE-AWAY TUG OF WAR

Rising U.S. gas production has producers and pipeline developers scrambling for new take-away capacity against a backdrop of dicey financial markets.

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A rattled global financial system has turned institutional money, private-equity capital and hedge funds toward energy and infrastructure investments, says Mike Parham, managing director of McGladrey Capital LLC. Facing page, a welder's shed is lowered into position during construction of the Rockies Express Pipeline, near Bainbridge, Indiana.

A plethora of much-needed gas-pipeline projects are on drafting boards, driven by increasing U.S. onshore production. But some projects are stymied by commercial lenders' frozen funds and the precipitous fall in equity markets, making funding difficult. Midstream master limited partnerships (MLPs) and private-equity investment firms may get the job done.

This year, by October, about 2,713 miles of new or expansion gas-pipeline projects had been completed onshore the U.S. In comparison, some 1,700 miles of onshore gas pipe was installed in 2007—more than in any year since 2003—according to Energy Information Agency (EIA) data.

"There has been an unprecedented amount of domestic spending on pipeline infrastructure over the last couple of years, by a factor of six," says Mike Parham, managing director of Costa Mesa, California-based McGladrey Capital LLC, an investment-banking firm.

"The real pipeline growth areas seem to be in Alaska, the Midcontinent and the Rockies," he says. "But I don't want to underestimate even West Texas, New Mexico and some of the Permian Basin. Across the board, the industry spent about $12 billion nationwide this year, compared with about $6 billion last year. And only about $2 billion in 2006."

How will new projects be funded? "That's the big question. I think the MLPs are a likely source," says Parham. "They have to put their money into projects like these and I think they will also raise more capital, although the markets aren't being very friendly right now. Also, in this market, mezzanine funding is going to play a big role."

In fact, due to the rattled global financial system, Parham sees institutional money making a flight to safety, as well as private-equity capital that historically wouldn't touch energy, and hedge funds, all turning to energy and infrastructure-related investments.

Also, pension funds are directly investing in infrastructure for long-term income. "In the past, the cyclicality of the industry spooked a lot of these types of investors," says Parham. "But now, it is the rest of the market that is spooking them.

"They are seeing that the long-term trend for infrastructure is quite positive. We have an archaic grid and a tremendous need for pipelines. We need an extreme makeover. I can't find another industry where a dollar should be invested, other than in energy."

Several trends have developed in the U.S. gas marketplace to promote escalation of new-build pipeline projects: the maturity of conventional gas resources, such as the Gulf of Mexico; increasing output from unconventional gas plays, including Texas, Oklahoma, Arkansas and Louisiana shales, and East Texas and Rockies tight gas; and increasing demand for gas from the power sector.

Pipelines are not currently where they need to be.

While some trends encourage pipeline growth, others discourage it, creating a tug-of-war between increasing demand for new infrastructure and decreasing supply of capital and enough production to support them.

Some 2,600 miles of planned new gas pipe has instead been cancelled. One project was a new, 1,600-mile, $2-billion joint venture between Centerpoint Energy Inc. of Houston and Duke Energy Corp. of Charlotte, North Carolina. Meant to be an interstate expansion line, it would have run from Dumas, Texas, to southwestern Pennsylvania. It was cancelled "due to lack of market support," according to the EIA.

Also cancelled, "for lack of customer interest," was Duke's Alliance Lebanon Connector, a new 170-mile pipe from Cook County, Illinois, to Indiana, which would have used the existing Texas Eastern Lebanon Lateral to transport supply to Northeastern U.S. markets.

Houston-based El Paso Corp. cancelled its Continental Connector, a 650-mile line that was planned to extend from the vicinity of Custer, Oklahoma, to Perryville, Louisiana, "due to competition in the marketplace."

According to a recent analysis by Houston-based Tudor, Pickering, Holt & Co. Securities, if public-debt and project-finance markets remain closed, other major infrastructure projects are at risk. Ironically, past forecasts indicated that 2008 would be the heavy capex-spend year for most of the infrastructure companies. The trend was expected to slow in 2009, and ramp up again in 2010.

Meanwhile, E&Ps find themselves paring drilling plans to operate within cash flow—a reversal of the previous standard of spending up to three times cash flow on drilling—due to nearly shuttered debt and equity markets. Re-