Why inflation can be a tailwind for midstream

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Midstream assets are uniquely positioned from regulatory and/or contractual mechanisms that may provide an offset to inflation

In a previous note, *"A review of midstream equities and interest rates"*, we provided data reflecting the historical tendency of midstream equities to perform well during periods of rising interest rates. In this note, we describe how midstream assets can benefit from regulatory or contractual mechanisms that may provide an offset to inflation and increasing interest rates.

As recent headlines attest, both consumer and industrial inflation gauges are registering multi-decade highs. Ideally, every company would like to have their revenues tied to inflation to help offset the impact of potentailly increasing costs, but few do. Fortunately for the energy infrastructure sector, where nearly all projects are underwritten with long-term contracts, inflation protection is more commonplace. In March 2022, Wells Fargo Securities estimated that 60% of midstream EBITDA, or earnings before interest, taxes, depreciation, and amortization, is exposed to inflation escalators while our research suggests that 60% may be the lower boundary. Our conversations with companies in the sector suggest that a majority have between 60-90% of their EBITDA protected from inflation. Below we break down the different types of contracts and the ways in which we believe these contracts are a tailwind for company earnings.

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Interstate liquids pipelines

Federal Energy Regulatory Commision (FERC) regulated liquids pipelines which move crude oil, natural gas liquids, or refined petroleum products across state lines adhere to the Energy Policy Act (EPAct) of 1992. Interstate pipelines that the FERC has deemed to supply non-competitive markets adhere to an indexed rate which is adjusted annually based on the prior year's average Producer Price Index for Finished Goods (PPI-FG) plus or minus an adjustor. These pipeline rates adjust every July and on 7/1/2022 they will increase by approximately 8.73% even if an operator's expenses do not increase. They will continue to re-adjust annually by the PPI-FG less 0.21%, benefiting roughly$22.5 billion in revenue generated from these assets during periods of high inflation.[1]

For interstate pipelines that the FERC has deemed to supply a competitive market, operators are allowed to negotiate individually with customers. Most companies include a form of inflation adjustment in their contracts but need to be sensitive to alternate takeaway options so they do not lose barrels to a competitor. For example, while non competitive FERC regulated pipelines will increase tariffs by approximately 8.7% in July, a company like Magellan Midstream Partners (NYSE: MMP) which has FERC regulated interstate refined products pipelines in multiple competitive markets, has stated that they will increase their market-based rates by roughly 5% in July 2022.

Interstate natural gas pipelines

Interstate natural gas pipelines that are regulated by The Natural Gas Act operate under the requirement that rates charged for interstate pipeline services be "just and reasonable". Similarly, operators are allowed to earn a pre-determined reasonable rate of return on their investment of around 10%. If costs increase, then they are allowed to increase the pipelines' fee over the subsequent years to make up for the increased expenses. Even though a fee adjustment is not immediate, the return earned by these pipelines is supported during times of high inflation through a predetermined calculation. This mechanism, called a cost of service (COS) contract, is identical to a regulated utility.

Not a Deposit | Not FDIC Insured | Not Guaranteed by the Bank | May Lose Value | Not Insured by any Federal Government Agency

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Gathering and processing pipelines

Gathering and processing assets are typically located near producing fields to aggregate and treat well head production for delivery to long haul pipelines. The contracts that support these assets are individually negotiated with an oil and gas producer so they can vary greatly. However, these types of contracts are typically for the life of the producing asset and therefore can last for decades. For such long duration contracts, it is common practice to incorporate inflation protection either at a fixed annual percentage or pegged to an inflation measure, such as the Consumer Price Index (CPI), which transfers any inflation to the customer. Many of these contracts commonly passthrough the cost of fuel, the largest variable expense, directly to the customer, protecting the midstream operator from volatility in electricity, diesel, or natural gas prices. From our conversations with multiple company management teams, a majority are well protected from the effects of inflation and consider the current interest rate environment as “constructive”, that will contribute to earnings this year.

Intrastate pipelines

Like gathering and processing contracts or interstate competitive market pipelines, intrastate pipelines, or pipelines that do not cross state boundaries, are supported by negotiated contracts that are typically a decade or more in duration. These contracts also typically pass along fuel costs to customers and have annual escalators tied to either a fixed rate or pegged to an inflation measure like CPI or PPI.

Conclusion

Prior to the recent surge in inflation data, we believed the midstream sector was well positioned as we reopened from lockdowns caused by the COVID-19 virus. Capital spending requirements for operators have become very modest, a sharp change from the previous decade-plus of massive capital spending. Further, many midstream operators are now generating cash flows that significantly exceed their distribution or dividend obligations. This newfound financial flexibility has allowed many operators to reduce leverage or, more recently, pursue equity buybacks and/or dividend increases.

While the current inflationary environment may cloud the outlook for many industries, we do not believe inflation threatens the positive outlook that energy infrastructure companies are projecting. In fact, as described above, we believe the heightened inflationary environment may serve as a secular tailwind for the midstream sector.

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Important information

1. Federal Energy Regulatory Commission as of March 2022.

The Producer Price Index (PPI) measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

As of 3/31/2022, Invesco SteelPath MLP Alpha Fund, Invesco SteelPath MLP Income Fund, Invesco SteelPath MLP Select 40 Fund and Invesco SteelPath MLP Alpha Plus Fund held 7.78%, 6.95%, 4.79% and 7.94% respectively in Magellan Midstream Partners.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations.

The opinions referenced above are those of the author as of April 22, 2022. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations. The opinions are based on current market conditions and are subject to change. They may differ from these of other Invesco investment professionals.

An investment cannot be made into an index. Past performance does not guarantee future results.

Most MLPs operate in the energy sector and are subject to the risks generally applicable to companies in that sector, including commodity pricing risk, supply and demand risk, depletion risk and exploration risk. MLPs are also subject the risk that regulatory or legislative changes could eliminate the tax benefits enjoyed by MLPs which could have a negative impact on the after-tax income available for distribution by the MLPs and/or the value of the portfolio’s investments. Although the characteristics of MLPs closely resemble a traditional limited partnership, a major difference is that MLPs may trade on a public exchange or in the over-the-counter market. Although this provides a certain amount of liquidity, MLP interests may be less liquid and subject to more abrupt or erratic price movements than conventional publicly traded securities. The risks of investing in an MLP are similar to those of investing in a partnership and include more flexible governance structures, which could result in less protection for investors than investments in a corporation. MLPs are generally considered interest-rate sensitive investments. During periods of interest rate volatility, these investments may not provide attractive returns.

Energy infrastructure MLPs are subject to a variety of industry specific risk factors that may adversely affect their business or operations, including those due to commodity production, volumes, commodity prices, weather conditions, terrorist attacks, etc. They are also subject to significant federal, state and local government regulation.

Before investing, investors should carefully read the prospectus and/or summary prospectus and carefully consider the investment objectives, risks, charges and expenses. For this and more complete information about the fund(s), investors should ask their advisors for a prospectus/summary prospectus or visit invesco.com/fundprospectus.

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