

ARCLIGHT BLAZES A TRAIL IN A BOOMING US ENERGY INFRASTRUCTURE SECTOR

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US infrastructure investors know the challenge of getting familiar with the ins and outs of federal, state, regional, and municipal jurisdictions that play a role in procurement. US energy infrastructure investors are putting geologic formations on their list of essential investment knowledge.

Terms like the Barnett shale, the Marcellus shale, the Haynesville shale, the Woodford shale, the Eagle Ford shale, the Fayetteville shale, the Antrim shale, or the Granite Wash are part of the working vocabulary of the energy infrastructure sector like Texas, Florida, Virginia and California are part of the transportation infrastructure geography.

For Robb Turner, at least, the US energy infrastructure landscape is the one going through the more profound change.

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"In my 20 years in energy, I have never seen anything like this," says Turner, co-founder and senior partner of ArcLight Capital Partners, a Boston-based manager of four energy infrastructure funds. "In the next three to five years, we will see a complete reconfiguration of the natural gas business and fundamentally change how we produce and deliver natural gas in the US. The business will become a manufacturing business rather than an exploration business and will make gas production a low cost and predictable business."

"Shale gas is going to shift even more of US power production to natural gas as the commodity value will be lower and more predictable," says Turner in an interview with InfraAmericas. "Because of this, we think the more interesting investment area is going to be in the infrastructure required to deliver gas to market rather than the commodity itself."

"Five years ago, people predicted that thousands of miles of new transmission lines would be built to support the build-out of renewable power plants," he says. "While some of this has occurred, the risk-reward of building new gas transmission infrastructure is far more interesting than building infrastructure for the transmission power. Cheap natural gas makes it even harder for wind and solar power plants to compete. What cell phones were to telecommunications, what the internet was to retailing, midstream gas infrastructure will be to the US energy industry."

Natural Gas Reserves Soar

The US Energy Information Administration said in a November 2010 report that shale gas accounted for more than 90% of net additions to proved reserves of natural gas. Proved reserves of shale natural gas were 60.6 trillion cubic feet at the end of 2009, up from 34.4 trillion cubic feet one year earlier.

Investing in the infrastructure required to transport gas from its source to end-user is a big part of ArcLight's investment pipeline. While approximately 10% of ArcLight's committed capital is invested in Europe, Turner predicts that the majority of its capital will be invested in North America where investing in such infrastructure is more prevalent.

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"Right now, there is much more opportunity in North America," says Turner. "We have been active in Europe for 10 years but it's difficult to source opportunities in Europe that can compete with those in the US."

ArcLight's four funds – named I, II, III and IV for easy memorization – have USD6.8bn under management.

ArcLight divides its investments into four categories: production, generation, midstream, and transmission and distribution. Power generation and midstream encompass the bulk of its holdings, reflecting the deep pockets and cutting edge technology required to weather the inevitable commodity cycles that affect the production end of the value chain and the low returns that characterize the transmission and distribution end of the value chain.

Value in the Middle

"Modern oil and gas production is expensive and risky so you've got to be low cost and employ cutting edge technologies. Therefore, big oil and gas companies will dominate that market, not financial investors. "While the transmission business sets up better for financial investors," he adds, "we can't get the returns we're shooting for in transmission as there are very few opportunities to create value in that sector. Passive investors such as pension funds are likely to be the owners of those assets."

Therefore, the opportunity for ArcLight is in the middle but it is far from being the only infrastructure fund to have shown interest.

Global Infrastructure Partners (GIP) has a joint venture with Chesapeake Energy Corp., a company that produces natural gas in the Barnett shale and elsewhere. GIP and El Paso Corp. also jointly own the Ruby Pipeline, a 675-mile natural gas pipeline. And Alinda Capital Partners owns the Regency Intrastate Gas System, a 464-mile pipeline that carries natural gas from the Haynesville shale in Louisiana. Alinda has several other natural gas investments as well.

Unlike GIP, Alinda and other infrastructure funds that invest in a wide range of infrastructure projects, ArcLight invests only in energy. But the size of the opportunity in shale natural gas infrastructure and power plants has attracted all of them to energy infrastructure.

Exxon's Seal of Approval

In a deal seen as an endorsement of the sector's future, Exxon bought XTO Energy in a USD41bn all-share deal in early 2010. XTO's resource base at the time was put at the equivalent of 45 trillion cubic feet of gas, including shale gas. Its properties are primarily in Texas, New Mexico, North Dakota, Pennsylvania, West Virginia, Arkansas, Oklahoma, Kansas, Wyoming, Colorado, Utah, Louisiana and Montana.

As the XTO Energy holdings suggest, the shale formations are found widely around the US and Canada, meaning the supply is close to the demand. Natural gas also has the virtue of being cleaner than coal, making it more desirable in electricity generation. Technology improvements and production efficiencies are making it more reliable to harvest. The Energy Information Administration's November 2010 report noted that the increase in proved reserves took place when prices were low, a measure of the improvement in exploration and production technologies.

In one of its most recent transactions, ArcLight bought a 9.9% stake in Enogex, the midstream gas pipeline subsidiary of OGE Energy Corp. for USD183m. The transaction is structured to give ArcLight the ability to increase its stake in Enogex by funding the expansion of Enogex's network, which is "smack dab in the middle of the Granite Wash, the lowest cost gas shale play in North America," says Turner.

"Enogex has 8,000 miles of pipeline. We're building the infrastructure to connect the commodity into the existing network."

For the uninitiated, the Granite Wash is a formation that straddles the Oklahoma and Texas panhandles. Strictly speaking, the Granite Wash isn't a shale play, but rather a close relation, a tight sands resource. "Enogex has 8,000 miles of pipeline," Turner says. "We're building the infrastructure to connect the commodity into the existing network."

Local Gas for Local Users

"Shale plays exist in most regions of the US, from North Dakota down to Texas and east," he says. "There is lots of gas in local markets and there is a lot of value in the intrastate pipes."

"We focus on contracted pipelines where you have a base of customers trying to eliminate the volume risk associated with interstate pipelines."

“These are base-load assets with predictable cash flow that we grow and enhance utilizing our detailed knowledge of the energy value chain,” he says. “We like to see cash flow to equity begin within 12 to 18 months of our investment so we are less interested in long- dated development projects.”

Turner doesn't rule out opportunistic acquisitions of production assets – its active holdings include five such investments – as such investments generate interesting and profitable insights to downstream activities. “We will look at mature assets but those are hard to find.”

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Leverage on ArcLight's power generation investments with long-dated contracts ranges from 50% to 80%. “You can put more leverage on these assets, but we typically don't as less leverage allows for greater freedom in pursuing value enhancing projects around such investments. Midstream gathering assets tied back to a reservoir can accept even less leverage, maybe 30% to 40% while the intrastate pipelines typically are levered 50:50. We've made over 100 investments in energy most of which are leverages so we have a lot of experience in financing these assets and have never had a bankruptcy.”

ArcLight's funds have ten-year durations and usually take majority or control positions in its investments although a few minority positions have been taken. Turner says the industry allows for what he calls negative controls, the ability to protect the investment even with a minority stake. The exit can come in a range of ways: from a public listing of one or several bundled assets, to trade sales, to securitization of cash flows, or recapitalizations.

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