A Pipeline to Growth:

Private Equity and Private Funds in America's Energy & Infrastructure Industry

Within the next five years, the United States is projected to become the world's top oil producer.[1] Driven largely by the shale revolution and technological advancements in the extraction of tight oil, the United States has experienced the fastest growth in oil production since the Saudi Arabian boom of the 1960s.[2] The Permian Basin, which straddles West Texas and Eastern New Mexico, accounts for about 55% of all operating oil rigs in the United States and is expected to increase production by approximately 60% in less than fifteen years.[3] While U.S. oil production is near its prior peak,[4] adequate midstream infrastructure—e.g., pipelines and storage—does not exist to support the current level of production,[5] and additional midstream infrastructure is needed to sustain anticipated future growth.[6] The preferred source of capital for the midstream business has historically been obtained via publicly traded master limited partnerships ("MLPs"),[7] but challenges with the MLP financing model has some businesses seeking alternative sources of capital. Given the structuring flexibility and long-term investment horizon of private equity, private fund structures may be uniquely situated to supplant MLPs as a source of capital for the midstream energy and infrastructure industry.

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Background

The inability to transport production from wellhead to market is a principal risk of the U.S. shale industry.[8] Recently, a lack of pipeline capacity in the Permian has caused double digit price differentials for a barrel of oil between delivery points in Midland, Texas and those in Houston.[9] Flaring—the burning of associated natural gas resulting from oil extraction—while decreasing globally,[10] has increased in the United States as

[1] Int'l Energy Agency, Oil 2018 Analysis and Forecasts to 2023, 4 (2018) [hereinafter, IEA Executive Summary].
[2] Int'l Energy Agency, World Energy Investment 2018, 135 (2018) [hereinafter, IEA 2018 Report]
[3] World Oil, *Permian Oil Production Requires Additional Pipeline Infrastructure*, WORLD OIL (Aug. 2018), https://www.worldoil.com/magazine/2018/august-2018/features/permian-oil-production-requires-additional-pipeline-infrastructure.
[4] U.S. Energy Information Administration, *U.S. Field Production of Crude Oil*, https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=pet&s=mcrfpus1&f=a (last visited Sept. 24, 2018).
[5] World Oil, *supra* note 3.
[6] *Id.*
[7] *See* Alerian, *Midstream Energy Infrastructure Universe by Market Cap*, ALERIAN, https://www.alerian.com/education/figures-and-tables/ (last visited Sept. 24, 2018).
[8] IEA 2018 Report, supra note 2 at 140.
[9] Matt Zborowski, *Is the Permian Barreling Toward a Breaking Point*, J. OF PETROLEUM TECH. (Jun. 20, 2018), https://www.spe.org/en/jpt/jpt-article-detail/?art=4321.
[10] Ed Crooks, *Gas Flaring Drops Off Globally, but U.S. and Others Buck the Trend*, FIN. TIMES (July 17, 2018), https://www.ft.com/content/0d66da44-899f-11e8-bf9e-8771d5404543.

pipelines lack sufficient capacity to transport gas to market.[11] Other critical midstream infrastructure associated with production activities, such as wastewater and other byproducts of fracking may also be insufficient.[12] As the United States becomes an increasingly dominant force in global oil and energy markets,[13] significant midstream infrastructure investment will be needed not merely to address these deficiencies, but to also increase storage capacity and to make port upgrades on the Gulf Coast in order to facilitate access to global markets for U.S. energy products.[14]

Master Limited Partnerships

MLPs are the dominant source of capital for midstream infrastructure, representing approximately 56% of midstream market capitalization.[15] As publicly traded limited partnerships, MLPs offer investors the liquidity of public markets as well as certain tax advantages, including those of pass-through entities. While MLPs have no tax or regulatory obligation to make annual cash distributions to unitholders, they have historically paid out distributions between 80% and 100% of annual cash flows per year.[16] Given the dominance of cash-on-cash yield in determining market value, MLPs do not typically maintain cash reserves necessary to pursue large, multiyear development projects. Instead, they have historically raised new equity or debt in the capital markets,[17] with the former having a dilutive effect on existing unitholders and the latter resulting in significant leverage. When oil prices collapsed in early-2016, transportation and processing volumes dropped[18] and some MLPs were strapped for cash. Although many midstream-focused MLPs have since moved to curtail distributions in order to retain cash to finance future growth, the sector is now comparatively less appealing vis-à-vis other cash yielding investment strategies in light of the risk-return profile of midstream investments and the rising interest rate environment.[19] Consequently, the cost of equity for MLPs has increased and other sources of capital may be needed to replace MLP money that has historically supported the midstream market.[20]

Private Equity

Private equity and private funds may offer a compelling alternative (or partner) to MLPs for midstream energy and infrastructure investments. As compared to MLPs, private funds typically have more flexibility to retain current income for reserves and to recycle capital from realizations. These features of the private fund toolkit give sponsors optionality to utilize cash flow for future investment or to distribute income as yield to investors. The MLP market is dominated by retail investors,[21] and has faced challenges in attracting institutional capital due in part to the significant dilution risk posed by the sector's historical reliance on

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[11] Rebecca Elliott, *In America's Hottest Drilling Spot, Gas is Going Up in Smoke*, WALL ST. J. (Aug. 29, 2018, 5:30 AM), https://www.wsj.com/articles/in-americas-hottest-drilling-spot-vast-volumes-of-gas-go-up-in-smoke-1535535001.
[12] IEA 2018 Report, *supra* note 2 at 140.
[13] IEA Executive Summary, *supra* note 1, at 4.
[14] Olivier Lejeune, *Commentary: Infrastructure Investments Key to Unlocking More US Oil Supply*, INT'L ENERGY AGENCY (Mar. 28, 2018), https://www.iea.org/newsroom/news/2018/march/commentary-infrastructure-investments-key-to-unlocking-more-us-oil-supply.html.
[15] *See* Alerian, *supra* note 7.
[16] Alerian, *MLP Primer: A Guide for Both New and Experienced Investors*, 6 (2018).
[17] John Dizard, *Shale Oil and Gas Infrastructure Bubble Goes Flat*, FIN. TIMES, (Apr. 13, 2018), https://www.ft.com/content/4bc1efb8-3e27-11e8-b7e0-52972418fec4.
[18] U.S. Energy Information Administration, *U.S. Crude Oil and Natural Gas Production both Fell in 2016*, (March 8, 2016) https://www.eia.gov/todayinenergy/detail.php?id=30252.
[19] Gregory Meyer, *US Oil Pipelines Pivot South as Shale Surges*, FIN. TIMES, Mar. 6, 2018) https://www.ft.com/content/7a5f7236-1d94-11e8-aaca-4574d7dabfb6.
[20] Dizard, *supra* note 17.
[21] Pimco, *Understanding Investing Master Limited Partnerships (MLPs)*, PIMCO (Apr. 2018), https://www.pimco.com/en-us/resources/education/master-limited-partnerships-mlps/.

cycles of equity fundraisings. By contrast, private fund sponsors are likely to be more effective in this respect in light of their strong relationship with institutional investors and their ability to offer exposure to regulated energy infrastructure without the dilutive risks of MLPs. Given the reduced volatility of private funds vis-à-vis equity raised in the public markets, private equity may also be more focused on long-term capital appreciation versus the short-term cash yield pressures faced by MLPs.[22]

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Private funds also lend themselves to a degree of customization not available for products traded in public markets. The bespoke nature of private fund structures enables sponsors to develop midstream-focused energy or infrastructure products that can attract institutional capital focused on cumulative return or cash-on-cash yield. In that regard, energy and infrastructure funds have employed the full range of potential fund structures:

- Closed-end funds: Represent the traditional fund structure utilizing a fixed term (8-12 years) and investment period (4-6 years). Closed-end funds remain the most common private equity fund structure for illiquid energy and infrastructure investments.

- Evergreen funds: A median between closed-end and open-ended funds (described below). Evergreen funds include rolling commitment periods (typically 3-5 years) and a “series” concept, with subscriptions accepted within an initial marketing period and subsequent periodic subscription windows. Each series typically stands on its own for investment and economic purposes. At the end of each commitment period, investors may choose to continue their participation at their current level, increase their commitment or cancel their remaining commitment altogether. Evergreen funds can represent an efficient on-going fundraising tool, particularly among a smaller group of investors.

- Open-ended funds: A recent trend in the private funds space. Open-ended funds are a move from the more commonplace closed-end fund model towards longer-term products, which may pair well with the long lived, physical nature of most midstream assets. Open-ended funds typically follow a modified hedge fund format, include a perpetual term and employ economics and valuation principles based on a mark-to-market approach (i.e., incentive allocation and management fees based on net asset value and unrealized values). Usually, these open-ended funds offer some manner of liquidity/withdrawal rights for investors after an initial lock-up period.

- Club funds: Can represent an opportunity for a newer energy and infrastructure fund sponsor (or existing sponsor entering the space for the first time) in order to establish a track record outside of a large, blind-pool fund. A club fund is a commingled fund product comprised of typically a small number of investors, where each investor may elect to participate in investments on a deal-by-deal

[22] While private funds in the core and core+ infrastructure space typically market their cash yield, they typically retain recycling and reserve mechanics that are found in private funds focused on other investment strategies.

basis. On the heels of a successful club fund, a sponsor may then seek to market a blind-pool product, where the sponsor retains full investment discretion.

- Separately managed accounts: Investment arrangement with a single investor. Separately managed accounts are highly customized products, representing an opportunity for creating a structure to meet the needs of sponsors and investors in an efficient manner. Separately managed accounts can take on a wide variety of terms, forms or functions, such as to further a long-term partnership, operate a multi-strategy program, or accelerate new product development.

The broad nature of the private equity structuring toolkit allows sponsors to fit their products closely to target energy and infrastructure investments, as well as to accommodate investor need.

Conclusion

By 2035, approximately $791 billion is projected to be invested in new oil and gas infrastructure in the United States, including about 41,000 miles of pipeline.[23] As the midstream sector expands its search for capital beyond MLPs, private funds and private equity are attractive alternatives to fill-the-gap. Not surprisingly, Texas, the Energy Capital of the World, received more private equity investment in 2017 than any other state in the United States.[24] Advisors to private funds will therefore need to be increasingly attune to the unique challenges posed by sponsors active in the midstream space, including those related to leverage, extended hold arrangements, environmental, social, and governance considerations, and the national security implications of certain infrastructure investments. The U.S. shale industry has matured and so has its capital needs. As a consequence, the flexibility of private fund structures should ensure that private equity has a role to play in expanding and maintaining U.S. infrastructure, and in particular the midstream infrastructure necessary to cope with the expected "colossal" growth of U.S. oil output.[25]

[23] ICF, *North America Midstream Infrastructure through 2035 Significant Development Continues*, 2, ICF (Jun. 18, 2018), https://www.ingaa.org/File.aspx?id=34658.
[24] American Investment Council, *Top States and Districts in 2017,* https://www.investmentcouncil.org/wp-content/uploads/top-states-and-districts-2017-5242018.pdf (last visited Sept. 22, 2018).
[25] Amanda Cooper, *Surge in Global Oil Supply May Overtake Demand in 2018: IEA*, REUTERS, (Feb. 13, 2018, 3:09 AM) https://www.reuters.com/article/us-iea-oil/surge-in-global-oil-supply-may-overtake-demand-in-2018-iea-idUSKBN1FX0VQ.

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Named the "Lawyer of the Year" in Private Funds/Hedge Funds Law in New York City for 2018 by *Best Lawyers*, Michael Wolitzer has wide-ranging experience in private investing and alternative asset management. Michael is Head of the Firm's Investment Funds Practice. He has represented such well-known sponsors of PE funds as Apax Partners, Ares, Blackstone, Centerbridge, Lexington, Patria, Silver Lake Partners and TSSP. He has also represented sponsors in other asset categories, including real estate, mezzanine, energy/infrastructure and credit/distressed debt. In addition, he has represented global financial institutions in the establishment of their employee investment programs; been involved in acquisitions of private investment firms; and represented buyers, sellers and sponsors in the disposition of private fund interests. Michael serves on the editorial board of the *PLC Cross-border Private Equity Handbook*, as well on the Board of the nonprofit Association to Benefit Children. He previously served as Chairman of the New Partners Committee and currently serves as a member of the Executive Committee.

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