PERMIAN BASIN MIDSTREAM DEVELOPMENT

Trends and Other Factors Challenging The Growth of Permian Midstream Investment

Jeffery C. Fawcett
NorTex Midstream Partners, LLC
June 27, 2013
Trends in Energy Midstream

• Industry appears to be braced to consolidate:
  • 14 transactions valued at US$2 billion or greater in Q1 2013
  • New regulations likely to spur more oil and gas M&A

• Private Equity transactions are off to a slow start in 2013 but that may be hangover from Q4 2012’s near record pace

• Foreign investment in E&P is propping up transaction activity and pours money into the Permian region:
  • Producers and Service Providers must be careful to balance timing with needs

• Producers are accelerating drop-downs of midstream assets into MLP offerings

• North America’s energy resource abundance yields range bound commodity prices, with gas on a slow but steady climb:
  • Midstream development may slip as a result
Trends in Energy Midstream

- Increased government regulations threaten the pace of midstream development
  - Raises costs for compliance: lowers yields on investment
- Tepid pace of economic recovery hinders demand for new investment in E&P, midstream development
Industry Braced to Consolidate

- Energy industry marked by nascent wave of large scale industry mergers and consolidations – Kinder Morgan’s acquisition of El Paso in 2012 was a breakthrough

- Larger scale of operations seen as a hedge against future negative indicators:
  - Access to capital
  - Geographic diversity
  - Means of weathering the economic storm
Not Everyone Agrees Deals Will All be Huge

• In a Merrill Datasite study of M&A activity, respondents said that growth in the region will be balanced primarily: “On the strength of opportunities in the middle market.”

• Whether the increase is on the back of mega-mergers or not, most agree volume and value will rise
Private Equity Deals Suffering from Hangover

- There were just three PE transactions of $1 billion or more that closed in 1Q 2013
- More than half of the Energy industry’s deals during the first quarter are concentrated in the $100 million to $500 million size band
Permian Basin is now the “Belle of the Ball”

- Permian rig counts are higher than the Eagle Ford and Bakken combined
- Yet the news isn’t all good…. total rig count in the Permian is actually **down 10%** year on year
Near-Mid Term Clearly Favors Oil Investment

- Absolute prices appear to be range bound for the time being
- Several industry analysts view oil as stuck between ~$90/barrel and ~$100/barrel
- Gas is viewed as having a positive long term tilt, but for now look for trades in a $3.80/MMBtu to $4.20/MMBtu range

Future Commodity Price uncertainty can impede new infrastructure investment
Its Not Only Price - Spread Also Matters

- Takeaway capacity from the Permian had lagged growth in production recently.
- Infrastructure projects such as Magellan Midstream Partners’ (MMP) Longhorn pipeline have started service and helped to alleviate bottlenecks in the area.
- Matching capacity to the pace of drilling will help ensure an unfettered correlation to wider markets.

![WTI Cushing-WTI Midland Crude Oil Differential Graph](Image)
Builds Should Improve Netbacks

- Infrastructure projects have started service and several will follow.
- These are expected to help alleviate bottlenecks both in the West Texas and in Oklahoma.
- Trucks, rail and pipelines all have a seat at the table and will be focus of increased capital investment.

New Pipeline Projects

- Magellan Longhorn (completed)
- OXY & Magellan – BridgeTex
- Sunoco Logistics Perm Express II
- Sunoco Logistics Perm Express I
- Enterprise/Enbridge Seaway (partially)
- TransCanada Gulf Coast Project
- Shell Houma-Houston (partially)
- Centurion Cline Shale Project

Source: WSJ
Development
Spurred in part
by Foreign
Investment

- International firms such as Norway's Statoil, India's Reliance and China's CNOOC and Sinopec have all cut shale deals elsewhere, mostly joint ventures.
- Japan's Sumitomo Corp purchased a 30% stake in 650,000 acres from Devon in the Cline and Wolfcamp Shale for $1.4 billion
- Pioneer agreed to sell a 40% stake in 207,000 acres in Wolfcamp Shale to Chinese conglomerate Sinochem for $1.7 billion

Top Permian Basin Operators

<table>
<thead>
<tr>
<th>Operator</th>
<th>Acreage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occidental Petroleum Corporation</td>
<td>2,400,000</td>
</tr>
<tr>
<td>Apache Corp.</td>
<td>1,600,000</td>
</tr>
<tr>
<td>Devon Energy Corporation</td>
<td>1,500,000</td>
</tr>
<tr>
<td>ConocoPhillips</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Chevron Corporation</td>
<td>950,000</td>
</tr>
<tr>
<td>Pioneer Natural Resources Co.</td>
<td>815,500</td>
</tr>
<tr>
<td>Concho Resources, Inc.</td>
<td>750,000</td>
</tr>
<tr>
<td>Royal Dutch Shell</td>
<td>618,000</td>
</tr>
<tr>
<td>Cimarex Energy Co.</td>
<td>462,000</td>
</tr>
<tr>
<td>EOG Resources, Inc.</td>
<td>450,000</td>
</tr>
<tr>
<td>Chesapeake Energy Corporation</td>
<td>407,000</td>
</tr>
<tr>
<td>Exxon Mobil Corporation</td>
<td>400,000</td>
</tr>
<tr>
<td>BHP Billiton Limited</td>
<td>325,000</td>
</tr>
<tr>
<td>Anadarko Petroleum Corporation</td>
<td>300,000</td>
</tr>
<tr>
<td>Energen Corp.</td>
<td>268,683</td>
</tr>
<tr>
<td>SandRidge Energy, Inc.</td>
<td>228,000</td>
</tr>
<tr>
<td>Clayton Williams Energy Inc.</td>
<td>185,000</td>
</tr>
<tr>
<td>Approach Resources, Inc.</td>
<td>145,000</td>
</tr>
<tr>
<td>EP Energy</td>
<td>138,000</td>
</tr>
<tr>
<td>EnerVest, Ltd.</td>
<td>126,000</td>
</tr>
</tbody>
</table>

- OXY accounted for 16% of the oil produced in the Permian Basin; 2013 plans call for investing $1.9 billion to drill approx. 300 wells
- Apache is planning on drilling 700 wells in the Permian Basin in 2013 – the most active driller with 38 operated rigs
- Shell is back in the Permian after its deal to acquire Chesapeake's Wolfcamp acreage
Royal Dutch Shell’s $1.935 billion purchase of 618,000 net acres in the Permian Basin from Chesapeake signals that many of the majors which had exited are now looking for a way back in.

- Oil and Gas majors led the exodus from the Permian Basin in the 1980s
- Smaller independents have been converting the faithful - leading to a renewed interest in the basin
Timing of Development Matters

- Devon plans for 2013 drilling was trimmed recently from 40 down to 30 wells in the Cline Shale partnership acreage.
- Devon plans to employ 3D seismic to better characterize the play.
- Midstream investment is difficult to support in an environment where the drilling program is still largely scientific.

“We are testing a very, very large area. If you don’t have the benefit of 3D seismic...just having 1-2 wells across an entire acreage position doesn’t confirm or condemn an area.”

John Richels - Q1 ‘2013 Earnings Call
Regulations May Contribute to Increased M&A activity

- Companies may view scale as an insulator against the negative impact of increasing regulatory regimes

An overwhelming majority – nearly nine in ten (85%) – of oil and gas industry professionals expect the US regulatory regime to get tougher in the coming two years, even on top of the changes already implemented.

The impact of US reform on the oil and gas industry

- Federal hydraulic fracking legislation
- Renewed pressure for federal carbon legislation
- Implementation of EPA rules on air emissions

Permian operations, though subject to federal rules, likely benefit from decades old legacy of oilfield friendly environs.

Larger firms can redirect investment to more welcoming areas, whereas smaller players typically have little option but to commit to additional spend in the region in which they currently operate.
Other Challenges to Investment

• Private Equity investment may be stymied by structure:
  • ‘Buy and flip’ is not generally regarded as high quality ownership; PE may be disadvantaged as candidates for long term JV Partnerships
  • IB heritage difficult to translate into ownership mentality

• As consolidations and mergers continue, larger companies struggle to maintain an entrepreneurial edge
  • Culture is one of the first casualties
  • Reaction time is the second

• Educating investors on the wide-ranging impact of commodity risk on enterprise
  • Fee for service contracts do not ensure freedom from commodity exposure; talk to an underground gas storage operator
Other Challenges to Investment

• Fierce midstream competitor in one region may actually be the right partner in another:
  • Creates additional layer of complexity
  • Who operates? -- is often the rub
### Takeaways for Midstream Investors

<table>
<thead>
<tr>
<th>Mergers and Consolidations Accelerate</th>
<th>Private Equity Continues as a Major Source of Finance</th>
<th>Oil Prices Underpin Investment Decisions</th>
</tr>
</thead>
</table>
| - Large scale (>\$1 billion) M&A activity has seen a recent boon  
- Expect M&A focus to be on small to middle market transactions in 2013 | - Despite taking the first quarter off, PE will be an important source of finance for new infrastructure development  
- Midstream may look to non-traditional commercial structures to safeguard return on investment | - Current Oil and Gas price deck appears to be range bound; long term view is not as clear  
- Gas and NGL midstream will be ancillary to oil development; dry gas investment will be later and opportunistic |
### Foreign Capital Will Continue to Invest in Basin

- Look for more foreign investments as Basin acreage development continues
- Midstream joint ventures may be next on horizon

### Expect Regulations to Increase in the Next Two Years

- Obama to issue ‘presidential memorandum’ to implement federal carbon mandates for power plants
- Supreme Court has agreed to hear CSAPR appeal; may result in early shuttering of coal fired plants in Texas
- EH&S regulations will also deepen; compliance is expensive and impacts yield on investment
- ‘Regulatory agility’ may be a commercial differentiator when evaluating companies for investment
<table>
<thead>
<tr>
<th>Private Equity Resets Expectations and Approach</th>
<th>Non-Traditional Relationships May Become the ‘New Norm’</th>
</tr>
</thead>
<tbody>
<tr>
<td>• PE capital must learn to be patient as Permian Basin customers sort through geoscience related development delays</td>
<td></td>
</tr>
<tr>
<td>• Success of producer joint ventures (or outright asset sales) may depend on PE investment horizons</td>
<td></td>
</tr>
<tr>
<td>• Fund investors need to be better educated on impacts of commodity risk on midstream business; even ‘fee for service’ enterprises</td>
<td></td>
</tr>
<tr>
<td>• Even competitors can be partners under certain conditions</td>
<td></td>
</tr>
<tr>
<td>• Identify core competency of individual partners; what are the synergies?</td>
<td></td>
</tr>
<tr>
<td>• Align goals for the partnership; including exit timing and strategy</td>
<td></td>
</tr>
</tbody>
</table>
Contact

Jeffery C. Fawcett
Managing Director

NorTex Midstream Partners, LLC
1201 Louisiana Street
Suite 700
Houston, Texas 77002

Office: 713.623.5930
Cell: 713.724.2555