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Changing Natural Gas Fundamentals And Recontracting Risk Prompt Rating Actions On U.S. Single-Asset Pipelines

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Standard & Poor's Ratings Services has observed changes in U.S. natural gas supply fundamentals over the past two years which brought about a review of our U.S. single-asset pipeline ratings and credit quality in the generally stable sector. After the review, we took several ratings actions on pipeline companies on July 19, 2010. While the resulting impact was not significant -- there were no ratings downgrades of greater than one notch -– we believe that the inherent risk profiles of certain pipelines have increased. We also took positive ratings actions in some instances where business fundamentals remained unchanged and financial measures improved. (See the Rating Actions section below for details on the actions.)

The increasing prominence of shale gas is primarily driving the changing supply fundamentals. These various unconventional natural gas resource basins have become more abundant, and producers have shifted their drilling activities away from more traditional areas to the generally lower cost shale plays such as the Haynesville Shale in northern Louisiana, the Eagleford Shale in southern Texas, and the Marcellus shale in Appalachia, to name a few.

As a result of these new supply sources, overall natural gas prices have fallen and basis differentials (i.e., the price differentials between two locations) have changed. In particular, the growing Marcellus Shale could change gas flows due to its proximity to the Northeast, where gas is used widely. For many routes -– particularly those originating at more traditional natural gas basins where supply is flat to falling -- basis differentials have collapsed. These pipelines could face higher recontracting risks when existing contracts expire, although we also recognize that supply-demand fundamentals can change rapidly and tight basis differentials on a certain route today could widen before a contract expires in, say, 5 to 10 years.

Even for pipelines originating in shale regions, recontracting risk exists. Today's "hot" shale play could become less attractive in the future, as the industry hunts for newer and better plays. While not a prominent risk in the pipeline sector, competitive pressures are relevant. Midstream energy companies are usually eager to work with producers to build new pipelines out of a growing basin. If this growth does not materialize, pipelines will be forced to compete more with one another after existing contracts expire. In general, Standard & Poor's receives significantly more comfort from "demand pull" pipelines (i.e., those with contracts underwritten with consumers) as opposed to "supply push" (i.e., those with contracts underwritten by producers). Demand, whether for local gas distribution or power plants, tends to be fairly stable, while supply dynamics can shift.

Despite these negative trends, Standard & Poor's continues to view the pipeline sector's creditworthiness favorably. In fact, all of our public ratings on single-asset pipelines continue to have investment-grade ratings, predicated on business risk assessments of 'excellent' or 'strong'. All of the single-asset natural gas pipelines that we rate get a substantial portion of their revenues from firm transportation agreements, or take-or-pay contracts. These contracts provide transparent cash flows because shippers under these contracts must make payments whether or not they ship gas. The Federal Energy Regulatory Commission (FERC) regulates the rates on the contracts.

Given the predictability of cash flows, sponsors place high leverage on the pipelines, contributing to 'aggressive' financial risk profiles. We commonly rate pipelines in the 'BBB' category with debt to EBITDA in the 4x to 5x area due to the underlying business risk strength and contract profile. Some of the pipelines we rate in the 'BBB' category have higher-than-average leverage, with Rockies Express Pipeline LLC (BBB-/Stable/--) and Midcontinent Express Pipeline LLC (BBB-/Stable/--) at over 5.5x and NGPL PipeCo. LLC (BBB-/Stable/--) expected to produce similar leverage over time. We expect Florida Gas Transmission Co. LLC (BBB/Stable/--) to have leverage above 7x during its large Phase VIII expansion project, but we rate through the spending period because we believe remaining costs are fairly transparent. However, with such aggressive measures, ratings could quickly come under pressure if a pipeline's intrinsic value becomes more suspect as its contract life dwindles.

Rating Actions

We changed our ratings or revised our outlooks on eight pipeline entities on July 19, 2010. Three were negative in nature (downgrades or outlook revisions to negative), and reflected the industry dynamics cited above. The other actions were either positive or were outlook revisions to stable from negative. In these cases, business fundamentals were largely unchanged and either financial metrics or liquidity improved.

As a result of our review, we have changed the ratings/outlooks on the following:

- NGPL PipeCo. We affirmed the rating at 'BBB-' and revised the outlook to stable based on the pipeline's 'excellent' business profile, which we believe offsets high leverage created by declining cash flows. Hampering cash flows were the settlement of the FERC Section 5 investigation that will significantly weaken credit metrics over the next two years. However, we believe that the pipeline's demand-pull nature, with hundreds of interconnects with downstream customers and service offerings including storage, mitigates recontracting risk.
- Rockies Express. We lowered the rating to BBB-/Stable/-- from BBB/Stable/-- based on much narrower Rockies region basis differentials, which, if unchanged, will decrease the underlying value of the pipeline capacity. This could result in substantially lower cash flow when contracts expire in about nine years. We also expect credit metrics in 2010 to be slightly weaker than we previously expected, while we still expect debt to EBITDA to be weak for the rating through the life of the existing contracts at about 5.75x.
- Midcontinent Express. We lowered the rating to BBB-/Stable/-- from BBB/Stable/-- mainly due to narrower basis differentials and also, but to a lower degree, a sizable competing pipeline capacity. These factors could decrease the underlying value of the pipeline's capacity and result in substantially lower cash flow when contracts expire in about eight years.
- Iroquois Gas Transmission System L.P. We raised the rating to A-/Stable/-- from BBB+/Positive/-- based on strong credit metrics for the rating; this is a demand-pull pipeline with a strong demand market.
- Northern Natural Gas Co. We affirmed the 'A' corporate credit rating assigned to Northern Natural Gas and revised the outlook to stable from negative. The stable outlook reflects that while the company has exposure to interruptible volumes -- about 10% of its forecast revenues in 2010 and beyond -- if basis dynamics drive sales lower, weaker financial performance will be mitigated by the company's business profile that we view to be among the strongest of pipelines we rate. The essential nature of the asset, serving key Midwest markets, should support capacity recontracting needed to recover debt obligations.
- Northern Border Pipeline Co. We affirmed the 'A-' rating and revised the outlook to negative from stable based on declining metrics due to a tight basis spread between supply markets from the Western Canadian Sedimentary Basin and demand markets in Chicago, exacerbated by short remaining contract lives.
- Florida Gas Transmission We affirmed the 'BBB' rating and revised the outlook to stable from negative based on lower liquidity risk as the company issued $850 million notes on July 8, 2010, to fund the Phase VIII expansion

and refinance $350 million notes that are set to mature in December (see Florida Gas Transmission's $850 Million Notes Are Rated 'BBB'," published July 8, 2010 on RatingsDirect).

- Southern Star Central Gas Pipeline Inc./Southern Star Central Corp.We affirmed the 'BBB' ratings and revised the outlooks to positive based on credit metrics that have been strong for the current ratings and a business profile that we believe reduces recontracting risk. and the action also reflected steadily improving credit metrics.

U.S. gas supply dynamics are evolving very quickly, which may significantly influence the value of a single-asset pipeline's capacity. Existing contract lives are supportive of stable cash flow generation and are a key underpinning of the pipeline's investment-grade ratings. However, certain pipelines may be more negatively impacted than others and will have to reduce debt accordingly to avoid credit quality pressures if recontracting risk becomes severe. While future basis spreads and natural gas prices are difficult to specifically quantify, current conditions will be very challenging for some companies if sustained.

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