



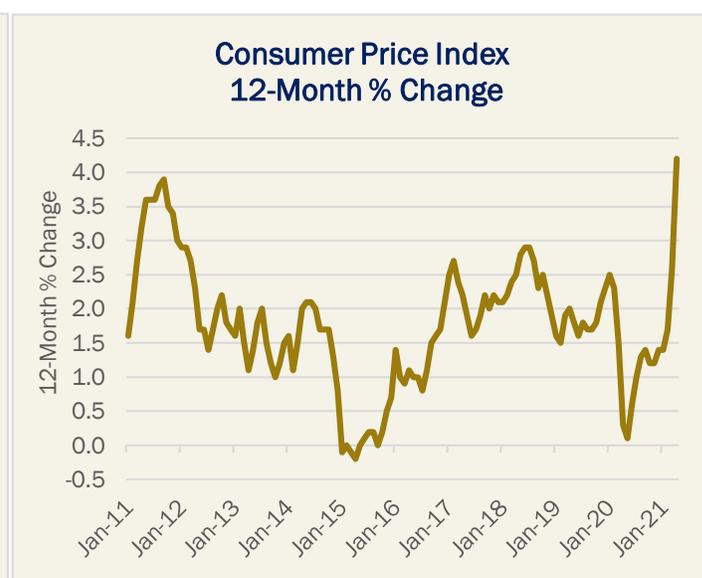
Inflation Fears Shine Spotlight on Defensive Midstream Assets

- New data pointing to surging prices for goods and services have rattled markets, with many investors now scouting for defensive plays that can weather the risks posed by rising inflation.
- Investor worries present an opportunity for a fresh look at midstream assets that can serve as a natural hedge in an inflationary environment. We highlight common carrier liquids pipelines, whose ceiling tariffs are set by the Federal Energy Regulatory Commission (FERC) and adjusted based on the Producer Price Index for Finished Goods.
- Countering base business risks identified by our Treadmill Incline Intensity (TII) index, higher inflation would serve as a tailwind that boosts earnings for liquids pipelines with tariffs or contracts tied to FERC rate indexing.
- The companies with the greatest earnings exposure to these pipeline tariff structures include DCP Midstream (DCP), Enterprise Products (EPD), Magellan Midstream (MMP), NuStar (NS), and Plains All American (PAA).

Inflation Signals Rattle Markets

New data pointing to rising prices for goods and services have unnerved investors and tapped the brakes on a broad rally in stocks. The [Producer Price Index \(PPI\)](#) accelerated 0.6% from March to April, the Labor Department said May 12, or about double market expectations. Prices paid to producers jumped 6.2% for the 12 months ended in April, the highest annual increase since the U.S. Bureau of Labor Statistics (BLS) started tracking the data in 2010 (see Figure 1). A sharp increase in steel mill products (18%) was the biggest contributor to the jump in prices paid to producers in April, the BLS said, with higher prices also reported for meat and dairy products, plastic resins, and residential natural gas.

The PPI data follows an earlier report from the Labor Department showing prices paid by consumers for goods and services jumped 4.6% Y-o-Y in April, the biggest annual increase since 2008 (see Figure 2). The month-to-month gain in the [Consumer Price Index \(CPI\)](#) was 0.8%. American consumers paid 25% more in April for energy than a year ago, including a 50% increase for gasoline and 37% more for fuel oil, the BLS reported. Used car and truck prices were 21% higher than a year ago, including a 10% jump from March to April, which the BLS said was the largest monthly increase dating to 1953.



Figures 1 & 2: Producer Price Index and Consumer Price Index for all Consumers, 12-month Percent Changes (U.S. Bureau of Labor Statistics)

Signs of rising inflation are prompting market rotation. After a terrible year in 2020, oil and gas stocks have been market leaders in 2021. WTI crude prices are nearly 40% higher so far this year (as of May 24), part of a broad-based rally in commodities (copper, lumber, steel) as markets anticipate expanding global demand. The Alerian Midstream Energy index is up 34% YTD. Meanwhile, the technology-heavy NASDAQ market, which soared in 2020, is lagging and up 7.6% YTD (see Figure 3).

The technology stock rally began last spring as initial fears of economic damage caused by COVID shut-ins gave way to massive monetary stimulus, including \$120 billion in monthly asset purchases by the Federal Reserve. Inflation skeptics point to the economic disruptions from one year ago as one of the main reasons for April's big gain in annual inflation, lowering the base comparison as economic activity picks up in 2021 with rising vaccinations and loosening travel restrictions. The Federal Reserve believes the impacts are temporary. In late April, the Federal Open Market Committee voted unanimously to maintain accommodative policies aimed at holding down short-term borrowing costs between 0% and 0.25% while maintaining its monthly asset purchases. Investors fear the Federal Reserve and other central banks will need to reverse course and sharply raise rates to tamp down inflationary forces, cutting off the liquidity spigot.



Figure 3: Year-to-date Market Performance of the NASDAQ, Alerian Midstream Energy Index, and WTI Crude Front-Month (Bloomberg)

Rate Indexing Creates an Inflation Hedge

Market movements suggest investors are scouting for defensive plays that can weather the risks posed if inflation heats up. In this *Midstream Navigator*, we highlight common carrier liquids pipelines that have tariffs tied to indexed rates. This tariff structure can serve as a natural earnings hedge if inflation eats away at returns elsewhere in a portfolio.

Liquids pipelines are regulated by the Federal Energy Regulatory Commission (FERC), which under the Energy Policy Act (EPA) of 1992 is required to establish a “simplified and generally applicable” ratemaking methodology that is a just and reasonable standard. To implement the EPA 1992 mandate, FERC established an indexing methodology that allows liquids pipelines (crude oil, NGLs, and refined products) to charge indexed rates that can be adjusted annually, subject to certain ceiling levels.

Figure 4 provides the midstream companies we expect to generate the largest share of 2021 earnings from liquids pipeline assets, according to our *Risk Matrix* tool. Only certain liquids pipeline assets use indexing for their tariffs, which apply to common carrier pipelines and are distinct from rates based on cost-of-service filings or market-based rates (though some negotiated contracts include rate adjusters). For example, we exclude Shell Midstream (SHLX) from our list because most of its crude pipelines are offshore and not subject to FERC oversight. But these identified midstream companies serve as a useful filter for potential exposure to rate indexing on liquids pipelines.

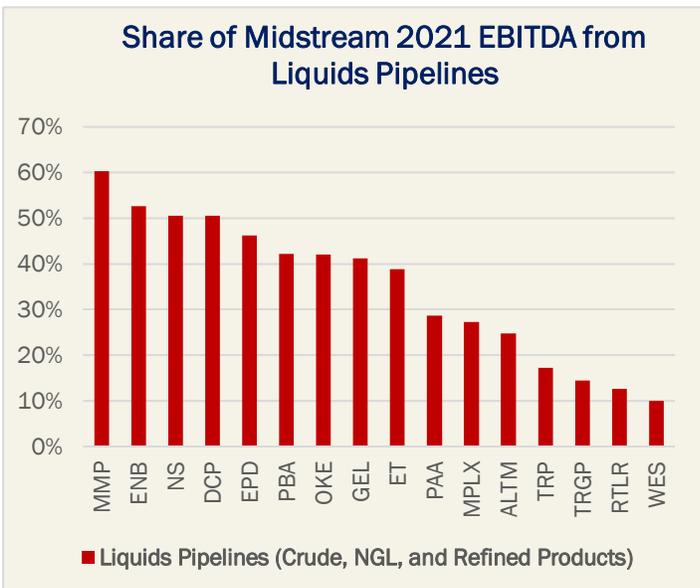


Figure 4: Share of Estimated 2021 EBITDA from Liquids Pipelines, by Company (East Daley Midstream Risk Matrix)

Under indexing, liquids pipelines may adjust their rates annually so long as the rates remain at or below the applicable ceiling levels. The formula is based off the Producer Price Index for Finished Goods (PPI-FG), plus an adjustment factor based on an index that tracks industry-wide cost changes. The PPI-FG is provided by the BLS and is a straightforward calculation using the PPI commodity data for the final demand of finished goods.

East Daley reviewed FERC’s updated indexing methodology in December 2020, focusing on the agency’s determination of the adjustment factor to the PPI-FG that will be applied to index tariffs for the next five years. FERC set the annual index rate for liquid pipelines at PPI-FG + 0.78%, which was much higher than its initial proposal of PPI-FG + .09% and a bullish development for several midstream companies (see our Jan. 5 *Midstream Navigator*, “[FERC Throws Liquids Pipelines a Bone](#)”). This rate adjustment will be applied to common carrier liquids pipelines from 2021-2025. The ceiling level is adjusted every July 1 based on the prior year’s average PPI-FG, so higher inflation this year would be applied to index rates starting in 3Q22.

Midstream EBITDA Sensitivity to Inflation, 3Q22 - 2Q23 (\$MM)					
Company	Base Case (2021 Inflation = 1.7%)	Elevated Case (2021 Inflation = 4.9%)	High Case (2021 Inflation = 6.9%)	Base/High Case EBITDA Variance	Asset Drivers
DCP Midstream (DCP)	\$1,206	\$1,226	\$1,238	2.7%	Sand Hills, Southern Hills, Front Range, Texas Express
Enterprise Products (EPD)	\$8,440	\$8,551	\$8,620	2.1%	MAPL, ATEX, Shin Oak, South TX NGL, AEGIS, TEPPCO
Magellan Midstream (MMP)	\$1,497	\$1,507	\$1,514	1.1%	Refined Products Pipeline, BridgeTex, Saddlehorn
NuStar (NS)	\$753	\$775	\$790	4.9%	NuStar Logistics, NuStar Pipeline Operating, NuStar Permian
ONEOK (OKE)	\$3,125	\$3,174	\$3,203	2.5%	Bakken, Elk Creek, Sterling I & II, Arbuckle North, Arbuckle II, West Texas NGL, Overland Pass
Plains All American (PAA)	\$2,451	\$2,501	\$2,532	3.3%	Plains Pipeline LP, Cactus II, Diamond, Capline

Table 1: Sensitivity of EBITDA to Inflation for Select Midstream Companies (East Daley Asset-Level Blueprints)

Identifying Midstream Winners from Higher Inflation

Table 1 reviews how an inflationary environment can drive earnings benefits for liquids pipelines with rates set at the index ceiling, or long-term negotiated agreements that adjust based off the FERC index. We show current earnings expectations found in our 1Q21 *Earnings Reviews* for six midstream companies starting in 3Q22. (Our 1Q21 *Earnings Reviews* assumed annual inflation of 1.7% in 2021). In the medium case, we assume the higher inflation rate seen in April continues for the remainder of the year, resulting in annual inflation of 4.9%. In the high scenario, we assume inflation accelerates at a 0.5% monthly pace for the rest of the year, pushing average inflation in 2021 to 6.9%. We filter these assumptions through our *Asset-Level Blueprints* to identify liquids pipelines that use indexed rates, then estimate a full 12 months of earnings based on these inflation scenarios.

We identify NuStar (NS), Magellan Midstream (MMP), Plains All American (PAA), DCP Midstream (DCP), ONEOK (OKE), and Enterprise Products (EPD) as the companies with the most exposure to liquids pipelines that set tariffs through indexing. In our view, NS is most levered to inflation; we calculate 4.9% higher EBITDA starting in 3Q21 in our high inflation case for NS due to its ownership of several crude (NuStar Permian) and refined products (NuStar Logistics, NuStar Pipeline Operating) pipeline systems with indexed tariffs. PAA is also highly levered, with a 3.5% earnings gain in a high inflation

scenario compared to our base inflation case. Plains Pipeline LP, Cactus II, Diamond, and Capline pipelines drive PAA's exposure to indexed rates. By EBITDA value, EPD is the most exposed to earnings upside if inflation rises. EPD would see \$180 million in higher annual earnings in our high inflation case (\$8,620 million) vs. our 1Q21 Earnings Review outlook (\$8,440 million). Assets leading the earnings impact for EPD include Mid-America Pipeline (MAPL), the Appalachia-to-Texas (ATEX) ethane pipeline, the Shin Oak NGL pipeline, South TX NGL, the Aegis ethane pipeline, and Texas Eastern Products Pipeline Company (TEPPCO).

A Reverse Treadmill Effect

Earnings gains are not guaranteed for these companies if inflation rises. Assets would still be subject to base business risks resulting from regional midstream competition, expiring contracts, and market price spreads. East Daley developed our Treadmill Incline Intensity (TII) calculation to quantify these structural business risks to midstream assets. However, inflation would serve as a tailwind boosting underlying earnings for liquids pipelines that have contracts tied to the FERC index, countering the TII drag on these systems. The higher the pace of inflation, the more future earnings should expand from these pipelines' existing base of shippers.

Conclusion

Investors are scouting for defensive plays that can weather the risks posed by an overheating economy. Inflation worries present an opportunity for a fresh look at common carrier liquids pipelines, which can serve as a natural hedge in an inflationary environment. We identify DCP Midstream (DCP), Enterprise Products (EPD), Magellan Midstream Partners (MMP), NuStar (NS), and Plains All American (PAA) as the midstream companies with the most to gain if inflationary forces take hold. These operators will have more flexibility to raise ceiling tariffs on shippers based on adjustments tied to the PPI-FG. Countering base business risks identified by our Treadmill Incline Intensity (TII) calculation, higher inflation would serve as a tailwind boosting underlying earnings for owners of liquids pipelines with tariffs tied to FERC indexing.

Highest Regards,

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