Midstream/MLPs: 2020 Cost Discipline Has Benefits Into 2021

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Summary

- Cost management and asset optimization helped partially offset macro headwinds in 2020, contributing to stable EBITDA and allowing excess cash flow to be used for debt reduction and in some cases, buybacks.
- While controlling costs helped many companies navigate market headwinds, some companies elected to reduce their distributions in order to further improve financial flexibility and reduce leverage.
- A continued focus on controlling costs and optimizing assets should benefit the space into the future as some savings prove sustainable and new efficiencies are realized.

The unprecedented events brought upon by the pandemic, including the oil price collapse in 2020, presented a true stress test for energy broadly, including midstream. As previously discussed, despite a pressured commodity price environment and the related impacts to production and demand, the outlook for midstream companies remained fairly stable through 2020 (read more). While some companies lowered 2020 guidance, others maintained their forecasts or ultimately revised guidance back to pre-pandemic levels after initially reducing expectations in the spring of 2020. While midstream's fee-based business model and contract protections largely drove resilient cash flows, cost reductions also helped drive stable EBITDA. Today's note examines 2020 cost savings and how recurring savings could benefit the space going forward even as the macro environment improves.

Cost reductions helped support EBITDA stability.

Cost management helped partially offset macro headwinds in 2020, contributing to stable EBITDA and allowing excess cash flow to be used for debt reduction and in some cases, buybacks. For example, MPLX (MPLX) reduced operating expenses by over $200 million in 2020 relative to initial forecasts by addressing their long-term cost structure. With help from cost reductions, MPLX saw a modest increase in EBITDA year-over-year (+2.1%) and generated excess cash flow after capex and distributions, allowing unit repurchases to begin in 4Q20. On the fourth quarter earnings call, management alluded to cost reductions being maintained over the long term, and continued cost discipline is expected to help the company generate excess cash flow again in 2021 that could be used for unit repurchases. On their 4Q20 earnings call, the management of Enterprise Products Partners (EPD) noted that total 2020 operating costs were $400 million below budget. EPD was able to reduce its base cost structure partly through supply chain negotiations, power utilization efficiencies, and data-driven fractionator optimization. While management did not provide a specific number for recurring cost reductions, the cost optimization from 2020 is expected to continue in 2021.

For companies providing 2021 financial guidance, projections likely include some assumptions around ongoing efficiencies. For example, Magellan Midstream Partners (MMP) included $50 million of cost savings in their 2021 guidance. For MMP, these savings relate to pipeline power and drag-reducing agent optimization, company-wide process improvements, and minor workforce reductions. While these are only a few examples, reducing costs was a key focus among MLPs and midstream corporations last year as management teams navigated unprecedented market headwinds. Though some costs may creep back up as the macro environment improves, many cost savings are likely to remain, resulting in leaner and more efficient businesses better positioned for the long term.

Cost reductions were paired with distribution cuts to enhance deleveraging for some.

While controlling costs helped many companies offset market headwinds, some companies elected to reduce their distributions in order to further improve financial flexibility and reduce leverage. With the exception of Energy Transfer's (ET) 3Q20 cut (read more), 2020 MLP distribution cuts were mostly limited to smaller names in the space that lowered payouts in April and May 2020 when the pandemic's impact on energy markets was particularly severe (read more). For these companies, controlling costs helped with EBITDA stability, but distribution cuts were a more needle-moving contributor to efforts to improve the balance sheet and enhance financial positioning.

For the companies that cut their distributions in 2020, cost reduction efforts are still noteworthy but are just one aspect of steps taken to improve financial flexibility. ET realized more than $500 million in savings in 2020 general and administrative (G&A) and operating expenses. The company expects about $300 to $350 million of this to be reoccurring. EnLink Midstream (ENLC) reduced operating and maintenance and G&A costs by over $140 million, a 23% decrease relative to 2019, helping the company surpass the high end of 2020 financial guidance ranges provided in May 2020 for adjusted EBITDA and free cash flow after distributions. As noted on ENLC's 4Q20 earnings call, 2020 cost reductions are expected to be maintained in 2021, with 85% to 90% of savings expected to be sustainable even in an environment of modest growth. DCP Midstream (DCP) reduced costs by $145 million in 2020, outpacing its initial target of $120 million and offsetting a negative $144 million commodity price-driven impact to distributable cash flow. Management guided to sustaining those cost efficiencies in 2021 with plans to utilize increasing excess free cash flow to further strengthen the balance sheet.

Bottom line

While the midstream/MLP space proved resilient in the face of a challenged environment in 2020, mainly due to its fee-based, more defensive business model, initiatives to reduce costs were also beneficial. A continued focus on controlling costs and optimizing assets should benefit the space this year and going forward, even as the macro environment continues to improve.

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