

Energy Insights:
Midstream Master Limited Partnerships

Managing large scale
capital projects*

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Managing large scale capital projects and expanding organic growth programs: How midstream companies can fully exploit value and achieve strategic goals

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Midstream master limited partnerships are often challenged to effectively manage high-stakes capital investment projects and organic growth programs.

The ability of midstream master limited partnerships (MLP) to achieve future growth targets is generally achieved through a combination of the completion of organic growth projects and strategic acquisitions. An increasing focus on organic growth projects has resulted from:

- Increased competition (and prices) for midstream acquisition targets;
- Recent volatility in the capital markets and higher costs of capital for certain market participants;
- United States energy infrastructure being in a phase of significant expansion not seen in recent periods;
- Identification of operational synergies from prior acquisitions and leveraging of existing assets, resulting in a significant increase in the size and scale of organic growth projects; and
- Recognition that achieving growth goals primarily through acquisitions has become more and more challenging, especially as companies get larger and larger.

Certain midstream MLPs are also undertaking large scale capital constructions projects such as pipelines, processing facilities, storage or terminal facilities.

This trend, together with the growth of organic growth projects, has quickly received the scrutiny and attention of Board members, investors and management teams. If such projects are not properly planned and managed, they may not be completed on time or within budget and potentially attractive returns may not be fully realized. Delays in the completion of organic growth projects and/or cost overruns have the potential of adversely impacting the amount and timing of an MLP's future cash flows, which in turn would negatively impact an MLP's ability to achieve desired future distributions and distribution growth rate targets. Further, the need to adequately address and comply with applicable regulatory requirements in a timely manner is crucial to the successful completion of capital projects.

These projects are strategic to an MLP's overall growth strategy. Effective execution is essential to driving the unitholder value that is demanded from these management teams. The projects have complexities where business plans hinge on integrating new physical assets, technology and comprehensive optimization strategies. To get the job done, management will often hire multiple outside contractors representing varied competencies and devote significant internal resources to managing these projects. It will be the MLPs and their management teams—not the external contractors hired to do the work—whose reputations and futures hinge on effective regulatory compliance, cost control and on-time project delivery.

However, considering the limited amount of major construction undertaken in the U.S. energy industry over the past decade, many midstream MLPs may lack the in-house expertise and processes to manage such large and complex capital investment projects. Besides the core operational areas, midstream MLPs may find that other related functions such as accounting and state and local tax departments are understaffed or under skilled for the level of capital projects activity now in consideration. Further, although midstream MLPs typically have strong controls over routine capital projects, major construction efforts and expanding capital programs require a more enhanced controls focus.

The large scale, multi-party involvement and compressed project timelines associated with these projects increases their complexity, and management teams can sometimes lose sight of the factors contributing to scope creep, cost overruns, schedule delays and quality control issues. Additionally, midstream MLPs may be unable to recover reasonable costs if they or their contractors do not maintain a strong control environment and document costs according to the applicable regulatory need.

Knowing relevant risks up-front can save a midstream MLP not only money, but also its reputation.

To help ensure management and unitholders enjoy the full benefits of these significant investments, in our view, management should consider the following three steps: analyze and plan for each project's regulatory climate and risks; establish a capital investment management framework; and develop focused management reporting.

- 1. Analyze and plan for each project's regulatory climate and risks** so that you can fully identify and manage relevant issues based on regulatory expectations and requirements.

An up-front awareness of the project's regulatory implications is critical for effective management of the project, because of the key role the regulatory environment and potential regulatory scrutiny play in the successful completion of a large-scale capital project. Explicit front-end planning for regulatory risks and opportunities can drive important tasks, such as a proactively communicating program specifics to the regulators; building in the right controls to actively manage project cost, scope, time and quality; and designing innovative rate solutions to minimize rate shock and reduce uniholder risk.

- 2. Establish a capital investment management framework** that identifies project components and related issues for each phase of the project lifecycle.

To effectively manage these large scale and complex projects or programs, management should establish a structured framework that maps the specific requirements of a project's lifecycle to discrete management activities and controls. Such a framework enables the MLP to identify—and, where appropriate, proactively address—risks and potential gaps in management controls before embarking on the project and assists in improving operational performance. Multiple requirements are associated with managing a project such as scope and change control, schedule/time management, quality and inspection, cost

management, HR management, communication and reporting, procurement and contracts, and issue management. The challenges involved in any project component may change as the project moves through its lifecycle—from initial project planning through design, testing, and implementation to maintenance and operations. The up-front creation of this capital investment risk management framework enables management to gain visibility into the entire landscape of the project—across all project components and the full project lifecycle—so that issues are surfaced and can be addressed on a timely basis.

Using the framework, an MLP’s management team can consider risks and opportunities associated with each project component at each stage in the project lifecycle. For example, specific project implementation issues that are typically associated with the scope and change control component include excessive and inadequately supported cost estimates; delays and labor disruption caused by a change that is not adequately assessed at the change approval stage; change approval delays leading to work disruption; and implementation of unnecessary changes.

Once established, the capital investment management framework also helps integrate disparate efforts so that duplicate or unaligned compliance and control processes can be eliminated or improved, thereby reducing governance and compliance costs. When integrated into a broader risk management program, a capital investment management framework can contribute to a comprehensive governance, risk management, and control program that enables future financial and operational success.

The framework is most effective when involving key stakeholders to ensure that management leverages key areas of expertise. For example, the tax department can assess key tax considerations that can create a competitive advantage by reducing overall project costs and minimizing unnecessary cash flows by considering the availability of local tax credits and incentives.

By understanding the risks and opportunities involved in the capital investment project, management can analyze and prioritize, distinguishing actions based on whether they will have a major, a moderate, or a minor impact on the success of the project. In this way, management can make the best decisions about how and where to focus its mitigation efforts, ensuring that the biggest issues receive the most attention. Then, management can formulate a response that assigns the appropriate level of effort to each risk. This may involve taking steps to prevent an event from occurring at all or, if it does occur, to minimize its impact.

Through effectively managing project risks and prioritizing responses, management can make better decisions, avoid surprises, and improve operational performance. In addition, the same framework that is used internally to understand and manage projects can also be used externally to communicate project issues from start to finish as well as the steps the midstream MLP is taking to manage those risks. This transparency with investors and regulators builds confidence that management will perform well in these high-stakes capital investment projects and programs.

- 3. Develop focused management reporting** of both ongoing and exception situations to highlight project risks, adequacy of mitigating actions, and impact on operations and enterprise risk.

This results in a centralized and coordinated risk management program that is available to all levels of an organization and ensures that challenges and risks are not only clearly visible, but also can be continuously managed throughout the project lifecycle. The right reporting helps ensure actions are taken when needed, thereby improving execution, and helps provide a clear audit trail of management decisions. It also promotes accountability at all levels and facilitates a process for communicating plans and results to the Board of Directors and stakeholders.

These three steps help management of midstream MLPs successfully deliver major capital investment programs as necessary to implement their strategies. The result? Midstream MLPs can better serve their customers, fulfill regulatory responsibilities, and protect and enhance unitholder value.

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Simon Tait is a Houston-based Assurance partner with 17 years experience serving energy clients. Simon has gained extensive experience in providing audit, accounting and advisory services to local and multinational companies in the US, Moscow and London, working in the last two cities for 10 years. Recently, Simon has focused most of his time working with master limited partnerships taking an active role in developing the PricewaterhouseCoopers MLP Practice in Houston.

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