

Manuel Prieto and
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Spectra Energy: ‘We go where the lights are’

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President and CEO Greg Ebel on how Spectra Energy became one of the most successful pipeline companies in North America and the future of the industry.

Headquartered in Houston, Spectra Energy owns and operates about 21,000 miles of pipeline, 300 billion cubic feet of natural gas storage and 4.8 million barrels of crude oil storage positioned across most key North American supply basins, strategically linked to growing demand markets. As CEO Greg Ebel likes to say, their pipelines “go where the lights are,” which gives them a first and last mile advantage.

In this interview with McKinsey partner Manuel Prieto and senior expert Joe Quoyeser, Ebel shares his perspective on how Spectra Energy has grown, how the pipeline industry is changing, some implications of the North American fracking revolution, where future growth will occur, and what has made the company successful.

McKinsey: *What has been your path to where you are today?*

Greg Ebel: Well, it wasn’t a straight path. After some early career work in public opinion research, I spent four years with the Canadian government as chief of staff to the Minister of Finance and then moved to the World Bank doing infrastructure loan syndication in developing countries. About 20 years ago, I started in our western Canadian business and was in charge of its M&A activities, and during that time I also attended the Advanced Management Program at Harvard Business School. We were eventually sold to Duke Energy where I spent some time doing M&A, and then, eventually, I ran our utility business, Union Gas. At the start of 2007, when Spectra Energy was spun off from Duke Energy, I became the CFO. Two years later, I was appointed CEO, and took over on January 1, 2009.

McKinsey: *In creating Spectra Energy, what were the biggest challenges from an operational and cultural perspective?*

Greg Ebel: From a cultural perspective, we didn’t have much changing to do. The utility culture hadn’t entirely subsumed us, as we still had a much more commercial, entrepreneurial gas business with its heart and soul in Houston, western Canada, and Ontario. We had a lot of long-time employees; they remembered what it was like to be a pipeline company. So, the culture part was easy, which was a huge advantage, as that’s one of the hardest things to change.

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The biggest operational issue was resetting our corporate headquarters. Regulation, accounting, and governance issues changed. We had to reconstitute boards, and build our ability to issue equity and debt. We had to reconstitute everything from a corporate perspective in Houston and, perhaps most challenging, we had to do it in six months. We made the decision to split the companies in June 2006. And on January 2, 2007, we rang the bell to launch Spectra Energy. Six months after that, we knew we had to reconstitute a master limited partnership (MLP). So, within 12 months we started a Fortune 500 company and what I think has turned out to be one of the best MLPs out there. We used a methodical process to do it, and not having to do much on the culture was a big advantage.

How is the industry changing?

McKinsey: *What are your views on the link between utility and midstream companies today, and how might this change?*

Greg Ebel: Midstream is not a great word to describe our business. Everything from wellhead to burner tip is deemed midstream, which I think is a disservice to our business, and I don’t think that description has served investors well. You can group everyone from low-risk gas distributors to pure commodity-based volume risk players, and everything in between, as midstream. The Texas Easterns, and Tennessees, and Transcos, which are owned by Spectra Energy, Kinder Morgan, and Williams respectively, are very stable pure-play pipeline entities. Many companies have added other services and perhaps have created problems for themselves by creating too much midstream through increased volume and commodity risk. We’ve tried to stay focused and disciplined. Any commodity risk we have is totally isolated in our DCP joint venture with Phillips 66.

Overall, the convergence of utility and pipeline companies may be coming back with recent actions by some of the big players (for example, Southern Company and NextEra Energy). Our largest project currently in execution, the Sabal Trail project, has Duke and NextEra as minority partners. In New England we’ve been working with National Grid and Eversource, and NEXUS, our project connecting the Utica and Marcellus to Ontario and Michigan, has DTE as a partner. So, yes, convergence, and I think that’s because there’s great growth opportunity. With the economy growing at less than 2 percent, that is harder on utilities. Conversely, our business is growing at 7 percent to 10 percent, depending on the entity.

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McKinsey: *The industry is facing several changes, such as becoming global through LNG and Mexican exports, as well as the potential for commercial energy storage and other energy disrupters. How are these changes affecting pipelines and how companies think strategically about their investments?*

Greg Ebel: First, if you are a single entity pipeline or a regional pipeline, you're going to have great challenges. Supply is everywhere. You need to be able to go to as many markets and supply areas as possible because they will ebb and flow at different times.

I think pipelines are going to become much more essential to global trade. In the United States, this will be more about north and south than east and west, and across borders as well. For example, the Dawn Hub, in Ontario, is the second largest trading hub in North America for natural gas, and it is interconnected with 12 or 15 different pipes. The border doesn't even exist from that energy perspective. Most of our customers there are utilities that also have contracts from western Canada. They'll continue to have contracts from different areas for natural gas because no one wants to be caught short on supply.

In terms of energy storage, it needs to be done at scale, and I think that achieving that is still elusive. We're making progress, costs are coming down, but not by enough to scale. Distributed generation is something I would consider more disruptive today, and one where natural gas can provide tremendous benefits, especially with municipalities, universities, schools, and hospitals, all needing very highly reliable energy sources.

Implications of the North American fracking revolution

McKinsey: *Production has grown exponentially since 2008. What were the biggest challenges in identifying and selecting the right opportunities for investment?*

Greg Ebel: We have the advantage of serving four of the five fastest-growing natural gas demand markets in North America, and we're connected to virtually every key supply basin. I like to say, "We go where the lights are." If you took a nighttime satellite picture of North America, you would find that Spectra Energy's pipes end at major light centers: Boston, New York, Philadelphia, Tampa, Houston, Toronto, and Vancouver. I don't know what is going to happen in the world, and I don't know what production will do, but we do know one thing—the lights are going to come on every day. If you can get to that last mile where the lights are, the rest sort of falls into place.

With fracking, the main challenge to ramping up volume was time. Producers knew what they had, and they were ready to produce before the infrastructure was built. The entire cycle took eight to ten years. It took producers two to three years to finalize plans and commit to paying pipeliners to build the pipes. Then it took two to three years to build them. Meanwhile, on the demand side, utilities and industrials, our customers, were asking, "Is the gas really there?" It took another two or three years to get utilities and industrials on board. This dynamic drove the

pipeline market from supply-push to demand-pull. About 80 percent of our projects currently are demand-pull, meaning the lights are pulling them.

McKinsey: *Since the oil price drop in 2014, how has the paradigm changed for midstream players? Have you felt any backwash on the E&P side, or are you insulated from that?*

Greg Ebel: There are two ends to the pipeline. At relatively low prices, the producer's not happy, but the user is extremely happy. If you are largely a demand-pull pipeline system with last-mile pipes, there is an advantage to low prices, as only one or two pipelines go to big demand areas like New York, Boston, or Tampa. These companies will be able to add projects to their backlog incrementally. In fact, 2016 has been our largest capital spend year in history. We're two years into the pullback in the price of oil, but natural gas has stabilized, relatively speaking, at three bucks. This continues to prove the point of the demand-pull system and our connection to the lights driving our business. Everything we have signed up this year has been demand-pull. That's not right; it's not wrong; it's just the cycle we're in.

The whole market has seen a rise in its yield since 2014, which is obviously a partial indication of the market's view on the cost of capital. But our cost of capital has been far less than virtually anybody else's. I think the players who have used their MLP for the right purposes—such as Enterprise, Phillips 66, and ourselves—haven't seen much in the way of backlash, but it takes a lot of discipline.

Following the lights

McKinsey: *When you say, "We go where the lights are," do you mean that the lights have been the driver for gas demand? Our base outlook is that gas saw more growth from power in the last ten years than it may see in the next ten.*

Greg Ebel: I think that's fair in parts of North America. However, the Midwest still has a bunch of coal, so the biggest demand driver there for gas is power generation. Also, not all the power generation that's been built is being fully utilized, and not all of it has pipes. Most of the pipes that have been built are for demand in gas utilities, not power. In the summer, the power plants, which particularly in the Northeast aren't generally inside utilities, are drafting off the local gas distribution company [LDC] winter capacity, which is obviously not needed in the summer months by the LDC itself. This is not sustainable because there are now summer and winter peaks for power, and they are going to need separate pipelines just to support the power plant.

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Today, gas LDCs, and gas distribution customers, are often subsidizing power producers. The discussion in the Northeast is, “Oh, pipeline capacity is a tax on electric generation.” It’s not. That’s like going to a hotel on Friday night and asking for a room. The hotel says, “We’re full. Do you have a reservation?” And you say, “No, but I should still get a room.” Well, none of the power plants have any reservations for this gas.

Also, we are still using 65 to 80 million barrels a year of oil to provide heating in the Northeast, so there’s still a great deal of potential growth for changing to natural gas. Renewables need backup, and virtually all that backup is natural gas, so you need pipelines to be able to do that.

We also need to look at exports, specifically LNG exports and the growing Mexican demand. We just secured one of the largest natural gas pipeline contracts awarded in the last 18 months to build a pipeline to the Mexican border to serve increasing demand in Mexico, largely driven by power generation. Mexican players are going to continue to reach further back in the US supply areas. Today we are building in south Texas, but, ultimately, they will need to get to the Marcellus and the Utica. So, I think there are still lots of opportunities on the natural gas side to also serve export markets.

Spectra Energy’s path forward

McKinsey: *JVs have the reputation of being complex to form, and even more complex to manage long term. DCP has been quite successful. To what do you attribute that success?*

Greg Ebel: It’s a must-run business as 60 percent to 70 percent of the gas produced in North America must be processed. We are the biggest player in the business and that creates a certain esprit de corps among the owners. We also put a good management team into DCP, and it’s rare that either parent has taken people from DCP, so we have built and kept an experienced team at the JV.

The partnership recognizes the type of leadership it needs at different times. When it was first started, the management team was all about go, acquire, consolidate. When things slowed down, we shifted the focus to consolidation and lean operations and making it one company, not a group of companies that came together. Today, it’s about efficiency of operation.

The results have been great. The JV has provided the parents dividends of over \$5 billion in the last ten years, and we took virtually all our half of those, avoided the issuance of equity, and reinvested it in the less volatile and stable pipeline business.

There is also great trust between the JV partners. Phillips 66 and Spectra Energy have extremely senior people on the board. This allows us to avoid struggling with decisions, which can happen when you don’t have the top executives involved. That’s a common challenge that many JVs face. Lastly, we’re not direct competitors. Phillips 66 gives insight on refining and marketing, and we provide insights on the pipeline and distribution of products.

McKinsey: *There's some noise within the analyst community about the future of the MLPs given lower growth prospects. What is your opinion about the future of the MLP structure?*

Greg Ebel: We have been using MLPs at Spectra Energy for more than 20 years and we are believers in the structure. But it needs to be used responsibly. It is not a separate company; it is a tax efficient financing vehicle. If you are a smaller player with only one or two assets, it can be risky because you are 100 percent reliant on the capital markets without any other source of equity and you're paying out 100 percent of your cash flow. I don't think it's dead, but I do think you will see consolidation in this sector that's going to put a more stable and reliable group of assets together.

McKinsey: *Spectra Energy announced in September that it had entered into a merger agreement with Enbridge. What is the value to investors?*

Greg Ebel: The proposed merger with Enbridge will deliver tangible benefits to all Spectra Energy stakeholders. With such a transformational combination—merging the best-in-class natural gas and liquids assets—we will become the largest energy infrastructure company in North America, and we expect that the combined company will offer the best total return opportunity in our sector for investors. The combination will provide an expected annualized 15 percent dividend increase in 2017, and is expected to increase and extend future annual dividend growth to a range of 10 to 12 percent annually through at least 2024, with greatly enhanced distributable cash flow coverage also expected over this time frame. Overall, the proposed merger positions us exceptionally well for the future, with customers, employees, investors, and the communities we serve.

It would appear shareholders also understand the value opportunity. They overwhelmingly approved the merger in December 2016, and we have just two approvals remaining—from the Federal Trade Commission (FTC) and the Canadian Competition Bureau. We continue to expect that we will close the transaction in the first quarter of 2017. ▣

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