October 2021

Alex Pickard:

Good morning and thank you for joining us for our third quarter TortoiseEcofin energy update call. My name is Alex Pickard and I am part of the strategic relationship group here at TortoiseEcofin. Joined with me today is director and client portfolio manager, Mark Marifian.

Alex Pickard:

Momentum continues as energy and midstream continue to make progress on a number of fronts, which is helping position the sector for rebound in 2021. A few of the key topics we want to hit on today are a review of the domestic and global energy infrastructure markets, how US midstream energy continues to recover from the pandemic as well as highlights from a strong earning season, the increased focus on clean energy solutions and how midstream and broader energy infrastructure companies benefit from this, and finally, the impact of a broader infrastructure bill on both the traditional and sustainable energy markets.

Mark, let's start with a recap of the changes we're seeing in the energy markets.

Mark Marifian:

Thanks Alex and thanks everyone for tuning in today. We've seen commodity prices really rise significantly since the end of the second quarter. You look at prices specifically were already pretty constructive, when natural gas and natural gas liquids started to breakout in mid August. As we close the quarter, we saw crude oil surge as OPEC plus declined to change course on their supply plans.

When you look, several pundits across the street are expecting prices to remain high, and they're basing that thought on years of under investment in the sector and that could even lead to a commodity super cycle.

I think why in our mind are prices rising? You have to go back almost to last winter and in the beginning of this year. We saw a very cold spell in Asia. That depleted natural gas inventories. As we've gone throughout the year, we've had unexpected LNG (liquid natural gas) outages globally, whether it's Norway or Nigeria. Brazil faced a severe drought. They need to import more LNG. At the same time, you have all this demand coming. You're seeing increased natural gas demand from people working from home. Residential demand has surged higher in the work from home environment.

This really has led to escalating natural gas prices globally. Just recently, if you looked on a crude oil basis, natural gas prices have reached as high as $200 a barrel, and that's actually leading to some switching to fuel oil for power generation. What that's doing is bringing forward unexpected additional crude oil demand somewhere between half a million and 750,000 barrels a day of unexpected crude oil demand.

That's really pulling demand for it. We haven't even mentioned the main driver of what we've kind of talked about over the last 12 months is how does the economic recovery play out post COVID. We've seen COVID cases start to, again, decline. Mobility has generally kept increasing globally, so demands being pulled forward. We could actually see demand meet pre-pandemic levels here in the coming months, which is really a far-fetched though given where we were just one year ago.

Just quickly on demand, a couple other points. We did see mobility data slip in the beginning of the third quarter over Delta variant concerns, but that’s picked up in recent weeks so we think that was more temporary.

Then, specifically, just diving a bit deeper. One product, which we expect to see a slow recovery in versus other transportation of fuels is jet fuel and TSA travel throughput numbers, they're increasing, but they're still down about 20% from their 2019 levels. We think that improvement takes time, but are encouraged there.

Then just on, that's the demand side. If you go to the supply side, OPEC Plus again, they've remained supportive of global crude oil markets that they're bringing back barrels slowly to market. It's keeping the markets very balanced. I'd say you've had a very strong production and add here inspired by the individual countries to the production cut agreement.

But when we look at the EIA forecast for production domestically, we expect the US to end at about 11.3 million barrels per day of production. That's up slightly from where we were at the beginning of the year at 11 million barrels a day.

What's driving that supply, while higher prices have spurred a revival of shale drilling in the Permian, that's America's biggest oil field, and production there we think is going to return to pre-pandemic highs in the coming weeks. The surge is being driven by private operators rather than the past where you've had the public fueling those previous booms.

I think that's an important delineation. OPEC's certainly watching the public producers’ approach and they continue to highlight capital discipline. Management teams are from an E&P perspective and broader energy perspective are talking about higher free cash flow generation, return of capital to the shareholder. Scott Sheffield, the CEO of Pioneer and kind of de facto, talking head of US producers, he continues to emphasize capital discipline so long as US and global inventories need to decline versus their long-term averages.

Alex Pickard:

Is this an opportunity for US natural gas?

Mark Marifian:

Yeah. Natural gas market obviously appears very tight right now. I think it's a big opportunity for natural gas. You look at the EIA, they're putting out numbers on LNG exports. We're exceeding at 10 BCF a day. That's a record high. You recall about five years ago, that number was zero. I think it's an opportunity for us to export natural gas. Demand globally this year is up 5% for LNG as the world continues to move away from coal towards cleaner alternatives. You can really see it in China. Their demands up 22% year to date for LNG.

I think the bottom line, Alex, is we need more infrastructure. We need more LNG export terminals. We need additional natural gas pipeline infrastructure. You look at the Marcella space in the Northeast. That's home of low cost natural gas across the world, but we're pipeline constrained. We need additional takeaway pipelines there. LNG, we need LNG export facilities. Those take time to construct. We did get an indication this quarter that Cheniere is going to probably move forward with their Corpus Christi stage three final investment decision.

As they move forward, they're going to get greater visibility to signing long-term contracts. Ultimately, they're going to have a really nice line of sight for cash flows for their investors.

I think that being said, the other thing, as we think about natural gas, renewables are becoming a bigger and bigger part of the story. As renewables become a large part of the story, I think intermittency needs to be a real consideration. There needs to be a move here to broaden our power infrastructure. We need to make it more resilient and add some redundancies where we can. We know those redundancies are important, specifically with some of the events that have taken place over the past year. You saw winter storm URI. It knocked out power to Texas. We saw California had near blackouts earlier this year.

I think this in my mind argues that we need natural gas today and also natural gas is going to be the predominant bridge fuel for decades to come.

Alex Pickard:

Great. Let's transition to fundamentals. Is free cashflow still being emphasized?

Mark Marifian:

Yeah. You think about fundamentals, it's kind of in the same story here for several quarters, which is good. 2021's been the steadiest year we've seen from the energy infrastructure group in recent memory and kind of the themes are free cash flow and return it to shareholders. That's really been prioritized.

2021 has been helpful. We've seen EBITDA expectations revised higher. You've had elevated volumes, primarily driven by, again, those private producers drilling. Then you look at midstream companies, they already have the energy infrastructure in place. As you have additional volumes come online, that's just operational leverage to the upside for them.

On the cost side for the midstream companies, we're watching very closely. They're keeping their cap ex numbers very conservative. They're much slower than they have been in the past. They're taking that excess cashflow and they're using it to mostly buy back or mostly reduce debt right now, but you're also seeing them layer in stock buybacks. I think down the road you can see some distribution increases as well.

Just on the debt levels, they're trending now between kind of three and four and a half times, is the target range. In the past, it's been four to five times has kind of been the target leverage. I think lowering that leverage leads to less volatility over time.

Then you have companies taking that excess cashflow and also buying back stock. 17 midstream companies now have active share buyback programs. The leader in the clubhouse so far year to date is kind of MPLX. Then they've been purchasing about $155 million of stock quarterly. I think that provides a nice floor for stocks as companies are out in the open market buying back share.

I love the stability of the business model for midstream. The free cashflow generation is ramping. Spending's constrained. I think over the next couple years, you're going to see a free cashflow yield between 10% and 15%. That certainly differentiated from the broader market. You look at the S&P 500 free cashflow yield, that's at about 4% today.

Alex Pickard:

Great. With the increased focus on clean energy solutions continuing throughout this year, how are midstream and broader energy infrastructure companies thinking about this?

Mark Marifian:

I guess, their perspective I think is very much in line with our perspective. At TortoiseEcofin, we think the focus needs to be on more energy and less carbon. We've studied energy transitions and typically these transitions, they're slow in nature. They take 50 to 80 years on average. As we see an increased focus on reaching net zero emissions, we know that renewables and clean power will be part of that story.

But also part of the story is going to be decarbonizing the existing infrastructure. That's something that we really are pushing our companies to focus on. There's been so many announcements, seems like they're coming on weekly and daily basis at this point, but I want to highlight one that just came out about two weeks ago. That was an announcement between that the natural gas pipeline company Williams and a wind farm, a developer Orsted.

This was a really cool announcement. The companies are going to use Orsted's renewables and hydrogen expertise and then couple that with Williams' natural gas and processing experience, and what they want to do is build a large scale wind farm and electrolysis in Wyoming. Williams has significant natural gas infrastructure there. Ultimately, they believe they can make this their energy infrastructure network more extensive and adaptable to renewable energy, storing it and transporting it.

That's just one announcement, but I think it demonstrates the change in sentiment you're seeing with energy companies across the board. They're not resisting energy transition like they had in the past, but they're participating in it. Within our portfolios today, nearly two thirds of portfolio companies have a numeric commitment to reducing emissions. One third of them have a net zero target. We expect our midstream companies to be focusing on reducing greenhouse gas emissions. I think you're going to see further announcements as we move towards the end of this year.

Alex Pickard:

Great. Thank you. Let's wrap up by discussing how potential infrastructure bills might impact the traditional energy companies.

Mark Marifian:

That's kind of the last, I think key element to the story, and let's just take a step back. The predominant theme around President Biden's energy plan is to address climate change and really create job opportunities for Americans around that.

I think investors assume this is going to mean tax incentives for renewable focused initiatives, but we think there's going to be regulatory support to decarbonize existing infrastructure. Specifically, we have this section 45Q tax credit. It's around carbon capture adoption. That was implemented a few years back. We think that could be expanded. It would be expanded to impact harder-to-abate sectors. You think about steel, cement, chemicals, very energy intensive sectors, and so provide some incentives there and to the degree you do that, we could see the carbon capture market grow significantly and possibly 10 times by 2030 and be a trillion dollar market by 2050.

That's a way, yes, the infrastructure view might be viewed negatively in a lot of lights for traditional energy, but I do think there's going to be some serious support for existing infrastructure.

The other part of this infrastructure bill I think that's worth addressing is just around the MLP structure. Every time you have a potential change like this, it can create some uncertainty for the group. I would tell you that the proposal in the house to expand the definition of MLP qualifying income to include removals is positive. That's supported by the Biden administration. I think that's one key element that we're looking at.

Then the other more broad picture is what happens to the MLP advantage tax status? Does that go away? We don't think that goes away. Our consultants in D.C. believe if there's going to be a change, you're likely to see the definition of qualifying income expanded not removed in total.

I think despite the rhetoric of these are just a couple of examples where we believe the administration is going to take a more holistic view to the energy transition and that they understand that fossil fuels remain critical today and they're going to remain critical to the economy for decades to come.

Alex Pickard:

Great. Thank you, Mark. One thing that we keep being asked, as far as thoughts on the recent news of the US potentially banning crude oil exports, could you speak to that?

Mark Marifian:

Sure Alex. This came up about a week ago. I think it's more rhetoric. There's some frustration within the US administration about how high prices are. I think there's frankly, some concern that what happens if the prices go higher. They continue to release statements that they're working with OPEC to manage where commodity prices are.

They were a bit frustrated that OPEC came out about a week, week and a half ago and said they're going to keep the path that they're on and basically raising production by 400,000 barrels a month. I think they want to see more. The US certainly wants to see more production come online quicker. Then they, of course, the next day or two you have potential news about banning crude oil exports.

In short, we don't think this is going to happen. I think it's more rhetoric and leverage against OPEC. Then, when you look broader, whether it's crude oil or liquified natural gas, we're exporting both. If you were to do something like that, you're going to violate the sanctity of long-term contracts. We're trying to provide low cost energy to the rest of the world. We're very privileged in this country to have an abundance of energy that we can export. By doing a pretty stark move of potentially banning exports, that's going to present a lot of geopolitical challenges. But this is an example of kind of the back and forth that you're seeing and in today's geopolitical environment.

Alex Pickard:

Great. Thank you, Mark. Thank you all for joining us today. As a reminder, our portfolio managers report and publish weekly podcasts, which are focused on current events, which is within the energy markets. You can find those by searching for TortoiseEcofin Quick Take podcasts, wherever you listen to podcasts. If you do have any other questions, please feel free to reach out to your TortoiseEcofin relationship manager or call 888-870-3088. Thank you.

Mark Marifian:

Thanks Alex. Thanks all.

Disclosures

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