TortoiseEcofin QuickTake Podcast

December 14, 2022

Welcome to the TortoiseEcofin QuickTake podcast. Thank you for joining us as we provide timely updates on the market.

Hello, I am Tortoise Senior Portfolio Manager Rob Thummel, and I am joined by my fellow senior portfolio managers James Mick, Brian Kessens, and Matt Sallee. For this final podcast of the year, we are going to provide an overview of the commodity markets and outlook for 2023, a midstream year in review and outlook, and a view on the broader energy sector and key themes going forward. Let's get started.

Starting with oil, U.S. oil prices started in the 70s at the beginning of the year and are in the 70s at the end of the year as we record this podcast. Kind of a ho-hum type of year, right? I'm just kidding. Oil prices were a tale of two halves with the first half of the year experiencing of rise in prices to over $120 per barrel tied to lack of supply concerns while the second half of the year saw oil prices retreat into the 70s tied to lack of demand concerns. Going into 2023, global oil inventories are the lowest levels in decades. Global oil demand led by China is expected to rise in 2023 while supply could have difficulty keeping up primarily due to declining Russian volumes. What does this mean for oil prices? Our expectation is that U.S. oil prices rise into the 90s during 2023 as the world still relies on oil as its largest source of energy supply.

Shifting to natural gas, U.S. prices started the year below $4 per mcf and approached $10 in the summer before settling in around $7 currently. Natural gas prices in Europe began the year around $25 per mcf spiking to $90 and are currently at $43 per mcf – 6 times higher than in the U.S. What's going to happen in 2023? The U.S. is forecasted to grow natural gas production reaching record levels that should help keep U.S. prices rangebound between $5 - $6 per mcf in 2023. The outlook for Europe is a bit more challenging as Europe looks for alternative sources of natural gas to replace Russian volumes. Europe and Asia are expected to compete for global liquified natural gas so European prices will likely remain at least 6 times higher than in the U.S.

Given that commodity price backdrop, let me turn it over to James to talk midstream.

Thanks Rob.

I am going to cover the midstream year in review, and it was quite a year.

To set the stage, let's review performance for midstream.

The Alerian MLP index was up 27.3% as of December 9th for the year-to-date period.

The Alerian Midstream Energy Index, which is a bit more broad and contains midstream c-corps, was up 20.5% as of the same date.

If we did a word cloud for the year regarding midstream, it would contain topics such as:

- Ukraine
- Energy security
- The Fed
- Inflation
- China zero covid policy
- Free cash flow
- Crude oil and
- Strategic Petroleum Reserve

All of these had an influence on the returns for midstream energy in 2022.

Of course, it started with a surge in commodity prices as a result of the Russian invasion of Ukraine. Purely from an energy standpoint, the offensive led countries to rethink their supply chains in terms of energy, with a focus on energy security, a phrase that has moved into the lexicon of investors and governments alike.

The war in Ukraine exacerbated already stretched supply chains and with rising commodity prices, continued the surge in inflation that began in 2021. The Fed raised rates a few times during the year, with unprecedented 75 basis point hikes being the norm. Whenever that occurred, equity markets, and energy markets as well, traded down. Despite midstream's ability to pass-through most of the inflation costs, it was not immune to these impacts.

Of course, the Fed's desire to squash inflation drove concerns of a potential recession and what that might mean for demand for crude oil specifically and all commodities more broadly.

The other major concern during the year revolved around China and it's zero Covid policy. As it ebbed and flowed in and out of lockdowns, the effects were felt in the crude oil market, as prices have declined quite substantially due to China and recession fears.

All that said, midstream had a great year. Mainly because companies generated exceptionally strong earnings, with multiple positive revisions, set a record for stock buybacks, and generally speaking still sport one of the investment world's best free cash flow yields. An enviable position to be sure.

With that, I'll turn it over to Brian to discuss what to expect in 2023.

Thanks James.

An amazing year we had when you think crude oil supply and demand is as tight as it is, yet crude oil prices are currently at the same level we started the year at. We don't think that's the case in 2023. Supply and demand should further tighten as China relaxes its COVID policy, adding potentially 2 million bpd of demand, Russian barrels struggle to find a home outside of Asia, OPEC+ strives to manage the price modestly higher, and the US refills its Strategic Petroleum Reserve vs drawing like we had for nearly all of 2022. We expect these dynamics to put upward pressure on the price and is part of the reason we'll see US crude oil production increase by 500-600 mbpd next year.

LNG will continue to drive the natural gas market. We believe there will be several final investment decisions for US LNG export projects to move forward, maybe three focused in the first half of 2023 alone, putting the US on track to roughly double LNG export capacity by 2026 to 2027.

In Washington, the energy focus will be a on a permitting reform bill to streamline the ability to build new pipelines and transmission lines to connect energy supplies with areas of demand. Led by Senator Manchin of West Virginia, hard to say when this gets done, yet with the President and modest bipartisan support, there is reason to believe this reform has a real chance to become law.

At the company level, we expect management teams to continue allocating capital in shareholder friendly ways. Now that debt targets are largely met, we expect dividend / distribution growth to be a priority and share buybacks to continue. We believe we'll see a repeat of the midstream share buybacks we saw this year at over $3 billion. Capex will be measured, with investment limited to projects with returns over 20%, short completion timelines under one year, and that are complements to existing assets. We think energy transition projects focused on carbon capture and hydrogen will also accelerate.

We expect total returns of low double digits to mid-teens. That is based on growing free cash flow yields of over 10%, current yields 6% plus growth of 7%, and the fact that many long-haul pipelines are regulated with allowable returns of 10-12%. Further, the PPI escalator of 13% going into effect on July 1 is a nice tailwind. I should also add that despite the strong 2022 performance James discussed, valuations as measured by firm value to EBITDA remain about one standard deviation below historical levels. If we get some multiple expansion due to better recognition of the sector's many merits, that only adds to the upside.

Needless to say, we remain ever excited about the compelling opportunities that energy will bring in 2023.

Matt, any final thoughts on the energy value chain?

I'll cover the energy value chain with 3 key topics.

1) First, energy is the best performing sector by huge margin…no other even close

As of last Friday 12/9, the S&P energy sector is up 55% while the S&P 500 is down 16…over 70% outperformance. As I mentioned, no other sector in the S&P is even close. The next best are utilities which are up 1% reflecting a strong outlook offset by interest rate headwinds. Back to energy, I find it remarkable that this return occurred while the WTI price is basically flat for the year, granted the average during the year was much higher vs 2021. Not surprisingly, energy is the only sector in S&P with meaningful earnings growth. Using 3rd quarter as an example energy earnings were up 140% yr/yr. Earnings growth was expected but numbers came in even better than forecast surprising to the upside by over 10%, a recurring theme all year.

2) My next point is energy delivered on year 3 of the new playbook, capital discipline.

2020 was painful but did lead to a much healthier industry. Companies cut cost and reduced capital investments. This trend has continued since and as demand has recovered, cash flow has grown in a major way and leverage has but cut massively. Now the companies are returning that cash to equity holders through dividends and buybacks with many companies sporting dividend + buyback yields well into the double digits.

3) My final point is 2022 was the year where geopolitics matter again, leading to the conversation of energy security potentially marking the end of the era of low commodity prices.

After trading at an average price of $50 from 2016 through 2020, oil prices finally started to break out to the upside in 2021 and gapped higher in 2022 averaging $95 and natural gas exhibited a similar trend. This is not just a geopolitical premium; the physical market is very tight. Global oil inventory is at the lowest level since 2004, the Department of Energy has released 200 million barrels of oil from the Strategic Petroleum Reserve this year, OPEC continues to struggle to produce at their stated quota and US producers are helping but can only do so much. Also, the flow of energy is shifting globally with the US becoming the supplier of choice to world. This is best seen in the gas market where US LNG exporter have signed about 8 bcf/d of new contracts in 2022 alone. For context this is nearly 10% of US production and would nearly double US exports over the next several years.

Thanks for listening. Happy Holidays.

Thank you for joining us. And stay tuned for our next episode. Have topics you want covered or other feedback to share? Write us at info@tortoiseecofin.com.

The **Alerian Midstream Energy Index®** is a broad-based composite of North American energy infrastructure. The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMNA) and on a total-return basis (AMNAX).

The **Alerian MLP Index** is the leading gauge of energy infrastructure master limited partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

Liquefied Natural Gas (**LNG**) is natural gas that has been cooled to a liquid state for shipping and storage - the volume in this state is about 600 times smaller than in it's gaseous state, able to transport for much longer distances when pipeline transport is not feasible.

Producer Price Index (**PPI**) measures average change over time in the selling prices received by domestic producers for their output.

The **S&P 500® Index** is an unmanaged, market-value weighted index of stocks that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

The **S&P Energy Select Sector Index** is a modified market capitalization-based index of S&P 500 companies in the energy sector that develop and produce crude oil and natural gas and provide drilling and other energy related services. Returns include reinvested dividends.

West Texas Intermediate (**WTI**) is light, sweet crude oil commonly referred to as "oil" in the Western world. West Texas Intermediate is the underlying commodity of the New York Mercantile Exchange's oil futures contracts.

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