Tortoise

Top questions from investors during the volatile market environment

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Why did the most recent oil price decline, with negative prices for the first time in history, occur and what does it mean for the market?

The crude oil market includes a combination of both physical and financial buyers of crude oil. Financial buyers of crude oil invest in contracts that require them to take delivery of crude oil at a specific location on a specific date. Generally, financial buyers don't have the ability to take delivery of oil because they don't have access to oil storage. Financial crude oil buyers will close out current month contracts near expiration by selling the contract in the market. Normally, this occurs without any challenges. However, the temporarily oversupplied oil market is causing oil storage levels to reach capacity. The current contract month expires today. So, financial buyers that were left with contracts must take delivery of the oil volumes specified in the contract if they still hold the contract at the end of the day today. As a result, financial buyers had no other choice than to sell their contracts to avoid becoming a physical buyer. The lack of available crude oil storage reduced the number of buyers. The situation caused by an abundance of contract sellers and a limited pool of buyers resulted in a rapid decline in the price of current month oil.

We continue to expect weakness in near term oil prices as we have too much supply relative to the demand destruction associated with the "stay in place" policies. Globally, a significant amount of crude oil will be curtailed, in addition to the 9.7 million barrels per day that OPEC+ agreed to take out of the market, until "stay in place" policies are removed and crude oil demand improves. As a precedent, we have seen Chinese crude oil demand bounce back quickly with indications that it is exceeding levels seen a year ago as people forgo mass transportation and prefer driving to maintain more "social distance".

Does this downturn mark the end of the shale revolution in the United States?

The demand destruction from COVID-19 does not end the shale revolution in the U.S. When crude oil demand improves, production will increase over time as well. Shale wells are relatively short-cycle compared to other oil production. We expect that some of the global curtailed production will not to return to the market, and it will be short cycle projects, like U.S. shale that will make up the difference. Further, lower crude oil production results in less associated natural gas production. Shale gas producers are likely to materially benefit, particularly those with the lowest cost operations in the Marcellus. In fact, the natural gas price forward curve is higher by about $0.50/mmbtu across the curve, with spot prices approaching $2/mmbtu.

Are pipeline carriers under contracts that require producers to continue production even when prices of natural gas and oil are below break-even and how does this impact the pipelines?

This depends on the type of contract the midstream operators and producers have. Generally, all midstream contracts are fixed fees contracts, however, only about two thirds of those contracts guarantee a midstream operator revenue regardless of the producer volumes flow on the pipeline. This is more commonly known as a take or pay contract. Midstream pipelines typically sign these take or pay contracts with investment-grade counterparties, where there is a line of sight to future production volumes. The remaining contracts for midstream operators are volume dependent. These contracts tend to be shorter in nature and can see cash flows fluctuate depending on the throughput for the pipeline. In basins where there is excess capacity it is likely that midstream operators will lower tariffs as a way to retain volumes on their pipeline systems.

Have production efficiency improvements better-positioned producers for lower commodity prices?

Producer balance sheets and hedge books are in a better position than they were in the 2015-2016 downturn. Approximately 50% of production is hedged through 2020, which should help ease volume declines at least in the first half of 2020. That said, it is difficult for any producer worldwide to generate profits at these low current prices. We are seeing U.S. producers take significant steps to retain cash and protect their balance sheets. Over the last month, exploration & production companies have on average cut their capex approximately 30-50%. Another sign of this is through the rig count, which has fallen by more than 1/3 over the past month or so.

Should we expect an uptick in consolidation in the business going forward?

We believe consolidation is likely to occur as volatility subsides. Majors and large independents that are strong financially should be in a position to add some distressed assets.

What is your outlook for oil prices by the end of the year, assuming economic recovery leads to positive GDP by the end of the year?

It is very difficult to prognosticate where the new equilibrium price of oil will be until we understand the fallout from COVID-19 and get the global economy back up and running. That said, our portfolio team looked at a couple of different scenarios. In a rapid recovery, where OPEC+ production cuts are adhered to and G20 production is limited by economics, we could have low prices at or below $30 for 2020 but then averaging $40+ and $60+ in 2021 and 2022. In a delayed recovery, where OPEC+ is not adhering to production cuts and global inventories take longer to fall to historical levels, WTI prices could be at or below $30 for 2020 and average $30 or $40 in 2021 and 2022. Regardless of the scenario, higher crude oil prices are required in the future, which should benefit short-cycle shale.

Will contracts be enforced if storage reaches capacity and there's no movement through pipelines?

It is important to distinguish between crude oil and gasoline (liquids) storage and natural gas (gas) storage. There will be a time horizon over the next couple of months where we see liquids storage filling for both crude oil and refined product (gas & aviation fuel). This is a direct result of the demand destruction from the "stay in place" policies around the country and around the world. As those orders eventually lift, we should see demand rebound quickly and the system should normalize again if even at some lower volume of throughput. For natural gas, there has not been comparable demand destruction. The market may have lost a bit of industrial demand, but with people sheltering in place, households have continued to utilize natural gas for heating and cooking and electrical demand has been fairly stable as well.

It's worth mentioning that all pipelines are not the same and have differing fundamentals and catalysts. A good resource for more information on this is our stress test podcast transcript which digs further into our expectations of the impact on these different types of companies. In terms of contracts holding up if there is no movement through the pipeline, we don't see this being an issue for the natural gas pipelines. On the liquids side, there is unlikely to be a time that no product is flowing. Gasoline demand is down ~30% currently, not down 100%. So, refiners continue to need crude oil and gas stations continue to need gasoline. This is why it is important for producers to have contracted capacity so they are able to continue to move their products.

Not being able to move product through a pipeline for a period of time actually does happen to pipelines occasionally. For example, when a backhoe accidently cuts a pipeline, it is unable to ship for a period of time and then, as the pipeline comes back online, the contracts pick-up where they left off or are sometimes automatically extended. The current situation is certainly bigger than a single asset being hit by a construction worker, but the idea is basically the same. The Force Majeure clauses are generally in the contract for the benefit of the pipeline, not the shipper.

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Lastly, it's important to note the risks to pipelines if a producer declares bankruptcy. Unfortunately, the industry has faced producer bankruptcies in the past. Generally, bankruptcy court maximizes value for stakeholders by continuing to produce the commodity, not liquidate the assets. As such, the midstream is generally deemed an essential provider to the bankrupt company and any contracts are affirmed by the court. There are usually property rights and other protections built in contracts as well, but it is usually plain old economics that are most important.

What's the investment case for midstream?

The essential nature of energy infrastructure is very critical. The U.S. owns and operates the largest energy infrastructure network in the world. And midstream companies own and operate those assets – 75,000 miles of crude oil pipeline, 300,000 miles of natural gas pipeline. As the economy starts to rebuild, these assets will be even more critical to get energy from the places where it's produced to where it's ultimately consumed.

The selloff has created an opportunity and stock selection is extremely important in this scenario. There have been several distribution cuts from certain securities, but there are also several that haven't, and likely won't, cut their dividend. Those are the high quality, diversified, midstream companies that came into this crisis with a high coverage ratio of their dividends. Because of that, they can allow for cash flows to decline a little bit and still generate sufficient cash flow to continue to pay the dividends. Those high quality names also came into this crisis at sufficiently lower leverage than they've had historically. As we move back to a degree of normalcy, the cash flows of these companies will increase. Management teams are lowering their capital expenditures as a result of the decrease in production that's expected over the next few years. Therefore, they're going to generate more free cash flow that they'll be able to utilize in the future to reduce debt, buy back shares, or grow distributions.

We think cash flow and cash flow growth of the sector will bring investors back to this asset class. In addition, we believe that investors will clearly see the essential nature of these assets, the resiliency of the business models and the free cash flow yields that are higher than many other sectors of the market.