Tortoise QuickTake Energy Podcast

March 15, 2018

Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provides a timely update on trending topics in the market.

Brian Sulley: Beware the Ides of March was the ominous warning given by a fortuneteller in Shakespeare's Julius Caesar to the dictator of the Roman Empire. On the Ides of March in 2018, it had a bit of a different outcome than it did in 44 BC, but when FERC issued their ruling today regarding the income tax allowance cost recovery for MLP pipelines, it did have a negative effect on the market. So we want to talk a little bit today about what that was, why it happened and what we can expect to happen coming out of this ruling. So thanks for joining us here on this special edition of the Tortoise QuickTake podcast. I'm Brian Sulley, a client portfolio manager here at Tortoise. And with me is Matt Sallee, a senior managing director and portfolio manager here at Tortoise as well. So Matt, just to kick things off here, can you give us a little bit of the background of this case and what exactly did happen with FERC's ruling this morning.

Matt Sallee: Sure. So FERC is acting to address an issue that believe it or not runs back to 1995 and the issue is whether not MLPs are allowed to include in their allowed returns on equity and income tax allowance given that they're passthroughs. And historically, the view has been that yes they are allowed to because ultimately the unit holders that own these MLPs are indeed taxpayers.

Brian Sulley: So looking at MLPs, the question we're hearing a lot right off the bat is how many of these MLPs will be impacted by this decision and overall what can we expect the space to experience coming out of this ruling.

Matt Sallee: So I'd say (well this will sound bad) lots of pipelines are impacted. However, the offsetting factor is you have to ask yourself what is the materiality of that impact. And the bottom line is that the impact gets diluted down pretty quickly. So I think the way we've gone through this today, looking at the portfolio and refreshing our numbers is who's impacted in a material way. And what we're coming up with is about five names will be directly impacted by this specific issue in a meaningful way, and we're defining that as north of 5%. However, if you think about it, those names in pretty much every case we see offsetting or mitigating factors. As an example, maybe they're under-earning on pipelines currently that are held in an MLP so even if you take away the tax allowance you know they don't necessarily need to reduce rates because they're not earning as much as they're allowed to per the Federal Energy Regulatory Commission anyway. There's other mitigating factors I'll touch on later on as we continue in the discussion so I'll leave it at that for now, but I would also note that as I was walking in here, I believe if I'd gotten the latest count, seven MLPs have already issued press releases stating that they do not foresee a material negative impact from today's news. Those companies represent a pretty meaningful percentage of our midstream portfolios, and it would include (I should point out) our two largest MLP holdings, Enterprise Products and Magellan Midstream.

Brian Sulley: So to take that and then maybe get even a little more specific and put a number directionally to some of those comments, is there a way that we can understand the percent of revenues that are subject to regulated rates or maybe even overall, what percent of revenues for companies will be impacted? And maybe to tie into that additionally, is there a way we should think about what percent of the overall pipeline space falls under FERC regulation or what's the breakdown of pipeline types between cost of service, negotiated rates, market rates, etc.?

Matt Sallee: Sure, that is unfortunately a complicated question and there's lots of different ways to define names and there's not perfect information around on any given asset what is the mix of contracts, but I think we have probably about as good of information as anybody on this. At a high-level, the space as we define it is around 67% (or just round up 70%) long-haul pipelines, and then the balance of the space are either gathering and processing names or propane or shipping, other names like that, that are not regulated by FERC or exposed to this particular issue. When you look at the 67% that are long-haul pipelines, about only 25% of those are natural gas pipelines, where we see this issue as most acute. And the reason I say that is FERC just traditionally in its rulemaking has been much more hands-on with the natural gas pipelines compared to crude oil and refined product pipelines, and from speaking to policy experts that were actually in the room today when this ruling came out, that's the take that they are hearing as well, so traditionally that's been the case and they would expect a more hands-off approach on the liquid side. Not to say that they won't be impacted, but I think most specific on the natural gas pipelines. Stepping down from there, within pipelines, what's impacted is, at a high level, three different types of contracts to think about. The one that is impacted here are cost of service, long-haul pipelines. And I've got this question several times today… what the heck is a cost of service structure? Explained simply, that is basically like the traditional utility type of rate-making framework where a pipeline is allowed to earn a maximum return on equity. So if you think about an asset, just simplistically, if you have $100 worth of plant in the ground or pipeline value and you're allowed to earn a 10% ROE, then you would be allowed $10 of earnings on that asset. Obviously, those are made up numbers and round numbers, but that's how to think about that particular type of framework. There's a lot more nuance around it, but I don't want to put everybody to sleep. Also beyond that framework, there are either market-based rates or negotiated rates. And the thing to point out about negotiated rates is that's really been kind of the standard for all new pipelines; that structure has been for pretty much all pipelines that have been built within the last 10 years and keep in mind, I like to generalize, but that is typically the case that is used. And the reason is, what a negotiated rate is, is basically I'm Matt the pipeline builder, Brian's the E&P, you want to have capacity out of a basin, I don't want to build a pipeline without a contract, so you and I figure out what is the right rate is for that pipeline. That is not impacted here. Also, as I said market-based rates are not impacted. And that's just where FERC has determined that there is at least some level of competition so there's not a limitation to what they're allowed to earn per the federal energy regulatory commission. It's more dictated by the market. Bottom line, this is an issue that you know, this isn't the first time we've ever heard of this risk. We've followed it for some time and actually have models built out where we can assess the impact. As you might imagine, we freshened that up this morning when the news came out, and the bottom line when you look at the midstream portfolios that we're running, the weighted average cash flow impact is 2% or less. And that 2% is based on current EBITDA so it does not account for the fact that… that number will get smaller in other words as new assets come into service or companies make acquisitions, volumes grow, those sorts of things.

Brian Sulley: So now that we got a number put to it, we can at least conceptualize a little bit of the impact this could have on other pipeline companies, let's think about the risks involved. Do you think this could lead to distribution cuts or do you think that this impairs access to capital in any meaningful way?

Matt Sallee: Well, so going back to the 2% weighted average portfolio impact, we don't believe or foresee a material negative issue (or widespread distribution cuts I think is an easy way to talk about it) by any stretch, given this specific issue. Now that said, theoretically for a company if it's already tight on coverage, or its leverage is high and they're under pressure from rating agencies, even a 5% to 10% cash flow hit could lead management to reduce a payout. And the reason I use 5% to 10% is for the five companies that I mentioned before where we do see a material impact, that's kind of the range we started it we're defining material at 5%. We don't really see anybody with a more than 10% impact, so that's kind of the bookend of companies either have no impact, or on the top-end, there was one company where we saw a 10% impact. Looking through our specific portfolio, we don't forecast, based off running this through the models this morning again, anybody going below 1x specifically tied to this issue. There is one name that gets close, but it's already trading north of a 10% yield, and just for context it's a pretty small weight in the portfolio so not something that at a portfolio level we're very concerned about at all.

Brian Sulley: So shifting away from income statements and the companies that constitute our portfolios, of course a lot of the focus is on market reaction today. Do you think that the market is panic selling and maybe not taking into account things like future capex, accretive projects?

Matt Sallee: Well I'll tell you, if somebody sneezes in the MLP market recently has been panic selling, and I shaved my beard last night so I don't know if that was the issue, but I'd say there's definitely some panic selling in the market. It did start to come back quite a bit towards the end of the day. I think at one point we were down 10% or so. Finished down, call it 4%... and the market really started to come back after Enterprise and Magellan and those other companies issued press releases stating that it will not be a material impact to them. So you know when you think about it, I think the market is a little overdone today for sure. I'm kind of going back to noting that 2% that I mentioned. And then also again, to put that 2% in context, that's on current EBITDA. It doesn't include a lot of new projects that are coming in (volume ramps from crude oil production growth and demand growth on the natural gas and NGL side. And if you think about it, there's some other mitigating factors you have to think about when you're thinking about that 2% and the market activity today. A lot of these companies are either E&P or otherwise refinery-sponsored, and the parent is the largest customer in a lot of these cases (and those are negotiated rates). So it's not as if the parent company sponsor that has a tremendous economic interest in these companies succeeding is going to force them to reduce rates tied to this issue. So I think when you take a step back, it's a small part of the space that is actually impacted and then even of those, lots of them have these pretty significant mitigating factors. Another one to think about is lots of MLPs in the portfolio have drop-down inventories that are multiples of what current EBITDA is. So yeah, the market action today wasn't much fun to think about or fun to watch and be a part of, but I think you kind of have to put it into context and take a step back.

Brian Sulley: So given the focus of this ruling on MLPs, of course it makes sense that our focus today is on MLPs, but taking a step back and talking about the midstream space as a whole. Do you think that this could make C-corps more attractive than MLPs? I know this was a question that bounced around a little bit as the tax bill was being floated in December, but is that more so the case now?

Matt Sallee: You know, we like to talk to clients about midstream and pipelines more so rather than C-corp versus MLP, but specifically we do get the question a lot, and I would say marginally, yes. When you think about it, most C-corp pipelines or at least the ones that we own don't have a cash tax drag, and that's largely due to depreciation shielding their income. So they are not even cash taxpayers but they will still get to charge this income tax allowance. So, if I'm thinking about it correctly it is probably a marginal benefit to C-corps over MLPS. Again, tied to this specific issue for certain companies. I would say overall it's still better to have no entity level tax then to have a tax liability, whether current or future. So I'd say, overall still better to be an MLP, the price shifted slightly towards C-corp today. And I wouldn't tell you that if there's a certain name that hasn't been trading so well anyway, I am speaking hypothetically, not thinking of a particular name, but if there's a name that hasn't been trading real well and then you know they get hit a little disproportionately relative to the space on this particular impact, I mean I would think that a management team, I believe it is their fiduciary duty to consider whether they need to think about doing something structurally, so you know we'll see what comes of that, I'm certainly not forecasting widespread conversion to C-corps again given kind of the materiality of the cash flow that we've already talked about, but you know there might be one or two names that make a change based off this.

Brian Sulley: Alright thinks, and then finally, changing our focus to looking forward. Given that valuations in the sector were already fairly low with this sell-off, do you think that this could present a bit of a buying opportunity?

Matt Sallee: Geez. I said this on my podcast, I don't remember which one, it is been somewhat recently but, full disclosure my four kids college funds totally depend on MLPs working so, I'm kind of biased. I guess you know, factually I would reiterate that we believe the cash flow, the portfolio cash flow impact is 2%, market was down 4%, so yeah I believe the market just got a little cheaper. And on top of that you know I always like to ask myself, our CEO is Kevin Birzer, and I have this little bracelet and it says WWKD, What would Kevin Do. So what would he do, he would remind on top of 25% discounted valuations, on top of that, underlying cash flows are still extremely strong, the fundamentals are strong, volumes are growing, cash flow on a per unit basis in the portfolios has been growing about 10% per year basically since the downturn started work. We're expecting similar growth in cash flows this year and next, so the space does remain discounted. It got a little cheaper today, some of which was justified but the fundamentals, following the cash flow, in the long term has paid off for us.

Brian Sulley: Alright well thank you Matt and thanks everyone for joining us today. On a day where MLP owners were probably feeling a little bit like that that famous Shakespeare character and saying "Et tu, FERC?" at least were left here with the silver lining that the impact may not be commiserate with the with the selloff today and certainly could be an opportunity looking forward. Again, thanks for joining us on this Tortoise special edition QuickTake podcast. We forward to speaking with all of you during are regular scheduled time next week.

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