

Tortoise QuickTake Podcast

October 17, 2016

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.

Thanks for joining us today on the Tortoise Quick Take Podcast. I'm James Mick, Managing Director and Portfolio Manager with Tortoise Capital Advisors.

Mark Twain once said, "Whenever you find yourself on the side of the majority, it is time to pause and reflect."

Such is often the case in investing when something seems so pre-determined that virtually everyone is stating it as fact. For example, inflation is MIA, crude oil will never hit \$100 again, natural gas will never go over \$5, OPEC never sticks to quotas and on and on. It's often at these exact times that a team has to dive in and determine not necessarily exactly what will happen, but what is the probability that something else actually happens and what are the ramifications if it does. Never easy, but then again, it wouldn't be fun if it were easy!

We'll circle back to a few of these thoughts later, but for the moment, let's discuss performance this past week:

- On the commodity front, crude oil was up just over 1%, primarily on Russian commentary about participating with OPEC in a potential freeze, while
- Natural gas was strong, up 2.9% for the week on yet another bullish storage report
- Shifting to equities, the broader S&P Energy Select Sector Index[®] finished lower, falling 1.1%
- Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers IndexSM, struggled as well, down 1.0%
- And finally MLPs were marginally higher, as the Tortoise MLP Index[®] finished up 58 bps

A few quick headlines to touch on first:

- Earnings season kicks off this week with midstream giant Kinder Morgan reporting on Wednesday as well as late week earnings from oil field service heavyweights Haliburton and Schlumberger
 - More broadly, we will be watching for data from both upstream and midstream companies regarding capex spending for 2017 as we enter budget season
- One of the largest natural gas producers, Chesapeake Energy, has its annual analyst day on Thursday, October 20th
- The upstream sector saw its first IPO this year with the successful launch of Extraction Oil and Gas
 - The success of the IPO may set off a wave of additional offerings according to several banks
- RSP Permian, an upstream producer in the Permian Basin, announced the largest acquisition of the week as it will acquire Silver Hill Energy Partners for \$2.5 billion, coming in the form of stock and cash
 - RSP has an enviable position in the Permian already and this simply further solidifies it with another 41,000 net acres, primarily in Loving and Winkler counties
- The U.S. rig count was up 15 last week, including 4 oil directed rigs and 11 natural gas directed rigs

As we circle back to the opening, I wanted to touch on two ideas: spare capacity and crude oil scenarios.

When market participants speak of spare capacity, usually in reference to OPEC or a specific country, the concept is often misunderstood. It is NOT the ultimate capacity that a country or group can produce over time or at their peak, but rather, as the EIA defines it, the volume of production that can be brought online within 30 days and sustained for at least 90 days. This

paints a different picture than many suspect, because oftentimes lost production may take a significant amount of time to bring back online, which would not put it within the definition of true spare capacity in our view, at least as defined by the EIA.

Not to delve too deeply into everything supply and demand, but I thought it might be interesting to just address what are some of the things that could go well for crude oil prices and what are some things that could go poorly for prices.

In that spirit, here's a list of items that we think may prove bullish for crude prices:

- **What if some of the numbers being reported out of OPEC countries are simply a drain of existing storage?**
 - Reports from a select few energy consultants have crude oil floating storage almost completely drained at this point after a surge to almost 80 million barrels
 - Iran in particular built up quite a supply of floating storage during their years of sanctions and while it is hard to get any concrete data, it's possible they have drained a good portion of that excess
- **What if some OPEC countries have been producing at levels that are simply not sustainable for a longer period of time in fear that a freeze agreement might be reached and they wanted the highest possible rate associated with that freeze deal to allow flexibility?**
 - It has been noted that Iraq is at odds with other members of OPEC in terms of what reporting mechanism, either independent or country led, would be utilized in a freeze/cut scenario as the two numbers can differ substantially
- **What happens when the multiple years of underinvestment lead to real issues with supply across the world and it takes prices much higher than this to bring back investment dollars, yet it simply can't come on fast enough?**
 - One of the quotes oil and gas engineers often use is "the decline curve always wins," i.e. a well's production will go down and if you don't drill another well, overall production has to decline eventually as the decline curve wins

To be fair, let's take the other side as well and discuss some things that we think could impact prices negatively:

- **What if U.S. production remains resilient due to continued technological improvements that lower the break-even price even more?**
 - There could be a cap on crude for some time and not allow it to rise above the U.S. marginal cost
- **What if Russia continues to pump record levels of crude oil?**
 - Russia has actually been helped by the depreciation of their currency, which has been similar to the fall in the price of oil
- **What if OPEC decides to truly push out all high cost producers in a prolonged market share war?**
 - Interestingly this would likely cause a fracture within the organization as the Gulf countries are in a far different place financially than the non-Gulf countries, yet it's not out of the realm of possibility

The point of all those items is that each is potentially very realistic or is already happening to some extent.

And yet the market remains generally in one camp.

It's complicated, but that doesn't make it any less interesting or fun to discuss and debate, especially when everyone seems to believe only one side of the story.

What if they are wrong? What are the ramifications and what are the investment implications? That's what we spend every day thinking about here at Tortoise.

That will do it for today. Have a great week and we look forward to speaking with you 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

The S&P Energy Select Sector® Index

The S&P Energy Select Sector Index is a capitalization-weighted index of S&P® 500 Index companies in the energy sector involved in the development or production of energy products.

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The Tortoise North American Oil & Gas Producers IndexSM is a float-adjusted, capitalization weighted index of North American energy companies primarily engaged in the production of crude oil, condensate, natural gas or natural gas liquids (NGLs). The index includes exploration and production companies structured as corporations, limited liability companies and master limited partnerships but excludes United States royalty trusts.

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