Tortoise QuickTake Energy Podcast

June 18, 2018

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

Hello. I am Tortoise Managing Director and Portfolio Manager Rob Thummel with this week's Tortoise QuickTake podcast.

Last week started out promising with the anticipation of the historic handshake that ultimately took place in Singapore on Tuesday. However, the euphoria from this historical event evaporated quickly as tweets and tariffs weighed on the market.

For the week, the S&P 500 index was flat. The energy sector as represented by the S&P Energy Select Sector® Index fell by 3% while MLPs dropped by 2.5%. Broadly, the energy sector felt the impact of a 1% decline in oil prices last week.

When it comes to trade, you probably saw China's retaliation to U.S. tariffs announced last Friday. In case you missed it, China announced 25% tariffs on 659 U.S. goods. Tariffs on 545 goods worth $34 billion go into effect on July 6th. No effective date was designated on the remaining 114 U.S. goods that includes crude oil and natural gas.

Despite this announcement, we believe that the U.S. energy sector is well positioned to be a positive contributor towards improving the trade deficit through higher energy exports. According to the U.S. census, energy related exports are one of the fastest growing areas up 47% in the last year.

Related to oil prices, traders are positioning in advance of the 174th OPEC meeting in Vienna on June 22. With global oil inventories at three year lows and OPEC compliance exceeding expectations, the key question is whether or not OPEC will increase production. If I had a vote which I obviously don't, I would recommend a small increase in production. Why? Currently, in my opinion, the global oil market is potentially vulnerable to an oil price spike. A small increase in production from Saudi Arabia and Russia allows OPEC to maintain one of its key tenets – stable oil prices. We believe that OPEC will act like a central bank going forward raising and lowering production as necessary with an objective of keeping global oil inventories at normal, 5-year levels. We think this discipline keeps oil prices in a tighter band offering welcomed relief for investors in the energy sector.

Believe it or not, there are other things going on in the energy sector besides OPEC. A complex quandary is currently happening in the Permian Basin. What am I talking about? Basis-differentials. In the energy sector, a basis-differential represents the difference in prices between locations. For example, the price received by a producer for a barrel of oil sold in Cushing, OK, the WTI benchmark, is approximately $65. The price paid to sell that same barrel of oil in Midland Texas in the heart of the Permian Basin is $56. So, the differential between these two pricing points is approximately $9 per barrel. For perspective, the average Permian Basin differential was 37 cents in the first quarter of 2018 according to Bloomberg. The average differential for the second quarter is almost $8 dollars while the current differential is over $9 per barrel.

Why is the differential widening? We believe there is simply not enough infrastructure to transport the increasing supply of oil being produced by Permian Basin producers. The differential expands until more expensive forms of transportation such as trucks and railroads rather than pipelines are used to transport oil away from the Permian.

How long will the differential last? It's likely to last until new pipeline infrastructure becomes operational in our view. In this case, the differential likely persists for at least 18 months until two large oil pipelines operated by EPIC and Plains All American become operational in the late 2019.

Will the differential get worse? Yes, we think the differential widens out especially during the first half of 2019. Permian Basin production is slated to grow. In our opinion, railroads are not an option to transport crude oil as most railroads are fully contracted transporting sand into the Permian Basin for the fracking process. Trucks need truck drivers and there is a labor shortage in the Permian Basin making trucking oil a less viable option as well.

So, what happens next? We believe it is likely that Permian Basin oil production growth likely slows allowing the infrastructure specifically pipelines to catch-up. It's possible that 2019 Permian Basin production growth could be 300,000 - 400,000 barrels per day lower than current forecasts. This is temporary and we still believe that the Permian Basin will be the key driver of U.S. production growth for decades. Are there winners and losers? Yes, we think the clear winners are refiners that are able to buy crude oil at discounted prices in Midland. These refiners experience expanded margins resulting in higher EBITDA and earnings. Energy infrastructure companies that own existing infrastructure can benefit from rising basis differentials as well. The losers in our opinion are Permian producers that have not committed production volumes to pipelines. These producers receive a discount to WTI oil prices. This discount is expected to get even larger. These producers are the ones that likely reduce capital spending and temporarily slow production growth.

Lastly, one additional big picture energy issue to discuss this week is IMO 2020. What is it? The International Maritime Organization has issued a regulation that requires a reduction in marine fuel sulphur by 2020. This regulation is expected to significantly reduce greenhouse gas emissions. Approximately 3 million barrels per day of high sulphur fuel oil will be displaced by low sulfur fuel oil as a result of this regulation. In our view, the U.S. energy sector specifically refiners and energy infrastructure stand to benefit from this regulation. Given the increased demand, low sulfur fuel oil prices are forecasted to rise benefiting U.S. refiners. In addition, U.S. refiners have the ability to increase production to meet growing demand for low sulfur fuel oil as well. Additional energy infrastructure will be necessary to store and transport this product as well. We believe companies outside of the U.S. will be the most negatively impacted by this regulation since most high sulfur fuel oil is currently refined in Latin America and Russia.

Those are the highlights from last week. Thanks for listening. We will talk to 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.

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