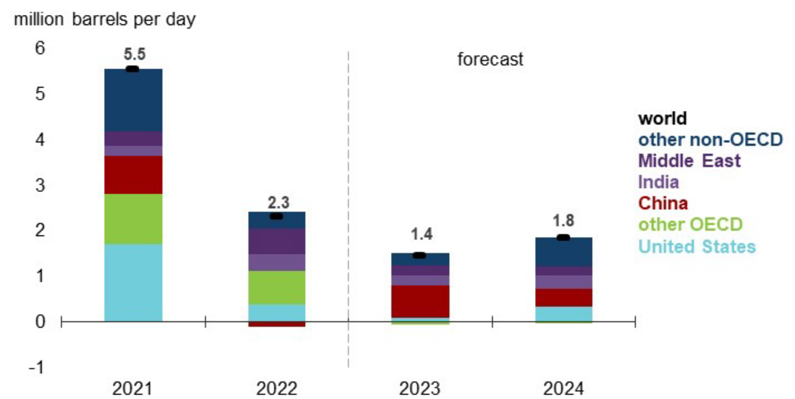
Energy infrastructure

1Q 2023 QUARTERLY COMMENTARY

The broad energy sector, as represented by the S&P Energy Select Sector® Index returned -4.37% for the first quarter. The first quarter saw the energy sector pressured by lower prices in both crude oil (-4.1%) and natural gas (-58.2%) on recession concerns and warmer-than-expected winter weather. On the contrary, long-term supply concerns remain as 2022 was the eighth consecutive year of underinvestment in oil and gas. The opportunity for North American energy infrastructure remains as the U.S. energy industry focuses on maximizing shareholder returns. Global underinvestment resulting from environmental, social and governance (ESG) commitments and energy transition is likely to keep global stock balances extremely tight for the foreseeable future.

The global energy markets remain dynamic to start 2023. Most notable was the Organization of the Petroleum Exporting Countries+ (OPEC+) cutting production by 1.6 million barrels per day (mm b/d) and tightening the market at the end of the quarter as short-term demand concerns remain. This is the second production cut from OPEC+ following the 2mm b/d production cut in early October. We believe OPEC+ is sending a clear message to the market that they are focusing on profits over market share. This is a marked change from past messaging and is aligned with U.S. shale prioritizing profits over market share. On the demand side, U.S. inventories started drawing again in March and are well below their 5-year averages going into the summer driving months. Global demand did see a boost from China, as the country re-opens from COVID lockdowns ahead of market expectations. In the physical markets, volumes continue to steadily grow. In their March report, the Energy Information Agency (EIA) forecasts U.S. oil production at approximately 12.6 mm b/d and U.S. natural gas supply at record high of 110 billion cubic feet per day (bcf/d). For 2023, the (EIA) forecasts that U.S. production will increase 0.4 mm b/d to 12.7 mm b/d, up from 12.3 mm b/d at the end of 2022.

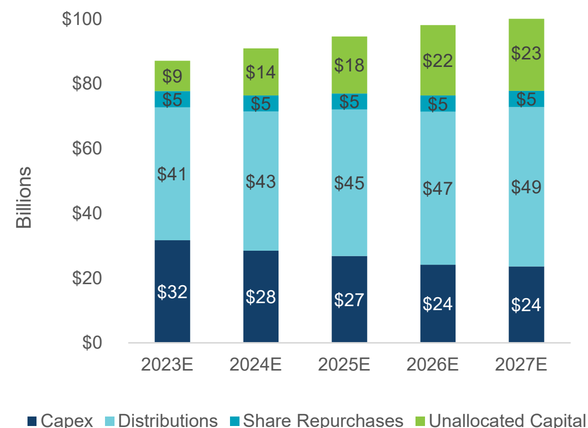
Annual change in world liquid fuels consumption



Source: EIA, IEA, UBS, JP Morgan

Midstream's strong fundamentals, attractive valuations, defensive characteristics in a higher interest rate and inflationary environment and improved free cash flow should support outperformance on a relative basis. With lower commodity prices during the quarter, midstream was defensive, outperforming other energy subsectors. The banking crisis in March provides another opportunity to highlight the resiliency of the asset class. Energy infrastructure credit facilities were and remain largely undrawn with an average utilization of 10%. With significant free cash flow today and expectations for free cash flow in future years, we believe there is limited need for credit facilities and access to capital markets.

Midstream cash from operations disposition



Source: Bloomberg, TCA, UBS, Goldman Sachs, Morgan Stanley, Wells Fargo. Reflects TCA views and opinions as of date herein which are subject to change at any time based on market and other conditions.

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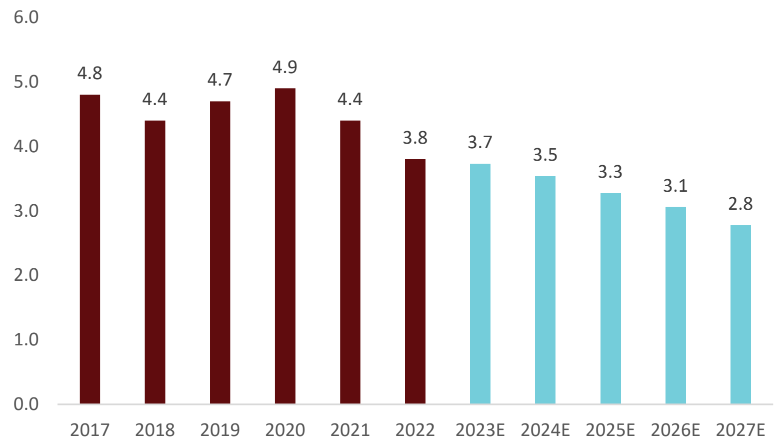
The balanced return of capital story continued for investors via debt reduction, share buybacks and increased distributions. Debt paydown across the sector continues to be paramount led by Enterprise Product Partners (EPD) which lowered its targeted leverage to 3.0x. During the quarter, S&P upgraded EPD's credit rating to A-. This is the first time we recall a midstream company with A rated debt! Western Midstream and Cheniere Energy are other midstream companies which saw improvement in their debt ratings during the first quarter. Distribution growth continued in Q1 2023 as companies targeted a return to pre-COVID levels and midstream companies ended 2022 with a total of $4.8 billion in stock repurchased.

Midstream leverage



Source: Company filings, TCA estimates, Bloomberg, WF

The other use of capital was for mergers and acquisitions (M&A). During the quarter, Energy Transfer announced the acquisition of privately owned Lotus Midstream. Management expects this transaction to deliver immediate accretion to free cash flow per unit driven by significant overlap of existing assets. Importantly, this theme allows operators to control energy volumes across more of their value chain and helps existing midstream companies improve the competitive advantage around their businesses.

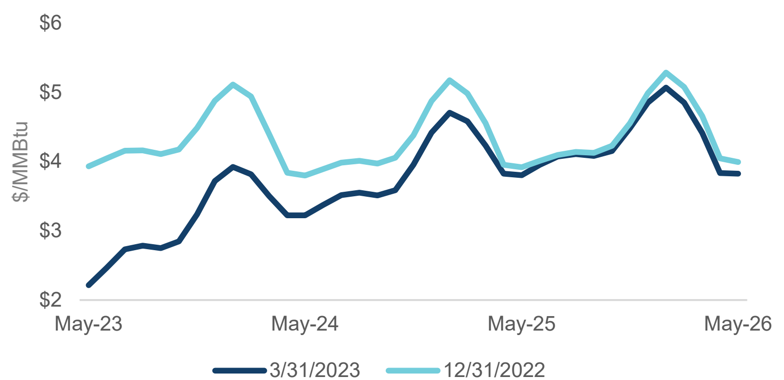
Another continuing theme for energy infrastructure companies is the focus on export related infrastructure. With energy security a higher priority and concern around natural gas inventories, Europe is increasingly importing U.S. liquefied natural gas (LNG). Throughout 2022, LNG exporters contracted almost 6 Bcf/d of new contracts, signing 15 to 25-year contracts with European and Asian counterparties. The first quarter saw two Final Investment Decisions (FIDs) proceed to construction at Sempra's Port Arthur LNG project and Venture Global's Plaquemines LNG project. The U.S. remains on track to roughly double LNG export capacity by end of the decade.

Cheniere Energy Sabine Pass Project

Despite all the positives, risks to our outlook remain. Sticking with the natural gas market, in 2023, we expect a more mixed setup for natural gas, as supply outpaces demand. Unseasonably warm winter globally lessened the gas demand for Europe and North America. One short-term positive is the restart of Freeport LNG, offline since the second half of 2022. While natural gas supply remains abundant in the short-term, we expect consistent demand pull for natural gas as LNG facilities come online in the back half of the decade.

Energy infrastructure mega-projects, while few, continue to face legislative and cost hurdles. The much-discussed Mountain Valley Pipeline continues to face legal challenges in the 4th circuit court. While 90% complete, we do not believe the pipeline will go into service until 2024 at the earliest. TransCanada's Costal Gas Link, located on the west coast of Canada, is also facing delays due to cost overruns, which TRP announced would increase 30% during the first quarter. These examples highlight the importance of infrastructure already in the ground.

Henry Hub Curve



As of 3/31/2023. SSource: Bloomberg, Platts, Baker Hughes, TCA

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Recession concerns weighed on investor psyche highlighted by the banking crisis in March. The world remains undersupplied in energy, and we believe sector balance sheets are in much better shape than in past recessions including 2001, 2008 and 2020. One final offset to a potential recession is pipelines which typically have long-term contracts with inflation protection from regulated tariff escalators. Federal Energy Regulatory Commission (FERC) indexing could be a material driver of liquid pipeline cash flows with rates potentially increasing double digits this summer on top of an 8.7% increase that went into effect July 1, 2022.

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