Tortoise

MLP and Energy Infrastructure Market

March 9, 2020 Commentary

At the March 5th OPEC meeting, OPEC, led by Saudi Arabia, recommended a 1.5 million barrel per day reduction in oil production due to lower crude oil demand from the coronavirus. The recommended allocation called for OPEC, mainly Saudi Arabia, to reduce production by 1 million barrels per day and non-OPEC, which is mainly Russia, to reduce production by 0.5 million barrels per day subject to Russia's agreement. Russia choose not to participate with OPEC's recommendation and their refusal resulted in Saudi Arabia reversing course suggesting that it would begin to increase oil production in April.

On Saturday, March 7th, Bloomberg reported that Saudi Arabia would increase oil production in April after failing to reach an agreement with Russia to cut production. Bloomberg news reported that Russia wants U.S. producers to reduce production as well. In addition, Russia is retaliating against the U.S. for U.S. sanctions placed on Russia specifically related to the construction of the Nord Stream 2 natural gas pipeline.

Oil prices continue to decline due to the impact of coronavirus on 2020 global oil demand is uncertain. Estimates for 2020 global demand reductions range from 600,000 – 1,300,000 barrels per day. Note this is the reason why OPEC recommended a 1.5 million production cut. Global oil supply could increase by 500,000 – 1,000,000 barrel per day based on how much Saudi Arabia increases production. The net result is an oversupplied global oil market between 1.1 and 2.3 million barrels per day. Keep in mind global oil demand is approximately 100 million barrels per day, so the market is oversupplied by 1-2%. History suggests when global oil inventories exceed historical averages then oil prices decline.

Most OPEC countries, including Saudi Arabia, are operating in a fiscal deficit and cannot afford to have oil prices in the $20's or $30's for an extended period of time. The average breakeven price for OPEC oil producers is $80 per barrel, and that includes Saudi Arabia. According to Reuters, Saudi's cash reserves were $490 billion at the end of 2019 down from $714 billion in 2014. With current oil prices, Saudi Arabia's cash reserves would be reduced by $50 - $100 billion per year. In addition, Russia's reported breakeven is $42 per barrel. OPEC is likely not to reverse the last four years of hard work to reduce global crude oil inventories.

In reaction, we think that U.S. producers are likely to accelerate the capital discipline that they had already begun last year or even two years ago and immediately start reducing drilling rigs. In fact, we got indications from some producers that they are already starting to reduce their overall rig count. U.S. production likely declines if low prices persist. For reference, during last oil price decline, U.S. oil production declined by 1.1 million barrels per day peak-to-trough.

The winner of the oil battle between Saudi Arabia, Russian, or the United States is not an either/or proposition. We need oil production from Saudi Arabia, Russia, AND the U.S. to balance oil markets longer term. Russia is effectively producing at its maximum rate of approximately 10 million barrels per day. Saudi Arabia is currently producing about 9.7 million barrels per day and has produced up to 11 million barrels per day in its history. And the U.S. is producing 13 million barrels per day today. As global oil demand continues to increase, the U.S. and Saudi Arabia will need to increase production.

Midstream assets remain essential and cash flows are resilient. The current Alerian Index (AMZ) price is significantly lower than the AMZ Index on February 11, 2016 when oil prices bottomed at $26.21. Midstream balance sheets have improved since 2016 and dividend/distribution coverage ratios are much higher. At that time, midstream companies were probably dependent on the equity capital markets being open to finance capex needs and today they are nearly all self-funding. We expect midstream companies to focus free cash flow capital allocation on dividends and share buybacks. Prolonged low oil prices may result in some producer bankruptcies. However, there are over 9,000 oil producers in the U.S. according to the American Petroleum Institute. Currently, we don't expect producer bankruptcies to materially impact the cash flow of our midstream investments. The vast majority of the counterparties to public midstream companies are investment grade and many producers are well-hedged for 2020.

On the positive side, low oil prices are great for the consumer. Consumer response to low oil prices has been strong in the past with global oil demand growth rising to 1.6 million barrels per day or 60% higher than normal in 2016 and to 1.8 million barrels per day or 80% higher than normal in 2017. Gasoline, diesel, and jet fuel demand rises when oil prices are low. Crude oil storage likely benefits if the forward curve for crude oil moves higher to steeper contango, and contango effectively means current prices are lower than longer-dated prices. There is more to the U.S. energy sector than just oil. Natural gas prices will likely improve and lower oil production means less associated natural gas production from oil production.

In conclusion, midstream companies generate primarily fee-based cash flows from moving energy products and those cash flows are not tied to oil prices. Midstream cash flows really remain resilient through crude oil price swings. Our analysis and conclusions are that midstream EBITDA actually increased during the 2015/2016 decline in oil prices. Counter-party risk over the last 30 years also has been essentially negligible to midstream companies despite fear to the contrary.

Oil prices are declining, but we think that's a temporary decline. Saudi Arabia, in our opinion, is using lower oil prices as a negotiating tactic but cannot afford low oil prices for a prolonged period of time. The Saudi's strategy is to lower oil prices in the short-term forcing Russia back to the negotiating table, so a new oil production cut agreement can be put in place. Now, don't forget, U.S. remains the largest oil producer in the world. Lower oil prices will accelerate though a reduction in capital spending for U.S. oil producers that will likely halt U.S. oil production growth.

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The Alerian MLP Index is the leading gauge of energy infrastructure master limited partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

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