Tortoise Capital Advisors

Tortoise QuickTake Podcast with James Mick

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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.

Well I must confess, we are now in uncharted territory for my podcasts, as this is the first week since we started these in July of 2015 that I get to report MLPs had a positive return for the week. March Madness indeed.

The positive uptick in energy has continued to be driven by the rebound in crude oil, as macro growth concerns have somewhat waned, OPEC and other key producers continue to discuss and contemplate a production freeze agreement, and 4th quarter reporting season highlighted the long-anticipated acknowledgement by US producers that production will likely decline in 2016, helping to rebalance the market. Even more interesting is that crude advanced higher despite a large build in inventories.

As for last week's performance,

- On the commodity front, crude oil moved higher by 9.6%, while
- Natural gas trended lower, down 7%, primarily due to warmer forecasted weather
- Shifting to equities, the broader S&P 500 Energy Index® was up 5.8%
- Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers Index℠, were up 13.6%
- And last but not least, the Tortoise MLP Index® increased 7.7% last week

I wanted to touch on some interesting tidbits prior to our central topic of the week:

- Volatility within the MLP space in particular remains at historic levels as one investment bank pointed out the following: of the 43 trading days this year, MLPs have moved up or down by at least 4% on 17 of those days, or 40%. That compares to only 22 such days in all of 2008 and 27 total days in 2009 all the way to 2014. Extreme volatility indeed, especially considering we are only in early March.
- Insider buying has been exceptionally high on the MLP side as well, with another investment bank reporting some very interesting and encouraging numbers.
  - They identified 60 distinct MLP insider buys since the beginning of 2015, totaling over $500 million dollars
  - Additionally, it has become even more pronounced recently with over 85% of the $500 million dollars occurring since July of 2015
- Finally, ExxonMobil, the industry bellwether did price $12 billion of various tranches of debt during last week, the largest ever raise for the energy giant

For our main topic this week, I wanted to address contracts in the midstream space and specifically what happens if an exploration and production company goes bankrupt and attempts to void the contracts they have in place with midstream companies.

This has been a hot topic lately and courts are currently evaluating two different cases, one with Quicksilver Resources and one with Sabine Oil and Gas. While neither is large or material to most MLPs, we wanted to discuss how we view potential outcomes.

First and foremost, what follows is void of legal predictions as we simply do not have the knowledge or background to understand all the outcomes from a legal perspective. Hence, we have resorted to what we do know, the fundamentals.

It is our understanding that each case is unique as each contract is a little bit different, hence extrapolation to the entire space based on one court ruling or decision is generally not advisable.

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At issue is whether or not an E&P company can eliminate or void its contracts with midstream providers in the event of a bankruptcy.

In this instance, we feel it's best to simply assess the rate times the volume and determine where the risks are:

Big picture wise, a couple of things need to be pointed out:

- First, midstream companies provide a critical service to the E&P company; they help get the product to market, which allows for the E&P to sell their product to generate revenue
  - Without the midstream company, the gas or oil doesn't flow and the E&P doesn't get paid
  - This creates a symbiotic relationship where the groups work together and are dependent on each other for success
- Second, contracts with E&P companies are only one part of the broader MLP universe, which we refer to as gathering and processing as well as supply push pipelines, i.e. those pipelines moving product directly from the well-head or out of a particular basin, compared to demand pull pipelines, which would have counterparties such as utilities or refiners
- Third, we feel this issue is predominately in regards to gathering and processing companies and not long-haul pipelines, but the outcome is similar either way as we'll discuss.

So let's get back to rate times volume. This is how cash flow is generated for a midstream company, so assessing the two key drivers is the easiest way to determine the impact.

From a rate perspective, the risk is that the contract is structured with above market rates. This could happen for various reasons, but the net effect is we feel if rates are above market, they would be shifted down to market rates. This is not prevalent in the midstream space, but there are instances of above market rates between parties.

More interesting is the volume side. The key component here is if the midstream company has minimum volume commitments, or MVCs. If it does, it is possible that those MVCs are eliminated in the event of a bankruptcy and contract restructuring. This does create more risk for the midstream company as it removes the floor on volumes. Not all gathering systems or long-haul pipelines have MVCs associated with them. Hence, if they are eliminated, what you are left with is simply volume exposure, which is no different than the majority of all gathering contracts and a good number of liquids pipelines as well.

Given that, what we are left with is assessing the strategic nature of the assets, both in terms of location, counterparties and ultimately utilization.

Clearly there is always risk in situations such as these, but we caution investors to not extrapolate rulings to every midstream company and to look at the worst case scenario, which in our view is simply aligned with how we have always viewed the world, i.e. invest in companies with the most strategic assets, operated by the best management teams.

That doesn't change regardless of legal outcome.

Thanks for listening 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

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