Tortoise QuickTake Podcast

December 4, 2017

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.

As we enter Christmas season, I am reminded of one of those classic gifts we came up with for people like our teachers, the annual Far Side calendar by Gary Larson. Inexpensive, yet showed you had a sense of humor. Perhaps my all-time favorite Far Side was the one with the two deer and one says to the other, who happens to have a bullseye painted on his chest, "Bummer of a birthmark, Hal." It oftentimes feels like energy stocks are Hal, and the birthmark is crude oil prices. No matter the association, crude oil drives energy stocks, at least in the short-term. Of course, fundamentals and cash flow should eventually win out, but this past week, for a change, the birthmark of crude oil proved to be beneficial.

Let's start with a recap of market performance:

- On the commodity front, crude oil was down slightly, approximately 80 bps, while
- Natural gas was up nicely, 8.8% on colder weather expectations
- Shifting to equities, the broader S&P Energy Select Sector Index® increased 2.7%
- Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers Index℠ increased as well, up 2.2%
- And finally MLPs caught a bid, as the Tortoise MLP Index® improved by 3%

It's safe to say that OPEC stole the show this past week as the announcement on Thursday confirmed leaks that the member countries as well as several other countries, most notably Russia, agreed to extend production cuts for another nine months until the end of 2018. Investors responded like Clark Griswold seeing the family Christmas tree ready to be chopped down.

Some quick highlights:

- Technically this is a new deal extending from January 2018 to December 2018
- The amount remains the same, approximately 1.8 million bpd, including 1.2 million bpd by OPEC member countries
- Libya and Nigeria, exempt from the last deal, have agreed to cap production at their respective maximum 2017 levels
  - This is probably more form over substance frankly, as many believe both countries are already producing at their maximum levels
  - That being said, both were surprises and hiccups to the existing deal, so having each involved is certainly positive and removes potential wild cards
- The agreement will be reviewed in June, yet it felt very clear by commentary from the groups that the cuts will remain in place until inventory objectives are achieved
- In particular, the Saudis stated that inventories were still too high and they would not be satisfied until they were down considerably, with energy minister Al-Falih stating Saudi would like to see inventories 150 million barrels lower.
- Interestingly, when we ran our crude oil walk for 2018 in October, we anticipated crude inventories would decline by approximately 400,000 barrels per day. That assumed the production cut agreement would be extended. Running the math, 400,000 bpd would equate to an inventory draw down of approximately 146 million barrels, right in line with the Saudi oil minister's target.

In short, the OPEC announcement was a strong positive for the market. As we have stated on this podcast for several months, oil price stability would be a welcome event for energy investors and would drive lower volatility and ultimately more investor confidence. As Rob stated last week, $55 to $65 feels like a pretty good range for 2018 and one that should provide investors a positive backdrop to invest in energy stocks.

Another big piece of news was of course the ongoing saga over taxes in Congress. On Saturday, the Senate passed its version of the tax plan to cut the corporate rate to 20%. It was a very close vote, 51-49, almost entirely along party lines. Now that we have both chambers with a bill, the two will meet in reconciliation to hammer out details of the final bill to be sent to the president for approval.

As it relates to energy, the most impactful piece was likely related to MLPs in our view. Initially, it was unclear if pass-throughs would receive the same favorable treatment as they have previously. After some hard work however, it appears the Senate bill will be a positive for MLPs.

The outcome for MLPs differs slightly depending on which chamber's plan ends up advancing, with the House version putting pass-through taxation at 25% and the Senate version putting it at roughly 30%. Not quite as good as the House version, but let's not forget, most importantly MLPs RETAIN their tax advantage and this seemingly puts to bed an endless debate about whether or not the MLP structure, from a tax standpoint, will continue to exist. And to be clear, both of these outcomes result in LESS tax for MLP investors than they currently pay.

All in all, while the details still need to be worked out, we view this as a big win and the likely removal of a significant overhang on the sector.

Finally, I wanted to highlight a trend we believe will continue to take place throughout the MLP sector, removal of incentive distribution rights, or IDRs. In the latest action, Spectra Energy Partners announced it received a proposal from parent company Enbridge Inc. to eliminate its IDRs. While nothing formal has been announced, it is quite likely we see follow-through on the proposal. IDRs have traditionally served a purpose in terms of incenting general partners to drop-down assets into the limited partnership and accelerate distribution growth. As we have noted before however, the rising take by the general partner creates an ever-increasing headwind in terms of cost of capital that eventually impairs growth and renders the MLP uncompetitive.

What's great to see is that if you include already announced transactions yet to close, the top six MLPs by weight in the Tortoise MLP Index® have all eliminated, or are in process of eliminating their IDRs. Spectra resides outside of that top 10, but will eventually join the ranks of those without IDRs. Of course the largest MLP left with IDRs is probably the one that draws the most scrutiny, Energy Transfer. Yet even ETP has noted that a simplification transaction is on the horizon, likely in 2019. While still some time away, management has clearly received the message that it must simplify and they have listened. Once the capital structure allows it, we fully anticipate that to take place.

Elimination of IDRs and simplifying the structure is a key ingredient to attracting new investors and we continue to believe more and more MLPs will move to this more sustainable model over time.

That will do it for today…have a great week and we look forward to speaking with you again soon.

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@tortoiseinvest.com.

The Tortoise North American Pipeline Index℠ is a float-adjusted, capitalization weighted index of pipeline companies headquartered in the United States and Canada. A pipeline company is defined as a company that either 1) has been assigned a standard industrial classification (SIC) system code that indicates the company operates in the energy pipeline industry or 2) has at least 50% of its assets, cash flow or revenue associated with the operation or ownership of energy pipelines. Pipeline companies engage in the business of transporting natural gas, crude oil and refined products, storing, gathering and processing such as gas, crude oil and products and local gas distribution. The index includes pipeline companies structured as corporations, limited liability companies and master limited partnerships (MLPs).

The Tortoise MLP Index® The Tortoise MLP Index® is a float-adjusted, capitalization weighted index of energy master limited partnerships (MLPs). The index is comprised of publicly traded companies organized in the form of limited partnerships or limited liability companies engaged in transportation, production, processing and/or storage of energy commodities.

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