The fear factor appears to have lessened a bit since our previous Energy and Income Advisor issue. But with all eyes still on the global economy, these still aren’t especially good times for energy stocks, many of which are pricing in a big future drop in oil.

The Alerian MLP Infrastructure Index, for example, is lower by more than 10 percent in barely a month. That’s despite the generally robust second quarter results of most index components, as well as multiple dividend increases.

For readers interested in betting on a rebound through mutual funds or ETFs, we suggest taking a look at closed-end funds like Kayne Anderson MLP Midstream (NYSE: KYN). Not only are its top holdings arguably over-discounted to otherwise solid prospects but it trades at a discount to net asset value of more than 10 percent. That’s double leverage to a recovery in MLPs, though there’s risk as well: The fund cut its monthly payout by 20 percent at the start of 2019.

We believe a well-chosen portfolio of energy stocks offers far greater potential upside at lower risk than any fund or ETF. One reason is this is still a market where weaker sector companies carry huge downside risk. Going for average in other words is still very dangerous, despite the enormous yields now offered by numerous sector stocks including more than a few with solid distribution coverage.

As we noted in the previous issue as well as our August 9 Alert “Fear Rules But Q2 Earnings Measure Up,” we’re generally pleased by our recommendations’ business performance at this time. We’re also convinced they’re in good shape to weather another drop in energy prices and even an economic recession.

That doesn’t mean they’ve run out of potential downside, even with prices so low as they are now generally. But it does mean we’re comfortable sticking with them and even adding to holdings when they trade below recommended entry points. If you’re following the Actively Managed Portfolio, be sure to use our position sizes, shown in column three.
In This Issue

1 Feature: Our Energy Outlook Post-Q2 Earnings. Now that we’ve seen the numbers and heard guidance, here’s our view on what’s ahead.

2 Portfolios. We’re adding Western Midstream Partners LP (NYSE: WES) to our High Yield Energy List.

3 Endangered Dividends List. Sanchez Midstream Partners (NSDQ: SNMP) has eliminated its dividend. Navios Maritime Acquisition (NYSE: NNA) still looks likely to cut sometime in the next 12 to 18 months, but second quarter results make the case it may not.

High Yield Energy Target List, Active Portfolio, Endangered Dividends List

The Actively Managed Portfolio holds our top recommendations in a $100,000 hypothetical model, including specific position sizes.

Our High Yield Energy List focuses on big distribution stocks that meet five criteria: (1) Yield of 7 percent or higher, (2) Strong and rising distribution coverage, (3) Consistent progress stabilizing and preferably reducing leverage, as measured by the debt-to-EBITDA ratio, (4) Manageable needs to raise new capital over the next 24 months, for CAPEX as well as refinancing existing debt, (5) Ownership structure that discourages changes in structure.

<table>
<thead>
<tr>
<th>Company (Exchange: Symbol)</th>
<th>Date</th>
<th>Recent Pr</th>
<th>Yield</th>
<th>12-Mo Dist Gr</th>
<th>Proj Dist Gr</th>
<th>Coverage</th>
<th>Debt/EBITDA</th>
<th>Total Return</th>
<th>Advice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antero Midstream Corp (NYSE: AM)</td>
<td>5/22/19</td>
<td>7.46</td>
<td>16.51</td>
<td>146.0</td>
<td>5.0</td>
<td>1.00</td>
<td>3.2</td>
<td>-42.9</td>
<td>Buy&lt;14</td>
</tr>
<tr>
<td>Enable Midstream LP (NYSE: ENBL)</td>
<td>5/22/19</td>
<td>12.81</td>
<td>10.32</td>
<td>3.9</td>
<td>5.0</td>
<td>1.37</td>
<td>4.0</td>
<td>-3.8</td>
<td>Buy&lt;17</td>
</tr>
<tr>
<td>Energy Transfer LP (NYSE: ET)</td>
<td>5/22/19</td>
<td>13.68</td>
<td>8.92</td>
<td>0.0</td>
<td>5.0</td>
<td>2.00</td>
<td>3.6</td>
<td>-6.2</td>
<td>Buy&lt;17</td>
</tr>
<tr>
<td>EnLink Midstream LLC (NYSE: ENLC)</td>
<td>5/22/19</td>
<td>7.87</td>
<td>13.57</td>
<td>6.0</td>
<td>5.0</td>
<td>1.20</td>
<td>4.0</td>
<td>-29.2</td>
<td>Buy&lt;10</td>
</tr>
<tr>
<td>Hess Midstream Part (NYSE: HESM)</td>
<td>5/22/19</td>
<td>18.41</td>
<td>8.63</td>
<td>15.0</td>
<td>15.0</td>
<td>1.02</td>
<td>0.5</td>
<td>-8.9</td>
<td>Buy&lt;24</td>
</tr>
<tr>
<td>MPLX LP (NYSE: MPLX)</td>
<td>5/22/19</td>
<td>27.86</td>
<td>9.58</td>
<td>6.4</td>
<td>6.0</td>
<td>1.36</td>
<td>3.9</td>
<td>-11.1</td>
<td>Buy&lt;37</td>
</tr>
<tr>
<td>NuStar Energy LP (NYSE: NS)</td>
<td>8/9/19</td>
<td>27.67</td>
<td>8.68</td>
<td>0.0</td>
<td>5.0</td>
<td>1.39</td>
<td>4.0</td>
<td>3.1</td>
<td>Buy&lt;28</td>
</tr>
<tr>
<td>Oasis Midstream Part (NYSE: OMP)</td>
<td>6/6/19</td>
<td>15.18</td>
<td>12.92</td>
<td>19.7</td>
<td>20.0</td>
<td>1.70</td>
<td>2.8</td>
<td>-17.3</td>
<td>Buy&lt;20</td>
</tr>
<tr>
<td>Suburban Propane Part (NYSE: SPH)</td>
<td>6/6/19</td>
<td>23.04</td>
<td>10.43</td>
<td>0.0</td>
<td>0.0</td>
<td>1.25</td>
<td>4.4</td>
<td>1.5</td>
<td>Buy&lt;24</td>
</tr>
<tr>
<td>Western Midst Part (NYSE: WES)</td>
<td>8/22/19</td>
<td>22.83</td>
<td>10.83</td>
<td>6.1</td>
<td>5.0</td>
<td>1.20</td>
<td>4.2</td>
<td>NEW</td>
<td>Buy&lt;30</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Energy & Income Advisor

Prices and yields as of August 22, 2019 close. Projected distribution growth is based on company guidance and Energy & Income Advisor analysis. Coverage is distributable cash flow divided by current distribution rate. All prices, returns and buy targets in US dollars.
# Energy & Income Advisor: Actively Managed Portfolio

<table>
<thead>
<tr>
<th>Company (Exchange: Ticker)</th>
<th>Date Added</th>
<th>Position Size</th>
<th>Price</th>
<th>Indicated Yield</th>
<th>Total Return</th>
<th>Profit/Loss</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Halliburton (NYSE: HAL)</td>
<td>12/04/17</td>
<td>100</td>
<td>$18.67</td>
<td>3.86%</td>
<td>-55.88%</td>
<td>-1,043.32</td>
<td>Buy &lt;20</td>
</tr>
<tr>
<td>MPLX LP (NYSE: MPLX)</td>
<td>05/04/17</td>
<td>150</td>
<td>27.86</td>
<td>9.58</td>
<td>-1.43</td>
<td>-59.66</td>
<td>Buy &lt;37</td>
</tr>
<tr>
<td>Texas Instruments (NSDQ: TXN)</td>
<td>05/01/18</td>
<td>50</td>
<td>125.21</td>
<td>2.46</td>
<td>26.00</td>
<td>1,627.87</td>
<td>Buy &lt;112</td>
</tr>
<tr>
<td>Concho Resources (NYSE: CXO)</td>
<td>10/26/17</td>
<td>30</td>
<td>73.05</td>
<td>N/A</td>
<td>-43.64</td>
<td>-956.30</td>
<td>Buy &lt;165</td>
</tr>
<tr>
<td>Core Laboratories (NYSE: CLB)</td>
<td>06/30/18</td>
<td>35</td>
<td>38.15</td>
<td>5.77</td>
<td>-64.86</td>
<td>-866.05</td>
<td>Buy &lt;133</td>
</tr>
<tr>
<td>Enterprise Products Partners LP (NYSE: EPD)</td>
<td>01/09/17</td>
<td>150</td>
<td>28.96</td>
<td>6.08</td>
<td>24.38</td>
<td>1,058.97</td>
<td>Buy &lt;33</td>
</tr>
<tr>
<td>Hess Midstream Partners LP (NYSE: HESM)</td>
<td>03/28/18</td>
<td>200</td>
<td>18.41</td>
<td>8.63</td>
<td>10.04</td>
<td>369.63</td>
<td>Buy &lt;24</td>
</tr>
<tr>
<td>Occidental Petroleum Corp (NYSE: OXY)</td>
<td>09/29/17</td>
<td>45</td>
<td>44.70</td>
<td>7.07</td>
<td>-24.39</td>
<td>-490.68</td>
<td>Buy &lt;75</td>
</tr>
<tr>
<td>Crestwood Equity Partners LP (NSDQ: CEQP)</td>
<td>11/06/17</td>
<td>120</td>
<td>35.80</td>
<td>6.70</td>
<td>67.41</td>
<td>2,895.92</td>
<td>Buy &lt;40</td>
</tr>
<tr>
<td>Northland Power (TSX: NPI, OTC: NPIFF)</td>
<td>11/27/17</td>
<td>150</td>
<td>19.02</td>
<td>4.74</td>
<td>10.57</td>
<td>301.70</td>
<td>Buy &lt;20</td>
</tr>
<tr>
<td>WPX Energy (NYSE: WPX)</td>
<td>12/28/17</td>
<td>150</td>
<td>10.57</td>
<td>N/A</td>
<td>-25.56</td>
<td>-405.31</td>
<td>Buy &lt;19</td>
</tr>
<tr>
<td>Marathon Oil (NYSE: MRO)</td>
<td>06/01/18</td>
<td>320</td>
<td>12.26</td>
<td>1.63</td>
<td>-42.13</td>
<td>-1,652.80</td>
<td>Buy &lt;23</td>
</tr>
<tr>
<td>Plains GP Holdings (NYSE: PAGP)</td>
<td>06/14/18</td>
<td>328</td>
<td>22.42</td>
<td>6.42</td>
<td>-6.59</td>
<td>-484.37</td>
<td>Buy &lt;26.50</td>
</tr>
<tr>
<td>Antero Midstream GP (NYSE: AM)</td>
<td>12/28/18</td>
<td>70</td>
<td>7.46</td>
<td>16.51</td>
<td>-37.30</td>
<td>-194.80</td>
<td>Buy &lt;14</td>
</tr>
<tr>
<td>Magellan Midstream Partners LP (NYSE: MMP)</td>
<td>01/02/18</td>
<td>30</td>
<td>66.48</td>
<td>6.09</td>
<td>3.95</td>
<td>78.76</td>
<td>Buy &lt;75</td>
</tr>
<tr>
<td>TechnipFMC (NYSE: FTI)</td>
<td>08/07/18</td>
<td>100</td>
<td>24.02</td>
<td>2.16</td>
<td>-21.05</td>
<td>-505.61</td>
<td>Buy &lt;33</td>
</tr>
<tr>
<td>Schlumberger (NYSE: SLB)</td>
<td>08/15/18</td>
<td>135</td>
<td>33.71</td>
<td>5.93</td>
<td>-43.42</td>
<td>-1,975.98</td>
<td>Buy &lt;42</td>
</tr>
<tr>
<td>Kinder Morgan (NYSE: KMI)</td>
<td>02/19/19</td>
<td>200</td>
<td>20.20</td>
<td>4.95</td>
<td>8.10</td>
<td>327.30</td>
<td>Buy &lt;22</td>
</tr>
<tr>
<td>Pembina Pipeline Corp (NYSE: PBA)</td>
<td>09/16/13</td>
<td>75</td>
<td>36.51</td>
<td>4.94</td>
<td>55.54</td>
<td>1,520.89</td>
<td>Buy &lt;35</td>
</tr>
<tr>
<td>EnLink Midstream LLC (NYSE: ENLC)</td>
<td>12/28/17</td>
<td>150</td>
<td>7.87</td>
<td>13.57</td>
<td>-21.82</td>
<td>-257.59</td>
<td>Buy &lt;13</td>
</tr>
<tr>
<td>TransCanada Corp (NYSE: TRP)</td>
<td>11/15/13</td>
<td>30</td>
<td>48.69</td>
<td>4.63</td>
<td>36.63</td>
<td>534.98</td>
<td>Buy &lt;50</td>
</tr>
<tr>
<td>Brookfield Renewable Energy Partners LP (NYSE: BEP)</td>
<td>09/16/13</td>
<td>40</td>
<td>37.11</td>
<td>5.55</td>
<td>99.72</td>
<td>1,480.26</td>
<td>Buy &lt;35</td>
</tr>
</tbody>
</table>

As of 08/22/19, close. Source: Bloomberg, Energy & income Advisor
Endangered Dividends List

Endangered Dividends List companies are vulnerable for one or more of the following reasons:

- Cash flow coverage of distributions is inadequate.
- Elevated debt levels with imminent refinancing needs.
- Revenue pressure triggered by weakness for at least one key asset.
- Inability to access the equity market on favorable terms to fund capital spending, forcing management to utilize more internally generated cash flow.
- Exposure to volatility in commodity margins from either rising or falling prices of raw materials.
- Aggressive general partners anxious to buy in limited partners’ cash flows at discounted prices.
- Regulatory reversals.
- Expiring contracts with little hope for renewals at comparable rates.

As we pointed out in our August 14 Energy Commentary “The Hammer Falls on Sanchez: Who’s Next,” Sanchez Midstream Partners (NYSE: SNMP) has eliminated its quarterly dividend. We now believe there’s a better than even chance it may have to follow its general partner Sanchez Energy (OTC: SNECQ) into bankruptcy. We’d avoid both Sanchezes.

In contrast, we’re retaining our hold rating on Navios Maritime Acquisition (NYSE: NNA), after that company held its quarterly payout of 30 cents per share and reported better than anticipated second quarter results. The shares’ elevated yield of nearly 20 percent is a stark reminder the market considers the tanker company’s payout endangered, if not solvency.

But while a cut is still likely, Navios did report a 41.2 percent lift in revenue and 130 percent increased EBITDA from the year ago quarter. Management also made progress cutting the average age of its fleet (8.1 years) by selling 3 of “our oldest vessels,” replacing them by finalizing 12-year “bareboat” charters for three new ships to enter service in 2020 and 2021. It also affirmed a 3 percent debt reduction by the end of the year, including prepayment of the higher cost Term B loan.

Global shipping conditions remain weak. But Navios has pre-stabilized revenue somewhat by contracting 83.1 percent of available days for the second half of 2019. There’s no real margin for error here but that looks priced in for a company that seems to managing. Next earnings are expected in late November. Hold.
Talking Point #1: How much should we worry about the possibility of stalling or even falling production growth in North America for producers, drillers, midstream and downstream companies we own?

Elliott Gue (EG): Ironically, I think falling US production would be a huge positive for most of the upstream (producers) and services companies we recommend.

That’s because the cornerstone of the bear case for oil is that US oil production will continue to accelerate even with WTI in the $50/bbl range, overwhelming Saudi and OPEC-plus production cuts.

I believe the view the world faces a near-chronic oversupply of crude is the main reason why some of our favorites like Schlumberger (NYSE: SLB), WPX Energy (NYSE: WPX), Occidental Petroleum (NYSE: OXY) and Marathon Oil (NYSE: MRO) have continued to trade at depressed valuations despite growing evidence they’re in a position to see significant growth in free cash flow over the next few years. Investors have been slow to embrace changing narratives in the energy patch.

Five years ago, conventional wisdom held that Saudi Arabia was unwilling to accept oil prices much below $100/bbl. Indeed, for years up until the summer of 2014, the Kingdom seemed willing to manipulate production to keep oil prices stable around that level, which lent some credence to that consensus view.

In this service, we argued the outlook was changing because the Saudis came to the realization that $100/bbl oil prices were helping to underwrite a sustained boom in US shale oil output. In effect, a policy of maintaining high oil prices was good for OPEC nations’ finances in the short run but was ultimately doomed

---

**Endangered Dividends List**

<table>
<thead>
<tr>
<th>Company (Exchange: Symbol)</th>
<th>Potential Cut</th>
<th>Risk Level</th>
<th>Last Increase</th>
<th>Rating</th>
<th>Declaration Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARC Resources (TSX: ARX, OTC: AETUF)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Aug-08</td>
<td>Hold</td>
<td>9/16/19</td>
</tr>
<tr>
<td>CrossAmerica Partners (NYSE: CAPL)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Nov-17</td>
<td>Sell</td>
<td>11/7/19</td>
</tr>
<tr>
<td>Cypress Energy Part (NYSE: Celp)</td>
<td>-100.0</td>
<td>Elevated</td>
<td>Nov-14</td>
<td>Sell</td>
<td>10/25/19</td>
</tr>
<tr>
<td>Equitran Midstream Corp (NYSE: ETRN)</td>
<td>-33.0</td>
<td>Moderate</td>
<td>May-19</td>
<td>Sell</td>
<td>11/5/19</td>
</tr>
<tr>
<td>EQM Midstream Partners (NYSE: EQM)</td>
<td>-33.0</td>
<td>Moderate</td>
<td>Feb-19</td>
<td>Sell</td>
<td>10/22/19</td>
</tr>
<tr>
<td>Gaslog Partners LP (NYSE: GLOP)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Jan-19</td>
<td>Sell</td>
<td>10/24/19</td>
</tr>
<tr>
<td>Golar LNG Partners (NASDAQ: GMLP)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>May-15</td>
<td>Sell</td>
<td>10/23/19</td>
</tr>
<tr>
<td>Green Plains Partners (NYSE: GPP)</td>
<td>-33.0</td>
<td>Moderate</td>
<td>May-18</td>
<td>Sell</td>
<td>10/18/19</td>
</tr>
<tr>
<td>Martin Midstream Part (NASDAQ: MMLP)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Nov-14</td>
<td>Sell</td>
<td>10/17/19</td>
</tr>
<tr>
<td>Navios Maritime Acquisition (NYSE: NNA)</td>
<td>-33.3</td>
<td>Moderate</td>
<td>Nov-15</td>
<td>Hold</td>
<td>11/5/19</td>
</tr>
<tr>
<td>NGL Energy Partners (NYSE: NGL)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Nov-15</td>
<td>Sell</td>
<td>10/22/19</td>
</tr>
<tr>
<td>Peyto Expl &amp; Dev (TSX: PEY, OTC: PEYUF)</td>
<td>-25.0</td>
<td>Elevated</td>
<td>Dec-14</td>
<td>Hold</td>
<td>10/15/19</td>
</tr>
<tr>
<td>Sprague Resources LP (NYSE: SRLP)</td>
<td>-25.0</td>
<td>Elevated</td>
<td>May-18</td>
<td>Sell</td>
<td>10/24/19</td>
</tr>
<tr>
<td>Vermillion Energy (TSX: VET, NYSE: VET)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>May-18</td>
<td>Buy&lt;30</td>
<td>9/16/19</td>
</tr>
</tbody>
</table>

Source: Energy and Income Advisor.
because it would necessitate deeper and deeper production cutbacks to sustain those elevated prices.

While many observers described OPEC’s decision NOT to cut output in November 2014 as “shocking,” it should not have been a surprise as the Saudis had consistently signaled a change in strategy starting six to 9 months earlier. As a result, we indicated that oil prices could tumble under $30/bbl, a target that was realized in early 2016.

Fast forward 5 years and the market has embraced the late 2014 narrative and an unwavering faith in 1 million bbl/day+ annual growth in US oil production. After all, despite moderate oil prices, US oil production stood at 12.1 million bbl/day in May of this year, up 2.925 million bbl/day compared to the same month two years ago.

That’s growth of nearly 1.5 million bbl/day!

In effect, the US alone accommodated all the growth in global oil demand (and then some) over the past two years. The only problem is, once again, market conditions have changed, the late 2014 playbook no longer applies, and the Saudi/OPEC response is likely to be far different than it was 5 years ago.

There have been several changes in the US exploration and production space over the past two years; however, the most important shift has been driven by the market and energy investors. For most of the history of the industry, companies have been rewarded for production growth – by and large companies with the strongest growth in oil output (measured in barrels per day) were also the top-performing stocks.

Today, investors aren’t interested in growth. They’re focused on returns and cash flow. The shale industry has developed a reputation as a perennial cash sink – companies show strong production growth and are always finding new high-potential drilling targets but none of this growth ever results in actual free cash flow, share buybacks and dividends.

Talking about well efficiency and reserves is all well and good but investors ultimately need to benefit and get paid for providing capital. Over the last 18 months or so, the better producers of all sizes refocused their attention on giving the market what it wants. Companies have set their capital spending budgets at a level that allows them to generate positive free cash flow at mid-cycle oil prices – usually defined as around $50/bbl.

Even when oil prices were 30 percent or more higher than that level this spring, the producers by and large did not budge – none of the major producers announced major plans to increase capital spending or drilling activity to take advantage of higher spot oil prices.

That’s why you’ve seen a big slide in the US oil-directed rig count this year – from 888 active oil rigs just before Thanksgiving last November to 764 rigs earlier this month. Ultimately, that means US oil production growth will slow and it’s going to slow down significantly whether oil stays where it is today or rises to $60 to $65/bbl. Gone are the “Wild West” days of 1.5 million bbl/day of annual US oil production growth.

The Saudis and OPEC understand this and they’re responding accordingly – it’s why Saudi Arabian oil output is under 9.7 million bbl/day, well below its agreed quota to produce just over 10.3 million bbl/day. And it’s why Saudi Oil Minister Khalid al-Falih said earlier this month that US shale output will peak, plateau and decline “like every other basin in history.”

The Saudis and OPEC are willing to cut production now to combat a transitory oversupply of oil because they can see that US shale production growth is already slowing sharply. Five years ago, they were unwilling to do so because with oil prices above $100/bbl there was no prospect for shale growth to slow.

When high prices encourage extra supply, OPEC production cuts are an ineffective tool to manage prices.
However, when oil supply is NOT sensitive to changes in the spot price of oil, OPEC and Saudi can manage prices without the fear of long-term market share losses.

In my view, this shift will become apparent by early next year and the decline in US oil output growth will be broadly a positive for the upstream and services names we recommend because it will help quell fears of a continued global glut of crude and another big sell-off in oil prices.

Roger Conrad (RC): All I would add to that is I believe better run US midstream companies have adapted to this new environment. There are companies like EQT Resources (NYSE: EQT) that have made it fairly clear they intend to pull in their horns even more. And that’s a unique concern for the midstream companies that serve them, in this case EQM Midstream Partners (NYSE: EQM).

But as Elliott points out, this is not the shale industry of 2014, when the name of the game was grow at all costs for producers—and all too many midstream companies seemed to operate under the assumption of “build it and they will come.” In fact, for the past five years, midstream companies have had to constantly adapt to the risk of what lower selling prices and slowing output would mean to their system throughputs, and therefore to their cash flow and distributions.

They’ve cut operating costs and leverage. And as a result they’re far better prepared to handle an environment where shale output is no longer a question of boom or bust. I find that very comforting when I think about the future of our recommended companies.

Talking Point #2: What do you expect to see over the next 12–to-18 months for new pipeline infrastructure construction in North America? Is there any hope of a consensus that will break the logjam?

RC: I think the answer more than ever depends on geography. I’m not going on a limb to say the subject of energy has become even more politicized and therefore polarized this summer.

It’s now pretty clear that anyone with the resources to access the legal system can stall almost any large energy project. There’s also the continuing vacancy on the Federal Energy Regulatory Commission that continues to grind action there to a halt. And if anything, state governments like New York’s are more aggressive than ever.

All those factors contribute to delays and since time equals money in this business, that can be enough to kill a project entirely. The exceptions are when developers are exceptionally incentivized to get the pipeline built and financially powerful enough to see it through.

The developers of the Atlantic Coast Pipeline and Mountain Valley Pipeline measure up on those counts. That’s the main reason I believe sometime this fall the U.S. Supreme Court will agree to hear the appeal of a lower court ruling that overturned certain permits for the Atlantic Coast Pipeline. And if the high court does, odds will be great that they’ll uphold those permits, and work will resume on both ACP and MVP.

Attorneys general in 16 states have joined the ACP appeal. So has U.S. Solicitor General Noel Francisco. But I think it’s also worth pointing out that lead developer Dominion is also looking at alternative ways to secure supply, including a plan to obtain 4 percent of its needs from so-called “renewable” methane from livestock and landfills.

Maybe after the November 2020 election we’ll see people on all sides of this issue start to work together again. As we’ve pointed out, it’s more important than ever for pipeline companies to pick their spots well, as well as for investors to choose developers wisely.
The big exceptions to that are still Texas and the upper Midwest. But danger elsewhere is why it’s critical for us to delve into the details of what the politics are where midstream companies operate, particularly if there’s a project that’s particularly critical to growth plans.

■ EG: Picking up on what Roger said about Texas, we’ve just seen a mini boom in oil pipeline construction in the Permian Basin with several new pipelines serving the region coming onstream in 2019.

I believe we’re already seeing the effect in pricing – WTI priced in Midland is trading at just a $0.60/bbl discount to WTI priced in Cushing, Oklahoma, down from spreads as high as $17.90/bbl about a year ago towards the end of August 2018.

We’re also seeing convergence in pricing across other widely watched differentials – East Houston is only trading at a $2/bbl premium to WTI-Cushing and WTI is only trading at a less than $5/bbl discount to Brent, which is less than half the levels earlier this year.

So, I think some of the glaring pipeline shortage issues we wrote about in Energy & Income Advisor last summer have eased. However, I still think there are plenty of energy infrastructure projects to keep the midstream companies busy including a need to build up more export infrastructure to serve the boom in US oil exports from the US Gulf Coast and gas processing and transport infrastructure to serve the Permian Basin.

I was also interested to see Rattler Midstream LP (NSDQ: RTLR) go public back in late May, sponsored by Permian-focused producer Diamondback Energy (NSDQ: FANG). The company owns traditional crude oil and natural gas gathering and long-haul pipelines but it’s also in the water and wastewater business including 575,000 bbl/day of freshwater gathering capacity.

As we’ve written in the past water is a crucial resource for shale producers and it’s one of the top cost centers for producers. I think we may see water and water recycling businesses like this be a new area of growth for MLPs in future. In the past, water and wastewater MLPs have been fundamentally flawed partnerships; however, FANG is a respected and quality producer, so I think it will be interesting to see how these water assets perform within Rattler.

Talking Point #3: You’ve talked a lot about producers cutting costs. Where do you see the best opportunities for the industry to do more and who will benefit?

■ RC: As Elliott said, water is one area where there’s still a great deal of potential savings. If you want to frac, you’ve got to have a robust, reliable and always available supply. But the more you have to transport in and out (liquid waste) from the drilling site, the higher the cost.

One way to reduce this cost is simply to cut water usage by more efficient completion design. Another is to actually recycle the “flowback,” which reduces both the water that must be transported in and the waste needed to be trucked out.

As a Diamondback shareholder myself, I’m very intrigued by Rattler. But there’s also a major test case going on in Appalachia, where mountain roads make for uniquely difficult transportation challenges.

With a lack of pipeline capacity holding down regional selling prices for natural gas, Antero Resources (NYSE: AR) is hinging its plans for 10 percent production growth on being able to wring $800,000 in cost savings per well by next year. That includes reducing water used in completions from a range of 40 to 45 barrels per foot to just 35 to 38.

Antero is also targeting $650,000 per well savings from replacing third party water and waste suppliers.
and transporters with output from recycling facilities owned and operated by its midstream affiliate **Antero Midstream Corp** (NYSE: AM). Increased revenue from those facilities will offset the negative impact of $25 to $35 million lower sales at the midstream company, caused by reduced water usage by the parent. So will increased cash flow from gathering and processing facilities if Antero Resources is able to meet its aggressive output targets.

Stakes are high here for both Anteros: Failure to achieve targeted savings in water will undermine Antero Resources’ drilling economics further. That could eventually force production cutbacks, and thereby reduce throughput, cash flow and probably dividends at Antero Midstream.

On the positive side, both stocks appear priced for failure and success, even though management reported during the second quarter call that 35 percent of target savings had already been achieved as of early August. Antero also has a long record of success cutting costs, with more than 40 percent reductions in per unit gathering, compression and water expenditures the past five years.

I think if Antero and Antero can make this work, we’ll not only see a recovery for them. But other producers will be able to follow their lead for big savings as well.

**EG:** I agree it’s all about technology. To date many of the industry’s efficiency gains have been all about raw power – bigger wells, longer lateral segments, bigger fracturing jobs and more proppant (sand) in wells. However, gains from simply drilling more complex wells are getting exhausted.

As we explained at greater length back in the August 2nd issue of *Energy & Income Advisor* “Services: International Growth, Shale Changes,” producers are beginning to encounter issues like parent-child well interference, which suggest we’re reaching the limits of how closely wells can be spaced together. Already you’re seeing some producers experiment with scaling back the amount of proppant they pack into wells in an effort to reduce costs.

I think the next wave of efficiency gains and cost reductions will be driven by technology and “smarter” wells. For example, better managing the well completion process to “target” fracturing on reservoir rock the producers want to stimulate while avoiding problem areas. Also, “big data” type of analysis of well performance can help the producers tweak efficiency and avoid the issue of parent-child well interference to maximize production from their acreage.

I think the big services firms should benefit from this oil “tech” trend, especially **Schlumberger** (NYSE: SLB), which has long been known as the technology leader in the services space.

Outside the US, what we’re seeing is that producers are rethinking some of their developments, especially in the deepwater. By downsizing these projects, they’re able to cut costs significantly and make deepwater oil projects competitive and profitable even at relatively low (sub $50/bbl or even sub $40/bbl) oil prices.

**Talking Point #4: Is US shale going to keep taking market share from the traditional global producers like OPEC and Russia? Is there a cost?**

**EG:** In the short run, yes, shale will continue to take market share. The reason is simply that I expect OPEC to continue its campaign to reduce global inventories indefinitely. That means Saudi Arabia in particular will maintain output well below the quotas they agreed with the rest of OPEC Plus while Iran, Venezuela, Angola and others will likely see further downside to output going forward. Meanwhile US production will continue to rises somewhat so, by definition, market share will increase.

Longer term, though, I think the dynamic is changing as shale matures.
In future, I think the big shale producers are going to start acting more and more like the traditional integrated and national oil companies that have dominated the industry in decades past.

That is, they won’t be quick to respond to changes in commodity prices but will plan and budget for a mid-cycle $50/bbl oil price environment and drill accordingly. If oil prices rise well above that level – say to $65 or $70/bbl – I think you’ll just see the major shale producers accept the free cash flow windfall and deploy it to buy back stock or pay down debt.

Over time, that leaves room for demand to outpace US supply growth and for OPEC production levels to stabilize and for the cartel to even gain some market share.

And, it’s also worth noting that outside shale, non-OPEC production is likely to fall over the intermediate term. That’s because most of the projects sanctioned before the 2014-15 oil price collapse have already gone into production or soon will and there are very few major new non-OPEC projects sanctioned after 2014-15 to offset natural base decline rates from mature fields.

OPEC and shale will both need to fill that supply gap. As for a cost, I think the most obvious one is that the world consumes round 100 million barrels of oil each and every day. Shale is a tremendous resource but it’s also a sort of treadmill – producers have to drill pretty aggressively just to offset accelerating production declines from older shale wells.

Traditional conventional wells require a large up-front capital investment but then generate years of dependable, steady oil output. It’s difficult to rely on a volatile, activity intensive resource like shale to meet a large portion of global oil demand. I think ultimately, global oil supply will be more secure and dependable if it comes from a mix of long and short-cycle sources.

■ RC: Coming at this question from the midstream side, I don’t think US shale has to dominate the world for owners of pipelines and infrastructure to prosper. But I do think there’s a tremendous opportunity for exporting, for natural gas and natural gas liquids as well as for oil. In fact, the US advantage might be even greater when it comes to gas and NGLs like propane, ethane and the like.

Production growth is going to ebb and flow as E&Ps respond to pricing. And there will be snags with execution as well, particularly when it comes to siting and building pipelines as we noted earlier. But there’s committed capital and enormous reserves available under even the most pessimistic assumptions, and all within a country that operates under rule of law. That’s a formula for growth and gaining market share, especially from less politically stable places around the world.

The only thing I see holding us back right now is us. Not too long ago, there was broad consensus in this country that producing more natural gas was a good thing. The big switch from coal to natural gas in electricity generation, for example, cleaned up the air and water and cut customer bills at the same time. It’s also why the US is I believe the only major nation right now that’s actually met its CO2 goals under the Paris accord.

But now you have Consolidated Edison (NYSE: ED) literally turning away new heating customers. The reason is the governor of New York is refusing to grant permits needed to build pipeline capacity to New York City. And in the meantime, the customers Con Ed is turning away will keep burning far less environmentally friendly fuels like heating oil. That’s why it’s so important for us to pick and choose our midstream energy targets carefully, no matter how bullish the big picture looks.
Talking Point #5: You've been negative on tankers for some time. Are there any recent changes in your outlook?

RC: I’ll take this one. There’s no doubt that global demand for natural gas is likely to grow robustly well into the next decade, with Asian coal substitution a primary market. What’s less clear is where that supply will come from. China, for example, is ramping up development of pipelines from places like Kazakhstan and Russia. The fact that it’s doing so despite low LNG spot prices in Asia is a clear sign the country intends to diversify its energy sources, which by definition cuts into what it will need to bring in via tankers.

That doesn’t mean China or any other country will stop using LNG. In fact, it’s almost certain they’ll use a lot more in coming years than they do now as the government tackles the environmental crisis brought on by over use of coal. Global LNG demand was reportedly up 16 percent over the last 12 months, with European imports rising by 110 percent.

Despite that growth, however, prices were still weak. And the implication is global LNG shipping demand is still having a tough time catching up to the glut of transportation capacity, as older ships stay on the market longer and newer ones are commissioned.

I did notice at least a few “green shoots” in the earnings of some of the tankers we track. Most of these however, relate to tankers’ management efforts to de-risk the balance sheet and business, such as GasLog Partners’ (NSDQ: GLOP) focus on locking in “multi-month” and “multi-year” charters even when it means accepting lower rates. Another Endangered Dividends List member Navios Maritime Acquisition (NYSE: NNA) also boosted profitability, largely by increasing the size of its fleet.

A lot of readers ask us about Capital Products Partners (NSDQ: CPLP), which earlier this year separated its liquids tanker business and merged it with DSS Holdings LP to form Diamond S Shipping (NYSE: DSSI). Capital subsequently reverse split its shares on a 1-for-7 basis, completing the spinoff on March 27.

Since that time, Diamond S shares are basically flat. Management reported a lower second quarter loss despite what it called “weak” operating conditions. It forecast a recovery over the next 12 months in part because 16 percent of the world’s shipping fleet will be installing scrubbers to control emissions. On the other hand, there’s still no indication if or when Diamond will pay a dividend, considerably lessening the appeal of its shares in my view.

As for Capital itself, second quarter results were generally solid with a distribution coverage ratio of 1.5 times. The company, which focuses on dry bulk tankers now, also had some encouraging news on rechartering. Shares have returned nearly 4 percent since the spinoff, including dividends, though they’re still lower by almost 20 percent over the past 12 months. And the basic business is potentially at risk to global economic slowdown, which accounts for the yield of nearly 12 percent.

Bottom line is tankers may tempt us again at in the future. But at this point, there’s not a lot of attraction, given the large number of midstream companies with better prospects and similar yields.

Talking Point #6: Are you concerned about the exodus of global energy companies from Canada? Is there any hope for that country?

RC: This one’s more in my wheelhouse as well. I actually think “Canadian-ization” has been very positive for the handful of best-in-class companies that have been able to take advantage. One of those is Pembina Pipeline Corp (TSX: PPL, NYSE: PBA), which as we pointed out in our August 21 Alert is buying the rest of Kinder Morgan Inc’s (NYSE: KMI) Canadian assets as well as the US portion of the Cochin pipeline.

Pembina is offering a sizeable premium of about 30 percent to buy 100 percent of Kinder Morgan Canada
(TSX: KML, OTC: KMLGF). But it’s all in stock and under the terms it will save about 60 percent from what Kinder is paying out now in quarterly dividends. The new assets will also be immediately accretive on a per share basis, even before the company starts realizing savings and incremental expansion opportunities.

As for Kinder’s motives for selling, the company has a huge opportunity to build pipelines bringing associated natural gas out of the Permian Basin. In contrast, political opposition to tripling capacity on the Trans Mountain pipeline largely stymied its Canada plans. And after selling Trans Mountain, it was looking for a profitable exit. This transaction delivers around $1.6 billion in cash to cut debt and roughly a 5 percent stake in Pembina, which though management says it plans to sell could lay groundwork for a valuable partnership in North America.

On the upstream side, acquisitions of non-Canadians’ assets have definitely boosted the resiliency of Suncor Energy (TSX: SU, NYSE: SU), Canadian Natural Resources (TSX: CNQ, NYSE: CNQ) and Cenovus Energy (TSX: CVE, NYSE: CVE) by adding scale. Suncor and Canadian Natural have actually been able to continue raising dividends, even while smaller producers continue to flounder.

To be sure, this is still a region crying out for takeaway capacity. And the major pipeline projects like Trans Mountain, T.C. Energy’s (TSX: TRP, NYSE: TRP) Keystone XL and Enbridge Inc’s (TSX: ENB, NYSE: ENB) Line 3 continue to encounter delays for the same reasons US developers have.

Until there is more takeaway capacity, Canadian producers will be selling their oil, gas and natural gas liquids for less than their US rivals do. And that means more sector bankruptcies. Obsidian Energy (TSX: OBE, NYSE: OBE), formerly Penn West, looks like a pretty good candidate for one after posting negative operating cash flow in the first six months of 2019 while increasing net debt by 17 percent.

But the more weaklings fall by the wayside, the more concentrated the industry becomes and the stronger the long-term position of the survivors. True, it’s a game for patient and risk tolerant long-term investors now, just as so much of the energy sector is. But sooner or later, some of this promised new capacity is going to come on stream and companies that survived the tough times will be in prime position to boom.

This week, for example, the Canadian government announced Trans Mountain construction will resume “within in month,” now that it’s received the required permits. And earlier this month, pre-construction work resumed for Keystone XL, after a U.S. court overturned an injunction blocking it.

Talking Point #7: What do you think it’s going to take to shift investor sentiment more positively for energy stocks in general?

EG: I touched on this in replying to a few of the prior questions, but I think the key will be execution. The trouble is right now that many investors – general investors rather than energy-focused investors – just don’t see the sector as particularly investable.

That’s because some of the big shale producers destroyed so much capital chasing growth over the past few years and were humbled every time oil prices fell to the low end of their range. If the shale producers remain disciplined about drilling and capital spending and follow through with generating real free cash flow even at moderate oil prices, I think you’ll see more value-oriented investors re-engage in the space.

It would also help if oil prices were to stabilize a bit – the constant sentiment-driven booms and busts in the sector have been exhausting for the producers and the services firms as well. I think ultimately, we will see oil settle into a more sustainable range above $50 to $55/bbl, which is comfortable for all concerned.

Ultimately though I’m convinced value will out. If the shale producers do generate the level of free cash flow we’re projecting over the next 2 years or so and the stocks don’t see renewed investors attention
think you’re going to see a wave of new dividend announcements, share buybacks and maybe even some big producers like Continental (NYSE: CLR) – more than 76% owned by founder Harold Hamm -- choose to go private.

■ RC: I completely agree with those comments about value winning out eventually. That conviction in fact underlies why we continue to hunt for the best companies in the energy space.

As we’ve noted, the midstream companies are suffering because of the perception that shale oil and gas production is about to drop off a cliff, putting a huge dent in system throughputs and cash flows.

That is basically what happened to Sanchez Midstream Partners (NYSE: SNMP) when its parent Sanchez Energy (OTC: SNECQ) filed Chapter 11 earlier this month. It’s what appears increasingly likely to happen to EQM Midstream Partners, with new management at EQT Resources looking for ways to cut per unit costs and throttling back output.

It’s also what people are obviously worrying about for smaller midstream companies like Antero Midstream Corp, Enable Midstream Partners (NYSE: ENBL), EnLink Midstream LLC (NYSE: ENLC) and Oasis Midstream Partners (NYSE: OMP). That’s despite the fact that second quarter numbers were solid and management guidance growth will continue. All four have also seen recent insider buying, indicating executives and directors are putting their money where their mouths are.

I think if companies like these can continue to put up good numbers, investors will eventually take notice. But it’s worth noting that Enable shares were actually lower on August 6, the day management announced the MLP’s first distribution increase since late 2015. And they were down nearly 6 percent the next day when Centerpoint Energy (NYSE: CNP) affirmed it will not sell its 50 percent general partner or 53.75 percent common units ownership.

People have literally worried for years about the potential market disruption, should Centerpoint follow through on often repeated selling plans. The affirmation that it intends instead to be a long-term investor should have triggered a big gain.

The fact Enable lost ground clearly shows the magnitude of investor worries about midstream companies now. So I think it follows we’re not going to see sector values really unlocked until either those fears subside, or companies prove with numbers how much better shape they’re in now than they were back in 2014-15. Either way, I think it’s only a matter of time. But in the meantime, there’s almost surely going to be more volatility and unfortunately sector downside.

Talking Point #8: Will there be more M&A ahead for energy? What sectors do you think will see the most activity? Will most of the transactions be simplification deals? Any takeover candidates you’d recommend?

■ EG: I think a lot of people saw the Occidental Petroleum (NYSE: OXY), Chevron (NYSE: CVX) bidding war for Anadarko (NYSE: APC) and concluded that mega-deal was the beginning of a wave of M&A activity for the upstream space. I don’t see it that way, at least not yet.

After all, even though I think OXY has made tremendous strides in disposing of non-core assets and cutting costs, investors still hate the OXY-APC tie up and there’s an endless stream of articles out there about how OXY overpaid. With that sort of hostility toward M&A, I think a lot of management teams are going to be reluctant to make deals right now.

Longer term, as I said I think a more disciplined shale industry will help improve investor sentiment, and
then it's logical we'll see some more tie-ups. In particular, I can see some of the big integrated producers – Chevron, Total and Royal Dutch Shell spring to mind – looking to beef up their exposure to the Permian and US shale.

You may also see some of the larger shale producers look to the small and mid-cap names like WPX Energy (NYSE: WPX) or maybe even Marathon Oil (NYSE: MRO). However, until sentiment towards the industry improves I think it’s going to be tough for buyers and sellers to agree on a price for deals in the upstream space.

RC: Despite the carnage of the past five years, I think there still are too many midstream companies in the US. That leaves a lot of space for consolidation, though I suspect the best many can hope for is a take under—rather than a high premium takeover offer.

As the Pembina/Kinder Morgan deal showed, there are a lot of midstream assets available that can be immediately accretive for buyers, as well as motivated sellers willing to part with them to free up cash to invest elsewhere.

The intense skepticism of deals Elliott noted is a real impediment to getting deals done. But Western Midstream Partners (NYSE: WES) is an interesting case now. This midstream company has great assets and is just a few months from completing its own simplification merger and now has a much more favorable capital structure for investors. But it’s almost certainly going to be on the block now that Occidental has acquired Anadarko Petroleum’s interest and is looking for ways to cut debt. And the general partner and 55.45 percent common equity interest in Western is a logical place to go.

Investor fears here appear to be two-fold. First is the concern that OXY will sell low in its haste to reduce what’s now a $52.5 billion debt load. Second, they’re concerned Occidental will try to cut a better deal for itself vis-a-vis its midstream service providers and/or will reduce production volumes.

I think the first is highly unlikely. The second is likely but certainly priced into Western’s units now. This MLP also has solid distribution coverage, modest debt and despite more conservative guidance a reasonably clear path to 5 to 6 percent distribution growth this year. That's why we're adding Western Midstream Partners to our High Yield Energy List as a buy below 30 with a yield of almost 11 percent.

Talking Point #9: Where do you see the greatest risk of energy sector dividend cuts now? Where are dividends most likely to be raised?

RC: I'll restrict my comments to midstream. If you look at our Endangered Dividends List now, you'll see primarily smaller companies and MLPs. The biggest is EQM Midstream Partners, and even it has a market value of less than $6.6 billion. Plus, I would argue it faces a unique set of circumstances, with the Mountain Valley Pipeline stalled and its largest customer EQT angling to cut costs. Its general partner Equitrans Midstream (NYSE: ETRN) faces the same risks and is the next largest company at $3.6 billion. Nine companies on our list, however, have a market cap of less than $1 billion.

I really believe the larger midstream companies have for the most part adjusted to the lower for longer energy price environment. Some had to cut dividends sharply to get there, like Energy Transfer LP (NYSE: ET), which perfected the art of “stealth” reductions coupled with mergers. But now even that MLP is self-funding most or all capital spending with cash flow left over after paying dividends, even while cutting debt.

The dividend increases we’ve seen this year at Plains All-American Pipeline (NYSE: PAA), Plains GP Holdings (NYSE: PAGP) and Enable Midstream Partners (NYSE: ENBL) are no flash in the pan. They’re the clearest sign yet that these large MLPs have turned the corner. And Energy Transfer should join them
by returning to a policy of regular payout increases by early next year. Contrast that with what happened to much smaller Sanchez Midstream Partners this month.

Obviously, not every small company or MLP is in trouble. But the combination of high leverage, weak distribution coverage and lack of scale clearly indicates elevated risk to dividends. Conservative investors should stay away.

And don’t count on distributions to hold once they’ve been cut. Sure the coverage is likely to improve at least temporarily, and there will theoretically be more money to pay down debt. But unless the underlying reason for deterioration is addressed, risk remains elevated. In fact, one of the most reliable forecasters of dividend cuts the past five years has been a previous reduction.

■ **EG:** I’ll focus outside the MLP/Midstream space in answering this question.

Looking at the EIA model portfolio, I think investors are clearly concerned about the sustainability of dividends from Occidental and Schlumberger, which now yield around 7 percent and 5.9 percent respectively. In both cases, those are the highest yields these companies have offered since 1980s!

I actually think both dividends are sustainable, and management is committed to maintaining and growing those yields. Should they execute well and hold those payouts, I think you’d see OXY and SLB return to a more normal yield range of about 5 percent and 3 percent respectively, which implies more than 40 percent of upside for OXY’s stock from the current level and more than a double for SLB.

It’s not going to happen overnight, but I actually think those are pretty conservative targets over the next 2 to 3 years. I also think that you’re going to see more dividend announcements and raises from the major shale producer companies in coming years as their free cash flow position improves. Companies like Marathon Oil, Continental Resources and **Concho Resources** (NYSE: CXO) all offer small yields already with both CXO and CLR initiating their first-ever dividends this year.

Again it all depends on free cash flow generation plans working out and on the producers remaining disciplined but with oil averaging in the $55/bbl area you could easily see these companies double their payouts or more over the next few years as another way of attracting more value-oriented investors to the space.