



EIP's Brothwell: Energy Market Amid Supply Woes Requires Diversification

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Sam Brothwell, director of research at Energy Income Partners. Read the Q & A below as Sam says that the current cycle of under-investment in capital spending has made it harder for energy producers to respond to the current global supply-demand imbalance; that has pushed energy prices – for oil, natural gas, electricity, and alternatives – dramatically higher, where they are likely to stay, even as energy



companies work to increase capacity and respond to market conditions.

Brothwell says that investors should respond to current conditions by diversifying their energy holdings as legislators and corporate executives wrestle with economic issues while searching for solutions.

Sam Brothwell

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CHUCK JAFFE: Sam Brothwell, director of research at Energy Income Partners is here and we're talking about the changing global energy picture, welcome to The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today we're looking in the direction of energy investing with

Sam Brothwell, director of research at Energy Income Partners, which invests in pipelines and utilities. They are long-only investors, and you can get more information on the firm and what they do at EIPInvestments.com. And while you're checking things out, you can get a lot of knowledge about business-development companies, interval funds, and closed-end funds at AICAlliance.org, the website for the Active Investment Company Alliance. Sam Brothwell, thanks for joining me on The NAVigator.

SAM BROTHWELL: Thank you, Chuck. It's great to be on your program again.

CHUCK JAFFE: Sam, you were on The NAVigator last fall, and lord knows, there has been a lot that has been going on throughout the energy space. It doesn't really make a difference which type of energy we're talking about, there's been a lot of change. But let's start with natural gas, and what's been happening there and the supply-demand picture, because maybe that is where we've seen the most froth since you and I spoke last.

SAM BROTHWELL: Yeah. No, we were talking about natural gas last fall. If anything, the things that we were discussing then have just intensified. Certainly we've had some geopolitical events that we don't need to drill into, but one of the things that we're seeing that's not in short supply is passing of blame, finger pointing. The usual partisan divide has the political right kind of blaming the Biden administration for embracing renewables and stopping natural gas and oil development. The left of course points to over-reliance on fossil fuels and the need to break that cycle with renewables. And as usual, there's false narratives on both sides. We prefer to focus on the facts. And I would just point out a couple things that stand out to us, first of all, supply is driven by capital spending. We had a decade of over investment by the industry, very poor returns on capital, and that kind of drove an investor revolt. And now the industry's gotten religion in the form, focus on capital discipline and shareholder returns, and now we're in a cycle of underinvestment. We've been in it for the past five years, so the rush to drill up new supply to meet higher prices isn't happening the way it used to. And second, second point is that, yes, the current administration has had a decidedly anti-fossil fuel narrative, at least up until recently, but while current policies and tones may affect future growth, they have not driven the current supply-demand situation that we're facing today.

CHUCK JAFFE: What they have done though is been part of an environment where energy prices have gone way up. I mean, natural gas three times what it was a year ago, oil topping

\$120 a barrel. So if that hasn't been enough to solve the supply-demand problem, what has to happen or where are prices going?

SAM BROTHWELL: Yeah. No, you know it's interesting, the CEO of a major oil company was quoted last fall saying that he needs two signals to start ramping up drilling activity. One was a high price, clearly we've got that. But the second was willingness on the part of the capital markets to fund that increased development, and he said he still wasn't getting that signal. Which means in other words shareholders wanted cash returned to them rather than drill back into the ground. To kind of put a finer point on it, some numbers, oil and gas capital spending is down 57% since peaking in 2014. It's running about \$400 billion a year, but that's not really adding to production because the depletion rate, which is just the rate at which shale production naturally tapers off each year, that rate is in the high single digits. So the capital that's being spent, that \$400 billion is actually not growing supply, it's just kind of keeping things running in place. And the industry's capital base has been shrinking since 2016 despite all that spending because they're just not replacing that depletion rate with the capital they're spending.

CHUCK JAFFE: Is there anything else that winds up holding back supply here? We'd like to believe that supply and demand all occurs naturally and everything else, but we watched as Covid kind of messed everything up, and we watched as everything else was happening. Does oil and gas and the rest have any of those sorts of outside other pressures that are affecting supply and demand right now?

SAM BROTHWELL: Well, you're right, Covid destroyed demand, rig count fell off, and while it's coming back up, it's not back to the pre-pandemic levels. But the other thing that we often hear is politics and the actions of the current administration. Everybody loves to point fingers at what federal officials are doing. The important thing to remember here is that less than 15% of US oil and gas production, which is less than 2% of global production, actually comes from federal land. The moratorium that the Biden administration talked about has long since expired. And while there's no question that a negative narrative and tone that has been decidedly against fossil fuels, that can affect future oil and gas production by discouraging new development. But as we just discussed, the reason that we're in the situation we're in now, goes back to this capital allocation decisions that the industry's been making for the past five years. Decisions driven by shareholders who decided that they could

no longer trust the industry to invest profitably. The numbers bear that out. The return on capital employed for the S&P 500 energy sector over the last seven years is less than 2%, despite oil prices averaging over \$50 a barrel during that same time period.

CHUCK JAFFE: Let's take this away from oil and natural gas and turn it to the other thing that you've written about that a lot of people don't talk about. The headline on inflation is gasoline at five dollars a gallon, but electricity costs, as you've noted in your commentaries, are significantly up. So what's happening with power?

SAM BROTHWELL: Yeah, right, that's the one that doesn't get as much attention. But we're hearing not only concerns about rising prices, but we're hearing growing concerns of the reliability of our electricity grid. We talked last fall on your program about California and their aggressive push to drive out natural gas power generation and replace it with wind and solar, and that led to rotating blackouts when solar production dropped off and there was nothing available to fill that gap. Now we're hearing about heat straining the grid in Texas, and once again, the thing that we're seeing plenty of is the blame game. It's either, well, there's too much wind and renewables, or there's too much dependent on natural gas. The reality with our power situation is neither. It's that over the past two decades we transitioned from a fully regulated, utility-owned power supply system to one that is increasingly market driven, especially in the major population centers like the Northeast, California, and Texas. Markets don't like spare capacity that isn't generating a profit. It took the airlines two decades to figure that out. So today we have an electricity system in many parts of the country that doesn't pray for reliability, and reliability is unfortunately something that electricity customers have kind of come to expect. And so today, California's faltering grid reliability has led a very progressive governor, former mayor of San Francisco, to openly seek federal funding to keep the States last remaining nuclear plant from closing down in a couple of years as is currently planned.

CHUCK JAFFE: What about all the development of alternative energy sources? I mean, aren't wind and solar your reliable alternative, and aren't they developing at least some sort of pace to be a replacement?

SAM BROTHWELL: Yeah, they're developing very quickly. I think they're nowhere near the share that natural gas occupies. But the thing to remember is that every energy source has got its pros and cons: cost, reliability, environmental impact, and none of them are perfect.

Just like no single stock will make a perfect portfolio. Wind and solar don't produce power around the clock, and it's surprising the number of people who just don't fully understand that. Renewables are cost-competitive because the fuel is free, but they don't run all the time. They have to be paired with something that can balance that variability, and the best something that we have today happens to be natural gas. But as we discussed, natural gas has gotten a lot more expensive. The disciples of renewables would have you believe that the answer to variability is to just pair it up with batteries. The oil and gas folk, die-hards, would tell you just say no to wind and solar. But we think the best solution is a combination, optimizing what each resource brings to the table in terms of cost, safety, reliability, environmental impact. In other words, put together a portfolio.

CHUCK JAFFE: So that's going to be of course what you guys do from an investment standpoint. But as we watch, everybody is looking for somebody to take action that's going to make it that gas prices will go down again or electricity costs will fall, or all those other sorts of things. Are those challenges addressable?

SAM BROTHWELL: Certainly all the issues that we're facing leads the public to look to their elected representatives to intervene somewhat. Everybody wants lower price. A lot of people want US gas and oil production to achieve energy dominance, whatever that is. Yeah, I think if you're going to address the challenges, things like supply, security, price, you're going to have to convince the owners, the shareholders to open their wallets. And when you start talking about things like a windfall profits tax, that's probably not going to get that done. Global energy, production, refining, delivery, all of that stuff is owned and run by private companies, and capital has to flow where it's needed to address these challenges. So I would just add that energy policy often tends to be colored by preferred solutions or technologies. We've seen that among a lot of states that like to pick winners, whether it's solar or wind or natural, whatever. We think picking winners is a bad idea, and I'd suggest that defining outcome-driven economic incentives. Both in the regulated and unregulated parts of the system, whether you're talking oil and gas or utilities. That would help attract capital that's going to be needed to come up with those effective and economic solutions.

CHUCK JAFFE: Sam, really interesting stuff, thanks so much for joining me. Let's do this again down the line sometime.

SAM BROTHWELL: Absolutely. Pleasure to be here, thanks Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Sam Brothwell, director of research at Energy Income Partners. Learn more about the firm, its investment process, and its funds at EIPInvestments.com. The NAVigator podcast is new every Friday, ensure you don't miss anything by following us on your favorite app. And if you like us, please leave a review because they really do help. Until we do this again next week, happy investing everybody.

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