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Date: October 20, 2023
Topic: Income, MLPs

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GLOBAL X ETFs RESEARCH

Energy & MLP Insights: Record-High U.S. Oil and Gas Output Requires Midstream Infrastructure

Extended OPEC+ production cuts through year-end and increased demand with economic activity in China picking up are suggesting tighter oil markets for the rest of 2023 and likely into 2024. For U.S. midstream MLPs, we expect an oil market deficit coupled with record U.S. oil and gas production to be a recipe for success, given greater demand for midstream transport systems, warehouses, and factories. As discussed in our previous Energy & MLP Insights, the price environment is likely to remain volatile, but midstream's defensive contracts and fees structure make it uniquely positioned to benefit compared to other segments of the energy market. With diversification potential and inflation pass-through capabilities core features of the sector, midstream equities can bring unique energy exposure to investor portfolios.

Key Takeaways

- Saudi Arabia and Russia remain aligned in their protracted curtailment of oil production, setting the stage for a likely oil market deficit in Q4.[1]
- U.S. oil and gas production at an all-time high suggests increased demand for midstream infrastructure.
- Demand for midstream infrastructure is likely to keep the merger and acquisition market active, with the latest example being Energy Transfer LP's purchase of Crestwood Equity Partners.

Supply Concerns Suggest an Oil Market Deficit Is Likely

Amidst a confluence of variables including supply reductions and geopolitical tensions, oil futures have lately approached record levels on a consistent upward trajectory throughout the year.[2] While the elevated spot prices have the potential to amplify concerns regarding global inflation, the oil futures curve firmly indicates a tight market, by showing a pronounced backwardation.[3]

Originally slated to end in September, Saudi Arabia announced that it will prolong its voluntary crude oil output cut of 1 million barrels per day (b/d) till the end of the year.[4] In August, Russia announced that it would decrease exports by 300,000 bpd through the end of the year.[5] These moves pushed oil prices to near record highs and kept global oil supply below demand.

Although the most recent conflict in Israel & Gaza have not had much of an impact on the physical oil markets, it increases the possibility of disruptions in oil supply, which in turn could lead to increased volatility in oil prices.[6]

WTI OIL FUTURE FORWARD CURVE
Source: Bloomberg Data as of 10/12/2023

On the demand side, unanticipated shifts in global GDP growth in the upcoming months may have an impact on energy consumption because the forecast for the world economy is still uncertain. However, China's recovery and U.S. weather patterns are in the spotlight. Average global oil consumption is expected to reach a new high in 2023, helped by increased demand from China, the world's biggest oil importer.[7] From July to August, China's crude imports jumped 21% to 52.8 million tonnes.[8] Fresh stimulus measures from Beijing and stronger production from Chinese refiners due to solid export margins contribute to the positive outlook for demand.[9,10,11] Finally, amid summer heat in the past few months, strong U.S. air conditioning demand increased natural gas-fired power generation and decreased coal-fired generation.[12]

Record U.S. Energy Production Puts Midstream Equities in Demand

Saudi Arabia's production cuts and Russia's exports cuts may increase price volatility, but U.S. oil and natural gas output can fill global energy market supply gaps with the help of U.S. midstream companies. We think this current production setup represents an opportunity for US midstream companies, given that US producers can step in to fill the void.

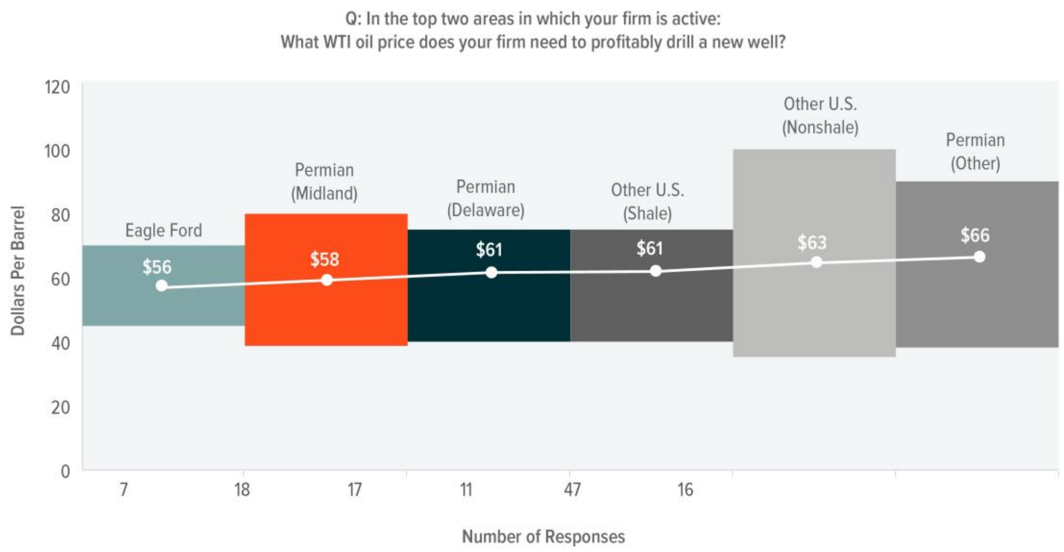
With the WTI price being above the level at which most U.S. oil drilling sites break even, we expect oil rigs, mostly in the Permian Basin, to increase production.[13] Also, global export data for first half of 2023 shows that the United States is about to surpass Australia and Qatar as the world's leading liquefied natural gas supplier.[14] Abundant shale resources and foreign buyers' enthusiasm for U.S. liquefied natural gas (LNG) after moving away from Russian gas due to the war in Ukraine are behind the U.S.' rise. According to EIA predictions, U.S. natural gas exports might set a record in 2023 and continue to rise in 2024.[15]

SHUT-IN PRICES FOR EXISTING WELLS

Source: Federal Reserve Bank of Dallas. Line shows the average, and bars show the range of responses. 83 E&P firms answered this question from March 15-23, 2023. As of 10/18/2023.

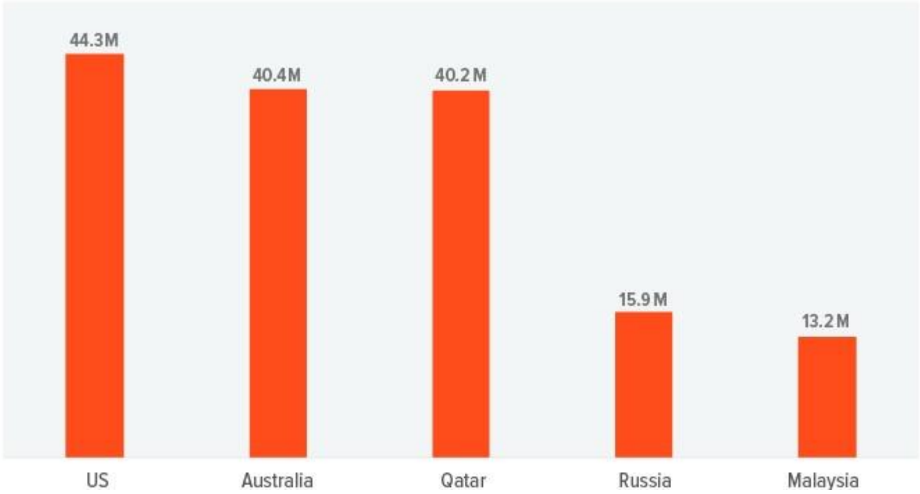
BREAKEVEN PRICES FOR NEW WELLS

Source: Federal Reserve Bank of Dallas. Line shows the average, and bars show the range of responses. 84 E&P firms answered this question from March 15-23, 2023. As of 10/18/2023.



FIRST HALF OF 2023 LIQUIFIED NATURAL GAS EXPORTS BY COUNTRY (METRIC TONS, MT)

Source: Bloomberg as of 06/31/2023



Against this backdrop, the EIA expects non-OPEC global liquid fuels output increase by 2.2 million b/d in 2023 and 1 million in 2024, led by the United States, Brazil, Canada, and Guyana.[16] Moreover, they see U.S. oil production averaging 12.92 million barrels a day (Mb/d) in 2023 and 13.12 Mb/d in 2024, or 8% and 10% higher than average production of 11.91 Mb/d in 2022.[17]

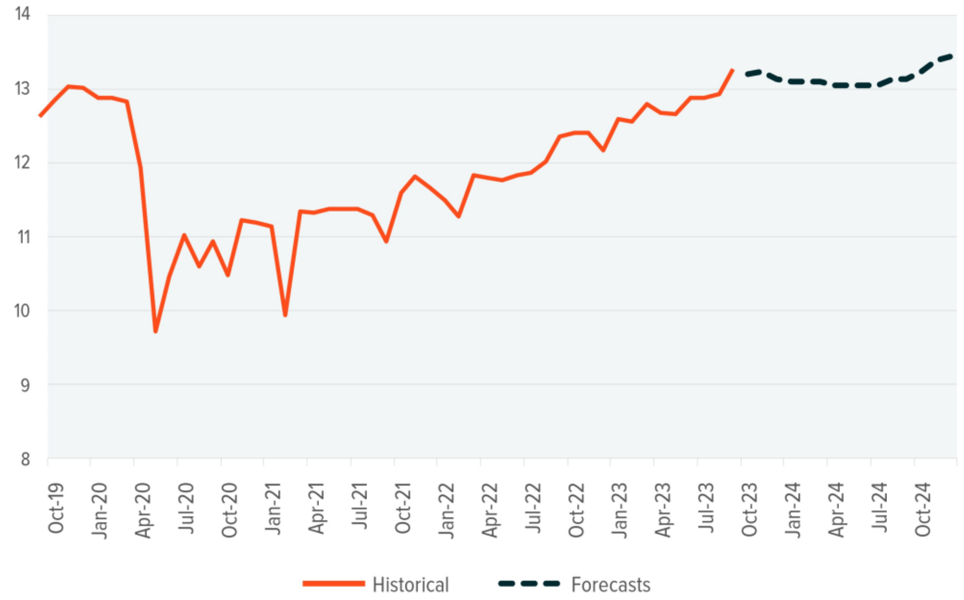
In September, oil output in the United States surpassed the previous record level of barrels per day (bpd) observed prior to the onset of the pandemic and is projected to continue to increase in 2024. The EIA also forecasts U.S. natural gas production to average 103.7 billion cubic feet per day (Bcf/d) in 2023 and 105.1 Bcf/d in 2024, or 6% and 7% higher than average production of 98.07 Bcf/d in 2022, setting the stage for record levels of energy production.[18]

U.S. NATURAL GAS PRODUCTION (BCF/D)

Sources: EIA, monthly data from December 2013 to September 2023 and monthly forecasts from October 2023 to December 2024. As of 10/11/2023

U.S. FIELD PRODUCTION OF CRUDE OIL (MILLION B/D)

Sources: EIA, monthly data from December 2013 to September 2023 and monthly forecasts from October 2023 to December 2024. As of 10/11/2023



Mergers & Acquisition (M&A) Activity Helps Midstream Companies to Continue their Strong Performance

Midstream companies, as measured by the Solactive MLP Infrastructure Index, have performed well year-to-date, increasing by around 22% and outperforming the broader energy sector, measured by the Standard and Poor's 500 Energy Index, which shows approximately a 7% increase year-to-date as of October 16th, 2023.

The main reasons behind this positive performance are the record US energy production, as previously discussed, and the M&A consolidation in the midstream industry. Indeed, it has been a robust multi-year run of M&A activity in the sector. As we discussed in our last Energy & MLP Insights, M&A can help midstream companies expand their operations quickly, increase their profits, and cut their operating expenses, and in this environment, we expect the deal activity trend to continue.

The latest example is Energy Transfer LP's acquisition of Crestwood Equity Partners LP in an all-equity deal valued at approximately $7.1 billion, including assumed debt of $3.3 billion.[19] Expected to close before year-end, the deal expands Energy Transfer's footprint in the Williston and Delaware basins and provides an entry point for the Powder River basin.[20] The deal also brings commercial synergies to Energy Transfer's natural gas liquids and refined products business and its crude oil business along with strategically located storage and terminal assets. Energy Transfer expects to achieve at least $40 million of annual run-rate cost synergies before additional benefits of financial and commercial opportunities.[21] Crestwood unitholders are projected to benefit from the tax-efficient transaction and have the chance to participate in Energy Transfer's targeted annual dividend per unit growth rate of 3–5%.[22]

Earlier this year, Energy Transfer rival Oneok Inc paid $18.8 billion for Magellan Midstream Partners to get access to crude oil transportation and storage markets, a transaction that recently closed. Also, Energy Transfer co-founder and main owner Kelcy Warren bought Lotus Midstream for $1.45 billion.[23,24] Moreover, the breadth of this phenomenon extends beyond the realm of midstream mergers and acquisitions: the Exxon transaction that took place was of significant magnitude. At the beginning of

October, Exxon Mobil sealed a deal to purchase Pioneer Natural Resources (PXD) for $59.5 billion in an all-stock deal, representing the greatest takeover in over twenty years among oil giants. This latter deal, too, shows renewed momentum in consolidating small-midsize enterprises and large diversified energy producers.[25]

Conclusion: Oil Supply Crunch Highlights Midstream Energy's Investment Profile

As long as OPEC+ extends production cuts, more U.S. energy production moves into the spotlight. Rising U.S. oil and gas production combined with a likely oil supply shortfall means midstream's role as facilitator of the oil and gas market has added significance. Deal activity within the sector can remain high as well with new projects difficult to get off the ground. Even if prices stay volatile, the midstream sector's fee-based business models and contractual escalators mean they are not as correlated to energy prices as other energy sectors. From a valuation point of view, these companies can also offer strong distribution yields, potentially higher than those of 10-Year Treasuries and REITs, and low valuations, trading at an 8% discount relative to their 5-year average, a greater discount than REITs.[26,27] These considerations are two more attractive ingredients in their investment profile.

Footnotes

1. Reuters (2023, September). OPEC+ cuts to tighten oil market sharply in fourth quarter, IEA says.
2. Bloomberg Data. WTI future oil price. Oil measured by CL1 COMB Comdty. Field:PX_LAST
3. Bloomberg Data. WTI future forward curve. Oil measured by CL1 COMB Comdty. Function:CCRV.
4. Reuters (2023, October). Saudi Arabia, Russia to continue voluntary oil cuts.
5. Ibid.
6. Energy Information Administration (2023, October). *Short-Term Energy Outlook*.
7. IEA (2023, August). *Oil Market Report*.
8. China Customs Crude Oil Total Imports Quantity. Data from 07/31/2023 to 08/31/2023.
9. World's top Exports. *Crude Oil Imports by Country*. Accessed on October 17, 2023.
10. Barron's. (2023, August). Barron's live coverage of financial markets, from stocks and bonds to oil and crypto.
11. Reuters. (2023, September). *China oil refinery output rises to record on firmer demand, export margins*.
12. Energy Information Administration (2023, September). *Short-Term Energy Outlook*.
13. NPR. (2023, June). America is going through an oil boom – and this time it's different.
14. NPR. (2023 July). The rise of American natural gas.
15. Energy Information Administration (2023, October). *Short-Term Energy Outlook*.
16. Energy Information Administration (2023, September). *Short-Term Energy Outlook*.
17. Ibid
18. Energy Information Administration (2023, September). *Short-Term Energy Outlook*.
19. Energy Transfer – Press Release. (2023, August). Energy Transfer to acquire Crestwood in a $7.1 Billion All-Equity transaction.

20. Ibid.

21. Oil & Gas Journal. (2023, August). *Energy Transfer to acquire Crestwood for $7.1 Billion*.

22. Energy Transfer – Press Release. (2023, August). *Energy Transfer to acquire Crestwood in a $7.1 Billion All-Equity transaction*.

23. ONEOK. (2023, May). *ONEOK to acquire Magellan Midstream Partners in a transaction valued at $18.8 Billion*.

24. Reuters. (2023, March). *Energy transfer boosts Permian presence with $1.45 billion deal for lotus midstream*.

25. Bloomberg. (2023, October). Exxon to buy pioneer for $60 billion to dominate shale oil.

26. Bloomberg Data. MLPs measured by MLPA US Equity, Yield to Maturity; 10 Year US Treasuries Constant Maturity Rate. REITS measured by FNERTR Index, Field: EQY_DVD_YLD_12M.

27. Bloomberg Data. MLPs measured by SPMLP Index. REITs measured by FNER Index. Field: IDX_EST_EV_EBITDA. Data from 9/28/2018 to 9/29/2023.

Glossary

Run Rate: the financial performance of a company, using current financial information as a predictor of future performance.

Standard and Poor's 500 Energy Index: An index that comprises those companies included in the S&P 500 that are classified as members of the GICS energy sector.

Solactive MLP Infrastructure Index: is intended to give investors a means of tracking the performance of the energy infrastructure MLP asset class in the United States. The index is composed of Midstream MLPs engaged in the transportation, storage, and processing of natural resources.

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expect to generate significant investment income, and the Fund's investments may not distribute the expected or anticipated levels of cash, resulting in the risk that the Fund may not have the ability to make cash distributions as investors expect from MLP-focused investments. Past distributions are not indicative of future distributions. There is no guarantee that dividends will be paid.

The potential tax benefits from investing in MLPs depend on them being treated as partnerships for federal income tax purposes. If the MLP is deemed to be a corporation then its income would be subject to federal taxation at the entity level, reducing the amount of cash available for distribution to the fund which could result in a reduction of the fund's value.

MLPA has a different and more complex tax structure than traditional ETFs and investors should consider carefully the significant tax implications of an investment in the Fund. MLPA is taxed as a regular corporation for federal income tax purposes, which differs from most investment companies. Due to its investment in MLPs, the fund will be obligated to pay applicable federal and state corporate income taxes on its taxable income as opposed to most other investment companies. The fund expects that a portion of the distributions it receives from MLPs may be treated as tax-deferred return of capital. The amount of taxes currently paid by the fund will vary depending on the amount of income and gains derived from MLP interests and such taxes will reduce an investor's return from an investment in the fund. The fund will accrue deferred income taxes for any future tax liability associated certain MLP interests. Upon the sale of an MLP security, the fund may be liable for previously deferred taxes, which may increase expenses and lower the fund's NAV.

Shares of ETFs are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Brokerage commissions will reduce returns.

Carefully consider the Funds' investment objectives, risk factors, charges, and expenses before investing. This and additional information can be found in the Funds' summary and full prospectuses, which may be obtained at www.globalxetfs.com. Read the prospectus carefully before investing.

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