

PERITUS

ASSET MANAGEMENT, LLC

Market Commentary

Independent Credit Research – Leveraged Finance – September 2014

ENERGY MARKET UPDATE

Access to and pricing of energy in all forms matter immensely to consumers, markets and economies. Prices of electricity, gasoline, diesel and jet fuel are directly affected by oil prices and impact all consumers. We have seen the pricing on near month WTI oil futures contracts fall over the last month and during the past year. So does this have any real impact on our portfolios and does it change our thesis of higher oil prices in the future?

The Short Term

First let's talk a little bit about the complexity of these markets. Oil markets and prices vary dramatically based on types of crude (sweet/sour and heavy/light). At Peritus, our exposure comes mainly in the form of the Western Canadian market, as we believe this basin represents the most attractive assets as they produce primarily heavy oil (in much shorter supply and greater demand) and have much lower decline curves than the shale/tight oil basins in the US. Prices for Canadian heavy crudes are represented by a grade known as Western Canadian Select, or "WCS" for short. Note the pricing comparison by year in the table below¹:

		9/12/2014		9/12/2013		13/14	Avg. Price
<u>Crude Oil</u>		<u>Close</u>	<u>Change</u>	<u>Close</u>	<u>Change</u>		<u>YTD</u>
Synthetic Crude	(\$C/bbl)	100.81	-77 ¢	108.46	-7.65		108.71
Western Canada Select	(\$C/bbl)	87.08	-55 ¢	84.98	2.10		87.68
Differential (WTI/WCS)	(\$C/bbl)	15.12	34 ¢	27.09	-11.97		21.66
WTI Cushing Spot	(\$US/bbl)	92.27	-56 ¢	108.60	-16.33		100.20

So while West Texas Intermediate (WTI) near month pricing has fallen year over year by \$16.00, WCS prices are actually up over \$2.00 during this time as the differential has come in almost \$12.00. The reasons for this are numerous, but investors need to keep in mind that much of the production out of the Eagle Ford, Bakken and Permian (US "shale" producers) is super light oil or condensate. This is why many companies are petitioning the US government to be allowed to export this product (see our blog "[US Crude Exports Announcement](#)"). While there is some refining capacity for this production, much of it is used as a blending stock. The US Gulf Coast ("USGC") refiners have very substantial demands for heavier grades of crude, not this light oil and condensate. Historically, this heavy crude has been supplied by Mexico and

¹ "Industry Statistics & Information Market & Commodity News," <http://psac.ca/firstenergy/>, data provided by FirstEnergy Capital.

Venezuela. However, this production has declined substantially leaving the USGC starved for the heavier grades of crude it is set up to refine.

The following is from the State Department’s own report on the Keystone XL Pipeline²:

Imports from Mexico and Venezuela, traditional heavy oil suppliers, fell during the 2000s as production from those countries declined. EIA’s forecast implies that net oil exports from these countries will continue to decline.²¹ There is uncertainty about how production levels will develop and both countries are looking to alter the trend, which are explored further in Section 1.4.4, Updated Modeling. However, even if this trend changes, Mexican production is becoming lighter on average as new supplies are relatively lighter than those in decline,²² and Venezuela is actively trying to market its crudes to non-U.S. buyers.²³ Meanwhile, as discussed above, U.S. demand for imported crude is expected to grow heavier. Declining supplies from Mexico and Venezuela were partially offset by greater imports from Canada as well as small volumes from Colombia and Brazil, which are heavy crude producers where oil production has been growing.

U.S. refinery demand for WCSB heavy crude imports is likely to remain robust given expected global trends (see Table 1.4-8). Apart from WCSB, heavy crude supply from some traditional sources may decline. In addition, some countries that produce heavy crude oil are attempting to expand domestic refining and upgrading capacity to process more of their heavy crudes at home.

Table 1.4-8 U.S. Heavy and Canadian Heavy Crude Oil Refined (thousand bpd)

	2011	2015	2020	2025	2030	2035
Total U.S. Heavy Crude Refined	2,611	3,134	3,987	4,030	4,022	4,183
Canadian Heavy Crude Refined in United States	1,242	1,769	3,277	3,535	3,690	3,900

Source: Hart 2012

As this notes, the void of supplies from Mexico and Venezuela is being filled by Canada. The news actually gets better: the Canadian dollar has also fallen significantly over the past year. The reason this matters is that oil is priced in US dollars, but these producers’ costs are in Canadian dollars supporting higher margins for these companies.³

	9/12/2014		9/12/2013		13/14	Avg. Price
	Close	Change	Close	Change		YTD
Can-US Exchange Rate (US¢)	90.29	-0.36	96.90	-6.61		91.48

I expect weakness in both WTI and Brent crude prices to be temporary. Much of this recent price weakness is related to poor technicals and seasonality, which is masking much of the underlying production issues. Many refineries go down in the fall for maintenance so crude

² Final Supplemental Environment Impact Statement, Keystone XL Project, U.S. Department of State, p. 1.4-27.

³ “Industry Statistics & Information Market & Commodity News,” <http://psac.ca/firstenergy/>, data provided by FirstEnergy Capital.

inventories tend to build. This is temporary. Another significant factor in the decline in near month futures prices is the unwinding of speculative long positions by hedge funds and traders. It was a very crowded trade and in a very short period of time it has become uncrowded.

The Long Term

Let's just touch on the long term thesis of much higher oil prices. The reason I am an oil bull relates to both supply and costs. Nigeria, Libya, Venezuela and Iraq are just the more obvious examples of countries that are significant oil suppliers and are in complete disarray. How about Russian production? Does anyone believe that Putin's desire to re-assemble the USSR and the requisite sanctions against capital and technology into the country from the West will lead to more oil production sustainability? If you want further evidence on supply issues just study Brazil and Kazakhstan. It was a decade ago that these two countries were going to be the new production superstars, yet today production in Brazil is actually down while Kazakhstan is nowhere near their forecasts.

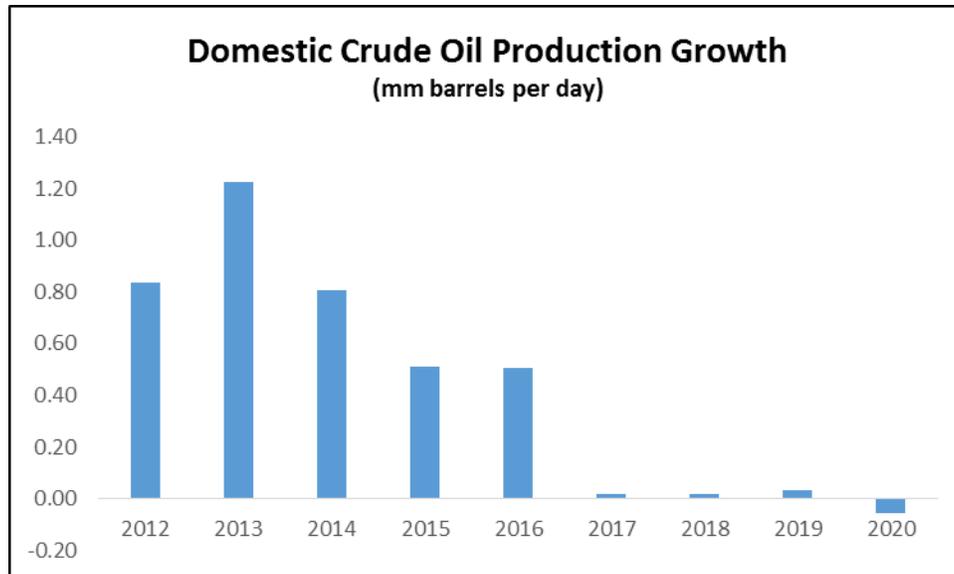
Perhaps none of that matters because according to some the US is now heading toward energy independence and becoming the largest oil producer in the world. I have been very vocal about my skepticism surrounding this new "energy revolution" of ours. My belief is that this increase in oil production is not sustainable. Keep in mind that Texas and North Dakota are responsible for almost all of this new found production. These basins have sweet spots that are small and the beginning wells are very prolific as they are drilled into the heart of the best locations. But decline curves for these wells are severe (meaning production dies after 2-3 years), requiring more and more drilling just to keep production from declining and of course this drilling moves into less productive areas. The following is from the Energy Information Administration's ("EIA") 2012 Annual Energy Outlook⁴:

The length of time over which the rapid growth can be sustained depends on the size of the technically recoverable resource in each play, the rate at which drilling activity increases, and the extent of the play's "sweet spot" area [115]. In the longer term, production growth tapers off as high initial production rates of new wells in "sweet spots" are offset by declining rates of existing wells, and as drilling activity moves into less-productive areas. As a result, in the later stages of a play's resource development, maintaining a stable production rate requires a significant increase in drilling.

Depicting this graphically⁵:

⁴ Energy Information Administration/Department of Energy, "2012 Annual Energy Outlook," June 2012, p. 57.

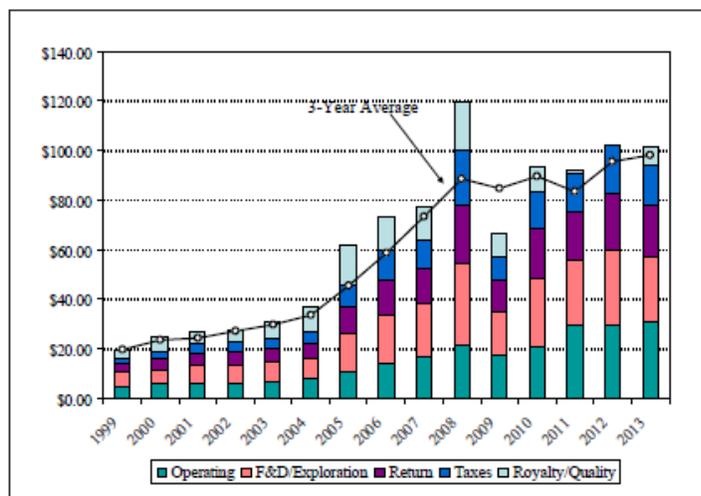
⁵ Source: U.S. Energy Information Administration, data as of January 13, 2014.



So according to the EIA (we could write an encyclopedia about how ludicrously optimistic they are), growth tapers off substantially in the coming years. Funny how this is never discussed by the investment community.

Finally, there is the subtle issue relating to the costs to produce a marginal barrel. The difference between “resources” and “reserves” is significant in that reserves are actually the resources that can be produced to generate an economic profit. What is unarguable is that operating and reserve replacement costs have soared over the past decade. Unconventional oil is what is left and it is expensive to produce. So should prices actually fall further, production would simply be curtailed. In the law of markets, low prices cure low prices.⁶

Chart 2: Worldwide Breakeven Supply Cost (US\$/boe) @ Realized Oil/Gas Price Ratio



Source: BMO Capital Markets, Company reports

⁶ “Oil & Gas Global Cost Study,” BMO Capital Market Research, July 2014, p. A3.

Conclusion

To summarize, while posted Brent and WTI crude futures prices have fallen, this has not affected the profitability or pricing for Canadian heavy oil producers. In the short run, all markets are unpredictable, but we believe fundamentals ultimately win out. We believe that fundamentals in the case of oil are being disguised by the short term technical and seasonal factors now at play. The incredibly well behaved oil prices in the face of the crisis going on in Russia-Ukraine and ISIS in Iraq has much to do with the misplaced comfort being provided by the increase in US production. As the bloom comes off the rose domestically, we expect oil prices to stair step significantly higher and are positioning ourselves accordingly.

Peritus I Asset Management Disclosure:

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