

Oil Industry: Won't Get Fooled Again

"Everyone running an oil company today is a survivor of that massacre, and that affects their behavior on capital spending and the like. I don't think this point can be emphasized enough."

The quote of mine above, which concluded a [Columnist Conversation](#) exchange a week ago, triggered a number of e-mails as well as a request for elaboration from Cody Willard, who certainly has brought a great deal of insight to both oil and oil stocks on RealMoney.

I have tried over the years to establish several broad ideas, including a long-term skepticism about real commodity prices. The record is clear: Over time, real commodity prices *must* fall as a factor input to production; this reflects the effects of substitution, technological improvement and other efficiencies. Over the long-term, betting against human ingenuity loses.

But between now and the long-term - a concept not marked on anyone's calendar - supply and demand can move into imbalance and require higher prices to move back into balance. This certainly has happened in the energy markets. Whether the current imbalance reflects the inevitable consequences of [Hubbert's Peak](#), which is to geology what the [Laffer Curve](#) is to tax policy, is immaterial. (Everyone can agree on three things about the Laffer Curve: At either a 0% or a 100% tax rate, the government takes in no money, and there is some optimum point for tax revenues in between. So profound.)

The reason we can ignore the gloomy endgame for Hubbert's Peak, the idea that the physical reserves of conventional crude oil will deplete at some point in time, is its silence on what comes thereafter. I am not one who waxes euphoric over resources such as Canadian oil sands, oil shale in Colorado and Utah, or heavy oil in Venezuela: All of these require such massive investments of capital and consume so much energy in their current methods of production that the marginal barrel of conventional crude oil always will be cheaper.

The Sum Of Some Fears

Once production of these massive resources begins, the price will fall to accommodate the new source of supply. As is the case for nearly all resource projects, the costs of shutting down or even reducing production are quite high, and the fixed costs involved in the project do not disappear. As a result, resource prices can and do fall well below the marginal costs of production during a price collapse.

The endgame generally involves the bankruptcy of the initial investors in these projects; see the history of other mega-projects such as the Panama Canal or the Chunnel. Or, for that matter, who has survived the first quarter-century of personal computers, the pioneers or the next generation of low-cost producers?

Non-state corporations capable of making these huge investments are few and far between, and most of them have concatenated names such as ExxonMobil, ChevronTexaco, TotalFinaElf or ConocoPhillips. Toss in BP, briefly known as BP Amoco, and Royal Dutch/Shell, and you pretty much have the list. And herein lies the rub: These firms have to compete with state oil firms whose incentives are not profit maximization but (in some order) total revenue, employment, and tax revenue and other emoluments to the governing powers who be. If ExxonMobil thinks it can win a price war with Saudi Aramco, or Mexico's Pemex or Venezuela's PdVSA, or the various entities in Putin's Russia, it is wrong. And its shareholders had better hope they do not try to do so.

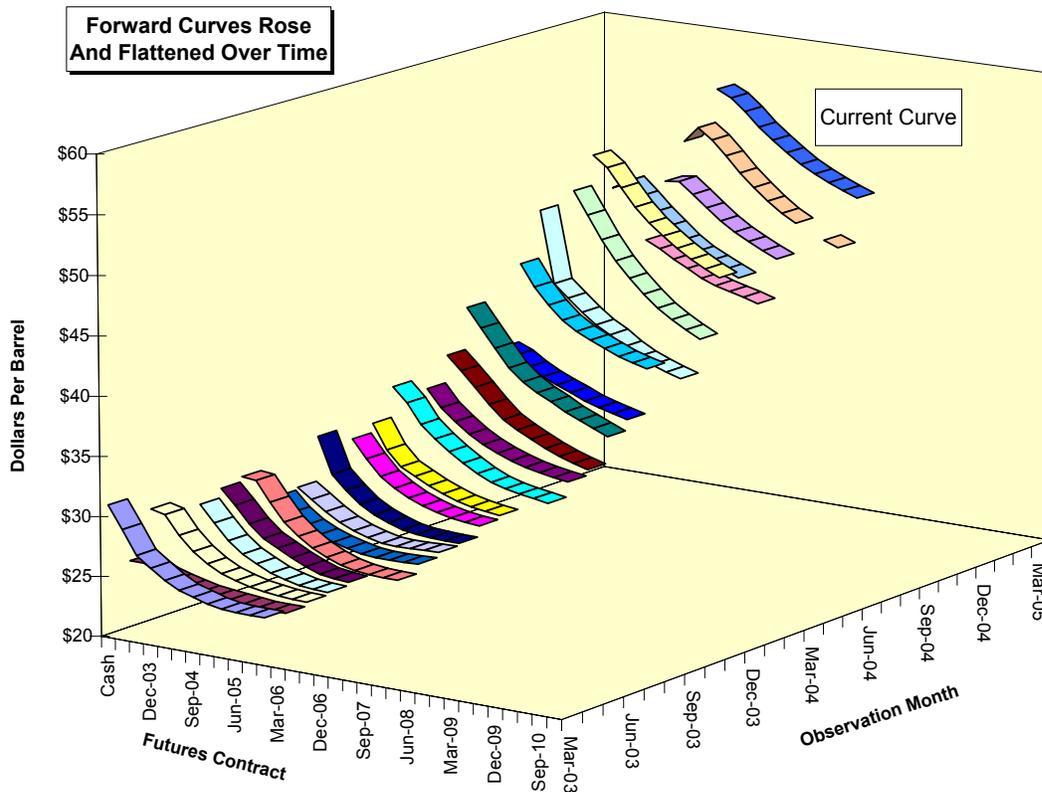
In a negative-sum game, each player in trying to maximize their individual welfare winds up minimizing the wealth of the group as a whole. This is how a crowd behaves in a fire or in a market crash. Or, participants in an auction can overbid for items out of fear that if they do not win, they effectively are out of business. This happened to European wireless firms in the late 1990s and in some ways happened to oil companies in the late 1970s and early 1980s. In both cases, entire industries overbid for licenses or offshore drilling rights, respectively, and immediately succumbed to financial stress for doing so.

The oil industry fears making what each company correctly fears to be a bet-the-firm decision and as a result the oil industry as a whole will become less important in the global market relative to the state oil firms. In attempting to avoid a ruinous bankruptcy they risk achieving a long-term irrelevance. Corporate twilights can be tough and long-lasting: Who of my age ever thought AT&T would disappear from the corporate landscape, or that Sears would be taken over by an out-of-bankruptcy K-Mart run by a hedge fund manager, or that we would have to play games with credit rating agencies to keep General Motors out of junk status, and so on?

Market Acceptance

While the senior executives who lived through the oil price collapse fear another one just as generals fight the last war, the market increasingly has accepted higher prices as a long-term reality. The forward curve of the futures market has an effect on how the stock prices of various oil industry groups behave, as I noted here [in July 2000](#). As an aside; I will update this analysis next week.

Until then, let's take a look at the forward curves of a set of crude oil futures contracts since the Iraq War. As prices rose from one observation month to the next, the forward curve of the futures contracts did not exhibit increased backwardation. Indeed, the current curve shows a remarkable degree of acceptance, one that would not exist if this were truly a market bubble.



Of course, the futures prices for crude oil do not represent price forecasts, but rather reservation prices at which both producers and refiners can transact and remain in business. These are operational considerations and contain no information on whether an investment made today will be profitable when the future arrives. A capital budgeting decision made in the expectation of those prices being realized may turn out to be a disaster in 2010, and that is what the oil industry fears.