Comments on Oil – Tom Crooker, 10/29/2014

· For the past four decades, since the imposition of the 1973 Arab oil embargo, the oil sector has been highly volatile. This has created both opportunities and pitfalls for investors.

· In recent weeks the commodity price of crude oil has plunged from above $100 per barrel to near $80. This is beneficial for consumers and potentially so for the broad economy because much of the economy is dependent upon consumer spending. Conversely, high oil prices stimulate investment, creating jobs and increasing tax revenues.

· The last time crude prices fell sharply was in the mid-1990s when the price of crude briefly fell to $10. It provided a great opportunity for investors.

· In some important aspects, this time is different.

· First, the hydraulic fracturing ("fracking") revolution has produced a gusher of new oil supplies and The Wall Street Journal makes reference to a "global oil glut." This new supply of oil has helped increase U.S. domestic oil production by 50% in recent years. New deepwater offshore supplies have also contributed to this increased domestic production.

· But, these new supplies are entering a market where domestic consumption of refined petroleum products is almost flat. The U.S. is becoming much more energy efficient, both for fossil fuels and for electricity consumption. And, crude oil from domestic sources cannot be exported under federal law. However, refined petroleum products can be exported and are done so on a large scale.

· Much of the fracking business is in the hands of exploration and production (E&P) companies, many of which are relatively small players compared with Big Oil and are highly leveraged. According to Barron's, energy comprises 17% of the high-yield bond market—by far the largest sector.

· Finally, the production cost of many new sources of petroleum is high. Some shale production (fracking), deepwater offshore, and Canadian tar sands require oil to be above $80 to break even. According to The Wall Street Journal, new projects being brought online by BP and Royal Dutch Shell require oil to be above $85 to break even. The Saudis, whose oil is cheap to produce, would be very pleased to see some high-cost supplies that threaten their geopolitical power be priced out of the market.

- However, production costs are difficult to generalize. For instance, once the initial investment in securing drilling rights and doing the drilling has been amortized, actually extracting the oil and delivering it to buyers can be relatively inexpensive. These latter costs are referred to as "half-cycle production costs."

- Another complicating factor regarding costs is that wells in shale deposits have short production lives and it requires a lot of drilling to extract oil from such deposits. Typically, production rates fall 50% during the first year of production. Advanced technologies developed by the big oil service companies are aimed at producing wells with longer production lives.

- There is one silver lining for cheaper oil. It puts pressure on foreign countries that have nationalized their oil resources but have done poorly at managing these assets. Mexico provides an example. Some of these countries are becoming more favorably inclined towards inviting Big Oil back in to revitalize their oil fields, including U.S. companies.

- Most countries that depend upon oil production for most of their national wealth require the commodity price of oil to be well above $100 per barrel in order for their economic needs to be met. Russia, Iran and Venezuela fall into this category. Saudi Arabia, where production costs are low, can continue to prosper with oil selling well below $100.

- Many prognosticators are busy making predictions about the future commodity price of crude oil. These are probably worth as much as stock market predictions. But, if the price falls far enough and stays low long enough, there will be both peril and opportunity for investors.

- Finally, a word of caution. Several years ago, Shell got into serious trouble with the SEC for supposedly overstating the size of their oil reserves. Quantifying oil reserves is highly subjective. Oil analysts have recently warned investors that some E&P companies are reporting much smaller oil reserves to the SEC than to their shareholders. Caveat emptor.