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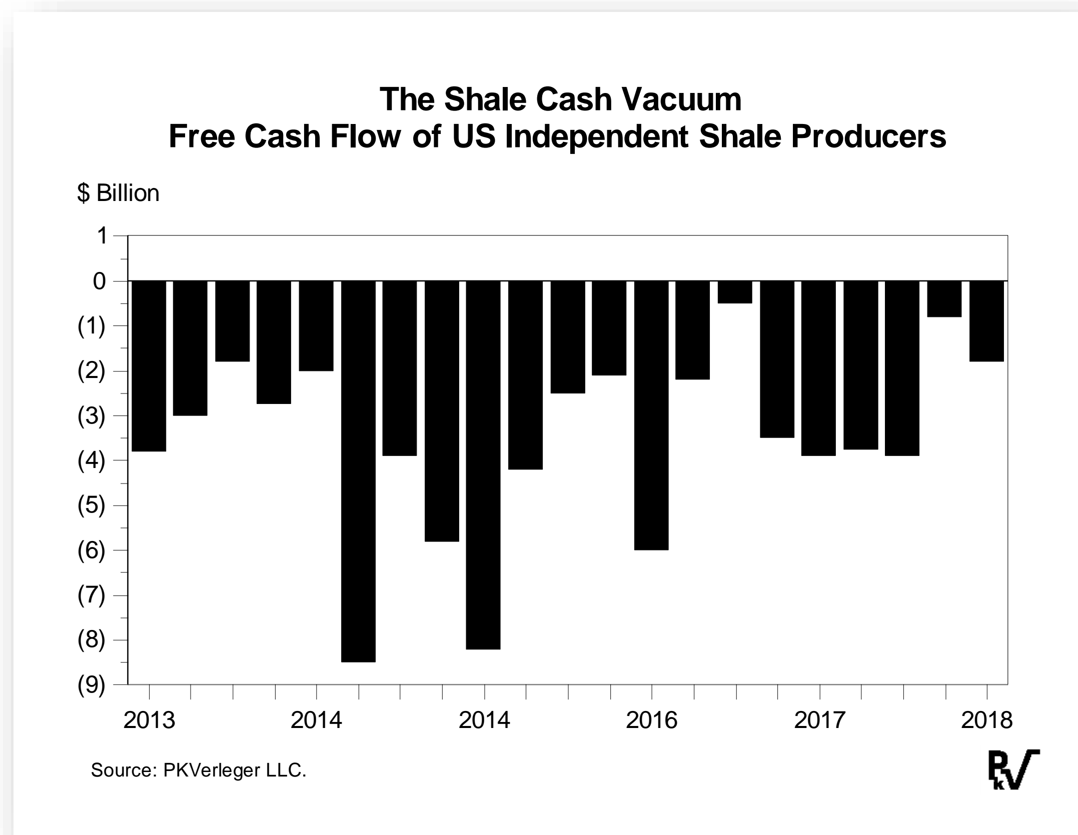
The Hedge Fund War on Fracking



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Summary

Vanity Fair contributing editor and author Bethany McLean thinks US oil companies, particularly independent shale oil producers, are "on shaky footing." The reason, she asserts, is that the domestic energy boom has been "fueled by debt and years of easy credit." She considers these firms to be "economically unstable" and their future bleak. "Most things that are economically unstable," she writes in a *New York Times* op-ed, "from money-losing dot-coms to subprime mortgages, eventually come to a bitter end."[1]

McLean adapted her article, titled "The Next Financial Crisis Lurks Underground," from her book *Saudi America: The Truth About Fracking and How It's Changing the World* (New York: Columbia Global Reports, 2018), which was published shortly after the op-ed. According to Amazon's description of this short work, McLean "digs deep into the cycles of boom and bust that have plagued the American oil industry for the past decade." Her sources include "the investors who are questioning the very economics of shale itself."

Our research indicates that these investors seem to be doing much more than "questioning" shale economics. From recent reports, it appears they are actively engaged in pressuring shale oil producers to slow their expansion and, along with it, the rate of increase in US oil production. The goal of this effort is likely higher oil prices and greater returns, an objective that is understandable given that the cumulative free cash flow of shale producers has been negative to the tune of $75 billion over the past five years.

In this report, we explore, as the title conveys, what appears to be a hedge fund "war" against the fracking industry. Along the way, we point out the shortcomings of McLean's *NYT* article and *Saudi America*. Our main intention, however, is to highlight the pressure being put on frackers. After discussing McLean's op-ed, we summarize the investor attacks on the industry, which have been going on for more than a year. Next, we provide an economic assessment of the fracking business, one we dubbed "manufracturing" three years ago. Finally, we examine the key observations presented in *Saudi America*—all of which we find to be off the mark.

A quote McLean attributes to investor Charlie Munger captures the book's conceptual problem. According to her, Munger believes the United States should limit the rate of production increases from fracking to an amount that allows the technology to progress but leaves most of the oil in the ground. Free markets should be replaced by government dictate. In Munger's view (one seemingly endorsed by McLean), "You shouldn't mind at all paying prices that look high for foreign oil." He then added, "You will be better off because you delayed gratification, instead of grabbing for it like a child."[2]

Fifty years of studying the US oil industry as a professional economist leads this author to different conclusions. First, markets work. Leaving oil in the ground would cause economic harm to a group of asset owners. Second, one should mind paying "artificial prices" (as defined by competition law) regardless of the source.

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[1] *Bethany McLean, "The Next Financial Crisis Lurks Underground,"* The New York Times*, September 2, 2018 [https://tinyurl.com/y8y2nzrs].*

[2] *Saud America*, p. 128.

Third, it is not possible to stop technical progress. The costs of finding and developing oil are dropping steadily, just as the costs of communications and computing have declined. Moore's law applies to oil and gas production technology just as it applies to microchips. Investors who back the wrong developers will lose, just as those who backed the wrong technology firms did.

Finally, global warming is real. If the oil industry does ultimately come to a bitter end, it will not be caused by, as McLean asserts, a lack of capital or a dearth of recoverable crude oil. Instead, the industry's greatest fear today must be "stranded assets." As one BP report warns, we might have twice as much "technically recoverable" oil as the world will need between now and 2050. If this is true, McLean and the attacking investors should consider focusing on a different concern, one that Saudi oil minister Sheik Yamani voiced succinctly more than two decades ago: "the Oil Age will end long before the world runs out of oil."