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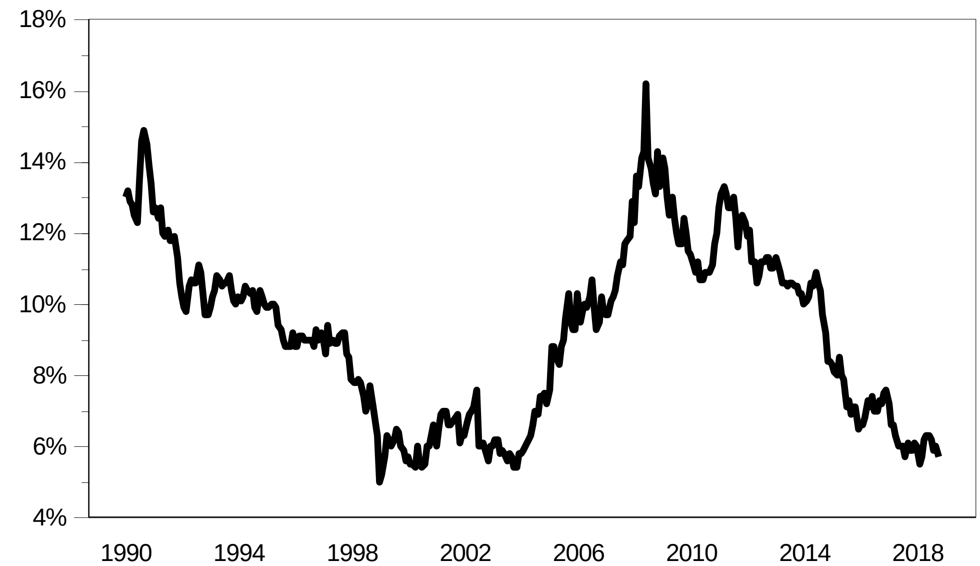
Will Investor Aversion Bring Higher Oil Prices?



Energy's Weight in the S&P 500: Value of Large Energy Firm Subindex as Share of Total S&P 500 Value, 1990 to 2018

Source: Bloomberg.

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Summary

Each week and sometimes daily, policymakers at the International Energy Agency, ministers from oil-exporting countries, consultants at firms like Wood Mackenzie, and some former government officials now at nonprofit policy institutions hammer away at the oil industry's failure to invest sufficiently in reserve development. Of these, the IEA's executive director, Fatih Birol, and Saudi oil minister Khalid al-Falih have been the most outspoken, warning that the lack of investment will come back to haunt the industry and consumers.

The common view of such individuals is that underinvestment will lead to a production decline. Prices must rise, they assert, because consumer demand for oil (and here a distinction is made between demand and consumption) will stay strong. A "supply gap," to use Birol's term, will develop. Of course, any potential shortfall could be eliminated if the industry spent more—hence, Birol and the OPEC ministers incessantly exhorting the industry to boost exploration and production (E&P) expenditures.

Despite such efforts, one very important segment of the global population refuses to be spooked by these dire pronouncements: the investment community. Indeed, investors, to put it bluntly, have developed an aversion to the oil sector. Our cover graph captures the impact of this dislike. It illustrates how the weight of oil equities in the S&P 500 index has declined from July 2008 through October 2018. The decrease has occurred because investors are shunning oil and putting their incremental money into other economic sectors. Thus, while the value of oil shares has been relatively stagnant during the period (the oil index rose just thirty percent), the total value of the S&P 500 went up two hundred seventy-one percent. One might say the oil sector is not just lagging the rest of the economy but has nearly stopped dead.

Investor aversion to oil shares has required oil companies to increase dividends aggressively and sell billions in noncore assets to keep their share prices from falling further. At the same time, their shareholders have pressured them to buy back shares and pare debt. This has constrained their free cash flow and hence their ability to fund large E&P projects.

Under such pressure, the large multinational companies have moved strongly to drive down the E&P costs for the substantial new reserves Birol and other energy policy officials believe necessary to supply the world over the next decade. They are succeeding in this. *Financial Times*' Anjli Raval reports, for example, that firms have halved the cost for deepwater rigs in just four years by "cutting thousands of jobs, utilizing existing infrastructure better, negotiating more favorable terms with contractors and increasing drilling efficiency and safety through automation."[1] The lower outflow enables firms to stretch their limited funds.

Much of the success in driving down costs occurred at the expense of the drilling industry. Several major offshore drilling companies have declared bankruptcy over the last four years as their customers, the major oil companies, substantially cut spending. The drilling firm shareholders lost. However, good assets remain to be hired for exploration efforts at much lower rates.

[1] *Anjli Ravel, "Shell taps its deepwater legacy to fund its future,"* Financial Times*, October 30, 2018 [https://tinyurl.com/y9as54zh].*

For better or worse, the financial constraint on firms exploring for oil and gas in the traditional areas, particularly offshore, will remain. Investors have put a chokehold on the companies' ability to invest. There is little likelihood that new investment sources for developing large, long-lived reserves will appear. That activity, once the primary focus of the multinational oil industry, is seen as a dying business. Oil company executives realize this and have gone to great lengths to rebrand their firms as "energy companies" and diversify into businesses outside of oil such as electric car recharging stations.

Given these circumstances, the question posed by our report title, and several others, need to be answered. Does the lack of investment matter? If the funds do not materialize, will prices be pushed dramatically higher? Are investors shortsighted in demanding that the large companies offer hefty returns and return capital rather than spend on E&P? Or do investors have it right? Will technological changes that open new reserves, combined with cost reductions and collapsing consumption, keep prices down?

The answer offered here is that investors are likely correct. The projections of underinvestment leading to a prolonged period of high prices are almost certainly wrong. If anything, the data suggest that investor demands are rational.

This conclusion comes as a surprise. We started this report expecting the data to support Birol's view that the industry requires significant capital inflows to meet demand and moderate prices. However, data can be a hard taskmaster. Absent further changes, the industry does not appear to be short of the funds needed to expand. In fact, the decisions announced by various large companies over the last year seem to confirm this conclusion.

Of course, circumstances can shift. Ten or fifteen years ago, the oil industry and world economy seemed to teeter on a cliff edge. The peaking of oil supply threatened. Dramatic price increases were in the offing along with enforced austerity. Today, the situation has reversed. Global warming will cap oil use, and fracking has given us access to billions of barrels of reserves, many of which may never be produced. For now, at least, oil does not face a capital constraint. Given these circumstances, our answer to "Will Investor Aversion Bring Higher Oil Prices?" is an unequivocal no.