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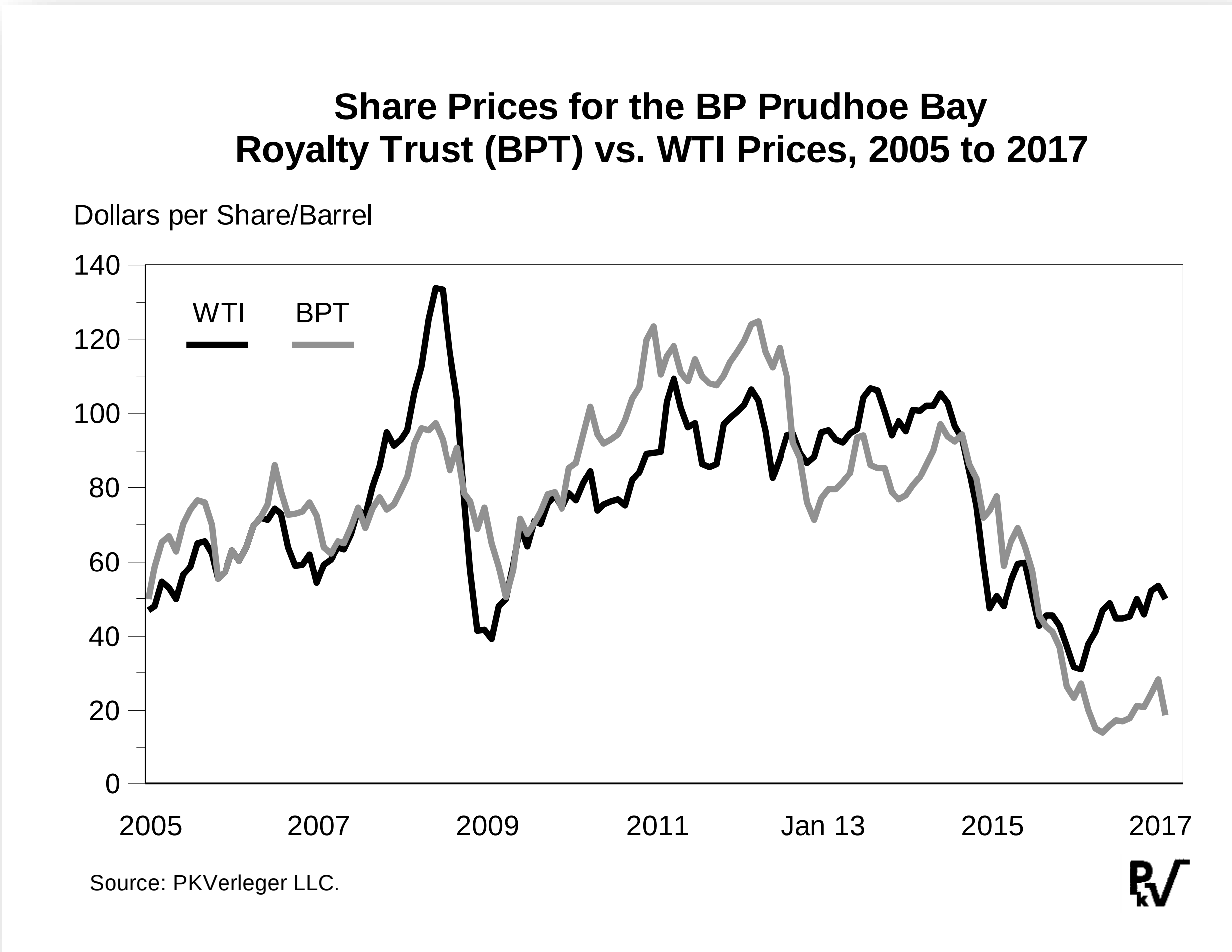
The Don Quixotes of Oil: The Demise of Petroleum's Old Order



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The Demise of Petroleum's Old Order

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Summary: The Don Quixotes of Oil – The Demise of Petroleum's Old Order

The word "shortage" has dominated thinking regarding oil markets for a long time. The 1973 Arab Oil Embargo laid the foundation for this mindset. For more than forty years since then, the threat of shortfalls has been used to mobilize those who follow the markets. The fear of disruptions is strong. At the recent IHS-Markit CERAWeek conference, the International Energy Agency's executive director, Fatih Birol, "threatened" the industry and anyone else interested with this prospect:

> Without "substantial" investments upstream, the market could tighten around 2020 as spare production capacity will shrink "big time," Birol told reporters.
>
> Prices could rise sharply by 2020 "unless significant new projects are sanctioned soon," he said.[1]

Those who live in the oil "silo" and who have not bothered to focus on developments in economics, read economic theory, or note the changes occurring in the global economy reacted as expected. The response among many followers of traditional oil market analysis—referred to here as the "old order"—was to call, as Birol did, for more investment.

Those who do not populate the oil silo ignore these calls.[2] They recognize that global markets have advanced well beyond the world of 1973, just as railroad industry leaders recognize the steam engine has been obsolete for seventy years, communications industry leaders understand copper wires are no longer required to link civilizations, and computer industry leaders understand personal computers replaced mainframe machines and handheld devices are now displacing PCs.

The oil industry's old order, though, clings to the past. Thus, IEA representatives and some executives demand that investors pour hundreds of billions into high-cost projects to boost the capacity to produce oil from large oil fields in ten or fifteen years. These individuals threaten the public by raising the specter of the very high prices that will result if the investment money is not forthcoming.

The public seems not to believe them, however, and investors clearly doubt the old order's pronouncements. In March, a Canadian firm, Cenovus Energy, bought the oil sands assets of ConocoPhillips. Industry observers explained that Cenovus was betting it could profitably expand the high-cost production in Alberta. The investor response was to drive the shares of Cenovus down while bidding up those of ConocoPhillips.

Like it or not, the beliefs of those representing oil's old order are viewed with great skepticism. The doubters understand the oil market has undergone "creative destruction." This term was coined by the late economist Joseph Schumpeter. As he explained it, creative destruction "incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one."[3]

Schumpeter's concept characterizes what has happened to the traditional oil industry. There are two important points of relevance, both discussed here. First, we explain that OPEC's efforts

[1] Brian Scheid, "IEA chief says global demand not peaking," *Platts Global Alert,* March 6, 2017.
[2] The term "silo" is explained by Gillian Tett in *The Silo Effect: The Peril of Expertise and the Promise of Breaking Down Barriers* (New York: Simon & Schuster, 2016).
[3] Joseph Schumpeter, *Capitalism, Socialism, and Democracy*, Third Edition (New York: Harper and Brothers, 1950), p. 83 [see https://goo.gl/MYjL0v].

to force stocks down to sustain higher prices will fail because this strategy promotes the accumulation of more inventories. Second, we note that calls for greater investment to develop large, very-long-term projects are inconsistent with a business dominated by accelerating technical change.

The subtitle of this report, “The Demise of Petroleum’s Old Order,” calls attention to the fact that the thinking that has dominated the oil sector for fifty years needs to be retired. New market institutions, new players such as trading companies, well-educated consumers, and most importantly, the breakdown of monopoly institutions make those bent on perpetuating the old ways—the IEA’s executive director, for example—irrelevant in today’s world.

The share price of the BP Prudhoe Bay Royalty Trust (BPT), shown on the cover, best captures the obsolescence of this thinking. The share price reflects the market’s view of the future. Representatives of the old order warn of shortages and future high prices. The BPT share prices and forward crude oil prices would rise if these officials had any credibility. The fall in prices depicted in the cover graph makes it clear that the old order’s warnings are being ignored. In short, the IEA and others in the old order have assumed the role of Don Quixote, a gentleman trying to live in a world that had been dead and gone for many years.