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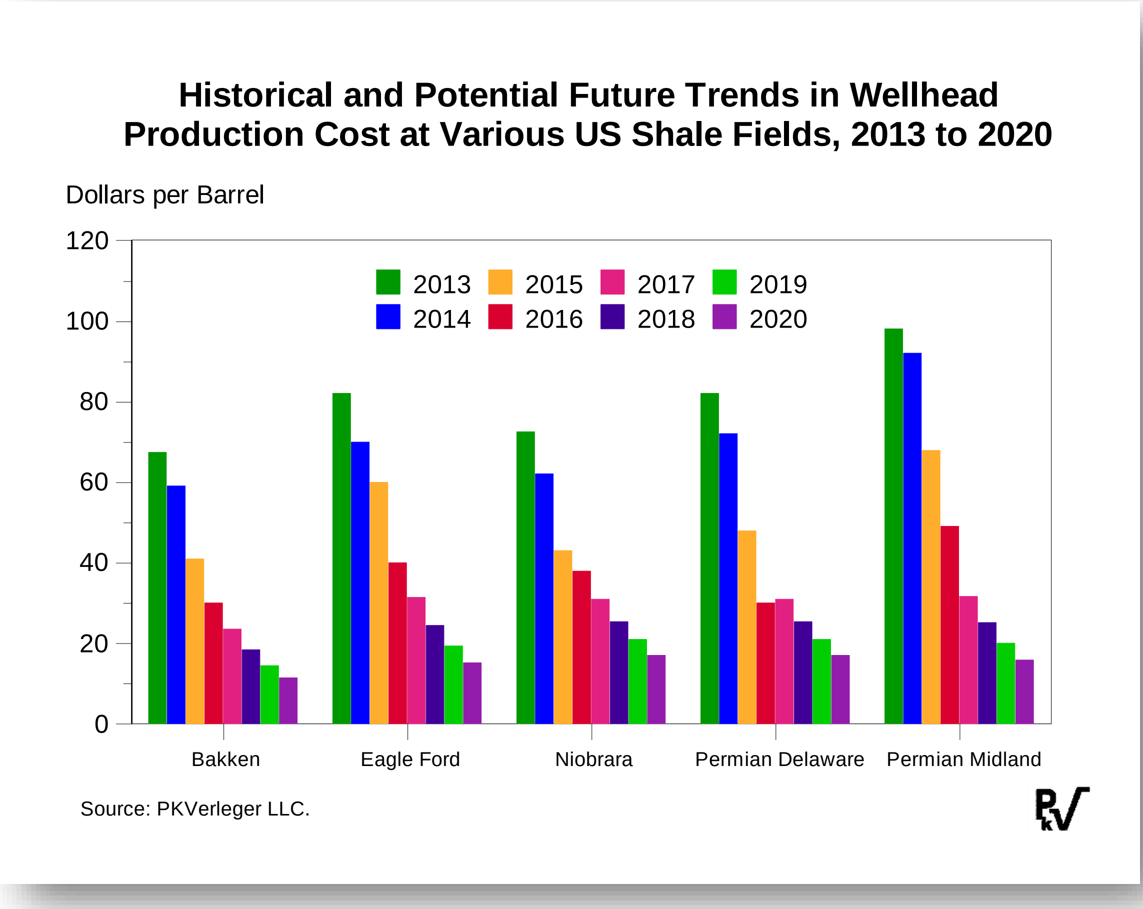
Oil's Johnny One-Note, Peaking Oil Demand, Capital Expenditures, Vulture Capitalists, and ManuFracturing



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Summary: Oil's Johnny One-Note

In 1956, jazz singer Ella Fitzgerald revived the song "Johnny One-Note," originally from the long-forgotten musical *Babes in Arms,* when she included it on *Ella Fitzgerald Sings the Rodgers & Hart Songbook*. The first verse of Ella's version goes like this:

> Johnny could only sing one note
> And the note he sings was this
> Ah!
> Poor Johnny one-note
> sang out with "gusto"
> And just overlorded [sic] the place
> Poor Johnny one-note
> yelled willy nilly
> Until he was bleu [sic] in the face
> For holding one note was his ace
> Couldn't hear the brass
> Couldn't hear the drum
> He was in a class
> By himself, by gum!

The "only sings one note" lyric is relevant today except the name "Johnny" should be changed to "Fatih." The single note Fatih Birol and the International Energy Agency keep belting out again and again is "invest." Birol, the IEA's executive director, started crooning this tune in 2014 as oil prices collapsed. Then, a year later, his rhetoric became more strident when the IEA issued its annual report on investment. In late April 2017, still true to form, the IEA worried that global oil discoveries had declined to "record lows in 2016." This concern is an exaggeration because more oil was found in 2016 than in the entire span from the beginning of time to perhaps 1930.

The agency really intended to say that less oil was discovered in 2016 than had been found since perhaps 1960. However, accuracy is not essential in press releases. Birol likely approved the hyperbole. He sought to make the point that billions must be spent on oil exploration. To bolster this assertion, Birol raised an important question, in his view, in the IEA's April 27 press release:

> "Every new piece of evidence points to a two-speed oil market, with new activity at a historic low on the conventional side contrasted by remarkable growth in US shale production," said Dr. Fatih Birol, the IEA's executive director. "The key question for the future of the oil market is for how long can a surge in US shale supplies make up for the slow pace of growth elsewhere in the oil sector."[1]

[1] IEA press release, "Global oil discoveries and new projects fell to historic lows in 2016," April 27, 2017 [https://goo.gl/pjNKpH].

His question emphasizes his one-note thinking: to avoid a future supply squeeze, the world needs significantly larger investments in conventional projects than what is being spent today. Such a squeeze would, he cautions, drive up prices.

Birol's position was echoed at the end of the month by Saudi Aramco's CEO Amin Nasser:

> The supplies required for the years ahead are falling behind substantially because the vast, long-term investments in proven and reliable energy sources are not being made. This presents a grave and growing threat to world energy security.[2]

Nasser added that "what we need in the industry is…megaprojects that would mitigate the decline over the long term." He is particularly anxious about the decline rate in existing large fields.

The message from Birol and Nasser to producers (the multinationals and state-owned oil companies) is put up the money now or see the world burdened with much higher prices later. It is a familiar refrain. In support of their argument, they assert that demand will not peak soon. In March, Birol told listeners at the CERAWeek conference in Houston that global demand was not headed toward a zenith. Indeed, it would increase, he believed, 7.3 million barrels per day by 2022. He added that prices could rise sharply by 2020 "unless significant new projects are sanctioned soon."[3]

In singing their one note, however, Birol and Nasser make an important mistake: they assume that consumption and prices will increase. The true situation is an either/or one:

Either consumption will increase because prices remain at current levels

or

Consumption will not increase because high prices have suppressed demand growth.

In short, those adhering to conventional forecasts (referred to as the Don Quixotes of oil in our last report) need to face facts. Consumption may not peak if prices remain relatively stable, but consumption will peak and then begin to fall if prices rise.

There is a further element in this. The hundreds of billions the IEA says we need to invest in conventional projects *will not be forthcoming*. The doors on capital markets are closing on the major oil companies, as they are on many other economic sectors. Structural changes in investing are creating circumstances where privately held companies will be prevented from making the large capital expenditures Nasser and Birol demand. Today executives must be sure they cover their dividends and limit debt. Their investors' demands for significant returns constrain spending on multi-year megaprojects.

The investors asking for these returns are themselves under pressure. For years, most shares in the multinational oil companies able to fund megaprojects have been held by large pension funds and other institutions. These groups have been passive, allowing company officials to invest for the long term. However, the expansion of exchange-traded funds (ETFs) has fundamen-

[2] "Aramco, IEA Warn of Supply Crunch," *Argus Global Markets*, April 27, 2017, p. 4.
[3] Brian Scheid, "IEA chief says demand is not peaking," *Platts Global Alert*, March 6, 2017.

tally altered the investment models. Specifically, the passive funding model is threatened by investors such as pension funds that wonder why they should pay high fees for poor performance. These funds and other institutions are actively demanding results from companies today. Firms that fail the test could be "attacked" by activist investors. A recent decision by a large, traditionally passive institutional investor to go after the US grocery firm Whole Foods should serve as a warning. Many of the investor-owned multinational firms will confront this kind of action if they do not practice fiscal constraint.

Therefore, prices will rise unless the increase in global oil use slows or greater supplies materialize from sources such as national oil companies (e.g., Saudi Aramco, Petrobras, and PDVSA) or US independents (primarily the frackers).

Our conclusion, then, is that oil's "Johnny One-Note" is singing into a gale-force wind. The message may be correct, but the "required" investment being called for will not be forthcoming. Increases in consumption in the short term will lead to higher prices, which will dampen use and prompt an early peak in demand. A slower increase in consumption, though, could allow additional supplies to develop from unconventional sources.