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ADAM WATEROUS
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Commentary: Institutions urged to act now on opportunities created by current global oil disruption

As the world awaits broad availability of various COVID-19 vaccines, the consequences of a severely weakened U.S. oil industry are flying under the radar.

With continued lockdown measures and the West Texas Intermediate oil price hovering in the $40s, a growing chorus believes that U.S. shale oil production has peaked. Indeed, institutional investors expect industry consolidation to continue and global energy organizations predict U.S. oil production to continue to decline (current U.S. oil production has already declined to about 10.7 million barrels of oil per day, from a high of 13 million earlier this year). The industry has experienced a wave of defensive, all-stock merger activity to cut costs and survive this downturn.

As capital continues to flee the oil sector in favor of energy transition technologies, we are beginning another tectonic shift — the global oil industry will be increasingly dominated by autocratic governments, not free enterprises in North America. This is "peak investible oil," a global challenge but also an opportunity for long-term investors.

Peak investible oil differs from "peak oil demand," which has become a hot topic along with the "electrification of everything" following Tesla's rocketing share price and BP's prediction of oil demand peaking in the next decade. Peak investible oil is a supply-side theory that investor-controlled oil production has peaked, and that OPEC nations, Russia and other countries' national oil companies will have an increasing market share of global oil production in the future. For context, in 2019, roughly 27 million barrels of oil per day (27% of total global output of 100 million) was controlled by the free market, or companies controlled by investors. The rest was owned by governments, many of which do not rank well when it comes to rule of law, individual rights, environmental stewardship or general transparency. We believe that global investor-controlled oil production will decline to roughly 20% by 2030. This is the ESG story that is not being discussed.

Three primary facts support peak investable oil:

1. U.S. shale oil production will continue to decline. Over the past six years, shale producers raised an incredible amount of capital but earned abysmal returns. Shale is some of the highest cost, steepest decline production in the world, and only significantly higher prices will bring capital back. Investors eschewed producing fields with low-cost conventional production, which generate profits at today's oil prices.

2. Major European oil companies' elevated focus on energy transition will reduce their share of oil production over the next decade, with BP alone targeting a 1 million barrel per day reduction (40%) in oil production by 2030. Shell, Total and Repsol have all committed to net-zero emissions by 2050 and have identified renewables as the key growth driver of their go-forward business plans.

3. Global oil demand will continue to grow (post-COVID-19 vaccine) due to global GDP growth. Much of the developing world lives in energy poverty, consuming a fraction of the per capital oil consumed in North America, and based on historical trends, economic development will drive oil demand growth in those countries.

Shrinking investor-controlled supply coupled with resilient global oil demand means only one thing: the share of future global production controlled by OPEC nations and other nationally owned oil companies will grow. In turn, U.S. energy independence will dwindle. In a peak investible oil world, the price of oil will increasingly be set by Riyadh, Moscow and Tehran and less by the marginal drilling economics of North American producers. The implications are vast and far-reaching: reduced North American energy security; a growing U.S. trade deficit; less industry transparency; and eroding ESG standards. At the same time, the transfer of market share to OPEC states and other nationally owned oil companies translates into a global tax on all consumers.

Investors should not simply pass on this asset class based on depressed oil prices and poor recent returns. Higher oil prices combined with the accelerated issuance of U.S. federal debt to levels last seen during World War II could create inflationary pressures not seen since the 1970s. Direct ownership of hard assets, such as oil, has historically been an effective inflation hedge, and the investible universe of oil assets is only shrinking. An opportunity exists today to buy low-cost producing assets at a fraction of replacement cost by pursuing them through distressed and complex situations.

While the negative implications of peak investible oil are apparent, higher prices post COVID-19 vaccine will certainly benefit those few investors left owning the lowest cost, lowest greenhouse gas-emitting barrels of oil in North America. These investor-owned entities will manage top-decile assets with optionality to grow with higher oil prices, emerge with stronger, more liquid balance sheets and right-sized operating costs. They also provide uncorrelated returns which may surprise even the most ardent skeptics.