

End of an Era: Big Oil Loses Control of its Destiny

Most investors speak wisely of investing in companies and industries whose prospects were seen as mediocre at the time, only to have them improve and the associated investment succeed in appreciating. Twenty-five years ago financial stocks sported single-digit multiples as their prospects were considered at best pedestrian and at worst boring. More recently railroad stocks have recorded solid returns for an industry that was written off by many as literally over the hill.

Perception shifts can work the other way. The most compelling case study of this is the major pharmaceutical stocks. Their prospects were seen at one time as being the best of the health care industry. The prices of the stocks sported above-market valuations as a result. While the demographic argument for health care demand is intact, the politics and economics of health care reimbursement have insured that meeting demand has not always resulted in the level of profit margins once considered the rights of intellectual property. Also, the very existence of the bullish health care demand forecast unleashed huge amounts of venture and speculative capital which has competed for the inevitably finite returns of the industry, driving down returns for everyone. The bottom line is that pharmaceutical stocks have consistently underperformed the overall market for the past decade.

A similar shift in perception is beginning to occur in the energy sector. Originally the major oil companies owned the acreage from which their oil was extracted. Their profits came from the difference in the price paid for the oil in the ground (known as reserves) and the price in the marketplace. At this stage oil firms were no different than coal companies, copper mines or any other mineral extraction industry.

After the end of World War II, it became obvious that there were insufficient reserves of oil in the US to meet future demand. This realization was accelerated as increasing amounts of land both on- and off-shore were placed off limits to drilling. As a result the major oil firms went abroad to increase their reserves.

The key difference in exploration abroad was the inability of American firms to take title to the oil in the ground in the manner done in the US. This limitation was driven home in 1972 when Saudi Arabia and other countries expropriated the assets of foreign oil firms. Instead of acquiring reserves at a fixed rate, the oil companies became subcontractors to the foreign government owners. What kept a balance of power between the countries that owned the oil and the firms that extracted it was the fact that the oil companies still controlled the refining and marketing of the oil. While they no longer took title to the petroleum reserves, their expertise and assets were required to convert the oil into hard currency. Because there were few firms with the assets and infrastructure to perform this task on the scale required, the firms became a sort of quasi-oligopoly. On this oligopoly rested the profitability of large energy companies.

More recently trends have evolved to undermine the oligopolistic arrangement. The increasing markets of China, India and other developing countries have led to increasing amounts of petroleum being purchased by foreign firms for markets that were not considered players a decade ago. These sources of demand and the firms they have supported are putting competition and price pressure on incumbent oil companies to take a smaller amount of profit in future contract negotiations with the countries that own the oil. Some new contracts call for a flat rate per gallon of oil handled, with all price changes (up and down) reflected in the pocket of the oil's owner. The oil company is still liable for the investment in recovery assets, but cannot participate in the price fluctuation of the oil itself. Nor will the oil firm be able to influence the flow of oil to its own refineries. The company will have to compete for the oil with all other interested parties.

This loss of negotiating power is analogous to the loss of pricing power by the drug companies in the face of volume purchasing by HMOs and foreign governments. This loss of pricing power will probably have similar results. The environment for American petroleum companies was made more difficult two years ago when Congress objected to the purchase of Unocal by the China National Offshore Oil Corporation (CNOOC). The feeling among the Third World countries is that the West wants to have it both ways—profit from the sale of the oil while objecting to emerging economies making money off the developed countries.

While the environment of integrated energy companies has grown more tenuous, another sector of the energy industry that provides services for energy extraction has boomed. The oil service industry provides the technology for energy extraction. At this time Western companies are far ahead of foreign competitors in terms of extraction technology. Since demand for such technology is driven by the difficulty in petroleum extraction as well as the unit demand for oil, such companies are expected to be in a favorable position for some time to come.

The Economy

While economic activity has slowed it has not shown any signs of recession. The declines in housing construction have been offset to date by government spending and export demand.

One trend of concern is the sub-par spending by companies on capital goods and infrastructure improvements. This reflects in part the desire of firms that are being taken over by hedge funds to use cash flow to service debt as opposed to make capacity improvements. Even among firms not being taken over, it is considered better management to use extra funds to buy back stock instead of add to capacity given the uncertain economic outlook.

The problem is that such forecasting becomes self-fulfilling as a lack of spending by companies causes the economy to slow further. It also leaves the company with insufficient capacity to meet future demand and thus weakens the firm's competitive position over time. On a macro level, a lack of capacity addition can become a source of inflation especially if the dollar's decline makes imports more expensive.

Interest Rates

The parlor game of guessing when the Federal Reserve will reduce interest rates is going into extra innings. Strong employment numbers and a decline in worker productivity coupled with an increase in compensation all suggest that it will be later in the year if then before any interest rate cut is considered.

Almost unnoticed by most commentators is the correction of the yield curve in the past month or so. Until recently the yield curve was "inverted" with interest rates on two-year Treasuries being higher than ten-year obligations. Such a state of affairs was considered by some to be the precursor of a recession. Now that the yield curve has corrected and the two-year yields are less than the ten-year yields it would seem that the bond market is signaling a stronger economy ahead.

Inflation

Supporting keeping interest rates steady by the Federal Reserve is the ongoing evidence of higher prices. Ethanol production is adversely impacting food prices as cattle and dairy farmers compete with ethanol plants for a finite supply of corn.

A more profound trend is that of worker productivity. The rate of workplace productivity is the rate of pay increase that can be awarded to a worker without (in theory) driving up the inflation rate. As worker productivity has declined, the risk that pay raises would eventually become a source of inflation increases. Current rates of productivity gains are less than two percent. With average wages increasing at a rate of 4-5 percent it would appear that labor inflation would run on average 2-3 percent.

The Stock Market

The slowdown in corporate earnings growth without an offset from lower interest rates does not bode well for the stock market near term. Also, there seems to be a sense that the hedge fund strategy of replacing owner's equity with loans will at some point end in tears.

Offsetting the above trends is the fact that the rest of the world seems to be experiencing faster economic growth than the US. Such growth should be a source of demand for US exports at some point.

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