

Discussing BP Without Tears: The Threats and Opportunities in Investing

Since late April when its Deepwater Horizon well erupted, burned and sank, BP has been in the news as the poster child of environmental disasters. Armchair pundits on television and elsewhere bloviate over estimates of damages which they have no knowledge or competence to assess. Public outcry has reached a feverish pitch where people boycott BP stations in spite of the fact that they are owned by independent businessmen. Another group wants to expropriate BP's US assets to pay for the environmental damages. Politicians demand that the legal standards for liability not only be changed but also be applied retroactively.

All this comes about because people are treating BP as if it were some capitalistic version of Al Qaeda. The reality is more mundane and more human. BP has 80,000 employees world-wide with the largest concentration in the United States. It has a net worth of over \$105 billion and a cash flow in normal times of over \$30 billion. It is the fourth largest energy company in the United States and the largest driller in the Gulf of Mexico. It operates in an environment that is significantly regulated by law and edict. It operates in some of the most hostile regions in the planet.

The last two points deserve elaboration. Much of the orchestrated attacks on BP are designed to shift the focus off the Government's culpability in this disaster. The Office of Minerals Management (OMM), which both supervises the drilling and collects the royalties on the extracted hydrocarbons, displayed an appalling lack of oversight. In the 24 hours leading up to the eruption, BP requested no fewer than three modifications of its original drilling plan. The Government members of OMM approved all three changes. One was approved five minutes after being requested. If this is not a rubber stamp functioning as a regulator it is hard to say what it is.

The second point also bears note. Oil going forward is not going to be as easy to find. The easy fields are in control of those who are at best hostile to the US (Venezuela, Iran) unstable (Nigeria, Ivory Coast), or have their own agendas (OPEC, Russia). To find oil in secured areas will take an increasing amount of expense, effort and risk. BP was willing to assume that effort and risk because the potential rewards exceeded what they considered to be the risks. If BP or other energy companies become convinced that the risks exceed the rewards then no additional oil will be found. While in public other major oil companies try to distinguish themselves from BP for public relations purposes,

the fact is that all major oil companies have to assume risks of the scale of BP to satisfy America's thirst for energy.

Thus to really change dynamics requires changing the demand for oil. The normal way governments discourage conduct it considers not in the public interest is to tax it. Think liquor or tobacco taxes. Perhaps something along these lines would be appropriate for gasoline.

As pointed out in this newsletter several years ago, a gradual increase in gasoline taxes of, say, five cents every three months would force consumers to consider rising gasoline prices when it counts most, which is to say at the time of the purchase of a car. At the same time, such a tax would be gradual enough to not put those driving less fuel efficient cars into hock due to their immediate car selection. It would send a message that the next selection needs to have fuel economy as a higher priority than in the past.

Such a law, coupled with the repeal of fuel economy rules which try to mandate much the same thing, would put the US on a path to energy self-sufficiency. One reason the BP spill gets so little international sympathy is that the rest of the world is starkly aware that the US, with five percent of the world's population, consumes 25 percent of the world's oil. Using the tax law to bring this ratio down will benefit our balance of payments, environment and international standing.

As for BP, it will survive. Most of the ideas for its prosecution will be struck down by the courts who have become increasingly pro-business. The company itself would have continued to pay its dividend had the US Government not pressured them to do otherwise. The Gulf beaches and ecosystem are more robust than the waters of Alaska. Warmer water breeds microbes that actually eat the oil and render it harmless. The same microbes provide food for other organisms until they are finally eaten by oysters and shrimp. Both the Gulf and BP will go on.

Once the November elections are past the rhetoric against BP will decline. Hopefully cooler heads can approach this matter the right way. Treat it as a plane crash in the early days of aviation. Something to be studied, learned from, and with that knowledge impose systems (both human and mechanical) and equipment to prevent the re-occurrence.

In terms of an investment, the book value of the stock is about \$33 per share. Not one barrel of BP production has been lost since this was an exploratory well. Lawsuits will take years to litigate, and BP has both partners and vendors who can be cross-sued for the burden. Oil is estimated to go to \$200 per barrel by 2020, given the world demand and dearth of exploration. There are risks in BP. But the company is not without resources, and the scenario is not without rewards.

The Economy

Economic activity continues to display a pattern consistent with economic recoveries. Inventories are low relative to sales, prompting the need to produce more than demand. Exports are strong and business demand for capital goods is taking off.

While there appears to be a good deal of pent-up demand for autos and to a lesser extent housing, there are economic concerns. Foremost is the desire to shrink the deficit before the recovery gains self-momentum. A decline in Government demand either outright or by proxy in the form of reduced transfer payments would pose a significant challenge to the economic recovery. A second issue is the ability of importers to continue to keep up demand for US goods.

Interest Rates

Government interest rates have declined to some of the lowest levels on record. This trend reflects the anxiety investors feel about the economic environment. At this time ten-year US Government bonds yield less than three percent. One would have to have a very rosy view of the future to believe such a yield will provide any return after inflation over the next decade.

At the other end of the spectrum, high-yield bonds are posting increasing yields due to the anxiety over the economy. The spread between the two instruments provides for significant allowance for default while still returning more than “risk free” Treasuries.

Inflation

Inflation still has a power to move markets, even when it cannot be currently measured. The increase in the price of gold to record levels presumably indicates a concern about a return to high levels of inflation. At the same time, the record low bond yields along with a decline in industrial commodity prices argue for little or no inflation. Both investment proxies cannot be right at the same time.

Perhaps the answer is that they will be right over different time periods. The present time would suggest no inflationary pressure, which is good for bonds. Looking out, the potential for higher interest rates due to inflation would pressure both Government bonds and gold. Gold performs best when there is little or no cost to borrow to buy it. When interest rates tick up, holders of gold must decide to pay the higher interest rates out of pocket or sell gold to pay for the same. These sales are usually the short-term turning points in the metal's trading. Government bonds would also do badly with inflation. The lower the coupon rate on a bond the more sensitive it is to shifts in interest rates. Thus gold, whose price is considered a predictor of inflation, may not do well in inflation if interest rates increase. Government bonds are considered the most vulnerable asset class in the event of an increase in inflation because of the corresponding increase in interest rates.

The Stock Market

The first half of the year has been one of little progress for stocks. Indeed year to date the Standard & Poor's 500 Index is off about three percent. International indexes are down double digits due to the sharp decline in the Chinese stock market.

The irony is that this stock market performance is occurring in a backdrop of rising earnings and dividend payouts. At some point the two divergent views will have to be resolved one way or another. The company view of a stronger economy should overrule a market more spooked by psychological factors such as the situation in Greece and banking reform.

One factor concerning investors is the attitude of Government towards business. The BP situation does not sit well with those who believe that blame should be spread around more evenly. Also, the need of the Government at some point to rein in its own deficit will require higher taxes. If the pledge not to raise taxes on families whose incomes are less than \$250,000 is to hold, it leaves the investor class and corporations as the ones who will pick up the tab. Until these issues are resolved (perhaps by the results of the November elections) the markets will continue to fret. For those who expect favorable resolution this is a buying opportunity.

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