



A Great Debate About the Future of Crude

by Sean Brodrick and David Fessler with Rachel Gearhart

As the turbulence in the oil market continues, there's controversy over the direction of oil prices moving forward. And, if you've read any of their recent articles, you'd know that our *Oxford Resource Explorer* Editors, Sean and Dave, have opposite opinions on what the price of oil will do next. That's why we decided to add a special Q&A debate session to this month's issue.

RG: *You two clearly have opposite opinions on the direction of oil prices. Sean, why do you think prices could still go down?*

SEAN: It is a combination of:

Weak global demand. In the International Energy Agency January estimate it said, "Macroeconomic weakness continues to restrain global oil demand growth, with 4Q14 deliveries estimated at just 0.6 million barrels per day (mb/d) above year-earlier levels. Despite lower prices, demand growth is only forecast to accelerate to 0.9 mb/d in 2015."

A surplus of 1.5 mb/d to 2 mb/d of global production that isn't going away overnight. I expect this will tighten over the course of the year.

And potentially more supply from Iraq and Iran.

Floating storage in oil tankers – now estimated to be 50 million barrels – that is growing, and that will be sold into the market if and when prices rise.

RG: *Dave, rebuttal? Why do you think prices are about to surge?*

DAVE: Let's be clear. I believe prices will remain at current levels for the next three to six months. After that, a combination of several factors will send oil prices skyward.

The first is a natural phenomenon that occurs with all oil and natural gas wells. The amount of oil or natural gas coming out of a well decreases over time. Let's just talk oil here.

The well depletion rate (on a per-barrel basis) for a

conventional vertical oil well is about 5% per year. For an unconventional (horizontally drilled and fracked shale) well, the depletion rate is a whopping 30% to 40%.

The only way U.S. production will continually increase is if unconventional drilling continues at a breakneck pace. Unfortunately, that's not going to be the case in 2015.

Far from it. Oil companies are cutting back on drilling, laying off workers and freezing salaries. And here's the important part: *They've been through this before.*

There's no sector that can react quicker to changing market conditions than the oil and gas sector. All the upstream exploration and production (E&P) companies are going to be cautious when it comes to their balance sheets.

That means taking more drills offline to play it safe. We're already seeing that in the rig numbers. The rigs coming offline are doing so at the highest rate since 1987. By mid-year, the measly 1 million barrel per day surplus will be gone. Global demand growth hasn't stopped, it's just slowed down.

Here's the big problem: Once oil companies spend money to take expensive drills offline, they aren't going to be in a huge hurry to start drilling again. They're going to want to see a three-year window of time where oil prices are high enough to make drilling profitable. For deep sea projects, the time window is even longer. Unconventional drilling will resume first, but not until oil prices are high enough.

How high will they go? In July 2009, oil prices peaked at around \$147 per barrel. Within six months, oil bottomed around \$40. These price fluctuations and corrections can happen quickly and drastically.

RG: *So where do you both see oil settling this year?*

SEAN: I am using the December futures price of West Texas Intermediate to fix my price. This is what oil traders are actually willing to pay for December oil, not what they say, but what they do. In other words, putting their money where their mouths are. That price was recently \$53. Take out some money for simply holding the contract, and it's

closer to \$50. That is my year-end price. \$50.

DAVE: I think we'll see WTI crude seesaw in price between \$40 and \$55 until mid-year. I believe prices will increase after that. How fast and how far will be determined by how much demand increases and how much supply decreases based on the factors I discussed earlier.

RG: *Come on, Dave, you can't get out that easy! Give us a year-end price.*

DAVE: I think by the end of 2015 we could see WTI crude in the \$80 to \$100 range again.

RG: *What do you think is the single most important factor in determining the future of oil prices?*

DAVE: Fundamentally, like any other commodity, it's a supply and demand issue. Oversupply means low prices. Undersupply means high prices. There are other factors that can and do have an effect on pricing such as financial firms buying and storing oil in tankers or other storage vessels, geopolitical events that can disrupt or provide more oil than is necessary, and weather-related issues. But the biggest issue is supply and demand.

SEAN: The combination of global supply and demand. Right now, we have a surplus.

RG: *Oh! A point of agreement! Which do you feel is more critical in this situation? Supply or demand?*

DAVE: One isn't any more important than the other. If too much supply is taken offline, oil prices will rise. If supply stays the same and demand increases, oil will rise. Given that demand will slowly increase during 2015, a lessening of supply will eventually cause the oversupply situation we now have to disappear. The timing of that is the \$64,000 question. I'm betting it will happen sooner rather than later. We'll just have to wait and see.

SEAN: Agreed. Neither factor is more important than the other. Supply has surged – but if demand went up along with it, then the market would be in balance. Right now, there is a surplus of about 1.5 million barrels per day on the market.

RG: *Speaking of supply and demand, how will the recent Commerce Department decision from the end of December affect the price of oil and oil companies?*

DAVE: It allows U.S. producers to export "condensate," which is a lightly processed form of crude oil. This processing makes the oil safer to ship by removing some of the more volatile compounds found in crude.

The decision will ultimately lead to WTI and Brent prices approaching each other. It's a positive move for U.S. producers as they will have more outlets for their product. Ultimately, an outright lifting of the 40-year-old ban will probably happen in the next year or two. If not then, then certainly after the 2016 elections.

SEAN: Don't forget this will boost the profit margins of tanker companies too, simply because there are more exports.

RG: *Dave, as the Club's Energy and Infrastructure Strategist, who do you see pushing for the end of the ban? Why?*

DAVE: U.S. producers, so they can sell more oil. We have limited refining capacity here in the U.S. and most of it is set up to process the heavier crudes found in the Middle East and Venezuela. The light, sweet WTI crude is more easily processed by overseas refiners.

RG: *Who's hurting the most from the drop in oil prices right now?*

DAVE: Overleveraged E&P companies. They are cutting expenses, mostly by shutting down drill rigs and laying off employees.

RG: *Sean, this one's for you. What is the key metric to look for when studying the industry? Where's the connection to the resource industry?*

SEAN: The No. 1 measure of performance in oil and gas producers is core cash flow. A company with cash flow can meet debt obligations (the oil industry generally carries larger levels of debt). Across the resource space, companies with cash flow cannot only meet debt obligations; they can expand their businesses organically and buy up other

prospective companies. A company with cash flow has more flexibility in how it operates, and especially in how it reacts to a downturn in the market.

But cash flow isn't everything. The resource and potential for expanding the resource are also important. As is management. Good management really makes a difference. And if you're looking at explorers or developers, you aren't looking for cash flow. Then the resource becomes more important, as does management.

RG: OK. This one is for both of you. What is the most surprising thing you've seen come out of this rout in crude prices?

DAVE: I guess I'm surprised by how many people feel oil will remain low for years to come. That just isn't in the cards. If they're avoiding the energy sector because of that view, they're going to miss one of the best investment opportunities in their lifetimes.

SEAN: Just how quickly oil prices fell. The waterfall decline was stunning.

RG: Dave, you don't think oil will stay low for long. What do you see as a longer-term play if they rise?

DAVE: My favorite subsector in the oil space is midstream pipeline MLPs. They will rise along with all of the other companies in the oil space. I also like E&P companies with strong balance sheets, however, I'm not sure they've hit their lows just yet. But 50% upsides in 12 months' time won't be uncommon for the strong players in the E&P space.

RG: Sean, how do you feel about MLPs? Do you agree with Dave?

SEAN: Yes, in the presentation I made for The Oxford Voyager Club's Inaugural Beyond Wealth Retreat in Hawaii, a pipeline MLP was one of my picks. A pipeline is a great way to play America's rising energy production. Pipelines are the toll roads on America's energy highways, and you can get a big, fat yield. I think it's more important to get a company that keeps raising its dividend than just a big dividend.

RG: Dave, you recently changed the name of Peak Energy Strategist to Advanced Energy Strategist. Why is that? What should your subscribers expect from the change?

DAVE: Over the last few years, it's become increasingly obvious to just about everyone in the energy sector that "peak oil" or "peak natural gas" isn't going to happen anytime soon.

New technology in the form of hydraulic fracking and horizontal drilling has put so much oil and natural gas at our disposal that prices are the lowest they've been in nearly a decade. In an incredible turnaround, we no longer import natural gas, at least not in liquid form. In fact, we now have so much of it, we're going to be exporting liquid natural gas (LNG) by the end of this year.

My home state of Pennsylvania now supplies nearly 25% of all the natural gas produced in the United States. It comes from the Marcellus and Utica shale formations. It's all unconventional gas produced with the new technologies mentioned above.

This sort of transformation was virtually unthinkable a decade ago. Solar and wind energy is also becoming increasingly more important, especially as it relates to energy generated on the distribution side of America's electrical network. And just look at what Elon Musk is doing in the automotive world. He's turning it upside down.

All of this is happening largely as a result of new and advanced technologies. After taking a long, hard look at the energy sector and where it's going, I decided that the name "*Peak Energy Strategist*" no longer makes sense for our research service.

I wanted to name it something fresher... something more in tune with the current environment.

Advanced Energy Strategist is far more descriptive, not only for my service, but also for the sources and types of companies I'll be profiling and adding to the portfolio in the coming months and years.

While oil and natural gas companies are a big part of our portfolio, they're not the only ones I focus on. Solar, wind, geothermal and other groundbreaking companies that are upsetting the traditional energy models are right on my radar screen.