The Case for Capital Discipline… And Sound Energy Policy

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INTRODUCTION

Commodity price spikes are almost always the result of supply shocks that are caused by geopolitical events (i.e. – wars and trade wars) or natural disasters. They are, in a word, unsustainable.

While the current energy crisis was catalyzed by Russia's invasion of Ukraine, its roots were formed over many years by poor energy policies in the West, which reflect a tremendous lack of understanding regarding the amount of investment that is required to support the energy transition as well as the importance of diversity and security of supply.

Energy policies and capital availability have been influenced more by partisan politics and virtue signaling than strategic, economic, and environmental considerations. Ironically, these efforts have resulted in higher commodity prices, an increased reliance on less stable countries, and higher levels of CO2 emissions.

Listen to industry "experts" on one cable TV network and you will be left with the impression that the energy crisis can be solved by simply increasing shale oil production in the U.S. On the other network, "experts" try to convince viewers that transitioning more quickly to renewables is the solution and that, in the interim, Iran and Venezuela will be good partners in the united front against Russia.

Neither approach makes much sense.

Serious energy policy and investing should be guided by three objectives: 1) increasing diversity and security of supply, 2) generating attractive economics and limiting cost increases to consumers, especially in developing countries, and 3) reducing carbon emissions.

To achieve these goals, we believe that significant (and environmentally responsible) investments are needed in safe jurisdictions to increase: 1) renewable power generation AND the supply of materials required to support wind and solar power projects and an expanded and more stable grid, 2) decarbonized natural gas production, and 3) zero-carbon conventional power capacity, including nuclear. Too much reliance on any one source of energy and any one country/region is inherently destabilizing, at least until long duration storage is economic and scalable.

CAPITAL DISCIPLINE

Over time, we expect oil demand to decline as electric vehicles take more share. We would not be surprised to see the events in Russia/Ukraine accelerate this trend as gasoline prices rise above $4 per gallon across the U.S. To the extent that higher commodity prices trigger a recession, which we view as an increasingly likely outcome, the impact on oil consumption will only be exacerbated.

At the same time, efforts to bring oil production in line with capacity within OPEC countries, including Saudi Arabia, Iran, Venezuela, and Libya could add a few million barrels of supply over the next several years.

Russia is the wildcard. While we have no idea how the current situation will evolve, it seems plausible, if not likely, that either China and other countries will continue to consume Russian oil or that some change, either in Russia or Ukraine, will lead to a normalization of Russian oil exports over the next 6-24 months.

With so much uncertainty regarding the outlook for oil demand, OPEC production levels, Russian exports, and the fundamental mismatch between current production *capacity* and demand, a significant increase in investment in high-cost shale oil production would be nothing more than a highly speculative bet on the duration of any disruption to Russian oil exports.

Given the minimum 6-9-month lag between changes in drilling activity levels and changes in production (assuming that companies can even find the equipment and people to increase activity), we do not believe that it makes sense for shale oil companies to significantly increase investment in more marginal wells on the off chance that the oil market will be undersupplied in a year or two. That seems like a highly uncertain proposition, at best.

Rather, we believe that the low-cost countries within OPEC should produce more to offset any decline in Russian exports. Why should the high-cost producers add supply when the low-cost producers still have excess productive capacity? The shale industry has tried this before and it hasn't ended well, either in 2014/15 or in 2019/20.

Any increase in shale oil supply will only exacerbate the downside risk to producers when oil prices do eventually decline by widening the supply/demand gap, pushing oilfield service costs much higher, accelerating corporate decline rates, and significantly reducing the capital that can be returned to shareholders. As we have seen time and time again, when the focus shifts toward growth, the actual returns that are generated from incremental drilling activity end up being meaningfully lower than what the spreadsheets forecast.

Furthermore, we believe that any short-sighted move to transition away from "value over volumes" would permanently destroy the infinitesimally small amount of credibility that the industry has started to earn back by focusing more on returning capital to shareholders than growing for growth-sake.

Every price spike is characterized by a temporary supply/demand imbalance, or in this case the risk of an imbalance, that increases the temptation that higher prices can be achieved on ever-higher levels of production. Nonetheless, we are not aware of one instance when it has made economic sense for high-cost producers to ramp production into a price spike. If anything, history has taught us that companies should invest less into a price spike, not more, and return ALL excess free cash flows to the owners or build a stronger balance sheet to invest counter-cyclically.

In our view, the risks associated with increasing capital spending into a highly inflationary environment significantly outweigh any potential short-term benefits. Depending on how the companies move forward, this will either be the death knell for the shale oil industry or the proof case for the real governance changes that have been implemented over the last few years.

DIVESTMENT, RECONSIDERED

Divesting from fossil fuels will be remembered as a terrible, misinformed, procyclical, and counter-productive virtue signaling exercise.

By divesting from natural gas in North America, investors have inadvertently increased reliance on coal and oil in the U.S. and abroad, pushed natural gas supply into countries like Russia that are less friendly politically and environmentally, and significantly increased energy costs for consumers.

Ironically, divestment has contributed to higher carbon/methane emissions, higher energy prices, and untold human suffering. That is the reality.

A much more nuanced and responsible ESG framework is desperately needed. Instead of divesting from natural gas and the minerals that support the energy transition, investors could have a much more positive impact in the world if they helped capitalize the low-cost projects in safe jurisdictions that will be needed to diversify energy supplies, transition away from coal and oil, reduce carbon emissions, and limit future increases in consumer prices.

Ownership and engagement make much more sense than divesting from the businesses and commodities that will be needed to address climate change and global energy poverty.

CONCLUSION

If the shale oil industry could turn the tap and increase production quickly with limited capital investment, it would make a ton of sense to do so both economically and strategically. However, the reality is that it will take billions of dollars of investment and many months of less efficient drilling before shale oil production can grow meaningfully. Even then, significant increases in shale oil production are probably not sustainable, due to high depletion rates and deteriorating drilling inventory, and the fundamental backdrop is likely be materially different in 6-9 months than it is today.

As the major oil companies have shown, it has always made far more sense to run a stable, capital-efficient, and safe drilling program. Chasing growth never ends well.

The current energy crisis, therefore, should not be used as a reason to significantly alter the focus on returns, safety, and environmental stewardship. The economic risks are going up, not down. Declining oil demand, the growing risk of recession, higher OPEC utilization, and increasing service costs suggest that capital spending levels should either remain stable or move lower, if anything.

Since price spikes are not sustainable, excess cash flows are better off being distributed to shareholders than reinvested at lower returns on capital. The first price spike after the great shale oil collapse is probably not the time to lose discipline.

Rather, all that is needed is sensible energy policy and responsible long-term investment from institutions around the world.

Reducing reliance on Russian energy, transitioning away from coal and oil, reducing carbon emissions, and addressing global energy poverty in a cost-effective way will require trillions of dollars of investment in renewables/storage, minerals such as copper, nickel, lithium, rare earths, and aluminum, decarbonized natural gas, nuclear, and other carbon-abatement technologies and businesses.

The time to start is now.

DISCLOSURES