The Real Reason to Worry about Oil

By Robert Huebscher
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Few question the prevailing wisdom that tensions with Iran have caused the recent rise in oil prices. But another possibility exists – and it's a much greater long-term threat to economic growth.

Oil prices last spiked, in 2008, because supply and demand were tightly balanced. Those conditions may have returned, according to Jim Hansen.

Hansen is an independent financial consultant with Ravenna Capital Management in Seattle. His practice focuses on investing in the energy sector, and he distributes a weekly report a broad range of issues related to peak oil.

Over lunch a week ago, Hansen told me that "global spare capacity is approaching zero from a statistical standpoint," and those conditions are the primary driver of the recent rise in oil prices.

Hansen is not an alarmist when it comes to energy, and doesn't expect a return to the lines that snarled streets near gasoline stations during the 1973 oil crisis. His analysis is backed by a careful examination of the data.

One troubling statistic that the media largely ignores, according to Hansen, is the background depletion rate from existing oil wells, which Hansen conservatively pegged between 3% and 4%. This is the percent reduction in production from existing wells. With total world crude oil production now at 75 million barrels per day, the same wells will produce only 72 or 73 million next year. That 3%-4% depletion rate has to be made up for by new wells coming on line if world production is not to decline.

That problem, Hansen said, looms larger than the growth in demand. Chinese demand, for example, might grow by 10% next year, which is less than the 2-3 million barrels lost to depletion. "Everyone focuses on China," he said, "and overlooks depletion which never takes a break like China may if its economy slows."

"Even if there is spare capacity," Hansen said, "There is still a problem."

Hansen is skeptical about recent claims by the Saudis that they have as much as 25% spare capacity. If they had that much capacity, then Hansen said there is no reason why they wouldn't have brought it on-line sooner.

But even if those spare capacity claims are true, one must consider the Saudi's internal needs. Saudi Arabia is reserving a rapidly growing percentage of its oil production for internal consumption.

Hansen said OECD oil inventories outside the US are in fact shrinking, according to IEA data, just like they did from 2007 until oil prices spiked in 2008. During that period, Hansen said that published OECD oil inventories were steadily declining.

Due to the increased Texas and North Dakota production, US inventories, predominately in Cushing, OK have been growing, which Hansen said is the result of transportation constraints.

The first result of dwindling inventories, he said, is that it becomes tougher for oil buyers to get the grade of crude oil they want. Then they start having to pay a higher price.

Speculators have a role, he said, but only to amplify a trend once it is already in place. "They don't create trends," he said.

This year's numbers are not influenced as much by commodities traders, because there is less volatility than in 2008, Hansen said.

The global economy will have trouble with oil prices above $125 per barrel, Hansen said. At the other end, the cost of production establishes a floor for oil prices. That cost ranges from around $80-$90 per barrel for Saudi Arabia to $100 for Russia. Those are the prices necessary to guarantee domestic stability, since both countries use oil revenue for political purposes; the variable cost of production is much lower.

"That's not a big window," Hansen said, "and it's getting tighter, because the floor is going up as the cost of exploration, extraction and production of oil goes up." When prices go outside of that zone, "someone suffers," he said.

The investment opportunities

Hansen's portfolio is built on a long-term expectation of diminished resources and higher oil prices.

He doesn't own any airlines, which he said cannot overcome the high percentage of fuel costs built into their cost structure. He also thinks long-haul trucking will be chronically troubled by liquid fuel prices, although local trucking will thrive as an extension of the rail network.

Railroads will be the big winner in transportation, and rail infrastructure represents the biggest sector holding in his portfolio. Aside from transporting coal, rail traffic has been increasing in recent years, Hansen said.

"Trucks cannot compete with rail," he said. "This is a permanent trend."

Hansen expects natural gas prices to increase, but he doesn't hold any direct commodity positions in gas or in oil. He dislikes commodity-based funds and ETFs, citing the well-known problems posed by carrying costs with commodities that are in contango. Instead, he said, the biggest winners from increasing natural gas prices will be larger, low-cost power generators.

Almost all of Hansen's investments are in individual securities. He prefers dividend-paying investments that offer downside protection. His biggest holding is a hydro-electric company.

Over the very long term, Hansen worries that rising energy prices will dramatically change the way we live. Liquid fuels, he said, support 95% of global transportation needs. As fossil fuel supplies stagnate, we will spend far more time closer to home – which, he said, was the way we lived 50 years ago, before air transportation became cheap and readily available. Car ownership in the US could go from 90% of households to 70%, as it is now in Europe.

Neither time nor the supply of financial resources are aligned with the problems the world faces in replacing the 95% of transportation energy needs, Hansen said. "It took over 150 years to build out the liquid fuel infrastructure that exists today and it is going to take decades to replace it," he said.

When it comes to alternative fuel development, Hansen said if it is in the lab today it is 10 years to large-scale deployment. "Our problem is well inside that envelope."