What has happened to Black Gold? | Maarten van Mourik

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THE MATTERHORN INTERVIEW: Maarten van Mourik – March 2016

“The Current Oil Price: A Blessing & A Curse”

Maarten van Mourik is one of the top oil analysts running his own consultancy since 2000. He discusses, inter alia, the ending of QE3 in the US and a strengthening dollar as part of the reason for the oil price demise and its effect on the mechanics in the energy space.
Lasr Schall spoke with him a few weeks ago when crude hovered just above 35 bucks.

Video podcast: 16 mins

Transcript

Lars Schall: As you have probably noticed, the price of oil gets quite some attention these days. It is now above $35 ($40) U.S. per barrel again and given the prior spikes of 2003-2008 and 2011 until the summer of 2014, oil lost dramatically in value. Maarten, may I ask you to explain the current situation and what concerns you the most about it?

Maarten van Mourik: I think that one of the things that happened is the dramatic sell off in all sorts of markets, with the strengthening of the U.S. dollar since 2014.

LS: This wasn’t just a reaction in the commodities market, and in particular with oil, but also in other sectors of the economy.

MvM: Yes. I think it has a lot to do with the ending of the QE3 Program and the gradual tightening of the financial markets. I am sure you saw the strengthening of the U.S. dollar gaining pace from the summer of 2014 onwards. It was really obvious before that period, when the central banks changed their policies, that this kind of thing was going to happen, so we are not too surprised.

LS: When you talk about the strengthening of the dollar, isn’t there historically also an inverse relationship between the dollar and the price of crude oil? When there was a strong dollar, we had a weak oil price and vice versa. Just as there seems to be that inverse relationship also for the dollar and gold.

MvM: Yes, well, that’s fully correct. The price of oil spiked to over $147 in July 2008 and the U.S dollar was close to 1.60 to the Euro, so it went in the same direction. It is even a question of, do you have a weak oil price when you have a strong dollar? It is basically two sides of the same coin.

LS: Okay, but why is there this sell off that you've mentioned?

MvM: I think it has to do with the global repatriation of the dollar back to the U.S., out of the emerging markets and all sorts of markets.

LS: Do we have problems in foreign oil companies related to the dollar?

MvM: Oh, absolutely.

LS: Please explain.

MvM: You can see this with a company like Petrobras, which has a large part of its debt denominated in dollars and euros, so the company is fighting to earn enough money to pay interest and repay its debts. As the currency goes down, the debt problem gets worse and worse over time, and the same goes for a company like Pemex, which has had to suspend payments to its suppliers for plenty of months to preserve their cash. Ecopetrol in Colombia, it's the same thing. There are plenty of oil companies in the emerging markets that are shifting from this kind of development and that has a direct repercussion on future supply because these companies will have a hard time to develop the oil fields in this situation.

LS: Yes. Do you think that oil prices with improve during this year or is the oil price, as suggested by a recent report published by Citibank, 'currently on a death spiral, driven by the resilient U.S. dollar, lower commodities prices, weaker trade and capital flows, and declining emerging market growth`'? (1)

MvM: I don't think that the oil price is in a terminal spell. The likelihood is that it will possibly go on further with the current temporary oversupply situation. It is possible that the dollar does something crazy and might strengthen again, who knows? Then the price of oil would come down further, but the longer this thing goes on, the more the oil supply will be affected and this can go, very quickly, back up again in a very odd situation.

LS: Yes, and because we see currently see a lack of investment in new discoveries?

MvM: Yes. You can say that again. CapEx spending by the oil companies has been cut massively in 2015. It is being cut for this year again, massively. So, activity is just way too low to sustain the output as at previous levels, let alone grow the production. This is going to come back like a boomerang. The other thing that I think could be putting a cap on oil prices is if money would be restricted. If there was a strong liquidity shortage, then the price of oil just can't go up too much.

LS: Okay. Do you think that the prohibition of cash money is on the cards?

MvM: It could be, it could be.

LS: Okay. You know that Lawrence Summers or Kenneth Rogoff are talking about this?

MvM: Yes, and not just them, other people as well.

LS: Okay. I think a logical question has to be, if needed when prices were to rise, has the world enough spare capacity as far as conventional crude oil is concerned? As far as I know, there was no spare capacity in the recent past. Since 2005 the daily production level of conventional crude oil couldn't be raised above 75 million barrels no matter how much money they have thrown at the problem, and may I remind you out there that there was a lot of money floating around in the last couple of years. Do we have spare capacity if needed?

MvM: Hardly. There is not enough. If you would look back at the production figures over the past few years, then we could say that with the cheap money we got very expensive oil in the form of shale oil from the U.S. and that has effectively functioned like a spare capacity buffer. If it hadn't been for that oil, the oil price would have been way higher than what we have seen and the demand for oil would have been much lower. So, it hasn't, and now that the oil price has come down so much that the shale producers are having to cut back effectively on production. We will quite quickly be requiring the few remaining spare capacity barrels that are in the middle east and we could be in a very strange situation.

LS: Yes, because?

MvM: Well, what are you going to do if you do not have the spare capacity? You can't consume more than can be pumped out of the spigot's.

LS: Yes. Do you think that we have plateaued at this 75 million barrels per day level?

MvM: Well, it certainly looks like it, because the world has been spending something like $5-6 trillion over the past ten years and we haven't increased that output. Not anywhere near. Big oil has spent 20% or so and they have seen the liquids go down over the same period.

LS: You said that without shale oil the prices would have been much higher. You are an authority in this capacity as an analyst for shale oil and gas, because you are doing ongoing research since, I think, 2013. It is called The Other Tale of Shale, and you examine 35 companies that are engaged in the shale industry. Please tell us about the main findings and trends. Furthermore, what are the challenges ahead for the fracking industry in the U.S.?

MvM: Well, basically when I did the analysis a couple of years ago I looked at the industry and I was surprised by the quick production goals. I thought, that's interesting, let's see how it's being done. So, we looked at the financials of these companies and I found that they were outspending their cash flow continuously. They achieved very high growth rates, which was very impressive, but then I thought, okay, let's look at production on the well level and how fast you have to drill, how strong are the decline rates in these wells and what capital expenditure is required to sustain that kind of production or grow it further? I did that and I found out that these companies were heavily indebted and they were adding to debt with every quarter that passed. I thought, well if that’s the way that you have to grow your production then someday when the price turns around or you cannot get cheap finance anymore, then the production will stop. To be unkind, you could even describe it as a physical Ponzi scheme, because of the mathematical growth path that is required for it. It is not intended to say something mean about the intentions, it is a mathematical issue.

LS: Would you say that this certain cash flow or spending pattern was only possible because of the cheap money period in the U.S.?

MvM: Yes, absolutely.

LS: Now, what are the challenges for the fracking industry in the U.S.?

MvM: To spend money within the cash flow from the operations and try to sustain the production, or at least manage the decline downwards and survive the period, but I think a lot of these companies will go under. Quite a few have gone under and more will go. There is no way out. Interestingly, one of the big producers yesterday released their fourth quarter presentation and said that production will decline if the Capex has to be within cash flow from operation limits.

LS: What do you think, at current levels, at what point are those companies really profitable?

MvM: It depends on where you are. I think it’s like any type of oil field, a lot of them can be very profitably at reasonable low prices and many will require very high prices. So, it’s just a matter of how you present it, but if you require skill and lots and lots of oil out of the ground, the price of oil will have to be much higher than what it is currently.

LS: Do you think that the people in Saudi Arabia who are calling the shots there when it comes to oil are looking at the U.S. with a smile when it comes to their fracking industry?

MvM: I don’t know if they look with a smile. I just think they observe this kind of thing and see, okay, well the production is coming down and it leaves more market share for the middle east.

LS: Yes, but I have read in the past, for example, from the Federal Reserve President in Dallas that he was saying the Saudis are enhancing the situation, or that they are cheering and that they are basically the cause of the situation in which the fracking industry finds itself with the low, slow prices. (2)

MvM: It’s a nice remark. He could also go and look in the mirror and say that the Federal Reserve has enabled the shale industry to rise in the first place.

LS: Yes. Okay. What do we do now when it comes to the current prices? How do we perceive them? Are they really a blessing or are they a curse?

MvM: I would say it's a blessing of course for the consumer in the short term. There is a form of blessing because it has made the industry wake up. The oil companies have woken up to the issue that they couldn't continue increasing the expenditure on developing new oil. It had been going completely out of control over the past ten years. There has been a focus on getting cost back under control and the industries that supply their services to the oil industry are themselves looking at getting costs back under control and looking at doing things more efficiently. So, from that perspective, I think there is a lot of gain also for the consumer because it brings the price of oil down over a much longer period. At the same time, it is a blessing in disguise. If the supply comes down as fast as it is coming down now then we will find ourselves in a supply/demand pickle in the not too distant future, with all the consequences of all of that.

LS: Yes. Please let us know about the consequences.

MvM: I think the Secretary General last week, or this week, was quite clear as well, he said that high oil prices will follow when the supply is running out. So, I think that basically sums up the situation. Whether that will be $100 or $200 or $50 when the dollar is very strong, it depends on quite a few elements, I would say.

LS: Okay. May we all live in interesting times. Thank you very much Maarten.

MvM: You're welcome Lars.

Background & References:
Maarten van Mourik (born 1967 in the Netherlands) studied micro-economics / industrial economics and shipping economics at Erasmus University in Rotterdam, Netherlands between 1988 and 1991. Afterwards he worked with the Netherlands Economic Institute on transportation policy research, mainly maritime transport. For Petrodata Ltd of Scotland he was doing offshore drilling rig and marine support vessel market forecasting.

From 2000 onwards he has had his own business, doing bottom-up field by field non-OPEC supply forecasting, oil market analysis as well as forecasting offshore equipment markets. The work was supplied to OPEC as well as investment funds. As an economist he has worked on port infrastructure feasibility studies around the world. He favours independent analysis, Austrian economics and an eclectic approach to analysing and predicting market behaviour. He currently lives in France. He co-authored the book "The Misunderstood Crisis: It's the energy stupid!".

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(2) "Saudi Arabia 'engineered' oil crisis: Dallas Fed chief", CNN, February 11, 2015: http://money.cnn.com/2015/02/11/news/economy/oil-price-fall-saudi-arabia/