Reaves Asset Management

Some Things Are Better The Second Time Around

Here I am trying to decide whether to regale the reader with stunning insight on either 1) the dramatic build-up in U.S. crude production over the past few years and its investment implications, or 2) the collapse in U.S. gas prices and how long those prices can last at such a disparity with crude oil prices. I even had a chart. As I am struggling about which issue to discuss, and why; a whole new issue arises (resurfaces) concerning the possible second round of a crude oil or refined products release from the Strategic Petroleum Reserve (SPR). I thought that this issue, the release of strategic reserves, was in the category of "been there, done that" rather than more along the lines of the title of this piece.

Part of the reason to write about the issue of the release from the SPR is just personal. I find the U.S. Government trying to manipulate gasoline prices via a reserve release to be entirely political and completely devoid of fundamental merit. This reserve had been created and sustained for <u>real</u> emergencies, such as the prolonged blockage of the Straits of Hormuz (we're not predicting that); and <u>not</u> short-term gasoline price movements during an election year. The clear history of the last release from the SPR, which cost the U.S. Government (read "taxpayers") a high logistical destocking fee, did little-to-nothing for short-term oil prices, and obviously nothing for longer-term prices. Further, I believe that the regular tapping of strategic reserves places the "tapee", i.e., the U.S. Government, in a position more like a market maker or even price manipulator; which under some interpretations may be addressed and frowned upon by the recent U.S. Government-passed Dodd-Frank legislation.

The above does not suffice to ease my emotional distress, but there are a few collateral investment issues that come to mind. The most obvious of which is that "high" oil prices are fundamentally a product of supply and demand. The average Brent crude oil selling price over the period 2007 through 2011, 5 years, was approximately $85.00 per barrel (B). The average for West Texas Intermediate (WTI) was nearly $82.00/B for the same time frame. Today, Brent is near $125.00/B and WTI above $105.00/B. According to the International Energy Agency (IEA), worldwide oil demand over these same past five years rose by about 3 million B per day, or 3.5%. There are fundamental reasons to support rising oil prices. While some sources of new production can be had at lower costs, especially in selected U.S. Shale basins, a large component of new worldwide oil supply comes from <u>higher</u>-cost areas such as offshore (Brazil and the U.S. Gulf of Mexico, for example) and high-cost oil sands production in Canada. Obviously, as just noted, demand for oil is still rising worldwide, though not so much or at all in most Organization for Economic Co-operation & Development (OECD) countries. Furthermore, oil prices retain a risk premium for global oil production uncertainty, not the least of which is associated with nuclear threats and denials by Iran. Other oil producer trouble spots over the past few years are Nigeria, Venezuela, and Libya, to name a few.

Some readers will be fatigued at this point and dismiss the above dialogue as either a political tirade or overreaction to a political trial balloon about the strategic reserves. On the latter, it becomes commonplace to jawbone or prepare the oil markets for release of strategic reserves. This is part of the political theatre. On occasion, petroleum reserves are in fact, released. On the issue of politics, I am trying to be evenhanded and non-political. I will recall for readers that post-Katrina, when oil prices and gasoline prices spiked due to supply unavailability, the Administration at that time pushed hard for a renewed effort to build new refineries in the U.S. Over the past two years, the market has witnessed an abrupt closure of many U.S. refineries due to poor economics and reduced demand. Still, even more U.S. refineries are for sale today by their existing owners. Had the previous Administration's efforts actually resulted in planning for new refinery environmental studies and (ultimately) their approval, the new refining units would probably be starting up about now.

Allowed to operate without too much governmental interference, there is a strong belief in the time-tested adage "that the cure for higher oil prices is higher oil prices". In my opinion, a politically-motivated release of strategic oil/product reserves would be wasteful and ineffective. Parenthetically, I am just as opposed to Federal Government programs (like the one just defeated in the Senate), to incentivize construction of retail natural gas fueling stations as an accelerated means to displace gasoline or diesel fuel for trucks. Mindful that OPEC is a politically (and financially) motivated organization, I believe the U.S. should respond to higher oil and gasoline prices by encouraging the price to act as a stimulant to new supply. Low U.S. natural gas prices may be viewed as a national economic stimulant, offsetting much of the financial effects of a rise in oil prices. Therefore, I believe the low U.S. gas prices afford a competitive national advantage to the overall U.S. economy, without the need for further political demand stimulus.

The current interplay between macro factors is likely to determine oil price direction in the short term. In the big picture, oil supply uncertainty counter-balances what is an announced slow-down in Chinese economic growth. Parenthetically, and obviously confusing, has been the recent oil import surge into China instead of any expected slow-down which would mirror economic trends. The Chinese oil import rise has been accounted for anecdotally by both a rise in real demand and a determined rise in inventories; although how much a factor each represents is unknown. Further dimming clarity about oil prices has been the outlook (and the statistical support) that the U.S. economy is again growing, which should be positive for energy demand (the U.S. is still the largest single consumer of oil). However, industry demand statistics, which have been reliable historically, are indicating a sharp U.S. demand decline leading many observers to speculate that data collection has fundamental flaws. Lastly, while an improved U.S. economy is positive for demand, the sharp seasonal rise in gasoline prices is believed by some to be dangerous to economic recovery, and may in fact lead to a resounding slowdown.

What to do? Of course we hope to be alert to short-term investment opportunities as they might arise. We, at Reaves Asset Management, believe that there are favorable long-term investment opportunities which can benefit from broadly higher oil prices, incremental oil volume growth, and a relatively lower-cost producing structure achievable through the use of evolutionary oil field service technology. Further, we believe that the infrastructure and transportation opportunities to move new and growing oil volumes and inexpensive (versus the rest of the world) gas volumes will prove rewarding. Optimistically, should these identified energy opportunities prove successful and durable, one can even envision a return to more narrow valuation discounts for the broader stock market indices, when compared to previous markets at higher interest rates than we are experiencing now. For that matter, even a decline in oil prices and a rise in U.S. gas prices may not be too distressing (or even, dare I say, positive) to energy stocks if resulting prices seem durable.

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