DK Analytics, Post #12: Will Big Oil to become Big Tobacco? **12/17/2015**
10-year Treasury: 2.26%; S&P 500: 2073.07; Oil: $35.43; Gold: $1,065.70; Silver: $14.06 (12/16/2015 quotes)

Senator Sheldon Whitehouse, a Rhode Island Democrat, recently wrote the following in the Washington Post: “Fossil fuel companies and their allies are funding a massive and sophisticated campaign to mislead the American people about the environmental harm caused by carbon pollution.” He also claimed that these activities were reminiscent of Big Tobacco denying the health dangers of smoking. Now, Whitehouse and others, including the AG of NYS, Schneiderman, are serving subpoenas and even calling for a Justice Department RICO probe of ExxonMobil, much like the RICO investigation of tobacco in the late nineties.

The rank energy industry extortion and the beyond the pale deception being sought by the toxic alliance of unscrupulous trial lawyers and government leftists related to unadulterated anthropogenic global warming claptrap further threatens the basis of our leveraged economic output, productivity, and standard of life.

Introduction:
Is there is no respite from the leftist/crony "CO2 is pollution" extortion racket? The leading CO2-emitting Chinese are surely salivating over the recently concluded Paris Climate talks as the West stands to foot the bill (if implemented, the US taxpayer would be on the hook for $300bn plus p.a.), shut down yet more production, and transfer wealth and technology to EM nations focused on true pollution abatement amidst rising fossil fuel use. (Relatively price inelastic global fossil fuel consumption will continue to increase nominally over time for a host of reasons, which prior publications delve into.)

When you shake down tobacco shareholders and smokers (anybody with a pulse and the capacity to inhale and exhale has always known that smoking is bad for your health or the “duh factor”), that’s one thing. Trial lawyers become “never produced a damn thing” multimillionaires and state politicians use the settlement money -- or the “net present value” of future settlement payments -- to finance pork in order to endear themselves to voters while they threaten state solvency.

But if “global government” extortionists and trial lawyer parasites succeed in massively misappropriating property from energy company shareholders/vital providers of dense energy and then redistribute it themselves and their statist hangers-on, that’s something else entirely. The reasons: the very underpinnings of an economy dependent upon hugely leveraged output thanks to fossil fuel (oil, gas, and coal) exploitation are threatened. For some historical insight into the horrid “science” and the dissembling politics at work, please see the apt description below as regards New York State Attorney General Schneiderman’s budding Big Oil extortion efforts:

> “The impetus for Schneiderman’s investigation appears to be recent revelations that Exxon, as far back as the 1970s, had funded studies concluding that global warming could result from carbon emissions — but that Exxon had failed to publicly disclose those risks to shareholders. But let’s get real. See this for what it is — a witch hunt against a big company with deep pockets that the anti-carbon lobby wants to fleece to support their pet renewable energy projects.
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> What’s the crime that Schneiderman is looking for here? Failure to disclose risks to shareholders? Really? Exxon has for years disclosed to shareholders the possible risk that the burning of fossil fuels could contribute to global warming. Ok then, maybe the crime is not disclosing risks to shareholders early enough? That’s a tough one to prove. Because at the time Exxon “should” have disclosed those “risks” they wouldn’t have been considered risks at all. Back in the 1970s the more pressing concern was the coming of a great global cooling, a new “little ice age” that would cause crops to fail and spread famine worldwide. In 1961 the New York Times reported that “an assembly of specialists from several continents seems to have reached unanimous agreement on only one point: it is getting colder.”
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> According to this Newsweek report from April 1975, scientists proposed to deal with the danger of Global Cooling by melting the arctic ice cap by covering it with black soot. And this 1975 story from the AP has the priceless line: “The panel reported that without doubt, colder climate will come.” In 1984 the Chicago Tribune reported that contrary to the forecasts of the newly heralded greenhouse effect, average temperatures in Illinois had fallen 3.5 degrees over the previous half century. So get this straight. Mr. Schneiderman and the anti-oil crowd must think that Exxon, 35 years ago, should have disclosed to shareholders the counter-consensus idea that the world might possibly be likely to heat up a few degrees?

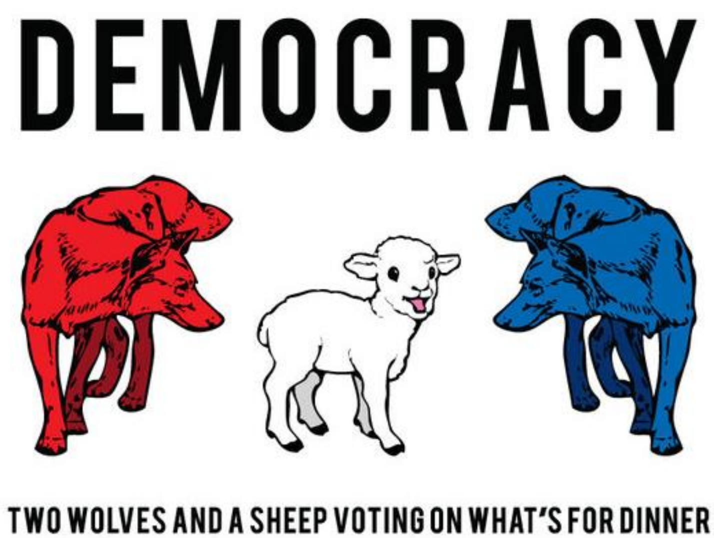
But how should Exxon have labeled this disclosure? Certainly not as a business risk. Given the scientific consensus at the time, Exxon could have touted a little bit of warming as good news — its contribution to saving the world from a new ice age. Ah, but then Exxon would have been lambasted as a Global Cooling denier."

A closer look:
A witch hunt against Big Oil turned into a litigation shakedown would add insult to the ongoing carbon tax-based property rights usurpations, misallocations, and "green cronyism" already being dished up by Obama:

"… It is the perfect way of shoring up his left-wing voter base while simultaneously rewarding all those rich liberal donors who have bankrolled his presidency. From Solyndra and BrightSource to the monstrously corrupt wind industry, Obama's cronies have been enabled, by presidential fiat, to make many billions of dollars -- much of this money funneled straight from the pockets of US taxpayers, either in the form of stimulus loans for ventures which certainly would never have survived in a free market or in the form of compulsory subsidy payments for 'clean' energy."

If administrative branch statists in the US succeed in joining their European brethren already collecting CO2 output taxes to a) further redistribute property/income from free market makers to takers (as of 2013, some 43% of Americans paid no federal income taxes) while b) simultaneously further subsidizing their increasingly wealthy green crony capitalist pals, additional negative political and economic ramifications loom. Specifically, while the unelected, unconstitutional administrative state's power grows and veers progressively further from representative, or republican, government, and cronies gorge on artificial demand for "green" mal-investments and taxpayer-financed subsidies, the private sector and the economy at large increasingly suffocate under the ills of "central planning" or statism -- big government. Concretely, productivity gets pummeled, high paying jobs get eliminated, and purchasing power is reduced as energy policy distortions continue unabated.

This is what happens when the ruling elite can literally get away with stunts that are tantamount to "taxing air" (CO2) as they shut down viable businesses at the expense of "Main Street" makers. This is not only how the "1% of the population" immensely enriches itself while disenfranchising the vast majority of property owners, but how a democracy lurches ever more powerfully toward one party rule ("California"), or totalitarianism, in the process. When such free market pummeling excesses are facilitated by an increasingly unbridled capacity to print money with which to sustain deficit spending and mal-investments, then usurpation of property and thus liberty ("property's sister"), declining overall societal wealth, and reduced protection against both tyranny of the minority and tyranny of the majority result, and representative government is eventually lost. As both Benjamin Franklin and Alexis de Tocqueville knew: "when the people find that they can vote themselves money, that will herald the end of the republic." *And a democracy lacking the tyranny-constraining constitution (a codified liberty bulwark!) of a republic is akin to "two wolves and a sheep:"*



So let's tie this back into "Big Oil, the New Big Tobacco?" How should investors view this as the West continues to lose its republic-based democracies? Explicitly, how should investors discount (value) the gathering effort to squeeze Big Oil (historically, that's where the money has been, which is obviously why the industry is a big, fat target) in a manner possibly similar to how Big Tobacco was taken to the extortionist cleaners. But before we go into particulars of said, let's revisit the damage such a fossil fuel shakedown, heaped on top of globalists' "Paris attempt" to "tax air," could inflict on the underpinnings of a leveraged output economy. Let's frame this by stating that nearly 82% of the world's energy supply comes from fossil fuels (including coal), and nearly 53% comes from oil and "geological sister" natural gas. Let's add that the only net growth in global oil and gas production over the past five years came from North American-based fracking, a sector which never made money, even when oil was over $100 a barrel!

When we refer to the underpinnings of a leveraged output economy, we're talking about reliable and affordable "24/7" power. Our entire transportation system, ag output/productivity (how we can feed 7.2bn people, up from 1bn 215 years ago) manufacturing output, IT, communications, HVAC everywhere (including your Publix, Trader Joe's, and Walmart supermarket freezers!), functioning home appliances/lighting, potable water, sewage treatment plants, gas pumps, and the hospital ER and intensive care units depend on it! Said differently, our entire modern lifestyle, and the infrastructure which enables it (which we often take for granted), depends completely on 100% on affordable, 24/7 power availability, which in turn relies on dense energy accessibility! Talk about relatively price inelastic demand …

To drive the point home further still, did you know that if an economy loses but an hour of power a day, economic output or GDP drops by up to 50%. For "graspable" flavor, have you ever pushed a car down the street, considered how long it would take you to bike 25 miles to work and back, have you ever carried a 50-lb cement bag a block and a half, have you ever used a handsaw instead of a chainsaw, have you ever tilled soil by hand instead of with a rototiller? When you contemplate this and just how much work gets done by energy-consuming machines, it's perhaps less difficult to comprehend or believe that one 42-gallon (159 liter) barrel of oil contains the combustion-based heat equivalent of over 11 years of agricultural labor at a 40-hour a week rate by one worker or over one year of "horsepower," i.e., a horse toiling in the fields for over 12 months at a 40-hour per week clip.

With oil, gas, and, to an extensive degree, coal, getting harder and ever more expensive to find, exploration and production budgets already crashing under the weight of falling energy prices, and drilling funding drying up, such looming extortions of property aren't exactly how the world will "incentivize" energy exploration and production companies/shareholders to increase their capital spending commitments! To wit, courtesy of the brilliant, London-based macroeconomist/strategist Andy Lees of the Macro Strategy Partnership just last week:

> "According to Tudor, Pickering and Holt (Peak Oil website), the oil industry has deferred or cancelled about 150 projects that could unlock 125bn barrels of oil over their lifetime – (nearly enough to supply the world's present oil needs for 4 years). At peak production these projects represent 19m bpd of production, more than 20% of world daily consumption. The main factor in project delays is economics. The projects need a breakeven of at least USD95bbl – USD114bbl. The article concludes by saying that producers may need to start work on projects that are currently not economic in anticipation of higher prices. I think the reality is the economy is simply not productive enough to afford the high prices needed to sustain production, and therefore we should get more used to a declining economy and more financial engineering (money printing) to try and support growth."
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> And:
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> "Chevron will cut its budget by 24% next year to USD26.6bn. It will also cut 10% of its staff numbers. The bulk of spending will be on international oil and gas exploration and production projects, with the second largest share going to projects in the US including shale. Some of the cut will be as projects in Australia complete. 'We gain significant flexibility in our capital program as we complete projects under construction.' Other majors are expected to follow with similar cuts"

Translation: if bigger than ever industry shakedown efforts gain traction, proceed, and spread -- and are superimposed on top of huge secular oil extraction challenges -- then "99% of the people" will have less energy, less "24/7" power, more expensive energy, and a much lower standard of living/less convenience while the "crony 1%" get richer than God. Think Venezuela, Cuba, North Korea, etc.

Neither national sovereignty violating, representative government-shredding "global diktats" nor class action lawsuit-based property extortions are how a capitalist system featuring an intact rule of law and sound property right protections is supposed to work. A constitutional republic is the antithesis of both fascist (such as today's Russia) and/or communist (such as the old USSR) political systems that the Western "leaders" are sadly increasingly gravitating towards.

Yet you know the saying: "if you can't beat 'em, join 'em," at least as regards your investment portfolio in an age of rapidly expanding cronyism threatening to morph into fascism; you owe it to yourself and your family to do no less. History shows that government-induced scarcity always triggers higher prices; this, in a nutshell, is the broad brush stroke oil investor opportunity. The statist leeches didn't want to kill the Big Tobacco hosts (besides being a huge excise tax generator/collector for American states, would you be surprised to know that Philip Morris International was the biggest single taxpayer in France for many years?). And they won't likely tolerate having litigators become billionaires only to potentially kill off long-lasting, prodigious Big Oil cash flow streams -- and the companies behind them. The statist thugs want to position themselves to "syphon off" and then redistribute, to the tune of potentially hundreds of billions of dollars over time, shareholder funds to settlement beneficiaries. Quite the re-election enticing political patronage racket. Quite predictable.

Oil investor upshot:

So what if turning ExxonMobil, BP, Chevron, et al. into "Joe Camel" is the plaintiffs' bar the next big target as they "circle the wagon" in a joint venture with old reds resurfacing as new age greens, all in the name of environmentalism, of course?!

(We wonder whether our green crony posterchild of the last decade, the jetting around the globe in a 95%-empty-jet-spewing supposedly-harmful-CO2 Al Gore, has already positioned himself for another huge green crony shakedown bonanza as this possibly biggest and most threatening litigation-based disenfranchisement of property effort moves ominously forward?)

More topical and, with a bit of luck, more useful: how should investors value fossil fuel energy companies in light of growing global CO2 output or "air taxation" threats? Is "Big Tobacco, revisited" a good historical guidepost? Smokers kept smoking marginally less cigarettes, the price of smokes kept going up more than volume went down, shareholders successfully past the costs of the tobacco class action settlement shakedown on to smokers, and shareholders that bought the shares either heading into the November 1998 $368.5bn "master settlement agreement" or long thereafter did just great, both in absolute and relative terms. Bottome line: they hugely outperformed the S&P 500 on the heels of the "master settlement" extortion. For flavor, let's look at how the stock price of RJR Reynolds, now known as Reynolds American (RAI), maker of Camels, has done approximately 6 months after the tobacco settlement through 12/10/2015 compared to the S&P 500 (GSPC):

Source: yahoofinance.com

The main reasons for sustained and material tobacco stock outperformance has been the fact that tobacco product demand is relatively price inelastic (tobacco is addictive) and also because tobacco stocks long had below market P/Es and outsized dividend yields in an era of increasing "yield deprivation." Concerning tobacco's price inelasticity, let's borrow a slide from the World Health Organization's book on this topic: a 20% increase in the price of smokes will reduce units sold by "only" 8%, implying that the top line would grow from "100" to "110.4." This has long been the crux of the "tobacco story."

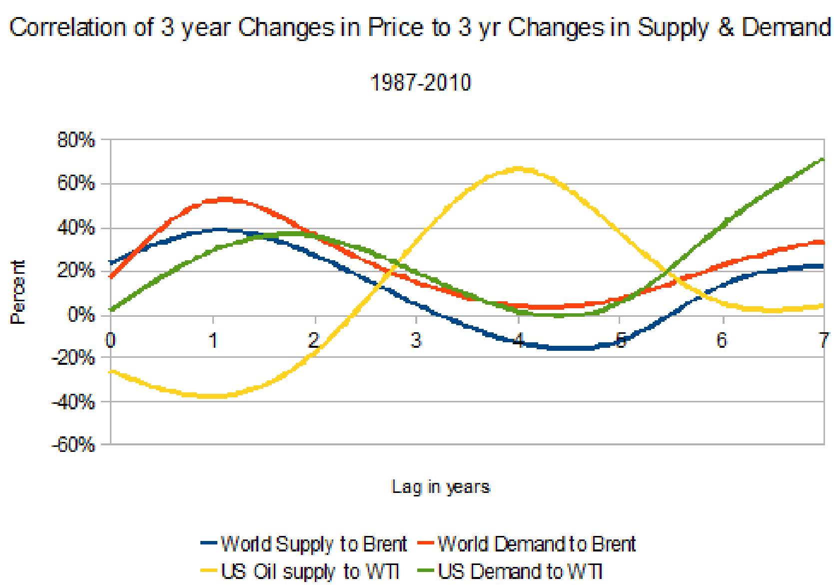
- Price elasticity is usually negative indicating that when price goes up, consumption goes down and vice versa.
- The greater the absolute value of price elasticity, the higher the price sensitivity of demand.
- For tobacco products, price elasticity is usually less than 1 or tobacco demand is price inelastic. It means when price increases, tobacco consumption decreases by a lesser percentage compared to the price increase.
- A price elasticity of -0.4 indicates that when price increases by 10%, demand reduces by 4% in a reasonable period of time that allows the consumers to adjust that tobacco use behavior. In effect, the cut down in aggregate consumption is expected to appear in the monthly or annual sales data available from government sources.
- Given the price elasticity of demand, it is possible to predict the amount of reduction in consumption in response to a price increase. For example, if price elasticity is -0.4 and price increases by 20%, one can expect that consumption would go down by 0.4 x 20% =8%. If initial consumption was 100 units, it can be expected that the 20% price increase would lower consumption to 92 units.

www.who.int/tobacco/economics/2_2estimatingpriceincomeelasticities.pdf

Now let's shift to oil and major oil company stocks, which currently feature above S&P 500 dividend yields (approximately 3.5% vs. 2.1%, respectively) and slightly below the S&P 500 trailing 12-month P/E (19 vs. 22, respectively). First of all, the fraction of the global oil industry that hasn't been nationalized, i.e., which shareholders can still buy (the "majors"), has much lower margins, is incomparably more capital intensive, and, not surprisingly, is not nearly as lucrative as tobacco in terms of ROI (return on investment). So let's be perfectly clear: there is no way that investments in oil majors will offer anything close to the scalding performance of Big Tobacco after the 1998 settlement.

Very aggressive "air taxation" extortion efforts, be they via sought after national sovereignty-and-representative government trampling global CO2 reduction accords as pursued in "COP-21 meetings" at the recent Paris Climate Conference or via litigation-based coercion, will, if successful, drive the cost of oil and other fossil fuels up. We expect that the oil majors, which until recently have been allocating record amounts of capital to exploration and production, will "double-down" on returning capital to shareholders the more CO2 output-based shakedowns raise the already markedly rising cost of oil extraction, the latter thanks to increasingly remote and typically smaller oil endowed formations that are being pursued by necessity, or due to "geology." *Combined, or even without new CO2 output-based extortion, we see the oil majors increasingly retiring shareholder capital to reflect their lacking reserve growth as well as their poor returns on capital, i.e., when they pursue reserve growth. This should support shareholder returns (ROE) as well as valuations (P/Es).*

We see this occurring either via dividend boosts or via share buybacks. Flexible share repurchases will likely be favored whenever oil prices are too low, such as now, and a heightened dividend payout commitment is undesirable; for oil price flavor, consider that the majors drilled for oil when it sold at $100 plus a barrel for years and, collectively speaking, hardly generated a positive return from it. Also recall that the tax-based deductibility of interest expense favors debt over equity financing, at taxpayer expense. All said, these factors will likely raise the historical global oil supply inelasticity (please see chart below, "World Supply to Brent"), causing the supply curve to "shift to the left." This should result in substantially higher oil equilibrium prices over time, thereby offsetting nominally regressive volume and underpinning Big Oil's global "cap ex light" earnings power, and especially earnings and dividends per share, boding well for shareholders. As such, we find oil majors, typically sporting high-teens trailing earnings valuation currently despite under-pressure-earnings thanks to the oil price collapse since H2:2014, attractively valued. This is all the more apt given a consensus oil price forecast, with which we take marked exception, that has drooped to near current oil price levels, down from a consensus near $100 a barrel some two years ago.



Source: http://b-i.forbesimg.com/tomkonrad/files/2013/10/Oil-correlation-of-price-and-volume3.png

Conclusion:
Will history repeat? Could "Big Oil become Big Tobacco? Our bet is a qualified "yes," for some similar and different reasons, and with much lower (than post tobacco settlement) oil investment return expectations, yet still attractive to S&P 500 return potential going forward. First, fossil fuel prices are more globally set (especially oil) and secular oil supply has huge challenges, which should underpin oil prices over time and thus oil majors' top lines (typically abundant tobacco leaf

is a relatively minor cost for very high margin, branded cigarette companies). Second, population-dominating emerging nations, if they are going to continue to emerge/re-emerge, will consume considerably more fossil fuel-based energy (packing a lot of heat and thus work capacity per unit volume) both in terms of deploying more machines to raise output/productivity and by way of sustained urbanization/electrical grid buildouts and the energy consumption growth that this implies. Third, as mentioned above, energy demand is quite price inelastic because we can hardly do without it (much like most smokers find cigarettes addictive, and pay up to continue to smoke them), suggesting energy consumers will, to the extent they can, subsidize any upcoming oil industry extortion, whatever its form, by paying more for oil, be it at the pump, when they buy or make all sorts of goods, or when they board an aircraft. Fourth, the litigation dynamics that could roil the P&L of energy companies by possibly raising their "costs per barrel" will likely be put in the shade by the secular (long-term) global oil supply constraints, i.e., markedly higher oil extraction costs, as juxtaposed against approximately 1% p.a. growth in secular global oil demand. In other words, geological factors, our leveraged economic output model, and 82% fossil fuel energy dependency suggest that much more powerful and determining factors will continue to determine oil supply, oil demand, and thus oil price dynamics than another outrageous ambulance chasing lawyer shakedown emanating out of "Absurdistan" as possibly augmented by Paris Climate Conference-based extortion efforts to globally tax air.

What do we view as the primary risks to our opinion that oil majors comprise attractive investments currently? First, the cessation of oil hedge-flattered earnings, which will take oil industry earnings down another notch or two, may not be "priced in." Second, sustained and material oil price weakness ("today"), which would clobber oil industry earnings power and render oil companies overvalued. Third, as stated elsewhere, that statist parasites forget to make sure that their trial lawyer brethren don't kill the "host" if Big Oil does in fact become Big Tobacco, revisited. Fourth, if capital, due to hugely punitive "carbon pollution" taxes extracted on a global basis and/or class action settlements that massively raise the oil industry's already rising cost structure, is further discouraging from drilling for ever harder to extract, more expensive to reach oil, then the underpinnings of our dense energy-leveraged global output would likely unravel completely. Such a development would trigger economic implosions and possibly widespread impoverishment. The related "demand destruction" could reduce global oil demand/consumption to a degree which would trump even our global 5 - 6% annual "oil production legacy loss rate," which would send oil prices and oil industry profits reeling.

Thus our best hope remains that unconstitutional, national sovereignty-violating, unrepresentative "global government" edicts aren't forced upon citizens/the true sovereigns, and that property rights are ultimately upheld in the courts against outrageous and false claims that oil companies hid the "dangers" of CO_2 (CO_2 is plant food and thus oxygen in the making) from consumers. Sadly, given the increasingly property rights-pummeling Supreme Court of the United States (SCOTUS) decisions over the past decade such as Kelo vs. the City of New London, Mass. vs. the EPA, and "Obamacare" (twice), we cannot assume that either logic or the rule of law will necessarily prevail. Thus we need to look at Big Oil as "extortion of Big Tobacco and smokers, possibly revisited," in addition to investing in what we believe to be mispriced scarcity assets. And we need to assume that the statist parasites have "host survival" in mind so that they can avail themselves of a material and recurring cash flow stream with which to further entrench themselves. Given the relatively substantial price inelasticity of oil demand (a good substitute for oil's myriad and essential uses has yet to be found), the consumer will end up paying both "geology's" price and the extortionists' price, if he must, for as long as he can. In other words, the oil companies look set to sell less oil, but over time much more expensive oil, and they'll have every incentive to use the tax deductibility of interest expense to shrink the shareholder base more aggressively given progressively lower exploration and production ROIs. Watered-down Big Tobacco, revisited, then, is our bet for Big Oil, with or without statist/crony extortion.

How is that for some energy investment food for thought? In terms of how we'd buy oil/fossil fuel assets in a diversified manner, please have a look at our model portfolio.

Greetings,
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