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Instead of Bailing Out the Oil Patch, Maybe our Government Should Give Everyone Vouchers to Use at Gas Stations

By George Schultze
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"Unprecedented" is probably the most overused word in the English language right now. We're dealing with an unprecedented disease, unprecedented unemployment figures, and unprecedented levels of governmental stimulus. But the most unprecedented event of all, something that none of us thought we'd ever see in our lifetimes, was recently watching the price for a barrel of oil go negative.

As we all know, the capitalist, free-market system is grounded on principles of supply and demand. And as far as oil goes, right now supply vastly outstrips demand. As we all sheltered at home and avoided going out to restaurants, sporting events, the movies or anywhere else we normally visit by car, train or plane, demand for oil plummeted by ~25 million barrels per day.

The oil industry had already been facing an oversupply problem before the COVID-19 pandemic. The combination of huge new domestic supply from the fracking industry, coupled with ramped up production by the Russians and Saudis, was already putting a strain on world oil markets. Now, we've gotten to the point where there's so much oil that's already been pumped to the surface that we've run out of places to store it.

Whenever we return to "normal", lots of things will no longer be as they were before, but that seems particularly true in the energy market. There's some thought that this is just a temporary disruption in oil markets and speculation that if you buy oil now, and put into a tanker or keep it in the ground for a year, that you're going to be able to sell it in the future at much higher prices. I'm not convinced that's a low-risk trade, because what's to say that next year there won't be even more supply, with everybody trying to unload the supply they held in storage while upstream producers simultaneously return to market with their prior levels of production. There's no doubt that demand for oil will rise as the global economy recovers, but the supply problem will still remain and there's no guarantee that anyone holding oil now will be able to sell it for higher prices next year.

When we come out on the other side of the pandemic quarantine, we may see a market with more disciplined supply but that's a big maybe. In the era when oil was synonymous with Texas, the Texas Railroad Commission could effectively control the supply, and therefore price, of oil. Then in the 1970s, the power to adjust supply and maintain attractive prices (for producers) shifted over to OPEC. But neither the US nor Russia, now both major players in the oil game, were members of the cartel back then. Fracking technology made the US the world's largest producer of oil, but it wasn't a disciplined new producer with centralized decision making. Instead, hundreds of small US fracking companies financed their drilling plans through junk-rated debt offerings. Some of them grew rapidly (usually, through aggressive acquisitions), but none ever grew large enough to dictate oil prices. As a group, they brought on a great new wave of oil supply which caused prices to collapse in 2014 (from over $105/barrel down to just $25 before rebounding). But, that was a false bear-market recovery. Prices rose to over $74 again before they plummeted once again to recent levels. Along the way, something occurred to oil prices which most economists thought would never happen – they dropped to zero and then even turned negative.

Although prices have rebounded since then, oil fundamentals still look rather bleak. However, this might wind up being the best crisis the oil market has ever witnessed in terms of an opportunity to consolidate, liquidate and wipe out weaker players which were highly-levered and/or high-cost operators. If you consider the entire junk-bond market, the total amount of distressed paper has climbed to over $1 trillion, with much of that attributable to energy companies. And with oil prices down so much, the likelihood of many of these firms successfully reorganizing is slim.

Ordinarily, a shakeout among the smaller, highly-leveraged producers would present an opportunity for sound operators with strong balance sheets. But oil companies all around the US, including the super majors (Exxon, Chevron, Royal Dutch Shell, BP), are all facing liquidity problems due to the total collapse in oil prices which has left them unwilling or unable to take advantage of this unprecedented opportunity. There may be some interesting mergers coming out of this, but even so, we won't necessarily see much more discipline in terms of controlling supply.

President Trump is trying to do everything he can to get the US economy, of which energy has become a major component, moving again. But, he doesn't have Congressional authorization to bail out the oil industry. At least not yet.

Even so, Treasury Secretary Mnuchin recently floated the idea of creating a government lending program for US oil companies which are drowning in a sea of cheap crude. The program would be run by the Fed and could include the government taking equity stakes in these firms as part of the loan, similar to what was done with GM during the US auto industry bailout.

Unfortunately, our government doesn't have a great track record when it comes to running businesses, so I doubt that Congress will grant authority to do this. If it does, that could give the US a much stronger hand in limiting domestic production and in negotiating production cutbacks from Russia, Saudi Arabia and the rest of OPEC. We'll just have to wait and see how things shake out at the political level.

And what's all this mean for investors who have seen energy asset values crumble but are afraid to invest now and miss the next market upturn? As Stanford economist Paul Romer once said, before the politicians got a hold of it, "a crisis is a terrible thing to waste." For committed long-term investors, this could be a great time to buy companies in the oil sector with strong balance sheets under the theory that eventually there'll be more discipline in the marketplace. Making such a move requires investors to have faith in a lot of things that may never happen. But then again, in the last few months we've been surprised by a lot of things that were never supposed to happen and so the probabilities of success are likely better now they were during times of more certainty.