

# STORM WARNINGS

Vol. 5, Issue 1 - April, 2016  
*Oil: A New Ticking Time Bomb*

## Oil: A New Ticking Time Bomb



**R. Michael Conley**  
*Founder*

"We are heading into a perfect storm and don't see it coming," according to R. Michael Conley, Founder of Weathering the Storm, LLC and this website.

The WTS mission is to "Awaken, engage and help others to weather the storm."

The WTS website provides the following on a regular basis:

**Storm Warnings:** An in-depth quarterly newsletter.

**News Flash:** Frequent postings on topical perfect storm issues.

**Best Practices:** Featuring leaders in sustainability practices.

The price of WTI crude oil bounced above \$106 per barrel on June 12, 2014. Few, if any, could have imagined the meteoric plunge - and carnage - that would soon follow this high point. The shock waves have reshaped the energy and financial markets and destabilized the geopolitical order. Worse, the shortsighted responses to date are sowing the seeds for a crushing new global oil crisis. In this issue, our publisher, R. Michael Conley, sounds the alarm on a ticking time bomb in the making.

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**WTS:** Oil prices are low and we have a glut of oil; what's the problem?

**Conley:** On the surface, oil seems to be the least of our problems, but things aren't as they seem. In fact, we are setting ourselves up for an oil crisis that could send prices soaring beyond all previous highs and destabilize the global economy and world order in the process. When you hear the story, I think you might agree - so let's get started.

**WTS:** Okay, let's start with this: The dramatic collapse in oil prices, and feeling that our new 'norm' will be more about oil gluts than shortages, occurred almost overnight. What happened?

**Conley:** We were all caught off guard and left groping for answers. Our assumptions about a tight oil supply, China's insatiable oil appetite, and the impact of shale oil proved faulty.

In retrospect, the signs of a major correction were there but we missed them. The equation abruptly changed when the production surge of new shale oil deluged the market with an over-supply it could not absorb. At about the same time, the demand for oil slowed as China and the global economy sputtered. A strengthened American *dollar* and competition from alternative energy sources contributed further to the plunging oil prices.

As the gap between supply and demand widened and oil inventories grew, oil producers - companies and nations alike - erratically responded by producing even more oil to offset the revenues lost from falling prices; predictably, the crisis worsened. In times gone by, Saudi

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**About the Founder:**

Mike Conley is the Founder of Weathering the Storm, LLC and Chairman & CEO of the Conley Family Foundation. As a former Fortune 500 business executive, author, lecturer, and public policy activist, Conley has written and spoken on topics related to the perfect storm. He graduated from the University of Minnesota, after serving in the U.S. Navy, and later completed a post-grad program at Stanford University. He is active on several boards and advisory groups.

Arabia would have cut back production to stabilize prices. This time they opted to ramp up production, protect market share and clobber competitors like Iran and the shale oil producers.

Since the downturn began, oil prices dropped by over 70% before starting to recover. The ripple effect has been stunning. The drilling rig count in the United States is now down 80% from its peak in October 2014 - the lowest since 1940. Sixty North American oil and gas companies have filed for bankruptcy with more expected to follow. The world's largest oil companies are expected to report dismal first quarter results, and total oil industry debt is thought to be in the \$3 trillion range. Oil-producing communities and states have been clobbered as well, and the default rates on debt has shaken Wall Street and the capital markets.

**WTS:** We'll concede it has been a rough time for oil producers, investors and others, but hasn't it been a bonanza for consumers and other heavy oil users?

**Conley:** Look, I'm not an apologist for the oil companies, big banks or Wall Street. Indeed, much of what happened is of their own making. And clearly, the lower pump prices have been a boon to consumers and oil-intensive sectors like the airlines. With over 90% of the world's transportation systems fueled by oil, and petroleum still a major feedstock for a humongous array of non-fuel products, the winners and losers are often determined by their dependency on the price of oil.

But there's no free lunch. We all love lower gasoline prices and are not particularly upset to see big oil and others take a hit, but when it gets too far out of hand - like it has - we all get hurt in some way. Our 401-K investment losses in the energy sectors; oil service workers and suppliers getting chopped back in droves; mom & pop stores in oil producing communities like North Dakota going out of business, and ripple effects across the entire economy are but a few of the repercussions. It's not a zero sum game; we all feel the pinch in one way or another.

What we're seeing now are badly battered oil-producing companies and countries operating in a survival mode. Their short term strategies of ramping up production and cutting costs to generate cash flow and service debt have relegated oil exploration and infrastructure improvements to a secondary status. While understandable, the basic "blocking & tackling" mechanics that have long sustained the oil business have been myopically discarded; sowing the seeds, in the process, for the next great oil

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crisis.

**WTS:** Without getting too far into the weeds, can you highlight some of the so-called “blocking & tackling” mechanisms you referenced and our responses to them?

**Conley:** The list is long and impacts great, so I’ll limit my comments to a few that are most often forgotten:

1) Oil is extracted, not produced. Technology is great, but it can’t overcome the immutable laws of geology. Through technology, we can extract more oil and extend the life cycle of oil fields, but we can’t, in effect, “create” new oil. Further, not all oil is created equally. The production cost differentials between the low-cost “conventional” crude oil extracted in Saudi Arabia and high cost “unconventional” fracked shale oil from the Bakken, tar sands in Canada or deep water drilling in the Gulf are significant. To meet future demand, we must to rely more heavily on these expensive unconventional sources.

Impact: Future oil costs have nowhere to go but up, and new unconventional oil is currently too expensive to extract at today’s market prices - a serious supply-side challenge. (See: An Unconventional Truth)

2) Oil depletion and decline is a chronic disease: Oil is finite and non-renewable; once it’s gone, it’s gone. On average, conventional oil fields decline at a rate of 5-7% or more per year. Shale oil wells deplete at a sky-high rate of as much as 40% or more per year. Like running on a treadmill, we’ll have to produce more and more oil just to stay even. Impact: Finding sufficient reserves of new oil just to maintain current production levels will be a challenge; ramping up incremental production to meet growing new demands will be downright daunting.

3) Oil development cycles are long: It takes several years to explore, seismically map, test, drill, extract and bring oil to market. Exploration efforts started today will not provide oil for years to come. Unfortunately, the robust, capital-intensive efforts required to sustain future production are not happening these days. Impact: Oil companies - strapped for cash and fighting to remain solvent - have dramatically cut back on exploration and infrastructure to preserve capital. We’re actually using up more oil today than we are finding; a bad omen for tomorrow.

4) Supply and demand curves are highly-sensitive: The world currently produces about 95 mb/d (million barrels of oil per day) while consuming over 93 million barrels. Even with today’s all-out production efforts and a slower global economy, the annual demand for oil continues to incrementally grow - projected to be in the 96 mb/d range next year. Impact: It takes very little to disrupt the supply & demand curve. With little excess capacity in the system, the situation will get dicey once the excess inventories are drawn down. Look for oil prices to escalate - and just hope that a pipeline isn’t sabotaged or refinery shut down in the interim.

5) Peak production; not peak oil: Peak oil is a geologic concept stating that once an oil field reaches

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maximum production it will peak and then start to decline. Peak “production,” adds an important “above ground” dimension that will truly determine future production levels. *Above ground* factors include things like the political, economic, geopolitical, environmental, financial and rising production cost factors. **Impact:** Though there’s oil in the ground for extraction, it’s the *above-ground* constraints that will most limit our future production. The unpredictability of the market and capital shortages will be among the top barriers to growth in the near future.

**WTS:** The “basics” you mentioned are formidable. How are we doing?

**Conley:** Not good, I’m afraid. Consumers are mesmerized by lower oil prices and an expectation that it’s our new *norm*; new light truck *and* SUV sales attest to that fact. Oil producers are in a survival mode and sabotaging their future to live another day. Both trajectories are moving in the wrong direction.

The recent OPEC/Russia conference in Doha, Qatar - representing nearly 50% of the world’s oil production - failed to produce a cooperative agreement on oil production. *Above ground* geopolitical factors trumped geology; the Saudi/Iran feud could not be resolved. The oil crisis continues to destabilize the global order, and several nations like Venezuela, Libya and Nigeria are at or near the brink - a breeding ground for terrorism and revolution.

American shale oil producers are also in dire straits. Their production binges of yesterday - in which they spent far more for production than they took in - have decimated their balance sheets. Though they have a “frack-log” of from 800-1000 wells that have been drilled but not fracked, they will be strapped for cash to kick-start new production efforts. The capital markets are wary, and default and bankruptcy rates are climbing. Production levels will soon drop as the rapid depletion of shale wells exceeds the production generated from new wells.

Oil storage is another above-ground constraint plaguing producers. Storage facilities are bursting at the seams; it has gotten so bad that massive tanker ships and railroad cars are often used now to store - not transport - oil. Port facilities are jammed with tankers, and the storage and transportation costs of oil will further cut into a producer’s cash flow.

**WTS:** Do you see the situation reversing itself and if so, when?

**Conley:** The reversal is now underway, but the road back will be lumpy and fraught with challenges. In some respects, it will get worse before it gets better. Though WTI crude has increased over 67% from a low of under \$27/barrel this past February - still well below the price point needed to extract “economically recoverable” oil - the roller coaster of dips and surges will continue until the massive oil inventories are digested and markets rebalanced. In the meantime, energy companies will continue to get clobbered.

Looking ahead, the supply & demand curve will rebalance. Global oil consumption is expected to increase

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by about 1.3 mb/d in both 2016 and 2017, and production will level out. American oil production peaked at 9.4 mb/d in 2015 and is expected to decline to 8.6 and 8.0 mb/d by 2016 and 2017 respectively. As the inventories are drawn down and prices rise, we will again return to a paradigm of oil shortages and higher prices - this time far worse for reasons mentioned.

Barring an unforeseen “black swan” event that would totally disrupt the market, my guess is that the markets will gradually stabilize by 2017, but then what?

**WTS:** What do you mean by “but then what?”

**Conley:** The future is murky. With no Plan B in our hip pocket to stave off rising prices and growing shortages, there’s no telling how high future oil prices will go. Look for oil shortages - as a result of current exploration cutbacks and rising demand - to occur. Don’t look for a quick fix; even if the massive amounts of capital required to kick-start production were available from wary banks and investors still licking their wounds from the previous fiasco, the long production lag time will be too great to make a difference. It’s hard to say how bad or how devastating the future shock of soaring oil prices will be. *This, I would suggest, is our “new crisis in the making.”*

As an aside, it would be a great time for the United States - a country that still imports almost 7 million barrels of oil daily - to increase its Strategic Petroleum Reserve on the cheap as a hedge against future oil disruptions. Better yet, use the time to create clean fuel alternatives to ease an oil addiction that can only get worse.

The four great hurdles directly confronting all oil producers - and all of us more indirectly - will be; a) the unpredictability of the oil markets, b) finding access to capital, c) mounting production costs - particularly with respect to any form of *unconventional* oil production and d) environmental constraints

**WTS:** Can you comment more on the “*environmental constraints*” you mentioned?

**Conley:** The fossil fuel industry - oil, gas and coal companies - and some utilities have dropped the ball on environmental issues and the backlash is growing. Recent incidents like the massive methane gas leak in California, the horrific BP oil spill in the Gulf, growing concerns with the environmental impacts of fracking, the alleged Exxon cover up with respect to climate change, and an almost endless litany of leaking pipelines and overturned railroad tanker cars are the types of issues having a collective impact on public opinion.

The hangover effect of these past occurrences will hamper future drilling and exploration efforts and delay the issuance of right-of-ways and permits. Their years of benign neglect and a growing public concern about the environmental impact of indiscriminate energy practices will take a toll. With the paradigm shifting toward a less oil-intensive environment and cleaner alternative transportation fuels and fuel systems, the economic connection to sounder environmental practices are starting to sink in. Sensing this, oil producers will find cleaner new ways to conduct their business and play the game; they’ll have

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little choice.

**WTS:** In the meantime, as these things are happening, what are your recommendations for how we, as individuals, should “play the game?”

**Conley:** There are several things we can and should do - and this applies not only to individual behaviors but also to companies and countries:

Think strategically: Cast aside short term thinking, the quest for instant gratification and quick fixes and move toward a longer, more thoughtful timeframe for addressing problems. For instance, before buying a gas guzzling car based on lower pump prices today, consider how it will play out when oil prices double or triple in the future.

Act prudently: Anticipate and preemptively respond to higher oil prices. A good first start is to seek the cleanest energy sources possible; reduce fuel consumption patterns through demand reduction and conservation efforts, and change behaviors while there’s still time.

Leverage effectively: Recognize that we are more powerful than we think. Through our purchasing decisions, voting power and ability to coalesce with others to form a critical mass of public opinion, we can be policy movers and market makers. We’re not victims and need not meekly accept whatever energy future comes along; we can help shape it.

For more information, please visit our website at:

[www.WeatheringtheStorm.net](http://www.WeatheringtheStorm.net)