LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"The fact that other people agree or disagree with you makes you neither right or [sic] wrong. You will be right if your facts and reasoning are correct."

– Benjamin Graham

Our first contact with Charlie Maxwell was during the energy crisis of the early 1970s. Mr. Maxwell was an energy analyst with the brokerage firm of C. J. Lawrence. He was gaining a great deal of respect for his insight about the developing energy crisis. His reputation gained even more respect after he proved to be correct in not agreeing with the many analysts who were predicting $100-per-barrel oil as the energy crisis reached its peak in 1981.

Speaking at the Contrary Opinion Forum at Basin Harbor, Vermont, last month, Mr. Maxwell shared his contrary view of the future of oil prices going forward. Much of Wall Street feels the current high price of oil is temporary, as it is caused by political and economic events. However, contrary to the prevailing Wall Street view, Mr. Maxwell feels we are in for a long period of higher prices because the world is reaching its geological limit to cheap oil production.

Mr. Maxwell has considerable respect for M. King Hubbert (1903–1989), a geophysicist who was the first to effectively apply the principles of geology, physics, and mathematics to the projection of future oil production from the U.S. reserve base. His most famous predictive analysis was published in 1956. In that paper, he indicated United States conventional crude oil production would peak in the early 1970s and start a downward trend. Much scientific heat was generated by Hubbert's conclusion at that time. It was widely assumed that America's oil output could still climb for many decades as new areas were opened up and new technologies were applied.

In 1970–71, the U.S. hit its high point of oil output, and entered a period of production decline that has carried to this day. Hubbert had been right on target. Seeing the accuracy of his forecast, Hubbert's followers subsequently extended his concepts globally and now believe that world-wide production will top out in 2010 or 2020 at the very latest.

On a short-term basis, the price of oil is likely to decline somewhat. Currently, there is certainly a premium in the price of crude amid concern about disruption of production in Iraq, Russia, Nigeria, and Venezuela. In due course, these concerns should subside. Moreover, Saudi Arabia is increasing its production. However, on a longer-term basis, we are approaching the geological limit to cheap oil. Hubbert's peak applies only to conventional crude oil production, not to the heavy oils of Saskatchewan, or Cold River and Peace River in Alberta, or the tar sands of Athabasca. Due to the high cost of extraction, justifying production from these and other places with heavy oils requires high prices for crude.

Contrary to what much of Wall Street was suggesting, Lawson Kroeker managed portfolios have emphasized positions in energy companies for several years. The energy position has been of great benefit to our clients' portfolios of late. If Mr. Maxwell is correct, superior performance by energy companies may be in an early stage.

October 2004