

**Joel Moser** Contributor*I cover investment in energy and infrastructure.*

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Decoupling From Oil Prices

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Quick, when is an energy investment not an energy investment? When it's an infrastructure investment. How could this be when energy is itself part of the usual assortment of assets included in the infrastructure class? Well, there is energy and then there is energy risk, and there are infrastructure assets and there is infrastructure risk. Is it clear yet?

I teach a course on infrastructure investment at Columbia University at the School of International and Public Affairs (SIPA) and part of the first class is devoted to distinguishing between the things that constitute infrastructure, which usually means truckloads full of cement, and the characteristics of infrastructure risk that institutional investors look for when they seek exposure to this asset class, such as long-dated, asset-based, steady revenue streams with high barriers to competition.

Energy as an asset class spans the extremes of risk characteristics, from upstream exploration and technological innovation which have venture investment characteristics, to fully long-term contracted midstream businesses, like pipelines and storage, and independent power plants (IPPs) with long-term PPA's—power purchase agreements. Some of these investments have exposure to the price of oil and some of these investments fit into an infrastructure risk bucket, but probably not both.

Within this range of investment options, there is a whole universe of options that are fully disconnected from oil, starting with US renewable energy, which competes generally with natural gas and coal, but is still heavily policy driven.

What about the recent boom and feared bust in US unconventional oil production? These are the fracking and horizontal drilling businesses that may have driven the excess inventory that has led to the price slide.

So far just this week, we have seen two major reports on oil price. The International Energy Agency (IEA) and the Citi commodities research team both came out with gloomy reports about the price of oil based upon excess inventories and slow demand growth, with Citi even predicting a rebound slide following the recent rally.

More important, however, is that the reports agree a more fundamental point about US unconventional production: it is here to stay. There are several

reasons to believe this. First, these reports are based upon deep quantitative analysis of the global supply and demand for oil. In the most reductive interpretation of these results, the world needs some, but not all, of the US unconventional oil so, necessarily, the price of oil must rise to a point sufficiently high to allow continued production.

So while the US production is the reason that the prices fell, it is also essential to global markets and will continue. The IEA concludes that the US will continue to be the top global producer at least to 2020, which means continued shale production.

Another reason to believe this is that we are already seeing production costs dramatically fall with the falling price of the commodity. While \$100 per barrel oil may be history, so too are the frothy profits that were being made at the shale party. This market is starting to behave more like an industry with cost controls reflecting the need to get to a bottom line profit. Nevertheless, there is no basic law of nature that dictates a production cost below the market value of the extractive product. What about the horizon beyond 2020? This is important for investors who are seeking infrastructure risk characteristics including long-dated investment.

Here, there is an analogy to the renewable market, driven by government policy to reduce carbon emissions. Without even getting to the “bridge fuel” argument for shale-based natural gas and staying with crude, can anyone contemplate either a Republican or a Democratic administration or Congress allowing the goal of energy independence for the US, long thought to be out of reach and now effectively achieved, to simply fade away in a market based price decline?

Oil price is based upon more than a mere supply and demand market, with government policy playing a major role. I find it reasonably unlikely that the US government will not also make policy decisions to prevent the complete idling of the entire unconventional energy industry throwing the US back to reliance upon imports should markets ever get to that point.

So infrastructure risk-based investment can even still happen even around the unconventional energy industry, effectively decoupled from oil prices.