Rodney's Take

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When Oil Becomes Cigarettes

It's possible that cigarettes aren't as bad for society as we've been led to believe. In his 2013 book *Unlucky Strike*, John Staddon outlines how a judge allowed lawyers to target tobacco companies in court with incomplete data. The plaintiffs argued that cigarettes caused massive healthcare spending by governments. The defendants weren't allowed to show that cigarette smokers tend to die fairly quickly just after retiring which, while horrible, actually saves the states and the federal government money by limiting payouts for lingering health issues and Social Security. The judge found the argument reprehensible, so he didn't allow it, but that doesn't change the facts. Cigarette companies definitely hid health information from consumers in the early 20th century, but by the mid-1960s, the FDA required warning labels on cigarette packs, and by the late 1960s the warnings were clear: cigarettes are dangerous to your health. By the 1990s, an entire generation had grown up with warnings about cigarettes.

The 1998 master settlement among the cigarette companies and states created a gusher of cash for states and lawyers. It also severely limited advertising and other activities by cigarette manufacturers and created a huge barrier to entry for anyone who wanted to set up a new cigarette firm.

Oil companies could be walking down the same path.

ExxonMobil has been sued several times by those claiming it contributes to climate change. Litigants have claimed everything from misleading investors to destroying the planet. Many suits have been dismissed, but a court in Massachusetts has allowed one to continue. Eventually, plaintiffs will find a sympathetic court and jury that agree major oil companies are responsible for greenhouse gas emissions and therefore should hand all of their value to some public entity and then shut down. The Securities and Exchange Commission (SEC) appears to be bent on helping this process along.

The SEC has been taking comments about on how to frame carbon-emission disclosure requirements for publicly traded companies. Staff at the SEC claims that investors need such information to make informed decisions about a company's future, including how it will be affected by climate change both as a buyer of goods and services, such as electricity, and as an emitter in its course of business. Carbon emission disclosures come in three scopes. Scope 1 includes carbon emitted during a firm's business process, such as using electricity to run machines or burning fuel to deliver goods. Scope 2 refers to inputs to a firm's business, such as the carbon emitted when purchased electricity was generated.

The devil lies in scope 3, which encompasses all indirect carbon emissions both up and downstream. Upstream carbon emissions include an employee's share of airplane emissions while on a business trip, while downstream includes emissions by companies in which the firm invests, or how end clients use the company's products or dispose of them.

As the SEC broadens what must be disclosed, it will create substantial gray areas where companies will be targeted and sued for not disclosing enough. Oil companies will be the first target, and it's unlikely that they will get the chance to show how much good their products have done for the world. Eventually, certain companies and even entire industries will be pariahs, likely locked out of financing and kicked out of most investment funds, just like cigarette companies.

But the process might set up a great opportunity.

While cigarette companies aren’t, at least in the U.S., highly desirable assets, they generate substantial cash and throw off great dividends. Altria (NYSE: MO) has been a dividend machine for decades. It won’t provide much in the way of capital gains, but if you’re looking for 6%+ yield, this could be a stock for you. As Americans get older, cash becomes king.

Oil companies have been reining in their capital expenditures over the last couple of years as the product has fallen under a cloud. Less exploration and production (E&P) means less oil, even as world demand rebounds and climbs higher. Oil companies could have more cash, because they aren’t spending on E&P as they had in the past, while also selling their existing product at higher prices. This could lead to oil companies existing in that in-between space where they don’t grow substantially but continue to throw off cash.

Unlike cigarette makers, oil companies provide a necessary product that will be used for decades to come. In a world of ultra-low interest rates, they could be great income generators for millions of Boomers as they go through retirement.

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Got a question or comment? You can contact us at info@hsdent.com.