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"Crude Oil Prices Fall! Is the Energy Shortage Over?"

"Not by a long shot! Cheaper oil is a temporary situation at best.

"For proof, this month we'll look at one of crude oil's hoped-for replacements: natural gas!"

James DiGeorgia, Editor

- **The "BOE" scam in the energy markets**
- **Natural gas and the *GEA* portfolio**
- **I meet with President Clinton and Congresswoman Nancy Pelosi. Here's what I think lies ahead for the election.**

Gasoline prices have fallen from their recent highs, and people are cheering.

Actually, gas prices are still outrageous by historical standards, but after weeks of $3.00 gasoline, $2.50 looks mighty good!

Nevertheless, there aren't any reasons to rejoice here. Yes, OPEC countries are arguing among themselves again, and failing (so far) to restrict supply. And yes, the Gulf of Mexico has made it through the hurricane season unscathed (so far). But these are temporary factors.

Long-term, our energy problems remain.

For proof, this month we're going to look to an unusual source. Confirmation of our oil shortage is coming from an unusual place: jubilant announcements of natural gas finds by major oil companies.

NG (natural gas) strikes have been in the news a lot lately. We already had several decades' worth of gas in known reserves (or so we're told), and we're finding more and more all the time.

We're also told that NG can be used in many of the same applications as crude oil. Thus, this clean "wonder fuel" will soon replace oil, and solve all our energy woes…won't it?

Not so fast. As is usually the case, there's a lot you aren't being told here.

Contrary to glowing media reports, NG is actually an excellent illustration of why cheap, abundant energy is a thing of the past. Since the *GEA* portfolio contains several companies that are heavily involved in NG, it's also worth discussing this market in its own right. So this is our main topic this month.

A Hoped-For "Bridge" Energy

In the energy industry, you hear a lot of discussions about "bridge" fuels.

The world is utterly dependent on crude oil today, but someday there won't be enough petroleum for everybody. Therefore, we need a "bridge" fuel: something that can bridge the time between oil and whatever will replace it as the world's primary energy source.

This idea is instructive for a couple of reasons. First of all, it's an admission by oil insiders that our oil supply is failing a lot faster than they admit.

Oil executives claim that we have enough oil to last us 40 more years. (This is a flat-out lie, as I'll discuss later.) But if this was true, why are we frantically looking for a bridge fuel already?

Second of all, NG is being discussed as potentially being our primary bridge fuel. But if we really have enough oil to last us until 2046 or so, then why would we want to create a bridge based on today's technology? Surely once 2046 does arrive, we'll want an energy industry based on technology from 2040 or even 2030, not 2006.

Why should we lock ourselves into NG today (a non-renewable fossil fuel), when we might have cleaner, renewable, more powerful technologies later—like the fuel cell, nuclear fusion, or maybe even something that hasn't been invented yet?

Obviously, the oil executives don't believe their own stories about "40 more years."

Which isn't surprising, since…

The oil companies' claims are all a bunch of hooey anyway!

The 40-more-years story assumes that all of the following are true:

- Current reserve estimates are accurate
- Oil-producing regions remain politically stable
- Consumption rates stay constant
- Production rates remain constant

And all of these assumptions are wrong!

Current reserve estimates are almost certainly inflated, probably grossly so. I've written before about the bogus "discoveries" that the major OPEC countries have reported, in order to increase their export quotas. Oil insiders have known about this for decades, but the public is still being kept in the dark.

Recent scandals only confirm this truth. Kuwait has admitted to lying about its reserves, which slashed four percent off the claimed reserves of the entire world. And you might remember that Shell recently got caught with its pants down, finally admitting to a years-long pattern of fraudulent reporting. It eventually slashed its reserves by 4.5 billion barrels.

How much of the rest of the world's claimed reserves are just "paper barrels" that haven't been admitted to yet?

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The next assumption in the 40-years story is political stability, which needs little comment. Just open your morning newspaper and read the latest news about Iraq…or Iran…or Nigeria…etc.

As for consumption rates remaining constant, this assumption is just ridiculous. Oil consumption has increased every year since people started using the stuff over 100 years ago. Just since 2003, demand has shot up by 3.8 *million* barrels per day.

The world's biggest user of oil is the U.S., and you might have heard that we just passed 300 million people, with another 100 million to be added by 2040 or so. Meanwhile, China (with one-sixth the entire world's population) is just starting to industrialize, and their consumption will inflate rapidly.

Nope, we're not going to see decreased consumption any time soon.

As for production rates remaining constant, this one really sets my teeth on edge. It's *physically impossible* for oil fields to produce at constant rates throughout their entire lifetimes, and oil executives know this.

With each barrel of oil that's removed from an oil field, the pressure inside the remaining deposit declines. So as a field is worked, its oil comes out more and more slowly.

This has been known for 140 years. Oil executives are lying to us if they claim otherwise.

So let's examine the numbers they're giving us. Total claimed oil reserves today are about 1.2 trillion barrels. When you divide this by current world production of about 30 billion barrels per year, you get 40 years' worth of oil.

Even if you assume nobody is lying about how much oil they have (which almost certainly isn't true), and that world consumption won't change (which *definitely* isn't true), the 40-more-years story still can't happen. At least not how they describe.

What will happen instead is that the oil will last longer than 40 years…but our supply situation will be far worse than today's!

Because oil fields decline as they age, today's fields won't be able to maintain their current production rate of 30 billion barrels per year. It's impossible. Instead, yearly production will gradually fall. This means it will take longer than 40 years to pump all the oil out.

Unfortunately, it also means that even though the oil lasts longer, annual production will fall farther and farther behind demand. Prices will skyrocket.

An Example of Declining Production

To see what an old field looks like, just look at the Appalachian Basin oil wells. One hundred years ago, the Basin was a true bonanza (producing about 1.3 billion barrels), and there are still an estimated 28 million barrels of oil left in the field today. But the wells are worthless now—only a trickle of oil comes out, just a few barrels each day, and the wells are unprofitable to operate.

The "40 more years" story is meant to soothe us and calm our fears about running out of oil. But it's all nonsense. We'll never run out of oil completely—there will always be a trickle available—but annual supply will eventually plummet until each barrel costs a multiple of what it does today. Oil executives are not only lying to us, they're covering up the real problem we're facing.

Of course, all of this assumes that we don't find new fields to replace the aging ones. As long as we keep finding new fields, we can keep increasing production indefinitely. This is how production has kept up with increasing demand ever since oil was first discovered in 1859.

Too bad the frantic search for more oil is now failing to find any…

Desperately Seeking More Petroleum

Geologists have been hunting for petroleum for a long time. Over 140 years, in fact, and the entire world has been thoroughly explored by now (except for Antarctica, which is off-limits due to international treaties).

Like any other commodity, oil is most profitable when you find a bunch of it in one place. A smaller deposit is far more costly to extract and transport away than a larger one. So geologists have consistently sought the biggest fields they could find.

As a result, the largest fields in the world were all discovered fairly quickly. The last "elephant" strikes were found in the 1950s and 1960s. Since then, even the largest discoveries have been relatively puny. The world's 19 largest fields produce an average of 500,000 barrels per day, but they have an average age of 70 years (!) On the other hand, of the hundreds of fields found since 1980, only three produce 200,000 barrels per day.

In short, we've run out of big fields. There just aren't any left to find, after 140 years of scouring

Latest prices as GEA goes to press—October 25, 2006

Comex spot contract: silver $11.93, gold $592
Nymex spot platinum: $1064, palladium $318
Nymex Light Sweet Crude Oil $60.50

Silver coins			Dealer will buy at this price	Dealer will sell at this price
100 1 oz. silver American Eagles			$1,100	$1,280
100 1 oz. common rounds			$1,000	$1,250
$1,000 face value US pre-1965 coin bag (circulated)			$7,600	$8,300
$1,000 face value US circulated silver dollar bag (VG or better)			$10,900	$13,900
US Morgan silver dollars		PCGS MS64	$45	$65
		PCGS MS65	$110	$140
		PCGS MS66	$280	$375
Platinum coins				
U.S. Platinum Eagle:		1 oz.	$1,058	$1,158
		1/2 oz.	$460	$600
		1/4 oz.	$250	$325
		1/10 oz.	$99	$150
Gold coins				
Australian Kangaroo			$580	$635
British sovereign (Kings)			$120	$158
(Elizabeths)			$120	$158
Canadian Maple Leaf			$580	$615
Credit Suisse 1 oz. gold bar			$580	$615
Mexican 50 peso Centenario			$680	$755
South African Krugerrand			$575	$620
US Gold Eagle:		1 oz.	$589	$625
		1/2 oz.	$285	$335
		1/4 oz.	$140	$172
		1/10 oz.	$50	$68
US $20 double eagle:				
Liberty	Raw	MS60	$600	$775
	NGC	MS63	$800	$1,200
	NGC	MS64	$1,800	$1,950
	NGC	MS65	$4,150	$5,950
Saint Gaudens	Raw	MS60	$625	$725
	NGC	MS63	$800	$900
	NGC	MS64	$1,000	$1,100
	NGC	MS65	$1,100	$1,450

Prices provided by Finest Known
(866) 697-GOLD (4653)

the globe looking for them. Even the medium ones are scarce. Instead, the typical discovery is tiny. (If you ignore the top 3 percent of fields—most of which were discovered decades ago—the average field today produces roughly 10,000 barrels per day. This sounds like a lot, but it's only about .012 percent of the world's daily consumption.)

In previous issues, I've written about the complete failure of oil companies to replace their annual production. For years now, they've been unable to find enough new oil to match the amount draining from their reserves each year.

As just one example, in the last three years Shell has replaced a mere 38 percent of the oil it has pumped. The other major companies are in similar situations.

Obviously, this is an untenable situation: sooner or later, their reserves will run out.

This failure to replace reserves isn't from lack of trying. Exxon Mobil alone will spend an estimated $19 billion this year, frantically looking for more crude. But as I said, the oil just isn't there to find. Not in large enough quantities anyway.

Plus, there's another factor making all this worse...

Nationalization: A Little-Known Factor Exacerbating Today's Oil Problems

Our global oil supply was developed under the 'concession' system.

Back in the early 1900s, oil had already become a valuable commodity. An underdeveloped country could be transformed overnight by a major oil strike within its borders. As the petroleum streamed out across its borders, huge amounts of capital would flow in.

Nations around the world understandably wanted to get in on this game. But there was a problem: finding oil, and then building an infrastructure to bring it to market, was neither cheap nor easy.

The Western oil companies were the only entities in the world with sufficient resources and expertise to create entire oil industries. Therefore, underdeveloped countries all around the world eagerly granted "concessions" to American and European oil companies.

Under the concession system, the oil companies would explore for oil within the host nation. If oil was found, the companies would be granted property rights to the land and the oil underneath it. At their own expense, the companies would then build an

energy infrastructure in that country, produce the oil, and bring it to market. In return, the host nation would receive a royalty on every barrel sold.

This was a beautiful arrangement. Western oil companies received access to oil around the world, far outside their national borders. The host nations reaped massive profits from resources that were otherwise worthless to them, and were required to do little if anything in return. People all around the world had access to cheaper energy, thanks to the increased supply of oil brought to market. Everybody benefited.

Too bad it couldn't last.

As in every other situation where money is flowing, people got greedy. Host nations started to 'nationalize' the oil, by seizing the Western oil industries in their countries. The oil infrastructures were declared national assets: far too important to be left in the hands of those who had paid all those billions of dollars to build these industries.

Obviously, this is little more than theft wrapped in nationalistic jargon. That's why this almost never happened in nations with free governments. Starting with the original theft by national decree (by the Russian Bolsheviks in 1920), oil nationalizations were primarily performed by thugs or collective dictatorships.

Outside of America and Europe, practically every oil-producing nation in the world today stole its infrastructure from the original owners. Russia, Mexico, Iran, Iraq, Kuwait, Venezuela, Saudi Arabia, Libya, Algeria, Nigeria…the list goes on.

So why is this important today? Two reasons.

First of all, it means that Western oil companies have much less access to global resources than they used to. *Business Week* recently ran a chart (see below) that showed just how bad this situation has become.

"So what?" you might be thinking. "The oil still gets sold on the global market either way." Actually, that's not necessarily true.

Oil is perhaps the most political of all commodities. Many wars have been fought for it, as I wrote about in *Global War for Oil*. But even outside of war, oil makes a dandy weapon.

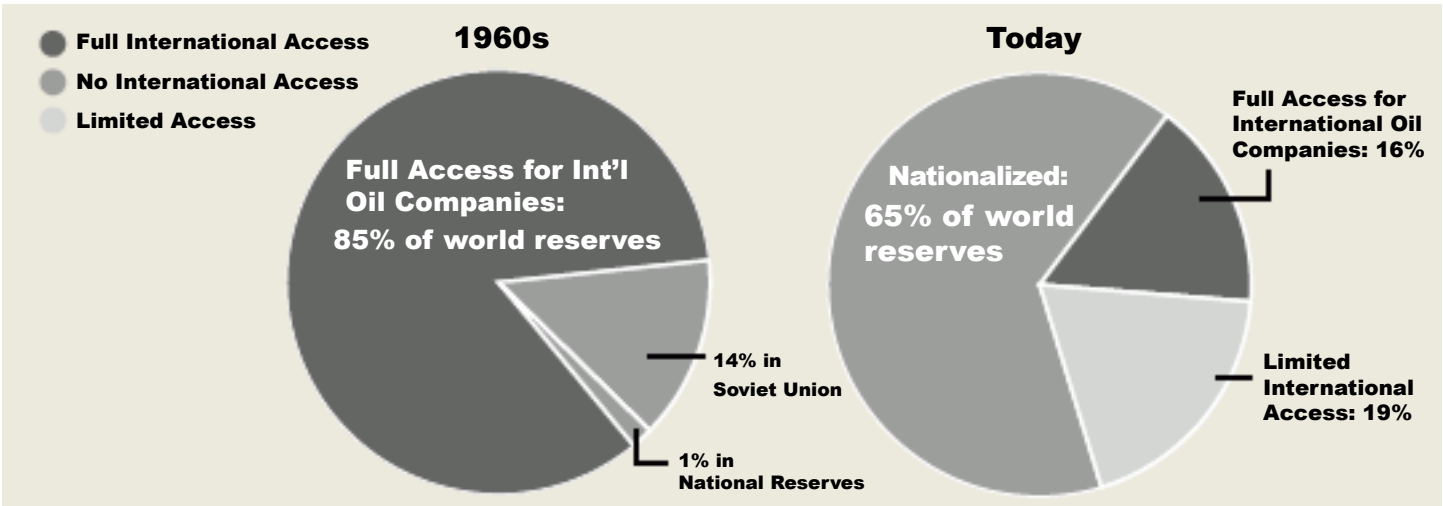
We've seen this over and over again. The Arabs embargoed oil in the 1970s because we helped Israel in the Yom Kippur War. They did it again in the late 1970s for other reasons. Both of these staggered the American economy. OPEC has used oil against us in less severe instances as well.

Even two-bit dictators have been willing time and again to shut off oil to the West, despite the fact that it hurts their own economies to do so. There's a long list of examples here: Mexico's Lázaro Cárdenas in 1938 ("It is better to destroy the oil fields than to let them be an obstacle to national development,"), Iran's Mohammed Mossadegh in 1951 ("Let the oil remain in the ground for future generations,"), Libya's Muammar Qaddafi in 1970 ("People who have lived without oil for 5,000 years can live without it again for a few years in order to attain their legitimate rights,"), and so on.

When Western companies had access to oil, the West was assured of a steady supply of it. Now that various dictators and gangsters around the world control the spigots, we're at their mercy.

So that's the first reason nationalizations impact us today. The second is that they've produced a growing long-term fallout. In most cases, Western technicians were chased out of the host countries when nationalization occurred. The locals who took over usually didn't have the know-how, and certainly didn't have the capital, that the Westerners did.

As a result, almost every nationalization has dealt a fatal blow to that nation's energy output. We



From *Business Week*, based on data from PFC Energy, *Oil & Gas Journal*, and *BP Statistical Review 2005*

see it today in Mexico, where Petróleos Mexicanos (the corrupt state-owned oil company) has grossly mismanaged the huge Cantarell field, which is now failing. (In addition, they've neglected to find other fields to replace it.) We also see it in Venezuela: Hugo Chávez is presiding over a steep fall in oil exports, despite having one of the richest reserves in the world. We see it again in Iran, which despite its wealth of resources has a decaying economy and an energy industry that's falling apart. The list goes on and on.

All of this is just more bad news for a global oil market that's desperate for more oil, but can't get it.

Which brings us around to natural gas again…

Portfolio Updates

In Update No. 246, we noted that the September call options we wrote against NE, ATW, ESV, and APC were expiring, and we would keep the premiums.

In Update No. 250, we used the weakness in energy stocks to add to our positions. We bought 100 shares of Ensco International (ESV), and January 2007 $40 calls on Global Santa Fe (GSFAH). We also sold short the December 2007 $70 puts on Diamond Offshore (DOXN).

In Update No. 252, we made recommendations for subscribers who own Talisman Energy (TLM), Cimarex Energy (XEC), and Apache Corp. (APA). We sold the January $16.63 call options (TLMAQ) against our Talisman position for $1.45. We sold the Dec. $35 call options (XECLG) against Cimarex for $2.10. We also sold the Jan. $65 call options (APAAM) against Apache for $3.80.

In Update No. 261, we took action on the APC option, GSFAH, NE, and ESV. We rolled up our option on APC: we bought back the Oct. 45 APC call (APCJI) and sold the Nov. 45 APC call (APCKI). We sold 100 of our 200 shares of Noble Energy (NE) for $69, and 100 of our 200 shares of Ensco International (ESV) for $44.70. We also closed our position in the Global Santa Fe January $40 calls (GSFAH) at $11.80. Overall, we brought in over $1,000 in cash and profits.

In Update No. 262, we made recommendations for subscribers who own BBG, APC and NE:

- Against Bill Barrett Corp. (BBG), we sold the November $30 calls (BBGKF) for $.60.
- Against Anadarko Petroleum (APC), we sold the Nov. $47.50 calls (APCKW) for $1.35.
- Against Noble Energy (NE), we sold the Nov. $70 calls (NEKN) for $2.85.

Yesterday's waste product becomes tomorrow's treasure

Crude oil and NG are both made up of the same types of molecules (hydrocarbons). Liquid crude, however, is much more concentrated and dense. A single barrel of oil has the same amount of energy as 5,700 cubit feet of gas—enough to fill a small house.

As a result, gas presents a real problem in transportation and storage. You have to collect huge amounts of it to get even a little amount of energy, and it bleeds out easily from the tiniest of pinholes or leaky seals. Yes, it's useful when piped into a house or an electrical plant, but it's extremely difficult to get it there.

So, for most of its history, NG was considered useless. Worse than that, it could be dangerous: an unwary oil driller would often hit pockets of gas when seeking oil, and a well venting an explosive gas isn't exactly a safe place to be working. So oil drillers usually flared the NG (igniting it as it comes out of the well, to burn it away).

Eventually, though, energy companies realized that they had been encountering some substantial fields of gas. In some cases, there was a large enough amount to justify an extraction effort, including the substantial costs for storage and transportation. Soon, drillers were even seeking large gas deposits as their primary goals. Today, NG accounts for 23 percent of American energy usage.

Natural Gas: A Growing Problem for the U.S.

The United States currently produces 19 percent of the world's NG, but our gas fields are getting old, and (just like oil wells) they're producing less and less as they age. Therefore, we need to bring in NG from elsewhere, in order to meet increasing demand.

Since most of the world's NG is in places like Russia and Iran, it has to be shipped across the ocean somehow. But this causes a big problem. Unlike oil, NG can't be economically transported in ordinary tankers. You have to supercool it to -260

degrees Fahrenheit, which turns it into liquid (LNG, or liquefied natural gas) and shrinks its volume by a factor of 600. Then you can finally fit enough of it onto a ship to make it worthwhile.

Unfortunately, this process is expensive. You need special facilities to cool it down, special tankers to ship it and keep it superchilled, and a special facility at the receiving port to remove it from the ship, gently warm it up again, and turn it back into gas for your pipeline network.

This last part is a special problem for the United States. The government's Energy Information Administration estimates that we'll need to quadruple our LNG terminal capacity over the next decade, to keep up with burgeoning demand for gas.

But despite this desperate need for more terminals (we currently only have six), and dozens of proposals to build more, only a few are likely ever to be built. The various proposals all face opposition from environmental groups, difficulties getting water quality certificates and dredging permits, legal roadblocks from the Coastal Zone Management Act, and a host of other obstacles.

So here's where the story gets interesting.

NG is useful for certain things, but very inconvenient overall when compared to oil. Little surprise then that energy companies have always preferred to seek and produce oil instead of NG.

Today, however, energy companies are flocking to gas. Conoco has made a huge investment into Burlington Resources (a large natural gas producer). Anadarko bought Western Natural Gas. Shell now relies on gas for a whopping 48 percent of its production by energy value. Other companies are ramping up their gas involvement as well.

Why this sudden trend? Why would energy companies run to an energy source that, compared to oil, costs more to produce and transport, is worth far less on the market per energy value, and is growing more and more problematic to import to the U.S.?

It's simple—they obviously can't get any more oil…

Not only that, they're using natural gas to cover up the truth about our plummeting oil supplies!

As I mentioned, energy companies are failing in their desperate attempts to replace their oil reserves. Soon they won't have any more oil to pump, and they're almost completely locked out of the few places in the world that still have large amounts of oil left.

So why don't you hear about this in the news? Because the executives know that if they admitted this to the public, their stock values would fall like stones.

So, to hide the truth, the energy companies are using their natural gas discoveries to confuse the issue. Every time a new gas deposit is found, the companies usually announce it in terms of BOE (Barrels of Oil Equivalent): the number of barrels of oil that this amount of energy represents. More and more, they're reporting their overall reserves in these same terms.

This makes it sound like the company is effectively replacing the oil that it's pumping. But in reality, that's not happening at all. One BOE of gas is not as useful as the oil it's replacing—not by a long shot.

Yes, 5,700 cubic feet of NG might have the same amount of energy as a barrel of oil, but so what? Using the energy industry's logic, I could say that if I cover my roof with solar panels, I'll collect one BOE after a couple of weeks.

But that energy will still be totally useless to a diesel locomotive or a tractor-trailer or an ocean-crossing container ship or any of the other countless things in our economy that are designed to operate on oil derivatives today.

It doesn't matter how many BOEs I collect. Those trains and trucks and ships all need ***oil***, not BOEs of some other form of energy.

How This Impacts Your Portfolio

I know this issue has been a bit of a rant, but there's a reason for this.

So far, the stock market hasn't caught on to this whole BOE business. But sooner or later, the truth is going to emerge—not only about our long-term energy problems, but also about the worst offenders in this BOE scheme.

I'm very choosy about the stocks I recommend for the *GEA* portfolio. When I see situations like this in the market, I'm unwilling to buy into them, even if the market overall is blind to their faults. This makes it more difficult to find good stocks, but I won't settle for less.

Therefore, in my stock updates, you might see some recommendations that 'go against the grain' of what the market is doing. Just remember that I'm unwilling to buy junk, even if the market doesn't know it's junk yet. We don't want to be in some shaky energy stock on the day the market suddenly wakes up to its faults. (Enron, anyone?)

No, we're in this for the long term. We'll continue to buy quality stocks on weakness, and hedge them on strength. That's the best approach to take, and that's what you can expect from *GEA*!

Election Day 2006: The Way I See It

I'm a Republican—I make no bones about it—but these past 8 years have been very confusing for me. It appears my Grand Old Party of fiscal restraint, low taxation, regulatory relief, and strong moral values has changed jerseys and become something very unpleasant.

A friend recently persuaded me to attend a Democratic fundraising event held in Palm Beach, Florida, at billionaire Jim Clark's mansion—an amazing 34,000 square-foot mind-boggling backdrop (complete with an art collection that would suit a national museum).

In this posh environment I met, shook hands, and spoke with former President Clinton. I was impressed with his genuine graciousness and warmth. I couldn't help but mention my Silver & Gold Newsletter headline of 1994 …

"Now that the Republicans control Congress, Clinton faces resignation or impeachment."

"How'd you know back then?" he asked. I told him it was simple—I knew the 'right wing conspiracy' was gaining strength and would be relentless.

Within a few minutes, I was introduced to Congresswoman (and likely, the next Speaker of the House) Nancy Pelosi. She doesn't have horns or a tail, and in fact is as vibrant a grandmother as I've ever met. Sharp as a tack.

We discussed the Chinese Renimbi. I urged her to consider the importance of getting the Chinese to relax their currency controls and to fully float or to widen the current trading band.

Its consequences for oil can't be understated. A weaker Chinese currency would buy less oil, slow their torrid economy, and reduce their spiraling demand for oil. Plus, this would create free and fair trade, as promised by the entire concept of the WTO.

A lot of Wall Street and newsletter gurus are touting China as an investment. But if the Chinese growth rate doesn't slow, excesses in China's banking system will never be wrung out.

Unless these banks are cleaned up, a Chinese version of the Japanese banking crisis is a scary possibility. The Chinese are among our nation's biggest creditors. If their economy is not moderated and fortified, an avalanche of dollars could hit the market all at once. This is the derivatives nightmare Greenspan often spoke of.

"Please send my office a copy of your book—I want to look it over." Only too happy to, Congresswoman.

A little later, President Clinton spoke to the 300 guests. I realized he was giving words to my Republican identity crisis. He called the Republican party a group of idealogues who insist on ignoring reality.

Idealogues can deny the truth before their very eyes, in belief it serves a higher purpose. As he spoke, I realized—that's it exactly!

- Remember the Contract with America, which my party created and pledged to back in 1994? Today it seems more like a wishful dream than a memory.
- The Iraq War has been proven to be a concoction.
- "Earmark spending" is completely out of control.
- We've seen a long series of cover-ups, campaign donation scandals, indictments, convictions and illegal conduct.
- The government claims we're fighting terrorist insurgents, when the vast majority of death and violence in Iraq is actually the result of sectarian violence.
- And where's Osama—not important anymore?

I'm still a Republican. Colin, are you still here? Anyone see Rudy? Hey, aren't we supposed to be proponents of ethical government?

By my count, on Election Day 2006 the Democrats will likely gain 18 seats in the House, and take a slim majority. As for the Senate, I see four, maybe five more Democrats being added, but the Republicans will still control it.

A divided government means shrill and bitter arguments over the next two years. The more shrill and divided it is, the lower the dollar will slide. A stalemate in Washington will invite one or more serious crises—a price of being a Republic we must endure.

Democracy has proven to require painful periods of blood, self-doubt, and internal conflict over matters of conscience and strategy. Most often, even after the strife subsides, the devaluation of the country's currency is the bad after-taste we have to endure.

My recommendation to buy gold for long-term hedging deserves repeating. Gold may well be heading for another leg up—on its way to $2,000.