# GOLD & ENERGY ADVISOR

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## "The Subprime Panic has knocked 1,000 points off the Dow Jones... and pushed many of my Model Portfolio recommendations off their highs. This latest purging of the market's credit excesses will have no long-term impact on the bullish supply & demand balance for oil. Supplies are tighter than ever, and the world's demand for energy is still growing rapidly. Prices might fluctuate, but the long-term trend is still up!"

*James DiGeorgia, Editor*

- **The cost of finding and developing oil is rising twice as fast as the price of oil itself! A revaluation is coming to the oil patch.**
- **Russia steals $20 billion of oil and gas from the West**
- **China threatens to crash the US dollar!**

In the last couple of *GEA* issues, I recommended several energy stocks.

With all the subprime-credit carnage in the markets lately, some investors are wondering if stocks of *any* variety are a good place to be now.

It's not really surprising that this has happened. In fact, I was warning about the housing bubble here in *GEA* over three years ago. Shame on those analysts who should have seen this coming, but didn't.

Regardless of that, "Helicopter Ben" and his fellow central bankers are busy injecting liquidity to bail out global markets. Will they succeed, or fail?

It's too early to tell how the credit fiasco will work itself out. But either way, the results will be interesting:

- If they succeed, this will reinforce the "moral hazard" originally instituted by Alan Greenspan. Financial institutions will just get even more reckless, knowing that the Fed will bail them out, whatever they do. Result: the continuing bailouts and liquidity injections mean our gold and oil investments will do great.
- If they fail, cascading cross-defaults will tear apart the markets. Investors will stampede to

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assets that can't be defaulted upon. Result: our gold investments will do *really* great. Long-term, as the markets recover, global oil problems will re-assert themselves, and our oil investments will do well too.

So we're protected either way.

However, regardless of short-term activity in the markets, it's important to remember the long-term fundamental trends. Since the last couple of issues focused on specific stocks, there hasn't been room to mention some recent events that reinforce our ongoing shortage of cheap oil. So that's what this issue is about!

I'll start with some…

## Woes in the Oil Industry

Remember the big political battle over drilling for oil in Alaska's Arctic National Wildlife Refuge?

Regardless of your position on that particular issue, this was symptomatic of a broader trend. Oil companies are having serious problems finding and developing energy reserves.

Finding the reserves is hard enough. Later in this issue, I'll discuss a couple of news items that show how hard (and expensive) this has become.

Even once new reserves are actually discovered, there's no guarantee that the energy will ever come to market. As we saw in Alaska, political and environmental controversies can make an entire field off-limits. Technical and financial minefields also have to be navigated—as we're seeing right now in Asia.

Kashagan, the huge oil field in the Caspian Sea, was the biggest oil discovery since Alaska's Prudhoe Bay in 1968. It contains an estimated 13 billion barrels of oil—none of which have come to market so far, thanks to an ongoing series of problems.

Production was supposed to start in 2005. (It didn't.) Then it was supposed to start in 2008. (It won't.) Now the deadline has been pushed back to the end of 2010. Full production has now been pushed back to 2019.

Why? There are lots of different reasons. The oil is contaminated with hydrogen sulfide. The northern part of the Caspian Sea freezes solid for five months each year. Rising costs in the oil industry overall have pushed the lifetime costs of the project from an original $57 billion up to $136 billion.

In fact, that last item deserves further discussion…

## Oil Production Costs are Skyrocketing

Kashagan isn't the only oil project where costs are spiraling out of control. Other big projects

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have been in the news lately too—such as Royal Dutch Shell's $10 billion cost overrun in Russia's Sakhalin field.

Costs are shooting up all over the industry. In fact, the cost to develop additional oil resources is shooting up far more than the price of oil has.

According to a study done by Lehman Brothers, the industry's average cost to find and develop new resources (F&D costs) has more than quadrupled since 2001. Five years ago, it cost $5 per barrel. Now the average cost is $20.40.

Meanwhile, the price of crude in that same period has 'merely' doubled. So F&D costs are rising twice as fast as prices. The report pointed out that it's becoming unlikely that oil companies will even be able to keep up with future growth in demand, never mind being able to ease current prices.

A different Lehman Brothers report surveyed 299 oil and gas companies, and discovered that their collective spending for exploration and production would increase from $268 billion last year to $292 billion this year.

Incidentally, note that F&D isn't the only expense an oil company incurs. F&D doesn't include the costs to pump the oil and sell it, nor taxes, overhead, and so on. Across the industry, these operating costs are up nearly 80 percent since 2000.

After talking to all these oil companies, Ed Morse, the chief energy economist at Lehman Brothers, is pessimistic. He told the *Wall Street Journal* that "we have not yet seen the top in prices." He believes oil will continue to go up by $5-$10 each year for the next several years—until biofuels and alternative energies become available.

Of course, we're still many years away from large-scale production of viable alternatives. Until then, the implication for oil prices is clear.

However, there's another important trend that's not obvious at all. In fact, it's actually quite surprising…

## Believe it or not, Oil Profits are Falling.

What? How can I say such a thing?

Oil companies are gushing cash. Exxon Mobil just reported a quarterly profit of $10.26 billion—one of the highest profits ever recorded by any company in history. So how can I say profits are falling?

First of all, on a year-over-year basis, profits *have* fallen. Just a year and a half ago, in the fourth quarter of 2005, Exxon made $10.7 billion. So its profits are down by a quarterly $440 million, or an annual rate of $1.76 billion per year. That's an enormous sum if you think about it. Other oil companies are reporting falling profits too: ConocoPhillips, ENI, BP, and so on.

Yes, they're still making a lot of money. But my point is that *profits are falling, even as oil prices are flirting with record highs*.

As one analyst told the *Wall Street Journal*, "All the oil companies are struggling to grow production. It's becoming more and more difficult to bring projects in on time and on budget."

In fact, let's take Exxon as an example of a disturbing trend in the industry. In the first six months of the year, Exxon bought back $14 billion of its own shares, and issued another $2.8 billion in dividends.

Obviously, these moves boosted Exxon's stock price. That's why management did them.

But this is a grave admission by Exxon's corporate directors. In effect, they're admitting that they can't do anything more profitable with the money than give it back to investors.

Exxon is an oil company. Oil companies are supposed to make money for their stockholders by *producing and selling oil*. That's why the stockholders bought Exxon in the first place, instead of Microsoft, or McDonald's, or the thousands of other companies they could have bought instead. They thought that investing the money into energy was the best long-term investment.

$16.8 billion is a tremendous amount of money. If Exxon's management believed that new oil reserves were readily available, surely they would have invested those billions into finding these reserves.

But they didn't do that. Instead, they chose a very short-term way to boost the company's stock price. This placates the investors temporarily, but betrays the reasons that the investors bought the stock in the first place—to make a long-term investment in energy.

Is this because Exxon is mismanaged? Nope. The top four energy companies (Exxon Mobil, Chevron, BP, and Royal Dutch Shell) combined have bought back $22.9 billion of their shares this year. That's 40 percent of their total earnings. And that's just the top four companies—the others are doing it too. For example, ConocoPhillips just announced a $15 billion buyback through 2008.

### Latest prices as GEA goes to press—August 17, 2007

Comex spot contract: silver $11.76, gold $657
Nymex spot platinum: $1,232, palladium $330
Nymex Light Sweet Crude Oil $72.00

| Silver coins | | | Dealer will buy at this price | Dealer will sell at this price |
|---|---|---|---|---|
| 100 1 oz. silver American Eagles | | | $1,200 | $1,300 |
| 100 1 oz. common rounds | | | $1,180 | $1,280 |
| $1,000 face value US pre-1965 coin bag (circulated) | | | $8,400 | $9,400 |
| $1,000 face value US circulated silver dollar bag (VG or better) | | | $10,000 | $11,000 |
| US Morgan silver dollars | PCGS | MS64 | $42 | $48 |
| | PCGS | MS65 | $112 | $125 |
| | PCGS | MS66 | $220 | $245 |
| **Platinum coins** | | | | |
| U.S. Platinum Eagle: | | 1 oz. | $1,242 | $1,300 |
| | | 1/2 oz. | $621 | $650 |
| | | 1/4 oz. | $311 | $325 |
| | | 1/10 oz. | $130 | $145 |
| **Gold coins** | | | | |
| US Gold Eagle: | | 1 oz. | $667 | $697 |
| | | 1/2 oz. | $335 | $350 |
| | | 1/4 oz. | $165 | $175 |
| | | 1/10 oz. | $70 | $77 |
| US $20 double eagle: | | | | |
| Liberty | Raw | MS60 | $680 | $750 |
| | NGC | MS63 | $800 | $900 |
| | NGC | MS64 | $1,300 | $1,450 |
| | NGC | MS65 | $3,500 | $4,300 |
| Saint Gaudens | Raw | MS60 | $660 | $690 |
| | NGC | MS63 | $760 | $840 |
| | NGC | MS64 | $840 | $900 |
| | NGC | MS65 | $1,200 | $1,350 |

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All these buybacks should tell us something. These companies have the most knowledgeable geologists and engineers in the world. They can prospect for oil and gas on six different continents on land, and in mile-deep ocean waters offshore. They own billions of dollars in exploration and drilling equipment.

Yet even they couldn't find a way to make a profit from energy with that $22.9 billion. So they're giving it back to the investors instead.

The CEOs and other managers of these companies know more about the true state of the world's energy reserves than anybody else. Their actions are sobering news for our oil supply.

## Russia Steals More Oil and Gas from the West

When oil companies are competing against each other to deliver energy to the markets, then prices will be as low as possible.

On the other hand, when a few governments control the supply, prices will be as high as they want to set them.

In the past, we've seen OPEC do serious damage to America's economy by embargoing oil for political purposes. Thankfully, the OPEC governments have since realized that they need us as much as we need them. Despite some occasional complaining about American actions around the world, OPEC hasn't enacted an embargo in decades. OPEC has even maintained crude's price at a lower level than some of its members would prefer.

So, even though there's a price cartel in the oil market, the market has been fairly stable since the 1970s. But that's all changing now.

Thanks to his country's vast energy reserves, Russian President Vladimir Putin is now a dominant force in the oil and gas markets. He's become as large of a threat to stable energy supplies as OPEC ever was.

For example, Putin is confiscating Western oil properties. You'll remember that late last year, Royal Dutch Shell lost control of the vast Sakhalin-2

> **"Supply is going no place, and demand is rising 2.5 percent to 3 percent a year."**
>
> Economist Philip Verleger Jr., speaking on energy to the *Wall Street Journal*.

gas project in the far east of Putin's country. More recently, British Petroleum lost control of the $20 billion Kovykta field. And Exxon Mobil is now under pressure at the Sakhalin-1 gas project.

Russian officials have gotten fairly proficient at these thefts. Let's look at BP's Kovykta project as a good example of how a takedown works.

Putin starts out with smiles and warmth, welcoming Western investment in his country. (He personally approved the formation of TNK-BP Ltd., the joint venture between BP and three Russian investors.) Then he waits until the oil company invests huge amounts into development. (BP spent $8 billion on TNK-BP in 2003 alone.) Then he swoops in for the kill, and confiscates one or more properties through some legal subterfuge. (Russian regulators denied TNK-BP the permits to build pipelines and export its gas to China. With no customers to sell to, the field couldn't produce any gas. Regulators then complained that TNK-BP wasn't meeting its production quotas, so they forced the company to sell the project to Gazprom, the state-owned energy monopoly.)

Even Russians citizens aren't safe from their government's thieves. For example, Mikhail Gutseriev used to be the President of Russneft, Russia's seventh-largest oil company. He quit recently because of what he said was "unprecedented persecution" from police, tax authorities, and prosecutors.

Vladimir Putin has made no secret of his plan to control Russia's energy industry (which he has called "strategically important"). He's also shown a preference for using energy as a blackmail weapon. So far, it's only been wielded against his neighbors. Eventually, though, once he controls enough of the market, I expect he'll try to use it against us.

Am I being too paranoid? I don't think so. Under Putin's leadership, Russia is re-emerging as a serious threat to world peace. Russian nuke bombers are now practicing long-range bombing sorties again, flying into airspaces patrolled by US and NATO countries. This hasn't happened since the Cold War.

Meanwhile, Putin has notified NATO that Russia is suspending its involvement in the 1990 Conventional Forces in Europe treaty. This agreement limits tanks, troops, aircraft, and artillery in Europe. Apparently Putin finds it too restricting now.

He's also threatening to tear up the 1987 Intermediate Range Nuclear Forces treaty, which not only limits medium-range nuclear missiles, it allows both sides to inspect the facilities of the other. What is Putin doing that he doesn't want us to notice? What is he hiding?

Eventually, Putin will feel confident enough to start throwing his weight around in the energy markets. I don't expect his overall plan to succeed (whatever it may be at the time). But I do expect the oil market to take a beating in the process.

Speaking of which, there are also other…

## Scary Trends in the Oil Markets

Despite high oil prices, oil demand isn't subsiding.

In fact, growth in world demand has doubled since last year. The rate in 2006 was 0.9 percent: the forecast for this year is 2 percent. Much of this is driven by swelling demand from China and India, the economies of which are expanding at blistering rates. (The International Monetary

### A Massive Transfer of Wealth

The United States consumes about one-fourth the world's oil production each day. We import some 13.72 million barrels of oil *per day* from countries like these:

- Saudi Arabia
- Venezuela
- Russia
- Libya
- Iran

At $73 oil, that's over a billion dollars *per day*. This is a massive transfer of wealth and capital from our country to theirs.

Plus, certain OPEC producers (especially Saudi Arabia) are now investing heavily in refining capacity too. Refineries in the US are already running flat-out, and thanks to environmental concerns and other factors, we haven't had a new one built here in over 20 years. (That's why gas and diesel prices have shot up even more than oil has.)

Now the OPEC countries want to be the world's refiners. Pretty soon we'll be importing gas and diesel from them directly, instead of just the cheaper crude oil.

That's even *more* wealth draining out of our country. High oil prices have damaging long-term effects, far beyond the cost of filling your tank every few days.

Fund is predicting growth rates of 10 percent and 8.4 percent, respectively.)

Meanwhile, supply isn't keeping up. In fact, OPEC is refusing to supply more oil to the markets. OPEC members argue that since demand is staying robust, the world economy has obviously adjusted to higher prices. Therefore, the higher prices aren't hurting anybody. So it's OK to keep the higher prices by not increasing supply.

In reality, this all bluster. OPEC doesn't have any spare capacity anyway—they couldn't increase production even if they wanted to. But either way, supply isn't increasing.

Oil prices have flirted with record prices again recently. The high prices last year were caused by Israel's war with Hezbollah in the Middle East. The year before had hurricanes in the Gulf of Mexico. But there's something vitally different this time…

## Portfolio Update

In Update #372, we issued a recommendation on Anadarko Petroleum (APC). We sold short the September APC $50 puts (symbol APCUJ) at $3.10.

We also sold options on S&P Oil and Gas Exploration & Production (XOP): the XOP Sept. $43 puts (XOPUQ) at $1.50.

In Update #373, we used the market's weakness to add to our positions. We issued a recommendation to buy Pioneer Natural Resources (PXD) at the market, about $46.50.

In Update #378, we issued a recommendation to buy Plains Exploration & Production (PXP). We recommended conservative investors buy PXP at the market. For the model portfolio, we chose the PXP January $30 call (PXPAF) instead.

In Update #380, we issued instructions for subscribers who sold short the EOGTN puts. We bought them back at the market price of $.45. We originally sold them at $2.55, so we made $2.10 from the equity of the account.

In Update #384, we issued instructions for subscribers who wrote options against Devon Energy (DVN), ConocoPhillips (COP), and Cimarex Energy Co. (XEC).

For Devon Energy, we rolled up our August $70 calls (DVNHN) into Sept $70 calls (DVNIN).

For ConocoPhillips, we rolled up our Aug. $70 calls (COPHN) into Sept. $75 calls (COPIO).

For Cimarex Energy, we rolled up our Aug. $35 calls (XECHG) into Sept. $35 calls (XECIG).

**For the first time, oil is in the mid-$70s from its fundamentals!**

Today's prices aren't being caused by a Middle Eastern war, or a hurricane in the Gulf, or anything else. Today's prices are purely the result of supply and demand—nothing more.

And now that high prices are back, it's…

## Déjà vu All Over Again

President Bush has announced his new "20 in 10" program, to cut gasoline consumption by 20 percent over the next 10 years.

Maybe this will be more effective than President Nixon's Project Independence, which mandated an elimination of foreign oil imports by the year 2000. (This didn't happen, obviously.) Or Jimmy Carter's dictate that 20 percent of our energy would come from solar technologies by 2000. (Ditto.)

Or Carter's Synthetic Fuels Corporation (where billions of dollars disappeared before it was shut down in 1985). Or the current Bush Administration's "FutureGen" program, to solve reduce carbon emissions from alternative energies. (Its unofficial nickname is "NeverGen," reflecting its lack of progress.) Or… you get the idea. It's been one boondoggle after another.

Despite this history of governmental incompetence, Congress is enthusiastically debating another series of new mandates to "fix" our energy problems. Some of Congress' proposals sound eerily familiar.

Let's see, windfall profits taxes on oil companies—didn't we try those before? Yup, we sure did, in the early 1980s. They were a disaster. According to the Congressional Research Service, these taxes reduced domestic oil production by 1.2 billion barrels, forcing an increase in imports by 13 percent. Not a good result.

What about "price gouging" laws? Well, we've already seen that oil industry costs are rising rapidly. And gas prices are high because there aren't enough refineries to make gasoline. Draconian laws to "punish" companies for high prices will just drive the less-profitable companies out of the market completely, reducing competition and making prices higher for everybody.

And don't even get me started about all the ethanol mandates that Congress is announcing. Congress can announce whatever it wants, but it can't change the facts:

- Ethanol contains 30 percent less energy than gas.
- Ethanol can't be transported in pipelines due to corrosion and its ability to absorb water.
- Corn ethanol requires a lot of energy just to grow the corn—as much energy as the ethanol itself contains, according to some calculations. There's not much point in an "energy source" that doesn't provide any net energy.
- There's not enough corn to produce an appreciable amount of ethanol. Question: According to a recent study, how much of our total corn supply would it take get ethanol up to a mere 6.7 percent of our gas supply? Answer: 31 percent!

Why then is there such an ongoing craze over ethanol? I'll just quote billionaire oilman Boone Pickens, who was recently interviewed by the *Wall Street Journal*. He said:

> "[Senator] Bob Dole once told me that there are 42 senators from farm states and that pretty much means the government is going to be into ethanol."

That explains a lot, doesn't it?

## Oil Sands: Not Looking So Good Either

Oil sand—the thick tarry gunk up in Canada—is still being promoted (by people who should know better) as a viable replacement for oil.

As a *GEA* reader, you know that this is ridiculous. There's a long list of technical reasons why oil sands will only provide a small amount of energy to world markets. Even the most optimistic promoters are looking for an additional production of 2.8 million barrels per day by the year 2020. This amount won't even cover the additional demand that the world will have by 2010 (ten years earlier).

Anyway, the oil sands situation is getting more interesting lately. I've written before about the growing environmental backlash against oil production from the sands. Apparently, some people don't like a process that bulldozes entire forests, strips away the topsoil underneath, consumes several barrels of pure water for every barrel of oil produced, and leaves behind vast poisonous lakes that can't be cleaned up by any known process. Go figure.

Now, in addition to environmental headaches, oil sands producers are getting political headaches too. Alberta, the province where the sands are located, is reviewing its taxation structure. The current royalty rate is a mere one percent—set back in the 1990s, when oil prices were low and Alberta was desperately trying to attract oil-industry interest to the high-cost sands.

Today, despite near-record oil prices and a booming oil-sands economy, Alberta is actually experiencing *falling* revenues because of the low royalty rate and other tax breaks. Not only that, the regions around the sands are experiencing high inflation and other problems from the crush of workers being imported. Unsurprisingly, the government is now considering jacking up royalties and taxes on the oil companies.

## Signs of Desperation

A couple of years ago, in my book *Global War for Oil*, I wrote that Africa would be the next growth

### Don't Neglect Precious Metals

I've focused the last several *GEA* issues on energy, but precious metals are still looking great too.

The big news lately is that **China is threatening to crash the US dollar**.

The US Senate is considering a bill that would punish China for manipulating its currency to maintain a huge favorable trade imbalance with the US. The bill would enact trade tariffs against Chinese goods.

In response, China is threatening to sell its gargantuan stockpile of US dollars and Treasuries, part of its $1.33 trillion foreign reserves. As a Chinese official told *China Daily*, this "might lead to a mass depreciation of the dollar."

The state media call this the "nuclear option." American bond yields would leap up, our housing market would crash down, and the entire US economy might be dumped into recession. Oh, and gold would skyrocket!

Simon Derrick at the Bank of New York Mellon warned, "The words are alarming and unambiguous. This carries a clear political threat and could have very serious consequences at a time when the credit markets are already afraid of contagion from the subprime troubles."

area for oil company activity. My reasoning was this: all the politically stable places in the world have been thoroughly explored. Also, many of the nations with known reserves have thrown out the Western energy companies completely, or otherwise restricted their activity.

Therefore, even though Africa has a long list of problems associated with it, it's the only place left to go.

My prediction is coming true quickly. For example, Total SA recently announced a shift in emphasis to Africa—two-thirds of its expected expansion from now until 2010 will be on this continent. Total already has more reserves in Africa (3.49 billion barrels) than in any other place, even in the Middle East (at 2.69 billion).

Also, up on the North African coast, British Petroleum just announced a new deal with Libya. Then again, "deal" might be the wrong word to describe this agreement.

BP will spend at least $900 million, and possibly $1.2 billion, exploring for natural gas in Libya. If it discovers any, it will spend several billion more developing the find. Once production starts, Libya will keep 78 percent of all gas produced. Another local partner will take a cut too. BP will get less than 19 percent.

How long will it take for BP to recoup its costs (never mind make a profit) with only 19 percent of production? Why would BP agree to such a deal?

For that matter, why would Total increase its involvement in places like Sudan, which has been in a civil war for 20 years? Or in Nigeria, where Total's existing facilities are already under attack by revolutionary militants? It's simple.

Oil companies are desperate.

Where else do they have a chance of making a significant oil find? Not here at home—the US has been explored top to bottom, and is played out now. Even Texas, the definition of America's 'oil country', is now *receiving* oil via pipeline for the first time instead of sending it. (The crude comes from Canada). Meanwhile, Canada has only its oil sands, and Mexico is off-limits to foreign companies.

As for South America, it's not any better. Venezuela just ejected Exxon Mobil and ConocoPhillips from the country for refusing to allow the confiscation of their facilities in the Orinoco Belt. Four other companies—Statoil, Total, BP, and Chevron Texaco—were allowed to continue their operations, but only after giving up ownership of their infrastructure and oil rights. The rest of the continent doesn't have much promise, either—whether geologically or politically. Even China's National Petroleum Corp., which is famously greedy for oil reserves, declined to bid on a recent sale of a property by Argentina's Repsol. Spreading South American nationalism makes the property too risky.

What about Europe? Like the US, it's been thoroughly explored, and the big fields are already played out. For example, production in the North Sea peaked in 1999, and is plunging now. Britain's production has lost 1.3 million barrels per day.

As for Asia, I've already mentioned that China is aggressively acquiring oil properties around the world, due to a dearth at home. Russia and the Middle East still have lots of oil and gas, but none of it is available to Western industry.

Indeed, a lot of it might never be available to the West at all. OPEC countries are industrializing and consuming more of their own oil instead of selling it to us. For example, Saudi Arabia, the world's largest producer of oil, now consumes one-quarter of its production. The Middle East and North Africa combined have 300 million people, but consume as much oil as the 1 billion people in China.

## Why We Invest as We Do

This all reinforces our investment approach in *GEA*.

The subprime problem might have a temporary impact on our portfolio. Nevertheless, the fundamentals for oil haven't changed. Our energy problems are serious, and still underappreciated by most people.

Unless the global economy suddenly goes into a steep recession, oil prices aren't coming down significantly for years to come. Viable alternatives are too far away.

Having said that, if you read my email Updates (and you should), you'll know that I'm cautious right now. Bull markets occur in stages, or legs. I believe we're at the end of Leg #1 of this bull.

This means there are probably two more legs to go, with even higher prices ahead for energy stocks.

But it also means there will probably be short-term dips as we transition from Leg #1 to Leg #2.

I'm viewing the current market stumble as a buying opportunity. But there's no rush—we'll wait until prices have stabilized before we move in.

Watch your email for my Updates with recommendations as I issue them!