

“What the Oil Industry is Afraid to Tell You!”

“As 2007 ends, oil is up in the mid-\$90s. Its year-to-date average is \$84.83, shattering last year’s record of \$72.05.

“Yet despite these blistering-hot prices, oil production is falling. And profits of major energy companies are plummeting as well. Meanwhile, demand is driving upward. This sounds insane, but it’s all true. Brace yourself for even higher prices in 2008!”

- **Why oil company profits are sinking**
- **The little-understood reasons why crude oil production is sliding**
- **New failures among alternative energies**

To paraphrase a certain musician: what a long, strange year it’s been in the oil markets!

Crude oil skyrocketed to new highs—at one point, up 81 percent on the year. According to basic economics, that means certain things should have happened.

The most obvious thing is that oil companies should be more profitable. Next, the oil companies should be producing more oil, since the higher prices make even marginal deposits cash-positive.

We would also expect demand to be tapering off. Finally, we’d expect some alternative energies to become viable.

But how many of those expectations have been met this year? *None!*

Despite oil’s price, the major oil companies are *less* profitable. And they’re producing *less* oil.

Not only that, demand is surging up. And alternative energies are looking less attractive today than they used to be.

2007 has turned out to be a seminal year in the oil markets. It’s the Year That Changed All the Rules. And that’s our topic this month!

I’ll start by explaining why...

ExxonMobil lost \$10.49 billion in profits last quarter

Exxon’s profits fell again in the third quarter. Profits are down by \$10.49 billion compared to the

same period last year. This is the second consecutive quarter where Exxon fell short of expectations. (Its stock fell 3.8 percent on the news. This helped take down the Dow by 2.6 percent.)

Shouldn't high oil prices have increased Exxon's revenue? Yes, they did. Gross revenue was up 2.8 percent from 2006.

But costs have increased even more—by 5.1 percent. Is the company being a spendthrift? Not

at all. In fact, Exxon is famous for being stringent on its costs.

What about the other oil majors? They're getting whacked too, especially ConocoPhillips, Chevron, and Eni.

According to a Citigroup analyst, the biggest oil companies' profits have fallen an average of 15 percent this year. Why is this happening?

In today's energy industry, operating costs have soared, thanks to high demand for people and equipment. We can see this by looking at the Upstream Capital Costs Index (UCCI) from Cambridge Energy Research Associates.

The UCCI measures expenses for drilling rigs, qualified personnel, offshore-related costs (installation, shipyards, etc.), fabrication, and more. It has risen by 98 percent since 2000. A stunning 93 percent of that is just since 2005.

On top of that...

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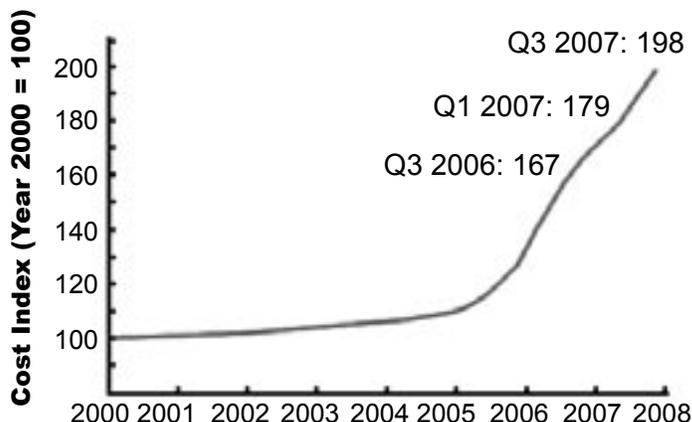
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Western oil companies are also getting hammered with new 'political' expenses.

For example, Russia has raised its oil-export duty. Along with its other state taxes, the total cost for Western companies is now almost 90 percent of revenue. Meanwhile, over in Canada, Alberta has raised its royalties on oil sand miners. Even the US is raising royalties on energy leases in the Gulf of Mexico.

The higher oil goes, the more these political costs are rising. Countries with oil reserves are



The IHS-CERA Upstream Costs Index tracks nine key cost areas for offshore and land-based energy projects. Costs have almost doubled since 2000. Source: Cambridge Energy Research Associates.

getting greedy, and changing or even canceling their contracts with Western firms.

A good example is the Kashagan field in the Caspian Sea, one of the largest oil fields discovered in the last three decades. It has an estimated 13 billion barrels of oil. Much of this is in Kazakhstan's part of the Sea.

Years ago, Kazakhstan put together a consortium of Western oil companies to develop and produce these reserves. The consortium is managed by Eni (Italy's biggest oil and gas company). Other members include Total, ExxonMobil, Royal Dutch Shell, ConocoPhillips, and Japan's InpexHoldings.

When oil started to rise, the Kazakhs realized there was going to be a lot of money made. So they added a "rent tax" on oil exports, which has raised the total tax to 65-85 percent depending on price.

Then in 2006, they demanded a change in the consortium's structure. They added their state oil company KazMunaiGaz, taking 8.3 percent of the consortium's shares.

Now oil is up even further, and the Kazakhs want more. They're now threatening to take over managerial control of the consortium. The Western members don't like this, but are afraid to say no.

After all, the Kazakh government has passed laws allowing it to cancel natural-resource contracts at will. The oil companies are worried that if they don't cave in to Kazakh demands, the government will cancel the agreement and kick the Westerners out completely. (The Chinese and the Russians are eager to step in and replace them.)

This is an interesting situation. Politically, Kazakhstan is in one of the most undesirable locations in the world. They have two huge power-hungry dictatorships as neighbors: Russia on one side, and China on the other. Plus, the country has no capital, no military power, no technical expertise, and no significant resources other than oil. Despite all this, the Kazakhs are still able to throw their weight around.

This tells us who has the upper hand in the world today. He who has the oil, makes the rules.

Other Problems

While all this is going on, refining margins are down. Oil companies remember all too well the "windfall profits" taxes in the 1970s. They're bend-

ing over backwards to keep gasoline prices as low as possible, to avoid political reprisals.

As a result, refining margins have been squeezed. Not all the majors have big refining operations, but those that do, are getting battered.

Across the industry, profits per barrel are falling. Can the oil companies compensate for this with higher volume?

Unfortunately, no. It's all because...

Oil Production is Falling instead of Rising

ExxonMobil is the biggest non-state oil company in the world. Despite record oil prices, its production of oil and NG (natural gas) has fallen by 2 percent year on year.

The same is true for the second-biggest firm, Royal Dutch Shell. Production there has fallen by four percent.

The third biggest company? That would be BP, also down four percent.

The list goes on. According to Citigroup, average energy production for non-state firms has fallen by 3.3 percent.

But that includes natural gas production, which has been relatively stable. As I've discussed before, oil companies use NG to cover up their shrinking oil reserves. (NG is useless for most oil-based applications, but oil companies include it in their reserves anyway as "barrels of oil equivalent.")

So let's remove natural gas from the calculations. When you do that, you find...

The average non-state oil company's production has plunged by 9 percent in the last 12 months!

On its own, that's a grim statistic. But what about state-owned oil companies?

As you can guess, it's impossible to get accurate figures individually for many of these. However, we can look at world production overall, to see what's happening.

And this number is equally grim. According

to the Energy Information Administration, in the first eight months of the year, daily world production was 448,000 barrels per day *less* than the daily average in 2006.

Where is the deficit coming from?

Non-OPEC Oil Production Falls Short... Again

The non-OPEC oil supply has fallen significantly short of expectations. The good news is that production is up by 301,000 barrels per day since last year.

The bad news is that according to the International Energy Agency (IEA), it was supposed to be up by 1.1 million. That's a shortfall of 800,000 barrels per day.

This is at least the fifth consecutive year that

Latest prices as GEA goes to press— December 14, 2007

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non-OPEC production has fallen short of forecasts. In fact, according to Deutsche Bank estimates, non-OPEC supply has provided a mere 40 percent of its estimated growth in the last five years.

The industry's woes are numerous. Existing fields are maturing (especially in the US and the North Sea), and production is declining.

This requires oil companies to find lots of oil just to replace the losses, never mind increasing overall production. They're running on a hamster wheel, and the wheel spins faster and faster every year.

Also, maintenance is getting more costly. Longer downtimes are being required. New projects are more expensive than expected, and getting delayed more often.

OPEC Countries Lost Production This Year

OPEC countries supply over 40 percent of the world's oil.

The good news from OPEC is that they managed to bring some new production online in 2007. The bad news is that they too have lots of mature fields. The declines from these fields have overwhelmed their gains. Their net production is down by 749,000 barrels per day.

Plus, the underperformance of non-OPEC countries is hampering OPEC's efforts at expansion. For example, the IEA forecasts that next year, non-OPEC supply will grow by 1.1 Mbpd (million barrels per day). This has dissuaded OPEC members from trying to increase their own production, since this would only suppress prices further.

But what are the chances that the non-OPEC countries will meet this forecast? They were supposed to grow by 1.1 Mbpd this year too, but achieved less than 30 percent of that.

Overall during the last five years, they've fallen short by more than half every single year.

Nevertheless, we won't know they failed again until 2009. That's 12 more months of OPEC not bringing its remaining spare capacity online. And 12 more months of high oil prices.

Speaking of the IEA, it just released an interesting study...

It says the world will be short 12.5 million barrels per day in just seven years!

According to this study, Western oil companies aren't expanding production enough.

Since Western production has *fallen* this year, I'd say that's a rather obvious statement.

Anyway, according to IEA figures, the world will be short of 12.5 Mbpd by 2015. Yes, that's over 12 million barrels *per day*.

The effect this will have on oil prices is obvious.

Meanwhile, Oil Demand is Accelerating

So far, we've seen that oil supply is already woefully inadequate, and getting worse.

You'd expect that high prices would decrease demand. But thanks to exploding economic growth in China, India, and to a lesser extent the Middle East, 2008 demand is predicted to grow by 1.9 Mbpd.

For example, the Chinese government is desperately trying to curb energy usage. It wanted to cut demand by 4 percent per unit of GDP last year. However, it only accomplished 1.3 percent.

Therefore, demand per GDP has been trimmed slightly. However, the GDP itself is growing a lot faster. This means China's oil demand will still grow an estimated 6 percent this year.

As IEA supply analyst David Fyfe has said,

Why is Oil so Volatile?

Oil prices have been swinging wildly. What's going on?

Much of the volatility lately is caused by oil's huge leap in price. When oil was shooting for \$100, lots of traders hedged by buying oil. When the option expiration dates approached, and oil hadn't breached \$100, the hedges were no longer necessary. So the oil was sold.

This hedging and de-hedging (along with some outright speculation) is normal in any market. It's just more visible in oil because the market has been getting so much attention lately.

Portfolio Update

In Update #428, we issued instructions for subscribers who participated in the DOXT and PDEDE trades.

We took a \$60 profit on the Pride International (PDE) April 2008 \$25 calls (PDEDE). We had bought for \$9.30, we sold for \$9.90.

We also took a \$315 profit on the Diamond Offshore (DO) Dec. \$100 puts (DOXT). We had sold for \$3.70, and we bought to close at \$.55.

In Update #433, we issued instructions for subscribers who own Enesco International (ESV).

We hedged by selling the January \$55 calls (ESVAK) for \$3.00. This reduced our cost basis in the stock.

In Update #435, we issued instructions for subscribers who have positions in XECLG, and DVNLO.

On Cimarex Energy (XEC), we rolled up our December \$35 calls (XECLG) to the January \$35 calls (XECAG).

On Encore Energy (DVN), we rolled up our December \$75 calls (DVNLO) to the January \$75 calls (DVNAO).

These actions reduced our cost basis in the stocks, gave us downside protection, and lowered the volatility of our portfolio.

crude oil supplies "will not be sufficient to match demand growth."

The weak US dollar is contributing to this too. Oil is priced in dollars, and the dollar has been falling. This is making crude cheaper for people outside the US. And it's encouraging demand instead of discouraging it.

So supply is down, and demand is up. Only one thing can save us from even higher prices—a viable alternative to oil.

Too bad then that...

Biofuels Are Looking Less Attractive

As oil supplies grow tighter, are alternative energies becoming more viable as replacements?

Surprisingly, the answer is no.

You would think that as crude prices have soared, alternative energies would become more workable. Basic economics would predict this. However, other forces are dominating the markets instead.

First of all, thanks to energy demand, raw materials and commodities costs are soaring. This has increased expenses for new projects of all kinds.

Secondly, some resources are too difficult to obtain. For example, despite all the money being thrown at the oil sands in Canada, production rates can't go up much further.

Mining frozen tarry gunk out of the ground is a hard, slow process. The price of crude in Saudi Arabia has little effect on the sub-zero temperatures in northern Alberta.

Other alternatives are similarly limited. For example, a few years ago, Malaysian palm oil was merely an ingredient in some packaged foods.

Now, all of a sudden, there's a big push to use it in biodiesel (diesel fuel made from biological sources). Thus, its price has shot up by 90 percent in the past three years. According to a report in the *Wall Street Journal*, palm-oil diesel has become non-viable until crude hits \$130.

There's another natural resource that was, until recently, touted as our energy savior. However, it has stumbled too. I'm talking about...

Ethanol

Remember President Bush's State of the Union speech in 2005? He told us that ethanol would solve all our oil problems.

People believed him—for a while. Corn doubled, going from \$2 per bushel up to \$4 almost instantly. Last summer, ethanol itself hit \$5 per gallon. And politicians in Washington were talking about legis-

A little-understood reason why higher oil prices are *reducing* production for Western companies

The large crude deposits in the West were all found long ago. There might be a couple of large fields left here and there, but overall, Western companies have been forced to look elsewhere for new reserves.

In the industry's early days, when Standard Oil or some other Western company explored in the developing world, they used concession agreements. In exchange for a monopoly on oil production in a certain region—often the entire country—they offered royalties on the oil produced.

Concessions gave the oil companies a lot of power—too much, in fact. For the most part, the host countries came to resent these agreements, feeling they weren't getting their fair share of the profits.

Today, oil agreements are structured much differently. A common arrangement today is 'production sharing,' where the oil is distributed differently depending on its price.

These agreements can be structured a variety of ways, but a typical way is to share the oil above a predetermined baseline.

For example, let's say that in a certain country, Exxon gets \$30 per barrel for costs incurred

and profit. As long as oil is \$30 or below, Exxon gets all the oil pumped.

But when oil goes up to \$100, Exxon only gets \$30 worth of oil from each barrel, or three-tenths (\$30/\$100) of each barrel produced.

That's a simplified example, but it illustrates what's going on today. Under these agreements, as oil prices rise, there are two important implications.

Number one, Western companies do *not* increase profits.

Number two, Western companies get *less* oil.

That's a big reason why production is falling for the West. Thanks to production sharing, Exxon lost 14 percent of its production in west Africa this year.

The other majors are having similar problems. For example, BP has a project in Azerbaijan that receives 50 percent less oil at \$100 per barrel, than at \$25 per barrel.

And Total has slashed its 2007 growth target in *half* due to production-sharing agreements.

(continued on next page)

lation to mandate ethanol usage. Such a mandate seemed inevitable.

Today, though, ethanol doesn't look so good anymore. The Congressional mandate never passed, despite swarms of pro-ethanol lobbyists in Washington. Instead, a growing cadre of anti-ethanol forces now has lobbyists of their own. The political battle is still raging, but ethanol appears to be losing.

Ethanol has turned out to be very expensive, in multiple ways. First, the corn that it's derived from is very sensitive to the additional demand ethanol has produced. Even though ethanol isn't as popular anymore, corn is still above \$3 per bushel.

Also, the prices of other crops (such as wheat and soybeans) have risen, as farmers have switched over to corn. In turn, this has boosted costs for our food supply.

It's now more expensive to raise and feed poultry and livestock. Also, packaged-food manufactur-

ers are paying a lot more for their corn syrups, vegetable oils, and other items. So the next time you go to the grocery store, you can thank ethanol for your rising food bill.

This is all the more aggravating when you realize this wouldn't be happening if the government wasn't interfering with the free market. Ethanol lobbyists have managed to get a 54 cents per gallon tariff exacted on imported ethanol. This keeps prices much higher than they would be otherwise.

Also, the government gives gasoline refiners a 51 cent subsidy for every gallon of ethanol they blend into their gas. Last year, the refiners made \$3.5 billion from this.

If it wasn't for heavy government subsidies and tariffs, ethanol probably wouldn't be made in this country at all.

So what are we as taxpayers getting for our money? A terrible fuel that:

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Unfortunately for us in the West, production-sharing agreements are a growing trend.

According to Citigroup, production-sharing accounts for 31 percent of all oil produced by major European oil companies. That number will rise to 46 percent in the next five years.

You might be wondering why this is so bad. Yes, Western oil profits are down, but the oil is still coming to market—the revenue is just going to a different seller. So what's the big deal?

The problem is this. As oil prices rise, Western production (and profits) are being whittled down to zero.

Exxon and the other companies have little incentive to drill more wells and build more infrastructure in these countries. Why should they bother? They'll get only a trickle of the oil.

It's not worth the effort.

Meanwhile, the host countries can't expand their industries themselves. We're talking about places like Nigeria, where the only technical expertise consists of sending out scam emails to Americans. ("Dr. Eleme Mugambe needs your assistance in smuggling \$4.68 million out of the country...")

Or do you think the citizens of Azerbaijan have billions of dollars in capital to expand their nation's petroleum infrastructure? What about Angola? Or São Tomé? Or Príncipe?

Why then can these little countries keep demanding such one-sided agreements? Because if Western companies don't agree, the Chinese will instead. In past issues, I've documented how the Chinese state-owned oil companies:

- Are desperate for oil
- Have no profit motive (since they're owned by the Communist government)
- And are well-funded by below-market financing from state-owned banks.

This has led to a series of acquisitions around the world, where Chinese companies are paying outrageous prices for even small amounts of petroleum.

China is ravenous for more oil. So wherever the Chinese get involved, much of the crude that's produced never comes to a Western market. Even when it does, it's at higher prices than those charged by BP or Exxon.

Summary: Today's high oil prices do not equal a higher supply. Production sharing agreements are resulting in less production, and higher prices.

- Costs more than the benefits it provides.
- Is turning out to be harmful to the environment.
- And can do little to help our oil problems.

According to a new study by the AEI-Brookings Joint Center, ethanol costs us more than we gain from it. The study said that if annual production increases by 3 billion gallons, the economic costs will exceed the benefits by \$1 billion.

Also, numerous studies are confirming that ethanol is bad for the environment. The National Academy of Sciences says that corn-based ethanol is straining our water supplies. The National Research Council confirms this, and adds that it hurts water quality as well (thanks to fertilizer runoff and other problems).

Meanwhile, the Environmental Protection Agency has discovered that “ozone levels generally increase with ethanol use.” And a study by Nobel Prize-winning chemist Paul Crutzen has discovered that ethanol increases emissions of nitrous oxides. These are greenhouse gases, far worse than carbon dioxide. When exposed to sunlight, they also turn into smog. That’s why the American Lung Association is now worried about increasing use of ethanol.

And this increased pollution comes with little help for our oil problems. For example, in 2005, ethanol production consumed 15 percent of the US corn supply. How much gasoline did it replace? Less than 2 percent.

According to the Agriculture Department, by 2010 about 30 percent of our corn supply will be consumed by ethanol production. (This will have a dramatic effect on food prices, obviously.) But this will supply less than 8 percent of US gasoline.

This price is far too high, for such little benefit received. That’s why the Organization for Economic Cooperation and Development recently said that biofuels “offer a cure that is worse than the disease.” And an advisor to the United Nations recently said using food to make fuel is “a crime against humanity.”

Now China has banned new ethanol plants from using corn. Mexico is angry about the doubling and tripling prices of corn tortillas, which are a staple among the poor in that country. Quebec has halted loan guarantees for corn ethanol plants, and its natural resource office has said, “The environmental costs of corn ethanol are higher than expected.”

Other countries recognize that corn ethanol doesn’t work. The US will soon recognize this too.

China Raises Gasoline Prices. Paradoxically, This Will Increase Oil Demand

China sets price controls for its gasoline market. As oil prices have shot up, oil refiners have been bleeding money. Their costs have risen, but their sale prices have not.

As a result, many Chinese oil companies have stopped refining completely. The two big state-run companies (Sinopec and PetroChina) have only been able to continue with heavy subsidies from the government.

Unsurprisingly, this has caused severe fuel shortages across China. Fighting has been reported at gas stations, resulting in at least one death. Now the government has been forced to raise gas prices.

With gasoline prices being raised, private refiners can afford to buy oil and make gas again. This is increasing oil demand in China.

So a higher price for gas is resulting in more demand for oil. Yet another example of the upside-down oil market we’re facing.

2007: A Year for the History Books?

In my book *Global War for Oil*, I wrote about “peak oil”—the idea that global oil production would eventually peak, and then gradually slide into a long, permanent decline.

This scenario doesn’t mean we’ll run out of oil. It does mean prices will surge to new, permanent highs.

The problem with peak scenarios like this is that by its nature, the peak is impossible to recognize until you’re several years past it. While we’re in the peak, all we’ll know is that production is no longer increasing.

Is 2007 the year for the peak? We won’t know for several years yet. We do know one thing, though. If this year isn’t the peak, it certainly has many of the characteristics that the real peak will have.

2008 promises to be a *very* interesting year in the oil markets. I’m expecting our *Gold & Energy Advisor* portfolio to have a great performance!