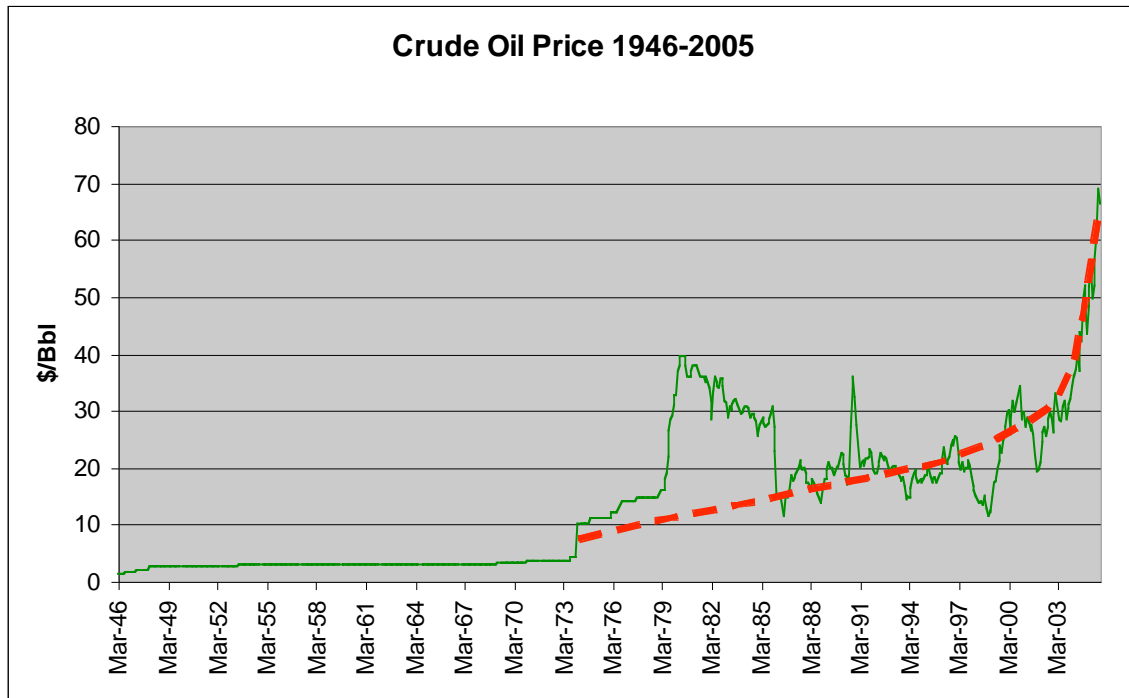


# Running on Empty – The Anatomy of an Energy Crisis

By Adrian Douglas

The headlines this weekend are truly shocking. For the third quarter of 2005 Natural Gas rose 80%, gasoline 44% and crude oil 13%! If you read many of the mainstream news comments about the energy market you will come to the conclusion that two very wild and mischievous twin sisters, Katrina and Rita were responsible for all of this, with a bit of blame also going to insurgents in Iraq who keep blowing up pipelines. So while it is painful to pay such sky-high prices for natural gas and gasoline we can rest assured that as soon as the storm damage to the energy industry infrastructure on the US Gulf Coast is repaired, and things get more stable in Iraq, Americans can go back to gas guzzling with their SUVs at a buck a gallon for gasoline. Unfortunately, that will not be the case. The current energy crisis has been more than 35 years in the making. Recent events have only acted as catalysts to what was already an accident waiting to happen.

Let's take a look at the price of crude oil from 1946 to 2005 in nominal terms.

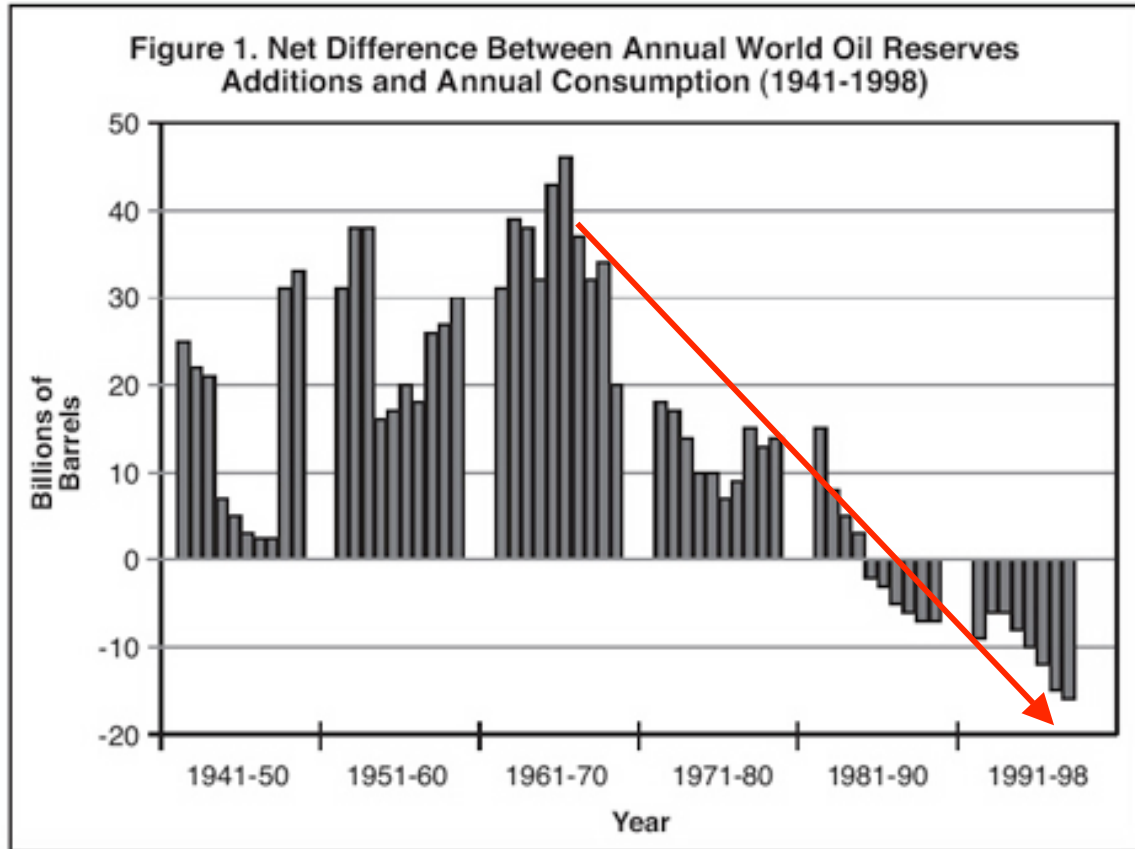


What you see is a price that has a lot of volatility but the red line I have drawn shows the average long term trend. You would be hard pressed to pinpoint Katrina or Rita price effects on this graph! In 1973 there was the first oil shock in the form of the Arab Oil Embargo where Middle East supplies to the West were cut off to protest Western policies toward Israel. In 1979 the Iranian Revolution, followed in 1980 by the start of the eight year Iran-Iraq War, further cut supplies to the West driving oil prices to \$40 per barrel. As a direct result of these oil price shocks oil exploration and production was actively encouraged in non-OPEC countries. A drilling bonanza ensued and production capacity was added so quickly that the crude oil price collapsed in 1986 to ten dollars per barrel because global production capacity exceeded World demand by 30%. Had these events not occurred the large upward excursion from the red long term trend line would not have been present and almost everyone would have been in agreement that the long term trend for oil prices was definitely "up". Many observers have taken a trend line from the \$40 per barrel peak through to around \$20 per barrel in 1999 and satisfied themselves that oil prices were trending downwards. But from 2000 onwards it is clear that it is difficult hold a view that oil prices are trending lower. Despite that many analysts have dismissed upward prices as temporary excursions from a long term declining price trend.

Here are a couple of press releases from forecasters

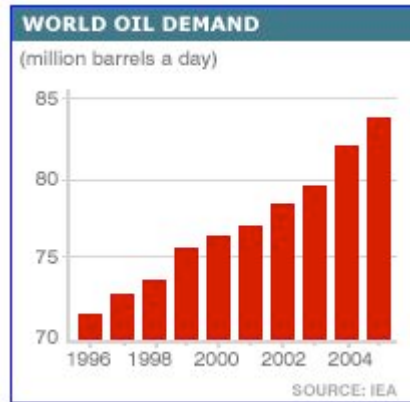
- **Wednesday, January 07 - 2004 at 08:50**  
**Citibank has raised its oil price forecast for 2004 to an average of USD24.50 per barrel, and USD22 for 2005. The bank's previous forecast was USD23 and USD19 respectively.**
- **March 2005 "The average forecast for crude oil this year is about \$32 a barrel, and the price continues to stay quite a bit above that, which means earnings expectations for oil companies are going higher," said George Gaspar, oil analyst with Robert W. Baird in Milwaukee. "But we expect that the bloom may be off the rose and oil prices will pull back eventually to the low \$30 level, though it may take time because of the situation in Iraq."**

The next graph illuminates the true origin of the energy crisis that is unfolding.



This graph shows, in general, before about 1967 the oil industry was finding more oil reserves each year than the World consumed in that same year. In addition the trend shows that World reserves were not only increasing but increasing by a larger and larger amount each year. From 1967 to 1984 the oil industry was still finding more oil each year than the World was consuming but, in general, each year the increase was less than the previous year. From 1984 onwards this actually turned into a deficit. **Ever since 1984 the World has consumed more oil each year than the oil industry has managed to find.** This means that for 21 years the World's reserves have been declining.

But the World still has plenty of oil. It is a shortage of production capacity and refining capacity that has affected the price of gasoline. World demand for oil has been increasing as the Third World countries rapidly industrialize.



To be able to meet rising World Demand the Oil Industry would have to invest a lot of capital to extract, transport and process known reserves faster. Most of the World's Non-OPEC Oil Companies are publicly held and are operated for the benefit of shareholders. They are not run with a socialist agenda of guaranteeing supplies at any cost. So from a purely business standpoint it does not make much sense to invest lots of capital into an industry that has reached its maximum reserves potential 21 years ago. So the industry has been living on its previous fat. The 30% excess production capacity that had been built up due to the drilling boom of the seventies and early eighties was a cushion that allowed production to be ramped up to meet growing demand. For example, no new refinery has been built in the USA for over thirty years. The gradually increasing world demand has been eating into the excess capacity of the Oil Industry over the years and recently supply and demand have come almost in to balance. A situation where if everything works perfectly there is no problem. This is, of course, the proverbial accident waiting to happen. And it has happened. We have seen supply disruptions due to insurgents in Iraq blowing up pipelines; we have seen the devastation inflicted on production and refining infrastructure by Katrina and Rita. These were not the root causes of the recent price spikes but only catalytic events in an industry where, under normal circumstances, supply and demand are now so closely balanced.

Saudi Arabia in a conference in South Africa this week assured the delegates that there was plenty of oil in the world and that they would themselves soon double their reserves. This is not the issue. There is also plenty of wind in the World and plenty of sunshine. Both of which can be used to generate electricity but there is no infrastructure to use these "free" sources of energy. The issue is that current production, transport and refining infrastructure is capacity limited. The current high prices will no doubt encourage investment to add to active drilling rigs, to add to tanker fleets, to build refineries but this will take years to achieve and is unlikely to do anything but moderate the upward trend in petroleum product prices. It will not reverse it.

The only immediate respite for energy prices would be if a worldwide recession or depression were to significantly reduce demand. But even that would only be a temporary lull before global growth resumes its upward march.

The good news is that high energy prices will encourage investment into renewable energy infrastructure which is a much longer term solution.

High energy prices will not be swept away with the debris left by Katrina or Rita. The inflationary effects of high energy prices are pervasive and must show up in everything we buy. This is the classic fuel of a precious metals bull market.

You can scroll back up to see that Citibank in January last year forecast a 2005 oil price of \$22 per barrel, and earlier this year Robert W. Baird analysts were forecasting \$32 per barrel! You have seen the forecasts for gold from the analysts. In my opinion they will be just as embarrassingly wrong as they were for oil. Investors will be shocked by how high gold can go. Investors who are well positioned will soon understand what I mean when I say....

***You haven't had a rush until you've had a gold rush!***

Adrian Douglas

October 1, 2005