TheStreet.com

December 27, 2007

Big Dilemma for Big Oil

http://www.thestreet.com/newsanalysis/energy-and-technology/10394891.html

By Chuck Marvin

Demand for energy in all its forms is higher than ever, while the longstanding sources of supply are being more and more constrained.

The repercussions of energy use are broad and powerful, affecting individuals, corporations and entire nations, and the global balance of power is shifting as resource-rich countries flex their muscle in a new geopolitical landscape.

Now, energy is being squeezed from new forms of biomass and renewable sources in ways that can only be described as miraculous. Nuclear power, once considered to be dead in the water, is making a comeback worldwide.

Energy is changing who is in control, the environment in which we live and how we plan our future.

Because of this, energy grew into one of the most talked-about issues in 2007, and institutional money poured into the sector at levels never seen before. These trends are unlikely to reverse anytime soon, and certainly not in 2008.

Questions of Supply

According to Charlie Maxwell, senior energy analyst at Weeden & Co., next year could spell trouble for the major independent oil companies such as Exxon Mobil (XOM) , Chevron (CVX) and BP (BP) .

Roughly 70% of the oil and gas reserves in the ground are owned by national oil companies such as Mexico's Pemex, and with crude prices near $90, the nationals will likely continue to receive favored treatment in lease auctions and drilling programs, potentially shutting out the publicly traded integrateds.

This is problematic, because national companies are notoriously inefficient at getting oil out of the ground. Maxwell predicts that non-OPEC countries will reach their maximum production capacity in 2008, with the infamous Hubbard's peak becoming a reality by 2014.

With global demand on the rise, we need every drop of oil we can get. Unfortunately, we won't be getting all we need from the nationalized concerns.
BP's recent deal with Husky Energy in the Canadian oil sands may represent increasing worries among the integrated giants that they are losing their foothold in territories such as Venezuela, Russia and Africa, where national firms hold sway, Maxwell says.

In BP's case, its decision to re-enter Canada might have been a move to shore up long-lasting reserves in an environment in which it feels comfortable. If others continue to confront hostility overseas, they may follow BP's lead and return to the relative safety of the West.

Maxwell also predicts that 2008 could be a tough year for companies in the refining space, not only the integrated oils but also names such as Valero (VLO) . Refinery utilization rates were lower than normal for most of 2007, with many facilities undergoing maintenance and repairs.

A number of refineries that were off line this year will likely return next year to provide a greater supply of gasoline and other refined products to the market, and that could pinch crack spreads and hurt profit margins.

Maxwell believes that global demand for oil next year will approach 87 million barrels of oil a day, while supply will only be 86 million barrels. If so, expect the price of oil to be somewhere between $70 and $90 a barrel, Maxwell says.

While these predictions aren't as dire as Boone Pickens' recent forecast of 88 million barrels of daily demand and 85 million barrels of supply next year, they still suggest that the market for crude oil will remain extremely tight, with practically no excess capacity from producers.

Maxwell says that the U.S. economy is likely heading for a recession in early 2008, and that will keep a lid on oil prices. Still, global demand for crude will likely remain strong and supply limited. These factors should prevent crude prices from sliding too far.

Economic Factors

For traders, 2007 was not just the year of $99-a-barrel oil. It was also a year of record volatility in the futures markets. Commodity trader Eric Bolling doesn't just believe that high volatility will persist in 2008, he believes it will increase.

"2008 is a presidential election year. We also haven't seen any major hurricanes in two years, and many traders think that it is time for another big one," he says. "Thus, I think we will see very high volatility in 2008, with both sides being traded. We could easily see oil go as high as $105 a barrel and as low as $75 a barrel."

Bolling also says that crude will continue to trade independently of petroleum product prices.

"Oil has traditionally traded with a high correlation to gasoline," he says. "However, oil and gasoline went their separate ways in 2007." That could continue next year, Bolling says.

Bolling doesn't believe that the U.S. is heading for a recession, but even if the domestic economy slows, growth in China and India will keep demand for oil strong, he says. "The notion that when the U.S. catches a cold the rest of the world catches the flu no longer applies," he says.

Crack spreads for petroleum products have risen from their 52-week lows in August, and energy stocks followed them upward through most of the fall. But oil stocks took a dive in mid-October and have yet to recover fully. The cause? The subprime mortgage mess, and worries about an economic crisis.
According to Brian Hicks, co-manager for U.S. Global Investors' Global Resources Fund, oil stocks, as represented by the Amex Oil Index, are no longer running parallel to commodity prices or to refining margins but are instead following the broader stock indices like the S&P 500.

"As goes the economy, goes the demand for crude oil," Hicks says. And the greater the demand for crude oil, the better that companies in the energy sector will perform.
The pattern was reinforced on Dec. 11, the day that the Federal Reserve met to decide whether to adjust its benchmark lending rate. The market was hoping for a 50-basis-point reduction, which would inject liquidity into the market and reduce the likelihood of recession, but the Fed only cut by 25. Upon the announcement, the Amex Oil Index immediately lost almost 2% in value, moving in tandem with Hicks' interpretation.
Heading into 2008, market participants will continue to focus on the strength of the U.S. economy and the potential ramifications it may have for the global demand for oil, Hicks says.

Alternative Solutions

If $99-a-barrel oil is one thing that 2007 will be known for, the arrival of renewable fuels and green technology as essential components of the energy mix is another.

Dan Pullman, principal at McNamee Lawrence & Co., says that a year ago he was educating people about the basics of solar power, biofuels and wind energy. "Now, conferences on this stuff are being held every week, and everybody is suddenly an expert," he says.

The interest in some type of renewables as investment vehicles will inarguably persist through next year, **Pullman** says.

Of course, as with many hot sectors, mood changes can occur at lightning speed. Corn-based ethanol, which was popular among investors just 12 months ago, is already out of fashion, as production capacity is surpassing government mandates and profit margins for the fuel have all but disappeared.

Some analysts believes companies like VeraSun (VSE) and Aventine Renewable Energy (AVR) should probably be avoided next year until prices for corn fall to a more reasonable level.

Pullman predicts that investors might adopt a more realistic mindset in 2008 and begin to place their investment dollars where they can expect quicker and more reliable results. One sector he believes offers excellent opportunities for growth is solar power.

"Solar power has lots of potential, especially on the venture-financing side and on the project-financing side of things," he says.

Companies he says are worth looking at in the solar space are Sunpower (SPWR) , Evergreen Solar (ESLR) and First Solar (FSLR) .

Another energy opportunity that could offer practical results in relatively little time is nuclear, **Pullman** says. Nuclear power will likely start making headlines as next fall's presidential election draws near.

Five companies filed applications to build new nuclear plants in the U.S. in 2007, including Duke Energy (DUK) , Dominion Resources (D) and NRG Energy (NRG) .
In short, there's no doubt energy will remain a front-and-center topic in the coming year, and that means investors will have to stay on top of the news, ready to act and willing to adapt.