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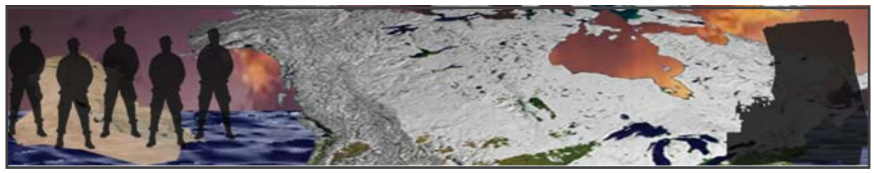

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October 2004

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GWEST
Global Water & Energy Strategy Team

FirstEnergy CAPITAL CORP.

To Our Readership:

Over the span of our last five issues, "The Global Politics of Energy" has examined a number of contentious and challenging issues ranging from Saudi Arabia's precarious circumstances, to Canadian-U.S. energy integration, to terrorist plans and priorities, to the increasingly significant role of the energy hubs of West Africa, the Caspian Basin and South America. In the process, we hope we have been able to provide insight and familiarity to a complex array of economic, political, security, military and strategic factors that are fast emerging as key elements in market calculations. As a Washington-based consulting firm, GWEST is proud, once again, to join with FirstEnergy in providing its clients with a product that serves "the need to know."

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Does Santa Have a New Landlord? By Frederick Cedoz

Canada's claims to territories above the Arctic Circle, including the North Pole, have recently been challenged by Denmark, Russia and indeed the United States.

In a world increasingly dependent on oil and natural gas, the geopolitical importance of hydrocarbon resources is indisputable. Since the beginning of recorded history wars have been fought over natural resources. And there is little doubt that if America isn't fighting one for, among other things, access to oil, now it certainly may face such a prospect in the future as worldwide demand continues to climb and all signs are pointing to the coming peak in non-OPEC conventional supplies. These realities are not new, but the potential battle front that has emerged above the Arctic Circle may be.

Ottawa must defend her historical claims to this territory; otherwise the potential for Canadian private sector oil and gas exploration and production companies to capture their share of the potential financial rewards of possibly the last great unexplored hydrocarbon reserve could be melting away.

The Race Is On

In addition to a rich cultural and political tradition, Canada has also been blessed with enormous land mass and tremendous natural resource wealth. Aside from Canada's conventional oil and gas production and her prolific unconventional oil and gas deposits, one key component of Canadian geopolitical strength literally lies in its geographic position on top of the world.

Much has been written about the heroic exploits of adventurers seeking a Northwest Passage to cut the travel time for trade shipments from Western Europe to the Orient. Ironically it may be the consumption of the same natural resources potentially locked under frozen ice packs that make Canada's historical claims to the Arctic north worth disputing.

According to reports in the *Daily Telegraph*, global warming experts estimate that "ice in the Arctic Ocean is melting at a rate of three percent per year."[1]

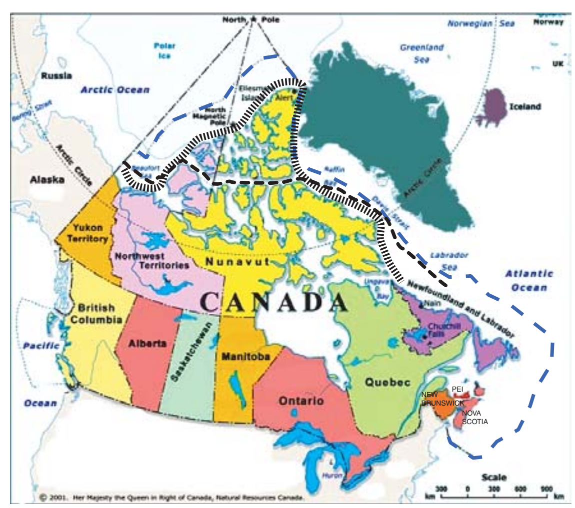
In addition to making the Northwest Passage more of a commercial reality for trading purposes, this new reality will also open up vast new territory for oil and gas exploration in an area surrounded by active hydrocarbon systems. The big question that has recently emerged is who will control one of the last unexplored natural resource reserves on the planet.

Canada's Historical Claims and Recent Show of Force

Canadian claims to territories in the Arctic Ocean extend back to 1924, though territorial assertions over the North Pole weren't manifested until the 1950s.[2]

The Canadian method of determining sovereignty over Arctic territory has been disputed by both the United States and Denmark. In fact, the United States government recently offered acreage in the Beaufort Sea, which the Canadian government has long claimed jurisdiction over, for lease to oil and gas exploration companies. The fact that no companies actually submitted bids is likely an indication of their not wanting to enter the international political maelstrom that boundary disputes between the United States and Canada would certainly entail.

Canada's Territorial Claims



---- Alternative Routes of the Northwest Passage
– – Canada's 19 Km Territorial Sea
Arctic Baseline, January 1, 1986

Source: Bowerman, Major, "Arctic Sovereignty," Department of National Defence, p. 9.

An International Court of Justice ruling from 1933 bolsters Canada's claims to all its present territory. But the mere fact that the U.S., friendly neighbor and largest trading partner, and Denmark, which is no military superpower, blatantly ignore Canadian sovereignty with claims to the Beaufort Sea and North Pole speaks volumes about the need for Canadian decision makers to aggressively defend its claims or face losing more than control over vast amounts of land, but also the resources that have drawn the attention of foreign suitors.

While most Canadian defense analysts agree that the fiscal efforts in balancing the federal budget in the 1990s led to a reduction in available funding for missions designed to defend Canadian sovereignty over its vast Arctic territory (some 40 percent of Canada's total land mass), recent military exercises in the region have been aimed at creating the impression among the world community that Ottawa has no intention of ceding control of its northern border.

An August 2004 military exercise code-named Narwhal was aimed at training troops to be able to comb the terrain in search of fallen satellite debris, according to reports by the *CBC*. "On his recent visit to the northern territories, Prime Minister Paul Martin said exercises like Narwhal are important 'to make sure that the rest of the world understands that this is Canadian territory," according to *CBC News*.[3]

At the same time, retired Major General Lewis McKenzie, himself a possible contender to lead the Conservatives, said, "I would say they're as much for Canadian benefit as they are for foreigners….In other words, get it on the record [so that] in the future, if we're challenged, we have a record of taking this issue seriously. It fulfills a purpose, it puts down a marker, and from a geopolitical point of view, it's certainly important."[4]

It is also important for Ottawa to establish a clear policy for dealing with unauthorized "visits" in its territorial waters by Russian and American nuclear submarines. Policy makers will also have to grapple with the coming environmental issues that increased commercial usage of the Northwest Passage will entail.

Denmark's Claim

Canada's eastern Arctic neighbor Denmark (through its internationally recognized sovereignty over Greenland) has recently declared its intentions toward Arctic territory claimed by the Canadians, including the North Pole. According to a report in London's *Daily Telegraph,* "the Danish bid is based on new geological data claiming to show that the Pole and Greenland - which has been owned by Denmark since 1814 - are linked by a 1,240km underwater mountain range, the Lomonosov Ridge."[5]

Naturally Denmark's primary motivation in asserting its claim to the North Pole is in capturing the potentially world-class hydrocarbon deposits believed to be situated under the Arctic ice cap. A secondary but perhaps equally important concern is in securing rights to the expanded Northwest Passage, which will be open to more commercial traffic as the ice cap continues to recede. Estimates from the Canadian Forces College indicate that "Utilizing the Northwest Passage would reduce the transit distance from Europe to Asia, by 8,000 kilometers."[6]

Europe to Asia

Europe to Asia
via the NW Passage: 15,000 km
via the Panama Canal: 23,000 km

Source: Canadian Geographic

Ships transiting the Northwest Passage would also be free of the charges currently borne by commerce transiting the Panama Canal.

Russia's Claim

Not one to ever be left out of a discussion of hydrocarbons' impact on geopolitics is Russian President Vladimir Putin. Russia made its claim for the North Pole in 2001. While this claim was rejected by the United Nations for lack of sufficient evidence of geologic links between Russia and the North Pole, it is certain that "'the Russians haven't claimed that area for nothing,'" according to Carleton University professor Nancy Doubleday.[7]

Russia's interest in the North Pole needs to be viewed in the context of the current state of world energy affairs. Kremlin planners, Putin chief among them, understand that the political, economic and military conflicts of the 21st century are likely to be centered around natural resources. China's growing energy needs combined with what many analysts predict will be a peak in non-OPEC crude oil production in the next two decades leave no room for doubt that securing access to stable energy supplies is at the heart of Beijing's foreign policy. And while the Chinese are out scouring the globe looking for oil and gas, making deals with Iran's Mullahs, the Khartoum government in Sudan, and Chavez's Venezuela, Russia is several steps ahead on the geopolitical chess board in attempting to control not only a sizeable portion of the volume of oil and gas that the world will demand in the coming years, but more importantly the routes by which that product will reach consumers.

Russia's interest in the Arctic Bridge program, which would potentially transport Russian natural gas via pipeline to Port Churchill on Manitoba's Hudson Bay shore, is another manifestation of its intent to control distribution networks for hydrocarbons in the 21st century. Such a project would no doubt be economically costly, but the political costs of having the activity serve as a foothold for future Russian sovereignty claims in the Arctic make the deal much less attractive for Canadian officials.

What's Next for Canada?

Issues of Arctic sovereignty and sustainable development of the potential world-class natural resource wealth locked under the ice must be met with a clear vision by Canadian political and military planners. It is clear from the competing claims over various pieces of Canadian territory of the U.S., Denmark, and Russia that planners in these countries sense opportunity to assert their own power and a certain weakness on the part of the Canadian government.

Fortunately it is not too late to counteract the challengers' strategy and secure Canadian control of the area not only for the economic and political benefit of the Canadian people who live in Nunavut but also those in the lower provinces who would be beneficiaries of the potential revenue to be derived from proper development of the area's resources.

To start, the government in Ottawa must continue the strategy of military exercises above the Arctic Circle and expand them to include war-like simulations. The Canadian Navy should be brought in for such exercises in order to prepare for real conditions of how to react to unauthorized commercial shipments through Canadian territorial waters as well as American and Russian nuclear submarine activity around the polar ice cap. Confrontations should not be sought out, rather a clear communication of Canadian intentions and sovereign claims to the region should be heard by those who have either been using the territory for transit or who have other designs on it.

These activities will no doubt require an increase in the Defence budget, but inaction now will prove far more costly in the future.

Secondly, further discussions regarding competing sovereignty claims should be discussed among the Arctic Council with the ultimate goal of clearly determining who is in control of what above and around the Arctic Circle. Only then will there be an ability to analyze what potential development might be environmentally and technologically appropriate for the region and what potential financial costs and benefits will be associated with such a final agreement.

Finally, interaction with private sector oil and gas companies with respect to Canadian political agendas north of the Arctic Circle is a must. If the old saying "possession is nine-tenths of the law" is still relevant at all, the government in Ottawa would be wise to begin plans for the encouragement of exploration and possible production from this potentially large hydrocarbon region before they are forced to explain how Russian pipelines and Danish cargo vessels appeared in their space.

No one expects anything less than peaceful and constructive negotiated settlements to the issue of Canadian Arctic sovereignty, but it is always prudent to be proactive and prepared to defend your rights and develop your land for the betterment of all Canadians, rather than to have to fight from behind in international courts.

(Footnotes)

[1] Coman, Julian, *Daily Telegraph*, "Denmark Causes International Chill by Claiming North Pole," London, 17 October 2004. Available online at http://www.telegraph.co.uk/news/main.jhtml;sessionid=DYJ0SXQ0EEMMZQFIQMFSM54AVCBQ0JVC?xml=/news/2004/10/17/wpole17.xml&secureRefresh=true&_requestid=316

[2] Bowerman, Major, "Arctic Sovereignty," Canadian Forces College, War, Peace & Security Program, CSC 28, p.4. Available online at http://198.231.69.12/papers/csc28/index.html

[3] "Military Exercise to Reaffirm Arctic Claims," 22 August 2004. Available online at http://www.cbc.ca/story/canada/national/2004/08/18/military_narwhal040818.html

[4] Ibid. Found online at http://www.cbc.ca/story/canada/national/2004/08/18/military_narwhal040818.html

[5] Coman, Julian, *Daily Telegraph*, "Denmark Causes International Chill by Claiming North Pole," London, 17 October 2004. Available online at http://www.telegraph.co.uk/news/main.jhtml;sessionid=DYJ0SXQ0EEMMZQFIQMFSM54AVCBQ0JVC?xml=/news/2004/10/17/wpole17.xml&secureRefresh=true&_requestid=316

[6] Bowerman, Major, "Arctic Sovereignty," Canadian Forces College, War, Peace & Security Program, p. 13. Available online at http://198.231.69.12/papers/csc28/index.html

[7] Gee-Silverman, Diana, "Polar Politics Heat Up," *Capital News Online*, Ottawa, 5 November 2004. Available online at http://temagami.carleton.ca/jmc/cnews/05112004/n2.shtml

Energy Policy & Policitical Capital — By Robert E. Heiler

A Look Ahead at George W. Bush's Second Term

Less than 72 hours after the results of the Presidential and Senatorial elections were known, Senate Majority Leader Bill Frist set the tone of Republican strategy on energy issues by declaring an intention to revisit the question of oil drilling in the Alaskan National Wildlife Refuge (ANWR) early next year.

ANWR
Map to
come

The measure that would have permitted drilling failed in the Senate last year by a single vote. With a net Republican gain of four Senate seats, not to mention the defeat of the determined obstructionist Minority Leader, Tom Daschle, in South Dakota, drilling in ANWR is sure to pass this time.

This is not the only indication of a Republican awareness of increased power, nor of an aggressive intent to wield it. Many indicators both on Capital Hill and at the White House foretell of a reinvigorated agenda for President George W. Bush's second term that will have far-reaching implications for the energy industry and for the economy at large. The sole political impediment to the implementation of his full agenda is Senate filibuster by the 44 remaining Democrats, possibly with cooperation from lone independent (and former Republican) James Jeffords of Vermont. Bush has already made several moves that challenge this obstruction.

Consider this as an aggressive, but plausible Bush political strategy:

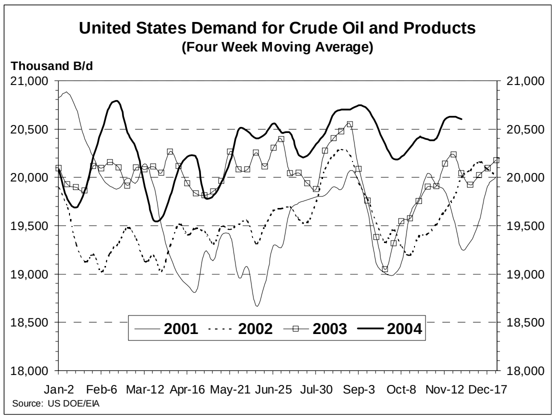
1. Bait the Democrats into overplaying the only ace they hold – Senate filibusters – on Cabinet personnel and judicial appointments. Gradually, over the next year and a half, paint the picture of a party frustrated by its minority status and therefore excessively obstructionist.
2. At the same time, consolidate your own party, largely in secret, around your core domestic political objectives: accountability in education, a plan for long-term solvency of Social Security, curtailing frivolous lawsuits, a coherent national energy strategy based on increased sourcing both domestically and with hemispheric allies, and possibly a flat tax.
3. In 2005, during an off-year election campaign with four more Democrat than Republican incumbents facing the voters, choose the one (or more) of these five goals that seems to be resonating most deeply with voters, particularly the ones in states with those 18 Democrats running for re-election. (Other factors weaken the Democrats' standing in the 2006 senate elections: Six Democrat incumbents are from "Red States" that recently went to Bush, while only three Republicans are from "Blue States" that voted for Senator John Kerry; all five senators over 75 are Democrats; and eight Democrats are first-termers, compared to just five Republicans.)
4. Then, one of two things will happen. Democrats that fear for their re-election may become more agreeable to escape the core Republican charge of excessive obstructionism. Or they may not, giving the Republican machine a heavy stick, possibly heavy enough to pick up enough seats to deliver a filibuster-proof majority for the final two years of Bush's tenure.

Effects On The Energy Market

Bush has a well-known preference for the power of markets and a desire to see them unencumbered by government interference. As a former oilman and advocate for robust economic growth, he naturally tends to gravitate toward energy solutions based on increasing supply, rather than curtailing demand. In addition, he is no doubt aware that almost no one in the environmental lobby or among those it persuades is likely to support his politics.

Thus Frist's declaration of intent to revisit ANWR drilling soon is no surprise. In addition, the pressures of the War on Terror are propping oil prices up and making the danger of dependence on the volatile

Middle East region ever more obvious. All of this suggests that Bush's administration will aggressively seek to promote increased domestic production. This may well be one of the motivators behind the flat-tax buzz, as such a reform would encourage both exploration and technological innovation, along with other forms of entrepreneurial activity (see *Stagflation & The Flat Tax,* in this issue).



But the U.S. demand for oil, as Bush and Vice President Dick Cheney surely know, far exceeds its production capacity even under ideal conditions. And the next logical step is to seek greater production from nations whose broader strategic interests are strongly aligned with those of the U.S. The most immediate and obvious of these are Canada and Mexico; in the next group are Venezuela (assuming reformers there ever succeed in ousting Hugo Chavez) and the countries of West Africa (assuming progress can be made on issues of financial transparency, good governance and regional stability). Moreover, this administration is aware that production is not the only problem in the supply chain. Excessive regulation (dozens of different gasoline blends) and environmental rules discouraging new refineries (none has been built in the U.S. in over 20 years) are likely to draw fire from Bush II.

It is these other considerations within the production chain that should concern Canadian producers. Oil Minister Murray Smith observed why in the October 18 *National Post*: "The great pipeline race has commenced. If we don't get Mackenzie gas to market now, Alaska will eclipse the Canadian project because of the resources it takes. The Alaska project is so large it will take all the attention of shippers and pipeline companies."

Warning that the U.S. will make the pipeline project of national interest, and fast-track the construction if natural gas prices climb above $8 per tcf, Smith continued: "Once the Americans mobilize to do something, look out. This is a country that can put resources, effort engineering technology at a focused point and deliver results in the shortest period of time. If anyone ever doubts American resolve to solve a problem of a colossal nature, they are underestimating the American people."

The window, however, for the Canadian energy industry to capture the American market share remains open, particularly if the Iraqi elections are delayed or problematic, or if *al Qaeda* or another terrorist group manages another attack on U.S. soil. In fact, Canadian companies might do well to seek American assistance in developing infrastructure that will benefit both them and their customers south of the border.

Readers of *FirstCommentary* may recall the analogy of American purchase of Canadian oil to buying a pickup truck from one's brother-in-law. In the next four years, the Bush administration may well go the extra step of seeing the benefits of investing in the brother-in-law's growing auto dealership. And because of the geopolitical pressures of the War on Terror and steadily growing demand in China and India, a return to the $20-per-barrel (and below) prices of the 1990s looks increasingly unlikely. All of this makes investment in the higher-cost production of unconventional oil, and the refining capacity required to use it, more attractive every day.

Moreover, sustained high oil prices have multinational production giants reaping record profits. They are paying down debt and buying back stock in large quantity, all of which positions them for an aggressive round of acquisition, aimed squarely at augmenting reserve base and daily capacity. In a time of geopolitical uncertainty, investment in a region where production cannot be threatened short of an invasion of North America is particularly attractive – a trend first predicted in *FirstCommentary* in a piece titled, "U.S. Energy Policy: A Rich Divorcee Re-Enters The Market," in May 2003.

In short, the Canadian energy industry should prepare itself for a greatly increased level of attention from both the U.S. energy policy community and from players of all sizes in the American private sector. If Canadian players have thought they were experiencing a busy time lately, they ain't seen nuthin' yet.

Canada & The Second Bush Administration

By Harold M. Waller

Canada may have a hard time adjusting to the second Bush Administration. Many Canadians have found it exceedingly difficult to deal with the idea of George W. Bush in the White House during the past four years. Both his style and his policies have been off-putting to many citizens of the United States' northern neighbor. Their dispositions have been reinforced by media commentary and attitudes. Thus it was hardly surprising that just before the recent presidential election, a poll found that some 75 percent of Canadians preferred John Kerry to George Bush.

As the new Administration considers its options regarding energy, the response in Canada will not be based solely on provisions that directly have an impact on Canada. Issues that appear to be purely domestic will be scrutinized in a Canada that is highly skeptical of almost anything President Bush does. Given existing Canadian attitudes about the environment, initiatives such as drilling in ANWR or easing EPA regulations may further antagonize Canadian public opinion.

U.S. Energy Policy and Canada

It is likely that President Bush will propose decreasing U.S. reliance on OPEC oil and compensating with petroleum from the Western Hemisphere, namely Canada, Mexico, and even Venezuela, as well as West Africa. That point has been stressed repeatedly in previous issues of *FirstCommentary.*

Canada, mainly in Alberta, now has oil reserves second only to Saudi Arabia. So the potential value to the U.S. market is exceptionally important. This historical juncture, wherein the U.S. must contemplate a major shift in the direction of Canada, offers great opportunities for both countries. The U.S. can use Canada to help wean itself from unstable, unreliable, insecure, and even hostile producers while Canada can revolutionize its political economy and ensure affluence for many years to come.

Given the seriousness of the petroleum situation, it is highly likely that energy policy will be among the top priorities of the second Bush term. Domestic political considerations may determine exactly how high a priority it will be. Admittedly there has been much more talk about such issues as taxation and independent investment accounts for Social Security than about energy during the few weeks since the election. Moreover, at the time of this publication the price of oil has leveled off at about $50/b. That is historically very high in nominal terms and translates into intimidating prices at the pump, especially in certain parts of the country. So initiatives in this policy area can be expected early in the new year.

Obviously drilling in ANWR will be the first step; approval by Congress is a foregone conclusion. That immediately raises two issues in Canada. The first is environmental. Although Canadians do not have any responsibility for environmental matters in U.S. territory, at this juncture Canadians do appear to have greater concerns about the environment than Americans do. So if they are convinced that drilling in ANWR despoils the environment, they may not be too keen to accommodate the U.S. on policy matters that are under their control. That leads to the second issue, transport of the ANWR oil from Alaska through Canada to the U.S. market. Since new pipelines will be required, there is likely to be a strenuous struggle to gain parliamentary approval. Regardless of the route chosen, building a new pipeline in itself raises environmental issues in Canada, and possibly questions of Aboriginal land claims. To what extent are Canadian politicians going to be well disposed to help the U.S.?

Accelerating Oil Sands Development

Over the longer term, the issue with greatest salience for Canada is the accelerated development of the oil sands as a reliable major source of oil for the American market. Already the oil sands produce in excess of one million Bbl/d. Expectations are that the output will steadily increase over the coming decades. The key question is whether increasing injections of capital for both research and development, capital that would surely have to come from the U.S., can increase the rate of expansion of production. At $50/b such oil is economically viable. But expansion of production will require substantial investments in infrastructure with all the attendant environmental issues.

Increased output, primarily from Alberta, creates some domestic problems as well. Alberta is already the richest province and is about to reduce its debt to zero. Under the existing equalization policy the few "have" provinces must share their wealth with the many "have-nots." So far Alberta has gone along with the federal government on that. But if its revenues should increase dramatically, provincial politicians would likely be under popular pressure to find a way to retain more of the windfall that is seen as a guarantee for Alberta's future.

Another by-product of increasing oil revenues is likely to be the continuation of the stunning rise in the exchange rate. During the past two years the previously ailing loony has rocketed from about 62 cents U.S. to over 84 cents. Admittedly this is primarily due to the fall of the U.S. dollar on international markets. But higher prices for commodities like petroleum have contributed as well. As the exchange rate has risen, Canadian manufacturers have been bleating about how their products for export are rapidly becoming uncompetitive in the U.S. market. (Who was complaining about the plight of ordinary Canadian consumers when the currency was plunging?) The government is certainly aware of the complaints but so far has not granted any relief. However, there is likely to be increasing tension between the government and the Bank of Canada if the Bank continues to raise interest rates gradually to stem inflation because such action makes Canadian dollars more attractive and therefore contributes to a rise in the exchange rate.

On balance, Canada may already be enjoying the economic opportunity of a lifetime. But in order to benefit fully, the government, already in a difficult and complex minority situation, will have to manage a number of conflicting positions domestically while tending to a troubled relationship with the United States. The fact that Canada is already considering imposing retaliatory economic sanctions on certain products from the U.S. because of the softwood lumber dispute suggests that rebuilding Canada-U.S. relations in the context of energy policy will be a complicated and highly challenging task. It is likely to lead to fractious political conflict internally, both in the federal and federal-provincial arenas, in addition to the dilemma of how Canada can hold its own as it deals with its dominant trading partner that has ten times its population. Prime Minister Martin is facing an intimidating range of problems, but also the potential of great rewards for his country.

Harold M. Waller is Professor of Political Science at McGill University.

Asymmetrical Economic Warfare - The Oil Market as Battlefield

By Paul Michael Wihbey

A few days before the U.S. elections, Osama bin Laden made one of his rare appearances on a videotape broadcast by Al-Jazeera television. The 18-minute recording was remarkable not only for bin Laden's blatant attempt to influence the outcome of the Presidential vote, but for his unambiguous dedication to employ an economically driven terror strategy to defeat the United States.

The basic message was that Al-Qaeda would confront the United States in a war of economic attrition using insurgency in Iraq and Saudi Arabia as the preferred means to manipulate the world oil market in the hopes of undermining a structurally weak American economy with untenable high oil prices. These high prices would be generated by actual and threatened disruptions of the supply chain.

Bankrupting America

Bin Laden was very clear about the application of this new warfighting doctrine which has a battle-proven calculus and is not only highly-cost effective, but maximizes the economic impact of Al-Qaeda terror tactics:

> *"All that we have to do is to send two Mujahadeen to the furthest point East to of cloth on which is written Al-Qaeda, in order to make the generals race there to cause America to suffer human, economic and political losses without their achieving for it anything of note other than some benefits for their private companies. This is in addition to our having experience in using guerrilla warfare and the war of attrition to fight tyrannical superpowers as we, alongside the mujahadeen, bled Russia for ten years, until it went bankrupt and was forced to withdraw in defeat….So we are continuing this policy in bleeding America to the point of bankruptcy…for example, Al-Qaeda spent $500,000 on the event (9/11 attacks), while America, in the incident and its aftermath, lost—according to the lowest estimate—more than $500 billion, meaning that every dollar of Al-Qaeda defeated a million (U.S) dollars besides the loss of a huge number of jobs."*[1]

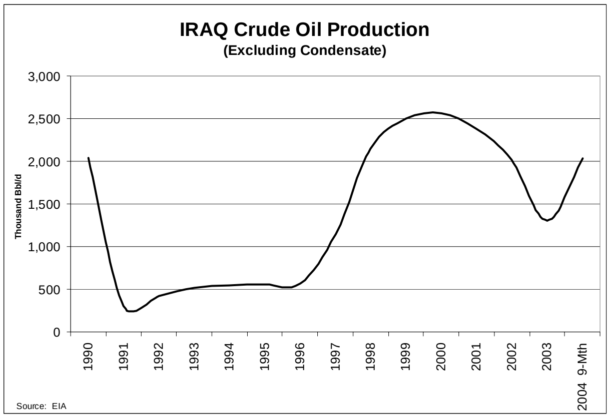
Bin Laden's statement communicated three important messages to receptive audiences in the Arab/Islamic world. First, that the 9/11 attacks did not result in a decisive victory against the United States with the consequence that the Americans reacted aggressively and unexpectedly against targets in the Islamic world. Second, Al-Qaeda and the Taliban could not defeat the United States in Afghanistan using classic or conventional guerrilla warfare. Third, that Iraq provides Al-Qaeda the perfect platform to implement a new operational strategy that, if successful, would not only 'bleed the American economy into bankruptcy' but also allow for that strategy to be exported to other Gulf oil producing areas such as Saudi Arabia or conceivably, through the use of mercenaries, to oil-producing regions of Latin America or Africa.

The words of bin Laden specifically reveal a dedicated effort to leverage the $400 billion-plus American deficit to advantage by forcing an unacceptable financial cost on the Bush Administration in its prosecution of the global war against terrorism and security measures to protect the American homeland.

> *"As for the economic deficit," Bin Laden said, "it has reached record astronomical numbers estimated to total more than a trillion dollars. Even more dangerous and bitter for America is that the* mujahadeen *recently forced Bush to resort to emergency funds to continue the fight in Afghanistan and Iraq, which is evidence of the success of the bleed-until-bankruptcy plan."*

The Iraqi Oil Infrastructure – Theatre of Operations

The "bleed-until-bankruptcy plan" is an Al-Qaeda euphemism for a systemic campaign to sabotage Iraq's oil infrastructure and related sectors, such as electricity and water, to defeat long-term American



plans for political stability in Iraq that would eventually permit Iraqi crude production of 5-6 million Bbl/d. In the short-term, a host of terrorist and guerrilla tactics (i.e. disruption of electrical output; attacks on pumping stations and refineries) has cut Iraqi crude exports by as much as two-thirds to 1.5-1.7 MmBbl/d, resulting in an anticipated $20/yr billion shortfall in revenue to the Iraqi treasury.

The lack of security has forced the Iraqi government to commit at least 20 percent of its reconstruction funds for security purposes, including more than 10,000 security personnel to guard the all-important 4, 000 miles of pipelines. This network has have suffered over 150 attacks, including 60 significant attacks since the export routes were reopened in June 2003. As Al-Qaeda and its Iraqi allies, led by Abu Musabi, target those routes, they aim to cripple the industry; and with little storage capacity, the entire system comes to a stop when the flow of crude is disrupted.

In June, Prime Minister Iyad Alawi claimed that sabotage had cost Iraq over $200 million since November 2003. The high-risk security environment has prevented any serious commitment by international energy firms or lending institutions to rebuilding the country's oil sector, an undertaking that will require an estimated minimum of $40 billion. Escalating murderous assaults on Iraqi police and national guardsmen are creating a climate conducive to achieving bin Laden's goals: destabilizing Iraq to the point where the political process ceases to function (i.e. delay of the January national elections) and inflicting on the U.S. diminishing economic returns in the form of significant crude volumes taken off-market resulting in a volatile, high-price market environment.

Combined with surging Asian demand and limited excess capacity, the Iraqi crude shortfall is contributing to a geopolitical risk premium in the $10-15/Bbl range. The fear of an unchecked sabotage campaign against the pipelines and the inability of the Iraqis to make the necessary repairs fast enough is one of the key reasons that U.S. forces launched their recent attack on the insurgency/Al-Qaeda stronghold of Fallujah. Whether the assault marked a decisive victory over the enemy or resulted in their displacement to other localities to continue the fight remains to be seen. If the markets are any indication, the jury is still out.

Linkage: Risk Premium & Tipping Point?

Viewed from the perspective of Al-Qaeda, the battle for Iraq is a fight for control over one of the main levers of oil market stability and pricing. Continuing instability and chaos over one of the largest estimated pools of proven reserves (115 Bbl), and a realistic potential production volume that would be third on the planet, generates a powerful weapon against American economic growth and signals its applicability to Iraq's next door neighbor – Saudi Arabia.

Interviewed in the June 1, 2004 issue of the Christian Science Monitor, Saud al-Sarhan, a Saudi Al-Qaeda analyst, said, "Hurting the US economy is a longtime Al-Qaeda goal and is one of the reasons the World Trade center in New York was targeted. They're now striking these oil-related sites in Saudi Arabia in an attempt to keep prices high and hurt the U.S. economy."

Although Sarhan was referring to attacks at Saudi oil installations in Yanbu and Khobar, his conclusion as to Al-Qaeda's ultimate goal is correct – maintain pressure on the market through supply disruptions and destabilization (perceived or actual) of key suppliers.

This warfighting doctrine was best exemplified by the chief of Al-Qaeda operations in Saudi Arabia, Abdul Aziz al-Miqrin, who said of the Yanbu attack, "The Yanbu cell which carried the daring and successful attack is one of the best examples…They hit the enemy in an important economic facility which had a big effect on world oil prices which continues to this day."

The attacks in Saudi, no doubt, contributed to oil prices climbing above $40/b in June and then reaching over $50/b two months later as the Iraqi oil-driven insurgency ratcheted up. Each spike represents a 33 percent and 66 percent increase over the $30/b "high" of November 2003 and 100-150 percent increase above the $20/b plateau of the 1990s.

Al-Qaeda and its allies clearly have the U.S. deficit, interest rates and inflation as their navigational guides to engineer an economic recession in America by undertaking actions that could spike prices over $60/b for a prolonged period of time. What is the tipping point for the U.S. economy? Some analysts suggest that for every $10 risk premium of terrorism, a minimum of $50 billion is drained from consumer spending representing .5 percent of GDP, which in turn could push the GDP into the recession risk zone of 3.7 percent to 2.5 percent GDP. As the U.S. trade deficit continues to grow (over $400 billion) with 20 percent going to pay for imported oil ($12 billion in August), American planners will need to understand Al-Qaeda's shift of strategy for what it is: the first fully calculated international campaign to apply asymmetrical warfare techniques to the battlefield of the global oil market.

[1] Note: The authoritative Government Accounting Office (GAO) of the U.S. Congress estimates the direct and indirect costs of 9/11 at $83 billion.

Greenspan's Remarks Should Embolden Canadian Producers

By Frederick Cedoz

Alan Greenspan recently provided the National Italian American Federation meeting with an interesting history lesson on the rise of oil's importance to and impact on the U.S. economy.

Though not billed as a policy speech, Mr. Greenspan laid out a policy roadmap after taking his time to explain how the current high relative energy prices will not likely have the same impact on the U.S. economy as previous periods of high prices following times of geopolitical uncertainty (the Arab oil embargo of 1973, and the 1979 Iranian revolution).

U.S. Economy Can Withstand Current Prices

According to Mr. Greenspan, "The impact of the current surge in oil prices, though noticeable, is likely to prove less consequential to economic growth and inflation than in the 1970s."

With respect to the importance of geopolitics on world oil prices he noted, "We and the rest of the world doubtless will have to live with the uncertainties of the oil markets for some time to come."

This is similar to what we recently wrote in "The Gathering Perfect Energy Storm?" *FirstCommentary* October 2004, pp.3-7, "OPEC's relative ineffectiveness [in controlling prices] is a result of a combination of factors coming together simultaneously…." Among these, without question, is the steady rise in the impact of geopolitics on oil prices since the last oil shock in the late 1970s.

The geopolitical instability that is helping push prices to new record highs almost daily will likely lead to a reversal of the trend against exploration we noted (essentially returning profits to shareholders rather than focusing on improving recycle rates) and lead to improvements in technology that will, according to Mr. Greenspan, "ensure the needed supplies (of energy) for a very long while."

He also noted that new technology and pricing inelasticity eventually paved the transition from wood to coal to conventional oil and now into the unconventional sources as means of meeting the world's energy needs. Eventually, it is hoped, technology will enable some reduced dependence on oil as an energy source.

The noteworthy things to take away from the Fed Chairman's remarks, aside from the moderate calming effect it had on the broader U.S. stock market, are that he believes that 1) the U.S. economy can withstand the current high oil price environment, 2) geopolitical uncertainties will continue to affect oil prices, and 3) the current high price environment will simultaneously destroy some demand and lead to an increase in exploration and eventual production.

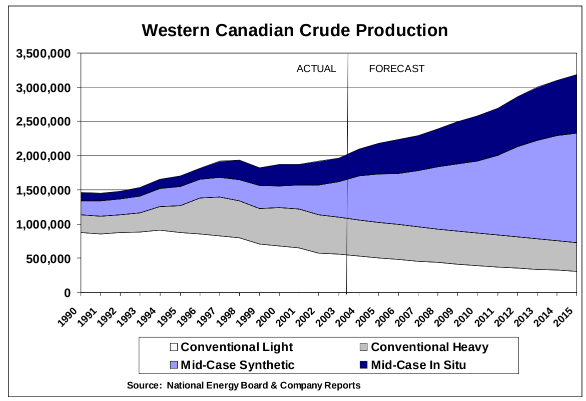
The context of these remarks for both Canadian producers and American consumers seem to us unmistakable. Notably that if the U.S. economy can withstand the current price environment, the Administration will not likely seek to artificially lower prices in the short term through manipulation of the Strategic Petroleum Reserve. This is important for producers' hedging and exploration strategies. While some relief from the mid $50s pricing is likely in order, virtually no one is predicting a price crash similar to that of the late 1990s.

And with Mr. Greenspan's realization of the impact of geopolitical uncertainty on the oil markets comes an acceptance of our principal tenet that stability of oil (and indeed all energy) supply is trumping pricing of that supply among U.S. policy planners. This naturally bodes well for Canadian producers and should lead to an increased enthusiasm for oil sands projects as well as coal bed methane projects.

Tough Decisions in the Board Room

Understandably many Canadian oil company executives have had difficult decisions to make regarding continued expansion of various oil sands projects in the face of rising costs and a continued difficulty in attracting skilled workers to operate in one of the world's most challenging climates. Several of the larger projects have experienced cost overruns on the order of 30%, which begs the question of whether oil prices will remain high enough for long enough to justify spending billions in capital expansion projects rather than merely returning that capital to shareholders as many other oil companies are doing.

The decisions to continue with planned expansions and to announce additional projects will likely be proven providential even though prices may settle at something less than $50/bbl, (FirstEnergy estimates an average in the mid-high $30s for 2005) as the announcement of major new conventional oil discoveries is continually dwarfed by current and expected growth in worldwide demand. Whether non-OPEC conventional production has already peaked or will in the next 20 years is a question for analysts to debate almost certainly after the fact. What is certain is that Canadian conventional crude production has already begun to decline. According to the Canadian Association of Petroleum Producers, "in 2003 [Canada's] total conventional light and heavy production was 1,120,000 b/d, and by 2015 this declines to 600,000 b/d."



Current and future expansions of Canada's massive unconventional oil sands deposits are necessary not only to prevent Canadian production from declining, but to grow total production and with it Canada's importance as a world leader in hydrocarbon production and export.

The Squeaky Wheel Gets the Grease

Essentially the sport of geopolitics in the world hydrocarbon markets is one where the squeaky wheel gets the grease. In simplest terms Canada is the wheel and the U.S. capital markets and consumers are the grease. Some backfilling of the issues important to both sides (refining capacity, pipeline routes, environmental concerns, effects of expanded production on Canadian natural gas production, etc.) should be discussed among Canadian oil company executives and government officials on both sides of the border. But projects of this magnitude and importance to so many constituencies (Canadian oil company workers and shareholders, the provincial and federal treasuries, and American refinery operators along with their workers and shareholders, and drivers) are not likely to get bogged down over minor disagreements.

The U.S. government has just announced, through its most powerful economic policy voice, that the American economy can withstand the current price environment. The ball is now in the producers' court.

The Validation of Murray Smith & the AEUB

By Paul Michael Wihbey

"IEA calls on all parties to work together to devise and implement a universally-recognized, transparent, consistent and comprehensive data system for oil and gas reserves."

"Doubts about the accuracy of reserves estimates could undermine investor confidence and slow investment. Governments should be concerned about reserves-data problems, since the long-term security of energy supplies depends on the development of oil and gas reserves." (emphasis added)
—***World Energy Outlook 2004***, International Energy Agency, Paris, Oct. 26, 2004.

The recently released IEA annual report on the global energy condition was an extraordinary document, not least for the validation of Murray Smith, Alberta's recently retired Minister of Energy and the EUB (Energy & Utilities Board).

As reported in the last issue of *FirstCommentary* (The Geopolitics of Oil Reserves: Alberta Transparency and Saudi Secrecy), in June 2003, Smith challenged Saudi Arabia and all national oil accounts to open their books for external examination by the IEA and the U.S. Department of Energy to determine the true reserve numbers in each oil-producing jurisdiction. And while the Saudis publicly declined to meet Alberta's offer because it would, in the words of Saudi Oil Minister Ali al Naimi "allow you to figure out reserves," the global community's energy monitor in Paris, the International Energy Agency, has taken up the clarion call from Edmonton for transparency and accountability in the calculations that determine proved oil reserves.

The "Smith Doctrine"

The IEA recommendation advances the "Smith Doctrine": that governments and not just private-sector oil companies need to be held to an empirical and scientific standard if investors really want to be safeguarded against fraudulent or exaggerated claims with respect to a given reserve base. With the IEA estimating that $16 trillion in energy investment will be required by 2030 (or $568 billion annually) to meet anticipated demand, the competition for those massive capital flows necessitates that sufficient, verifiable data be available to justify risk-conditioned decisions taken in boardrooms and with stockholders.

Given the high-risk security environment of the Persian Gulf and the need for massive infrastructural outlays in Saudi Arabia, Iran, Iraq, the capital markets will need to be reassured that reserve estimates have not been miscalculated or overbooked. As the IEA reports rightly states, "The global financial system has the capacity to fund required investments, but it will not do so unless conditions are right."

As a consequence of the Agency's new position on reserve numbers, it is likely that the U.S. Department of Energy's Energy Information Agency (EIA) and/or other U.S government bodies will encourage and develop the qualitative criteria on reserve estimates on the model of AEUB's methodology. DOE's predisposition to the claims of the AEUB, despite the contrarian view taken by the BP's 2004 Statistical Review of World Energy, was detailed in the EIA's 2003 International Energy Outlook insert, "And the Country With the Second Greatest Proved Oil Reserves Worldwide Is…."

Citing the Oil & Gas Journal's acceptance of AEUB methodology to include oil sands deposits in its definition of proved oil reserves, the article declares, "Heretofore, oil sands were considered 'non-conventional' and were not counted

Reserves of Crude Bitumen (Billion Barrels)

Recovery Method	Initial Volume In-Place	Initial Established Reserves	Cumulative Production	Remaining Established Reserves	Remaining Reserves Under Active Development	Active Developed Reserve Life Index
Mineable	113.2	35.2	2.9	32.3	8.0	35.6
In Situ	1,515.0	143.4	1.3	142.1	2.8	22.0
Total	**1,628.2**	**178.5**	**4.2**	**174.4**	**10.8**	**30.7**

Source: Alberta Energy and Utilities Board as proved oil reserves; however, dramatic reductions and developments in productions costs have brought oil sands into the realm of economic viability. With today's technologies and oil prices, it is entirely appropriate to consider western Canada's vast oil potential as being commensurate with conventional crude oils."

The feature continues, "The only thing that prevents Canadian oil sands production from being considerably higher (both now and in the future) is the lack of transportation infrastructure (most likely pipeline capacity) from moving production to market…if potential pipeline projects into PADDs II and IV materialize over the next two decades, the share of Canadian oil sands production going to U.S. imports could grow substantially."

High Price/Non-conventional/Non-OPEC vs Low Price/Conventional/OPEC

In a remarkable, thought-provoking discussion of future oil market scenarios, the IEA report contrasted its "Reference" scenario of $25/b crude with an "Alternative" scenario at $35/b. The former pricing environment would accrue to the benefit of OPEC with the cartel's global market share increasing to 56% by 2030 from the current 36% (including Iraq). However, the higher price range foresees a retreat on demand and resulting benefit to non-OPEC producers.

> *"Higher oil prices are profitable for (OPEC) exporting countries in the short-term," the report says, "but lead to lower revenues in the longer term…higher oil prices would encourage the development of reserves outside OPEC, as marginal fields become commercial."*

The IEA Outlook concludes that $35/b oil would spur increased production of non-conventional deposits such as the Canadian oil sands, resulting in the non-conventional production share of world oil supply increasing 5-fold from 2% (of 82 MmBbl/d) today to 11% (of 121 MmBbl/d) by 2030.

But, based on both the geopolitical risk premium and on still-surging demand in Asia, the market may have already reached consensus that, 1) return to a price range in the $20s is highly unlikely, and 2) that mid-$30s is a reasonable home for current and projected crude values. Hence, the IEA higher-priced alternative scenario may soon become the "reference" scenario, further consolidating the significance of the AEUB's December/02 decision to boost Canadian proved reserves from 4.9 bb to 180 bb, second only to Saudi Arabia.

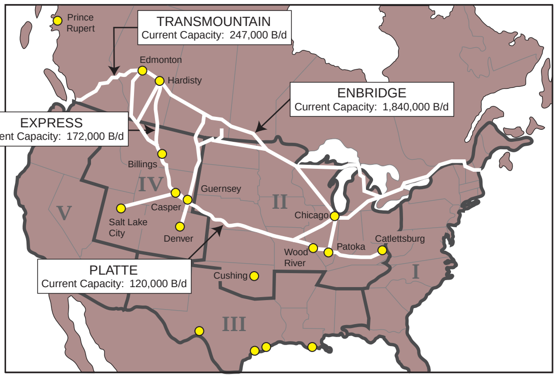
This higher-price outlook was given further credence by Sadad Al-Husseini, the former head of Saudi ARAMCO E&P, who the left the state-run company in March/04. Interviewed in The *London Daily Telegraph* on Oct. 31, 2004, Husseini, speaking to the issue of Saudi crude production, said: "The excess capacity is no longer there. That will mean more of the volatility and price surges. And the financial markets have yet to wake up to that. I suspect prices around $50 will be with us for a while." And as to whether Iraq could provide additional capacity, Husseini predicted, "I doubt they can exceed 3 MmBbl/d by the end of this decade."

The Beginning of a Beautiful Friendship

Echoing Husseini's concerns, the IEA delves into the impact of geopolitical circumstances impacting market conditions across the entire supply chain.

> *"Major oil and suppliers, including most OECD countries, China and India, will become ever more dependent on imports from distant, often politically unstable parts of the world," the report predicts. It continues: "Most of that additional trade will have to pass through vital chokepoints, sharply increasing the possibilities of a supply disruption… wells or pipelines could be closed or tankers blocked by piracy, terrorist attacks or accidents." According to IEA Executive Director, Claude Mandril, "oil markets are likely to become less flexible and prices more volatile."*

Major Oil Pipelines from Canada to the United States



Source: Terasen Inc., Enbridge Inc.
note: Petroleum Administration for Defense Districts (PADDs) are shown in roman numerals.

As reported in previous issues of FirstCommentary, geopolitical changes are a key driver in a volatile and changing global energy market; however, technological advances and skilled application of operating economics have made the Canadian oil sands a premier investment opportunity. As Mark Friesen and Steven Paget recently pointed in *FirstFocus: Oil Sand—The Future is Bitumen*, "The largest oil deposit in the world outside of Saudi Arabia deserves attention….With respect to operating costs, industry is addressing these pressures with economies of scale, improved efficiencies and by developing more energy efficient processes."

Projected higher prices, market volatility, lack of excess capacity, massive oil sands reserves, have come together to redefine the global market in a way that few would have foreseen just a few years ago. Alberta now stands as the new center of gravity in non-conventional crude production, and if the Smith Doctrine is applied, as will likely be the case, Canadian proved reserves could very well become the number one ranked deposit in world.

Stagflation and Tax Code Simplification

By Mark Broxmeyer

The current environment of high energy prices, large deficits and creeping interest rates represents a significant danger to the US economy, one that requires careful thought before making changes to the tax code. But significant changes may be required to avert a repetition of Carter-era stagflation.

High energy prices drive up operational costs for virtually all businesses. High interest rates, by definition, increase capital costs. Squeezing entrepreneurs between these two daunting forces lowers the bottom line for every conceivable project. Fewer initiatives get the green light, resulting in sluggish or nonexistent growth. Worse, businesses of all types, in an attempt to protect their shrinking margins, raise prices. The result is spiraling inflation, little or no real GDP growth, and rising unemployment as businesses cut costs. In a word: stagflation.

Clouds On The Horizon

Despite some sunny indicators, the U.S. economy is currently threatened by this scenario. Some have suggested that the lesson of Reaganomics was that deficits do not matter. They are only partially correct. Deficits matter little provided the economy as a whole is growing. But deficits in a low-growth environment matter a great deal, as the expenditure for debt service takes progressively larger bites out of overall GDP. Furthermore, instability in the Middle East, or another domestic terror attack, could bring about a dramatic economic contraction. Inflated oil prices have already helped retard GDP growth.

Deficit financing is not unlike high personal finance, where leverage is everything. In a personal corporation or other type of business, running a deficit is not necessarily a sign of weakness, provided that a plan exists for returning to solvency. Such a plan is always dependent upon growing the business. Very few businesses succeed without running a deficit at some point. Borrowing is the key to growth: that's why we call it *capital*ism.

But the U.S. Treasury's borrowing plans could be in trouble. During the last 18 months, up to 40 percent of our public Treasury auctions have been purchased by foreign central banks (largely China and Japan). If those governments should lose faith in the U.S. Government's fiscal policy and suspend or sharply reduce their purchases of U.S. debt, the negative impact on our currency and treasury market will be substantial. U.S. Treasury financing costs would rise substantially. This in turn, would drive domestic interest rates sharply up, beginning the nasty spiral outlined above.

Maintaining Foreign Investor Confidence

We will avoid this scenario if we continue to post strong GDP growth numbers, thereby reinforcing foreign government confidence in the health of the U.S. economy, sustaining capital inflows, supporting a stronger U.S. dollar, and a vibrant U.S. bond market. And the best way for the government to accomplish that is to consider tax reform that incentivizes entrepreneurial activity.

The best way to accomplish this and one receiving attention recently, is a greatly simplified tax code. The 60,000-page U.S. tax code is the product of ad hoc efforts to use tax law to encourage or discourage all kinds of activities, creating a ridiculously complex system that is an extended celebration of the concept of unintended consequence.

A lower, more consistent tax rate, with a bare minimum of allowed deductions, would eliminate the ability of the wealthy to avoid taxation through complex strategies devised by lawyers and accountants. In addition, it would allow millions of tax payers to compute their tax liability on a post- card, eliminating billions of man-hours.

Retaining Progressivism

Tax code simplification is not a panacea. In fact, it would work best if combined with other changes that would preserve some progressivism in the overall tax structure. Luxury taxes, for example, on big-ticket items purchased almost exclusively by the wealthy could be retained. Many remember such a tax levied on luxury cars, boats and airplanes as disastrous; but that was because it was indexed at nearly 10 percent, an onerous burden that threatened to destroy the industries it targeted. In combination with a less graduated income tax with fewer deductions, such a luxury tax could be levied at a far lower rate, preserving the concept of progressive taxation without unduly impeding activity in the sectors affected.

President Bush's economic team deserves credit for delivering growth during wartime, especially given the far-reaching and seldom-discussed impact on the economy of the September 11 attacks. But now is no time to let up. Continuing to deliver that growth in the face of very high oil prices will be difficult, and will require thinking outside the box, particularly on questions of taxation. A simpler, fairer tax code would be a very good start.

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