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Global Water & Energy Strategy Team

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MORE ENERGY THAN EVER

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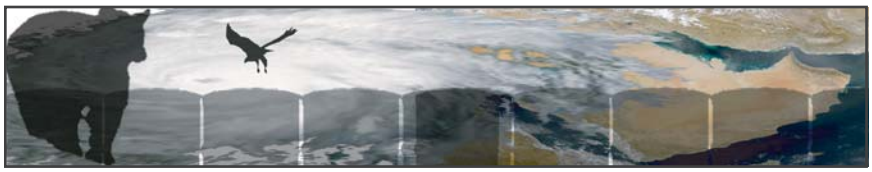
The Global Politics of Energy

A FirstEnergy Capital Corp. and GWEST Collaboration



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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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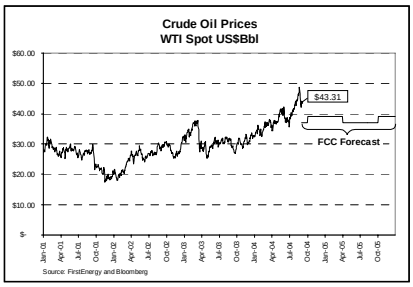
The Gathering Perfect Energy Storm?

By Frederick Cedoz

OPEC has been declared dead many times before. The cartel that controls 35 percent of daily world oil production and prides itself on its ability to control world oil prices always bounces back from reports of its imminent demise. So with prices increasing in spite of OPEC's best efforts to cool the market, one must ask: are things different this time and will OPEC survive as a price controlling mechanism?

The more than 25 percent run up in crude oil prices since July is more about geopolitical risk associated with myriad factors, from insurgency in Iraq halving production, Russia's not-so-thinly veiled nationalistic aims with YUKOS, which produces 1.7 Mm B/d (the same as Libya) and the referendum on Hugo Chavez in Venezuela (the world's fifth largest exporter of oil), than traditional supply and demand.



All of these factors have effectively crystallized the geopolitical risk premium at between $10-15/barrel. Add to that conventional and seasonal problems, like hurricanes in the Gulf of Mexico disrupting more than 1.5 million barrels per day (Mm B/d) of production, rampant hedge fund speculation, and the forward sale of production by oil companies and you have a recipe for the current price environment.

Effect of High Prices on OPEC's Power

Enter Saudi Arabia, America's long-standing "ally," world's largest oil producer (they go back and forth with Russia as to who produces more on a daily basis) and de facto head of OPEC with its usual response to runaway prices: a press conference with impressive statements about its willingness and ability to flood the market with oil.

In the case of Saudi Arabia announcing its ability, which is not necessarily a guarantee, to pump to the limit, the oil markets initially sold off, at one point nearly $1.20/barrel. This was the typical and expected response in Riyadh.

Soon after, statements out of Algeria sent prices higher reflecting their take that if the Saudies produce at capacity it still may not be enough to satisfy market demand. Others speculated that even if Saudi production went to capacity, the additional crude would not be Arabian Light, and hence, is less desirable, and will not necessarily create downward pressure on prices.

These factors combined to send oil futures prices up more than five percent (intraday) since the Saudi announcement. So much for OPEC's calming effect on the market.

There was a time not long ago, when OPEC was able to calm the markets through press releases after its regularly scheduled meetings. Those not invited to attend the meetings could only assume what went on behind the scenes at these conclaves but always accepted the public statements as gospel and futures prices reacted accordingly.

Now it seems OPEC is fighting high prices exclusively through the media, like wire services, to keep its member nations aligned. Recently, we've seen several OPEC members stepping out of line and speaking in contrast to OPEC's perpetual statements that they have enough oil to meet world demand and enough excess capacity to flood the market and drive prices lower if necessary.

"OPEC seeks stability in the oil market and endeavors to deliver steady supplies of oil and gas to consumers at fair and reasonable prices." (Source: www.opec.org)

U.S. Poll Indicates Deep Distrust of Saudis

A new poll performed by Luntz Research Companies indicates both widespread and deep distrust in the U.S. of both OPEC and Saudi Arabia and their roles in the world energy market.

Following are excerpted questions from the poll with top-line results. The poll was conducted between the Democrat and Republican Conventions, in August, and surveyed 800 registered likely voters. It carries a margin of error of +/- 3.5 percent.

The participants were read a list of names of people, organizations and countries and asked their opinion of each one from the list of options. If they have no opinion or have never heard of the name, that was recorded.

OPEC
5% Strongly Favourable
11% Somewhat Favourable
30% Somewhat Unfavourable
25% Strongly Unfavourable
22% No Opinion
5% Never Heard Of
3% Don't Know/Refused

SAUDI ARABIA
3% Strongly Favourable
14% Somewhat Favourable
32% Somewhat Unfavourable
28% Strongly Unfavourable
21% No Opinion
1% Never Heard Of
2% Don't Know/Refused

If you had to choose, which of the following do you think is most responsible for the recent increases in the cost of oil and gas?
55% Saudi Arabia, OPEC & Other Producing Countries
33% Oil and Gas Companies
12% Don't Know/Refused

When it comes to energy, we need an America that relies on its own ingenuity and innovation – not the Saudi royal family.
74% Strongly Agree
17% Somewhat Agree
2% Somewhat Disagree
3% Strongly Disagree
5% 3% Don't Know/Refused

In general terms, OPEC has attempted to affect prices to bring "stability" by producing more oil when supplies were tight, prices were high or by producing less when demand was weak. OPEC has been the glove outlining the invisible hand allegedly controlling the world oil markets. And for a time, world markets and consumers benefited from the comfort of this controlling presence.

Why is OPEC becoming ineffective and unable to reign in high prices? What makes things different this time?

OPEC's relative ineffectiveness is a result of a combination of factors coming together simultaneously in a "perfect energy storm."

First, market fundamentals are working against lower prices. Estimates for crude oil demand have been revised upward consistently for the past year or so. Demand, now projected to reach 84 Mm Bbl/d in the fourth quarter of 2004 according to OPEC's internal estimates, has risen dramatically faster than supply. One need only to witness the recent increase in merger activity in the oil and gas patch compared with announcements of new field discoveries to know that it has become more fashionable to drill on Wall Street than to add reserves by actually taking risks and getting dirty out in the field. Combine this with the estimates that most of the additional supply projected to come on line to meet this demand is from non-OPEC producers, and this leads to decreased influence by the cartel.

Second, geopolitical impact on the oil markets has steadily increased in the last two decades, especially since September 11, 2001. The political instability of the majority of OPEC's producers has taken on increased importance with the rapid advance of global terrorism. Attacks on Saudi oil infrastructure, once a remote possibility, now seem probable, as if it is just a matter of time before a terrorist event removes significant supply from the market. Add to that the threats of supply disruption from Iraq, Russia, Venezuela, Nigeria and Norway, and what's a price-fixing cartel to do?

Third, the price of oil's impact on the world economy is smaller today than it was at the time of the last "oil shocks" in the late 1970s. Even though analysts and pundits like to talk sensationally about "record high oil prices," the fact is that the U.S. gets more than double the GDP out of a barrel of oil now than it did in the mid-1970s. As a consequence, removing the psychological factor, oil's impact on the world economy as a whole is less now than it was at the height of OPEC's power in the 1970s. Certain industries feel the high cost of oil more than others (particularly highly competitive, low margin transportation industries like airlines), but on the whole, consumers have been able to adjust to higher gasoline prices this summer.

Fourth, momentum is having a tremendous impact on oil prices. It is unlikely that any cartel could prevent skyrocketing prices when there is a constant drumbeat on prices reaching $50/Bbl purely for psychological reasons. Seemingly, oil traders have been pushing for $50 oil since the price hit $40 for no other reason than it is a round number. Some of this momentum can be attributed to hedge funds that hold large long positions and look for any reason to pump prices up. Others see large forward sales of production by oil companies as a factor leading to higher prices.

These factors combined beg the question of why OPEC still exists. What's wrong with actually letting the market set prices based on fundamentals combined with geopolitical risk? Do we really need a

grouping of petro-states telling us they can do nothing to calm prices, but could send them higher at will?

What are we to make of all these elements of the perfect energy storm coming together at a time of heightened awareness of potential terrorist concerns?

Pumping at Capacity Could Drive Prices Higher

The situation is quite serious, and the market's reaction may be enough to throw any economic recovery, the U.S., Canada and Japan included, into reverse very quickly.

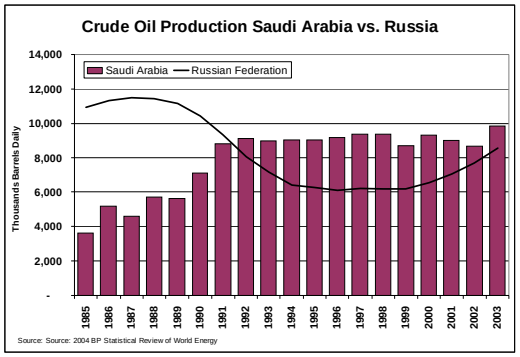
Consider that as a typical response to high prices, if Saudi Arabia begins to publicly announce that it is pumping at capacity, any elasticity (to the extent there is any currently) in oil supply would be destroyed instantly.

The current shortage of excess capacity is especially troubling if demand forecasts prove to be conservative. No matter what is tried to cool the Chinese economy, it is still forecasted to grow at more than eight percent per year, and recent reports have India's population surpassing China's by 2050.

Assuming a 1.5-2.0 MmBbl/d increase in 2005 demand over 2004, and non-OPEC supply increases of approximately 1.0 MmBbl/d (of which 700,000 B/d are projected to come from Russia), OPEC will be producing within 1.0 MmBbl/d of its stated capacity. This could essentially leave Saudi Arabia with less than 500,000 B/d of excess capacity.

It is widely argued that supplies have not been this tight since the end of World War II. If so, and with oil prices recently reaching over $49/Bbl it is curious that there has been a lack of new exploration activity announced. The conventional responses from major integrated oil companies have been that they were concerned that prices were at unsustainably high levels and they weren't willing to make potential billion dollar investments without prices at predictable levels above $20-25/Bbl. And any exploration activity might not yield production for up to five years, but with oil prices spending only six months out of the last five years below $20/Bbl, it stands to reason that exploration activity should have picked up years ago and not merely started this year.

And if the Saudis have no more spare capacity, and other non-OPEC/non-Russian production is not growing rapidly, we must look to Russia, right? Not so fast. Recently German Gref, the Russian Economic Development and Trade Minister said "We are unable to say that we are ready for a surge in oil production." If the Saudis and Russians are both tapped out where do we look next?



When you've used all your ammunition, as in the case of the Saudi's expressing their ability and willingness to produce at capacity, the stage is set where the sky is the limit for prices in the event of *any* disruption, be it geopolitical, geological or meteorological.

Which do you have a more negative opinion of?
23% Saudi Oil
22% OPEC Oil
18% Middle Eastern Oil
8% Foreign Oil
28% Don't Know/Refused

Do you think that OPEC is purposely withholding production to increase prices?
71% Yes
17% No
12% Don't Know/Refused

Do you think that the Saudis, as the top OPEC producer, are encouraging or discouraging higher oil prices?
66% Encouraging
14% Discouraging
20% Don't Know/Refused

If I were to tell you that Saudi Arabia is the #1 holder of oil reserves among OPEC nations, and the largest single supplier of oil to the United States, would that make you want to . . .
50% Pursue new sources of energy right here in America
32% More actively puruse supplies from other oil producing nations and regions, such as Canada, Mexico and Western Africa
7% No Impact
6% Pursue a closer relationship with Saudi Arabia
6% Don't Know/Refused

Taken all around, the results of this poll reveal that large sections of the American public are disenchanted with OPEC, Saudi Arabia, and U.S. dependence upon them for oil supplies. This poll's results are known to both current presidential campaigns; uses of its conclusions in the final six weeks of the race are sure to increase dramatically, creating a season of opportunity for energy producing companies from Canada and elsewhere to capitalize on the environment to secure additional market share.

Is it Possible to Talk Prices Down?

So what are drivers and investors to do? Crude oil supplies might indeed rise by the end of the year, though there have been no signs of inventory builds in the U.S. But there is an election in the U.S. before year-end. For politicians, resisting the temptation to comment on high energy prices with wild and wholly counterproductive ideas on what to do about them (such as claiming it is possible – or even desirable – for America to be "energy independent," or releasing oil from the Strategic Petroleum Reserve) will be nearly impossible.

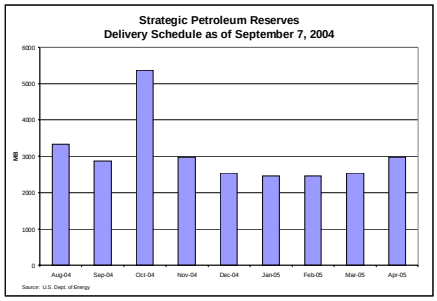
As such it is important for both candidates to come up with a real energy plan that focuses on dealing OPEC a final blow. Possibilities include developing all reasonable energy supplies (including nuclear power, clean coal, wind and solar) and creating a hemispheric (to include West Africa) oil pricing mechanism (most of the geopolitical premium per barrel of oil is added by countries in the Middle East and Russia) and working with current friends and making new ones who are more valuable and ultimately more reliable than mere "allies."

In this effort to calm markets and bring prices down, it may be possible to talk prices down to a more reasonable level. In the past, President George H.W. Bush and President Clinton, both directly and through their deputies, used political rhetoric and the Strategic Petroleum Reserve (SPR) to help drive oil prices down.

Strategic Petroleum Reserve Inventory for September 13, 2004

Current Inventory (Mmbbls)			To be delivered (Mmbbls)	
Sweet	Sour	Total	Royalty-in-kind	Exchange 2000
271.6	397.6	669.2	23.3	0

Source: US Department of Energy



However, we doubt whether releasing oil from America's Strategic Petroleum Reserve would have any significant effect on prices (see *FirstCommentary*, June 11, 2004, p. 20). Where, with refineries running at 98.5 percent capacity, would the oil go anyway? Moving crude from a cave to a holding tank is no way to bring prices down. But perhaps perception is truly more important than reality, in which case it might be possible to merely announce a release of oil from the SPR in an attempt to lower prices without ever following through with an actual release.

One thing is certain: in times like these, a clear energy policy is required on both sides of the U.S./Canadian border.

America needs to embrace the fact that it will be reliant to a great degree on imported energy. The popular notion of "energy independence" is all but a fantasy. The important thing is that we can choose whom we rely on for our energy imports. Choosing to rely on unstable, undemocratic, repressive regimes is not in America's interest. The examination of a hemispheric energy supply and distribution system offers strategic, pricing, and national security advantages over pursuing dangerous relationships solely with low-cost providers.

Both American presidential candidates should embrace the notion of increasing energy supplies from all sources, both domestic and international. Increased domestic oil and gas production should be encouraged, though it's doubtful that tax incentives should be required in the current price environment. Expanded Canadian production and exports to the U.S. should also be encouraged, through development of additional (and planned) oil sands projects, as well as oil and gas deposits in the Arctic north and Maritimes.

But whether prices go up or down, OPEC's relevance and ability to control prices are both in serious jeopardy. Either way, expect geopolitical factors, not pure supply and demand fundamentals, to drive oil prices throughout the U.S. election period and beyond.

A Strategic error and Its Potential Implications

By Robert E. Heiler

The world oil market is not a purely economic affair; it incorporates and encompasses the foreign and domestic policies of many nations, and has the potential to instigate large-scale conflict. What follows is a geopolitical snapshot from the past several weeks that has a profound potential to influence the oil market.

If the distribution of an essential commodity dictates that some nations have a superfluity, while others desperately need more, there are two modes of response: trade or make war. For many years, the entire world oil market has existed in the twilight between these two modes, a twilight that echoed that of the Cold War. The world has traded oil, but it has done so in an atmosphere of threatened conflict, often manipulated by the great military powers to achieve an advantage at the trade table. On the other side, OPEC attempted to use the leverage of its petroleum plenty to serve political as well as economic goals. This complex econo-political dance has long been a major facet of the global order.

A realignment of that global order began in earnest on September 11, 2001. The realignment process is similar to the opening of a safe: moving parts click into place, defining what is possible and laying the foundation for the next step in the process.

A major tumbler found its home last month in Beslan, Russia.

Aftermath of a Massacre

Within 72 hours of the unfolding tragedy at a school in which more than 330 were killed and implicating *al Qaeda* and other Islamist terror groups, Russia signed a memorandum with Israel pledging that the two countries would work more closely in fighting terrorism. This rapid response indicates that the Beslan massacre could be a watershed event in Russian foreign policy.

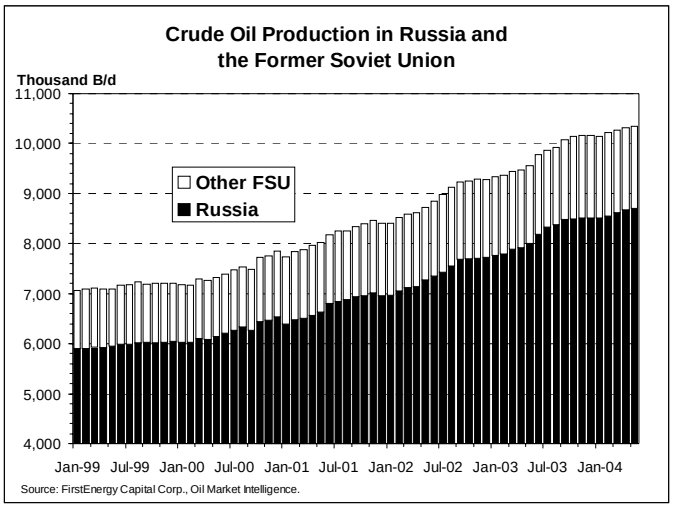
Until now, Russian President Vladimir Putin has struggled with the situation in Chechnya quietly, rarely drawing parallels or suggesting organic ties to the U.S.-led Global War on Terror (GWOT). One reason for this approach has been a reflexive Arabism that persists from the Cold War days, when the Middle East was one front in the great standoff between the U.S. and the U.S.S.R. An immediate strengthening of ties to Israel, specific to anti-terrorism efforts, is a clear signal that Russia is moving away from that remnant of earlier days.

This development has not eluded the notice of Washington. Immediately after the Beslan situation ended, Putin received a little-publicized call from President George W. Bush, who placed all blame for the incident on the terrorists and declared that America would support Putin in a vigorous response. This was important, especially because of criticism of Russian policy in Chechnya that has emanated from Bush's own State Department. This reassurance was perhaps on Putin's mind when he angrily responded to Western suggestions that he should seek a negotiated solution to the Chechnya question with a sarcastic suggestion that Osama bin Laden be invited to the White House (or the United Nations) to discuss his demands.

On September 14, Putin unveiled a plan to alter the internal political structure of his country, citing the need for national unity to address the terrorist threat to Russia, and characterizing it as an attack on the very existence of his nation. The plan amounts to an executive branch power grab, eliminating popular-

vote elections and mandating party slates in favor of individual candidacies. Because two thirds of the Russian parliament are loyal members of Putin's party, the plan's adoption is virtually assured.

Putin's political opponents have decried the plan as anti-democratic, and characterized it as "a return to the USSR." American response to this controversial move has been muted, to say the least. An unnamed White House official was quoted in *The New York Times*, saying, "This is a domestic matter for the Russian people. It is important for Russia to continue along the pathway of democracy and economic freedom."



The upshot of all this is that Russia, which has remained more or less neutral in the GWOT in order to avoid angering Iran and its Arab friends, is beginning to see itself as on the same side as the U.S. Perhaps more importantly, it is not shy about proclaiming this alignment, as the memorandum with Israel clearly illustrates.

Underlining this potentially historic pivot are the recent words of Russian Defense Minister Sergei Ivanov to *Eurasia Insight*. He said that Americans have "a much better understanding" of the seriousness of the threat faced by Russia, adding that finding "a basis for mutual understanding with the United States was much simpler than with many European states."

The gentle American response to Putin's consolidation of power indicates an eagerness to provide him with international political cover, which is to say, a green light from Washington to prosecute Russia's war on terrorism as aggressively as he deems necessary. Bush's unannounced visit to the Russian embassy in Washington to offer moral support and sign a book of condolences further strengthens this message.

Implications for the Oil Market

The position of Russia in the world oil market is utterly unique. To begin with, it is only slightly behind Saudi Arabia in the race for daily production primacy; in fact, when the Saudis are behaving normally with respect to the jealously guarded "excess capacity" that defines their position as the leader of OPEC, the Russians out-produce them daily. Russia is also the eastern border of the European market and enjoys proximity to the fast-growing markets of China and India. It is a littoral state of the Caspian and holds both vast gas reserves and substantial influence over many of the former Soviet Republics. All of these attributes combine to make it a power centre of the world energy market.

Internally, Putin has pledged to double his country's GDP in 10 years, a feat requiring approximately eight percent growth per year. Energy is one of few sectors of the Russian economy capable of significant contribution to such an effort. In addition, Russia's military is among the world's most formidable, even given its degradation since the end of the Cold War. Diplomatically, it is a permanent member of the UN Security Council, and one that has traditionally leaned heavily toward the Arabist side of Middle Eastern conflicts.

This is not a picture of a nation that the forces of Islamist terror should care to make into an enemy. And one more thing: it may not be considered good form to make pronouncements about national character in geopolitical analysis, but one thing is certain: Moscow is not Madrid. If the *al Qaeda* operatives that

trained and assisted those that Putin has called "child-killers" in Beslan were hoping to get a response similar to the Spanish elections, they are highly likely to be sorely disappointed.

The Bear and the Eagle

This event could well be the first step in a true *rapprochement* between Moscow and Washington, particularly with respect to the waging of the GWOT. If that process continues, the following developments could have profound effects on the global energy market:

- The U.S. government could begin to encourage direct foreign investment by the American private sector in Russian oil and gas projects. Currently, capital is the major limiting factor in Russian production increases. This could mean expanded Russian supply, fairly quickly.
- Intelligence sharing is almost sure to increase, meaning that terrorist funding paths will likely be identified and shut down more rapidly. This could slow the pace of terrorist operations around the world, which in turn could lower the current "terror premium" that *FirstCommentary* analysis suggests is substantially increasing barrel prices.
- U.S.-Russian cooperation on the GWOT will open pathways of communication that could affect the development of a new pricing mechanism to replace OPEC, as its ability to stabilize and regulate world prices further erodes (see "The Gathering Perfect Energy Storm," page 6).
- In places such as Iran and Saudi Arabia, the voices of reason will be strengthened in their struggle against the fanatics by this strategic error. The wealthy classes in these nations, all of whose money comes from oil, will not like the fact that the fanatics among them have made an enemy of Russia, especially if they are made to see the results of that misstep as outlined here.

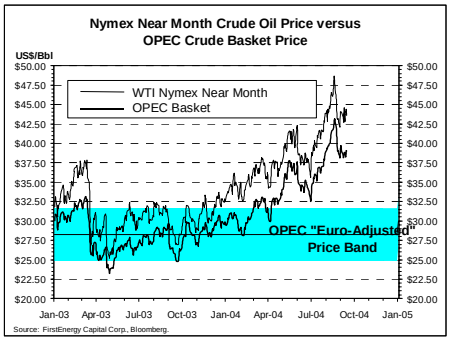
Bush's indications of support to Putin suggest that he may be able to play this hand well, despite the carping of the State Department that so angered the Russian President. Continued monitoring of U.S.-Russian cooperation in the GWOT might well reveal opportunities in the oil market in advance of their traditional economic indicators.

The Geopolitics of Oil Reserves: Alberta Transparency and Saudi Secrecy

By Paul Michael Wihbey

"The Saudis' failed attempt to jawbone prices lower suggest to many industry specialists that current conditions—production at near capacity, surging demand and fears of terrorism—are curtailing the long-established power of the kingdom in international markets…Analysts and traders said they were disappointed that the Saudi announcement (to increase production) lacked specifics. For example, in the conference call with reporters from Saudi Arabia, the Saudi foreign adviser could not identify which fields the additional crude would come from. In addition, he could not specify the type of crude that could be produced." ***—The Washington Post***, August 12,2004.

Simmons: Challenging the Saudi Family Jewels



Since 1999, crude oil prices have risen from a relatively stable plateau of $20/b to a volatile level just under $50/b, the most sustained price surge since the early 1980s. One new market dynamic underpinning this rise is fear of geopolitical instability in major producing countries and regions, inspiring hedge funds and speculators to take more long positions. Forecasts of strong demand growth in China and India are insurance, promising to keep prices high even if no geopolitical emergency arises.

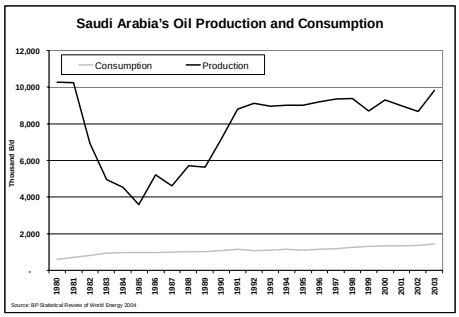
A key driver is the apparent loss of confidence in Saudi Arabia's ability to stabilize pricing as they have for the last quarter-century. Its excess capacity of 1-2 mbd has always been the Saudis' trump card to moderate the market, to claim status of "swing producer." This extra production volume, along with its unchallenged massive reserve base, is what made Saudi Arabia the central banker of the global oil market. It now seems that may no longer be the case; and the implications are striking.

In his forthcoming book, "Twilight in the Desert: The Fading of Saudi Arabia's Oil," Matt Simmons challenges the credibility and veracity of Saudi Arabia's oil account. Referring to Saudi claims on production and capacity, Simmons told *The Washington Post*, "They're basically lulling a lot of people into saying, 'We don't have anything to worry about.'"

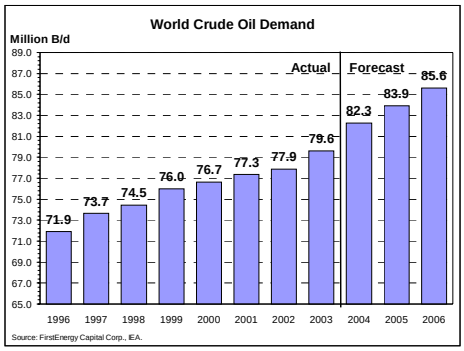
Implicit in Simmons' appraisal is that long-standing assumptions in regards to Saudi production, reserves, and excess capacity can no longer be the accepted standards for anticipating global pricing and supply. As a consequence, OPEC's own deliberations on global market conditions have come into question. (see "The Gathering Perfect Energy Storm" pp.3-6 in this issue).

Among the most significant of his findings:

- As the world's largest producer (9 milllion barrels per day (MmBbl/d) in 2004), largest exporter in the world (MmBbl/d) and largest reserve holder (est. 262 billion barrels), Saudi Arabia cannot substantiate its claims and estimates because it does not provide the necessary empirical data for external verification. Saudi oil figures lack transparency. The Saudis' only response when challenged, Simmons says, is "trust me."
- Five to seven fields produce 90 to 95 percent of Saudi oil output with the oldest, "Ghawar," accounting for 60 percent of the total. The U.S. Energy Information Administration estimates Ghawar at 50-70 billion barrels, while Saudi Aramco, the state-owned oil company, estimates 125 billion barrels. The two new fields, Qatif and Abu Safah, that the



Saudis say will start adding an additional 800,000 b/d this year, were according to Simmons, "announced as merely offsetting normal production declines in mature oil fields." If true, this places the issue of real decline problems in the Saudi fields far higher than had been anticipated. Saudi oil output will peak, if Ghawar experiences significant production declines.



- At the end of 1975, ARAMCO was managed by U.S. oil companies (Exxon, Texaco, Mobil, Chevron). At that time, all Saudi fields had a proven reserve base of 108 billion barrels. There have been no major discoveries since 1968. Since then, Saudi Arabia has claimed an additional 155 billion barrels of additional proven reserves. This extraordinary additional reserve base has yet to be empirically or geologically determined. This would also undermine the U.S. Department of Energy's estimation that Saudi Arabia could supply the market with 15 to 20 million barrels a day by 2025. Should this be the case, Saudi Arabia would fall from its position as the leading holder of reserves to a position behind Canada (180 billion barrels) and Iraq (115 billion barrels). Such a dramatic downward shift in the all-important reserve numbers raises the troubling question of whether Saudi Arabia has the capacity to sustain one to two million barrels per day of extra oil on the market for a prolonged period of time.
- Water injection techniques have kept Saudi reservoir pressures high, and that, in turn, has allowed Saudi Arabia to maintain high volume production (8 Mmb/d since 1992) thereby providing the vaunted "excess capacity" so much valued by the global market in order to maintain pricing stability. This aspect of additional volume production allowed Saudi Arabia to moderate the extremes of supply and demand and secure a financial point of equilibrium that has allowed U.S. economic planners sufficient latitude to calculate U.S. budgetary and fiscal projections with a certain degree of accuracy. As a result, Saudi Arabia has arguably become the most powerful international player in Washington over the last 25 years.
- Water injection has had an overall corrosive effect on the quality of Saudi reservoirs, suggesting that Saudi production decline may occur sooner than anticipated, despite the application of the latest oil-drilling technologies. According to Simmons, *"My worry is that too many other oil companies also believed these same technological tools would allow them to steadily grow their production from a reduced amount of wells drilled. Instead, it turned out that virtually every key oil producer utilizing these same tools sadly ended up seeing their production growth peter out. While the tools did extract more oil per well, they also simultaneously accelerated the recovery of the oil that could economically be produced from the well. In turn, this created decline rates never seen before in existing production… however if my concerns are correct, the warning signals should be very easy to detect if Saudi Arabia begins to adopt a far higher standard of petroleum data transparency and begins reporting timely field by field production statistics which are supported by the average number of producing wells in each field."*

Murray Smith vs Ali al-Naimi

The market impact of Simmons' contentions becomes increasingly apparent when Canada's oilsands-driven reserves are factored into the debate. After the Alberta Energy and Utilities board (AEUB) approved a 175 billion barrel increase in proven reserves to 180 bb in late 2002, placing Canada second only to Saudi Arabia, reports in *The New York Times* ("Canada Builds a Large Oil Estimate on Sand," June 18, 2003) claimed that those figures were exaggerated. What ensued was a little-noticed but highly significant verbal duel between Alberta and Saudi Arabia over the qualitative nature of proven reserves.

On June 21st, 2003, Alberta's Energy Minster Murray Smith told the *Financial Post* that Alberta was ready to open its books to back the AEUB estimates because they change the geopolitics of oil, boosting Canadian influence at the expense of other U.S. oil suppliers such as Saudi Arabia.

"We are extremely happy to engage," Smith said. "We are inviting the world community and the department of energy in the U.S. and the Energy Information agency in Paris…to look at our books and examine them in a very clear and open fashion. We are asking them to examine Venezuela's, Mexico's,

Saudi Arabia's and other members of OPEC. This is going to be a long, interesting discussion about oil and gas. What are the true reserves?"

Responding June 18, 2003 to a *New York Times* question as to whether Saudi Arabia would publish field production data that would allow experts to assess Saudi depletion rates, Ali al-Naimi balked, saying, "I'm not in favor; it allows you to figure out reserves."

Simmons' challenge on the Saudi data, Smith's forceful assertion of Alberta's estimates, and the absence of a Pavlovian market response to Saudi Arabia's August call on excess capacity and price stability may signal a sea-change in the way that traders and investors assess oil market fundamentals.

Indicative of such a transformation, ExxonMobil's CEO Lee Raymond recently proclaimed, "The unconventional energy sources of today will become the conventional energy sources of the tomorrow," speaking at the international OPEC seminar in Vienna. The conference was told that Canada's oilsands and Venezuela's heavy Orinoco deposits have emerged as possible solutions to the looming oil supply crisis.

Collapse of an OPEC Pillar

The uncertainty that drove the market to $49/bbl oil on August 20th has reflected poorly on OPEC and Saudi credibility, creating unprecedented doubts as to whether spare capacity and volume numbers have been based upon flawed geological data and/or deliberate overbooking of the reserve numbers. Only a transparent audit, as advocated by Murray Smith, can resolve this increasingly contentious issue. If Saudi reserves are as large as the Saudis claim, they ought not to have any worry to allow an outside audit. Should they refuse, the Saudis would be exposed for having maintained the fraudulent illusion of having the necessary assets to regulate the international market. Such a disclosure obviously has significant implications as to the current and future price range for oil, as well as medium to long-term impact on essential supplies to sustain world economic growth.

The probability that Washington would consider new transparency rules for oil producers has received impetus thanks to the fallout from the well-publicized reserves revisions from major private-sector producers like Royal Dutch/Shell and El Paso. In a June 24th memorandum to the U.S. Congress, U.S. Securities and Exchange Commission Chairman William Donaldson wrote that independent audits of company estimates may be needed to give investors better information about reserves held by oil and gas companies. U.S. Energy Secretary Spencer Abraham has suggested that a comprehensive "world oil data reporting system" could be mandated to the International Energy Forum whose secretariat is based in Riyadh.

Whether the IEF can overcome Minister al-Naimi's anxiety over transparency remains to be seen. If not, Washington ought to consider another mechanism, and soon. Only an internationally sanctioned external audit can provide the oil market with the verification it needs on Saudi reserves, production and excess capacity to allow a proper calculation of supply and demand.

As described in "Time for a New Oil Pricing Mechanism" (*FirstCommentary*, March 15, 2004), the OPEC-centric structural components of the oil market are being transformed by a wide array post-9/11 global forces. Not only is it likely that Canada could replace Saudi Arabia as the world's largest storehouse of crude, but Russian production, having increased by 10 percent in a year, now matches Saudi volumes at 9.3 mbd, thereby positioning Russia to lay claim to its stated goal of becoming the new "swing producer." The rise of the oilsands, dramatic Russian production levels, unprecedented market reservations over Saudi capacity and demands for transparency in national oil accounts signal a market system in transition, a transition requiring definitions and assumptions that reflect the emerging new global order in the oil market.

Putin Gets an Odessa-Brody Win

By Frederick Cedoz

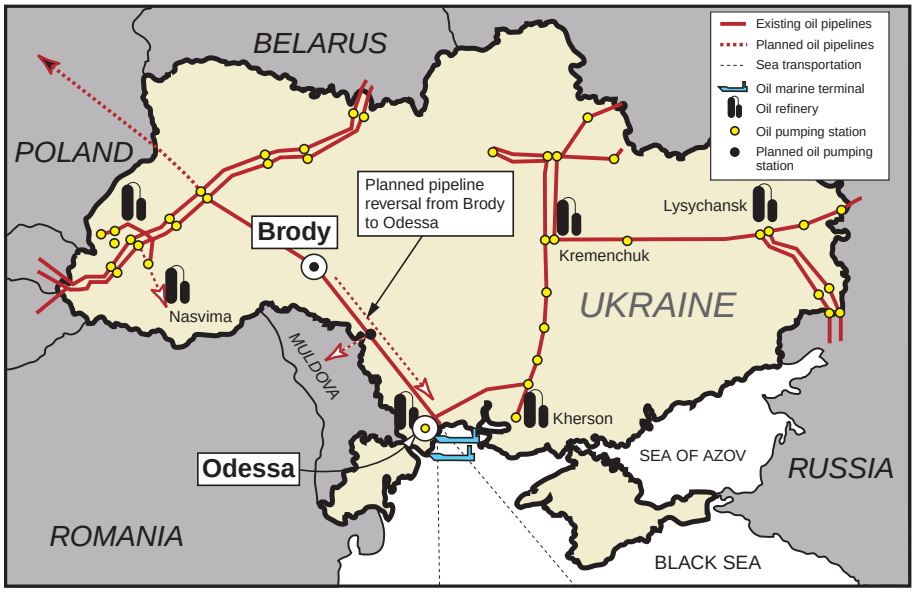
In the March 2004 edition of *FirstCommentary*, we wrote of the geostrategic importance of the Odessa-Brody pipeline to both Western European consumer nations and mega-producer Russia. We stated that "until oil is flowing through the pipeline…attempted Russian influence over Ukrainian energy decisions will not subside."

At that time, the government of Ukraine had resisted Russia's encroachment into domestic politics in the former Soviet republic by declaring that the pipeline would be used for its intended purpose: transporting Caspian crude to European markets.

Since then, Russian President Vladimir Putin has successfully lobbied for and received a reversal of the February 4th Ukrainian Cabinet of Ministers' decision to use the Odessa-Brody pipeline to transport oil "exclusively" in the direction of Odessa to Brody.

Ukrainian President Leonid Kuchma has apparently reconsidered the logic used to sign the original decree on direction of the oil flow of the pipeline. In February he stated that use of the pipeline to carry Russian crude to Brody was unprofitable. The official position of the Ukrainian government is that the reversal of oil flow in the Odessa-Brody pipeline is temporary while commercial volumes of Caspian crude are being made available for the planned route from the Black Sea port of Odessa to Brody near Ukraine's border with Poland. The pipeline has been empty since being completed almost two years ago, and any transit revenue will no doubt be warmly received in Kiev.

Ukraine Existing and Proposed Pipelines



Source: Transneft

The American voice that sought to secure the original direction of oil flow in the pipeline has gone virtually silent in the face of renewed Russian negotiations with the Ukrainian leadership. Mr. Putin has sensed what can best be described as an American ambivalence in energy security matters, or at least with respect to those involving Central Asia and Russia. It's no wonder that the Russian leader is asserting himself wherever possible.

Russia's stated goal is to be the world's leading oil producer by the end of the decade. They have production targets of 12 Mmb/d and an ambitious goal of supplying 10% of America's imported oil. That would have Russia exporting nearly 1.5 mbd to the U.S. Currently the Russians produce slightly less than the Saudis now that OPEC's largest producer is very near capacity at 9.3 mbd.

To facilitate reaching these lofty production goals, President Putin, who apparently plans to keep a firm grip on his office to see those goals reached, is consolidating his power over Russia's vital energy sector. While YUKOS is reeling from Putin's politically motivated attacks and no longer spending capital exploring for new oil, other Russian oil companies with closer ties to the Kremlin are moving to ramp up their production.

And with increased production one must focus equally on additional transportation routes. Russia's strategic aims with Iran include pipeline transit routes south from the Caspian to the Arabian Sea. In addition to securing all possible outlets for Russian crude, the exertion of influence in such a critical area as energy helps Russia reassert control over former Soviet republics in a way Washington had tried to stymie with the Baku-Ceyhan and Odessa-Brody (as intended) pipelines.

Ukraine's role is critical to Russian energy plans. Approximately 90% of Russian oil and gas exports to Europe transit Ukraine. As a consequence, it is highly unlikely that Russia will remain silent on energy matters where Ukraine is concerned. Also, the Ukrainian presidential election season ends with a run off in October. Moscow is backing the current Prime Minister Viktor Yanukovych over the U.S. favored candidate Viktor Yuschenko. Any guess as to who might win?

A maverick government in Ukraine with the ability to shut off pipelines delivering Russian crude to European and other customers is antithetical to Putin's aims of using the hard currency provided by its natural resources flowing through Ukraine to rebuild his country both militarily and industrially.

Putin senses growing tensions between the U.S. and Saudi Arabia and wants to fill that void so that in the next half century the U.S. is as dependent on Russian crude as it was on Saudi crude for the last half century. He knows, however, that he needs U.S. (and Canadian, and British, and Japanese, etc.) capital to get new supplies of Russian oil to market in order to satisfy both growing regional demand as well as reaching his American export goals. He will take capital from any source available, as shown by a recent AP report of Chinese Prime Minister Wen Jiabao discussing a $12 billion investment in the Russian energy sector. Transportation routes such as Odessa-Brody are critical to reaching these goals.

And if foreign oil companies are to invest potentially billions of dollars to deliver this crude to market, they ought to have all the information available on the person with whom they'll be negotiating. Notice Putin has decided to roll back on the efforts made in the last decade to introduce democracy in Russia in the wake of the horrific terror attacks in Beslan (see "A Strategic Error and Its Potential Implications," p. 7)

President Putin seems unique in his ability among world leaders to grasp the strategic importance of natural resources in the post Cold War era. Russia's aim in boosting production is to return to a position of prominence in the world community. While perhaps no longer a Super Power, Russia is critically important to the stability of the world oil market. It's clear that Odessa-Brody and YUKOS are merely the opening moves in what will be an interesting game of geopolitical chess.

The Danger of the Hibernating Bear

By Mark Broxmeyer

Current messages from the economy appear to many to be mixed and confused. While GDP growth numbers the past few quarters have indicated an economic recovery, markets are roiled by astronomic energy prices and the threat of creeping interest rates.

These two elements hold a dangerous potential to choke the U.S. economy in a way not seen since the stagflation days associated with Jimmy Carter's "malaise." This situation represents not only a bear market, but a hibernating one. To make matters worse, political rules of engagement render a serious address of these gathering threats unlikely before the presidential election or, in the case of a John Kerry victory, before January inauguration.

In the past four years, crude oil prices have risen over 140 percent, from roughly $20 per barrel to nearly $50. This is the most significant and sustained rise since the early 1980s, and represents a completely different market dynamic than the traditional supply and demand matrix. The new market reality is driven by geopolitical factors creating a psychological bubble, forcing traders and speculators to bet on higher prices well into the future.

Many of the world's largest petroleum producers have become increasingly unstable and unreliable suppliers of oil exports, not only to the American market, but to other key consumers in Asia and Europe. Terrorist attacks inside Saudi Arabia have become common; political turmoil is crimping Venezuelan production; Vladimir Putin's machinations aimed at re-nationalizing the Russian energy industry are threatening the solvency and production capacity of oil giant YUKOS. Concurrently, strong surges in demand in China and India show little sign of abating absent some near-catastrophic collapse in economic growth rates.

Old Strategies Failing

Things have become bad enough that traditional means of quieting the oil market are failing. Last month, a Saudi press conference announcing the ability to produce an extra 1.3 Mm B/d was followed quickly by Algerian and Iranian declarations that such a move would not matter; oil prices ended the day up over a dollar from the morning starting point.

This is all occurring against the backdrop of America's continued economic shift away from manufacturing and toward service industries. This fundamental shift is making a new analysis paradigm more valuable: instead of growth, the new economy is about speed. This is why the danger posed by current high energy prices and rising interest rates is so profound.

Everyone understands how high interest rates slow down the cycle of investment and entrepreneurialism. Projects that make sense (and profits) when the cost of capital is at three percent can lose their profit motive if capital costs go to five or six percent, meaning less overall activity and a slumping rate of GDP growth. Current high oil prices and *the reasons for them* are also slowing activity. Energy companies right now are reaping huge profits from the price elevation, but are loathe to invest them in new exploration or production. On the one hand, many areas that would otherwise be attractive for investment are fraught with daunting geopolitical risks that profoundly discourage investment. On the other, everyone is aware that $10-15 per barrel (perhaps more) of the current price elevation is a geopolitical risk premium, not based on market fundamentals, and therefore conceivably subject to collapse with little notice.

A Plan for Action

The political reality is that no one wants to open this can of worms before November 2. This two-month delay only means that action will be more urgent after the political season is over.

The solution will not be simple or immediate. It requires a phased approach, buying time for the natural quieting of psychological forces that are driving fear in the energy market. Moreover, it requires not only sound economic analysis but also foreign policy choices that release pressure and build confidence in which key oil producers can be relied upon to maintain output levels.

Economic elements include incentives for the energy industry to explore and produce, removal of regulatory barriers to their doing so and incentives to the automobile industry to invest in improved fuel efficiency. Temporary cuts in sales taxes on petroleum products should also be considered to provide short-term price relief to consumers, limiting the ripple effects of high energy costs throughout the greater economy.

Few now doubt that the Global War on Terror will be a lengthy struggle; Administration officials have used the word "generational" to describe it. This means that forward thinking is required to shift U.S. energy dollars away from the Middle East and toward more stable, friendly suppliers. Beginning this now might avoid the specter of rationing of such supplies down the road, a possibility that is already only one "improvised explosive device" at a Saudi pumping station away from reality. One way to begin that shift is to recognize the strategic, national security importance of Canadian heavy crude, and to offer tax credits for the construction of pipelines and refineries that will increase its contribution to U.S. energy requirements. Such a tax credit program will be more than self-financing, due to the expansion of the tax base from increased economic activity across the border. And it will shift U.S. energy dependence to a place that America's GWOT enemies have little chance of disrupting.

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Canadian Bulk Water Exports: Quebec's Proposal

By Paul Michael Wihbey

Asserting Quebec's right to export water in bulk to the United States, Quebec's Minister of the Environment, Thomas Mulcair said recently that he saw bulk water exports as a way to develop Quebec's remote regions and create jobs. Mulcair said:

> *"Quebec holds three per cent of the renewable freshwater reserves of the world, yet our population of about seven million is roughly one-1,000 of the world's population. We'll make sure that we know the resources are being renewed. The big advantage of water over copper and zinc or iron is that once the metal comes out of the ground, it doesn't come back. With water, once you've taken it out, if you are doing it properly with appropriate permits and appropriate supervision and scientific analysis, you can make sure the resource is being renewed."*
> "Minister says he's open to exporting Quebec water in bulk," Montreal Gazette, June 16, 2004.

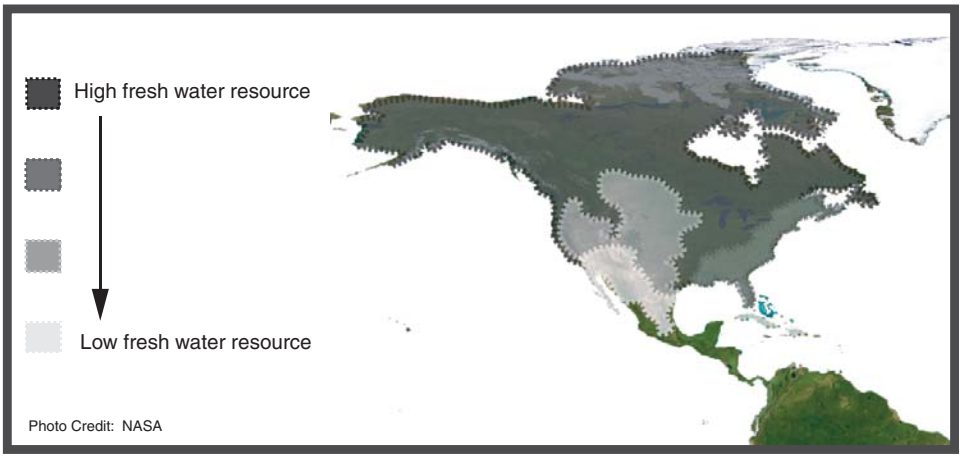
Responding to critics that Quebec water exports could compel other Canadian jurisdictions to export water to the U.S. because of the NAFTA accord, Muclair said,"I have been involved with NAFTA before it came into force. I was involved with drafting the provisions that had to do with the movement of professionals. NAFTA doesn't mean that when you start an activity you have to continue it."

Newfoundland's 2001 Ministerial Committee Report on Bulk Water Exports seems to confirm Mulcair's position. The study, which is probably one of the most comprehensive constitutional and legal reviews on the issue found in a conclusion credited to Professor Donald McRea of the University of Ottawa's Law Faculty, states:

> *"The decision whether or not to exploit natural resources in one province is thus not dictated by decisions on the exploitation of natural resources in other provinces. The fact that one province permits logging does not mean that other provinces are required by trade agreements to permit logging of their forests. Equally, a province cannot be compelled to permit the sale of bulk water simply because another province decides to permit such sales."*

In addition, the federal Department of External Affairs and Foreign Trade has determined that "like fishing, if water is traded as a good, governments still retain discretionary power to control and regulate that export." Water is recognized as a "good" by the European Court and water is an item of interstate commerce in the United States. Only by varying the provisions of NAFTA could Canada prohibit water exports; and that, in turn, would require unlikely ratification from both Mexico City and Washington.

North American Water Abundance and Scarcity



Ecosystems Don't Stop at the Border

Just as the U.S. and Canadian energy and power systems are converging and consolidating into an integrated North American grid, the NAFTA accord has generated a continental mindset conducive to more in-depth discussions

of Canadian water exports. This was most recently demonstrated at the June NAFTA-inspired Trade & Technology Summit held in Calgary, where Canadian, U.S. and Mexican water issues, including commoditization of water, were discussed.

The prospect of a North American water grid has emerged as more of a possibility as the increasingly populated American southwest, including California and Texas, experience chronic fresh-water deficits. Nationwide, U.S. water use from public water systems has increased more than 26 percent between 1980 and 2000, according to the U.S.Geological Survey.

The Survey has also deemed the current seven-year drought plaguing the American west as the worst in 500 years. Its impact is wide-ranging and diverse. Colorado's reservoirs were severely depleted as the state reached less than 40 percent of its annual average snowpack last winter and 100 Arizona farms have been lost annually due to lack of sufficient water supplies. Highly populated Southern California has experienced hundreds of dried-up water wells and underground aquifers and is over its quota on water imports from neighboring states. The U.S. Natural Resources Conservation Service is forecasting the potential for water restrictions and widespread crop and pasture losses in parts of Utah, Montana, Nevada and Idaho.

"We have serious issues here – water's declining, forests are burning and trees are dying," said Henry Diaz of the National Oceanic and Atmospheric Administration's Climate Diagnostic Center in Boulder, Colorado.

These relatively new regional conditions are creating new market opportunities that gradually make Canadian water, whether exported by tanker or pipe, increasingly competitive with domestic American supplies, including desalinated water. Not only would abundant Canadian supplies be viewed as dependable and of high-quality, long-term and high volume contracts could provide the buyer, especially U.S. municipal and county jurisdictions, with discounts that over the long-term could save local governments significant funds, given the politically unappealing alternative to an erosion of the tax base as farms, businesses and residents look to other municipalities or states for essential water services.

Market Prices: Conventional and Desalination

Although there is no integrated world market for water as for oil or wheat, sub-regional and domestic markets provide a frame of reference.

- Cyprus: US $0.55/$m^3$ (transportation cost from Turkish mainland)
- Israel: US $0.55-0.60/$m^3$ (estimated delivery cost by tanker from Turkey)
- Canada: US $0.40/$m^3$ (conventionally treated water including delivery)
- U.S: US $0.16-0.65/$m^3$ (conventionally treated water)
  US $0.80-1.50/$m^3$ (desalinated water)
- Germany: US $1.80/$m^3$ (conventionally treated water)
- Saudi Arabia: US $4.00/$m^3$ (estimated desalinated water)
- Newfoundland: US $1.35-3.00/$m^3$ (tankered water to potential Florida, Texas or Caribbean markets).

Note: *a cubic meter (m^3)= 1, 000 litres or 265 U.S. gallons.
Source: Ministerial Committee Examining the Export of Bulk Water; Government of Newfoundland, 2001

Put in perspective, one-half of one percent of Newfoundland's annual renewable fresh water amounts to 1,500 million cubic meters a year, which would fill 3,000 supertankers.

While Newfoundland's supplies would be competitive only with higher-end desalination costs, upward-trending market demand in the American west, combined with costly, energy-intensive and waste(brine)-generating desalination plants and the lack of a coherent American water policy (i.e. elimination of agricultural subsidies; incentivized conservation) could make tankered or piped western Canadian supplies attractive to needy consumers even at such costs.

As climate change, unimpeded population growth and depletion of local resources characterize the water conditions of the western United States, water-rich provinces like Newfoundland, Manitoba and British Columbia may well adhere to Mulcair's argument that it is not "a mortal sin" for Quebec to export bulk water.

Ultimately, control over water exports is a matter under provincial jurisdiction and with no specific prohibition under Canadian law or NAFTA, bulk water will probably be viewed as a tradable good sometime in the near future with royalty revenues accruing to the benefit of provincial treasuries. For additional background see "Canadian Water: Vital Natural Resource and Tradable Commodity," *FirstCommentary*, January, 2004.

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Energy Independence, Manhattan Projects and Other Absurdities

By Robert E. Heiler

Despite continued high oil prices and political unrest in some key oil-producing regions, serious public debate on energy issues is still lacking in the U.S. A large part of this silence is explained by the upcoming presidential election: America's energy questions are far too complex to be addressed in a sound-bite, although Senator Kerry is trying with his daily stump proclamation that, "America needs to depend on its own ingenuity, not the Saudi royal family."

Longtime energy observers will see in this line an echo of the oft-repeated need for that icon of American ingenuity, a "Manhattan Project," for energy independence. Every so often, some op-ed writer or talking head proclaims the necessity of such an effort, usually in a last paragraph or final sign-off before going to commercial, as though it is the answer to America's energy woes and the host of political snafus that attend them.

After the election, perhaps, a more serious look at energy security will be enabled. For now, however, one can consider what a "Manhattan Project for Energy Security" might look like. The immediate image of a group of lab-coated geniuses cooking up a new gadget that obviates both the internal combustion and jet engines is both absurd and dangerous.

Absurd because:

- American energy security is not entirely a technological problem. It is far more complicated than that, comprising elements of technology, economics, diplomacy, geopolitics and even culture and psychology. Unlike the push to codify Einsteinian physics and develop atom-splitting capabilities, U.S. energy security problems will not yield to any quantity or quality of purely technological analysis.
- One could argue that the original Manhattan Project was a Manhattan Project for energy independence. Certainly significant changes in the U.S. energy dependence profile could be wrought if America took the same approach to nuclear power plants as, say, France. This point illustrates precisely how useless technology can be in an atmosphere that destroys the political will to apply it.
- Even as a purely technical question, finding a technological solution to America's energy questions is likely to be far harder than the initial objective of the Manhattan Project. Production is always more difficult than destruction: Rome was not built in a day, but Hiroshima was leveled in an instant.

And dangerous because:

- It focuses attention on the purely technological, leading nearly everyone to conclude that finding the solution is over his head, above her pay grade, a job for technical experts. Nothing could be further from the truth. Problems arising from the energy question touch on every American life and on a host of important public policy issues, including where, when and why to go to war, what kind of tax policies to pursue and what countries are allies, competitors, or enemies. It also touches on important personal decisions: what kind of car to buy, what to set the thermostat at, how to construct a budget for a start-up company. The idea that such an issue should be left for resolution to a small class of specialized individuals is downright undemocratic.
- It allows politicians to avoid addressing important questions that have been ignored for far too long already. The implication that a few lab-coated geniuses can roll up their sleeves and fix the complex problems surrounding U.S. energy dependence in a few months (or even years) is a dangerous fantasy. This point is driven home by the observation that, during a hotly-contested presidential election with 150,000 troops in the Middle East and $45-a-barrel oil, no serious debate about energy policy is being heard.
- It allows both sides of the political spectrum to politicize and influence energy issues in service to pet causes and privileged groups. The left caters to environmentalists, resulting in energy industry regulation that only exacerbates the problem. (No new refineries have been built in the U.S. since the

Reagan days, and the rolling blackouts in California were at least partly caused by complicated regulation and attendant inefficiencies.) The right pushes for greater domestic production to serve its friends in the business world; but no amount of drilling within U.S. border will ever produce the oil and gas that the growing U.S. economy requires.

All of this pathology ignores central realities pertinent to U.S. energy policy. Without a revolutionary invention based on a non-oil paradigm, the American economic engine is too large and cycles too fast for "energy independence" to be a realistic goal. The likelihood of the internal combustion engine becoming obsolete within the next 20 years is nearly infinitesimal.

Moreover, a remarkably high percentage of current world oil production emanates from regions noted for extreme instability. American energy security policy should, therefore, be asking a layered series of questions, some designed to address near-term issues and others aimed at developing long-term solutions. And all of these questions should be addressed against a backdrop of appropriate urgency. In other words, if an idea will increase supply, or reduce demand without sacrificing economic growth, it should probably be pursued. The solution will have to be at least as multifaceted as the problem.

Evaluating those ideas will take a set of guiding principles. These principles, not some revolutionary bit of techno-magic, are what might be properly thought of as the foundation for a "Manhattan Project for U.S. Energy Security." Following are suggestions for what those principles might be, with rationales supporting them:

- **Avoid consideration of "foreign oil."** This phrase is ridiculously imprecise, implying that oil purchased from Canada and Saudi Arabia, or Mexico and Venezuela, carry the same cost-benefit profiles or geopolitical risks. So long as anyone using this phrase is taken seriously, the level of public discourse on energy is not commensurate with its importance as an element of national and economic security, nor with the urgency of its dangers.

- **Recognize the importance of energy security, as well as its status as one major aspect of foreign policy and national security.** For far too long, the energy debate in America has been conceived as an element of domestic policy. Part of this framing has been the occasional cry for the fantasy of "energy independence," a literal implication that the problem of energy sourcing has a potential solution that is entirely domestic. Recasting the debate under the rubric of foreign policy shifts the focus to realistic questions of trading preference, which will impel a shift toward oil purchase from hemispheric allies such as Canada, Mexico, West Africa and South America. Moreover, its elevation to an aspect of national security will help to keep the debate from being bogged down in partisan political concerns and ameliorate the "not in my backyard" approach to increasing domestic oil production.

- **Consider strategies for cooperation with energy-producing allies that can replace the current global arrangements designed to stabilize supply and demand.** Recent developments have made very clear the inability of OPEC to cool oil pricing in the current market and geopolitical environment (see "The Gathering Perfect Energy Storm," page 5). The basic reason for this failure is the political instability of many of the cartel's members, which inspires markets to be skeptical of their ability to maintain the increased production required to tamp down prices. The resulting boom-and-bust nature of the energy market plays havoc with the economic environment in both net-exporting and net-importing countries. A new pricing control mechanism, incorporating the more stable countries on both sides of the oil-trading table, would serve the long-term interests of both by bringing a measure of predictability to the market.

Vice President Dick Cheney's Energy Policy Review Board has been considering these and other strategies for increasing U.S. energy security for some time. But with gasoline prices hovering near or over

$2 a gallon in every major city, the administration does not care to draw attention to energy questions during this closely contested political season. Moreover, oil prices are high enough to imply that even higher pump prices may be in the offing, if the delay between crude and refined product pricing expires before the election. The Bush administration is counting on the end of the summer driving season and the mild weather of early autumn to keep demand low, in hopes that energy issues stay off of most voters' radar screens.

The Democrats, for their part, are not in a position to push energy issues very hard during the campaign either. They cannot push an austere energy conservation program during a campaign and a nascent economic recovery without turning off voters; they cannot push a plan to increase domestic production, or even to pressure for more production by allies, without alienating some of their base, the environmentalists, and ceding a percentage of votes to spoiler green candidate Ralph Nader. Worse, they have nominated a candidate that once advocated a 50-cent per gallon gas tax. Their reticence on the issue is completely understandable.

But the election will come soon enough, and after it will come a reckoning on the energy issues that both sides are currently hoping do not blow up in their faces. If President Bush wins a second term, energy issues will move toward centre stage almost immediately; if Kerry wins, it will be at least late January, and possibly much later due to the myriad of transition issues, before anything significant happens.

Either way, the day is coming when energy issues will occupy the position of policy importance that their economic and national security ramifications justify. Behind the scenes, these questions are already being addressed, and in the current administration, the above principles are already beginning to hold sway.

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Ranking System

FirstEnergy's rating system reflects our outlook for expected performance of an issuer's equity securities relative to its peer group over the next twelve months.

A *Top Pick* rating represents a security expected to provide a return materially higher than the peer group average.
An *Outperform* rating represents a security expected to provide a return greater than the peer group average.
A *Sector Perform* rating represents a security expected to provide a return in line with the peer group average.
An *Underperform* rating represents a security expected to provide a return less than the peer group average.
A *Speculative Buy* rating represents a security where the return potential is high, but the risk of a significant loss is material.

	Ranking Distribution	% Investment Banking Clients
Top Picks	5%	80%
Outperforms	40%	50%
Sector Performs	35%	67%
Underperforms	12%	36%
Speculative Buys	2%	50%
Under Review	3%	133%
Restricted Companies	3%	67%
Total	100%	

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