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ENERGY UPDATE

"BUT FOR" *ENERGY DATA*

AVERAGE & CLOSING COMMODITY PRICES FOR YEARS ENDING DECEMBER 2001 & 2002				
	2001		2002	
	Average	Year-end	Average	Year-end
Oil (WTI)	$29.64	$20.67	$25.66	$32.20
Gas (Henry Hub)	$5.19	$2.40	$3.10	$4.57

Two years ago, as oil closed at $29.40 and gas closed at $6.22 at year-end 2000, we published an energy research piece titled **"Looking For Waves, MISSING THE TIDE"** (January 15, 2001), in which we placed our Equilibrium Target Ranges at $22 to $28 for oil and $3 to $4 for natural gas (subject to spikes or ***"Waves"*** brought on by extreme weather or geopolitical events). Our reasoning is basic; that at these Equilibrium Targets, returns to the energy sector are very good and will attract capital without destroying demand or impairing economic growth. Over the past two years we have not adjusted that view, despite the impact of 9/11, the worldwide recession, or Iraq, or Venezuela, due to our longer term outlook on the energy sector and the tight supply/demand situation associated with both commodities.

"**BUT FOR"** ***Iraq*** (and its implied "War Premium"), "**BUT FOR"** ***Venezuela*** (and the disruptive effects of the "Strike" on U.S. deliveries), "we would have $18 to $20 oil," according to many well placed energy analysts and pundits. "**BUT FOR"** ***data*** is common in all sectors of the economy, government and daily life. "**BUT FOR"** ***the drought***, we should have had a bumper corn crop last year. "**BUT FOR"** the ***FDA failure*** to license ImClone's Erbitux drug, Martha Stewart would have had a much more enjoyable 2002.

We consider "**BUT FOR"** ***data*** to be important in the energy sector, but for different reasons than accepting what follows the "**BUT FOR"**. Contrarily, we see the "**BUT FOR"** ***data*** as an immensely relevant factor in the energy sector as anecdotal evidence that continues to support our incoming energy ***Tide*** thesis that we are in the early stages of a major up-cycle in energy (e.g. 1970 to 1981). The incoming ***Tide*** centers on the tight supply/demand dynamics present in both crude oil and natural gas that we have not seen since the very early 1970's.

In the face of the uncertainty surrounding the U.S. and World due to the Iraq standoff (as of the date of this report) we also have the chaos in Venezuela to add insult to energy injury. While Venezuela is only about 3% of world supply, almost all of their exported oil (2 million B/D) ends up in the U.S. either as direct crude imports or refined product imports. Replacement would be a logistics nightmare, as Venezuela is only a short boat ride away (versus six weeks to the Persian Gulf) and, more importantly, it is mostly a heavy crude grade that would be difficult to duplicate. This disruption has much of the feel of the 1973 embargo, which was also a logistics issue primarily. Logistics become critical (and challenging) when there is little spare capacity around the world.

Our recent concern has been that OPEC allowed inventories to get too tight because they underestimated the impact of the North American gas supply shortfall. Just as mild weather last winter caused an underestimate of true oil demand, as users switched toward gas, this year there will be a surprise the other way toward higher oil demand, as users are forced by lack of gas supply to fuel switch to oil products. These dynamics already imply strong pricing across the board, regardless of Venezuela, as the next wave on our rising energy ***Tide*** heaves into sight. The troubles across the Gulf of Mexico just amplify and accelerate a problem that is clearly a creature of the ***Tide***.

While all eyes are turned to Iraq and Venezuela as the energy drama on center stage, off in the wings an equally compelling story is building. In the Atlantic basin (U.S. + EU16), almost 40 million barrels were drawn from product stocks during October, the largest monthly draw since late 1999. Stocks are well below the lows of two years ago, and roughly 30 million barrels below last year. While nobody was watching, distillate stocks were falling by 200,000 B/D for the region in the period leading up to the heating season! In the U.S., distillate fuel oil stocks have plummeted 11% year-to-year and, as the DOE puts it, "are significantly below the lower limit of the normal range for the time of year." The heating oil component of distillate is even worse, down 13% year-to-year. There just hasn't been enough oil production! The winter of 2000/01 saw oil demand skyrocket as much as two million barrels per day temporarily, when fuel switching really kicked in, due to gas supply shortages and very high gas prices (See: Natural Gas, below). Over the course of the whole winter, demand was higher by some 500,000 B/D due to the gas situation.

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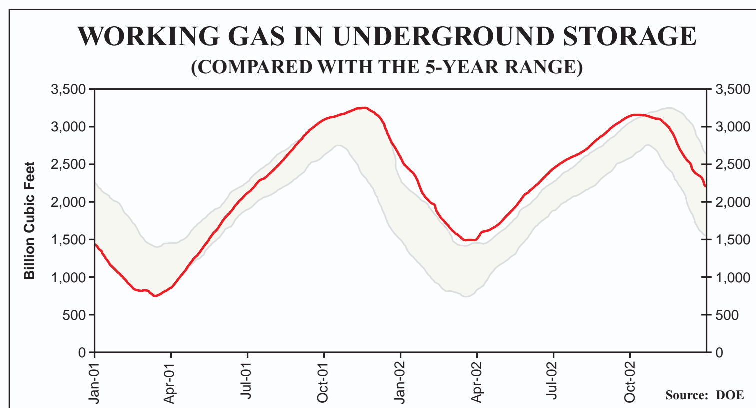
NATURAL GAS

Energy worrywarts may have been watching the wrong data series by looking at oil! They should have been focused on the interplay of lower natural gas production and rising demand. Not only has moderate economic recovery brought somewhat higher industrial demand for gas, unseasonably cold weather kicked off home and business heating needs at a much higher level and sooner than last year. Meaningful storage draws versus late injections last year have resulted in inventories falling well below last year's levels and back to the low end of normal. One trillion cubic feet of surplus has vanished.

Considering that rig counts have remained suppressed (one of the topics of a coming major piece), and state and company data still point to production declines both sequentially (1% -2% per quarter) and annually (5% - 6% year-to-year), supply adequacy in a "normal" winter is a hot topic of discussion (pun intended). The fact that Canadian production is falling for the first time since the mid-1980s, just when their demand is spiking up due to big tar sands project needs, adds to the dilemma. Their exports to the U.S. will probably fall 10% this year, just when we need it most to offset our own production declines. No wonder natural gas is trading above our normalized long-term target range of $3 - $4 per MCF.



Viewing the dramatic shift in natural gas from excess to tight supply, and considering the current distillate and resid inventory levels, one concludes that we quite probably have a near-term energy train wreck in the making. We have never before had this confluence of tight inventories for both oil and gas in an environment of falling gas supply and rising demand.

The next time you hear an analyst or energy pundit provide a **"BUT FOR"** explanation, or you see a **"BUT FOR"** headline relative to oil or gas supplies, weigh that pronouncement against the realities of the incredibly strong macro economic supply/demand dynamics at work in this huge sector of the worldwide economy. All of the anecdotal evidence is in place to support much tighter supplies of crude oil and natural gas than what is considered conventional wisdom, provided you can get beyond the **"BUT FORs"** in the headlines.

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