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## **Conflict of Interest: Oil Sands & the Environment in a World of \$100 oil March 2, 2008**

It has been over 2 years since the popular news program “60 Minutes” presented a story on Canada’s oil sands. The impact of the report was nothing short of an explosion in interest from all walks of society. At the time I thought that it would be a great for investors but as it turned out it marked a major peak in the sector that has only recently been exceeded. What is clear is that several other stakeholders have decided to lay claim on the incredible wealth in Alberta’s frozen north. For instance, both the Federal government of Canada and the provincial government of Alberta have proposed or enacted changes to get a bigger piece of the pie in the few years. This is similar to the pattern we have seen around the world in other oil rich countries such as Venezuela and Russia. Another stakeholder has been the environmental movement that has labeled the oil sands as public enemy number one in the fight to restrict greenhouse gases. Greenpeace Canada is spearheading a campaign to stop the oil sands with targeted emails to Canadian legislators. I understand and share some of the environmental concerns however there is a hard economic reality to the current world energy situation that I believe will trump all other considerations. As with all human activities, there are unintended consequences to even the noblest causes. The following is my analysis of what we can expect in the sector going forward given the forces at play.

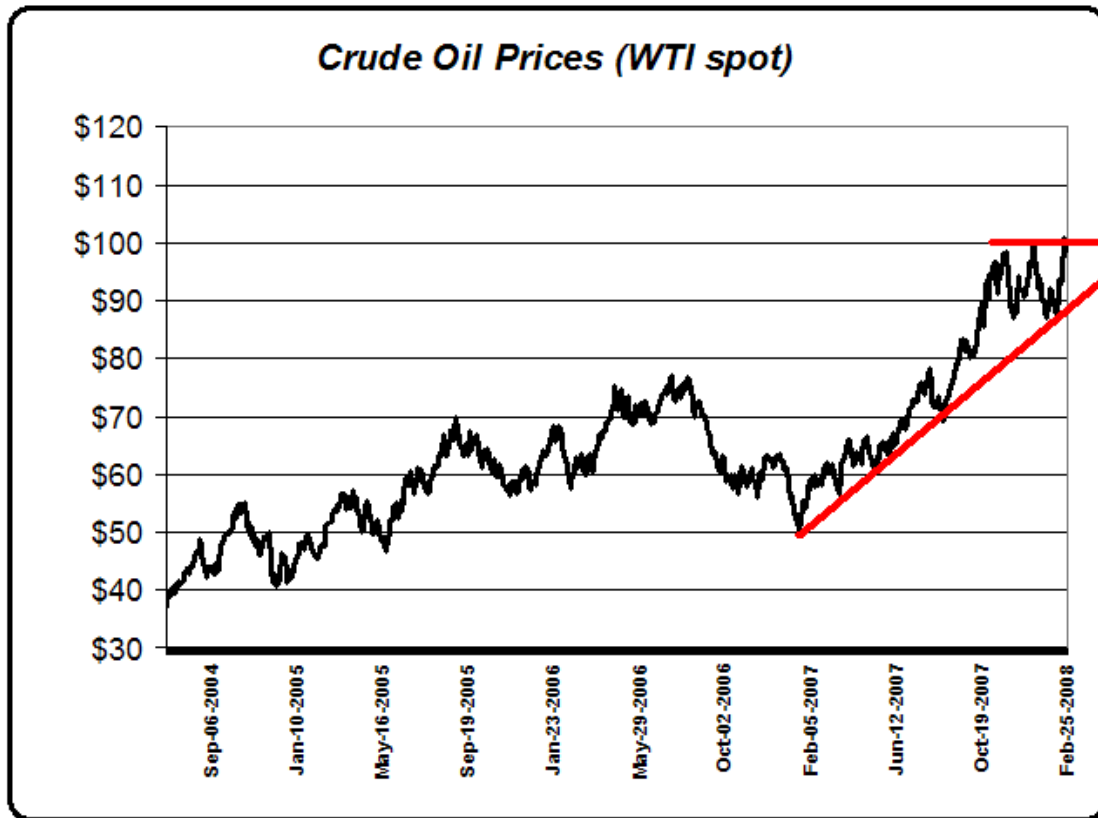
### **Crude Oil Prices Will Continue to Rise**

A stunning combination of stagnant crude oil supply growth, rising global demand from emerging economies and a weak US currency is propelling crude oil prices beyond all previous records. I expect this trend to continue. Two years ago, I stated publicly that by 2016 we would see \$180 per barrel price on West Texas Intermediary (WTI) oil which was significantly above the \$60 level at the time. To be on track to reach that level we should be in the \$75 range. Given today’s prices of \$100+ and the continued growth in demand and lack of demand growth, I fear we can exceed that \$180 level significantly in the next ten years.

The silver lining to a rising price trend is that it will encourage the development of long term solutions such as renewable energy, hyper efficient automobiles and energy efficiency/conservation solutions. Below is the historical price trend in WTI crude oil since the Oil Sands Sector Index was created. The price pattern looks to me like it might quickly breakout of the \$100 price level soon and move up dramatically in the short term. There is strong support in the \$90 to \$92 range that should support any short term pullbacks.



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### Global Oil Supply is Flat

It is hard to believe that we have yet to see a supply reaction to the record crude oil prices as you would expect in a well functioning capital society. Several factors are preventing the supply from catching up to rapidly growing demand:

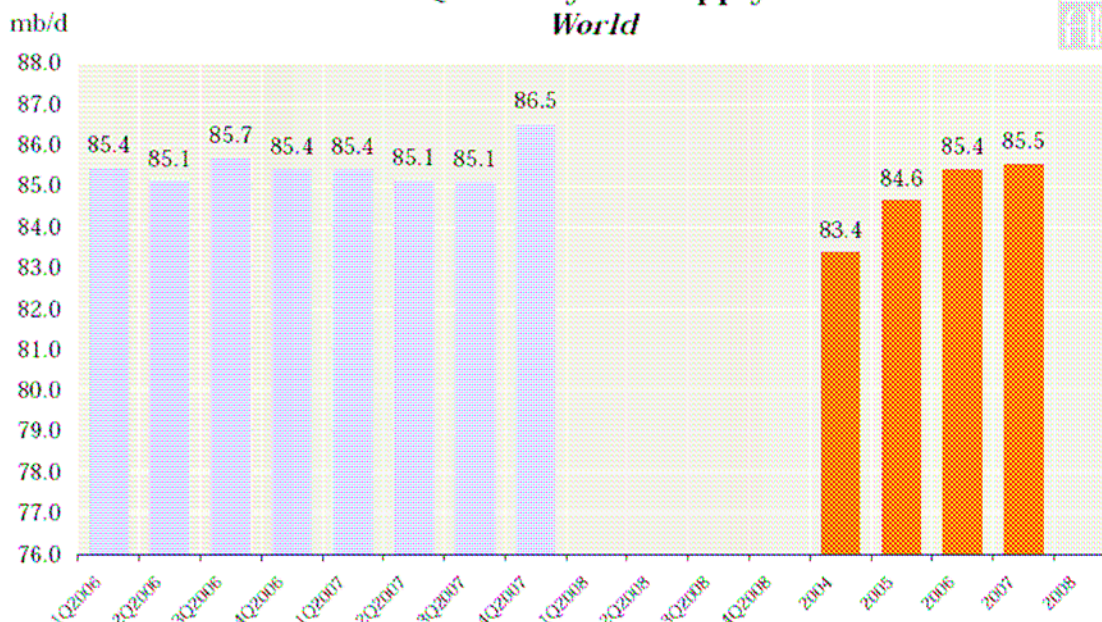
1. Most of global oil reserves are held in authoritarian, non capitalist countries
2. There is a lack of low cost, easily accessible new oil reserves to extract
3. Rising costs with marginal returns are making oil company executives cautious about new projects, preferring to pay dividends and buy back shares
4. Most of the remaining untapped oil reserves are in remote or dangerous locations with limited infrastructure and skilled workers

The chart below from the IEA clearly shows that supply has been flat for at least two years and they are unwilling to project out 2008 supply projection (yet are comfortable enough to post a 2008 demand projection).





### Quarterly Oil Supply World



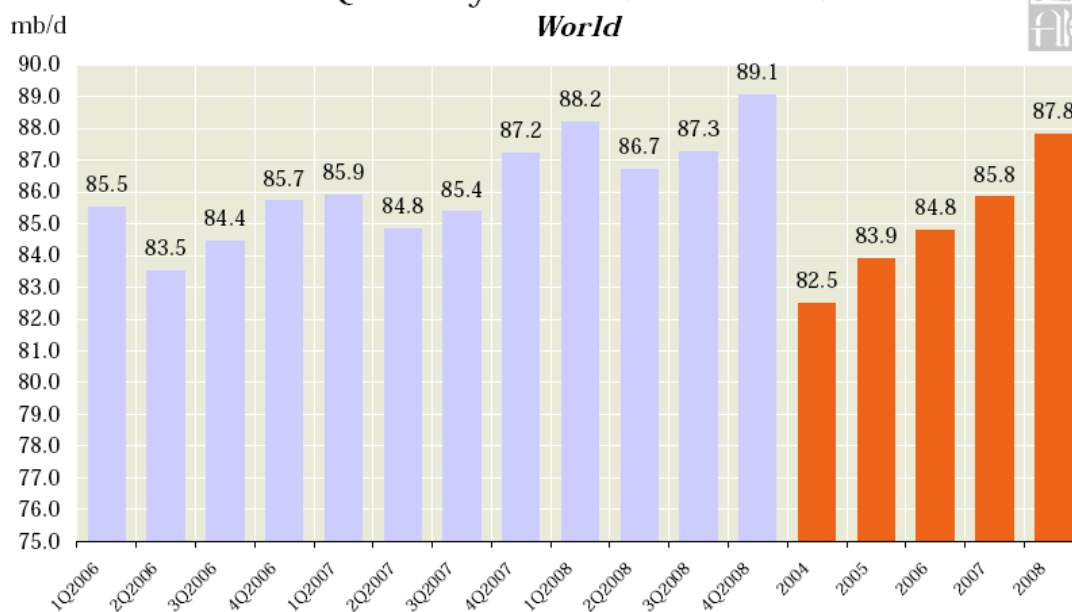
### Global Oil Demand is Increasing Rapidly

The world demand for crude oil seems to be growing irregardless of the rapidly rising price. This was similar to the trend in the 1970s when crude oil prices started the decade at \$1.35 per barrel and ended the decade at over \$35 (on its way to a \$40+ high in 1981). Despite a 25 times increase in crude oil prices there was 35% rise in world crude oil demand from 46 million barrels per day to over 62 million barrels. This represented a 3% growth rate in global demand which is substantially stronger than today's 1.6% demand growth over the last decade. Regionally, developed European countries have flat demand growth and North American demand seems to be slowing at this time. The real growth is coming from three main regions, China and India, oil producing nations such as the Middle East countries and Russia, and the Eastern European nations. The growth from these three regions is accelerating at over 4.5% per year. Even if the North American and European nations have flat demand growth in 2008 we are expecting to see above trend demand growth globally of 2.3%. Currently, supply is short of last year's demand by about 300,000 barrels per day. If supply remains flat in 2008 then demand will outstrip supply by over 2,000,000 barrels per day, a first since the 1970s when Saudi Arabian supply was withheld in 1973 and Iran supply was withheld in 1978. Assuming we experience no supply shocks in 2008 we can expect significantly higher prices will be needed to reduce global demand growth to match the available supply. Any supply shock this year will result in a huge run in crude oil prices similar to ones experienced in the 1970s. The chart below shows how strong the demand growth has been since 2004.





### Quarterly Oil Product Demand *World*



### Environmental/Political Trends will slow supply growth

The nationalization of oil reserves by socialistic governments around the world and the strong environmental movement is discouraging the search for and development of new oil reserves. The risk of a host country nationalizing a major oil project is making oil companies very reluctant to invest the billions necessary in these frontier regions such as the Caspian Sea, Arctic and deep offshore. The huge profits major oil companies are earning and their flat production growth has exposed them to criticism from politicians and consumers which are likely to result in windfall taxes and increased scrutiny in the future. Another risk is that tougher environmental concerns will stop the development of known energy reserves such as the oil sands. Lastly, the actions of major oil producing nations such as Venezuela, Russia and the Middle Eastern countries indicate that they are investing only minimal amounts into new crude oil production and diverting the excess to the government for social spending. This is a strategy that will guarantee that future oil production will soon peak and begin a downward trend.





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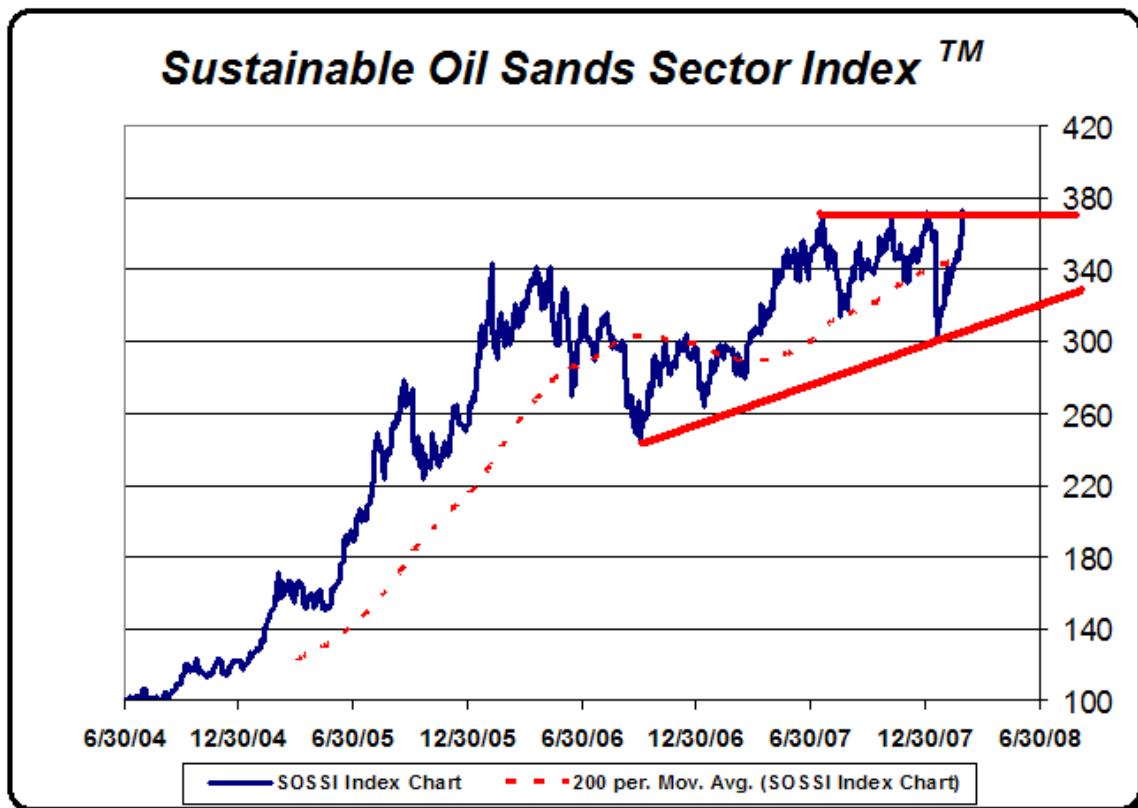
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**Impact on Oil Sands Producers**

The conflict between environmental concerns and the need for more energy will likely be resolved in favor of generating more energy. One of the world's major energy users, China, has already dealt with this issue. China is using its huge coal reserves to provide over 70% of the country's electricity needs. The US is not far behind with over 50% of its electricity coming from coal. Coal is even more damaging to the environment than oil sands yet its use in the future is destined to increase as other fossil fuels such as natural gas and crude oil become scarce. For investors, you can expect that oil sands producers will be one of the major beneficiaries of the continuing energy crisis. The chart below shows how the oil sands index is poised for a major break above the triangle pattern as long as the supporting trend-line is not broken in the near term.



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