



Energy Co2 : Fossil Fuels

"The Age of Easy Energy is Over"

Wondering about energy security and rising oil prices? Christopher Wheaton, manager of Allianz Global Investors' Global Energy Fund, cuts through the hype about the world's most important energy trends.



Christopher Wheaton, Allianz Global Investors

You run a billion-dollar fund, what would you personally invest in at the moment?

Even with the spikes of the last two months, average oil price this year is still only 69 dollars. I expect them to be higher next year, so I would still buy energy stocks leveraged to this high oil price. They make more money when oil prices go up.

Another area of interest is liquefied natural gas. The problem with gas is that it tends to be found far away from where it is consumed, so the challenge becomes getting it to market. Sometimes you can't put it in a pipeline, so what you do is liquefy it and transport it in huge tankers. That is a growth business given rising gas consumption worldwide and the declining gas production in western Europe and the United States.

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You mentioned high oil prices. Should we just start getting used to them?

Right now, oil prices are higher than they theoretically should be. They should sit around the level of production costs – around 55 to 60 dollars a barrel - but they aren't because of fears over supply shortages. Despite a weak U.S. economy, where oil demand is down about two percent on last year, the world still appears to be consuming all the oil it can produce.

For oil prices to come down, one of two things has to happen: either

high prices cut demand so that the world ends up producing more oil than it is consuming, or new supplies have to be brought into production. There is a big oil field in Saudi Arabia starting up this month, and there should be more projects coming in the next year, particularly outside Saudi Arabia and the rest of OPEC. If these things happen, then we should see reduction in oil prices to a lower level, but I still expect next year's average prices to be higher than this year's.

Some say we are already seeing a "peak oil" scenario where global oil production has reached its all-time high and will drop from now on, leading to constantly rising prices.

I don't think we are in a peak oil scenario. I see the investment the industry is making will deliver new production ahead of demand growth - not this year, but almost certainly next year, the year after, and probably the year after that, as well. So, the best forecast I can give is that oil production will rise not by much, but steadily until 2015. And then it will be much harder for new developments to offset the decline in existing production. Then I think we will see global oil production peak and start to decline between 2015 and 2020.

And then what will happen?

We have seen that fear of shortages can drive up oil prices much faster and much further than anyone could have expected. It is reasonable to assume that if peak oil scenario emerges, you will see a similar thing happen. Could oil prices spike to 120 or 150 dollars a barrel? Possibly. You would have thought there would have been an increasing amount of energy demand fulfilled by renewable energy by then. It becomes a much more complicated interplay between how much demand gets limited because of high prices, how much demand for fossil fuels can be substituted by renewables, and how people respond in that sort of scenario.

It is not clear how people will react. You will certainly see increased levels of resource nationalism. People will say "this is our energy - we will use it ourselves and not export it," which could aggravate supply shortages. You can paint a quite bearish scenario of a world running out of oil that doesn't have enough alternative energy sources and a disastrous impact on economic growth, the trend of globalization completely stops and reverses, and resource protectionism increases.

What can you say about the oil-rich tar sands in Canada?

Potentially, this is a huge hydro carbon resource. It would make Canada the second-largest energy resource holder after Saudi Arabia. It is heavy oil that is trapped in large deposits in the soil in the far north of Canada. And because it is in the far north and it is heavy oil, it always had low value and been very costly to extract. It costs around 20-25 dollars a barrel just to extract the oil, compared to 3-5 dollars in Saudi Arabia.

And there are environmental pressures as well. Oil sand extraction needs a lot of water - you use two barrels of water for every barrel of oil you process, and water resources are limited. - you have to get that water from somewhere, and you have to be able to treat it after it has

been through the production process. Obviously, when oil was at 30 dollars there was little money in oil sands developments. With the oil price rise, there has been an awful lot of investments- which in itself, has pushed operating costs up significantly.

What is your outlook for oil companies for the coming decades?

As long as oil prices stay high, oil companies will be among the world's most valuable companies simply because of the high profits and cash flow they produce. It won't just be Western oil companies either, but a much more international mix. It will be companies like PetroChina, the Russian Gazprom, or Petrobras from Brazil, because they own the energy resources in the ground. They will be some of the world's largest companies in the 21st century.

I think the major western oil companies will be among the losers. Established western oil companies have older producing fields, and they require more investment every year just to hold production volumes flat, let alone try and grow them. So even despite rising oil prices, the cash flow these businesses generated for shareholders has not increased much, because it has all been reinvested just to try and stand still.

What are the other impacts on the oil industry?

The cost of new projects has gone up. The age of easy energy is over. Oil is harder and more expensive to extract than ever before. The increasing amount of oil coming from deep, offshore oil fields where development costs are much higher is an example of this. Operating costs are rising, as well. There is a shortfall of investment: there aren't enough people entering the oil industry, and there isn't enough capacity in a number of important oil service businesses that the oil companies have to use to develop new projects, therefore cost inflation is significant: 10-15 percent annually.

And lastly, taxes have been rising. Because of high oil prices, governments want to take a bigger share of revenue through taxation. So you have a steady trend of rising tax rates for oil companies all around the world- some recent examples include Russia, Britain, Algeria, and Canada.

You mentioned Gazprom. How reliable is Russia as an energy supplier for Europe?

We are dependent on Russia for gas, but I don't really see an alternative. I think Russia will be a reliable supplier to Europe as long as it can meet its domestic demand for gas. What I see happening is Russia building new pipelines and investing in new producing fields, so there is limited risk of supply disruption. In addition, industrial users of gas in Russia will be forced to pay higher prices in the future, which will promote energy efficiency and reduce wasteful use of energy within Russia. So, I see enough supply for Europe.

Against this backdrop, does investing in nuclear energy make sense?

The world will have to invest in nuclear energy, because there are not

enough alternatives to meet energy demands. The concern is that investment in nuclear energy takes longer and is more expensive than the budget allows. But that investment will have to happen. I do not see how energy demand can be met over the next 50 years unless nuclear is part of the supply mix. We will see it in Western markets, but also in emerging economies like India and China.

How about renewables? Are they a viable alternative to fossil fuels and nuclear?

My fund is not focused on renewables; Allianz has another fund whose primary investments are renewable energy, though I do see some areas as attractive for investment by my energy fund.

However, there is a certain amount of speculation within the renewable energy market, and there is uncertainty regarding subsidies, because a number of these business models only make sense if they continue to receive government subsidies during the early part of their development. In the short term, that enables them build up a critical mass, but discussions about reducing subsidies faster than expected can hit stock prices.

Among the renewable energy sources, which one attracts most interest from investors?

That's a bit like asking what your favorite color is. All renewable sources are interesting in a different way. Wind and hydropower have low operating costs, but they are already being exploited in terms of potential sites. Solar or geothermal have higher costs, but much more growth potential. So there is no simple answer.

There is one fossil fuel we have not talked about so far, coal. What's its position?

Some of the best performing energy stocks this year were Chinese coal producers. Some have more than doubled in six months. Coal will have to be part of the future energy mix, particularly in developing markets. There simply isn't enough natural gas, other fuels or renewable energy to go around. But this has to go together with clean coal technology and maybe even carbon dioxide sequestration. This, along with "clean coal" technology, will be adopted in Western markets first ahead of developing markets.

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