Oil & Energy Investor
with Dr. Kent Moors

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$150 Oil

Five Reasons Crude's Set to Double… And Five Ways You Can Profit

by Dr. Kent Moors, Editor, *Oil & Energy Investor*

Dear Reader,

Right now, according to the Energy Information Administration (EIA), we have the largest stockpile of oil products on hand since January 1983. Between crude and refined products, there are more than 1.14 billion barrels of excess volume in the market.

With such a supply glut, you'd think oil prices would keep falling.

But that's the short-sighted view.

Companies are hoarding inventory for a reason: They know oil prices are about to rocket higher. And they want as much of it as they can get before that happens.

Indeed, crude could *double* over the next six months.

Here are the five primary reasons and how to profit from each one…

1. Refinery Capacity Is Maxed Out

We are slowly moving out of a financial crisis that significantly cut oil demand… and right into a world of constricted supply.

As the economic situation stabilizes, that demand will begin to return. It has already begun in a number of regions. But total present worldwide crude supply tops out at about 91 million barrels a day (mbd), while current daily demand is about 86.5 mbd… *and rising.*

As demand returns – and that margin of security narrows – the "excess crude" will be priced higher. *Fill up now*, the refineries are telling us, *before the price goes up.*

With U.S. refinery capacity use above 90%, it will be a strain to meet rising demand here.

Much has been said about the U.S. failing over the last 30 years to build a new refinery anywhere in the country. Environmental regulations and NIMBY ("Not in My Back Yard") opposition are often given as the causes. Yet these are not the real reasons.

It turns out that, by the time a new refinery in the States could move into production – *six years or more*, if the project were to start today – it becomes cheaper just to import the oil products from plants abroad.

Doing its own refining is just not an effective way to drive down a company's bottom line (or drive up its profits). National security considerations aside, therefore, the refinery market will become increasingly driven by plants built close to production locations, especially in developing countries.

To be sure, refining capacity is quickly taking over as the barometer of actual oil market control…

And moving forward, **this is the wrinkle in the global energy market that may well provide a substantial return on investments.**

Watch the companies building refineries in developing countries to service growing demand, both domestic and export. The overall capital needed to build the facilities in new oil countries like Uganda and Nigeria is lower, as are operating costs, while there's a significant *discount* in access to a guaranteed raw material flow to the expense of building the plant elsewhere and then importing the crude.

There are several high-profile engineering and construction companies currently emphasizing the building of refineries in developing production countries to straddle both the domestic and export markets. The list includes Texas-based **Fluor Corp.** (NYSE:FLR) and California-based **Jacobs Engineering Group Inc.** (NYSE:JEC), along with the ever-present **KBR Inc.** (NYSE:KBR) and **AMEC** (LSE:AMEC.UK).

This is an exploding market. While aggregate refinery capacity in developed countries shows only an anemic improvement over the past several years, those figures are rising significantly in other parts of the world. That means more and more of that returning demand will be met by oil products refined in emerging markets.

I wouldn't be surprised if somebody put together an exchange-traded fund (ETF) to highlight the engineering and construction companies at the leading edge of providing refinery capacity in developing nations to meet the rising needs in other parts of the world.

I'll keep an eye out for exactly that.

2. Iran Is Battling an Energy Crisis

In late July 2010, the U.S., European Union, and U.N. passed a new round of sanctions to compel Iran to stop its nuclear enrichment program.

And this time, they're aimed at its energy sector.

Despite having the second-largest oil reserves in the world (after Saudi Arabia), Iran has insufficient *refining* capacity (the same phenomenon I mentioned above). So it needs to import gasoline, diesel, and heating oil to meet domestic needs.

The sanctions make it more difficult for Iran to access banks, exchange currency from oil sales, and import fuel. But here's the key to the pop in crude oil prices coming and the investment profits that will result…

The sanctions will prevent Iran from doing oil sales in dollars or euros. Since virtually all oil contracts worldwide are in dollars – with euros being a distant second – that puts Tehran in a difficult position. Iranian banks cannot acquire either currency anymore. They will need to move to other currencies in a very inefficient attempt to continue doing business.

They have already signaled a move to the yuan (the currency of China, Iran's current primary oil trading partner) and the dirham (of the United Arab Emirates) to gain access to Dubai banks, Abu Dhabi oil swaps, and a backdoor into dollars and euros – although at a premium.

All of this will significantly cut into Iran's oil sale revenues, because the rest of the world still denominates oil exchanges in the very currencies Iran can no longer use.

As this situation unfolds, it is certain to add jitters to the market, reflected in crude oil contracts denominated in both dollars and euros. It will also increase the "crisis premium" on setting prices in futures contracts.

Because Tehran will not be giving up their nuclear ambitions any time soon, it may mean increasing pressure on hard currency pricing for oil.

And now how to make some money from it.

Timing is crucial. This profit opportunity will come and go quickly.

There will be a brief period of one to two contract cycles (about 45 to 75 days), in which the oil product trading market will be oversold. Trading companies will have excessive product on their books from the transitioning out of Iranian trade.

It is at this point that you should short my favorite oil ETF: the **PowerShares DB Energy Fund** (NYSE:DBE).

Based on the Deutsche Bank Liquid Commodity Index-Optimum Yield Energy Excess Return, DBE is the only liquid ETF allowing investors to participate in futures contracts movements in West Texas Intermediate Light Crude (the basis for NYMEX contracts), dated Brent (performing the same function for London and European pricing), heating oil, natural gas, and RBOB gasoline ("reformulated gasoline blend stock for oxygen blending," the new NYMEX benchmark gasoline contract).

In short, DBE is a security well-structured for the move. It is the only one available that will pick up the blip as it rapidly moves by.

The only two matters you need to know are when to *start* the process and when to *end* it. This will be a quick move in and out of a market that will experience a temporary imbalance.

When the time is right, I will tell you when to open and when to close the position.

3. The Oil Futures Bubble Continues to Expand

Normally, the market price for oil is pegged to the price of the next available barrel. However, in the current climate, we are beginning to see a mindset that questions both the sourcing and the quality of future crude. That will translate into the price being pegged to the *highest-priced,* next available barrel.

We have certainly seen this accelerated pricing practice recently – the run-up to $147.27 for a barrel of oil almost exactly two years ago, for example. This very thinking is behind the expected surge in capital expenses and the "big boys" getting bigger.

Oil is no longer simply a commodity – it's a financial asset. And that means trade in its future prospects attracts a lot of speculative attention bearing little relation to the value of the oil.

Much like one can bet on the total number of points scored in a football game (the "over-under") without caring who wins, so we are witnessing growing interest in maximizing the price spread of futures over "real oil."

Both are derivatives – one on a sporting event, the other on a commodity. Neither should be considered reality, as such.

Unfortunately, that is exactly what has happened with oil. Greater investment concentrations into futures, from investors with little interest in oil deliveries, will produce new derivatives to squeeze speculative value out of yet other derivatives. That will progressively undermine the market value of the oil itself…

Unless, of course, we change *access* to participation in price-setting.

Earlier this year, a group of heavy hitters (me included) met in London to hammer out such a solution. We proposed to the London Stock Exchange financial gurus the introduction of new exchange-traded funds (ETFs) reflecting the value relationship between oil as a commodity and oil as an asset – to bridge the gap between the oil of the speculators and the oil of the delivery market.

The difference over what currently takes place is this. An instrument so designed would allow hundreds of thousands of small investors to price the relationship, and thereby provide a way to peg futures contracts more firmly to the value of the underlying asset.

It allows the little guy to participate… where the big profits are being made. **And for us, it means there's a tradable connection between oil futures and oil barrels.**

Now, an ETF needs a real tradable asset upon which to operate. In oil, that has meant instruments based on oil for delivery. As the derivative market progressively established its own asset (the futures contract), an ETF based on the actual crude oil provided little reflection of what was developing (or, for that matter, where profits were being generated).

However, we have now reached a point where a tradable connection between two divergently developing oil assets (futures and barrels) is not only possible, it's *necessary*.

The approach should be pilot-tested in private trade, followed by the announcement of a London index reflecting a moving average (probably 30-day) to act similar to volatility indices (VIXs) already in use.

That will be followed by a new tradable paper that should finally give the average investor access to the real money-making. One of the side benefits should also provide some stability for traders to set realistic option swaps for futures contracts, curbing the primary problems resulting from cycles of volatility in pricing futures contracts.

Seems the little guy is back in the game… and now with an opportunity to change how that game is played. I'll keep you informed.

4. The BP Disaster Intensified the Global Oil Shortage

Deepwater drilling was to be an essential part of bringing on-line additional supply to meet that growing demand. (Remember, the decline in demand resulted from an international financial crisis. Not a sudden change in the oil market itself.)

The only net additions to U.S. production through 2015 were to come from deepwater drilling in the Gulf of Mexico. Worldwide, it was expected to accelerate – off of Brazil, Vietnam, Nigeria, Ghana, Russia, and a number of other locations. In five years, deepwater drilling was to have made up 10% to 12% of all global production.

This is the reason companies are assuming the great risk and expense of drilling considerably offshore – because that's where you find most of the major fields left undiscovered.

Moving forward, it is not just the volume lost from the Macondo well that will contribute to the shortage. Rather, as the BP disaster causes a rethinking of deepwater drilling production plans and a renewed call for legislation, it may result in the loss of a far greater volume of supply from all around the world.

And here's the investment play to watch out for, one that will provide a useful offset strategy moving forward.

The overall effect on investment in the energy sector will undoubtedly be an emphasis on the environmental impact of both onshore and offshore drilling. That, in turn, will bring into play a wide range of environmental service companies.

The most direct way to balance the entire sector is to use the **Market Vectors Environmental Services ETF** (NYSE:EVX). This exchange-traded fund attempts to reproduce – at least before fees and expenses – the price and yield performance of the **NYSE Arca Environmental Services Index** (AMEX:^AXENV). AXENV, in turn, is a modified equal dollar-weighted index comprising 21 companies, all included in EVX.

5. The Next Oil Disaster Is Coming... And It Will Be Worse

There is an accelerating oil disaster forming right now. We have seen three examples of it in the past six weeks.

First, on July 16th, a pipeline ruptured in the Chinese seaport of Dalian.

Then reports surfaced on July 26th that more than 150,000 barrels of crude oil were spilling from an **Enbridge Energy Partners** (NYSE:EEP) underground pipeline connecting the U.S. and Canada.

Finally, on July 27th, a tugboat hit an abandoned **Cedyco Corp.** (OTC:CYDC) wellhead in the waters off the mouth of the Mississippi River (in the beleaguered Gulf of Mexico).

Despite taking place in three very different places, these events all have one thing in common: They indicate that delivery infrastructures worldwide are beginning to show their age.

Leaking pipelines are hardly a new development. After all, reports point to as many as 5,000 leaks on any given day in the extensive Russian oil pipeline network administered by state-controlled **Transneft** (OTC:TRNFF, although it's hardly ever traded).

Then, in the case of the tug collision with the Cedyco wellhead, there are more than 27,000 other capped wells like that in the Gulf, some going back to the late 1940s. The integrity of at least some of them is very much an open question.

Elsewhere, the problem is even worse.

Thousands of insecurely capped wells from the Soviet period dot the coast of Kazakhstan. The water level there is rising, and crude is flowing back into the Caspian Sea. This has destroyed sturgeon breeding grounds, decimating the caviar industry and the local fishing economy along with it.

As a straining, aging system continues to put greater reliance on older, less maintained throughput networks, these problems will only intensify.

In the U.S., an overwhelming amount of the 55,000 miles of main trunk lines and as much as 40,000 miles of gathering and spur oil pipelines are more than 35 years old. That makes them prime candidates for leaks… and worse.

One thing is certain: The ability of companies to avoid repair will be drastically reduced. In the aftermath of the BP spill, new regulations issuing from both Washington and state capitals will require them to pay greater attention to facility integrity.

It will take increasing amounts of working capital to repair and maintain the extensive system of pipelines, terminals, pumping stations, and connections to both onshore and offshore shipping/transport locations. Companies that delay these repairs, in hopes of not having to worry about the matter, may end up simply worsening the result.

Currently, the immediate need worldwide is put at $500 billion… and it's growing by about a billion dollars every *week*.

This also means a lot of new business for companies that provide alternatives to simply watching a pipe corrode. As the system continues to deteriorate, there is going to be increasing activity in this sector.

And it holds some great plays for the investor.

One is **Insituform Technologies Inc.** (NasdaqGS:INSU), presently repairing more oil, gas, water, and sewer pipelines worldwide. Another is the **Mears Group** (LSE:MER.UK), specializing in international applications of pipeline and drilling engineering and accident prevention. And **Primoris Services Corp.** (NasdaqGM:PRIM) is positioning itself well for an expanding volume of work across a broad spectrum of pipeline repair needs in sectors from oil and gas to municipal waste water.

But the company likely to profit from the rising concern over capped offshore wells is **Cameron International Corp.** (NYSE:CAM). (It's also the world's leading manufacturer of blowout preventers (BOPs) – including the one involved in the BP mess. However, in that case, the BOP itself seems to have functioned well. Problems arose elsewhere.) The CAM division addressing the rising capped offshore well problem is the fastest-growing in the industry.

As always, count on me to keep an eye on things.

Sincerely,

Kent

Dr. Kent Moors *has been advising the world's largest and most active energy producers and buyers for 31 years, including six of the world's top 10 oil companies and high-level government officials from the U.S., Russia, Kazakhstan, the Bahamas, Iraq, and Kurdistan. Business clients include the Bank of England, Citicorp, AT&T, Deutsche Bank, the European Bank for Reconstruction and Development, the Russian Central Bank, and Westinghouse.*