LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"The genius of investing is recognizing the direction of a trend—not catching highs and lows."
—Anonymous

At Lawson Kroeker Investment Management, our focus is on long-term investing rather than short-term trading. A longer lasting move that we think has emerged over the last few years is the trend toward higher oil prices. Longer-term moves are frequently interrupted by short-term swings in the opposite direction. Trying to take advantage of these short-term swings is very difficult and exposes one to the risk of missing the long-term trend which we feel should be the focus.

To formulate our opinions, we utilize numerous resources. In the energy arena, one of those resources is Charlie Maxwell, an energy analyst, we came to appreciate during the 1970s—the last elongated period when energy proved to be a superior investment. Mr. Maxwell spoke at this year's Contrary Opinion Forum.

His main points were:

- *The world will reach geological constraints on oil production by 2015 or 2020.*
- *The current high energy prices are the result of the failure of the energy industry to invest in new discoveries since the late 1980s.*
- *Increasing demand from China and India will only exacerbate the supply demand imbalance.*
- *Increasingly, middle-eastern oil ministers are expressing an unwillingness to invest in new energy projects many years in advance just to satisfy our needs.*

Central to Mr. Maxwell's thinking is that the world's ability to produce increasing amounts of oil will peak between 2015 and 2020 with oil prices reaching $200-$300 per barrel by then. This position is based on reaching Hubbert's peak which we explored in our October 2004, *As We See It* (copy enclosed).

While in Mr. Maxwell's view, higher oil prices are inevitable because the world reaches peak production in a few years, the current high oil prices are the result of underinvestment in new oil projects since the late 1980s, when there was a 20% surplus of production. At that time, the international oil companies decided they did not need to invest in new projects, as a 5–6% surplus in capacity was ideal. So, in a world of 2% annual growth in oil demand, the oil companies increased capacity by 1% annually. Hence, by 2000 the surplus capacity had declined to 6% but the oil companies continued with only 1% increases in capacity. Surplus production capacity is now somewhere between 0–1% and getting back to 5–6% surplus in capacity appears extremely unlikely. Hence, Mr. Maxwell is forecasting that oil will trade in the $55-$75 per barrel for the next 1½–2 years and then move upward to the 2015–2020 peak.

Mr. Maxwell's third point was that both China and India have growing demands for energy. In the U. S. we consume 26 barrels of oil annually per capita. China consumes 1.625 barrels annually per capita—and India even less, but their demand is growing. For an indication of how that demand might increase, Taiwan consumes 16 barrels annually per capita. If China and India were to get anywhere close to Taiwan's usage, it would have a dramatic impact on oil demand and prices.

Finally, Mr. Maxwell noted that as he visits with middle-eastern oil ministers he is finding increasing reluctance to invest in new oil projects just to satisfy the needs of the rest of the world. The oil ministers are thinking that if they respond to world needs and invest aggressively only to reach peak production in 2015–2020, they will more quickly deplete their reserves and go from Bedouin to Bedouin in four generations. Therefore, most national oil companies who control 77% of the world's oil production are not increasing capital expenditures in hopes of delaying the production peak and letting the oil run out over six to eight generations instead of four.

The energy story is very complicated and has many parts to it. We at Lawson Kroeker have taken a long-term view which agrees with those who forecast high energy prices for the indefinite future. While recognizing short and intermediate terms may experience wide swings in price, we feel there are many fundamentals pointing to high energy prices in the long run—and they should not be ignored.

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