The Trudel Group Business Innovation Update 3Q08

"An occasional newsletter to share ideas and insights on information age topics."

Special Issue on Energy Self-Reliance

Context for a transition….

We argue the most crucial issue facing America is developing an energy policy that reduces dependence on foreign oil, but it's important to realize the problem is caused by a political blockage, one which is generally accepted, imbedded deeply into all the campaigns, but rarely discussed. That blockage is dysfunctional government. Examples of broken programs are common: FEMA, Health Care, Education, War on Drugs, Immigration, etc.

This is the elephant in the living room, with the approval ratings of Congress hovering in the low twenty percentile (22% last week) and of the President at around 30%. All the campaigns strive to distance themselves from Washington. Those who seek Washington's power simultaneously disown it. Obama is all about "Change," Hillary is about effective programs to help the masses, while McCain positions himself as a populist reformer alienated from his own party.

What does this have to do with energy policy? ***Nothing and everything.***

Everything, because, as we'll see, the transition from oil is a long, hard road. There are no simple solutions, silver bullets, or quick fixes. Investment, innovation, and technology are needed.

Everything, because the energy bubble and commodity shortages we're facing are not yet driven by "peak oil" or scarcity, but by policy. If you can accept this, the rest of our discussion about energy will make sense to you. If not, well, you're reading the wrong newsletter.

> *"How many entrepreneurs will invest in new food and energy sources when a currency is collapsing, investors are fleeing to speculation, capital gains taxes are set to go up, and green zealots are blocking breakthroughs in nanotech and genetically modified food? [JDT note: Plus oil exploration, shale extraction, new pipelines, modern refineries, nuclear plants, etc.] As has always been the case, bad government policy, not finite resources or growth, is what causes shortages and bubbles."*
>
> Rich Karlgaard, ***Forbes***, May 19, 2008

But, unfortunately, broken government has ***Nothing*** to do with attaining Energy Self-Reliance anytime soon, because there are no urgent plans to cut oil prices. The focus of policy is on long term alternatives. Cheap oil is simply not a priority, so the future will resemble the recent past.

> "There is some reason to believe the commodity bubble will keep inflating. None of the three Presidential candidates – Barak Obama, Hillary Clinton, John McCain – opposes the bad policies that have led to the shortages, and none is skeptical of global warming or willing to drill in the Arctic National Refuge."
>
> Rich Karlgaard, ***Forbes***, May 19, 2008

Oh, sure, there is discussion and interest in renewable energy, gas tax holidays, and a variety of clean, green, politically correct alternatives, but campaign rhetoric does not a viable energy policy make. Some major government programs actually move us ***away*** from Energy Self-Reliance.

Our 3Q07 newsletter reported that Corn Based Ethanol was flawed policy that used as much oil as it replaced, though I must confess we didn't predict it would also cause a major global food crisis. Ethanol policy, tariffs, and subsidies continue unabated despite these disastrous results.

And some of the best outcomes were accidental. Congress mandated cleaner diesel fuel, enabling carmakers to introduce a new wave of diesel-powered vehicles. Instead of the old, sluggish, stinky, smoky diesels, the new cars are clean, fun to drive, and get 35% better gas mileage than their gas-powered siblings. In Europe, half the passenger cars are now diesel. Energy wise, they do better than hybrids if total life-cycle energy consumption is considered.

Even the programs that do have links to sound policy – like imposing standards for increased gas mileage – tend to be highly misleading. Let's suppose that it was economic and practical to develop a 50 MPG car. How long would it take to bring it to market? Perhaps 5 years, which is to say, beyond the tenure of the next President. And the last attempt at this is what drove America into gas-guzzling SUVs and trucks, because these were perceived as safer in crashes.

And few policies are integrated, which leads to strange results. Recently a small private firm drilled a field in Colorado's Denver-Julesburg basin. It found a good supply of medium grade crude, but then had to shut down the well due to the lack of a pipeline for getting it to market. The CFO said, "We would sell for $30 per barrel if we could find a buyer." (Source, ***Forbes***)

How can that be? Paul MacAvoy, economic professor emeritus at Yale University, explained that the rates pipeline companies can charge to move crude are capped by the Federal Energy Regulatory Commission. Building new pipelines would significantly lower their profits.

It gets worse. Shell estimates that there are 1.5 trillion barrels trapped in the oil shale deposits of Colorado, Wyoming, and Utah. Unfortunately, Congress passed a measure last December – thank you Nancy – which prohibits spending to lease oil shale on Federal Lands. Royal Dutch Shell estimates the Continental Shelf contains 100 billion barrels of oil that is technically recoverable, but Congress has declared 85% of the U.S. Coastline off limits to drilling. Russia wants to develop oil from under the Arctic Ice pack, but American companies and the Navy dare not even suggest it. So much for cheap domestic oil. ***Better to buy from the Arabs and terrorists, I suppose….***

Many argue we don't need any more oil. They say we'll transition to something, perhaps to hydrogen, perhaps to battery powered cars. Yes, eventually, but how long would it take to develop the infrastructure and vehicles? ***Several decades, as a minimum.*** Meanwhile, we'll still need oil.

Recurrent huge gas cost spikes at pumps across America are largely caused by the limited capacity of antiquated, overloaded refineries. The newest refineries are 30 years old, some date from the 1940s, and, overall, all run within a few percent of capacity, leaving no margin for shortages or breakdowns, which are increasingly common in today's world.

There are no plans to change this. Congress recently had six energy executives testify, asking if they would add refinery capacity if permitted to do so. Not a single one was willing. Given the negative environment in America for developing oil, this shouldn't be surprise.

So Just Let Industry Do It….

In a perfect world, this might work. But I'm not optimistic, because this isn't about the "invisible hand" of free market economics; it's about cartels backed by governments manipulating prices to keep control, to keep prices up. (We call that "price fixing" here. It's not legal.)

"For OPEC the optimum pricing pattern is $100, $100, $100, **$10**, $100, $100," says Robert Wescott, president of Keybridge Resources in Washington DC. "Just when oil shale and tar sands get investment lined up, you (drop prices and) crush the investors."

Just a decade ago, oil was $10 a barrel. No big oil company is willing to place multibillion dollar bets that oil prices will stay where they are now. Speculation is now safer than development.

There are ways to reduce the cost of America's oil (domestic development, futures markets, etc.) but they require a ***policy commitment*** to low-cost gasoline. Green zealots wink, applaud Gore's conjured crisis, and say expensive oil is beneficial. Washington's own policies drive expensive oil.

Five discussion points for Energy Self-Reliance. What do you think?

- Advanced societies use ever more energy. This is good. We call it "progress." Alternative fuels are necessary long term. So is oil, for many decades to come.
- Government should encourage outcomes, not prescribe solutions.
- America uses a total of 20.7 million bpd [= $2.5 B/day @ $120/bbl] and is projected to ***import*** $400 B of oil in 2008. The transportation sector uses 70% of our oil. It's the crucial area. (Sources: Forbes, U.S. energy administration)
- To help energy consumers, government must enable energy producers.
- Congress needs honest, non-partisan, competent science advice. Bring back the Office of Technology Assessment (OTA) for wise, objective counsel.

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The Business Innovation Newsletter is published by The Trudel Group, 1102 N. Springbrook Road, # 281, Newberg, OR 97132. Telephone 503-538-1169; email mailto:jtrudel@trudelgroup.com or http://www.trudelgroup.com/.

“There are now 12 energy companies in the world whose reserves exceed those of the largest US energy firm, ExxonMobil.”

Is America Falling Off the Flat Earth?
Rising Above the Gathering Storm Committee
National Academy of Sciences, 2007
http://www.nap.edu/catalog.php?record_id=12021

John D. Trudel -- Author, speaker, columnist, and business innovation guru. John is a Certified Management Consultant (CMC).

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The Trudel Group
1102 N. Springbrook Road, # 281
Newberg, OR 97132

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