

Spills and Chills

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On the rare occasions that political rhetoric seems to understate a problem, it's big. BP has a big problem in the Gulf of Mexico, which they are now properly laying out. Blaming the company for the spill is possibly a bit overdone since it was after all an accident. However, claiming they and by extension the industry haven't been responsible enough with the work seems to be on the mark. This spill is going to impact deep water oil exploration and extraction for years to come. The cleanup will continue through the year, as will discussion of alternate energy sources.

We have questioned whether there was truly a shortfall of crude oil, and the shut down of US Gulf crude production will have limited impact on the global picture. The economic news is still too weak to strengthen oil pricing at any rate, or to stir up the favored alternate energy concepts near term. However, we expect "clean coal" and most probably natural gas to take more prominent roles on the hydrocarbon front, and for nuclear to pick up some steam.

Coal is one of those bulk commodities that made a once in a generation price stride on the back of new Asian demand. It has of course been higher end metallurgical coal that drove this. China and the US do have plentiful supplies of thermal coal, but even lower end coal has gained along with the energy complex. Emission standards are old hat in the West, but it will be China that leads the push to create electricity with a new generation of cleaner coal plants. China can afford to capitalize these plants, and needs to start dealing with its brilliant sunsets before they become metaphors.

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We also expect a growing focus on turning coal into liquids for use in transport. That is an old technology put aside because of cheap crude. Both politics and changing economics can bring it back. The conversion process needn't be polluting, and the products at worst no more so than what they replace. "Coal oil" could move into existing retail networks with little new capital requirement. The main benefit of this shift would be to diversify liquid energy supplies, which is enough to make it worth watching for.

Even in China replacing older coal generators with new ones will take a while. That leaves room for alternate power sources to be developed. China is rapidly becoming a

leader in wind-power and other renewable technologies as part of its trying to deal with a polluted landscape. This is more important to advancing these ideas than a gabfest in Scandinavia. That attempt to engineer global warming solutions ignored the first rule of engineering design – form follows function. The function of any generator is to produce useable electricity. Subsidizing any technology suggests it is less usable than some other, and in this case requires the “green tech” power to be coupled with some presumably less green generator that pays the bills.

The reality in China, and most other developing economies, is that all power has been subsidized for decades. Workable solutions to the need for more power in China and elsewhere have to include shifting to users pay pricing. Simply increasing subsidy for expensive schemes that haven't been proven at scale will fail. Costs also have to recognize that some of these schemes take up a fair bit of real estate, and those like wind or solar with highly variable loads require both heavier grid systems, plus power storage and/or a counterbalancing power source to keep customers happy. The BRIC countries have the advantages of regulating potential problems areas with the experience of Western industrialization to work with, plus available private funding to sort out practical solutions. Time spent doing that will create a long term solution, not a series of political fixes that need to be redone. In the mean time it will be a question of weighing the cost/benefits of existing technologies.

The stigma to using nuclear power will continue to be weighted against its very much smaller footprint. Our biggest issue with nuclear is the inability to choose and build long term solutions to waste products disposal. However, this problem is more one of perception than any thing else. Bury and seal the stuff deeply enough, and it's done. It doesn't happen because a discussion industry has grown up around the issue. In China the hierarchy for discussion industries generally allows solutions to go forward rather than being talked to death. China may be the first to do what seems obvious to us, and other BRIC economies will follow suit. This doesn't solve the issues at active facilities using dangerous isotopes. But designing and building containment systems for any power plant shouldn't leave more risk on the table than drilling into what turns out to be an over-pressured oil reservoir through a mile of ocean water. A recently expanded and near-surface domestic hydrocarbon source may come into its own due to the spill.

The auto industry in North America, and therefore much of the world, is gasoline driven because that is what came out of Detroit. If Ford hadn't been first to reorganize work to allow for mass auto consumption we might have a larger diesel focus in personal transport. That is both the preferred fuel for heavy transport and European engineering, but that of course doesn't much solve the crude oil issue. The stuff that could help reduce crude usage still gets burned off during the production of its sticky cousin in many oil fields.

Natural gas (natgas) requires pressurized storage for practical use in autos and has been avoided for the most part in transport. Some fleets such as Vancouver taxis converted cars to natural gas and set up their own refueling stations (Vancouver taxis switched to hybrids when natgas prices spiked in 2000). For everyone else there simply hasn't been a supply of natgas powered vehicles from automakers to push the concept. Despite natgas being a major component of home heating and cooking, little roadside service had developed and natgas vehicles remained a niche.

Lack of roadside service is the key element holding back any power innovation to keep wheels turning on pavement. Now environmental and domestic supply concerns mean some sort of change is coming. Existing service centers will either roll with these changes or roll over. Electric car buffs are focused on whether quick recharge or quick change batteries make the most sense. Auto makers are working towards both and view getting this right as important to their future. Natgas could use existing engine designs and tap existing distribution networks. It would provide cleaner transport at significantly lower running costs, at current pricing, than liquid fuels. The new drilling technologies that tap natgas from tight rock shale formations and other nonporous rock have the major oil producers taking a much larger interest in natgas. The tail wags the dog in this sector.

For an emerging economy such as China this can provide a large opportunity to be out front with a technology shift. It is now the world's biggest auto consumer, but is still fairly early in creating the infrastructure to go with it. A focus on natgas powered cars and their needed infrastructure is still doable. However, China's natgas power generation has, like many of its resource dependant sectors, been growing more quickly than China can supply domestic resources. A push is on to change this, which will include shale gas sourcing and methane extraction from coal beds as well as increased imports of natgas. China's need to reduce airborne pollutants is sufficient to ensure natgas will compete with coal and crude power. Natgas powered vehicles would aid this cause, and could put the leading growth area for autos in front of a potentially important fuel shift. From there, the next frontier could be using large ice-methane deposits.

Methane gas tops the list of greenhouse gases, but does burn fairly completely and cleanly. Huge fields of methane trapped in ice (gas hydrates) are found along the continental shelves and in the permafrost of North America and Asia. These are thought to be at least double, and possibly an order of magnitude larger, the natgas pool. Tests in Canada's Mackenzie River delta have produced a flow from gas hydrate fields without having to heat them. China is focused on deposits of this "fire ice" in the Tibetan Plateau to lead its development as a power source. Add to that a potential to capture methane from domestic sources like feces, and hydrocarbons get greener.

There is a model for continental glacier cycles based on this fire ice. Like most hydrocarbon it is created by rotting organisms. The model holds that marine sediments trapping it cool the planet, and that its rapid release generate periods of melting. Since methane is now being measured from the BP oil spill in the Gulf of Mexico, you may be seeing more on this concept over the next while. Regardless of whether you view the current ice melt as anthropomorphic or anthrop-coincident, release of this methane is an important end point in the climate change cycle. So any work to understand these deposits should be useful. The potential economic benefit (or anthrop-ecologic benefit if you prefer) could be twofold.

This coming week will determine if China's announced shift to a more flexible Yuan will be enough to stave off Yuan bashing after a report on the issue is finally released to the US congress. The report had been delayed to allow China some time to implement a policy shift, and to buy more T-bills. China's leaders choose to lean away from a beggar-thy-sanctions attitude some had feared, while avoiding specific changes. This could signal there is some continued rancor at the top of the Chinese leadership. That seems to have been as important to decision making over the Yuan as concern over Western reactions.

Its no secret there is disagreement in China about a change to the Yuan policy. That economy is also feeling the first real flowering of communist era labor dissent with strikes at foreign owned car plants amongst other things. Trade unions are the norm in China, but independent ones are not. If both the top and the base of China's system are in a shake up period, than global markets could also quiver as capital again goes to ground. Canadians are questioning the billion dollar security tab to host this week's G20 gabfest. The Yuan news allows politicos to happy face into the forum, but that billion could feel like chump change if markets don't like the new Yuan "flexibility".

The **gold** price has certainly been signaling that concern is still a growth area. This past week's new highs were preceded by some long anticipated gains to the yellow metal's senior producers. That means a firm move into the sector is taking place. There has been a trickle down into the sector's smaller stocks, but since this move is fear based it has been and will continue to be selective. There is still little reason to expect a broader summer rally, and diversification is still best focused on the other precious metals as far as we are concerned.

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