The Oil Drum: Canada
DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

# The Round-Up: January 3rd 2007

Posted by Stoneleigh on January 3, 2007 - 1:29pm in The Oil Drum: Canada
Topic: Site news
Tags: credit derivatives, hydro power, income trusts, natural gas, nuclear waste, oil sands [list all tags]

Oilsands growth now beyond regulator's ability to assess impacts

> Oilsands development, they say, has become a speeding car with a gas pedal and no brakes....
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> ...."It just doesn't work to have Alberta Energy pouring on the gas and not having another agency empowered to put on the brakes if necessary," he said.
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> Stelmach's signals have been mixed. He's promised to review Alberta's energy royalty regime and to put affordable housing at the top of his agenda.
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> But at his first news conference after winning the leadership, he pooh-poohed the notion that government should regulate development.
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> "There's no such thing as touching the brake," he said.

> Some facts on oilsands development and its anticipated impact on northern Alberta:
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> - Oilsands spending, scheduled or proposed - $12.5 billion in 2007; $57 billion over the next five years; $94 billion by 2015.
> - Revenue to government 2006-07 - $2.5 billion in royalties; $2 billion in lease sales, greater than last 10 years combined.
> - Influx - 3,950 workers required for Suncor's Voyageur project alone; 27,000 people moved into Alberta in the second quarter of 2006; Fort McMurray population doubled to 75,000 in last nine years.
> - Cost of living - $40,000 considered minimum "working poor" income in Fort McMurray, says president of Wood Buffalo Housing and Development Corp.
> - Vacancy rate in oilsands communities - one per cent in Grande Prairie; less than one per cent in Fort McMurray for third consecutive year.
> - Rents - Forecast to jump 20 per cent in 2007 in Grande Prairie; 25 per cent in Fort McMurray.
> - "Shadow" population - 11,779 people live in work camps, campgrounds or hotels near Fort McMurray, says 2005 survey.
> - Health gap - Fort McMurray needs twice as many doctors as current 44; will need three times as many within five years.
> - Services gap - Fort McMurray needs $1.2 billion in infrastructure to accommodate growth, including new water treatment plant, police station, recreation centre and fire hall.

Gas squeeze coming: Natural gas production expected to dwindle in 2007, pushing up prices next winter heating season

> Canadian exports, a mainstay of U.S. gas supply, satisfy about 15 per cent of American demand. They are forecast to take the worst dive in a generation. The reduction is expected to go as deep as one billion cubic feet per day or about 10 per cent off pipeline deliveries to the U.S.
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> Drilling is tapering off compared to last winter. Activity in the western provinces -- chiefly in Alberta, source for four-fifths of Canadian gas production -- is dropping by as much as one-third.
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> Part of the blame goes on the current price retreat, which resulted from a supply glut caused by mild weather and a drilling frenzy whipped up by last heating season's market spike.
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> Industry-wide desire to bring costs under control, by reducing competition for equipment and workers, is also a big factor. Double-digit jumps in fees for field services such as drilling rigs and well completion work prompted the Canadian Association of Petroleum Producers to call the 2005-06 winter busy season a time of "hyperinflation."
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> A Peters & Co. survey found six of 13 top gas producers have cut 2007 gas budgets. Total exploration and development commitments by the group are down by about $2 billion or nearly 20 per cent to $8.4 billion from $10.4 billion last year.
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> The industry's 31 income trusts, which do about one-fifth of Canadian gas production, are also expected to rein in spending after their failure to reverse Ottawa's fall decision to make them pay corporate taxes in four years.

Drillers hope for frost as drilling slumps

> Coming off a record year in 2005, this year was shaping up to be oilpatch nirvana for service and supply companies.
>
> Then a funny thing happened on the way to the ball. After a particularly cold finish to 2005 that sparked a frenzy of natural gas drilling, winter took a holiday and didn't come back.
>
> Strapped drillers that ran flat out through the first and second quarters suddenly had a lot of time on their hands as oil and gas producers slashed capital budgets and drilling-rig utilization rates plunged.
>
> "The first eight months of the year were spectacular or very, very good, but the last four months were unsettling," said Don Herring, the president of the Canadian Association of Oilwell Drilling Contractors, which represents drilling companies....
>
> ...."We need a cold or even normal winter in 2007 to use up our large gas-storage inventories. If we have another warm winter across North America, gas prices will weaken further in the spring, which could have an even more adverse effect on field activity."

[Canadian agency orders review of nuke-dump plan]

> The Canadian Nuclear Safety Commission has recommended to the federal government that the proposal for a nuclear-waste dump near Lake Huron be reviewed by a full panel of health, safety and environmental experts.
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> Ontario Power Generation is asking permission to create an underground storage facility for low- and intermediate-level nuclear waste in Kincardine, Ontario, about a mile from Lake Huron's shore....
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> ....Politicians and watchdogs from both sides of the border have been pushing for the full-panel review, because they are concerned storing nuclear waste close to Lake Huron could pollute the Great Lakes and contaminate drinking water supplies.

[McGuinty plans to target green vote]

> Premier Dalton McGuinty plans to make the environment a wedge issue between the governing Liberals and the opposition, according to sources familiar with the strategy. The Liberals will try to win over Tory voters in Ontario by attacking Prime Minister Stephen Harper's track record on the environment, said sources close to the government and in the environmental sector. At the same time, they said, the Liberals will reach out to New Democrats, who traditionally hold strong views on the environment.
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> The government is ramping up its efforts on the environmental file amid indications that Canadians are increasingly concerned about global warming and climate change. This trend was apparent during the recent federal by-election in London North Centre, where the Green Party finished second behind the Liberals.
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> Polling done by the Ontario Liberals reveals that the environment has supplanted health care as the top issue on voters' minds.

[Fresh alarm over global warming]

> Halfway into Joseph Romm's new book on climate change, Hell and High Water, I started to get angry.
> It didn't help my mood that we had a Christmas without snow this year, the planet's hottest year on record, or that last Thursday we learned that an ancient arctic ice shelf the size of 11,000 football fields broke off from Ellesmere Island yet another visible sign of planetary warming and the shrinking of Canada's northern geography....
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> ....Whereas the first third of Romm's book presents overwhelming and disturbing evidence that human-caused greenhouse gases are the primary ingredients behind global warming, the pages that follow offer alarming detail on how the U.S. public is being misled by a federal government (backed by conservative political forces) that is intent on inaction, and that's also on a mission to derail international efforts to curb emissions.

[Ottawa leaves the burning green question unanswered]

> Once a leader in the fledgling market for greenhouse gas emission credits, TransAlta Corp. has been on the sidelines as it awaits a clear climate change policy from Ottawa.
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> Two years ago, the Calgary-based power company spent $9-million (U.S.) to finance a methane-capture project on a Chilean hog farm.
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> The resulting reductions in greenhouse gases emissions were used as credits to offset the release of carbon dioxide at the new Genesee 3 coal-fired power plant, after the Alberta government ruled the plant could emit no more carbon dioxide -- after accounting for credits -- than a natural gas-fired plant of similar size.
>
> Last year, TransAlta was absent from the market, as were many Canadian companies, while much of the rest of the world moved forward withdevelopment of markets for greenhouse gas-emissions credits.
> With the election of the minority Conservative government last January, the Liberal climate change plan was jettisoned. After eight months in office, the Conservative government unveiled its environmental plan in October.
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> While the new government signalled its support for "industry-led emission trading systems," companies have been reluctant to buy credits until the Conservatives release their short-term greenhouse gas emissions targets along with compliance policies, expected early in the new year.

[Free electricity... created by bright sparks]

> The Beck Mickle low head micro hydro generator could potentially provide electricity to more than 50,000 British homes and could be used industrially. The inventors predict a series of them linked on the same river course could create enough electricity to power a small town or large hospital.
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> Mr Gilmartin said he came up with the idea after giving up work to look after his son, who had epilepsy. "There was nothing available on the market to recover any sensible amount of energy from low (pressure) heads, so in wanting something to think about at the time, I thought of the idea of having revolving buckets to recover energy.
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> "While we cannot say this provides free electricity, because of the initial cost of buying the machine, it is expected to pay for itself within two years and then greatly reduce the owner's electricity bills after then. Because what we are doing is cheap to make, the pay-back is very quick."

[High-flying Canada facing hard landing?]

> There comes a point when you've been flying high for so long the only place to go next is down.
>
> Some economists say it could be quite a way down for the Canadian economy in 2007 with the manufacturing sector contracting, the housing boom fading and a non-trivial

possibility the United States could fall into recession.

"Canada obviously has really enjoyed the rising commodity prices, the rising terms of trade, the positive real income shock," says David Wolf, Canadian economist at Merrill Lynch in Toronto. "It really has been boom times, but commodity prices have bottomed out, terms of trade has bottomed out and we may be starting to see the beginning of a more substantive hangover."

The economy ended 2006 on a decidedly ugly note.
"We've had just a string of terrible numbers," Mr. Wolf said.

[Analysts divided on energy, financials]

For investors choosing to ignore the Sell Canada sign being waved these days, there's total disagreement whether they should be overweight or underweight in Canada's energy or financial sectors.

[Alta's Samson Cree ask Supreme Court to rule on landmark royalties lawsuit]

Alberta's Samson Cree First Nation is asking the Supreme Court to rule on its multimillion-dollar lawsuit against the federal government over oil and natural gas royalties.

[U.S. housing market still a threat, analysts say]

Prof. Roubini says signs of increasing distress are everywhere: a sharp increase in defaults and foreclosures; lower revenue and profits in home-building companies; high building cancellation rates.

And the pain is spreading. Commercial construction is starting to slow, the auto sector remains under pressure and recent data show manufacturing slipping into recessionary.

"Consumption is going to be the last shoe to drop," Prof. Roubini said.

[Range for wheat is creeping northward]

Are there amber waves of grain in Alaska's future? Given the current rate of global warming, the answer might be yes.

That according to a new study that predicts that higher temperatures in North America will make it difficult to grow some varieties of wheat in the Lower 48 states by 2050.
By the same measure, however, the more northerly latitudes of Canada and Alaska should be ideal, according to an upcoming report by the International Maize and Wheat Improvement Center in Mexico City. Unfortunately for Canada, climate isn't everything. Soil conditions matter too. And the rocky terrain and thin soils of the eastern provinces -- what geologists call the Canadian Shield -- aren't considered suitable for grain

> production.
> But Alaska is a different story.

[Private equity rules as buyout kings]

> If 2006 proved one thing in the business world, it's that no company is safe from the buyout kings who run private equity funds.
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> And with more money than ever in the hands of acquisition-hungry firms such as Kohlberg Kravis Roberts & Co., Blackstone Group and Canada's own Onex Corp., investment bankers and analysts predict more to come in 2007.
> Globally, private equity buyout firms announced more than $700-billion (U.S.) in planned purchases in 2006, almost three times as much as in 2005.
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> And even after that spree, they still have $1.6-trillion to spend, according to investment bank Morgan Stanley, with about a quarter of that amount coming from capital put up by investors and the rest coming from loans or bond sales (that's the leverage in a leveraged buyout).
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> As the value of takeovers has increased, individual firms have teamed up in so-called clubs to make runs at ever larger targets. Three of the four biggest private equity takeovers in history were announced in 2006, led by Blackstone Group's $20-billion offer to purchase Equity Office Properties Trust.
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> "Nothing is beyond the reach of private equity - nothing," said Jim Kofman, vice-chairman of the Canadian investment banking arm of UBS AG.

[New fears for Thai economy after Bangkok blasts]

Thailand has been the trigger for financial contagion before. Watch this space.

> The bombings could further discredit the government in the eyes of investors rattled by draconian capital controls imposed last month that sparked a stock market crash, he said.
>
> "Investors are still worried, after the reserve requirement rules caused them to doubt government policies and its capacity to manage the economy," Santi told AFP.
>
> Stock plunged by 15 percent after the Bank of Thailand (BoT) on December 18 imposed capital inflow controls, aimed at curbing the baht's strength, which hurts exporters.
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> Trading remained volatile last week amid widespread concerns among investors about the government's fiscal policy. The BoT is set to review the rules in mid-January.
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> James Peter Blaney Davison, vice president for international business development at giant retail Central Group, said uncertainties have already spooked foreign investors.
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> "The reserve requirement has scared away foreign investors. Now Thailand is not only unstable but there is so much uncertainty in many ways," he told AFP, adding that consumer spending would be hit hard by the attacks.

> "Bangkok has changed overnight. People started to worry about their security and will keep money in their pocket. It is a very serious situation and the government should not underestimate the impact," he said.

Global economy faces a dangerous year

> Rising inflation and falling home prices are likely to push the US economy into recession by the second half of 2007. Gathering economic weakness, combined with negative real yields on US Treasury securities and growing political pressure to weaken the dollar will lead to significant dollar depreciation against most currencies.
>
> Economic growth in Asia, Europe and Latin America will also weaken in 2007. Slowing global economic growth will be very bad news for equity markets around the world. Dollar depreciation and rising international energy and grain prices will be good news for precious metals.

Wall Street's Spin-Meisters are at it again

> To quell investor concerns during the inflating dotcom bubble, Wall Street offered soothing commentaries from analysts such as Henry Blodget, Jack Grubman, and Mary Meeker, that explained why the "old economy" rules no longer applied. The latest twist on this "black is white" spin was offered by Bear Stearn's chief economist David Malpass, who in a recent editorial in The Wall Street Journal outlined why in the new global economy borrowing and spending, rather than savings and production, are the true engines of economic strength. Just as Blodget and the gang tried to justify ridiculous valuations for profitless internet stocks, Malpass uses similar logic to justify why America's enormous trade and current account imbalances are good for our economy.
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> Back in the 1990's, corporate losses were touted as evidence of a bright future. We were told it was a cyber "land-grab" where eyeballs and page views replaced sales and earnings. The calculations were necessary to keep the IPO spigots open and Wall Street profits flowing. Just as red ink was supposedly a sign of strength in the dotcom era, Malpass now tells us that America's gargantuan trade deficits and its lack of domestic savings and real goods production are actually signs of its growing economic might. Investors who buy into this nonsense will suffer the fate of those who bought shares of pets.com.

The dream machine: invention of credit derivatives

> The idea that attracted most excitement was the concept of mixing derivatives with credit. One of the pernicious problems that have always dogged business is so-called “credit risk” - or the danger that a loan (or bond) might turn sour. And as they sat in their conference room in Boca Raton, some of the bankers started to wonder if there was a way to create derivatives that could bet on whether bonds or loans would default....
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> ....The trade was what is known as a “first to default” swap. At that time JPMorgan was heavily involved in trading European government bonds and bond derivatives that left it exposed to losses if any bonds suddenly went into default (not an irrational fear in the

pre-euro mid-1990s). However, the bank created a contract which effectively insured itself against such a default for a basket of bonds (say, that of Sweden, Italy and Belgium). It stipulated that if any of these bonds went into default, an investor would pay JPMorgan compensation. If that default never occurred, the investor would make money because they were receiving a fee to take this risk; but if any bonds defaulted, JPMorgan was covered. Thus as long as a price could be found that kept everyone happy, it was a win-win deal: JPMorgan reduced its risk, and the investors could earn nice returns. It took another three months for the team to sort out the paperwork for this experiment. And it didn't at first make waves in the financial markets. At that time, other banks were also experimenting in this way - and groups such as Bankers Trust and Credit Suisse were considered more innovative and aggressive in this area than JPMorgan. Yet, as 1994 turned into 1995, JPMorgan moved out in front.

Quite why remains a matter of debate. JPMorgan's rivals say it was a simple matter of business expediency - and, above all, accounting pressure. International banking laws place strict limits on how much risk a bank can take before it has to stop doing new business, and the bank was hitting those limits. This meant JPMorgan had a strong incentive to look at credit in an innovative manner, because it had a bigger loan book than rivals....

....The deal looked even better for the original bank. For the act of selling the default risk on to new investors had crucial regulatory implications. International banking rules say that banks have to hold a certain level of spare funds (or reserves) to protect themselves from the danger that their loans might turn bad. However, since the banks had sold the risk of default on to somebody else, they could now argue that they did not need to hold these funds.

To anybody outside the world of finance, this might look odd (after all, the banks were still making loans); but the regulators accepted this argument, since the risk had moved, in accounting terms. And that let the banks free up funds to make even more loans. It was the financial equivalent of calorie-free chocolate: almost too good to be true....

....There is also a downside: spreading risk around makes it much harder for bankers, central bankers - or anybody else - to predict what might happen if a cataclysm did hit. For the whole credit derivatives world has exploded at such a dizzy pace that nobody is exactly sure where the loan risk has gone. Have all the investors who have bought credit derivatives contracts checked the fine print to see what losses they could sustain? Does anybody understand the chain reaction that might be triggered by such losses? Could the world's trading systems cope? And what would happen to all those hedge funds that have been jumping into the credit derivatives world?

Shell May Cut Reserves at Least 4 Percent on Sakhalin

Royal Dutch Shell Plc, Europe's largest oil company by market value, will cut its proven oil and gas reserves by more than 4 percent when it gives up half its stake in Russia's Sakhalin-2 venture, analysts said.

The equity transfer to state-run Russian energy company OAO Gazprom is expected to be completed by the end of February, and may not be reflected in Shell's reserves number for the end of 2006. Shell reports proven reserves once a year, usually around March, giving yearend totals for various geographical areas.

"This comes at a bad time for Shell, after writing down reserves just a few years ago," said Jeffrey Woodruff, an energy analyst with Fitch Ratings in Moscow. "Not only is Gazprom going to join the project, but it's taking a controlling stake."