
From: [REDACTED]
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Subject: Approved for external distribution: Eye on the Market, July 7, 2008

Eye on the Market, July 4, 2008

1776. "I have come to the conclusion, that one useless man is a Disgrace, two are a Law Firm and three are called a Congress". So said John Adams on U.S. Independence. The same applies to Energy Independence in 2008. As the U.S. endures an energy crisis and imports 60%+ of its energy needs, the House and Senate decided to take action: they overwhelmingly voted to allow OPEC to be sued in U.S. courts for running a cartel. The mind reels... Over the last 30 years, U.S. elected officials blocked nuclear build-out and spent fuel storage construction, impeded construction of oil refineries, refrained from passing meaningful alternative energy legislation, imposed an import tax on cheaper Brazilian ethanol, prevented offshore drilling in Alaska, California and Florida, delayed for 30 years tighter "CAFE" auto fuel efficiency standards, blocked the construction of LNG ports (in the Oregon Democratic primary, Clinton claimed to be more anti-LNG than Obama), killed wind farms in their own backyards (and back bays), and neglected opportunities for public-private sector partnerships on energy R&D. They got it wrong; Congress should sue itself instead.

Instead of ineffectual and counterproductive OPEC lawsuits, look at other countries. Germany has reached 14% renewable electricity use (they're shooting for 27% by 2020, and Denmark is already at 40%). Check out the attached "insolation" map: except for Seattle, the entire continental U.S. is much sunnier than Germany, yet Germany has 17 times the installed solar base per capita. Same goes for Japan, where "feed-in tariffs" (subsidies) have ended, and yet the solar business is thriving and competitive. The head of the U.S. government's Renewable Energy Lab said that the Federal Government is doing "embarrassingly few things" to foster renewable energy (a). Renewable energy research has fallen by 78% since 1978, and the Lab's budget is a paltry \$200 million (I will not mention the cost of the Iraq War again. It's \$1 trillion). This despite the fact that a handful of successful DOE R&D projects yielded benefits that exceeded the total cost of the entire energy R&D program (b).

The "just rely on the private sector" solution isn't sufficient, particularly when intellectual property rights aren't long enough for many energy-related investments (Congress did get around, however, to passing the "Mickey Mouse Protection Act", which extended that particular copyright for 120 years after creation). A National Task Force recommended in 2006 that the Federal government fund demonstration projects to provide proof of concept for carbon capture storage and other complex technologies (c), but it's not happening on any grand scale. Meanwhile, China signs oil and gas

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supply deals with Venezuela, Indonesia, Kazakhstan, Iran, Saudi Arabia, Brazil, Gabon, Russia, Ecuador, Myanmar, Turkmenistan and Australia, and is not wasting much time applying Chinese anti-trust laws to OPEC. The world is changing, much faster than the ability of the U.S. legislature to comprehend it. The bill's misplaced sense of entitlement is matched only by its pandering delusion.

On oil prices, they are likely approaching a breaking point of some kind later this year. Yes, the supply-demand equation is tight (U.S. reserves per well are half the levels they were a decade ago), and marginal costs are going up (more costly horizontal and directional drilling now account for 40% of wells drilled). Even so, marginal costs are \$70 a barrel, not \$140, and OECD demand is being destroyed at a rapid clip. China uses more energy per unit of GDP than any country in the world, so they're not exempt from energy pressures either; food and transport account for 45% of their CPI.

As for global economic data, it's all pretty downbeat (housing, labor markets, manufacturing surveys, service sector surveys, leading indicators, and small business surveys). A JPMSI research report on the ISM service sector survey captured the essence of the recent data: "There were no redeeming features in the details". Secretary Paulson's speech in London indicating that the U.S. needs more tools to deal with failed securities firms (and not just banks) is another sign of the times. I was also struck this week by a research report which referred to over \$100 billion in financial sector assets deemed "inestimable and undefined".

"Investing in the time of cholera" is still the strategy we're pursuing, which includes oversold first-lien leveraged loans, structured notes with principal protection down to 1150 on the S&P 500, Asian infrastructure funds (to accommodate the \$1 trillion being spent by China alone), and private equity funds sifting through the remains of the day (banks and their mortgage holdings). Our largest diversified hedge fund has generated positive returns this year, and remains the foundation of our hedge fund offering. As mentioned last week, subprime assets are priced assuming 80% default and 50% loss severity. The backdrop reminds me in some ways of February 2003, when Bloomberg headlines were filled with unyielding forecasts of bear markets, Al Qaeda manufacture of biological weapons, Spitzer lawsuits against the banks, PIMCO's description of the U.S. being perched on a deflationary cliff, weakening job markets, and skepticism about fiscal and monetary stimulus. I don't know if we've hit bottom yet, but I am pretty sure that when we do, you won't be reading about it in the press.

Notes:

HR 6074, which passed 324-84, allows energy cartels to be "prosecuted" in U.S. courts for anticompetitive activities; the Sherman Antitrust Act would be modified to apply to foreign states. The Senate version, S. 2976 (the OPEC Accountability Act), is similar to a bill passed by the Senate last year 72-23.

(a) Dan Arvizu, director of the U.S. Department of Energy's National Renewable Energy Laboratory, at the Harvard Center for the Environment's "Future of Energy" lecture series.

(b) National Research Council: "Was It Worth It? Energy Efficiency and Fossil Energy Research 1978 to 2000" (Washington, DC: National Academy Press, 2001).

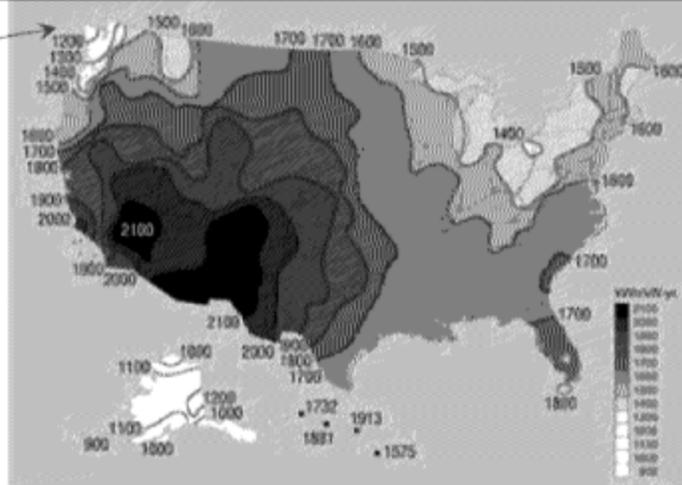
(c) Task force members included officials from the Ford, Reagan and Clinton administrations, the World Bank, the National Science Foundation and the World Wildlife Fund. The project was chaired by former Secretary of Defense and Energy James Schlesinger.

LNG = Liquefied natural gas
DOE = Department of Energy
R&D = Research and Development

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**Insolation: solar radiation energy comparison (kW-hours per year)
Germany leads with solar despite Seattle weather conditions**

Source: American Council on Renewable Energy, January 2007



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