

From Russia, with love: \$60 oil

Russia's oil industry won't get the foreign capital it needs, thanks to its government. It's grim for consumers, but these three tips might provide a silver lining for investors.

By [Jim Jubak](#)

Is \$60-a-barrel oil in our future? In our near future? Yep. It's a sure thing.

And once the oil market has cracked that psychological barrier, you should expect it to run higher before taking another breather.

You can thank Vladimir Putin and those apparatchiks who run Russia's economy for the run-up. They've just about guaranteed that Russia's oil industry won't get the foreign capital it needs to expand the number of barrels the country pumps annually.

That's big, bad news for anybody that uses oil, from airlines to commuters, since Russia accounted for about 75% of growth in oil production from non-OPEC (Organization of Petroleum Exporting Countries) sources in 2004. Russian production growth peaked at a 12% annual rate in the middle of 2003 before easing to 8% growth year-over-year in 2004, and then plunging to just a 4.6% annual growth rate in the first quarter of 2005. In March, according to the State Committee of the Russian Federation, crude oil output climbed even more slowly, by just 4.3% year-to-year. Official projections call for 5.7% growth in 2005, well above the first quarter's rate but way below the 8% average annual growth from 2000-2003.

On the other hand, that's good news for investors in energy stocks because it just about assures that the recent retreat in the prices of oil and oil stocks is

temporary and that stocks in the sector will finish the year well above current levels. The biggest stock-market winners from developments in Russia will be energy companies that produce their supply of oil, gas, or coal from fields and mines in safe, stable regions.

What has happened to Russia?

I'll end this piece with three stocks that I think fit that bill and I'll add two of them to Jubak's Picks with this column.

But first, some explanation of what has gone so wrong with Russia's oil industry.

On April 11, testimony in the Moscow trial of oil tycoon Mikhail Khodorkovsky drew to a close with the judge promising a verdict on April 27. Everyone in Russia believes that Khodorkovsky will be found guilty of tax evasion and fraud. According to unidentified Moscow officials who spoke to reporters, the sentence will be eight to 10 years in prison.

That verdict would put the final nail in the coffin of OAO Yukos, once Russia's largest oil company. State oil company OAO Rosneft bought the key asset of Yukos, its Yuganskneftegaz subsidiary, at fire-sale prices engineered by government officials after former CEO Khodorkovsky was arrested.

Since then Rosneft has filed lawsuits against Yukos, claiming that the company owed Yuganskneftegaz more than \$6 billion dollars for oil that Yuganskneftegaz produced when it was a Yukos subsidiary. Those suits have put Rosneft at or near the top of the list of Yukos creditors and will give Rosneft first dibs on remaining Yukos assets, such as the company's two remaining oil production units and its five Russian refineries, if Rosneft succeeds in pushing Yukos into bankruptcy. That bankruptcy got a step closer when a Moscow court froze those Yukos production and refinery assets on April 20. The Russian government claims that Yukos owes more than \$28 billion in back taxes.

So why is this more than a game of "inside baseball" between Khodorkovsky, a robber-baron who bought the assets that became Yukos for a pittance thanks to his political connections, and a new generation of politicians determined to reverse the results of the country's first round of privatization?

Lots of oil, little foreign investment

Because without outside capital, Russia won't be able to invest in the infrastructure its oil industry needs to improve production from its historically mismanaged oil fields. Russia is sitting on as much as 200 billion barrels of oil, the equivalent of five Libyas, but that oil will stay in the ground without foreign investment.

Lots and lots of foreign investment.

For example, in 2004 Alexei Kontorovich, director of the Russian Institute of Oil and Gas Geology, estimated that it would cost \$14 billion to explore and develop the oil deposits in Siberia required to fill the new pipelines planned to take Russian oil to China and Japan. Right now, only about 3.8% of the reserves in East Siberia have been explored and prepared for drilling.

And now, thanks to the Yukos trial and two other high profile government actions, foreign investors are extremely leery of putting their money at risk in Russia. The climate for foreign investment in Russia has turned so sour, in fact, that the International Monetary Fund (IMF) now estimates that the Russian economy will grow by just 6% in 2005 and 5.5% in 2006, down from the 7% growth of 2003 and 2004, thanks to falling oil production and declining foreign investment. On April 13, the IMF went on to issue a public call for "early measures to improve the investment climate, including limiting regulatory intervention."

What else besides the Yukos case has spooked foreign investors?

First, the February announcement by the country's Natural Resources Minister Yuri Trutnev that only companies that are 51% Russian-owned will be allowed to bid for licenses in six major projects that include the massive Sakhalin-3 oil-and-gas field off Russian's Pacific coast. That's a shot straight to the heart of **BP** ([BP, news, msgs](#))'s 50/50 joint venture with Russia's TNK. In 2003 BP put up \$7.5 billion for that 50% stake and, at the time, the deal was touted as evidence that major international oil companies were willing to put up big bucks to get access to Russia's oil deposits after years on the sidelines. (The BP deal also shows how important outside capital and expertise can be: In its first year, the joint venture got an extra 14% in production.)

Second, early this month Russia socked BP's joint venture with back-taxes totaling \$790 million. The new bill comes on top of a bill for \$140 million delivered last year for taxes from 2001. It's not quite clear how a joint venture formed in 2003 can owe taxes for 2001. But this sure meets my definition of "arbitrary and capricious" meddling with the marketplace. My vote for business understatement of the year goes to Viktor Vekselberg, executive director of the joint venture, who told reporters, "This is a very bad surprise."

Bad timing for consumers

The slowing growth prospects for Russian oil production come at a particularly bad time for global energy consumers. China's economy grew faster in the first quarter of 2005, at a 9.5% annual rate, than most economists had expected. Projections had growth somewhere below 9%. That has led some oil economists to bump up their predictions of growth in global oil consumption for 2005 to near 2.5% from earlier projections of 1.5%. With little new production capacity scheduled to come on line in the short term and with OPEC countries already pumping near capacity, every bump up in consumption counts. All this is likely to keep the upward pressure on oil prices going through 2005.

For investors, it's not just the upward direction of oil prices that counts; it's also a stark reminder to everyone who trades and buys oil of the political risk to oil supplies. A huge percentage of the world's oil reserves lie in not-especially stable countries: Russia, Nigeria, Iraq, Iran, Venezuela, Indonesia, and, to my way of thinking, Saudi Arabia. A coup here, a government takeover there and you've got not just a spike in oil prices but a serious disruption in supply that will make the energy in stable regions all the more valuable.

And that's where I'd put my short- and longer-term energy bets now -- into the shares of companies that produce a significant amount of their energy from stable regions such as the United States and into the shares of companies that sell the equipment and services needed to exact energy in those regions.

Three picks in stable regions

That leads me to three stocks: coal-producer **Peabody Energy** ([BTU](#), [news](#), [msgs](#)) and Gulf of Mexico oil drillers **Noble** ([NE](#), [news](#), [msgs](#)) and **Transocean** ([RIG](#), [news](#), [msgs](#)).

Peabody Energy: In my column "[5 stocks for your tax refund](#)" I called coal the energy of the future because it now costs less to produce electricity from coal than from either oil or natural gas. Coal is also the fuel of the United States, which sits on huge deposits equal to about 230 years of use at current levels of consumption. Utility generating plants that run on hydropower or natural gas are running near capacity while coal-powered plants, at 71% of capacity, have plenty of room for growth in electricity production. That just about assures growth in domestic coal production if we can figure out how to burn coal without creating so much pollution.

Here's where Peabody Energy has an edge: Not only does the company have 9.3 billion tons of proven or high-probability coal reserves (about double the reserves of the next largest U.S. coal company), but much of that supply is low-

sulfur coal from the Powder River Basin.

Noble: This caught my eye in Noble's April 22 conference call with Wall Street analysts and investors: There's a shortage of equipment in the Gulf of Mexico right now as the company sees increased business from **ChevronTexaco** ([CVX](#), [news](#), [msgs](#)), **Apache** ([APA](#), [news](#), [msgs](#)) and BP. On average, the company has been able to increase the day rates for leasing its rigs by 35%. And the demand for rigs seems to be sustainable, not a minor point in this notoriously cyclical business since Noble is seeing customers that are interested in leasing rigs up to two years into the future. (Besides exposure to the Gulf of Mexico, with Noble investors you get a big presence in the deep-water drilling off West Africa, a relatively politically stable area that is attracting increasing amounts of exploration.)

Transocean: The company signed contracts for four more rigs in the first week of April, which still didn't stop the stock from pulling back the following week below its 50-day moving average. Shares have since bounced back above that level, giving investors a buying opportunity with a bit of a floor under it. With Transocean, investors get a driller leveraged to the deepest of deep-water projects -- and that's where the growth is in exploration and production in the Gulf of Mexico these days. With few drillers adding new deep-water rigs -- which would take a long time to get to market anyway since they take so long to build -- I think Transocean can look forward to increased day rates well into 2006.

All this adds up to a pretty picture for energy investors -- if a pretty grim one for energy consumers. Saudi Arabia is the one producer capable of wrecking this scenario. In my next column, I'll take a look at the evidence that the Saudis don't have as much oil as they claim in their official reserve numbers.

Changes to Jubak's Picks

Buy **Peabody Energy** ([BTU](#), [news](#), [msgs](#))

Oil prices don't have to go up much from here for **Peabody Energy** ([BTU](#), [news](#), [msgs](#)) to sell more coal -- they just have to hang where they are. The longer oil prices remain at current levels, the more electric utility executives will be convinced to spend the money to build coal-fired generating plants rather than units fueled by oil or natural gas. Coal is already much, much cheaper as a fuel -- it's just that the cost of building a coal-fired plant is higher, so utility managers want to be sure that oil is going to stay expensive before they make the capital investment in coal. Revenue growth at Peabody Energy could easily top 25% in 2005 on greater coal volumes and higher prices. It also doesn't hurt that Peabody owns lots and lots of low-sulfur Powder River Basin coal, the fuel of choice for coal-burning utilities looking to control air pollution. I'm adding the shares to Jubak's Picks with an October 2005 target price of \$51 a share.

Buy **Transocean** ([RIG](#), [news](#), [msgs](#))

With Transocean, investors get a driller leveraged to the deepest of deep-water projects --and that's where the growth is in exploration and production in the Gulf of Mexico these days. With few drillers adding new deep-water rigs -- which would take a long time to get to market anyway since they take so long to build -- I think Transocean can look forward to increased day rates well into 2006. Wall Street analysts have started to move up their earnings estimates for the stock to \$1.53 a share for 2005, up from \$1.39 90 days ago, and to \$2.88 for 2006, up from \$2.09 90 days ago. But I think Wall Street is still underestimating how far oil prices of \$50 or better a barrel will push up day rates for drilling rigs and how long that run will last. I'm adding Transocean to Jubak's Picks with a target price of \$63 a share by December 2005.