



The Road to Kazakhstan August 22, 2006

I am “on the road” today in Omaha, Nebraska to meet with the CEO and CFO of a company that one of our clients has a major stake in. This is a “due diligence” trip.

It just so happens that on the flight from SFO to Minneapolis (no one flies directly to Omaha) I sat next to an engineer/physicist who works for Chevron. He was on the first leg of a trip back to Kazakhstan where he is working in some of the world’s most productive oil fields; the Tengiz and nearby Korolev oil fields. They are estimated to contain some 6 to 9 billion barrels of recoverable oil.

Current production is running approximately 250,000 barrels per day—every day. That is over 91 million barrels of oil per year. That is a lot of oil.

Needless to say, I couldn’t pass up the opportunity to get into a discussion with him about the future of oil supply, demand and pricing around the world. Here are a few of the things he told me.

1. Prices are going up. He was unequivocal about that. In fact here is a quote, “Over the next ten years price will rise substantially. That is inevitable.”
2. I asked him if he saw the possibility for any short term relief in prices. His response was that “if you have a two year perspective you might see some price reduction.” I asked him how much and he was reluctant to offer an answer. So I asked if prices might retreat to \$60 per barrel. He said “that is possible”. I asked him if prices might retreat to \$50 per barrel. He said “I suppose it is possible.” I asked him if prices could retreat to \$40 per barrel. He said, “I don’t see that as a possibility.” He then reiterated that while prices may moderate in the short term, people should not be looking for significant price relief. He firmly believes that the long term path for oil prices is upward.
3. One of the reasons that the inevitable path of prices is upward is growth in demand. The other is the rising cost of exploration and extraction.
4. I asked him if he believed that global oil production had peaked. He did not specifically answer. However he said that “there is probably 50 years of oil supply left at current pricing”. Higher pricing allows for more expensive exploration and extraction techniques.

He told me the story of how Chevron hopes to double the production of its fields in Kazakhstan by using a new extraction method starting next year. The method is “highly experimental and may or may not work”, according to my new friend. However, “we are confident”.

The oil that Chevron is pumping in Kazakhstan has very high sulphur content. It is currently refined right on the spot before being shipped around the world. The sulphur is currently a waste product. In the new extraction process it will be forced back down the drilling pipeline, under extreme pressures (never before used), and act as an agent to force more oil out of the ground.

If the technique works production may rise from 250,000 barrels per day to 500,000 per day.

5. So my next question was, “Does that mean that reserves have increased?” The answer was that Chevron already counts the extra oil in its reserve figures. Bear in mind that extra oil can’t be extracted today, but it is already counted in reserves. That led us into a discussion of what are reserve figures, and how reliable are they.

He explained that reserve numbers are “reliable guidelines” as to what is in the ground, but no one knows exactly how much oil can be extracted from a well site. He went on to say that many people have a mistaken impression that when an oil well is drilled that a pipe is sunk to a point at which it hits a big pond of oil underground. There are no such ponds! He likened oil wells or “oil fields” to sponges. He said that when you squeeze a wet sponge you never completely dry out the sponge, that some water always remains in the sponge. The same is true of oil fields in that they are rock formations with the oil in the rock. Some “rock formations” are more saturated with oil than others. “Squeezing” that rock “sponge” gets to be harder and harder in order to get the incremental oil out. Thus you have reserve estimates in Kazakhstan that range from “6 to 9 billion barrels of recoverable oil”. The new “injected sulphur” technique is set to squeeze that sponge ever so harder to try to drive that “reserve” number to the higher side of that estimate.

So let’s get back to the reliability of reserve figures. He reiterated that he/Chevron believes that there is currently a 50 year oil supply left on the planet at current pricing levels. He was quick to add that may change depending on the rate of growth in demand. Demand growth could moderate. It could increase.

Just to put that idea into perspective for you, I wrote a paper for K&A in June of 2005, in which I used a 40 year number as the remaining oil supply, given certain assumptions.

He then went on to say that as prices rise the money becomes available to explore in new places that cost more, and to use new and more expensive techniques for recovery that should stretch out the oil supply for another 50 years. He believes that higher prices will lead to another half century of oil.

As I noted to him, that should cover “you and me”.

As this is being written the **USA Today** is sitting next to me. The headline story is “Gas prices slip, and the worst may be over for this year.” That may be true, but if my engineer friend is right, no one should get too hopeful about a sustained downturn in prices.

I could write a lot more, but it is time to get ready to go to a meeting. More later. After all I had him up against the window for over 4 hours!

All the best, PK
August 22, 2006

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Sincerely,

Paul Krsek
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