

By Raj Shant, manager of the Mellon Continental European Equity Fund

"Energy is eternal delight."
William Blake, *Marriage of Heaven and Hell.*

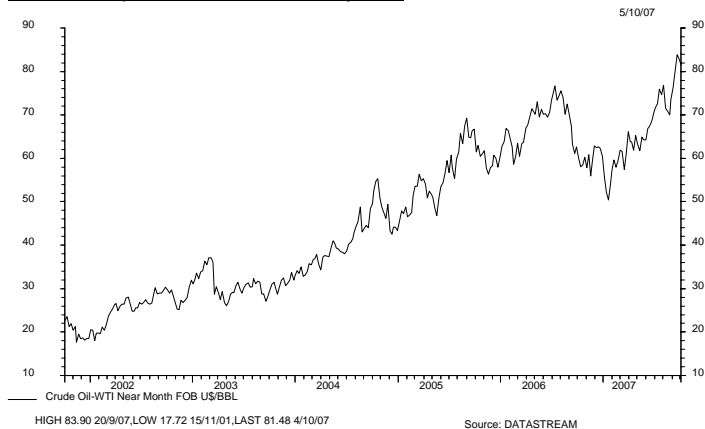
A longstanding Newton theme

Our view has long been that rapid growth in the developing world together with increases in per capita usage will add to the pressure on the world's energy resources, particularly oil. Meanwhile, production outside OPEC is peaking, and the political risks to supplies are growing. Chart 1 shows the rise in oil prices over the last half decade. It suggests that world energy demand is on a secular uptrend. This has enormous ramifications across a variety of sectors, and for the environment – what follows is a quick overview, we would be happy to discuss in more detail if you wish.

Oil is at the epicentre

Oil sits at the very centre of the global energy economy. The oil price is the most widely watched gauge of the world's supply and demand balance for energy. In fact the 'recent' low in the oil price was around US\$10 in 1998, coinciding with the Asian crisis which dented Asian demand for oil for several years. We are now near US\$80 per barrel.

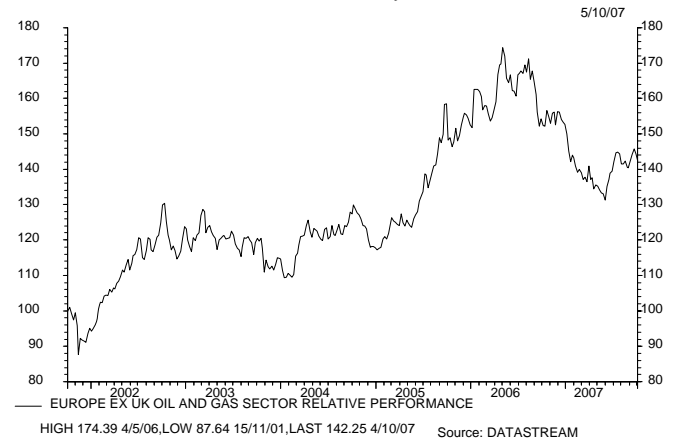
Chart 1: Oil prices over the last five years.



But big oil isn't the biggest beneficiary

Chart 2 shows that the oil sector has outperformed over the last five years, but has not performed as well as underlying commodity prices which quadrupled. There are three key reasons behind this. Firstly, the cost of inputs into the oil industry rocketed. We particularly like the oil services companies (who build the rigs, lay the pipes, etc), which suffered miserably in the 1990's but with sharply rising oil spending, the demand for their services far exceeds the supply, leading to rising prices and profits. Another headwind for oil profits has been that governments have taken a larger share of the rising oil wealth, whether through windfall taxes or effective nationalisations. Finally, chart 1 shows the price of oil in US\$ terms, but the dollar has fallen by nearly 60% against the euro over five years, so the oil price for European majors has not risen as much as it would appear.

Chart 2: Oil sector relative over last five years



Just a lot of gas?

Gas prices are linked to the oil price and it is often the fuel of choice for new power stations in many countries because it is cleaner than burning oil or coal. We like Gazprom of Russia, which has the largest gas reserves in the world. It enjoys a monopoly on gas exports and sits in a position to supply Europe, Japan and China – a large and energy-hungry set of neighbours. Even Gazprom will struggle to grow its output, but the key positive driver will be the fact that domestic prices are gradually being raised to converge with the world price. This is essential to conserve Russia's most valuable resource.

Power plays?

Utilities also benefit as power prices rise, as coal and gas prices tend to follow oil's ascent. However, we are underweight utilities as recent merger and acquisition activity has pushed valuations to challenging levels. We prefer the power equipment companies Alstom and ABB, who also benefit directly from growing power demand in the developing world.

And the environment?

The environment is now centre-stage for policy makers, especially in shaping energy policy. However, some renewable energy companies' valuations are simply too high, while other business models are entirely dependent on unpredictable subsidy regimes. Only Acciona in Spain, the world's second largest wind farm operator, satisfies on both counts – it is still cheap and has good visibility on its earnings growth. We continue to search for other renewable energy companies that fit these criteria.

So what are we doing?

We are slightly overweight oil, but prefer gas and oil services companies. We are underweight the utilities on valuation grounds, and look to increase our exposure to renewables where valuation allows.

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