

## MUSINGS FROM THE OIL PATCH

December 24, 2013

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**Note:** *Musings from the Oil Patch* reflects an eclectic collection of stories and analyses dealing with issues and developments within the energy industry that I feel have potentially significant implications for executives operating and planning for the future. The newsletter is published every two weeks, but periodically events and travel may alter that schedule. As always, I welcome your comments and observations. Allen Brooks

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### An Oilfield Poem For The Season And The Ages

**It was first published in the  
Sentinel in Troy, New York, on  
December 23, 1823, 190 years ago**

Included in a Merry Christmas greeting to us from Steve Jacobs was a poem he wrote and copyrighted in 1987 based on [A Visit from St. Nicholas](#), otherwise known as [The Night Before Christmas](#) or ['Twas the Night Before Christmas](#), based on the first line of the iconic poem. Despite some controversy, it is acknowledged that the poem was authored by Clement Clarke Moore. It was first published in the *Sentinel* in Troy, New York, on December 23, 1823, 190 years ago.

**The breakfast is a major industry  
networking event anchored by  
panels of industry experts  
opining on the future for the  
business**

Mr. Jacobs is now the SVP for Oil & Gas Strategy & Operations Management at The Sinclair Group. He is probably best known as the major domo behind the decades-old The Oilfield Breakfast, which grew to become not only an industry “happening,” but through the profits generated by the breakfasts, it also raised thousands of dollars for charity. The breakfast is a major industry networking event anchored by panels of industry experts opining on the future for the business. It also became known for its moving opening that involved the singing of the national anthem acappella by a performer from the Houston Grand Opera. We were fortunate to be asked to speak at several breakfast meetings, and we have the clocks to prove it.

**It was an era that those of us who  
lived through it hope never to  
experience again**

As we read Mr. Jacobs’ oilfield holiday poem, we reflected on the fact it was written when Houston and the oil patch was at the depth of its depression following the 1985 collapse of world oil prices. Not only were drilling rigs sitting idle, companies going broke and thousands of workers losing their jobs, but Houston neighborhoods were littered with abandoned homes suddenly unaffordable for laid-off employees. It was an era that those of us who lived through it hope to never experience again. Enjoy Mr. Jacobs’ poem in the spirit of this holiday season. We wish you a Merry Christmas and a Happy New Year. See you in 2014!

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### A Toolpusher's Night Before Christmas

'Twas the night before Christmas,  
when all through the rig,  
Not a roughneck was stirring,  
the moon was quite big.

The wireline was hung  
from the derrick with care  
In hopes that the service hands  
soon would be there.

The company man was nestled  
all snug in his bed,  
While visions of hydrocarbons  
danced in his head.

When out on the floor  
there arose such a clatter  
I sprang from the doghouse  
to see what was the matter.

The mud pit was rising,  
so lively and quick  
I knew in a moment  
it must be a kick!

More rapid than eagles  
the driller's plans shaping,  
He called to the floorhands,  
down painting and scraping.

So up to the rig floor  
the roughnecks they flew,  
They closed in the rams,  
the annular too!

Then down in the mud room,  
my heart was a stopper,  
We quickly dumped barite  
into the hopper.

The mud weight was rising,  
the pit level steady.  
The kick was subsiding,  
my relief was in ready.

When what to my wondering  
eyes should appear,  
But a miniature sleigh,  
and eight tiny reindeer.

With a little old driver,  
his eyes how they twinkled!  
And a beard as white as snow,  
his face drawn and wrinkled.

Once on the casing board,  
he climbed out of the sleigh,  
Then slid down the standpipe,  
and to me made his way.

He spoke not a word,  
but produced with great caring,  
A suite of yule logs that  
were hydrocarbon-bearing.

Then to my amazement,  
he reached in his sack,  
And gave me some targets  
on a subsurface map.

As I stood there quite dazed,  
he ran to his sleigh,  
And before I could thank him,  
they all flew away.

But I heard him exclaim,  
as he rang a small bell,  
“Merry Christmas to all,  
and to all a good well!”

## Energy Receives Little Support In *Barron's* 2014 Outlook

**As a group, the strategists are optimistic about economic growth for 2014, projecting the U.S. economy to expand by 2.7% compared to the expected 1.7% increase this year**

*Barron's*, the Dow Jones Business and Financial Weekly, always contains a plethora of economic, interest rate, stock market, industry and company forecasts. For investment professionals, it is a weekly must read. The mid-December issue contained its special report on the outlook for the 2014 stock market, including forecasts on market sectors and selected stocks projected to be good investments for next year. The article was based on interviews with ten strategists from Wall Street investment banks and fund management companies. As a group, the strategists are optimistic about economic growth for 2014, projecting the U.S. economy to expand by 2.7% compared to the expected 1.7% increase this year. Better economic growth, driven by greater U.S. consumer spending, a recovery in the economies of Europe and continued growth in China should propel corporate earnings higher by 9%, in contrast to the sub-par 5% gains of the past few years.

The article concluded with the following paragraph: “Our strategists don’t see a recession in 2014, just as they don’t see negative equity

**We don't consider either of those energy investment endorsements demonstrating true conviction about the earnings prospects and potential returns for investors**

returns – or a third year of 20% plus gains. Instead they see an unremarkable 2014 unfolding. After the thrills and spills of the past five years, chances are investors wouldn't complain about that.”

There wasn't much support for energy investments among the ten strategists. Only two of them actually cited energy as one of their favorite sectors while one strategist said to avoid the industry. One of the two strategists favoring energy is recommending investors use energy ETFs as the preferred investment vehicle while the other strategist recommended ExxonMobil (XOM-NYSE), as she considers the shares cheap and the company able to return “ample” cash to investors. We don't consider either of those energy investment endorsements demonstrating true conviction about the earnings prospects and potential returns for investors.

**Exhibit 1. Sector Returns Within The Stock Market**

<b>Sector Snapshot</b>					
Only four sectors are beating the market this year, with consumer-discretionary in the lead. Bond-proxy sectors have been dragging.					
<b>S&amp;P 500 Sector</b>	<b>P/E*</b>	<b>Price Returns</b>			
		<b>2013*</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
Consumer Disc	16.9	35.1%	21.9%	4.4%	25.7%
Health Care	16.0	34.1	15.2	10.2	0.7
Industrials	15.7	30.3	12.5	-2.9	23.9
Financials	12.9	28.2	26.3	-18.4	10.8
Info Technology	13.4	20.3	13.1	1.3	9.1
Consumer Staples	16.6	20.3	7.5	10.5	10.7
Energy	12.6	17.4	2.3	2.8	17.9
Materials	15.3	15.8	12.2	-11.6	19.9
Utilities	14.8	6.6	-2.9	14.8	0.9
Telecom	14.0	3.6	12.5	0.8	12.3
<b>S&amp;P 500</b>	<b>14.5</b>	<b>24.5</b>	<b>13.4</b>	<b>0.0</b>	<b>12.8</b>

\*Based on 2014 analysts' earnings estimates. \*\*Through 12/12.  
Source: Bloomberg

Source: *Barron's*

**Energy has the lowest P/E ratio among all the groups, barely beating the Financials**

A table in the article (Exhibit 1) showing the current price-to-earnings ratio for each of the ten major investment sectors composing the Standard & Poor's 500 stock index and their price returns in each of the past four years demonstrated two interesting points about energy. It has the lowest P/E ratio among all the groups, barely beating the Financials. For many investors, this forward valuation metric is seen as an indicator the sector is statistically cheap and possibly an attractive place to seek value. Investors should remember, however, that the P/E is the ratio of the sector stock market price and its estimated earnings. The P/E would be higher if the estimated earnings were lower, and vice versa, so one must examine the assumptions the analysts are employing when they estimate the per share earnings for the energy companies composing the sector. It is quite possible they are overly optimistic

**So far in 2013, energy is trailing the overall market's performance by seven percentage points, after trailing by 11 points in 2012**

**If oil prices were to fall next year, and natural gas prices remain stuck at their current average level for 2013, then the industry could be facing a liquidity issue that would negatively impact earnings and the attractiveness of energy stocks for investors**

about 2014 crude oil and natural gas prices, along with expectations for company operating costs. If that proves to be the case, then a reduced "E" in the P/E calculation would mean the resulting P/E would be higher making the sector less attractive.

The other observation from the table was how energy has performed during the 2010-2013 timespan. During that four-year period, energy beat the S&P 500 index in the first two years, but has trailed the index for the past two years. So far in 2013, energy is trailing the overall market's performance by seven percentage points, after trailing by 11 points in 2012. Energy did well in 2010 when it bested the market by five percentage points and was the fourth-best performing sector. In 2011, energy was one of six sectors that turned in positive performance for the year as the S&P 500 was flat. But of those positive performers, energy ranked fourth with a positive 2.8% gain for the year.

Given the long-term view of energy's prospects – growing oil and natural gas output, the opening of international markets to American oil and gas exports, and stable oil and gas prices – one would expect energy company earnings to be in an uptrend. The challenge for energy producers is that the shale revolution, which is driving the business now, appears to be an even greater consumer of capital than conventional oil and gas production. The absence of significant profitability from shale output means that many producers have been forced to add to their debt loads in order to continue drilling operations, or they have been forced to sell less attractive shale holdings or their conventional producing assets, potentially risking limiting their cash flow generating capability. Some producers have been fortunate to find additional capital on Wall Street and among eager private equity funds. However, if oil prices were to fall next year, and natural gas prices remain stuck at their current average level for 2013, then the industry could be facing a liquidity issue that would negatively impact earnings and the attractiveness of energy stocks for investors. The prime beneficiary from that scenario is the American consumer, who will see lower energy bills. Energy-intensive manufacturers, who have been expanding and/or building new U.S. plants to capitalize on cheap oil and gas should also be helped. The transfer of profits from producers to consumers underlies our 2010 stock market wager for this decade that states that companies helping energy consumers will outperform the producers of energy. That led us to suggest that GE (GE-NYSE) and Honeywell (HON-NYSE) would be better stocks over 2010-2020 than ExxonMobil (XOM-NYSE). We stand by that view.

## **Louisiana Senator Mary Landrieu - Politician Extraordinaire**

President Barack Obama has nominated retiring Senator Max Baucus (D-Montana) to be the next Ambassador to China. This move will result in him leaving the Senate early next year and

**“This is a big, huge loaf of bread with a big slice of butter just melting on top”**

**Ms. Strassel uncovered a strange situation in which the leadership political action committee Senator Landrieu has established, JAZZ PAC, provided campaign funds for Democratic senators who oppose the oil and gas industry and favor environmental causes**

**The Governor cannot make a decision without knowing what the polls say**

allowing a number of Democratic senators to move into new committee leadership positions that might help their re-election chances in 2014. One of those senators who could benefit would be Louisiana Senator Mary Landrieu who could move into the leadership position at the Senate Energy and Natural Resource Committee. The analysis of this development has created a fascinating juxtaposition of views. The liberal-leaning *Politico* news service carried an article discussing why environmentalists are concerned about Ms. Landrieu heading the Energy Committee. According to an official at a major environmental group that *Politico* contacted, he said, "It's just hard to be optimistic about the direction of the committee if it goes from Wyden to Landrieu." He went on to say, "That would be the big fear for us is that that committee would be very, very narrowly focused just on oil and gas." That sentiment would seem correct based on comments about the potential move from the last Louisianan to head the committee, former Democratic Senator Bennett Johnson. He said he was amazed at the possibility. He went on to say, "People in Louisiana understand where the bread is buttered. This is a big, huge loaf of bread with a big slice of butter just melting on top."

On the other side of the ledger was a column in *The Wall Street Journal* authored by Washington-based opinion-writer Kimberley Strassel entitled "Mary Landrieu and all that JAZZ." In the column Ms. Strassel sets out Senator Landrieu's pitch to the Louisiana voters that she will work to get the most money from the oil and gas royalties for the state and the best deals for the state's petroleum industry. But Ms. Strassel uncovered a strange situation in which the leadership political action committee Senator Landrieu has established, JAZZ PAC, provided campaign funds for Democratic senators who oppose the oil and gas industry and favor environmental causes. In particular, Ms. Strassel cites the 2012 vote when Senator Landrieu and her fellow Louisiana Senator, David Vitter (R-LA), were seeking to pass an amendment that would have implemented a 2008 offshore lease schedule that would have allowed more oil and gas leases to be sold. The amendment was defeated by 12 votes. Of the 48 Democratic votes against the amendment, JAZZ PAC had provided financial support to 37 of them.

After reading these two stories a matter of minutes apart, we were reminded of the Texas Governor played by Charles Durning in the movie version of [The Best Little Whorehouse in Texas](#). The Governor cannot make a decision without knowing what the polls say. It is one of our favorite songs and the lyrics from the chorus may be applicable to Senator Landrieu.

"Ooh I love to dance a little sidestep, now they see me now they don't –  
I've come and gone and, ooh I love to sweep around the wide step,  
cut a little swathe and lead the people on."

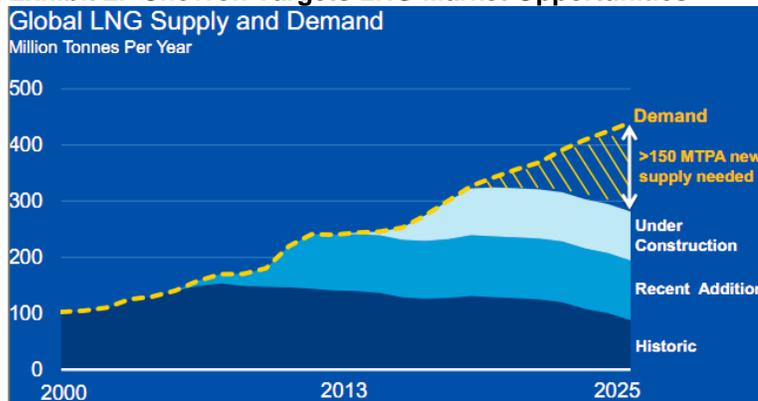
The Governor allowed the Chicken Ranch to close because the people had spoken!

## The Chevron Tower Decision – Sign Of Emerging Problems?

**The company is planning to transfer 1,700 employees into Houston from its California headquarters and elsewhere making Houston the new center for the company**

Last week, Chevron (CVX-NYSE) announced it was putting its new 50-story tower planned to be built on the former YMCA property in downtown Houston on hold. The 1.7 million square foot building would join the two existing towers owned and occupied by Chevron in an urban campus setting. The two towers were formerly the home of Enron. The planned tower was announced less than six months ago and has received \$2.7 million in tax breaks from the City of Houston and \$12 million in employment-related grants from a State of Texas fund. The company is planning to transfer 1,700 employees into Houston from its California headquarters and elsewhere making Houston the new center for the company. The tower would be able to accommodate 4,200 workers. Chevron said it is also delaying several other real estate projects. Justin Higgs, a Chevron spokesman, made the following statement: “Chevron continues to maintain a strong balance sheet and operating cash flow, but the company is in a unique, capitolly-intensive period that will drive peer-leading production and value growth.”

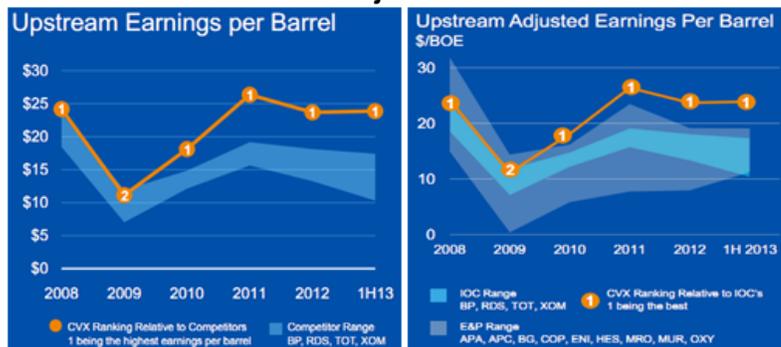
### Exhibit 2. Chevron Targets LNG Market Opportunities



Source: Seeking Alpha, Chevron

**As a global energy company, Chevron is finding that the liquefied natural gas (LNG) business is offering some attractive long-term opportunities**

Chevron has announced a \$39.8 billion capital spending budget for 2014, down about \$2 billion from its expected spending level for this year. As a global energy company, Chevron is finding that the liquefied natural gas (LNG) business is offering some attractive long-term opportunities. About 90% of next year’s capital spending will be for upstream projects including finishing the Gorgon LNG project off Australia, where the company has been plagued by significant cost over-runs. It is also engaged in building the \$4.5 billion Kitimat LNG project in Canada to export natural gas to Asia. Chevron is also planning to develop two large deepwater fields at a cost of \$12 billion that will eventually add 230,000 barrels a day of oil production from the Gulf of Mexico, more than doubling its current output.

**Exhibit 3. Chevron Leads Majors In Per Barrel Profits**

Source: Seeking Alpha, Chevron

**One has to wonder whether the abrupt (at least in appearance) decision reflects greater concern about the future direction in oil prices, and quite possibly the profitability from its shale investments**

The company is considered conservatively capitalized with a total debt to equity ratio of under 13%, and \$18 billion of cash on its latest balance sheet, and it has numerous long-term projects that would likely benefit from a consolidation of its workforce, especially into a lower-cost, reduced-tax area such as Houston. One has to wonder whether the abrupt (at least in appearance) decision reflects greater concern about the future direction in oil prices, and quite possibly the profitability from its shale investments. The company is considered to be one of the more profitable upstream operators among the major integrated companies. We watch corporate moves such as the one Chevron is making, along with the strategic portfolio shifts Royal Dutch Shell (RDS.A-NYSE) is making after announcing its upcoming CEO change. These “battleship-like” energy companies are not able to make sharp shifts in strategy without considering long-term trends. Just what is Chevron’s message?

## Supreme Court And Lawlessness In The Offshore Business

**The report claimed to have relied on recommendations of industry expert advisors, but that proved to be false, raising the specter of the report’s conclusions being politically motivated**

Last week the U.S. Supreme Court denied a petition for certiorari from Hornbeck Offshore Services (HOS-NYSE), which had challenged a Fifth Circuit Court of Appeals ruling allowing federal regulators to halt drilling in the Gulf of Mexico following the Deepwater Horizon accident and oil spill in April 2010. In a nutshell, the case involved the moratorium on granting new drilling permits put in place by the Secretary of the Interior as the government awaited a report about possible additional regulations that might be needed to address the safety of deepwater drilling as a result of the incident. The report announced a complete moratorium on all applications for drilling permits as well as for all drilling currently underway. The report claimed to have relied on recommendations of industry expert advisors, but that proved to be false, raising the specter of the report’s conclusions being politically motivated. Upon that realization, a federal district court granted a preliminary injunction roughly one month following implementation of the moratorium.

**The Fifth Circuit Court reversed that ruling on the ground that the injunction only prohibited the government from enforcing the first moratorium and not the second**

After the injunction was issued, Interior Secretary Ken Salazar issued a press release attacking the injunction and announcing he would soon issue a new moratorium. The federal government also appealed the injunction to the Fifth Circuit Court, but was denied. Following the denial, the Secretary issued a new moratorium that was essentially the same as the first moratorium in scope and substance. He also argued that the first case, which generated the injunction, was moot. The federal district court did not agree, but the Fifth Circuit Court did, thus declaring the case moot. But before the district court could rule on the second moratorium, the government lifted it and mooted the merits of the case. The original plaintiffs in the first case sought to find the government in contempt, and the district court agreed, but the Fifth Circuit Court reversed that ruling on the ground that the injunction only prohibited the government from enforcing the first moratorium and not the second. The Fifth Circuit Court agreed that the government had made an “end run” around the lower-court injunction when it replaced the earlier moratorium with the second, virtually identical, moratorium, but the court found that the lower court order did not explicitly prohibit a new moratorium. The Supreme Court’s denial of the certiorari petition leaves in place the ruling allowing the “end run.”

**We found the Supreme Court’s decision interesting since it seems to be granting free reign to the federal government as it deals with offshore oil and gas activity**

We say this with some trepidation, but courts normally don’t deal with future events, since they focus on “standing” meaning whether the plaintiff has been directly impacted by the defendant’s action. Our trepidation comes from the recent Houston land use case where damages have been awarded to the neighbors if a particular building gets built. But in the offshore case, the district court didn’t address any and all moratoria the government might put in place, thereby opening up the loophole for skirting the “spirit” of the court’s moratorium injunction. We found the Supreme Court’s decision interesting since it seems to be granting free reign to the federal government as it deals with offshore oil and gas activity. And we draw that conclusion from the broader perspective of the entire expansion of offshore oil and gas regulation spawned by the Deepwater Horizon incident and the role Michael Bromwich, the original director of the Bureau of Ocean Energy Management, Regulation and Enforcement (the successor regulatory agency to the Minerals Management Service), played in that move.

**According to The Wall Street Journal, before the trial, Judge Cote pre-declared her “tentative view” that Apple was an antitrust violator**

Mr. Bromwich’s regulatory expansion philosophy was recently highlighted in an editorial in *The Wall Street Journal* focusing on his actions as a monitor of Apple (APPL-NASDAQ) over its supposed violation of antitrust laws in the digital book industry. Judge Denise Cote of the New York federal district court ruled after her bench trial that Apple was guilty of a conspiracy to increase digital book prices that could be accessed on the company’s iPad tablet. According to *The Wall Street Journal*, before the trial, Judge Cote pre-declared her “tentative view” that Apple was an antitrust violator based on Justice Department arguments that have no precedent in antitrust jurisprudence.

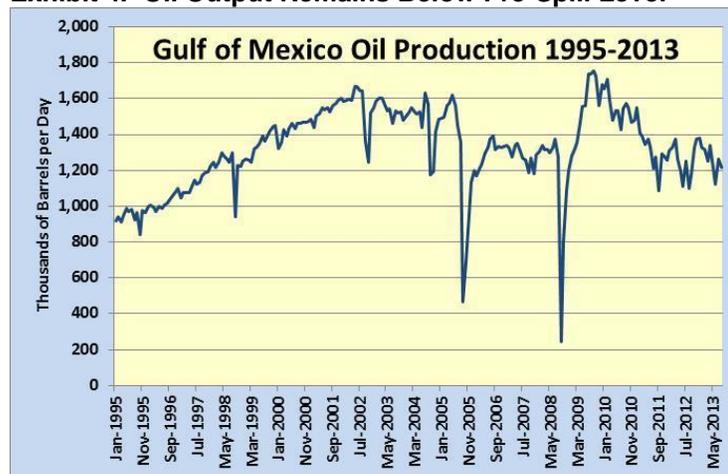
**When only two executives were available, he wrote a 6-page letter to the directors advising them “I have experienced a surprising and disappointing lack of cooperation from Apple and its executives.”**

**He is billing Apple \$1,100 an hour and \$1,025 an hour for his support lawyer who is an antitrust lawyer since Mr. Bromwich has no training in that field**

Following his appointment as the master to review antitrust at Apple, Mr. Bromwich assumed an unrestricted view of his power to investigate any and all activities at the company. He demanded to see proprietary documents beyond the scope of the case, and he went around Apple’s in-house counsel and sent letters directly to every top Apple executive, regardless of whether they have anything to do with the company’s antitrust policy, and to every board member living in California, including Al Gore, demanding interviews without counsel present. If the executives were not available at the time of his trip to the company, Mr. Bromwich wanted proof of why they could not meet. When only two executives were available, he wrote a 6-page letter to the directors advising them “I have experienced a surprising and disappointing lack of cooperation from Apple and its executives.”

Mr. Bromwich was backed by the judge in a subsequent ruling that also expanded his investigative powers. He is billing Apple \$1,100 an hour and \$1,025 an hour for his support lawyer who is an antitrust lawyer since Mr. Bromwich has no training in that field. Mr. Bromwich was formerly an inspector general for the Justice Department under President Bill Clinton and he oversaw high-profile investigations of the DOJ, the FBI and the CIA. He worked for independent counsel Lawrence Walsh in the Iran-Contra investigation during the Reagan era. But even more telling is that it was a highly supportive letter from Judge Cote that helped Mr. Bromwich over the Senate hurdle in his 1994 confirmation hearing for the IG position.

**Exhibit 4. Oil Output Remains Below Pre-Spill Level**



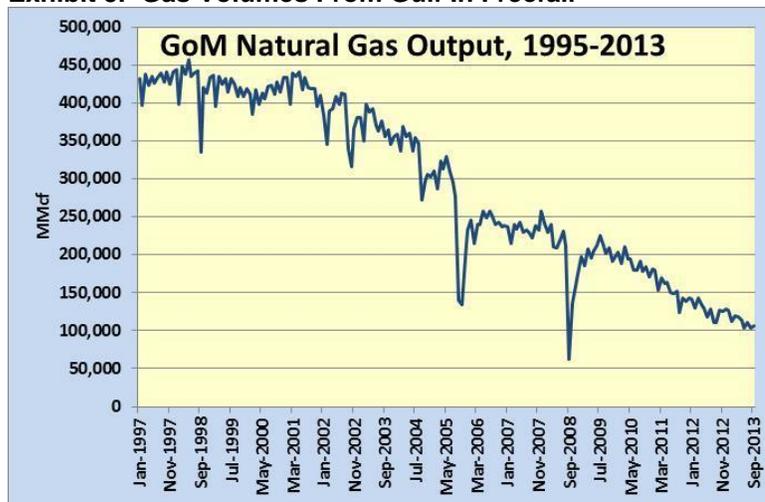
Source: EIA, PPHB

We remember Mr. Bromwich for his performance at the 2010 Fall Meeting of the National Ocean Industries Association. We wrote about his talk and the “Ghost of Future Regulation.” Many industry people may remember that he spoke at a 2010 Offshore Technology Conference session. It was there that he said, “Second, I have

**“The reason for our historical practice that has focused solely on regulating operators was that it served to preserve clarity and the singular responsibility of the operator”**

mentioned several times in recent weeks my interest in exercising regulatory authority over not only offshore operators but contractors as well. It has struck me as inappropriate to limit our authority to operators if in fact we had legal authority that reached more broadly to the activities of all entities involved in developing offshore leases. We have completed our review of the issue and have concluded that in fact we have broad legal authority over all activities relating to offshore leases, whether engaged in by lessees, operators, or contractors. We can exercise such authority as we deem appropriate. The reason for our historical practice that has focused solely on regulating operators was that it served to preserve clarity and the singular responsibility of the operator. I am convinced that we can fully preserve the principle of holding operators fully responsible – and in most cases solely responsible – without sacrificing the ability to pursue regulatory actions against contractors for serious violations of agency rules and regulations. We will be careful and measured in extending our regulatory authority to contractors.” With that pronouncement, the world of offshore operators and contractors was changed!

**Exhibit 5. Gas Volumes From Gulf In Freefall**



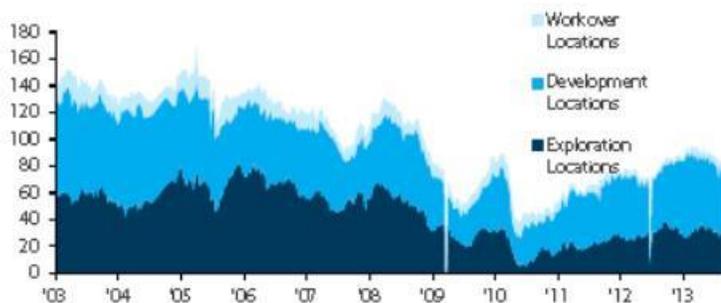
Source: EIA, PPHB

**Mr. Bromwich entered the auditorium from behind the stage and left the same way, without any attempt to interact with the audience other than to deliver his remarks and take a couple of pre-determined questions**

At the NOIA meeting, as we described it in our November 9, 2010, *Musings From the Oil Patch*, Mr. Bromwich was only able to spend 30 minutes with the members and he entered the auditorium from behind the stage and left the same way, without any attempt to interact with the audience other than to deliver his remarks and take a couple of pre-determined questions. He did shake hands with the organization’s Chairman, its CEO and the moderator of the session. In his comments he told the members that “the spill response effort was deemed inadequate and not acceptable,” and that “the nearly 60-year safety and environmental record of the offshore oil and gas industry he attributed to luck!” We concluded our observations of the meeting by stating, “We were taken aback by this arrogant

display by an industry regulator, but viewed it as part of the message he was delivering – we are here to regulate you and as such we will be judge and jury, which means we cannot mingle.”

#### Exhibit 6. Activity Up Since 2010 Except For Drilling



Source: IHS-Petrodata

Source: Barclays

**We are sure Apple CEO Tim Cook wishes he had had greater knowledge of what to expect from Mr. Bromwich**

We are sure Apple CEO Tim Cook wishes he had had greater knowledge of what to expect from Mr. Bromwich. We wonder whether Apple’s lawyers will be more successful in getting the courts to reign him in and to toss out the antitrust ruling, since digital book prices actually fell as a result of Apple’s entrance into the business, than Hornbeck had in getting the Supreme Court to reign in the federal government for its “end run” around the injunction against the moratorium. To those who say that because the moratorium was lifted a few months after the spill there has been no practical effect on drilling in the Gulf of Mexico right now, we can only shake our head and say, we wish it were so. See the exhibits in this article.

## The European Union And Challenges To Its Energy Policy

**Its claim would put at risk jobs and industrial competitiveness of the continent’s largest and strongest economy**

The economic strongman of Europe, Germany, is coming under attack from the competition regulator of the European Union (EU) for the country’s discounts that hundreds of companies receive for renewable energy surcharges. Chancellor Angela Merkel warned Brussels (home of the EU government and bureaucracy) that its claim, which could result in the companies being forced to pay back billions of euros, would put at risk jobs and industrial competitiveness of the continent’s largest and strongest economy.

**It also will look at the government’s energy policy that offers support only for companies using domestic green energy**

The EU antitrust commission is set to examine whether the reduction granted to energy-intensive companies on a surcharge for the financing of renewable energy sources in Germany is compatible with European state aid rules. It also will look at the government’s energy policy that offers support only for companies using domestic green energy and not imported renewable power. If the investigation determines that Germany has given the companies

**The announcement of this investigation comes shortly after the commission announced an investigation into the terms of a deal for the construction of a new nuclear power plant in the UK**

illegal state assistance, then the companies will have to repay that assistance. The exemptions were worth about €4 billion (\$5.47 billion) to energy-intensive companies this year, up from €2.3 billion (\$3.14 billion) in 2012. A total of 1,716 groups were awarded waivers this year, compared to only 570 in 2010. Some of the companies affected include BASF (BASFY-PNK), Thyssen-Krupp (TYEKF-OTC), Bayer (BAYRY-OTC) and Linde (LNAGF-OTC).

The Federation of German Industries said the inquiry could have a “significant impact” on German industry. Ulrich Grillo, the federation president, said in an interview, “The removal of exemptions for energy-intensive industry would be the immediate end for many businesses and thousands of jobs.” The announcement of this investigation comes shortly after the commission announced an investigation into the terms of a deal for the construction of a new nuclear power plant in the UK. Britain is struggling with having to close old coal-burning plants and nuclear reactors. The decline in its natural gas supplies, and cost problems for proposed new offshore wind farms that have resulted in three large projects being cancelled in the past 60 days, mean the UK might have an energy issue.

**The new 2014 French budget contains a carbon tax on household use of natural gas, heating oil and coal, which is sure to make the public unhappy**

The economies of European countries are struggling with huge debt loads, aging populations, fragile financial systems, and escalating energy costs due to the public’s embrace of renewable energy as the savior from greenhouse gas emissions and their impact on climate change. In fact, the new 2014 French budget contains a carbon tax on household use of natural gas, heating oil and coal, which is sure to make the public unhappy. It is interesting that Germany’s BASF, the world’s largest chemical manufacturer by sales, is shifting more of its production and research activities to the United States to take advantage of our economic recovery and our lower-cost natural gas as a result of the shale boom, and to escape the higher electricity costs at home. Look for more energy-intensive European manufacturing businesses to shift operations to the U.S. to capitalize on the energy cost advantage. This is certainly one major benefit from the shale revolution.

## **Is A Keystone Pipeline Decision Drawing Near?**

**The environmental movement, which views the approval of the pipeline construction permit to be its red line**

While there has been a continual low level of news coverage about the possible fate of the Keystone XL pipeline construction permit, based on the recent uptick in activity surrounding it, one might conclude that a decision could be forthcoming soon. The reality is the decision is still a ways off, but maybe the environmental movement, which views the approval of the pipeline construction permit to be its red line, has become more concerned that the public support for the pipeline coupled with President Barack Obama’s low approval ratings might influence him to approve the permit.

Environmentalists were heartened with the announcement that John Podesta, the Chair of the Center for American Progress and the

**The survey went on to ask whether building the Keystone pipeline is in the “national interest” and the support was overwhelming with 72% agreeing compared to only 18% opposing, with 9% undecided**

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**Only 15 percentage points of the Republicans were “strong” while it was 22% for the Democrats**

Center for American Progress Action Fund and the last chief-of-staff under former-President Bill Clinton, was returning to the White House as an advisor to President Obama on energy matters. But with the announcement came a statement that Mr. Podesta would recuse himself from any discussions about the Keystone pipeline.

Earlier this month, the American Petroleum Institute hired Harris Interactive to conduct a poll about the public’s attitudes towards the Keystone XL pipeline and the nation’s energy infrastructure. On the basic question of whether the U.S. should import more or less oil from Canada, the “more” response received 63% of the vote compared to 16% for “less,” with 18% either not knowing or refusing to answer. On the question of “Do you support/oppose the building of the Keystone pipeline?” the respondents supported the line by a 69%-17% ratio. The survey went on to ask whether building the Keystone pipeline is in the “national interest” and the support was overwhelming with 72% agreeing compared to only 18% opposing, with 9% undecided or unwilling to offer an opinion. On the issue of supporting or opposing increased development of the nation’s energy infrastructure, the support was even greater with 83% favoring compared to 9% opposing.

The survey went on to question whether increased development of the country’s energy infrastructure was good for American consumers (88% agree/7% disagree); increased infrastructure development would help create jobs (93% agree/5% disagree); and increased development of the country’s energy infrastructure would help strengthen America’s energy security (89% agree/7% disagree). Clearly, the public buys the value and need for this country to build the Keystone pipeline and other energy infrastructure projects as they would create jobs and improve the nation’s energy security. The margins of approval in the survey, conducted in early December, have drawn the attention of the environmental movement. They also had to focus on the results in light of the survey’s demographic characteristics, which were designed to be representative of registered voters. The survey universe was composed of 54% females and 46% males, while the age split showed that only 11% of those surveyed were between the ages of 18 and 34 years old with the rest being nearly evenly divided between 35-49, 50-64 and 65+ age categories. In terms of education, a third of those surveyed had a high school or less education with 53% having attended or graduated from college. Some 13% of the respondents had a post-graduate degree.

The surprise in the survey composition was the political split. The population survey had a 24/30/32 percent representation of Republicans, Independents and Democrats. More interesting was the fact that only 15 percentage points of the Republicans were “strong” while it was 22 points for the Democrats. So as Democratic politicians look at the survey make-up, their party and its ideals should be supported by the greater number of women, the higher

**The lack of high participation by the youth category in this survey and quite possibly their support for the pipeline has to be perceived as a clarion call to mobilize the troops against the pipeline**

educational levels of those surveyed and the larger share of Democrats and strongly Democratic-leaning respondents. Of the 30% of those surveyed calling themselves Independent, the leaning was split 12% for Republicans and 10% for Democrats. The real negative for the Democratic Party was the low participation of the young voters. However, since Harris was modeling the registered voters, the low level of young voters could be a surprise, even though they were supposedly among the groups who favored Barack Obama the most in his two presidential victories. The lack of high participation by the youth category in this survey and quite possibly their support for the pipeline has to be perceived as a clarion call to mobilize the troops against the pipeline.

**The company pointed out that it has never signed any contract with ERM and was only a participant in the consortium considering building a pipeline in Alaska**

Without the possible support of Mr. Podesta in this battle, the anti-oil sands troops began mobilizing. First was an effort led by Representative Raul Grijalva, (D-Ariz.) who enlisted 24 of his fellow Democratic House of Representative colleagues to co-sign a letter to President Obama urging him not to accept the Supplemental Environmental Impact Statement (SEIS) for the Keystone pipeline until the Department of State Office of Inspector General has completed its investigation of possible conflict-of-interest claims regarding Environmental Resources Management (ERM) and Keystone's developer, TransCanada (TRP-NYSE). The conflict-of-interest claim was raised because of ERM's involvement since 2011 in a contract for a pipeline project in Alaska that includes TransCanada as a participant. The company pointed out that it has never signed any contract with ERM and was only a participant in the consortium considering building a pipeline in Alaska. *Bloomberg* has also reported that in 2010 ERM published a list of clients that contained TransCanada's name. Again, there is no indication that the listing was of companies with whom ERM had signed contracts. According to media reports, the Inspector General's investigation will not be complete until sometime in February 2014.

**In January, the State Department would be in a position to release the SEIS that triggers the 90-day "national interest" determination period**

If that wasn't enough pressure, shortly after the Congressional Democrats' letter was sent to the President and made public, climate activists, as reported by the news source *Politico*, disclosed that they had proof that ERM was a member of several energy industry groups that have urged the government to support the Keystone project. We have written in the past that based on the number of public comments and the pace at which the State Department was posting them to their web site, the process wouldn't be completed until sometime in January, at which point the department would be in a position to release the SEIS that triggers the 90-day "national interest" determination period. This process, conducted by the State Department, involves security, economic and other concerns. The public will have a chance to comment in writing on the question and environmentalists already have requested hearings. The process can be interrupted by any coordinating agency requesting additional information. After a request from one of these agencies, such as the Environmental Protection Agency (EPA) or the Interior Department,

**Given that he might be handed the permit application at the start of the mid-term election cycle, one has to wonder if the administration wouldn't find some reason to avoid a decision until after the November vote**

**The dynamics of the pace of oil sands developments and the growth of oil production from the Bakken shale in North Dakota have forced TransCanada to begin moving forward with alternative transportation alternatives**

**While Mr. Girling said rail will not replace Keystone, the industry continues to order more rail cars for transportation**

**What frustrates Mr. Girling is the hypocrisy of the environmental movement**

the State Department would provide its draft presidential permit decision. At that point, the agency would have 15 days to review the decision, and if it objects, it can effectively place the final decision in President Obama's hands. If we assume both the EPA and Interior Department request information, then the review process would extend for up to 120 days, which would put the final determination at the White House doorstep in the May/June time frame. We don't know how long, or if there is a mandatory time period for the President to render his decision, but given that he might be handed the permit application at the start of the mid-term election cycle, one has to wonder if the administration wouldn't find some reason to avoid a decision until after the November vote.

Given the timing of this review and approval process, which has been ongoing for nearly six years, it was not surprising that TransCanada announced that the start-up of the pipeline would not occur until 2016. The dynamics of the pace of oil sands developments and the growth of oil production from the Bakken shale in North Dakota have forced TransCanada to begin moving forward with alternative transportation alternatives such as the Energy East pipeline from Alberta to the Irving refinery and export port on the East Coast of Canada. Last week, Russ Girling, the CEO of TransCanada, said the company is considering whether it may need to turn to rail as a way to bridge the border issue. "I don't think we would ever stop pressing the pipeline option, but there is a point in time at which we would consider a rail option," Mr. Girling stated.

According to Mr. Girling, 400,000 to 500,000 barrels a day of oil will move out of Western Canada by rail next year, increasing to one million barrels a day by 2015. At the beginning of last week, Harold Ham, the CEO of Continental Resources (CLR-NYSE), and one of the companies that committed to ship 35,000 barrels a day of Bakken crude oil on the pipeline told *Reuters* that his company and the U.S. oil industry in general are no longer counting on Keystone. They have reached that conclusion due to the six-year review process already and the possibility that the pipeline might not be done for another four years. While Mr. Girling said rail will not replace Keystone, the industry continues to order more rail cars for transportation rather than suffer a further extension of the high price discount for the landlocked Canadian oil output.

TransCanada already has the Alberta portion of the Keystone line under development and the portion from Montana through South Dakota and Nebraska could be built without State Department approval. What frustrates Mr. Girling is the hypocrisy of the environmental movement that is fighting Keystone in the name of wanting to reduce greenhouse gas emissions. By blocking the pipeline, they are pushing the industry to use rail to ship the oil, thus adding more emissions than would come from the pipeline. Mr. Girling said in his interview, "By forcing oil companies to look at

**We suggest Mr. Girling consider switching his hard hat for a train engineer's cap**

these alternatives, doing it by rail, we are actually increasing GHG emissions. But nobody will engage in a dialogue with me because (Keystone) is too big a boom for them, for their ability to raise money. They'd rather keep this symbol." We would caution Mr. Girling that if he receives a presidential permit, he should expect to see the inside of lots of U.S. courtrooms as the litigation against the pipeline will last longer than he can imagine. We suggest Mr. Girling consider switching his hard hat for a train engineer's cap.

## Is The Energy Glass Half Full Or Half Empty?

**The unwritten investment rule was that any oil and gas drilling deal that made its way to New York City was probably bad since all the good deals never left Houston or Dallas**

The answer to our headline question may lie in the perception of the viewer, or it may have more to do with how knowledgeable one is about the fundamentals of the oil and gas business. For decades, the unwritten investment rule was that any oil and gas drilling deal that made its way to New York City was probably bad since all the good deals never left Houston or Dallas. That rule popped into our head as we read the newspaper and online article headlines highlighting key points from the Energy Information Administration's (EIA) [Annual Energy Outlook 2014 Early Release](#) report.

"U.S. Oil Production Projected to Surge, Leading to Lower Prices at Gas Pump" cried the headline in the Business section of *The New York Times*. *USA Today* led its story with "U.S. forecasts natural gas boom through 2040," while the *ft.com* web site opined, "US oil production to test record high in 2016." That headline was similar to *Bloomberg's* statement that "U.S. Crude Output to Climb Toward Record by 2016, EIA says." After scanning these headlines it was easy to believe that the forecast for rising oil and gas output leading to the country becoming self-sufficient in energy has a real chance of coming true.

**We wondered whether her headline writers were just more grounded in the realities of the oil and gas business than those authoring the headlines for the other publications**

Our optimism was tempered, however, when we read the headline of the article posted to the *Houston Chronicle's Fuel Tech* web site, which was essentially the same article it published in that morning's newspaper. The headline read, "US oil boom's end in sight, feds say." Oops! Instead of focusing on how high oil production could grow and what this means for our nation's energy independence, the writer, Washington energy reporter, Jennifer Dlouhy, focused on the day when all the good news about our energy's future ends, and the physical constraints of oil and gas reservoirs begins to rule output trends. While Ms. Dlouhy's article wasn't necessarily different from those of the other publications, we wondered whether her headline writers were just more grounded in the realities of the oil and gas business than those authoring the headlines for the other publications.

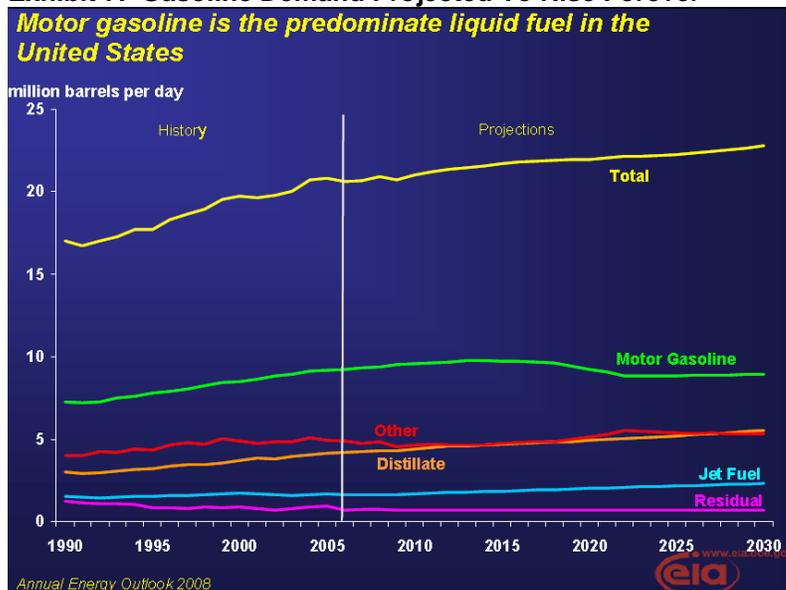
The lead paragraph in *The New York Times* story's said, "Domestic oil production will continue to soar for years to come, the Energy Department predicted on Monday, scaling to levels not seen in nearly half a century by 2016." That is very encouraging. But

**According to the EIA, the result of this new analysis is that the average annual increase in vehicle miles traveled for light-duty vehicles will be 0.9% from 2012 to 2040, down from 1.2%**

supply is only one part of the energy balance. We thought it interesting that the EIA stated that in its final report, due to be published in February 2014, it has a “new, detailed demographic profile of driving behavior by age and gender as well as new lower population growth rates based on updated U.S. Census Bureau projections.” According to the EIA, the result of this new analysis is that the average annual increase in vehicle miles traveled for light-duty vehicles will be 0.9% from 2012 to 2040, down from 1.2% used in the 2013 Annual Energy Outlook for the same period. While vehicle miles traveled grows, the increase in average fuel-economy of vehicles means that the volume of gasoline consumed will decline between 2012 and 2040. The decline in annual consumption for light-duty vehicles and commercial light trucks is from 8.68 million barrels a day in 2012 to 6.65 million barrels a day in 2040, a 23.4% reduction.

The gasoline market changed in 2008 just as the global financial crisis exploded. Unfortunately, due to a problem with the EIA’s web site, we could not access the 2008 Annual Energy Outlook with its detailed projections. However, we were able to locate two data points showing how badly the EIA missed structural changes in the transportation fuel market. First is a chart from a presentation made at the end of 2008 by Guy Caruso, the head of the EIA, showing the history of and projection for gasoline volumes. (Exhibit 7.)

**Exhibit 7. Gasoline Demand Projected To Rise Forever**



The chart shows that the EIA anticipated gasoline volumes to continue growing from 2006 until 2014, before slowing and then declining until 2021. That weak demand was obviously driven by assumptions about the impact of new car fuel-efficiency on overall

**According to the EIA web site, 12.95 billion gallons of ethanol were consumed in 2012, which was below the estimate made in the 2008 Annual Energy Outlook**

fleet consumption. It is interesting that following the decline in gasoline demand, it begins to grow again through 2030.

The second data point referred to the volume of ethanol consumption, which the EIA projected would grow from 5.6 billion gallons in 2006 to 13.5 billion gallons in 2012, exceeding the required 7.5 billion gallons mandated in the Renewable Fuel Standard. The EIA projected ethanol volumes would grow to 17 billion gallons in 2030. According to the EIA web site, 12.95 billion gallons of ethanol were consumed in 2012, which was below the estimate made in the 2008 Annual Energy Outlook. Given the decline in gasoline consumption and rise in ethanol production, the government was forced to reduce the amount of ethanol that must be blended into gasoline in 2014 and in the future.

We will have more to say about this 2014 EIA forecast in the future. We think the admission that the agency had to essentially go back and totally re-analyze the gasoline consumption model suggests there are probably other areas in its forecast that need to be re-examined. That will be a large undertaking, but an important one because the nation is making many decisions about how we are going to handle our domestic energy resources that will have long-term fundamental consequences for the economy, the social welfare of Americans and the nation's role in the global economy.

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