

MUSINGS FROM THE OIL PATCH

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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 oilfield service companies. The newsletter currently anticipates a semi-monthly publishing schedule, but periodically the event and news flow may dictate a more frequent schedule. As always, I welcome your comments and observations. Allen Brooks

Houston Energy Stocks Were Hot in 2006

There were a number of very “hot” energy stocks last year

Energy was not the top performing sector of the stock market in 2006 as it failed to extend its two-year leading stock sector run. However, there were a number of very “hot” energy stocks last year and some of them were included in *The Houston Chronicle* top 150 stock listing. The newspaper’s stock list is made up of public companies either based in Houston or that have a significant presence there. Other factors considered in compiling the list include stock market capitalization and revenues.

We have extracted from the newspaper’s list, those companies that we classify as integrated oil companies, E&P companies and oilfield service companies. In reviewing the results, it was quite interesting to note the performance of certain companies and the disappointing performance of others, all against the backdrop of continued high oil prices, but weakening natural gas prices.

ExxonMobil’s 36% gain was remarkable given the size and scope of the company

Marathon Oil (MRO-NYSE) was the best performing integrated oil company stock in 2006, but ExxonMobil’s (XOM-NYSE) 36% gain was remarkable given the size and scope of the company. The company continued to repurchase shares throughout all of last year, but it also had an industry contra-performance in boosting its oil production volumes. ExxonMobil outperformed its major foreign competitor on the list, BP plc (BP-NYSE), by nine-fold. That is not totally surprising given the string of operational and public relations problems BP has been experiencing – the Alaska pipeline leak; the Texas City refinery explosion, deaths and high profile court case; and the LP gas price fixing charges. ExxonMobil also performed better than its smaller competitors, Chevron (CVX-NYSE) and ConocoPhillips (COP-NYSE), both of whom had strong years, although the outperformance was modest.

Exhibit 1. The Houston Chronicle 150 Performance in 2006

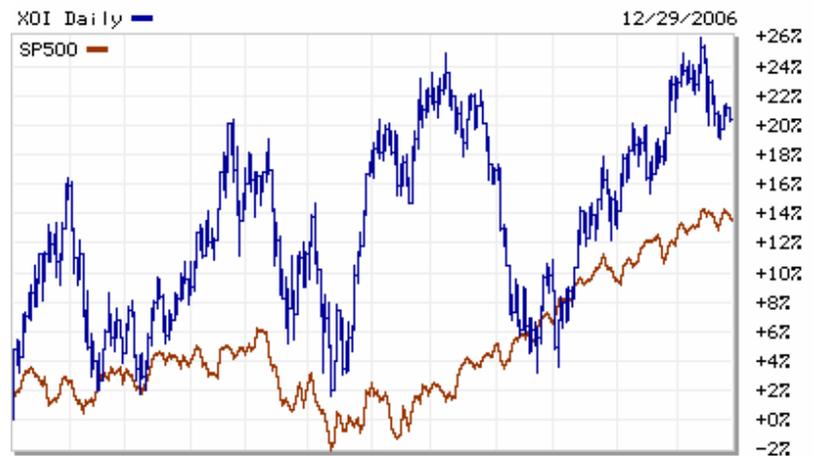
STOCK	DIV	PE	CLOSE	CHG	52-WK		YTD %CHG
					HIGH	LOW	
Integrated Oil Companies							
BP	2.30	10	67.10	-0.10	76.85	63.25	4.5
Chevron	2.08	9	73.53	-0.75	76.20	53.76	29.5
ConocoPhillips	1.44	7	71.95	-0.72	74.89	54.90	23.7
ExxonMobil	1.28	12	76.63	-0.70	79.00	55.60	36.4
Marathon	1.60	6	92.50	-0.63	98.73	59.55	51.7
E&P Companies							
ATP Oil & Gas	...		39.57	-0.84	49.70	34.16	6.9
Anadarko	0.36	5	43.52	-0.42	56.98	39.51	-8.1
Apache Corp.	0.60	8	66.51	-0.22	76.25	56.50	-2.9
Cabot Oil & Gas	0.16	9	60.65	-0.62	66.52	38.26	34.5
Devon Energy	0.45	9	67.08	-0.32	74.75	48.94	7.3
EOG Resources	0.24	10	62.45	-1.23	86.91	56.31	-14.9
Genesis Energy	0.80	33	19.48	0.23	20.65	10.25	67.2
Goodrich Petroleum	...	34	36.18	-0.91	44.57	22.59	43.9
Houston Exp.	...	14	51.78	-0.53	66.21	48.13	-1.9
Newfield Exploration	...	9	45.95	-0.78	54.50	34.90	-8.2
Noble Energy	0.30	12	49.07	-0.74	54.64	36.14	21.8
Petrohawk	...	9	11.50	-0.13	16.25	9.76	-13.0
Plains E&P	...	13	47.53	-0.12	49.73	31.45	19.6
Pogo Production	0.30	5	48.44	-1.20	60.42	38.01	-2.8
Swift Energy	...	8	44.81	-1.06	52.47	34.72	-0.6
Ultra Petroleum	...		47.74	-0.45	70.00	41.80	-14.4
W & T Offshore	0.12	10	30.72	-0.27	49.16	26.84	4.5
Oilfield Service Companies							
Atwood Oceanics	...	19	48.97	-0.51	58.44	38.20	25.5
BJ Services	0.20	12	29.32	-0.11	42.85	27.43	-20.0
Baker Hughes	0.52	11	74.66	-0.79	89.30	59.86	22.8
Cameron	...	22	53.05	-0.40	57.81	38.08	28.1
CB & I	0.12	28	27.34	-0.16	31.85	19.60	8.4
Diamond Offshore	0.50	19	79.94	-0.55	97.90	62.26	14.9
Dril-Quip	...	21	39.16	-0.62	45.02	23.15	65.9
FMC Tech.	...	21	61.63	-0.33	71.89	41.76	43.6
GlobalSantaFe	0.90	17	58.78	-0.54	65.21	44.26	22.1
Grant Prideco	...	13	39.77	-0.46	55.43	33.11	-9.9
Grey Wolf	...	8	6.86	0.05	8.93	6.10	-11.3
Halliburton	0.30	12	31.05	-0.21	41.99	26.33	0.2
Hanover Comp.	...	37	18.89	-0.22	21.10	14.00	33.9
Helix En	...	11	31.37	-0.16	45.61	27.55	-12.6
Hydriil	...	20	75.19	-0.04	89.71	48.71	20.1
Input/Output	...	39	13.63	-0.12	14.05	6.75	93.9
Jacobs Eng.	...	25	81.54	-0.66	93.27	67.22	20.1
KBR	...		26.16	-0.54	27.63	20.50	26.1
McDermott Intl	...	24	50.86	0.20	53.36	27.60	71.0
Nabors Indust.	...	9	29.78	-0.45	41.35	27.26	-21.4
Natco Group	...	18	31.88	-0.48	42.63	20.08	55.8
Natl-Oilwell	...	19	61.18	-1.16	77.60	51.62	-2.4
Noble Corp.	0.16	17	76.15	-0.96	86.16	58.51	8.0
Oceaneering	...	19	39.70	-0.60	47.23	24.48	59.5
Oil States Intl.	...	9	32.23	-0.49	43.87	25.00	1.7
Parker Drilling	...	8	8.17	-0.07	12.44	6.10	-24.6
Pioneer Cos.	...	5	28.66	-0.78	34.45	21.75	-4.4
Pride Intl.	...	19	30.01	-0.33	36.96	24.01	-2.4
Rowan	0.40	11	33.20	-0.30	48.15	29.03	-6.8
Schlumberger	0.50	24	63.16	-0.47	74.75	47.90	30.0
Seacor Holdings	...	10	99.14	-0.84	102.34	67.25	45.6
Smith Intl.	0.32	19	41.07	-0.39	46.48	34.87	10.7
Tetra Tech.	...	21	25.58	-0.31	32.00	14.45	67.6
Todco	...	15	34.17	-0.81	53.86	30.05	-10.2
Transocean	...	29	80.89	-0.82	90.16	64.52	16.1
Veritas DGC	...	35	85.63	0.39	86.24	34.61	141.3
W-H Energy	...	15	48.69	-0.45	57.98	32.57	47.2
Weatherford	...	17	41.79	-0.21	58.73	35.08	15.4
Willbros	...		18.90	0.17	24.53	14.00	30.9

Source: The Houston Chronicle, PPHB

Each peak in 2006 was higher than the prior peak

The American Stock Exchange oil stock index (XOI) showed a true roller coaster pattern throughout 2006. What was interesting in the index's trading pattern was that each peak in 2006 was higher than the prior peak. This is reminiscent of the design of many roller coasters that build higher each up-and-down cycle in the ride until the absolute last cycle, which then leads to the passengers disembarking. Our guess is that at some point in time, oil stocks in the stock market may experience a similar up and down pattern followed by abandonment by investors, but probably not quite yet.

Exhibit 2. Performance of Oil Index and the Market

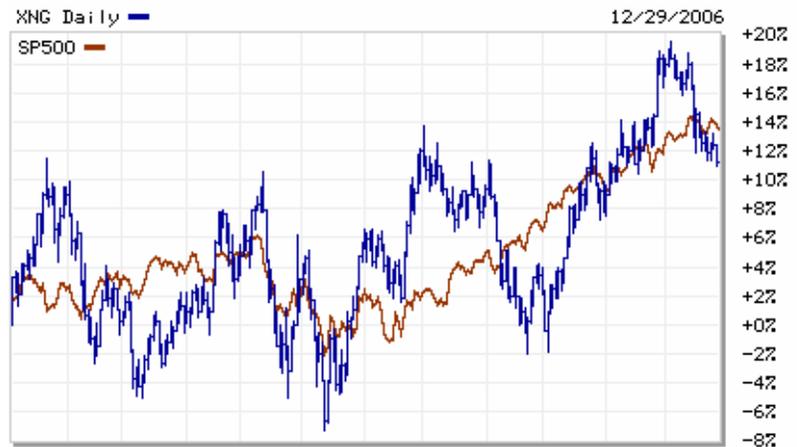


Source: Big Charts.com, PPHB

The decline in North American natural gas prices, and prospects of that trend continuing in 2007, was the primary influencing factor in the stocks underperformance

The divergence of share performance among the E&P companies was quite dramatic. Between the best performer, Genesis Energy (GEL-AMEX) with a 67.2% gain, and the worst, EOG Resources (EOG-NYSE) with a loss of 14.9%, there was a spread of 82 percentage points – a huge margin. In looking over the list of E&P companies and their respective performances, one is drawn to the view that the decline in North American natural gas prices, and prospects of that trend continuing in 2007, was the primary influencing factor in the results. The strong positive performance turned in by certain companies essentially reflected company-specific events rather than any broad industry trends.

This conclusion is demonstrated by the 2006 performance of the American Stock Exchange natural gas index (XNG), which ended the year trailing the broad stock market by almost three percentage points. Throughout the year, the index experienced periods of outperformance and underperformance of the overall stock market. By Thanksgiving time, the natural gas index and the overall stock market were about dead even performance-wise for the year. The early cold snap that hit the Midwest and Northeast regions of the country shortly after Thanksgiving jumped the natural gas index well ahead of the market, but then the warm December weather and projections for continued above normal winter temperatures took its toll on the stocks while the broad stock market continued higher.

Exhibit 3. Gas Index versus the Market in 2006

Source: Big Charts.com, PPHB

Generally the service stocks produced positive results for their owners with very few exceptions

The oilfield service industry showed a remarkable range of outcomes last year, from a decline of 24.6% by Parker Drilling (PKD-NYSE) to a 141.3% gain posted by Veritas DGC (VTS-NYSE), driven by a takeover deal. Generally the service stocks produced positive results for their owners with very few exceptions. All of the oilfield service stocks that produced negative returns are closely associated with the domestic natural gas drilling industry or have operations in the shallow waters of the Gulf of Mexico whose activity is largely gas-driven. The drop in natural gas prices from \$11.34 in mid September 2005 to \$4.98 at the same time last year made certain gas-drilling activity unprofitable. The concern about a warmer than normal winter has muted the traditional seasonal price lift for energy stocks driven by anticipated increases in demand.

While the winter storms rocking Denver and the Great Plains received intense media scrutiny, the first snowless December since 1877 for New York City is more important when considering winter gas demand. Forecasts for the balance of the winter call for above-normal temperatures, which are not positive for the outlook for domestic natural gas prices in 2007, especially given the outlook for weaker U.S. economy this year, also.

The strong outperformance of the oilfield service stocks in the first half of 2006 was essentially all given back by early fall

Overall, oilfield service stocks produced solid returns in 2006 as demonstrated by the performance of the Philadelphia oilfield service index (OSX). The strong outperformance of the oilfield service stocks in the first half of 2006 was essentially all given back by early fall. In fact, the OSX was trailing the performance of the overall market by almost 13 percentage points at the beginning of October. The service stocks surged through most of the last third of the year as the overall market's advance leveled out. In the second half of December, after having surged ahead of the overall stock market, oilfield service stocks dropped as the broad market held steady. The final result was about a four percentage point underperformance by the OSX, even though it advanced about 10% for the full year.

Exhibit 4. Oil Service Stocks versus the Market in 2006

Source: Big Charts.com, PPHB

The performance of the OSX versus the NASDAQ found the two indices ending in a virtual dead heat at up 10%

One interesting performance note for oilfield service stocks was how they performed compared to their traditional alter ego, the technology stocks. If we look at the performance of the OSX versus the NASDAQ, the market dominated by technology stocks, the two indices ended in a virtual dead heat at up 10%. The OSX demonstrated greater volatility during the course of the year, but the final year-end slump in the service stocks, driven by investors selling their winners and reducing their energy exposure in the face of a slumping economic and commodity price outlook for 2007, brought the two groups together at the end.

Exhibit 5. Oil Service Stocks Versus Technology

Source: Big Charts.com, PPHB

Does the performance of energy stocks in 2006 suggest anything about how they might perform this year? Probably not much, except that companies heavily dependent on North American natural gas-related activity are likely to continue to struggle this year. The rest of the stocks will perform with the movement of crude oil prices,

international drilling activity and the overall direction of the stock market.

Energy Experts Predict 2007 Will be More of the Same

Reporter Sharon Epperson of CNBC presented on Tuesday morning the results of its survey of 20 top energy analysts on the top factors that will influence world oil prices in 2007. She also presented the thinking of these analysts on world oil prices. The results of the survey were not materially different from what happened in 2006 and the prevailing wisdom about the outlook for the industry as we entered the last third of the year.

We found the seven key variables consistent with general thinking about the forces that have shaped, and are shaping, the world oil market

According to the survey, dubbed "7 for '07," it attempts to highlight the seven most important factors that will impact the commodity and therefore the investment outlook for companies involved in the industry. We found the seven key variables consistent with general thinking about the forces that have shaped, and are shaping, the world oil market, but we have some differences with the order that the experts list them.

Unless we have close to a permanent shutdown of oil supplies from one of these politically unstable regions, it is hard to see how world spot oil prices would stay elevated for long periods of time

The seven factors, in order of importance, were: 1) geopolitical considerations; 2) the OPEC cartel; 3) non-OPEC oil supplies; 4) the value of the U.S. dollar; 5) global oil demand; 6) alternative energy supplies; and 7) weather. The selection of geopolitical concerns as the most important consideration was based on the majority of the analysts agreeing that issues such as Iran's nuclear ambitions, instability in Iraq and continued rebel attacks on the oil infrastructure in Nigeria generate fear of significant supply disruptions that could send oil prices soaring. It is these fears that supposedly have injected a \$5 to \$15 per barrel premium into global spot oil prices in the course of last year. However, the world has approximately four billion barrels of oil reserves in strategic storage facilities around the world. That reserve will grow this year as China continues to fill its reserve and India initiates a new strategic storage initiative in 2007. Additionally, there are millions of barrels of oil supply in ships in transit from the oil producing regions to the oil consuming ones. Thus, unless we have close to a permanent shutdown of oil supplies from one of these politically unstable regions, it is hard to see how world spot oil prices would stay elevated for long periods of time, although the initial shock wave would send prices sharply higher in the immediate term.

Oil analysts remain very concerned about supplies in the global oil market balance, which is why they listed the OPEC cartel and non-OPEC oil supplies as the second and third most important factors. The value of the U.S. dollar was listed as important factor number four, but in our view, it is more a sub-factor since primarily it works by influencing other factors such as OPEC's supply decisions. The value of the dollar also impacts the fifth, and in our view the most important, variable – global oil demand. The health of global oil demand will determine whether the world has too much or too little

Absent investment there is little the world can do about its oil supply and demand balance except ration demand through higher oil prices

oil, and in turn crude oil prices. The health of oil demand will influence whether OPEC and non-OPEC countries and the oil producers plow ahead making the necessary investment to boost global oil reserves and production capability. Absent that investment there is little the world can do about its oil supply and demand balance except ration demand through higher oil prices.

Having weather on the list of important factors is virtually required by the fact that it influences both oil supply and demand, at least for short periods of time. For many of us, the past several years have been ones experiencing wild swings in weather's impact on either supply or demand. Weather considerations are a constant for those who operate in the global oil industry, much like farmers who look for rain when they plant their crops.

Alternative fuels such as ethanol may undercut the demand for conventional gasoline that accounts for a large share of all oil demand

The role of alternative energies (number six on the list) in the global energy supply picture is receiving increasingly greater attention from analysts because this supply source may erode demand for crude oil or become the buffer that enables energy supplies to meet growing global hydrocarbon demand. In particular, alternative fuels such as ethanol may undercut the demand for conventional gasoline that accounts for a large share of all oil demand. This variable may be the most important one to consider in looking at the outlook for oil markets. Alternative energy is also of growing importance due to the role that certain of these fuels will play in the environmental considerations of how the world will power its economies and provide for its people.

So what do the analysts think about the future price of crude oil in 2007? The majority think that oil prices will average in the range of \$60 to \$65 per barrel this year. These same analysts believe that there will be a floor for oil prices of \$50 to \$55 with OPEC willing to cut production to support that level. The more bullish of the analysts holds out hope that oil prices may average between \$75 and \$85, setting a new price record in 2007. Tim Evans, oil analyst at Citigroup, was quoted in the report as saying, "I think 2007 is going to be a more typical year for the oil market." Based on recent history, we're not sure what a "typical year" is any more. Mr. Evans went on to say, "I'm not expecting the big bull market to return." But does that rule out a small bull?

Denver and NOAA's Winter Forecast

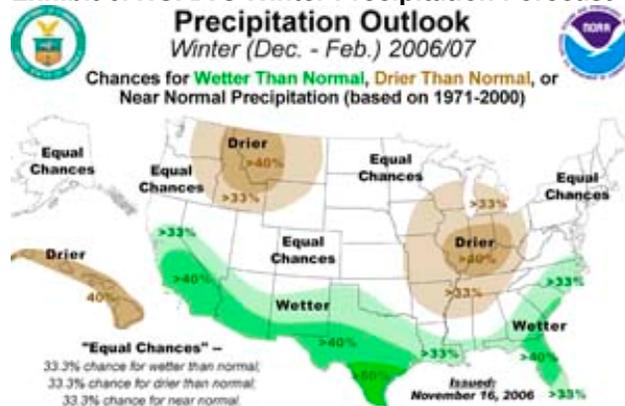
The City of Denver and the eastern half of Colorado along with the Great Plains were battered by two significant snow storms this past December. For Denver, the two storms, coupled with several other days of minor precipitation, produced a total of 29.4 inches of snow, making it the third snowiest December in the city's history. Denver's normal December snowfall averages 8.7 inches.

The record December snowfall for Denver was 57.4 inches that occurred in 1913. That month saw snow fall on each of the first six

days of the month with 37 inches of the total falling on the fourth and fifth days. The other memorable snow storm was the Christmas blizzard of 1982 when Denver was hit with 23.6 inches of snow, measured at the old Stapleton International Airport in downtown, during a 24-hour period starting on December 24.

Last month's total precipitation was 1.21 inches of liquid, some 0.58 inches above normal (0.63 inches). On December 20, the city received 0.73 inches, related to the first snow storm, which broke the old record of 0.24 inches established in 1918. Two of the last three months of 2006 were above normal for precipitation, although the entire year was the seventh driest on record for Denver.

Exhibit 6. NOAA's Winter Precipitation Forecast



Source: NOAA

NOAA gave Colorado equal chances of drier, wetter or near average precipitation this winter

On November 16, 2006, the National Oceanic and Atmospheric Administration (NOAA) published its final forecast for the 2006-2007 U.S. winter season. The forecast covers the months of December, January and February. In that forecast, as shown in Exhibit 6, NOAA gave Colorado equal chances of drier, wetter or near average precipitation this winter. We wonder what the people pictured in the photos below, taken during the latest Denver snow storm, think about the accuracy of the government's forecast.

Exhibit 7. Walking in a Denver Winter Wonderland?



Source: AP News

Exhibit 8. Shoveling Streets in Denver

Source: AP News

Canada Gas Supply to the U.S. at a Risk

Canadian natural gas exports to the United States could fall by as much as one billion cubic feet per day in 2007

A recent investment research report by the Calgary investment bank, FirstEnergy Capital, suggests that Canadian natural gas exports to the United States could fall by as much as one billion cubic feet per day in 2007 due to the impact of falling gas prices and rising oil sands-related demand. Currently, Canada is exporting 10 billion cubic feet a day to the United States, but that volume is at risk due to falling natural gas drilling activity.

Drilling activity in Canada began to diverge last fall from the earlier robust forecasts as natural gas prices fell due to bloated gas storage inventories in the U.S. and flagging demand due to a lack of cold weather in the populous regions of the country, coupled with a weakening U.S. economy. In response to weaker gas prices and escalating costs for drilling caused by oilfield inflation, Canadian producers began to cut back their drilling activity in the second half of last year. That cutback has resulted in estimates for the number of new wells to be drilled in 2006 being lowered marginally.

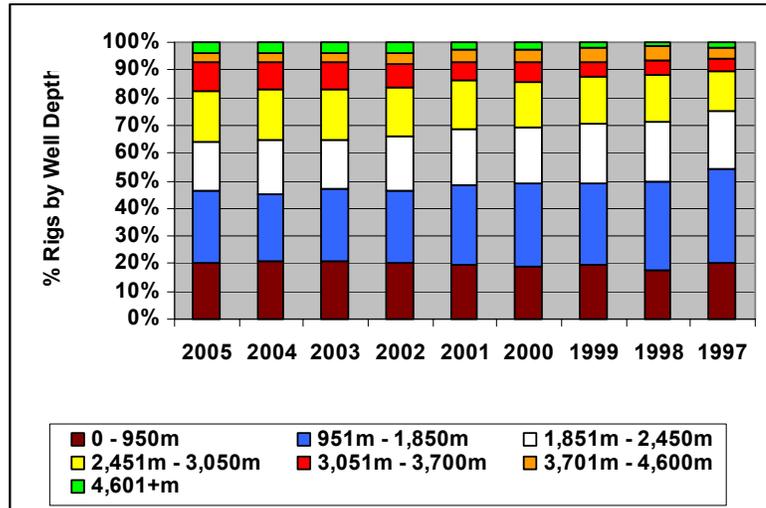
PSAC is now looking for about a 10% reduction in the number of wells drilled this year from those drilled in 2006

The Petroleum Services Association of Canada (PSAC) lowered its 2006 wells drilled forecast to 23,900 wells from their earlier forecast of 25,290. PSAC is now looking for about a 10% reduction in the number of wells drilled this year from those drilled in 2006. That forecast could prove optimistic given the recent oil industry exploration and production spending survey released by Lehman Brothers a few weeks ago that calls for about a 7% decline in producer spending in 2007. The key to how far the wells drilled number falls depends on the types of drilling producers cut back on.

Many analysts and industry watchers expect most of the drilling cutbacks to focus on shallow drilling, which tends to be much more cost sensitive because the size of reservoirs are small and production is depleted rapidly. With poor drilling economics and

prospects that they may not improve much until 2008, producers will be reluctant to want to sell their valuable gas production into a low-priced market. On the other hand, if they do cease drilling this easy to bring on gas supply, the imbalance between gas supply and demand may be corrected rather quickly.

Exhibit 9. Active Canadian Drilling Rigs By Well Depth



Source: CAODC, PPHB

The deeper drilling markets are likely to prove more stable in this low gas-price environment

When we look at the number of rigs working in the shallow drilling market in Canada, it becomes clear how stable, as a percentage of all rigs, this segment has demonstrated. This segment has grown in importance since the late 1990s, but that reflects the improving demand for Canadian gas. The deeper drilling markets are likely to prove more stable in this low gas-price environment, as they are targeting larger reservoirs that can be brought on stream at lower per unit costs, and the wells take longer to drill. Expectations are that there will be a sharply lower Canadian drilling rig count, at least through the first half of 2007, with a reduction in demand for other activity-related oilfield services. Those trends will receive substantial Wall Street attention in early 2007.

Natural gas demand associated with oil sands production has climbed

The other dynamic at work in the Canadian market is the growing demand for natural gas to fuel the processing plants extracting increased volumes of bitumen from the oil sands in northern Alberta. The oil industry has a huge amount of spending programmed to add new productive capacity over the next several years. Natural gas demand associated with oil sands production has climbed from under 400 million cubic feet per day 10 years ago to about a billion cubic feet daily in 2006. Some estimates are that gas demand has risen by 300 million cubic feet a day just since last summer as several new oil sands projects have recently come on stream.

If this forecast for Canadian gas exports proves any where close to being accurate, U.S. gas markets could be under increased price pressure even with large volumes of gas in storage currently. For

For most of the past 15 years, the U.S. has met its growing natural gas needs by importing increased gas volumes from Canada

most of the past 15 years, the U.S. has met its growing natural gas needs by importing increased gas volumes from Canada. If that source of supply declines, then the recent growth in domestic gas supply due to the surge in unconventional gas drilling could be overwhelmed. Of course that is the bullish case for a quick revival of the softening U.S. land drilling market. The key question will be whether this scenario, which has been predicted in the past, could be what is behind the revival of the coal and nuclear power industries. The revivals of these industries, however, are long-term in nature and will not alleviate any short-term gas supply shortages, although they would diminish the long-term gas market growth outlook. So while most U.S. energy investors are focused on domestic weather patterns, we suggest keeping an eye on oilfield activity north of the border may be more important.

Energy Stocks Plunge – Warm Weather Blamed

The fact that the Northeast was bathed by record warm temperatures as the new year arrived spooked investors into writing off investments in the energy sector

The opening trading day for the stock market in 2007 saw energy stocks plunge as crude oil futures prices fell by over \$2 per barrel. Warm weather was to blame according to the analysts. The fact that the Northeast was bathed by record warm temperatures as the new year arrived spooked investors into writing off investments in the energy sector. That abandonment was further encouraged by economic and corporate news that made investors think that economic activity in 2007 might be stronger than they had been led to believe in December. Of course, the fact that two oilfield service companies – Nabors Industries (NBR-NYSE) and Tetra Technologies (TTI-NYSE) – announced lower earnings guidance did little to help.

We thought it interesting that after the plunge in energy, and in particular oilfield service stocks, several Wall Street firms decided to downgrade the stocks. These stable hands were certainly closing the door after the horse escaped, even though the stocks fell again the next two trading days, but that's for another story. Given the market performance of energy stocks, we thought it would be interesting to look at how the OSX index did on the first day of trading shares in the new year. January 3, 2007, saw a sharp downward correction in the OSX index of 4.4%. This decline was magnified in importance by the business reporters who went to look up last year's performance and found a 5.7% gain.

Since the OSX was only created in February of 1997, there is only a ten year history to examine. Of those ten years, the ratio of negative first trading days of the new year to positive days is two to one. There was one year, 2001, where there was variation in the index's value over the course of the day, but the net change from the prior trading day close was zero.

Exhibit 10. The OSX and Winter Weather in NYC

Date	Closing		New York City		
	Price	% Chng.	High	Low	Median
1/3/2007	191.18	-4.4%	56	45	51
12/29/2006	199.90				
1/3/2006	192.50	5.7%	42	32	37
12/30/2005	182.14				
1/3/2005	119.38	-3.7%	60	40	50
12/31/2004	123.94				
1/2/2004	93.57	-0.4%	45	38	42
12/31/2003	93.95				
1/2/2003	89.61	3.4%	48	37	42
12/31/2002	86.70				
1/2/2002	83.42	-4.3%	35	21	28
12/31/2001	87.14				
1/2/2001	124.78	0.0%	30	23	26
12/29/2000	124.78				
1/3/2000	80.66	-6.2%			
12/31/1999	85.96				
1/4/1999	53.32	3.5%			
12/31/1998	51.53				
1/2/1998	112.55	-2.6%			
12/31/1997	114.37				

Source: Yahoo Finance, Underground Weather, PPHB

The 4.4% drop in the OSX was only slightly larger than the 3.7% decline in 2005

Many people wanted to make a lot about the magnitude of the OSX price decline last Wednesday. On an absolute basis, the index declined by 8.72 points, although the intraday decline was over 9 points. However, the 4.4% drop was only slightly larger than the 3.7% decline in 2005. In 2004, the index was barely down, posting a loss of only 0.4%. This year's decline was in line with the 4.3% drop experienced in 2002, but it was greatly exceeded by the 6.2% decline in 2000. That year, if you remember, was when the world was expected to fall apart as everyone's computer system was at risk of failure when the calendar turned to 2000 dooming the global economy. In 1998, the first day's OSX price decline was a modest 2.6%.

We then thought it would be interesting to see if there was any relationship between the New Year's Day temperature in New York City and the performance of the OSX. Unfortunately, we were only able to get exact temperature data back to 2001. As shown in

In 2002, when the OSX dropped 4.3%, the average New York City temperature was 28 degrees

Exhibit 10 the median temperature for New York City this New Year's Day was 51 degrees. In 2005, the temperature averaged 50 while the OSX was off 3.7% on the first trading day. We would hate to think that the difference of one degree in average temperature was responsible for a 0.7% greater decline in the value of the index.

The most interesting fact is that in 2002, when the OSX dropped 4.3%, the average New York City temperature was 28 degrees. The year before, when the average temperature was two degrees lower, the index produced a flat day-to-day performance. Moreover, last year, when it was 37 degrees in New York City, the stocks jumped by 5.7%. Our guess is that the weather explanation may really be a cover for other factors that are driving the stock performance such as expectations about the rate of growth of future earnings for the stocks or the amount of profits investors made in the prior year. For those who took profits on January 3, they have 15½ months before they have to pay taxes on those gains. That's a lot of time to make more money with those funds. Does greed override the weather?

Ethanol is Here to Stay

On January 1, 2006, the Renewable Fuels Standard (RFS) went in to effect cementing the future role for this fuel within the U.S. and global energy supply matrix. The emergence of ethanol, whether corn-based or cellulosic-based, as a supply source, given its environmentally-friendly character, has become both a rallying point and a bone of contention for the climate change debate. Early studies showed ethanol to be net energy neutral at best and negative at worst, but more recent reports are showing that newer ethanol plants are producing fuel with a positive net energy ratio. The more important consideration is that ethanol's use is mandated by law and subsidized and protected by the U.S. government. That's about as gold-plated a business as one can get. Just remember that the federal government mandated the use of asbestos in naval ships and gave away cigarettes to our soldiers during World War II.

The RFS requires the use of 4 billion gallons of renewable fuel in 2006 rising to 7.5 billion gallons of renewable fuel use annually in 2012

As a result of the implementation of the RFS and the decision by the oil refining industry to eliminate the use of the additive methyl tertiary butyl ether (MTBE) from gasoline, demand for ethanol soared last year. The RFS requires the use of 4 billion gallons of renewable fuel in 2006 rising to 7.5 billion gallons of renewable fuel use annually in 2012. The Renewable Fuels Association estimates that U.S. ethanol consumption in 2006 was more than 5 billion gallons, or 25% more than mandated.

At the end of 2006 according to the Renewable Fuels Association, there were 110 ethanol refineries operating in 19 states with a capacity to produce more than 5.3 billion gallons of ethanol. This capacity reflects a 1 billion gallon increase during the year. There are 63 new refineries and 8 expansion projects set to come on line by the summer of 2008, which will add 5.4 billion gallons of new

The Earth Policy Institute claimed that the ethanol industry was under-reporting the number of new refineries

production capacity. Ethanol is blended into more than 45% of the nation's gasoline supply. The more amazing statistics are that there are over 6 million flex-fuel vehicles capable of burning ethanol blends of up to 85% (E85) in use in this country today and there are over 1,000 E85 retail outlets.

A few weeks after the Renewable Fuels Association issued its data on ethanol, a study from the Earth Policy Institute, an environmental group, claimed that the ethanol industry was under-reporting the number of new refineries and that the explosion in new plant construction could lead to a clash over demand for corn between the fuel and food industries. According to the Earth Policy Institute there are actually 116 ethanol refineries currently in operation and the Institute estimates that there are 79 ethanol refineries under construction that would more than double ethanol production capacity to 11 billion gallons per year. In addition, they say that there are at least 200 plants, with a capacity of 3 billion gallons a year, in the planning stage.

Ethanol plants now running or under construction will pull an estimated 139 million tons of corn from the 2008 corn crop. That is about double the demand projected by the Agricultural Department and will require over half of the projected 2008 corn harvest of about 11 billion bushels. Even though farmers have responded to high corn prices and increased their plantings scheduled for 2007 by eight percent to some 85 million acres that may not be sufficient to satisfy demand for corn from the fuel and food industries.

Corn prices are likely to be heading higher in 2007 putting increased pressure on the food sector that uses corn for feed

As Monsanto (MON-NYSE), a major corn seed supplier, reported in its November quarter-end financial results, domestic corn prices rose 81% in 2006 to a 10-year peak in November of \$3.935 per bushel. With the future demand for corn from ethanol refineries being understated by 25% by both the U.S. Agriculture Department and the Renewable Fuels Association, corn prices are likely to be heading higher in 2007 putting increased pressure on the food sector that uses corn for feed thus driving the retail prices for meat, poultry and dairy higher. The Earth Policy Institute suggests that the government should institute a moratorium on granting licenses for new ethanol plants until the true extent of the ethanol demand on corn can be measured and the risk of food inflation is mitigated. Will the next big thing in 2007 be a debate about Peak Corn?

Lack of Uranium May Stall Nuclear Power Revival

A flood halted seven million pounds of uranium production in 2007 and will take another 12 million pounds off the market through 2009

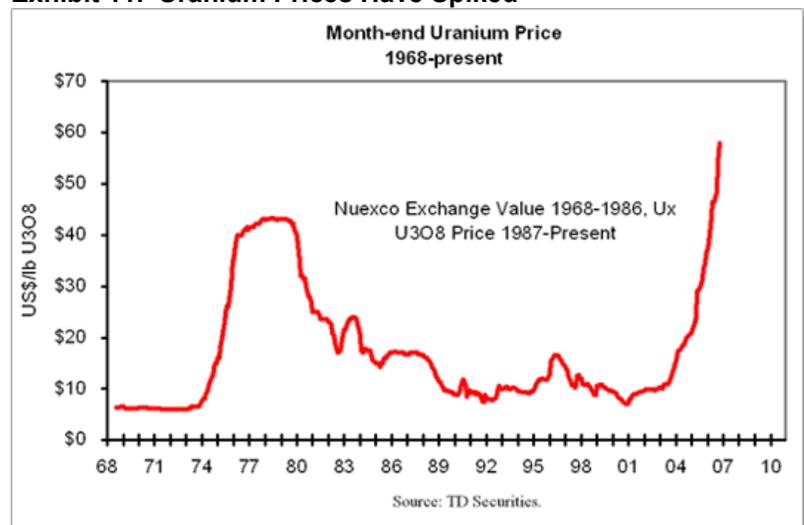
In October, the world's largest undeveloped high-grade uranium deposit was suddenly rendered useless. A flood halted seven million pounds of uranium production in 2007 and will take another 12 million pounds off the market through 2009. The production was coming from Canada's Cigar Lake mine. The impact of the shortfall on global uranium markets was so severe it immediately sent uranium prices up by more than 25% in the weeks following the accident.

The supply of uranium will become a much more important factor in determining how quickly the nuclear power industry develops

While the lost production is only a small fraction of its owner's 550 million pounds of proven and probable reserves, the shortfall will worsen an already growing gap between supply and demand for uranium. It is estimated that this gap between supply and demand is 15 million pounds, or almost 20% of annual demand.

With 441 nuclear power plants producing 16% of the world's energy, and forecasts calling for substantial increases in new nuclear power plant construction, the supply of uranium will become a much more important factor in determining how quickly the nuclear power industry develops. This change in the market follows decades of low uranium demand as nuclear power plant demand was stagnant or declining as no new plants were built and older plants were closed.

Exhibit 11. Uranium Prices Have Spiked



Source: TD Securities

Chairman Dale Klein expects the agency to receive the first application for a new nuclear reactor in 2007

In the United States, according to a spokesman for the Nuclear Regulatory Commission (NRC), at least 30 new reactors are being considered. These new plants would join the 103 reactors currently in operation. NRC Chairman Dale Klein expects the agency to receive the first application for a new nuclear reactor in 2007. The interest in building new nuclear plants is focused in the South or Southeast regions of the country where electricity demand is growing substantially. No new nuclear power plant has been built in the United States since the 1970s.

Nuclear power does not appear to be among the green-fuels that are being targeted for support by the newly elected Democratic Congress. These politicians plan to target the tax incentives enjoyed by the oil and gas industry and divert these funds to developing more alternative fuel supplies such as wind, solar and biomass.

The United States began incentivizing the nuclear power industry in

The idea was to provide subsidies to help the industry build a half-dozen reactors to demonstrate to the utilities and Wall Street that nuclear power is viable

2002 when the government urged utilities to look for new nuclear opportunities. The idea was to provide subsidies to help the industry build a half-dozen reactors to demonstrate to the utilities and Wall Street that nuclear power is viable. Additionally, this effort was designed to develop a standardized plant design that would lead to lower construction cost, improved operation and reduced operating expense. As each new nuclear plant is built, the cumulative construction and operating knowledge from prior plants would be incorporated into the latest plant.

Nuclear backers agree that these new plants are inevitable given the growing demand for electricity and the fuel choices available

Nuclear power plants are extremely expensive, costing billions to build and requiring several years to construct. However, once in operation, nuclear power plants generate electricity at the lowest per unit cost of any fuel. In addition, coal and natural gas prices have escalated in recent years, and environmental concerns over increased use of coal is making the country's most abundant fuel resource less desirable.

Many nuclear backers agree that federal government help is needed to stimulate new construction. They also agree that these new plants are inevitable given the growing demand for electricity and the fuel choices available. Andy White, president and CEO of nuclear energy at General Electric (GE-NYSE), a global power in nuclear energy, said, "If you look at nuclear without any incentives or tax credits, it's very competitive." He said that even without federal government incentives, "We probably would have gone ahead. We would have done it at a slower pace."

The 25 new reactors could be supplying one-third of Australia's electricity by 2050

A recent Australian government-commissioned report says that the country's future lies in nuclear energy that would bring both economic and environmental advantages to the country. The report urges Australia to build 25 new nuclear reactors, not only because of the electricity they would supply, but also due to the environmental advantages from elimination of future greenhouse gas emissions associated with power plants fueled with conventional oil and gas. Australia is fortunate because it contains about 40% of the world's uranium reserves, which would enable it to be self-sufficient in fueling these plants.

Australia currently has only one nuclear reactor but it is used strictly for research purposes. If the country follows through on the commission's recommendation and constructs the 25 reactors, those plants could be supplying one-third of the nation's electricity by 2050. Australian Prime Minister John Howard favors increased use of nuclear power and has said that the government will respond officially to the report's recommendations early in 2007. The country's energy needs are expected to double in the next 40 years.

The greatest problem the John Howard-led government may face is that the center-left opposition Labor Party, which controls all state governments, opposes nuclear power and the relaxation of restrictions on opening new uranium mines. At the same time, environmentalists are opposed to nuclear power as "too expensive

Maintaining restrictions on the opening of new uranium mines could further push uranium prices higher

and too dangerous” to provide any answer to the global warming crisis. They are encouraging increased investment in renewable energy sources such as solar, wind and water power. With this amount of opposition, it is hard to believe that Australia will move forward with any major new nuclear power plant initiative. From the world’s perspective, maintaining restrictions on the opening of new uranium mines, given the recent flooding of the Canada Cigar Lake mine, could further push uranium prices higher dimming the outlook for development of other new nuclear plants.

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