MUSINGS FROM THE OIL PATCH
February 20, 2007

Allen Brooks
Managing Director

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

The Canary on the Northern Plains?

For the U.S. natural gas industry, Canada may be the canary

Coal miners for years carried a canary in a cage whenever they descended into coal mines. The canary was the most rudimentary form of health and safety measures. As long as the canary was alive and singing, the air quality was sufficient for the miners to work. If the canary fell over dead, which they tend to do quickly when breathing unhealthy air, it is time to get out of the mine. For the U.S. natural gas industry, Canada may be the canary in the slowdown in drilling underway.

How much of the slowdown in drilling and service work in Canada is due to deteriorating economics for natural gas drilling compared to the impact from a crazy sequence of winter weather?

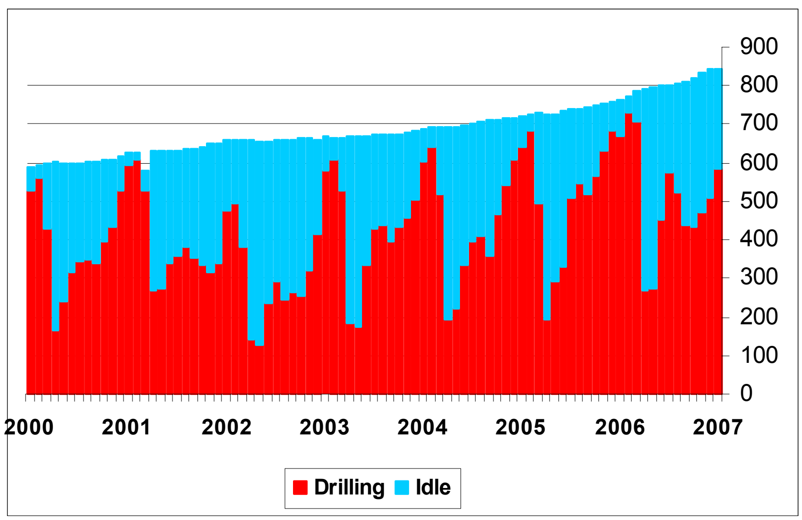
Last summer, several Canadian producers cut back their natural gas drilling efforts in response to weak gas prices, which were projected to get even weaker in future months, and rapidly escalating oilfield costs. The lines reflecting prices and costs were rapidly approaching a crossover point and these producers elected to react before they crossed. According to recent capital spending surveys, Canadian investment will decline in 2007. The challenge for analysts watching the Canadian oil and gas industry is to try to sort out how much of the slowdown in drilling and service work in Canada is due to deteriorating economics for natural gas drilling compared to the impact from a crazy sequence of winter weather. The budget cuts are a signal that the healthy fundamentals that have existed in recent years are under severe attack.

The 2006-2007 Canadian winter drilling season started oddly with a heavy snowfall in late October that coated the ground and acted as an insulation blanket and delayed the onset of the freezing of the tundra. An early and hard freeze followed by snow is the preferred winter pattern for oil patch operators. Producers want the ground frozen deeply and then over lay it with an insulation blanket of heavy snow so that drilling and well servicing equipment can move freely onto and off of drilling locations. When those conditions prevail, oilfield activity ramps up sharply in late fall and can remain at a high level, except for Christmas week when the industry goes on holiday, until spring breakup in March/April when the frost leaves the ground.

Magnifying the weather challenges has been the economic issues that were compounded by the Conservative government's decision to eliminate tax breaks for income trusts

This winter, not only was there an early snow and no freeze, but then the snow melted as warm temperatures returned only then to be followed by wet weather that further delayed the freezing of the soil. The soft ground prevented the movement of drilling equipment and has contributed to a less robust drilling and well servicing market, especially in the southern regions. Magnifying the weather challenges has been the economic issues that were compounded by the radical decision of the Conservative government to eliminate tax breaks for income trusts that had drawn a huge flow of foreign and local retirement money into the energy business. The shock to the financial system from the decision to commence taxing income trusts after a four-year holiday, had the effect of drying up new money flows into the trusts, which has raised their effective cost of capital and further strained the industry's economics due to weak gas prices and rising operating and drilling costs.

Exhibit 1. Canada Drilling Slumping With Low Gas Prices



Source: COADC; PPHB

Canada has become increasingly an environmentally sensitive country

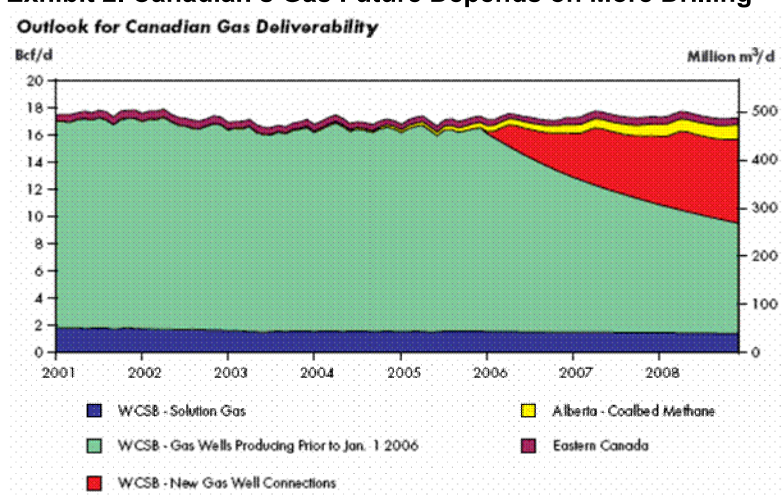
Recently, several additional factors have entered the mix that will challenge any analysis of the future of Canada's natural gas supply and demand balance. With the exception of the province of Alberta, Canada has become increasingly an environmentally sensitive country. The large, liberal population centers in eastern Canada have tolerated the capitalistic and natural resource exploiting attitudes of the residents of Alberta, and to some degree the views of citizens of British Colombia, too. But as the crescendo surrounding the global warming debate grew, some Canadians began to target energy projects that emitted large volumes of pollution and consumed significant amounts of energy. These

Recently, the Liberal party has put forth a revised tax rate proposal

challenges were also targeted at projects appearing to benefit primarily the U.S. In Canada, just as in the United States, the Iraq war has divided popular opinion. For many Canadians, the U.S. is viewed as an exploiter, a polluter and a political bully, and anything they can do to disrupt U.S. global strategies is viewed favorably.

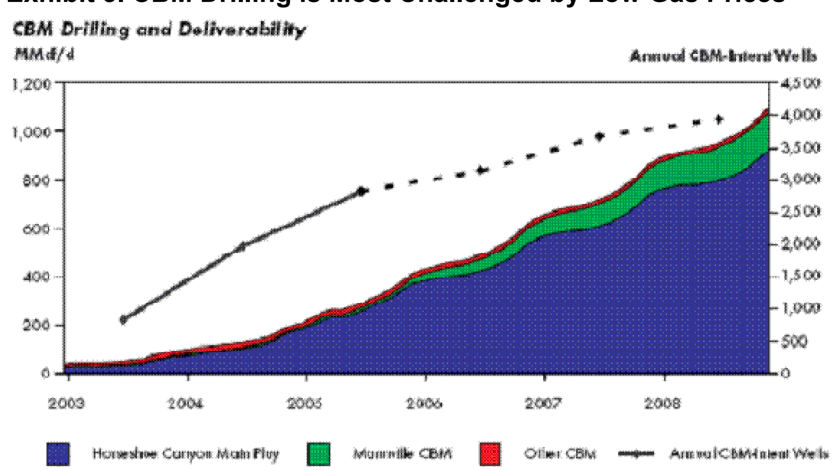
The government decision to tax income trusts, while addressing a way to level the playing field between income trusts and corporations, had the impact of shutting down the growing leakage of federal tax revenues. This tax change also was a backhanded slap at Americans who had actively invested in the income trusts. Recently, the Liberal party has put forth a revised tax rate proposal, a 10% rate with various rebate conditions, rather than the 31% rate of the Conservative's proposal. While there will likely be hearings about the Liberal alternative, observers believe it is not likely to garner much support.

Exhibit 2. Canadian's Gas Future Depends on More Drilling



Source: National Energy Board report

Exhibit 3. CBM Drilling is Most Challenged by Low Gas Prices

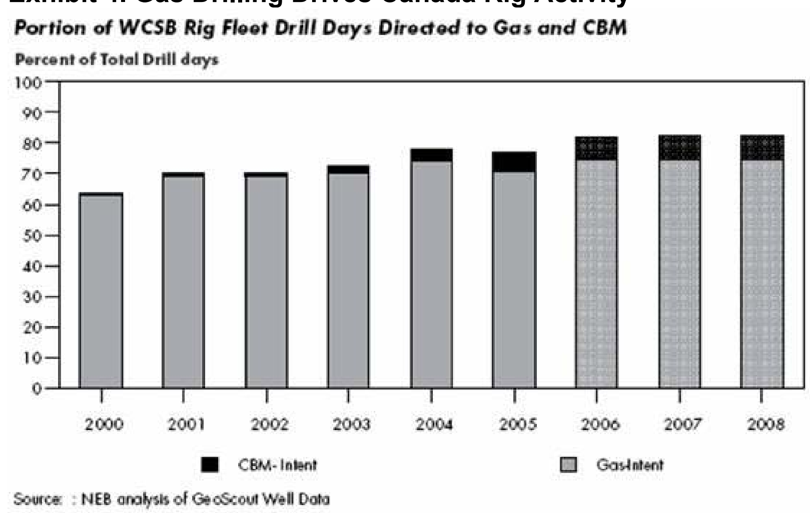


Source: National Energy Board report

The most economically-challenged Canadian gas supply sources have been shallow wells and CBM wells

The combination of the income tax change, the decline in natural gas prices and rising oilfield costs has altered the near-term outlook for natural gas drilling economics. The most economically-challenged Canadian gas supply sources have been shallow wells and coal bed methane (CBM) wells. These resources are challenged because either the reserve size is small, or the cost of drilling, completing and producing the wells is very high. So far, these gas resources have borne the brunt of the drilling slowdown. In the case of CBM production, today's projected future production is probably much lower than that presented in the National Energy Board (NEB) study released last fall.

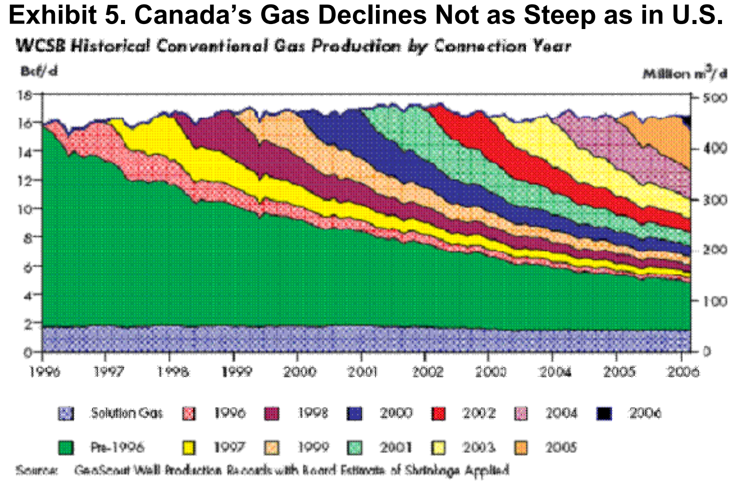
Exhibit 4. Gas Drilling Drives Canada Rig Activity



Source: National Energy Board report

The impact of the Canadian drilling slowdown is shown by the lower level of drilling rig activity experienced this winter so far compared to recent years, although as pointed out earlier, weather has also impacted drilling activity. The challenge for the Canadian drilling

Exhibit 5. Canada's Gas Declines Not as Steep as in U.S.

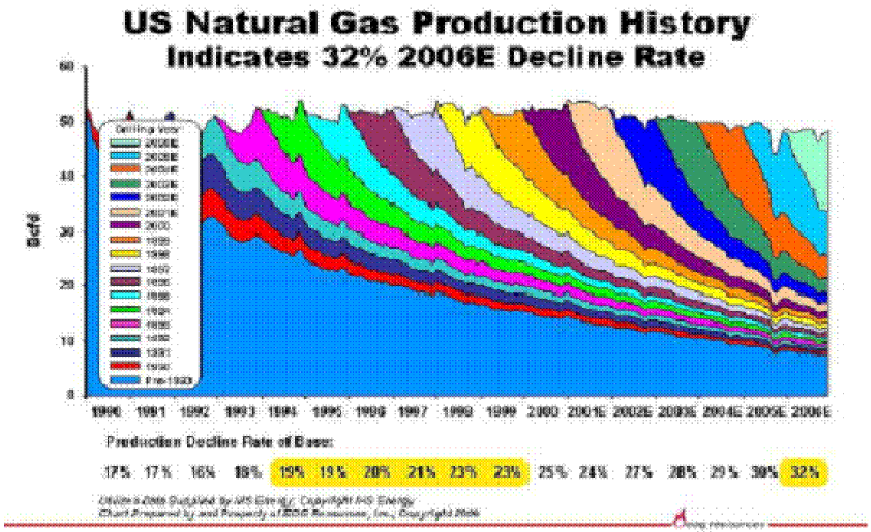


Source: National Energy Board report

Over 70% of Canada's drilling rigs work looking for new gas supplies

industry is the projected growth in the rig fleet and the prospect that drilling activity (fleet utilization) will fall well short of the projections in the NEB report. Since over 70% of Canada's drilling rigs work looking for new gas supplies, the eroding economics for gas will materially impact rig fleet utilization and in turn contract drillers' and well completion companies' profits.

Exhibit 6. U.S. Gas Decline Rates Faster Than in Canada

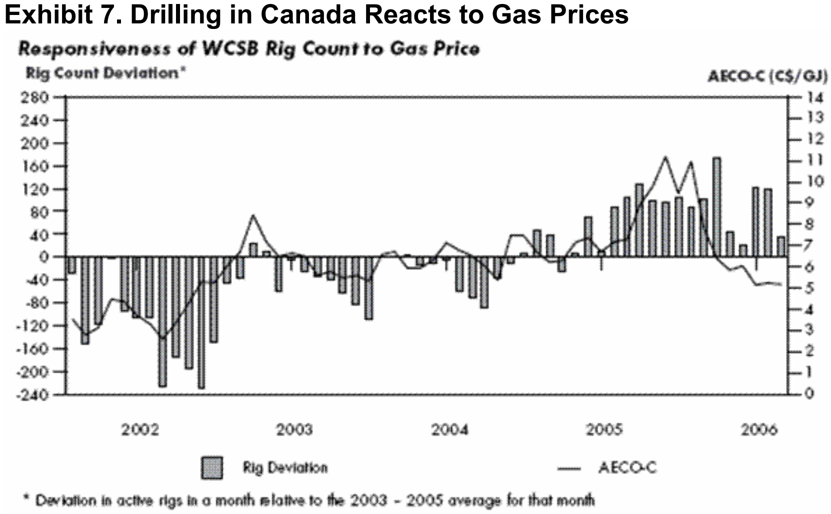


Source: EOG Resources

Canada has been increasing its drilling effort in order to sustain its gas production over the past few years

How can natural gas drilling be the canary for the U.S. gas industry? Canada has been increasing its drilling effort in order to sustain its gas production over the past few years. In actuality, natural gas production has dipped slightly over the past couple of years. But what is most telling is the chart showing the decline curves for gas supplies commenced in each of the past 10 years. Depletion is a reality in the oil and gas business. The decline curves for Canadian

Exhibit 7. Drilling in Canada Reacts to Gas Prices



Source: National Energy Board report

Lower drilling activity should cause costs to fall

natural gas over this period have not been as steep as those experienced by gas producers in the United States, and it is these production declines that will impact gas prices, and thus future gas drilling economics. This is not to ignore the impact of the drilling cost side of the equation, but lower activity should cause costs to fall as the less competitive market for drilling rigs and other drilling and completion equipment, along with an easing oilfield labor market convinces contractors to lower prices to secure new business.

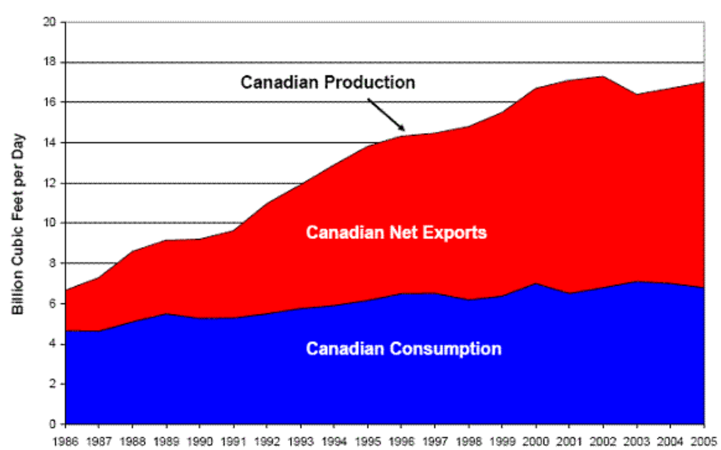
The oilfield labor market in Canada has turned on a dime in a matter of six weeks

The NEB study contained an interesting analysis of the impact on drilling rig activity from changes in natural gas prices. The data, contained in Exhibit 7, only covered from 2002 through the middle of 2006. As natural gas prices fell throughout 2006, we expect that the monthly impact on rig activity has shifted to the negative side, just as demonstrated by the historical data. As we learned in a visit to Canada last week, drilling contractors and oilfield equipment manufacturers were actively laying off workers in what is arguably the peak of the winter drilling season. As one observer put it, the oilfield labor market in Canada has turned on a dime in a matter of six weeks. From our experience, once the momentum switches directions, it has to run its course for a while before it can reverse. Therefore, we would expect the Canadian oilfield service industry to be struggling for at least the first half of 2007.

For the U.S. natural gas industry, Canada has been supplying a growing share of our gas consumption over the past decade. Last year, the growth in domestic gas production due to the growing importance of unconventional gas wells helped ease the supply situation, and that showed up in a slight reduction in gas imports to the U.S. Unfortunately, the growth in the unconventional gas supply arrived at the same time unseasonably warm winter weather and

Exhibit 8. The U.S. Depends on Canadian Gas Exports

Figure 3. Canadian Natural Gas Production, Consumption, and Net Exports, 1986-2005



Source: Statistical Handbook Database, November 2006. Canadian Association of Petroleum Producers, Calgary, Alberta. (http://www.capp.ca).

Source: National Energy Board report

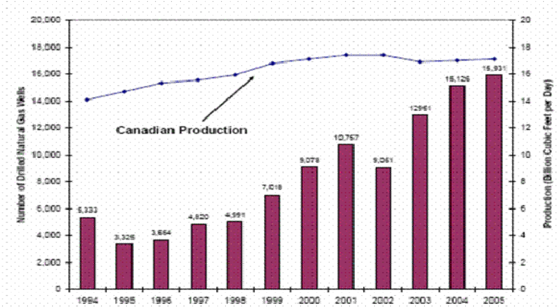
In the long run, gas storage inventories represent an above ground issue and have little to do with the underground challenges of finding and developing new gas resources

cool summers cut gas consumption resulting in record natural gas inventories. While gas supplies currently are being drawn down at near historic record rates because of the brutal winter weather covering much of the United States, gas prices remain depressed due to the inventories. In the long run, gas storage inventories represent an above ground issue and have little to do with the underground challenges of finding and developing new gas resources.

If we are correct that Canadian drilling activity is well below expectations this year, the producers' decline curve challenges should produce less natural gas than anticipated. As often happens in a commodity market, reduced supply in the face of similar or greater demand should drive prices higher. If producers successfully drive down oilfield costs, then gas well drilling economics will quickly improve.

Exhibit 9. Production Struggles Despite More Wells

Figure 5. Annual Canadian Natural Gas Well Completions and Production, 1994-2005



Source: Statistical Handbook Database, November 2006. Canadian Association of Petroleum Producers, Calgary, Alberta. (http://www.capp.ca).

Source: National Energy Board report

For the U.S., reduced availability of Canadian gas supplies, given the U.S. Energy Information Agency's (EIA) call for similar volumes to be imported in 2007 as in 2006, should help drive domestic gas prices higher. That would help re-ignite the upturn in domestic gas drilling and boost the employment of drilling rigs and all other oilfield service equipment and services. Call it a self-correcting mechanism. But the key is the Canadian gas industry's canary surviving in 2007.

Different Views of Oil Demand in 2007

Last week, both the International Energy Agency (IEA) and the Organization of Petroleum Exporting Countries (OPEC) issued their monthly reports on the global oil market. Each organization emphasized a different aspect behind its forecast, which is about 25% apart in the estimate of incremental oil demand in 2007. The IEA has the higher forecast with a projected annual growth of 1.5 million barrels per day (b/d). OPEC is more conservative with a growth projection of 1.2 million b/d.

The IEA boosted its forecast for 2007 by 273,000 b/d, or approximately 22% of the projected annual demand increase of 1.5 million b/d, based on its expectation of continued robust demand growth in China. The China demand forecast increase was tied to the IEA receiving new, revised data on consumption. The IEA pointed out that China has already filled about 75% of its first strategic crude oil storage facility of 25 million barrels. There are three additional storage facilities to be commissioned over the next two years that should further boost China's oil demand.

The IEA's forecast is now where it started in September 2006

The most interesting thing about the IEA's forecast is that when it discussed the increased forecast, it failed to point out that the forecast is now where it started in September 2006. This reflects a return to the IEA's historical pattern of overestimating demand growth and then having to reduce the forecast during subsequent months. The IEA started on that path with the 2007 forecast until it got the revised demand data that lifted the base of Chinese consumption and thus the projected amount when retaining the forecasted growth rate. We will see if the IEA is forced to return to its historic pattern.

In the OPEC monthly report, it reduced its demand forecast by 50,000 b/d to 1.2 million b/d. It warned that the forecast was at risk if warm weather continued this year. Even recognizing the recent blast of arctic winter weather in the U.S., a quick return to warm weather and a possible warm start to the 2007-2008 winter could cost about 200,000 b/d of demand lowering OPEC's global demand projection to a mere 1 million b/d increase. That would still represent about a 200,000 b/d increase over 2006's demand. We wonder if global demand might be reduced more by a U.S. recession that does not appear to be embraced in either of the two organizations' forecasts.

China is working to stimulate greater use of biofuels, something that OPEC seems to be more worried about than other analysts

OPEC also commented on China's accelerating effort to build more coal-fired power plants. It noted that China's new coal-fired power plants will grow 11% over the next three years and that coal demand in 2007 will be up 13% over 2005's consumption. Coal will continue to account for over 70% of China's electricity output. Additionally, China is working to stimulate greater use of biofuels, something that OPEC seems to be more worried about than other analysts. OPEC mentioned how Sweden, through incentives, will boost its biofuel consumption this year by threefold.

At this point it is too early to say who will prove more accurate. Our inclination is to favor the OPEC projection.

Oil Industry's Worst Nightmares

Parade Magazine published its annual list of the world's 10 worst dictators and the list of the ten runners up. In examining this list, one begins to understand the geopolitical challenges confronting the international oil industry. Seven of the top 10 dictators rule countries

These dictators oversee countries that contain 45% of the world's estimated proved oil reserves according to the 2006 BP Statistical Survey

that are important focal points for the global oil industry. Half of the dictators on the top 20 list rule countries with meaningful oil and gas reserves. In fact, as shown in Exhibit 10, these dictators oversee countries that contain 45% of the world's estimated proved oil reserves according to the 2006 BP Statistical Survey. These countries control about 40% of the world's production based on the BP data and some additional data from the CIA.

As *Parade Magazine* pointed out in its article, two of last year's dictators – Saparmurat Niyazov of Turkmenistan and Fidel Castro of Cuba – were off this year's list. In the former case it was due to his death and in the latter due to his turning over of government power to his brother. Four new dictators made the list including Hosni Mubarak of Egypt and Vladimir Putin of Russia – two important oil and gas producing countries. A third newcomer, Paul Biya of Cameroon, hopes that his country becomes more of an oil and gas producer in the future.

Exhibit 10. Leading Dictators Control Substantial Oil Reserves

Rank	Last Year Rank	Dictator	Country	bil. bbls 2005 Reserves	% of Total	kb/d Production	R/P Ratio
1	1	Omar Al-Bashir	Sudan	6.4	0.5	379	46.3
2	2	Kim Jong-Il	Korea				
3	3	Sayyid Ali Khamenei	Iran	137.5	11.5	4,049	93.0
4	6	Hu Jintao	China	16.0	1.3	3,627	12.1
5	7	King Abdullah	Saudi Arabia	264.2	22.0	11,035	65.6
6	3	Than Shwe	Burma (Myanmar)			18	
7	4	Robert Mugabe	Zimbabwe				
8	5	Islam Karimov	Uzbekistan	0.6	*	1,126	12.9
9	11	Mummar Al-Qaddafi	Libya	39.1	3.3	1,702	63.0
10	16	Bashar Al-Assad	Syria	3.0	0.2	469	17.5
11	10	Teodoro Obiang Nguema	Equatorial Guinea	1.8	0.1		13.6
12	12	King Mswati III	Swaziland				
13	13	Isayas Afewerki	Eritrea				
14	14	Aleksandr Lukashenko	Belarus			34	
15	17	Pervez Musharraf	Pakistan				
16	U	Choummaly Sayasone	Laos				
17	18	Meles Zenawi	Ethiopia				
18	U	Hosni Mubarak	Egypt	3.7	0.3	696	14.6
19	U	Paul Biya	Cameroon			58	
20	U	Vladimir Putin	Russia	74.4	6.2	9,551	21.4
		Total		**546.7**	**45.4**	**32,744.0**	
		World		**1,200.7**	**100.0**	**81,088.0**	**40.6**

Note: * is less than 0.1%; U represents unranked.

Source: Parade Magazine, Sunday, Feb. 11, 2007

This list reminds us of the problems of access to oil and gas resources

While this list reminds us of the problems of access to oil and gas resources, these challenges have always existed for the industry. The oil and gas industry has always been able to work in countries controlled by dictators, although state oil companies are becoming more important in certain countries, limiting the role of western independent oil companies (IOCs). The other point this list raises is the experience of many oil and oilfield service companies that have found themselves in the middle of revolutions or coups as bad dictators are overthrown. In most cases, the oil and gas industries continue to operate without interruption.

The geopolitical challenges for the international oil industry continue. Will they get worse or better in the future? Based on our history, we think they will continue along at the current pace, with the challenge for the IOCs becoming the declining production and resource bases in many of these old, dictatorially-ruled countries. Industry and geopolitical trends suggest less and less access to new petroleum resources in the future, and that will become the management challenge for these companies.

Warning Bells Are Ringing In Mexico

Crude oil production from Mexico's giant Cantarell oil field will fall by 14.5% in 2007, after declining 13.1% last year

The new director general of Petróleos Mexicanos (Pemex), Jesús Reyes Heróles, formerly an energy minister, announced that crude oil production from Mexico's giant Cantarell oil field will fall by 14.5% in 2007, after declining 13.1% last year. Production this year is estimated to average 1.53 million b/d, down from 2006's production of 1.79 million b/d. The problem for Mexico is threefold. First, the Cantarell field's production has entered a period marked by a severe rate of decline that appears irreversible. Second, Cantarell accounts for roughly 55% of Pemex's overall production of 3.26 million b/d. And third, the Mexican government relies on Pemex for approximately 40% of its income. The fourth problem from the collapsing production at Cantarell is for the U.S., which counts on significant crude oil imports from Mexico that could be in jeopardy.

According to Mr. Heróles, Pemex needs an additional investment of $8 billion to $10 billion per year to sustain its production, develop new reserves, expand its refining capacity and modernize its storage and transportation network. With the country's oil and gas industry constitutionally off-limits for private investment, unless the government figures out some way to reduce its needs for Pemex's income by either raising taxes or cutting spending, it is hard to envision how this needed extra income will be attained.

On February 5, Mexican President Felipe Calderon announced plans to revise and modernize the Mexican Constitution

On February 5, Mexican President Felipe Calderon announced plans to revise and modernize the Mexican Constitution. He said that in order to make the Mexican system more flexible and efficient, he is seeking to renovate the entire charter rather than follow the traditional practice of making piecemeal reforms. This drastic change is actually favored by Mr. Calderon's primary opposition and its leader, with the one exception that the changes do not include the privatization of either the electricity sector or Pemex.

After a shaky electoral victory, Mr. Calderon has increased his popularity by deftly handling several early political challenges. From masterminding his swearing-in ceremony for midnight rather than waiting for the official ceremony later in the day, he avoided some of the opposition's violence. He then decisively moved against the anarchists in Oaxaca and restored order in that battle-torn city. He also used regular army troops in a number of cities that were under de facto control of drug lords or are experiencing open battles among these drug lords for control. Lastly, he moved to limit the economic and political damage that could have come from the increase price for corn tortillas, a staple of the Mexican diet. The price of tortillas had been moving higher with the explosion in corn prices in the U.S. in response to the growth of the ethanol business. Even though Mexican corn tortillas are made from white, not yellow corn – the raw material for ethanol. U.S. corn buyers and speculators went across the border and bid up white corn prices in Mexico, possibly not recognizing that these are different crops.

Mr. Calderon moved to address this festering political problem that saw rioting in a number of Mexican cities over the jump in corn tortillas prices. He forced state stores to lower their prices at the retail level and he leaned on private bakeries to lower wholesale prices. By correctly reading the political tea leaves, Mr. Calderon has boosted his popularity to 58% as of Feb. 6. He will be risking all that he has achieved in his bold move to reform the constitution.

The challenge of constitutional reform rests on several challenging and slippery-slope issues. First, Mexico needs to be weaned from its addiction to oil money. Last year, Pemex's revenues surpassed $100 billion, but the company paid $79 billion in taxes, representing 40% of the government's budget. Pemex needs more money if it is to sustain and grow its crude oil and natural gas production. So far it has not been able to devise an attractive scheme to attract western oil companies to help explore and develop new reserves due to the constitutional restriction against foreign ownership of Mexican hydrocarbons.

Pemex needs more money if it is to sustain and grow its crude oil and natural gas production

Therein lays the second challenge for Pemex. Even if it is able to gain additional funding, Pemex lacks the technical capabilities to achieve a quick reversal of production fortunes. That is one reason why Pemex has been leading the charge over the past few years to figure out a way to gain western oil company involvement in its business, albeit in a highly controlled way. Pemex's leaders recognize that it is facing not a multi-year challenge, but rather a multi-decade battle against depletion and escalating petroleum demand.

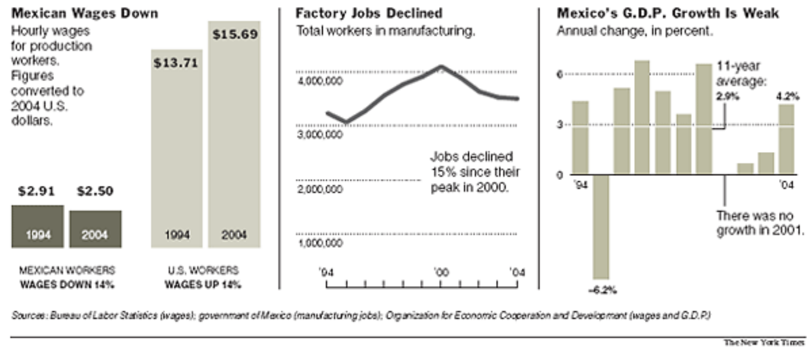
The third challenge for Pemex is to convince the citizens that there are ways to entice western energy companies into the country as active participants in helping revamp and modernize its energy producing sector. The constitutional ban on foreign involvement in energy covers more than just oil and gas, it also involves electricity. So while Mexico's aged electricity infrastructure contributes to experience regular power blackouts, the country is also faced with importing natural gas from the United States at the same time the country is rich with prospective gas reserves.

The constitutional ban on foreign involvement in energy covers more than just oil and gas, it also involves electricity

Last Sunday, *The New York Times* carried an article about the impact on immigration from Mexico that was supposed to have been reduced with the implementation of the North American Free Trade Agreement (NAFTA). In the article, which highlights the decline in Mexican wages and factory jobs in recent years, it was pointed out that in many cities the crumbling infrastructure was an impediment to a growing and healthy economy. At the root of this problem are the

Mexican government's taxing, spending and failure-to-invest policies. A crumbling energy infrastructure is merely one symptom of these problems, but a very important one.

Exhibit 11. NAFTA Is Only One Structural Problem for Mexico



Source: *The New York Times*

If Mr. Calderon can pull off this constitutional revision and put Pemex on firmer footing to attack the country's deteriorating energy situation, he will rank as one of the greatest presidents Mexico has ever had

Changing the Mexican constitution is a monumental task. It requires the approval of two-thirds of both houses of the national Congress, as well as majority support from more than half of Mexico's state assemblies. While Mr. Calderon's popularity has climbed, his party, which is not united on this issue, only has 206 of the lower house's 500 seats and 52 members of the 128 member upper house. If Mr. Calderon can pull off this constitutional revision and put Pemex on firmer footing to attack the country's deteriorating energy situation, he will rank as one of the greatest presidents Mexico has ever had. If he fails, the country could be at risk of falling apart economically, politically and socially. For the United States, that scenario carries great risk – the loss of oil imports, the imploding economy of a major trading partner, an unstable political ally in Latin American affairs, and eventually a socialist government on our border creating significant immigration challenges. Maybe one litmus test for the candidates for our 2008 presidential election should be fluency in Spanish.

Economics Confounds Hybrids

As gasoline prices have retreated, it appears the efficiency and environmental attributes are less of a sales motivator for hybrid vehicles

The attraction of hybrid vehicles was supposedly their greater fuel economy and their more environmental friendly nature. When gasoline prices were north of $3 per gallon, the idea of a vehicle that achieved 45-50 miles per gallon was attractive, along with being able to demonstrate an environmental concern. However, as gasoline prices have retreated, it appears the efficiency and environmental attributes are less of a sales motivator than hybrid vehicle manufacturers believed.

According to media reports, manufacturers of some gasoline-electric hybrids are resorting to inducements in order to sell them. That includes Toyota with inducements for the industry leading Prius hybrid. Some of the incentives being offered are similar to those used to sell SUVs when gasoline prices were high, including 0%

financing and cash back offers according to an analysis by Carsdirect.com.

Starting in February, for the first time ever nationally, Prius buyers can get 0% financing for two years or lease payments as low as $219 per month, according to Toyota. The Prius has been Toyota's best selling hybrid. Until late last year, it was in short supply and buyers waited months for delivery and/or paid premiums to get one. Now Toyota is boosting production of the Prius to 175,000 vehicles this year. According to a spokesman from Toyota, the company is fixing two things with its production increase – availability and affordability.

The impact of lower gasoline prices on Prius sales is noteworthy

The impact of lower gasoline prices on Prius sales is noteworthy. Sales of this model increased by 8.4% over the number sold in January 2006. However, this monthly sales increase is less than the overall 9.5% sales increase experienced by Toyota. Both the company and analysts acknowledge that high gasoline pump prices are no longer a major news focus. Analysts have pointed out that other Toyota models are selling at a faster clip than the Prius.

Carsdirect.com found a number of other sales incentives in their analysis. For example, Toyota is offering low interest rates (2.9%) for 24 months for its Highlander model. Honda is providing special discounts to dealers, which may or may not be passed on to customers. In select regions of the country, Ford is providing either $2,000 cash back or 0% financing for up to 36 months plus $1,000 cash back for purchasing an Escape. But Ford is offering even better deals for the Escape's sister vehicle, the Mercury Mariner. The Mariner has a $3,155 cash back or 0% for 60-month financing plus $655 cash back package in select regions of the country.

Exhibit 12. Hybrid Sales Impacted by Gas Prices

	January	
Vehicle	**2007**	**2006**
Toyota Prius	8,299	7,654
Toyota Camry	2,801	0#
Toyota Highlander	1,810	2,263
Honda Civic	1,783	3,165
Lexus RX 400h	1,245	1,477
Ford Escape	1,039	801
Saturn Vue	353	0#
Honda Accord	248	351
Mercury Mariner	199	97
Lexus GS 450	167	0#
Nissan Altima	10	0#
Total	17,954	15,808
Regular gasoline per gal.	$2.240	$2.316

- vehicles not sold in Jan. 2006

Source: Autodata

As Exhibit 12 shows, the number of new hybrid vehicles continues to grow and year-over-year January sales increased 13.6%, even though gasoline prices this January were 3.3% lower than a year ago. There is little doubt but that the global climate change movement will continue to keep consumers focused on these environmentally-friendly hybrid vehicles. The pace, at which these cars are purchased, however, may be determined by the strength or weakness of gasoline pump prices.

Conservation by Utilities a Major Initiative

A recent news release announced that all 24 energy utilities offering EnergyMiser[R] rebates had renewed their incentive programs for 2007. Additionally, two more utilities have signed on for the program for the first time. The program is run by USA Technologies in conjunction with the 26 utilities.

USA Technologies provides energy management technology that reduces the cost of operating vending machines and coolers by up to 46%

USA Technologies provides energy management technology that reduces the cost of operating vending machines and coolers by up to 46%. The participating utilities offer rebates from $30 to $125 per unit for customers who use the vending machines and coolers employing the USA Technologies systems. USA Technologies estimates that there are eight million vending machines in the United States with a similar number of coolers, costing upwards of $300 per unit annually to power.

The utilities participating in this rebate program are located in 13 states including California, Connecticut, Hawaii, Idaho, Maine, Massachusetts, Nevada, New York, Oregon, Utah, Vermont, Washington and Wisconsin.

In another effort to foster increased energy conservation and to help their customers deal with escalating power bills, FirstEnergy (FE-NYSE), a utility holding company with operations in Ohio, Pennsylvania and New Jersey, has created an Energy Calculator on its web site that consumers can use to review potential energy savings opportunities at their homes and to compare their utility bills with similar homes in their region to ascertain whether they are ahead or behind in their energy savings efforts. The tool enables homeowners to enter information about their appliances and energy consuming devices and determine how efficient each is, what comparable appliances are available and how efficient they are.

These programs are all about changing the mindset of consumers toward energy conservation, or in some cases attempting to catch up with the new consumer attitudes

While some might see these programs – rebates and energy calculators – as gimmicks, they are all about changing the mindset of consumers toward energy conservation, or in some cases attempting to catch up with the new consumer attitudes. Many of the reports about how the U.S. can best deal with its addiction to oil and the growing recognition of the need to address the global climate change issue point to conservation as one of our major hopes. Expect to see and hear about more of these conservation initiatives in the future. Remember, as Jim Rogers, the CEO of

Duke Energy (DUK-NYSE) put it; the most energy efficient power plant you can build is the one you don't build.

Money Manager Knows When to Abandon Energy

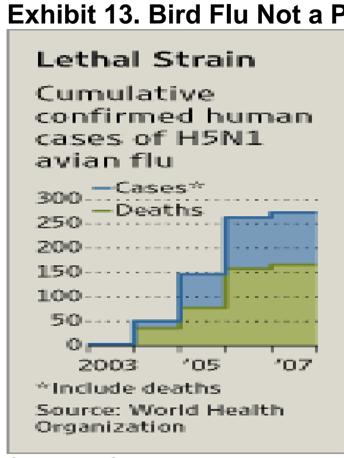
On the business channel, CNBC, portfolio manager David Kotok of Cumberland Advisors, was interviewed about his portfolio strategy and select investments he held. Cumberland is known as a deep value investor that likes to play long-term investment theses. It is even willing to hold stocks through periods of lackluster market performance as long as it believes the investment thesis remains in tact.

Weather events had driven crude oil futures prices to $77 last summer and down to $50 earlier this winter, but the underlying fundamental price for crude oil Mr. Kotok said was in the $60-$61 per barrel range

At the time Mr. Kotok was being interviewed, crude oil futures prices were climbing toward $60 per barrel in the face of the advancing strong winter storm that hit the Midwest and Northeast last week. According to Mr., Kotok, weather events had driven crude oil futures prices to $77 last summer and down to $50 earlier this winter, but the underlying fundamental price for crude oil he said was in the $60-$61 per barrel range. He arrives at that view because of the strong demand for oil emanating from China and India and the increasingly more difficult and costly measures needed to extract new supplies. Because he sees both continuing, Mr. Kotok sees crude oil futures prices trending higher over the next several decades. Given that view, Cumberland Advisors is maintaining its over-weight energy stock positions in client portfolios.

The interviewer questioned Mr. Kotok about what would make him alter his current portfolio positions. Mr. Kotok described one condition he was watching with potentially momentous implications, which was bird flu. He pointed out that bird flu was showing up in more and more countries around the world. There have been deaths from bird flu that spread from birds to humans, but these have been relatively isolated events. So far no pandemic has developed from the bird flu situation.

Exhibit 13. Bird Flu Not a Problem



Source: WSJ

What Mr. Kotok is worried about is a scenario where bird flu does begin to spread among humans. While this might not meet the pandemic description, he sees it as possibly the first stage of a pandemic. He said that if he were to see this first stage developing, Cumberland Advisors would aggressively sell down its stock holdings on a worldwide basis and raise cash balances in portfolios. It would look to position that cash in the highest quality and longest maturity bonds available – both corporate and government. It would reduce energy stock positions significantly.

If you have this condition, energy demand would collapse as travel would cease and industrial activity would contract and the price of oil would plummet

This latter move prompted the interviewer to question why he would do that after just talking about how solid the long-term energy story was. Mr. Kotok explained: If you have this condition, energy demand would collapse as travel would cease and industrial activity would contract and the price of oil would plummet. Who in the energy industry could withstand that scenario?

One point that Mr. Kotok failed to highlight under his disaster scenario is that in the face of collapsing energy demand, refiners would not only stop buying new supplies of crude oil to refine, they would be inclined to dump their inventories of crude oil and refined products as the carrying costs become a huge financial burden. If refiners maintain in supply a certain number of days of demand, then faced with collapsing demand, and no confidence in predicting when demand would stop falling, there would be no need to involuntarily boost the supply cushion. It was exactly this situation that exacerbated the crude oil price decline experienced in the Asian currency crisis in the mid 1990s.

It is always sobering to hear someone lay out the disaster scenario for your industry and how he would react to it professionally, even if the consequences are not pleasant to contemplate.

Canadian Pension Funds Must Mind Environment

A new report on pension fund management obligations was issued last week by the National Round Table on the Environment and the Economy in Canada. The panel, composed of two dozen business leaders, academics and former politicians, released their report saying that pension plans are currently obsessed with “short termism” and ignore important non-financial risk factors when investing. The report said that must change.

Pension plans must consider social, environmental and governance issues that are “financially material” to their investment decisions

The report recommends that guidelines be put in place to clarify that pension plans must consider social, environmental and governance issues that are “financially material” to their investment decisions. The funds should have to disclose publicly how those issues are taken into account when they invest and when they make proxy voting decisions.

David Wheeler, dean of the faculty of management at Dalhousie University in Halifax and a participant on the task force that wrote

It is clearly part of a fund manager's fiduciary duty to take into account social and environmental issues

the report, said it is clearly part of a fund manager's fiduciary duty to take into account social and environmental issues. Fund managers could even face class action suits if they don't, he said. According to Mr. Wheeler, "there are unacceptable levels of ignorance" among fund managers and financial advisors concerning what constitutes fiduciary duty.

Canada has a splintered regulatory structure, with the federal government and the provinces regulating different pension funds. That structure could make implementation of the recommendations more difficult. However, Mr. Wheeler points out that the federal government could get the ball rolling by stating clearly that pension funds should take environmental and social issues into account in their decision-making process. The report further made the point that accounting and actuarial bodies should also look at how their standards affect issues of sustainability.

To date, the socially-conscious mutual funds, i.e., those that for example don't invest in tobacco stocks or liquor stocks, etc., have not produced outstanding results

It will be interesting to watch and see how far these recommendations go. If Canada adopts them, either in full or part, the investment management business will need to adjust its investment decision-making process. If that happens in Canada, it will be watched anxiously to see what, if any, impact on investment performance results. To date, the socially-conscious mutual funds, i.e., those that for example don't invest in tobacco stocks or liquor stocks, etc., have not produced outstanding results. In fact, they generally have underperformed their peers. As a result, these newly proposed guidelines could hamstring pension fund managers and hurt their investment performance – something the pensioners might be unhappy about.

Contact PPHB:
1900 St. James Place, Suite 125
Houston, Texas 77056
Main Tel: (713) 621-8100
Main Fax: (713) 621-8166
www.pphb.com

Parks Paton Hoepfl & Brown is an independent investment banking firm providing financial advisory services, including merger and acquisition and capital raising assistance, exclusively to clients in the energy service industry.