

MUSINGS FROM THE OIL PATCH

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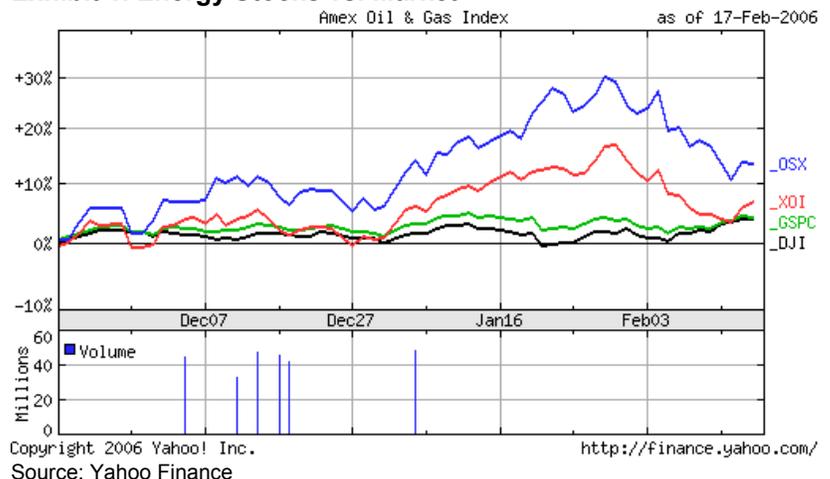
Note: *Musings from the Oil Patch* reflects an eclectic collection of stories and analyses dealing with issues and developments within the energy industry that I feel have potentially significant implications for executives operating oilfield service companies. The newsletter currently anticipates a 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

Energy Stock Correction Yields Differing Outlook Views

From mid November to the end of 2005, oilfield service stocks outperformed oil and gas producer stocks and the broad stock market indices – the S&P 500 and the Dow Jones Industrial Index

Energy stocks have been on one amazing rollercoaster ride since the start of the year. As shown by Exhibit 1, from mid November to the end of 2005, oilfield service stocks (represented by the Philadelphia Oil Service Stock Index - OSX) outperformed oil and gas producer stocks (Amex Oil and Gas Index – XOJ) and the broad stock market indices – the S&P 500 (GSPC) and the Dow Jones Industrial Index (DJI). January 2006 marked an almost panic energy investment market as shown by the relative performances of the two energy indices compared to the overall market. After the OSX reached an all-time high in late January, the air seemed to come out of the group as February opened. Since the peak, the OSX has given up about 15%, pretty much in line with the decline of most of the other energy stock indices.

Exhibit 1. Energy Stocks vs. Market



In 1980, the energy sector accounted for almost a third of the total market capitalization of the S&P 500

Energy stocks have contributed to the performance of the overall market that cannot be ignored. According to stock market research by Ned Davis Research, the energy sector of the S&P 500 Index soared 66% (excluding dividends) over the past two years, yet the S&P 500 rose only about 12%. Excluding energy companies, the S&P 500 would have still managed about an 8% gain over that period.

The reason for the muted overall market performance, despite the strong performance of energy stocks over the past two years, is due to the reduced weighting of energy stocks in the index. In 1980, the energy sector accounted for almost a third of the total market capitalization of the S&P 500. That weighting declined to 5.8% in 2003, reflecting the drop in oil prices and growth of the technology and financial service sectors. At the end of 2005, the energy weighting had recovered to about 9.3% of the index. The reduced sector weighting for energy is explained and justified by the smaller portion energy represents of the overall economy. That is a reason why the economy has continued to grow while showing relatively modest inflationary pressures despite a doubling of oil prices over the past two years. Some investors, however, are beginning to feel that the price inflation from the oil price rise is now starting to flow through the economy. They point to the sharper than expected 0.4% monthly jump in the core component of the Producer Price Index for January.

The energy sector showed a gain of 29.1% last year and accounted for almost 70% of the index's return

While energy's importance in the overall market has declined, its strong price performance in 2005 was the primary reason for the positive performance of the S&P 500 last year. The energy sector showed a gain of 29.1% last year and accounted for almost 70% of the index's return. Excluding energy, the S&P 500 would have posted a 0.56% return in 2005 instead of the 3% it showed (excluding dividends). In 2004, the index would have gained 7.6% instead of the 9% return with energy stocks included.

The Ned Davis Research also showed that energy earnings were extremely important for overall earnings growth of the index. Over the two year period ending September 30, 2005, Ned Davis Research calculates that the energy sector earnings rose 186.6%, which far exceeded the 73% gain in earnings for the S&P 500 companies. Excluding energy, the S&P 500 earnings would have risen about 54%. This relative earnings performance helps explain why some investors worry about the valuation of the overall stock market. At the end of November 2005, the price-to-earnings ratio (P/E) of the S&P 500 excluding energy was 20.1x, compared with 18.7x including energy. Some of these investors worry that with slowing energy sector earnings growth, it will take a significant pickup in other sectors of the economy to sustain the valuation of the stock market making it potentially vulnerable to downward P/E valuation.

Investors who believe that we are in a secular bull market for energy

Investors believe that the underlying energy market fundamentals of supply and demand have not been altered and therefore the strength in energy company earnings will continue

and that the February price correction, while volatile and unsettling, is nothing more than a correction in a bull market, point to Exhibit 2. The price chart for the OSX shows a number of sharp price corrections over the past three years. These investors believe that the underlying energy market fundamentals of supply and demand have not been altered and therefore the strength in energy company earnings will continue. They do not see oil and gas prices easing dramatically, therefore, producers will need to maintain their elevated level of exploration and development activity that will surely sustain the earnings performance of oilfield service stocks. Therefore, these investors urge the purchase of energy stocks on any price pullbacks.

Exhibit 2. Past OSX Price Corrections



Source: Stockcharts.com

There “is an abnormally large number of assets in the energy sector.”

On the other side of this debate is the distinguished technical analyst, Walter Deemer, the publisher and principal of *Technical Analysis, DTR*. Mr. Deemer was interviewed in the recent issue of *Barron's*. We have extracted some of the answers Mr. Deemer gave to questions posed by the *Barron's* writer. The writer had asked about what Mr. Deemer made of his tracking of the Fidelity Sector Funds. He responded that there “is an abnormally large number of assets in the energy sector.” He points out that it was also “an historically large number of assets in the energy sector.” To him, this implies enthusiasm and acceptance of the sector that indicates we are at some sort of a peak. Mr. Deemer went on to say, “Energy has been the obvious leadership in the market for some time. Interestingly, energy is usually the last group to move in a bull market, both up and down. It is usually the last group to top out and, indeed, that seems to be happening here.”

Barron's: But if energy is in a secular move, wouldn't that be a

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temporary correction?

Mr. Deemer: “Most people seem to think that there is a sea change in energy stocks. I go back to my last year at Putnam, which was 1980. They embraced the energy thesis of the late 1970s and early 1980s, which was the peak. The mantra was -- and I will never forget it because they kept repeating it -- we had gone from a period of abundant, cheap energy to a period of scarce, expensive energy. The stocks peaked in 1980, and it took seven years for most of the oil stocks to come back to those highs -- and it took 17 years for many of the leading oil-service stocks to come back.

“From a contrary-opinion basis, there is some reason to suspect this is more than just a cyclical top. By the time energy stocks go down, all this secular enthusiasm towards them will have cooled off. The risk is that buying at peak prices in 2006 means you won't see those peak prices again for a number of years. There is the possibility of some pretty good long-term risk in energy stocks.”

Barron's: Do you rule out the notion of secular change?

Mr. Deemer: We won't know until we go through the first correction in this bull market of energy stocks and see what they do on the other side. If they come back and fail, say halfway back, as the technology stocks did after the bubble burst, then you know that you have some secular problems.

Between 1982 and 2000, it was the cycle of financial assets, and, therefore, Mr. Deemer believes that from now through 2016 or 2018 hard assets should outperform financial assets

Mr. Deemer was also asked by *Barron's* how investors could protect themselves against a possible bear market. He suggested that areas of the market that hold up relatively well in a bear market usually are signaling that they likely will be the leaders in the next bull market. He pointed out that pharmaceutical stocks could be one group that may become the next leader. But Mr. Deemer also said that the metal stocks or the commodity cyclicals could be a place to hide, but that they are very volatile. He pointed out that it's said that there is a 16-18 year cycle between financial assets and hard assets. Between 1982 and 2000, it was the cycle of financial assets, and, therefore, Mr. Deemer believes that from now through 2016 or 2018 hard assets should outperform financial assets. The challenge for investors is the volatility of these assets that makes one very uncomfortable while they stage corrections. This certainly applies to energy stocks, which could be part of the hard asset class if one wants to define the class broadly.

So, do we have a correction in a bull market or a cyclical peak for energy stocks? Only time will tell, but we are becoming more convinced that it is the latter.

Natural Gas Production Responds to High Prices

How quickly things can change. In late September of last year, Dr. Michael Economides, professor at the Cullen College of Engineering

at the University of Houston and managing partner in a petroleum engineering and strategy consulting firm, was in Midland, Texas to speak to the Permian Basin section of the Society of Petroleum Engineers. At that time, Dr. Economides spoke about how precarious the natural gas market had become. He was calling for a shortage of gas supply, even without the impact of hurricanes Katrina and Ivan, that would send prices to \$20 per thousand cubic feet (Mcf) by Christmas-time.

The calamity Dr. Economides predicted did not come to pass

At the time Dr. Economides was making his predictions, Hurricane Rita was bearing down on the Texas and Louisiana coasts. On that day, 73% of Gulf of Mexico gas production was shut in waiting for the storm to pass. Natural gas prices were about \$12 per Mcf and apparently headed higher. Today, natural gas prices are a little over \$7 per Mcf. The calamity Dr. Economides predicted did not come to pass, albeit we have experienced an unseasonably warm winter, with very brief periods of wintry weather. But what may have really happened is that the industry's drilling response to unusually high gas prices may be delivering additional gas not thought possible before.

Natural gas production would have grown 2.7% or an increase of 1.4 billion cubic feet (Bcf) per day over 2004, had it not been for the impact of last year's hurricanes

According to a report from Bentek Energy LLC, U.S. natural gas production would have grown 2.7% or an increase of 1.4 billion cubic feet (Bcf) per day over 2004, had it not been for the impact of last year's hurricanes. This would have marked the largest annual production increase since 1994, and confirms that supply does respond to higher prices over time. The production increase, however, would not have altered the nation's gas supply and demand balance as demand grew by 2.2%, led by increased power generation consumption that more than offset an industrial demand drop in Texas and the Southeast.

Actual 2005 gas production dropped by 0.3% from the prior year after 572 Bcf of cumulative gas production losses from hurricanes Katrina, Rita and Wilma are included. According to Porter Bennett, the president of Bentek Energy, the hurricane-related damage masked changes in the gas market, both on the demand and supply sides. Despite the hurricane production damage, storage was filled prior to the start of the winter withdrawal season. That suggests that, even with demand growth and the loss of Gulf of Mexico gas production, the rest of the nation's gas supply grew more than most people expected.

Double-digit production growth in a number of onshore gas basins drove the industry's supply performance

Double-digit production growth in a number of onshore gas basins drove the industry's supply performance. Some older basins experienced production increases that also surprised observers. But more importantly, some of the growth has strained the capacity of the pipeline systems and is contributing to bottlenecks. This situation is spurring the construction of additional miles of pipelines to move growing gas volumes to market, or at least to major gas pipeline interconnection points. In many cases the new pipelines are trunklines to move large volumes from a producing basin to market such as the recently proposed Rockies Express line from

Wyoming to Ohio, to take away gas from the Rockies. In other cases, the lines are small diameter flowlines to gather gas from newly developed parts of a basin and move it to the principal export line already in place. In either case, the outlook for the pipeline construction industry in the United States is considerably brighter than it has been in a number of years.

Based on the Bentek study, gas flows from the Green River basin increased 3% to 3.7 Bcf per day, and have continued to increase through the end of 2005. In the Uinta and Piceance basins, the gas flow jumped 16% to 1.6 Bcf per day. The Wind River Basin climbed 6% to 0.7 Bcf per day and the San Juan Basin production grew by 0.1% to 4.2 Bcf per day.

Outside of the western basins, the Ft. Worth basin production grew by 17.2%, or a 232 Bcf increase. East Texas production increased 10.8%, or a 358 Bcf gain, while the Arkansas-Louisiana region was up 9.5%, or 125 Bcf, and the Arkoma basin increased production by 51 Bcf for a 4% gain. Offshore in the Gulf of Mexico, production declined 17.8%, or nearly 2 Trillion cubic feet (Tcf) including the nearly half a Tcf of production lost due to the hurricanes.

Net gas imports grew about 6% to an average of 7.9 Bcf per day compared to 7.5 Bcf per day in 2004

Net gas imports grew about 6% to an average of 7.9 Bcf per day compared to 7.5 Bcf per day in 2004. The gain reflected a 2% increase in imports from Canada and a 26% drop in exports to Mexico. LNG imports declined by 4%, or 0.1 Bcf per day, with the terminal at Lake Charles, Louisiana showing the largest decline at -38%, while the Elba Island, Georgia terminal had the greatest increase at +26%. With the gas storage situation today, we see that the LNG terminals are operating at less than 30% of their capacity since there is little reason to bring in additional gas volumes that are not now being consumed.

The gas market is becoming even more weather and temperature sensitive that will increase the volatility of natural gas prices

Natural gas demand growth in each of the Northeast and Midwest markets grew by 14%, followed by the Southeast, which was up about 11% and Texas up 5%. Demand in the West was flat compared with 2004. The challenging factor for the natural gas market is that the demand increase is coming from power generation consumers while industrial consumers used less gas. As a result, the gas market is becoming even more weather and temperature sensitive that will increase the volatility of natural gas prices. We have clearly seen that so far in 2006 as the record warm January and early February has left substantial gas volumes in storage and significantly weak natural gas spot and futures prices. At some point this volatility is likely to impact the oilfield market.

Offshore Rig Count to Grow

The number of new offshore drilling rig orders appears to have slowed. One reason may be the escalating cost of rigs as the shipyard industry capable of building these rigs has shrunk over the past ten years. Not only is shipyard capacity down, but the new rig

The most recent new rig building and rig modification effort in the early 1990s resulted in many financial disasters

owners are highly concerned about the quality of construction and the ability of shipyards to build the rigs on time and within budget.

The most recent new rig building and rig modification effort in the early 1990s resulted in many financial disasters as rigs arrived late and over budget. It was rare for projects to be on schedule. Today, drilling contractors are very concerned about schedules and costs, especially as they are trying to secure contacts from oil company customers to help finance these expensive new rigs.

Based on the latest list of offshore drilling rigs either on order or under construction, there are 70 total units, including 51 jackups, 17 semisubmersibles and two drillships. The total estimated cost of these units is \$15.8 billion, or an average of \$226 million per unit. While the amount of money being invested in the offshore drilling rig fleet appears enormous, based on historical information, the industry invested about the same amount in the 1980s, however that money bought 350 rigs, or five times the current number of rigs to be added.

Exhibit 3. Offshore Drilling Rig Capital Investment

Period	Units	Investment (\$mm)	Investment/Unit (\$mm)
1950s	91	265.4	2.9
1960s	147	823.4	5.6
1970s	321	7,500.0	23.4
1980s	350	15,800.0	45.1
2006-9	70	15,800.0	225.7

Source: Offshore Data Services, PPHB

As the cost of drilling rigs escalates, the financial risk of these projects could fall apart quickly if oil and gas prices were to revert to something closer to their long-term historical price range

As the cost of new offshore rigs escalates, the daily cost of drilling wells climbs dramatically for oil companies. Some of the newbuild rigs will support long-term field development projects. Other rigs will be needed to help the oil industry expand its global exploration efforts. But as the cost of drilling rigs escalates, the financial risk of these projects could fall apart quickly if oil and gas prices were to revert to something closer to their long-term historical price range. We point this out because of the similarity of the amount of capital that was invested in the offshore drilling rig fleet in the 1980s compared to the current newbuilds. The rigs built in the 1980s were ordered under similar beliefs that a paradigm shift in the oil and gas industry fundamentals had occurred, just before oil prices collapsed. Let's hope we do not have to experience a similar fate in the latter years of this decade.

Global Peak Oil Date Passed

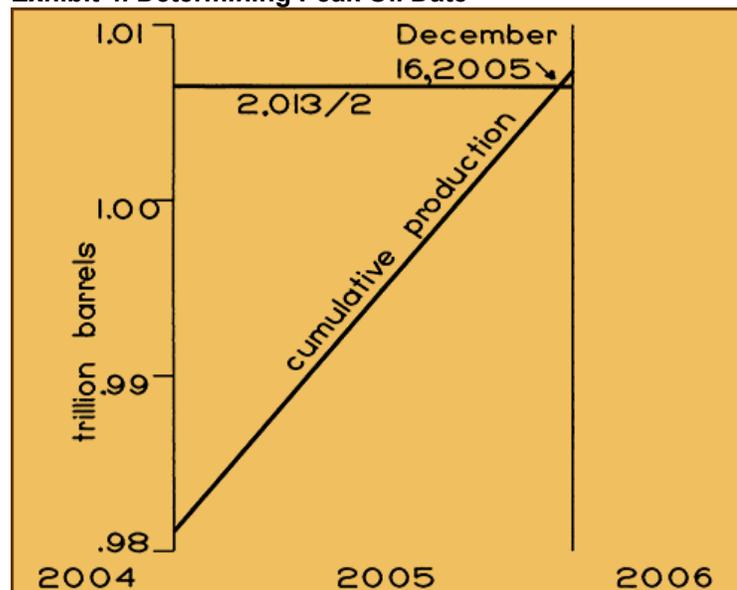
Professor Kenneth S. Deffeyes, one of the leading students of peak oil and Hubbert's Peak, has updated his analysis of the date that the world's oil production peak will be reached. He had predicted in January 2004 that the peak would be reached on Thanksgiving Day,

The peak occurred on December 16, 2005

November 24, 2005. He now says that based on the most recent reserve data, his analysis was off by about three weeks and that the peak occurred on December 16, 2005.

The analysis was prepared using the latest data from the *Oil and Gas Journal* that publishes an annual report on global oil reserves. The OGJ data was selected because their methodology is spelled out and the data is consistent over time. The peak in production is reached when cumulative oil production reaches the mid point of global oil reserves. Total world oil reserves are estimated at 2.013 trillion barrels, so the peak would be reached when we have consumed 1.0065 trillion barrels. Based on Prof. Deffeyes's analysis of the OGJ data, the cumulative consumption of reserves at the end of 2004 was 0.9812 trillion barrels and at the end of 2005 it was 1.0074 trillion. This implies that late in 2005 the peak was reached.

Exhibit 4. Determining Peak Oil Date



Source: Beyond Oil

Prof. Deffeyes believes that it will be almost impossible for global production to grow meaningfully

Prof. Deffeyes now refers to the peak oil event in the past tense. However, he does not necessarily expect that the world's oil production is about to fall dramatically any time soon, but he does believe that it will be almost impossible for global production to grow meaningfully. This also means that the decline rate in existing production is likely to accelerate.

The analysis is interesting and may be supported somewhat by statement's made by David Demshur, the head of Core Laboratories (CLB-NYSE), on the company's fourth quarter and full year 2005 earnings results conference call last week. During the call, Mr. Demshur said Core was re-examining its assumption that carbonate reservoirs in the Middle East were declining at a 1.5% per annum

Core is considering raising the decline rate estimate by 25 basis points to 1.75%

rate. He suggested that Core is considering raising the decline rate estimate by 25 basis points to 1.75%. Now one might scoff at such a small increase, but since most of the major oil fields in the Middle East are carbonate reservoirs, we are talking about an accelerating decline rate for most of the Middle East production.

According to the Energy Information Administration (EIA), oil production from the Persian Gulf in November 2005 was 23.558 million b/d. If all that production came from carbonate reservoirs, the difference in the decline rate estimates is equal to almost 59,000 barrels per day. If only 60% of the Middle East production comes from carbonate reservoirs, the decline rate boost means an additional 35,000-plus barrels per day are lost. The big challenge for global oil markets represented by this decline rate hike is that it may mark the start of a trend for further increases.

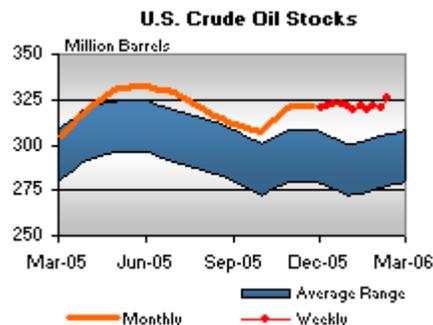
Glass Half Full or Does it Have a Hole?

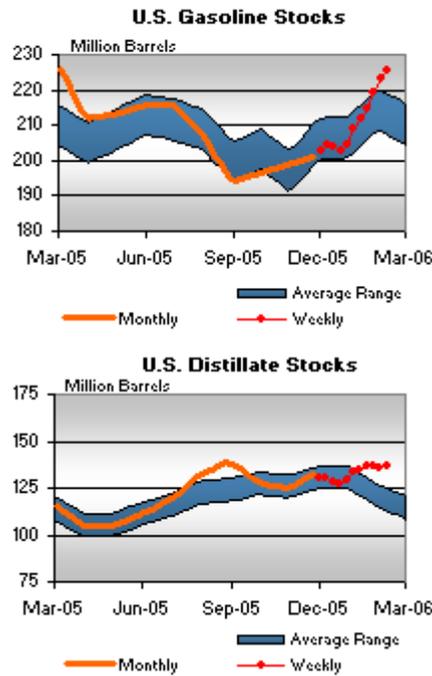
Virtually every fuel category is above its five-year average range of storage volumes

Forget the old debate about whether the oilfield service industry glass is either half full or half empty, the question many investors are asking (and managements, too) is whether it has a hole in the bottom? Despite the recent record snowfall in the Northeast, the record warm January has contributed to consistent weekly builds in crude oil and petroleum product inventories. As of last week, the Energy Information Administration's (EIA) report of petroleum inventories showed virtually every fuel category above its five-year average range. It appears, however, that the build up in crude oil inventories in recent weeks is widening the gap between current and historic inventory volumes.

As inventories are building, petroleum prices have started to slide. The drop was more evident in petroleum product prices as crude oil prices continued to be buoyed by geopolitical events. The fear of Iran's efforts to restart its nuclear energy development has kept investors on the edge of their seats wondering if the efforts of the international community to control this development will lead to economic sanctions against the country. If that were to happen, Iran could cut off its oil exports, although that would hurt the country's

Exhibit 5. EIA Petroleum Inventories



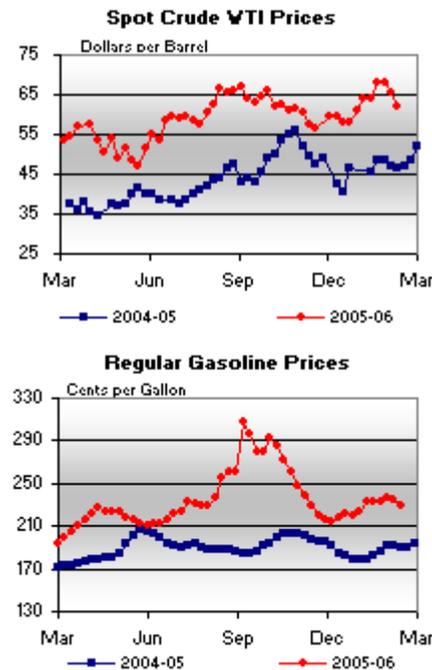


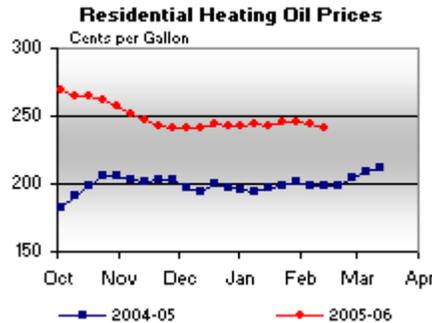
Source: EIA

The loss of Iran’s 4 million b/d of crude oil supply would strain the globe’s oil supply

income. Of course, the loss of Iran’s 4 million b/d of crude oil supply would strain the globe’s oil supply despite additional production capacity in Saudi Arabia and high global oil inventories.

Exhibit 6. Prices Respond to Inventory Growth





Source: EIA

The recent outbreak of violence in the Niger Delta directed against the oil industry has cost about 20% of Nigeria's oil supply

The recent outbreak of violence in the Niger Delta directed against the oil industry has cost about 20% of Nigeria's oil supply. The tensions there have been ratcheted up this weekend with the seizure of nine workers of Willbros Companies from one of its construction barges working offshore in the delta region. That action followed an attack last week by the Nigerian army against rebels and people suspected of stealing oil from pipelines in the area. The action sparked the rebels to declare war against the oil industry. They warned the oil companies and their suppliers to leave the area. The hostage seizure followed that warning, as did attacks against petroleum shipping and pipeline facilities. As a result of these actions, Royal Dutch Shell (RDS.A-NYSE) stopped exports from its Forcados terminal and shut in EA field production. This is costing Nigeria about 400,000 b/d of production and exports.

We further understand that EnCana is not the only company cutting its capex in response to falling gas prices

The challenge for the oil industry and OPEC over the next 30 days is to assess the geopolitical landscape, the global energy market and the inventory situation to try to gauge the impact high oil prices have had on underlying energy demand. The North American natural gas market has already experienced the first producer cutting back its capital spending in areas of high cost natural gas development in light of falling gas prices. As recent gas prices have been sliced in half from their September highs, EnCana (ECA-NYSE) elected to cut its capex by \$500 million, or about 12.5%. We further understand that EnCana is not the only company cutting its capex in response to falling gas prices. While the amount of capital spending being reduced is minor, this is a troubling development for investors, and one that merits watching.

The current blast of winter weather enveloping North America should help boost energy demand, especially since the forecasts call for more cold weather. Although late in the winter season, after the warm winter, any significant cold weather is a positive for energy markets. Anything that helps reduce the bulging gas storage volumes and building petroleum inventories will ease fears of an even greater fall in oil and gas prices when we reach the seasonal demand slump of springtime.

State of the Union Spooks, But China Could Be Worse

President George W. Bush talked about the addiction of the U.S. to oil and the need to break it

In his State of the Union speech the evening of January 31, President George W. Bush talked about the addiction of the U.S. to oil and the need to break it. He proposed that the U.S. reduce its dependence on Middle East oil by 75% over the next 20 years and that in order to achieve that goal, the country should step up its investment in alternative fuels. Immediately after the speech, the Saudi Arabian Ambassador to the United States said he wanted a meeting with government officials to understand exactly what President Bush meant by his language about reducing Middle East dependency. Clearly, our major ally in the Middle East was nervous, especially since the market for sand is not as robust as the demand for oil.

Minister Naimi could not ignore recent Chinese official statements about the need for their country to diversify its fuel suppliers in the future

The State of the Union address occurred at the same time OPEC oil ministers were meeting in Vienna to determine what they would do with their oil production quotas in the face of escalating oil prices. That was an easy decision – pump all you can to harvest the maximum amount of cash. For Saudi Oil Minister Ali Naimi, the OPEC meeting and State of the Union speech happened only days after he had accompanied his country's leader on the first ever state visits to China and India. In China, Ali Naimi was involved in discussions with Chinese officials about how Saudi Arabia could develop a closer working relationship with the host country, especially as it relates to Saudi investment to increase refining capacity in China.

The message was that Saudi Arabia would work to continue to be a source of stability for global energy markets

Minister Naimi, however, could not ignore recent Chinese official statements about the need for their country to diversify its fuel suppliers in the future, and followed with the announcement of a \$100 billion oil deal with Iran. So within a fortnight, Ali Naimi had heard his two largest customers talk about the need to reduce their dependence on oil and Saudi Arabia. As the protector of the kingdom's wealth – its oil sales – Ali Naimi had to be thinking about the long-term implications for Saudi Arabia if either, or both, customers were successful in executing on their veiled threats.

On February 8, Ali Naimi found himself in Houston in front of the Cambridge Energy Research Associates (CERA) audience of energy executives and with global media coverage. His message was not new, but one that Saudi Arabia clearly wanted repeated. The message was that Saudi Arabia would work to continue to be a source of stability for global energy markets. However, Saudi Arabia would need a clearer and more certain environment for predicting future energy demand growth in order to justify investment in new oil production capacity. He repeated his past statement that it was important for consuming countries to develop "energy demand roadmaps" that could serve both producers and suppliers.

In expanding on his views, Ali Naimi talked about the oil industry's historical problem of managing excess supply, a condition that

He went on to point out that so much spare capacity had been removed from the market over the past 20 years, that we cannot accommodate a significant increase in demand without major new investments

barely exists now. As he described it, “Today we face an environment where there are a myriad of constraints on supply. Those constraints are the product of the cyclical nature of investment patterns in the oil industry and the changing cost structure of oil supplies.” He went on to point out that so much spare capacity had been removed from the market over the past 20 years, that we cannot accommodate a significant increase in demand without major new investments. This tightness leaves the oil market vulnerable to price spikes. According to Ali Naimi, “In the current environment, market volatility is exacerbated. The lack of global spare capacity magnifies the price impact or relatively minor supply disruptions or demand surges.”

Will Saudi Arabia slow down its current accelerated capital investment program if the Bush Administration initiates actions to follow through on his goal of cutting Middle East oil dependency?

“A healthy oil market in balance is one where prices benefit consumers and producers,” said Ali Naimi. “It is imperative that prices be high enough to provide sufficient return to producers, but not so high that they harm economic growth. When oil prices are too high or too low they become unsustainable.” He went on to say that oil prices “should always provide an incentive to conserve and to use this valuable resource efficiently.”

The most interesting question is will Saudi Arabia slow down its current accelerated capital investment program, designed to boost the kingdom’s oil production capacity from 11 million barrels per day (b/d) to 12.5 million b/d by 2009, if the Bush Administration initiates actions to follow through on his goal of cutting Middle East oil dependency?

Like the Cold War foreign policy doctrine of mutual self destruction exercised by the United States and the Soviet Union, we are seeing more examples of mutual economic self destruction being put in place around the world. The pace of Saudi Arabian oil capacity investment may be dependent on the conservation and fuel-favoritism policies of western countries. Likewise, the economic trade and financial currency relations between China and the United States are other examples of mutual interdependency. The more major strategic countries are linked – economically, socially, militarily, and politically – the greater the potential for a problem down the road with unpleasant consequences.

Dayrates and Drillers’ EPS Estimates

Last week, Transocean Inc. (RIG-NYSE) reported its 2005 fourth quarter earnings and outlook for 2006 that was below the expectations of Wall Street analysts and investors. Earnings for the fourth quarter were \$0.45 when Wall Street had been estimating \$0.48. More important, Transocean management said that its earnings for each of the first two quarters of 2006 would be about flat with the fourth quarter results. The stock was pummeled that day, falling \$6.49 to \$72.10, or a decline of 8.26%. The stock continued to fall in after-hours trading that day.

Bob Long, Transocean's CEO, said this may be the best outlook the company has ever had

While there were a number of issues involving the impact from the hurricanes and shipyard costs, etc., one of the important factors was the impact of contract rollovers. Virtually every rig Transocean can work is working and the outlook for future work is bright. In fact, Bob Long, the CEO of the company, said this may be the best outlook the company has ever had. The company announced that its rig contract backlog stood at \$14 billion with an additional \$3 billion in letters of intent (LOI). This was up from \$10 billion of backlog and \$3 billion of LOI's at the end of the company's third quarter.

In response to an analyst's question about the impact of the contract rollovers, Bob Long made an interesting, and telling point for people trying to understand the current offshore drilling rig market. When a rig is drilling the final well of a contract, the oil company has tried to do a good job of timing the completion of the well with the termination date for the contract. Unfortunately, drilling wells is still something of an art and not an exact science. Therefore, there are times when the contract has to be extended beyond its termination date in order to finish up the job.

Contract rollovers have become a significant variable in projecting contract driller earnings

For many years, in fact I would venture to guess for the entire experience history of almost every current Wall Street oil service analyst, the timing of drilling contract rollovers has not been an issue because the change in the dayrate, either up or down, was minor. Today, the drilling world is very different. Contract rollovers have become a significant variable in projecting contract driller earnings. With rigs moving to new contracts that may be \$100,000 or even higher than the old contract, a few days or weeks without that higher dayrate can have a huge earnings impact.

Another factor impacting driller EPS estimates is time spent in shipyards for maintenance and fine-tuning work associated with new long-term contracts. As dayrates have escalated for new rig contracts, whenever a rig enters a shipyard for preparatory work for a new contract, the financial impact can be significant due to the delayed revenue. Again, this is a revenue timing issue versus Wall Street expectations and not a sign of weakness in the fundamentals of the offshore drilling business.

Computer models and statistical reporting services are curses for investors that lead to increased contract drilling stock price volatility

While analysts pore over the monthly rig status reports of offshore contract drillers, they may have to exercise greater caution in preparing their earnings models to allow for possible slippage in contract rollover timing or delays in new contract startups due to shipyard time, even though management will try to estimate these variables as closely as possible. This challenge reflects the dynamics of the positive environment contract drillers find themselves in, but it also points up a problem with trying to be too precise with company earnings estimates. Computer models and statistical reporting services are curses for investors that lead to increased contract drilling stock price volatility over normal business fluctuations. This volatility is truly uncalled for, but reflects the mentality of investors, especially within the institutional community.

Warm January Helps Restaurants

Late last fall, the U.S. restaurant association commissioned a survey to find out about people's dining out intentions in light of high and escalating fuel bills. As one would expect, the survey confirmed what we know generally to be a fact – when basic necessity costs (gasoline and heating) increase then discretionary expenditures (dining out) decline. Last week, the government released its January retail sales figures showing that warm weather helped restaurants, even though gasoline station sales increased the most of any retail sales category.

According to NOAA, temperatures across the U.S. averaged 39 degrees for January. That is the highest average January temperature on record, and 8.5 degrees warmer than average for the month

According to the National Oceanic and Atmospheric Administration (NOAA), temperatures across the U.S. averaged 39 degrees for January. That is the highest average January temperature on record, and 8.5 degrees warmer than average for the month. As you would expect, consumer heating, utility and gasoline bills were lower than in December. *The New York Times* reported that a 29-year old waiter in Buffalo, New York experienced a \$100 decline in his home heating bill last month allowing him to dine out two to three times a week. The government reported that sales at restaurants and bars rose 3.2% in January.

With colder weather in February, heating bills are headed higher, even though prices for oil and refined products are lower. That probably doesn't bode well for the restaurant industry.

Japan's Economy Helps Global Energy Demand – Marginally

Resumption of Japan's growth should help boost global economic activity and help energy demand

Japan's economy is set to grow its gross domestic product by about 5% this year. As the second largest economy in the world, resumption of Japan's growth should help boost global economic activity and help energy demand. The Japanese economic performance stands in sharp contrast to the most recent figures from the United States and the European Union. The most recent estimate of GDP growth for the fourth quarter of 2005 for the U.S. suggest it grew at only a weak 1.1% annualized rate above the same quarter last year. Many of the major economies in the EU are also struggling to sustain their economic growth rates.

Today, Japan's energy consumption per capita is almost half that of the U.S.

One of the major changes for the Japanese economy is its increased energy efficiency, the result of policies enacted beginning with the first "oil shock" in the early 1970s. Today, Japan's energy consumption per capita is almost half that of the U.S. That is the result of the adoption of energy conservation policies in response to the fact that Japan has no oil and must rely on imports for 100% of its needs. Japan now imports 16% less oil than it did in 1973, although its economy has more than doubled over that time period. This has been achieved both through conservation actions and promoting the use of alternative fuels.

Japanese industry also dramatically reduced its use of oil

Since the 1970s, Japan has invested billions of dollars to convert oil-fueled electric power generation plants into ones powered by natural gas, coal, nuclear energy and alternative fuels. Japan now accounts for 48% of the world's solar power generation versus only 15% for the United States. Japanese industry also dramatically reduced its use of oil. For example, Nippon Steel (NISTY.PK), the nation's largest steelmaker, has reduced its dependency on oil by 85% since 1974. Oil represents about 10% of the fuel Nippon Steel uses to heat its furnaces. Oil was replaced partly by coal, but increasingly the emphasis has been on improved efficiency and alternative energy. Five of Nippon Steel's 10 factories are now burning used tires and recyclable plastics such as discarded grocery bags and bottles, in addition to coal. In Japan, there may be greater weight given to answering the question: Paper or plastic?

Nippon Steel's plants can produce one ton of steel using 20% less fuel than American steelmakers, and 50% less than Chinese plants

As a result of the switch in fuel supplies to power Nippon Steel's plants, it can produce one ton of steel using 20% less fuel than American steelmakers, and 50% less than Chinese plants, according to the Japan Steel Association. Other industries have been even more successful, as the paper industry is using waste-based or alternative energy sources for 38% of its power.

One of the major social issues in Japan has been the effort to mobilize the population to conserve energy. This winter, the Japanese government issued a call for greater conservation. It urged consumers to turn off car engines while idling, particularly when stopped at traffic lights. In Houston, our energy solution is not to stop at red lights. But the Japanese take their conservation efforts much more seriously than others.

According to opinion polls, more than three-fourths of Japanese view energy conservation as a personal responsibility

According to opinion polls, more than three-fourths of Japanese view energy conservation as a personal responsibility, even to spending money to buy energy saving appliances that have very long payouts. The Japanese government has set strict new energy-saving targets for 18 kinds of consumer and business electronics. Home and office air conditioners now must be redesigned to use 63% less power by 2008. In Tokyo, "intelligent machines" such as subway fare changers and building escalators automatically turn off when not in use. Low-emission vehicles now account for 11 million, or almost 21%, of all autos on Japanese roads.

The "cool biz" campaign saved 70 million kilowatts of power from June through August, enough power to supply a city of a quarter of a million people for one month

One of the major energy saving initiatives has been the "warm biz" campaign to get businesses and government offices to set their thermostats no higher than 68 degrees this winter and to encourage employees to wear sweaters and jackets at work. This follows on the highly successful "cool biz" program initiated by Prime Minister Junichiro Koizumi's cabinet last summer. In that campaign, businesses and government offices were urged to set their thermostats no lower than 82.4 degrees. Office workers were encouraged to shed their jackets and ties during the summer. According to Tokyo Electric Power Company, the campaign saved 70 million kilowatts of power from June through August, enough power to supply a city of a quarter of a million people for one month.

With a rebounding economy, Japan's power needs will likely increase

The bottom line is that with a rebounding economy, Japan's power needs will likely increase. However, as a result of the energy conservation and fuel substitution efforts business and government have sponsored over the past 30 years, the growth in oil consumption will be much more modest than it might otherwise have been without these efforts.

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