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ENERGY INVESTMENT BANKING, LP

MUSINGS FROM THE OIL PATCH
May 1, 2007

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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

Contract Drilling Investing: It's the Cash, Stupid!

A perceptive stock market recognizes that earnings for offshore contract drillers are rapidly approaching a peak

Investors in the energy sector have struggled to understand the low valuations accorded the offshore drilling contractor stocks. For many, the conclusion is that a perceptive stock market recognizes that earnings for these companies are rapidly approaching a peak, and thus the future earnings trend will be downward at some point. What is unknown is when that point will be reached. Given the cyclical nature of the energy business, and in particular the oilfield service sector, investors are treating the stocks from a normal and fully rational investment approach to cyclical investments – peak stock multiples are attained at bottoms of industry cycles when earnings are low or nonexistent, while low stock multiples accompany peak earnings. So is there something wrong with the contract driller picture?

The offshore contract drilling industry had never been in a period such as it finds itself today where cash balances are huge, capital spending for new capacity well-controlled and backlogs for contractors extensive and long-lived

Two observations from different speakers at the recent 31st Annual International Marine/Offshore Industry Outlook Conference sponsored by the National Ocean Industries Association and the Texas Sea Grant Program at Texas A&M University held in Houston shed some light on the situation. Mr. Steve Newman, Executive Vice President and Chief Operating Officer of Transocean, Inc. (RIG-NYSE), pointed out that the offshore contract drilling industry had never been in a period such as it finds itself today where cash balances are huge, capital spending for new capacity well-controlled and backlogs for contractors extensive and long-lived. Mr. Jim Wicklund, partner, research analyst and Chief Investment Officer of Spinnerhawk Capital Management, an energy-focused hedge fund, suggested that the legal battle between Rowan Companies, Inc. (RDC-NYSE) and BP plc (BP-NYSE) some years ago following the cancellation of a North Sea drilling contract has changed the nature

Several major offshore drilling contractors have current contract backlogs that were more than 80% of their stock market value

of long-term contracting and insuring the viability of the offshore contract drilling industry's backlog. He pointed out that several major offshore drilling contractors had current contract backlogs that were more than 80% of their stock market value. In his view, the assured earnings and cash flow from this backlog is not being appreciated nor rewarded by the stock market investors. There must be some reason why not.

Exhibit 1. Rig Contract Backlog: As Good As Gold?

	Backlog in millions			Market	Backlog as
	Total	GOM	Int'l	Cap	% of Market Cap
PDE	$ 4,651	$ 126	$ 4,525	$ 5,230	89%
RIG	$19,269	$ 5,182	$14,086	$23,690	81%
GSF	$10,381	$ 2,353	$ 8,028	$14,260	73%
NE	$ 7,298	$ 2,271	$ 5,027	$10,640	69%
DO	$ 7,466	$ 3,435	$ 4,031	$11,270	66%
ATW	$ 1,023	$ 10	$ 1,013	$ 1,820	56%
RDC	$ 2,095	$ 389	$ 1,706	$ 3,790	55%
ESV	$ 3,796	$ 1,313	$ 2,483	$ 8,080	47%
THE	$ 449	$ 140	$ 309	$ 2,370	19%
HERO	$ 109	$ 38	$ 71	$ 858	13%
	$56,537	$15,257	$41,279	$76,778	74%

Source: James Wicklund, Spinnerhawk Capital, April 23, 2007

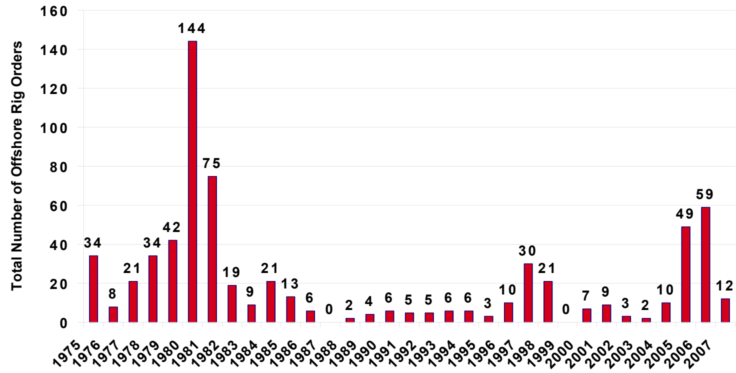
The surge in new rig construction orders has passed and therefore, the potential growth in future earnings is also slowing

It is very likely that investors in offshore drilling company stocks are more focused on the momentum of future earnings for these companies, and that trend is clearly slowing. It has slowed because the industry has been adhering to strict capital discipline in building new rigs. The surge in new rig construction orders has passed and therefore, the potential growth in future earnings is also slowing. Moreover, current drilling rig contract day rates have moved up to levels that are about equal to required long-term financial returns and thus, barring situations of oil company desperation in securing a rig to drill a near-term well against a firm lease expiration date, day rates for rigs will be more closely tied to owners' financial return hurdle-rates for the capital invested in the rigs. This lack of dynamic earnings outlook following the near-term earnings bulge due to the recent newbuilding effort has investors eying the stocks with a ho-hum attitude.

What to do with the cash?

Given the low valuation of near-term earnings accorded the stocks, investors have begun to focus on another issue for the companies – cash. Virtually every offshore contract driller has the strongest balance sheet it has ever experienced. Expensive debt has been paid off, and with controlled new capital investment, the companies are experiencing a torrent of cash from their virtual 100% fleet utilizations. What to do with the cash? This debate, which has been swirling around the industry for some time, broke out in an article in the April 23, 2007, issue of *Baron's*.

Exhibit 2. New Rig Deliveries Surged in 2006 and 2007



Source: James Wicklund, Spinnerhawk Capital, April 23, 2007

Ole Slorer believes that for the offshore drillers to boost their value, the metric for measuring the value of the companies needs to be changed from earnings per share to dividends

The *Baron's* writer focused on a valuation argument put forward by Morgan Stanley oil service and shipping analyst, Ole Slorer, that offshore drillers should adopt formal, high dividend payout ratios of earnings much like many of the shipping companies do, and shun stock buybacks. He believes that for the offshore drillers to boost their value, the metric for measuring the value of the companies needs to be changed from earnings per share to dividends. Because investors are worried about the next downturn for the business, they refuse to boost valuations for the companies. Mr. Slorer argues that if the companies were to pay out essentially all their earnings in the form of dividends, stock dividend yields would soar and attract yield-oriented investors who have been paying premiums for shipping stocks and energy limited partnerships with high dividend payouts. This class of investors now has fewer global high-yield equity investment opportunities given the change in the taxation of Canadian income trusts late last year.

Super high yields would certainly attract income investors who would drive share prices up and yields down

A table in the *Baron's* article showed the current yield for five of the major offshore contract drillers, their estimated 2008 dividend calculated by Morgan Stanley based on 80% payout ratios and the potential yields. The range of potential yields was from 14.4% to 16.9%. Those yields would certainly attract income investors who would drive share prices up and yields down to a range more in line with other comparably-risked investment current yields.

Exhibit 3. High Potential Yields to Drive Stock Prices

Added Dividends

Most offshore drillers pay meager dividends. Morgan Stanley argues they ought to boost their payouts, which would bolster stock prices.

Company	Current Yield	Potential '08 Dividend	Potential Yield
Transocean	0.0%	$11.64	14.4%
GlobalSantaFe	1.5	8.94	14.4
Diamond Offshore	5.5	12.49	15.3
Noble	0.2	11.85	15.0
Ensco Intl	0.2	9.06	16.9

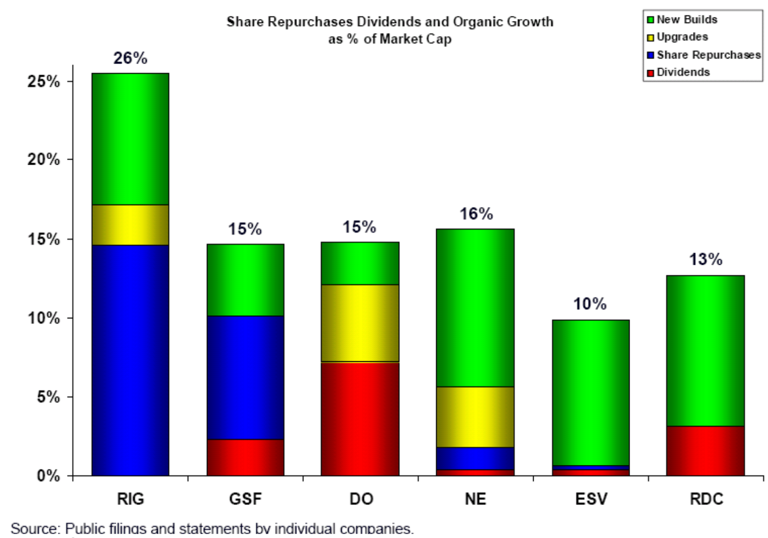
Sources:Thomson Financial/Baseline; Morgan Stanley

Source: Baron's, April 23, 2007

Mr. Tisch refers to the company's dividend policy as libertarian capitalism because it puts financial decisions in the hands of shareholders rather than the company

One of the arguments against paying meaningful dividends is management's belief that in such a cyclical and capital intensive business, companies should be conservative in handling their capital allocation decisions. Many managements are using their surplus cash to repurchase shares because they believe their shares are cheap. In contrast to that strategy, Diamond Offshore's (DO-NYSE) Chairman James Tisch describes his company's dividend policy as "libertarian capitalism." Diamond Offshore has been paying out significant special cash dividends since early 2006. With its January 2007 $4-a-share special dividend, Diamond Offshore paid out almost 80% of the company's 2006 earnings. Mr. Tisch refers to the company's dividend policy as libertarian capitalism because it puts financial decisions in the hands of shareholders rather than the company. If a shareholder desires income, he can take the dividend and put it in his pocket. On the other hand, if he favors share repurchases, he can buy more shares himself. This strategy means, according to Mr. Tisch, that a shareholder gets to make the decision on dividends versus share repurchases personally.

Exhibit 4. Prudent Stewardship of Cash



Source: Steven Newman, Transocean, April 23, 2007

The current valuations are also attracting predators interested in consolidating the offshore drilling industry

The cash buildups, growing drilling rig contract backlogs and low stock valuations may be attracting private equity investors who see the opportunity to reduce costs and leverage balance sheets in transactions whereby they take companies private. The current valuations are also attracting predators interested in consolidating the offshore drilling industry. Given the amount of private equity available and their increasing interest in the energy sector, the low stock multiples suggest that this industry will be the target of transactions. That appears to be the logic behind the conclusion of the *Baron's* article, which said: "Yes, good things often happen to companies with low price/earnings ratios."

On the dividend issue, the debate will continue to rage over whether

Managements often believe that when their shares are lowly-valued by the stock market, one of the best uses of surplus cash is to repurchase shares

share repurchases or dividends are the best way to return value to shareholders. Managements often believe that when their shares are lowly-valued by the stock market, one of the best uses of surplus cash is to repurchase shares. This strategy has the impact of reducing the number of outstanding shares boosting the reported earnings per share. If investors maintain the same valuation of the company's earnings per share, then share prices should rise in concert with the higher per share earnings. Unfortunately, the valuation metric often does not remain stable. The *Baron's* article pointed out that Transocean repurchased $2.6 billion worth of shares during 2006, or almost 11.8% of its outstanding share and roughly 10% of its market value. From the start of 2006 to the end of the year, Transocean's share price rose 16%, so on the surface it would appear that the share repurchase did have a positive impact. This performance was substantially better than that of the Philadelphia Oil Service Sector index (OSX) that was up 10.3% over the same period. Interestingly, *Baron's* selected the latest 52-week period in measuring Transocean's share price performance and found the stock had barely appreciated, which means one can often support a conclusion if you are selective in your measurement period.

The conclusion of the study was that one way to gain a sense of the price improvement potential for a stock is to look at how much its dividend has increased over the years

An interesting study about dividends and share price performance was recently reported on in an investment column of Canada's *Globe and Mail* newspaper in early April. The study was conducted by the editor of an investment newsletter and the analyst for Globeinvestor.com of stocks on the Toronto Stock Exchange that have paid dividends for the last 10 years. The conclusion of the study was that one way to gain a sense of the price improvement potential for a stock is to look at how much its dividend has increased over the years. Based on the study, the authors found that Canadian oil and metal stocks are usually too volatile to have much correlation between share price performance and dividend growth, with a few notable exemptions. They also found that solid dividend growth does not always mean a rising share price because of management problems. The study found that companies that increased dividends by small amounts often have tepid share price growth. To our knowledge, there has not been a similar study done of the U.S. stock market.

At the end of the day, there are numerous strategies managements can execute in an attempt to create shareholder value through the return of surplus cash building up on balance sheets. Which strategy is the correct one? There doesn't appear to be any one best strategy, so the debate between dividends and share repurchases will continue.

Lifetime High for OSX Highlights Declining Valuations

On Friday, April 27, the Philadelphia Oil Service Sector index (OSX) reached a lifetime high at 240.51. The OSX index closed the day at 238.15, which was a mere 0.67 of a point below the index's previous all-time intraday high of 238.82 established on May 11, 2006. Attention was paid to the new high by the financial media, and to the recent performance of oilfield service stocks. This is particularly interesting in light of the current popularity for technology stock investments among investment advisors.

Exhibit 5. OSX Index Hits Lifetime High

Source: Philadelphia Stock Exchange

Oilfield service stocks have been lifted in recent days by earnings surprises reported by some companies

The oilfield service stocks have been lifted in recent days by earnings surprises reported by some companies during the first quarter 2007 reporting season currently underway. More important, the comments by oilfield service company managements regarding their outlook for future earnings have been quite positive, especially in light of the drop in Canadian drilling activity and the slowing of oilfield activity in the United States.

The performance of oilfield service stocks has also been helped by crude oil remaining well above the $60 per barrel level plus the impact of late spring cool weather boosting natural gas demand and limiting early season storage buildups. Lastly, the disclosure on Friday of the arrest of 172 al-Qaeda terrorists in Saudi Arabia who were targeting the government and oil infrastructure facilities further focused attention on the need for the global oil industry to develop new supplies located outside of the Middle East region.

In light of the record high for the OSX, we thought it would be interesting to see how investors are valuing the oilfield service stocks that compose the OSX index as a measure of how the stock market views this sector. Since we are in the midst of first quarter 2007 earnings season, it was not possible to compare the valuation of trailing 12-month earnings per share of the companies. Therefore, we calculated the trailing price to earnings per share (P/E) ratio for the stocks based on the companies' latest annual earnings (2005 and 2006, respectively). We used the intraday high price for last Friday and the May 11, 2006, date of the previous high, so that we would be comparing comparable phenomenon. In addition, we examined the forward P/E as posted on the Yahoo Finance web site for each of the companies.

What was interesting to observe was that the average of the 2006 P/Es for the OSX stocks is almost exactly one-half the average of

The average of the 2006 P/Es for the OSX stocks is almost exactly one-half the average of the 2005 P/Es (16.9x versus 34.0x)

the 2005 P/Es (16.9x versus 34.0x). To further compare the valuations between the two periods, we totaled the earnings per share of the 15 companies composing the OSX for 2005 and 2006 and their respective share prices in order to calculate a P/E ratio for the entire group of stocks. What we found in this analysis was that total OSX earnings per share had increased by 90% between 2005 and 2006, while the trailing P/E ratio fell by 47%. It is also important to keep in mind that the earnings per share growth in 2006 was helped by managements using their surplus cash to repurchase shares, helping to boost their reported earnings per share. We also should point out that the 2006 OSX trailing P/E ratio of 16.9x is now generally in line with the current valuation of the overall stock market.

Exhibit 6. OSX Valuation: April 2007 v. May 2006

Company	Stock Symbol	EPS 2005	High May 11, 2006 Stock Price	2005 Trailing P/E	EPS 2006	High April 27, 2007 Stock Price	2006 Trailing P/E	4/27/2007 Forward P/E
Baker Hughes	BHI	2.59	87.86	33.9	7.32	82.75	11.3	14.1
BJ Services	BJS	1.38	41.79	30.3	2.52	29.97	11.9	11.3
Cameron	CAM	1.52	56.09	36.9	2.72	68.00	25.0	14.2
Global Industries	GLBL	0.30	18.67	62.2	1.70	21.90	12.9	13.0
GlobaSantaFe	GSF	1.73	64.13	37.1	4.13	65.75	15.9	7.2
Halliburton	HAL	2.27	41.58	18.3	2.23	32.14	14.4	11.3
Nabors Industries	NBR	2.00	40.71	20.4	3.40	33.20	9.8	7.7
Noble Corp.	NE	2.16	84.48	39.1	5.33	88.19	16.5	7.0
National Oilwell Varco	NOV	1.81	72.99	40.3	3.87	87.86	22.7	13.6
Rowan Companies	RDC	2.08	46.66	22.4	2.85	37.48	13.2	7.1
Transocean	RIG	2.13	90.16	42.3	4.28	88.69	20.7	8.0
Smith International	SII	1.48	45.50	30.7	2.49	53.28	21.4	14.3
Schlumberger	SLB	1.81	74.75	41.3	3.01	76.82	25.5	15.8
Tidewater	TDW	4.07	57.95	14.2	6.31	66.58	10.6	10.6
Weatherford Int'l	WFT	1.47	58.73	40.0	2.53	53.89	21.3	13.5
Average				34.0			16.9	11.2
OSX		28.80	882.05	30.6	54.69	886.50	16.2	

Source: Company documents, Yahoo Finance, PPHB

The average forward P/E represents a one-third decline from the 2006 trailing P/E ratio, suggesting that Wall Street expects healthy earnings for the companies, but maybe very little in share price appreciation

So what should we conclude from this analysis? First, the cyclical valuation of oilfield service stocks is at work, i.e., as earnings jump from business troughs toward peaks, stock valuations compress. In this case, a 90% earnings increase has been accompanied by an almost 50% decline in value. The bottom line is that while earnings per share have jumped in 2006 for virtually every company in the OSX, barely over half the stocks are trading at a higher price than it was on May 11, 2006. This past stock price performance doesn't really say much about future price action. According to Yahoo Finance, the average one-year forward P/E for the OSX companies is barely over 11 times, although the range of values for the individual companies is between 7.0x and 15.8x. The average forward P/E represents a one-third decline from the 2006 trailing P/E ratio, suggesting that Wall Street expects healthy earnings for the companies, but maybe very little in share price appreciation. Could Wall Street be wrong?

Green Channel to Hit Cable TV

If you ever thought being "green" wasn't rapidly becoming a mainstream phenomenon, then the announcement that Discovery Communications, the cable channel operator, plans to start a 24-

hour channel focused on eco-friendly living should dissuade you. The company announced that next year it will rebrand its Discovery Home Channel, seen by 50 million viewers, with a new name, as yet undecided, which will reflect the channel's position as the centerpiece of the company's initiative called PlanetGreen.

As part of this initiative, the flagship Discovery Channel will carry documentaries and other programming highlighting the new green lifestyle channel. The first project is "Ten Ways to Save the Planet" that is planned to be shown during the second half of 2008. Discovery will also focus on extending the initiative into internet components. It will also look at extending the green channel concept into the 170 countries where it has channels.

Advertisers now have distinct green budgets similar to their specific online advertising budgets

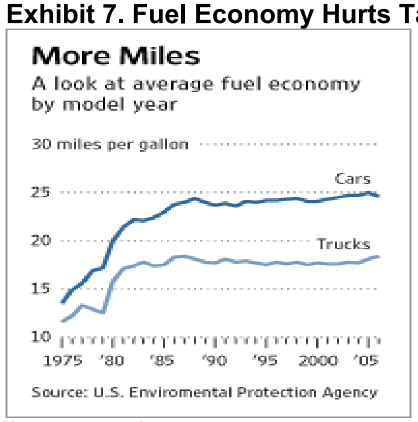
Part of the rationale behind the green channel is to capitalize on the interests of viewers and advertisers. Discovery CEO David M. Zaslav pointed out that advertisers now have distinct green budgets similar to their specific online advertising budgets. To capitalize on this advertising budget segmentation, Discovery plans to hold a PlanetGreen Innovation Conference gathering business leaders, scientists and conservation experts to discuss developing an environmentally friendly lifestyle. Discovery also plans to make its headquarters in Silver Spring, Maryland carbon neutral. As Mr. Zaslav states it, "Today, green means responsible." This is another example of the religion of global warming.

Fuel-efficient Cars Hurt State Gasoline Tax Collections

Drivers are paying less in federal, state and local highway taxes

We wrote about this issue almost a year ago when we first came across a story about a test being conducted by the State of Oregon Transportation Department of a mileage tax in place of a per gallon fuel tax to fund highway expenditures. As more efficient cars and trucks enter the U.S. stock of motor vehicles, the fleet average fuel efficiency rating increases, meaning less fuel consumed for the miles that Americans drive. That means drivers are paying less in federal, state and local highway taxes, which are the principal source of funding of roadway maintenance and new construction.

Exhibit 7. Fuel Economy Hurts Taxes



Source: *Wall Street Journal*

The highway tax revenue gap will not close without some action being taken by governments

A recent *Wall Street Journal* story highlighted that the Federal Highway Administration estimates that by 2009 tax receipts that make up most of the federal highway trust fund will be $21 billion below what's needed to maintain existing highways. That does not provide any funds for new highway construction or highway expansions. Facing this projected revenue shortfall and the reality that global warming concerns will continue to pressure automakers to produce more fuel-efficient and less polluting vehicles suggests the highway tax revenue gap will not close without some action being taken by governments. Just what action should be taken?

About 55% of highway and road funding comes from the combination of state and federal gasoline taxes. The balance comes from vehicle registrations, drivers' license fees, bonds and other public borrowing. States have been raising the fees for vehicle registration and drivers' licenses, but much of those increases have been used to offset the rising cost of administration needed to process these documents. Many states are raising tolls or imposing new ones on highways to raise more money. Some states are selling their highways to private enterprises that are turning them, if they are not already, into toll roads.

The Oregon study of a different structure for taxing drivers of vehicles to fund road maintenance and construction is drawing increased interest from other states such as Minnesota. In the year-long Oregon study, which has just concluded, 260 volunteers had their vehicles outfitted with Global Positioning Systems (GPS) and electronic odometers that recorded the number of miles driven. The drivers purchased gasoline at specially equipped service stations, where computers on the pumps subtracted the 24-cents-per-gallon tax and added a 1.2 cent fee for every mile driven.

A bigger challenge is the impact the mileage fee system might have on the initiative to sell more fuel-efficient vehicles along with privacy concerns

The Oregon state transportation department is reviewing the data from the study. However, the manager of the project indicates that the test will likely be revived and expanded once some of the bugs in the system are eliminated. Most of the problems seem to be hardware and software glitches and not fundamental operational issues. What appears to be a bigger challenge is the impact this system might have on the initiative to sell more fuel-efficient vehicles along with privacy concerns.

Critics of the Oregon program suggest that mileage fees penalize owners of fuel-efficient vehicles and take away the financial incentive to buy them. Supporters, however, point out that mileage fees are a fairer way than gasoline taxes to reflect the actual impact of miles driven on highways, regardless of the efficiency of the vehicle. The privacy issue concerns relate to the use of GPS systems that can "track" the driving patterns of people. As the Oregon state transportation official puts it, there is a big difference between "tracking miles and counting miles." He points out that the GPS technology employed has no ability to track drivers' movements. Therefore, privacy concerns have little validity.

We wondered what the financial impact was on consumers' purchasing of more fuel-efficient vehicles under this mileage fee system. We did the math for a car that got 30 miles per gallon (mpg) versus one that only achieved 15 mpg. We assumed each vehicle drove 12,000 miles in the course of a year and that gasoline cost $3 per gallon. When you do the math, it becomes clear that the most expensive vehicle to operate is the least efficient one under the traditional gasoline tax structure. That same vehicle under the mileage fee program would be $240 a year less expensive to operate.

The real cost winner is the fuel-efficient vehicle operating under the mileage fee program

However, the real cost winner is the fuel-efficient vehicle operating under the mileage fee program. That vehicle would save its owner $1,344 a year compared to the most expensive vehicle to operate, which is the least efficient vehicle under the traditional gasoline tax program. The least costly vehicle under the traditional gasoline tax structure would be $48 per year more costly to operate, but that is not really significant since it averages out to less than a $1 per week hike in cost. The conclusion is that more fuel-efficient vehicles are the least costly option, but a mileage fee tax structure is the least costly option. That advantage, however, would be negated if you have to pay a surcharged-price for the more fuel-efficient vehicle, such as has been charged for the super-efficient, hybrid Toyota Prius.

Exhibit 8. Mileage Fee vs. Gas Tax Helps Efficient Cars

	Vehicle 1	Vehicle 2	Vehicle 1	Vehicle 2
Mileage tax	$0.012			$0.012
Gasoline tax/gallon		$0.24	$0.24	
Cost of gasoline/gallon	$2.76	$3.00	$3.00	$2.76
Miles per gallon	30	15	30	15
Miles driven per year	12,000	12,000	12,000	12,000
Fuel consumed/gallons	400	800	400	800
Annual fuel cost	$1,104	$2,400	$1,200	$2,208
Annual mileage tax	$144	$0	$0	$144
Annual gasoline tax	$0	$192	$96	0
Total cost	$1,248	$2,592	$1,296	$2,352
Mileage fee advantage	$1,344		-$48	-$240
High MPG advantage			$1,296	

Source: PPHB

States and the federal government are going to have to deal with shrinking revenues for highways in the future as our vehicles become more fuel-efficient

It would seem from this analysis that even with a switch in the gasoline taxing structure, states and the federal government are going to have to deal with shrinking revenues for highways in the future as our vehicles become more fuel-efficient. That probably means we can be looking forward to higher pump prices as taxes are raised. In fact, Minnesota is proposing raising gasoline taxes by 50% from $0.20 per gallon to $0.30.

What a dilemma for those politicians who want to blame the oil companies for rising gasoline prices at the pump. They've already hidden away from consumers those gasoline pump charts that showed the breakdown in taxes in the price of a gallon of gasoline. We will be interested to see what slight of hand they can come up with next to cover the need to raise your gasoline prices. But rest easy as there will be no inflation as they have ruled these costs out of the Consumer Price Index.

Imperialism Is In The Eye of the Beholder

Last week a separatist rebel group known as the Ogaden National Liberation Front (ONLF) claimed responsibility for attacking a remote oil exploration site in eastern Ethiopia killing 74 oil workers. Among the dead were nine Chinese oil workers working for the Zhongyuan Petroleum Exploration Bureau, a division of Sinopec, China's largest refiner and petrochemicals producer. The Chinese company had been subcontracted to explore for oil and gas in the Ogaden by Petronas, the Malaysian company that won control over several exploration licenses in the Ogaden region in 2003.

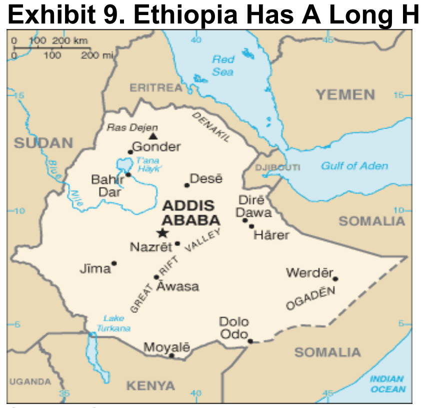
A spokesman for the ONLF claimed that any civilians killed were caught in the cross-fire of that battle

The ONLF also admitted to having taken seven other Chinese oil workers and said they would contact the International Red Cross to return them. A spokesman for the ONLF said that the deaths were related to a battle between their fighters and Ethiopian soldiers. He claimed that any civilians killed were caught in the cross-fire of that battle. Importantly, the battle was over the resources in the area claimed to be controlled by the ONLF and the government's challenge to that ownership. Ethiopia's proven oil and gas reserves are minimal, but analysts believe there is potential, particularly for natural gas, in the Ogaden.

Ethiopia is one of the oldest nations of the world and the second oldest officially Christian country, having converted in the 4th Century A.D.

Ethiopia is the second-most populous nation in Africa with about 76 million people. It is one of the oldest nations of the world and the second oldest officially Christian country, having converted in the 4th Century A.D. The country was also one of the original 51 countries forming the United Nations in 1942. The location of the battle in eastern Ethiopia is a remote area that borders on Somalia. In the 1970s, the two countries fought a war in this area.

Exhibit 9. Ethiopia Has A Long History



Source: CIA

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The spokesman said, "The Chinese used to be more populist but now they are turning into colonialists themselves"

As quoted in the *Financial Times*, the ONLF spokesman said about the dispute, "It is very unfortunate. But we don't allow anybody to drill on our land without our permission. The Ethiopians do not control the Ogaden and we have warned the Chinese that we will not allow them to drill there. They want our wealth without our consent. The Chinese used to be more populist but now they are turning into colonialists themselves. First there were the Russians, then the Americans, now it is them."

And we'll bet the Chinese thought they were helping out the Ethiopians when they began investing in the country and started to drill oil and gas wells. Of course the Chinese really want to make sure they have access to oil and gas reserves to satisfy their growing energy consumption. However, it goes to show you that anyone can become an Imperialist, even the friendly Chinese.

Democrats Can't Resist The Windfall Profit Tax

Eight freshmen Democratic senators have introduced a bill that would establish a windfall tax, equal to 50% of profits, on major oil companies

Big oil remains a target of politically-pandering Democratic senators who equate the size of oil company profits with their degree of outrage. A group of eight freshmen Democratic senators have introduced a bill that would establish a windfall tax, equal to 50% of profits, on major oil companies that would be triggered when oil prices rose above $50 a barrel. The bill, authored by Sen. Robert Casey (D-Penn), would also repeal oil industry tax breaks authorized in the Energy Policy Act of 2005 that have been the target of Democratic efforts to repeal them before and would raise the royalties the oil companies have to pay to the federal government.

Money raised from the windfall profits tax would be used for a new program to help the poor pay for transportation costs

Under Sen. Casey's bill, the money raised from the windfall profits tax would be used for a new program to help the poor pay for transportation costs. The money from ending the tax breaks would be devoted to funding research into alternative fuels. These are certainly laudable causes and overcome the fear that the windfall profits would merely disappear into the general treasury, but with regard to the first use, the government would be looking to establish a whole new social welfare program. But the real problem is the legality of taxing the profits of companies merely because the price of their product is going up.

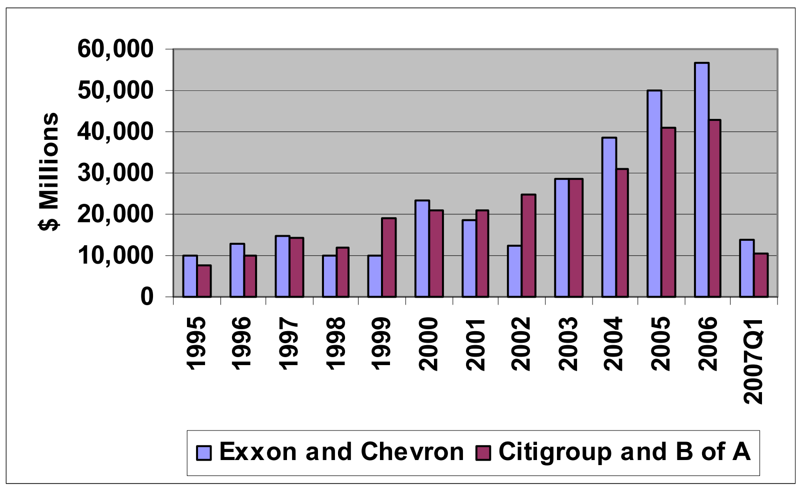
The group of senators scheduled their press conference to announce Sen. Casey's bill on the same day that ExxonMobil (XOM-NYSE) reported a 10% increase in its first quarter 2007 profits, up to $9.3 billion. The company's results, while lower than its record $10.5 billion quarterly profits in the third quarter of 2006, represented a pleasant surprise for Wall Street analysts who had expected ExxonMobil to suffer a fate similar to several other international oil companies that had reported lower results due to the decline in global oil prices. In ExxonMobil's case, strong refinery and petrochemical results more than offset the decline in earnings from its upstream E&P division due to lower oil and gas prices.

In the first quarter of this year, ExxonMobil achieved a 7.5% after-tax return on equity and an 8.1% return on invested capital

Whether it is nine billion or ten billion dollars, they are big numbers. However, the shear size of the number is irrelevant when we focus on other, very important measures of company profitability, e.g., profit margins and return on shareholders' equity and capital employed. In the first quarter of this year, ExxonMobil achieved a 7.5% after-tax return on equity and an 8.1% return on invested capital, very respectable numbers. In 2006, ExxonMobil's record $39.5 billion in net income equated to only 10.5% of revenues, below the profit margins of leading companies such as General Electric (GE-NYSE) at 12.8%, IBM (IBM-NYSE) at 10.4%, Johnson & Johnson (JNJ-NYSE) at 18.6% and Microsoft (MSFT-NASDAQ) at 25.9%.

But when the debate comes around to windfall profits taxes, it seems that the only industry Congress can find to tap is the oil industry. The reaction to rising gasoline prices at the pump is always to attack the oil industry and threaten them with a windfall profits tax. If one looks at the combined profits of ExxonMobil and Chevron Corp. (CVX-NYSE) compared to those of Citigroup (C-NYSE) and Bank of America (BAC-NYSE) over the past seventeen and a quarter years, there have been years when the oils out-earned the banks and vice-versa.

Exhibit 10. Oils and Banks Out Earn Each Other at Times

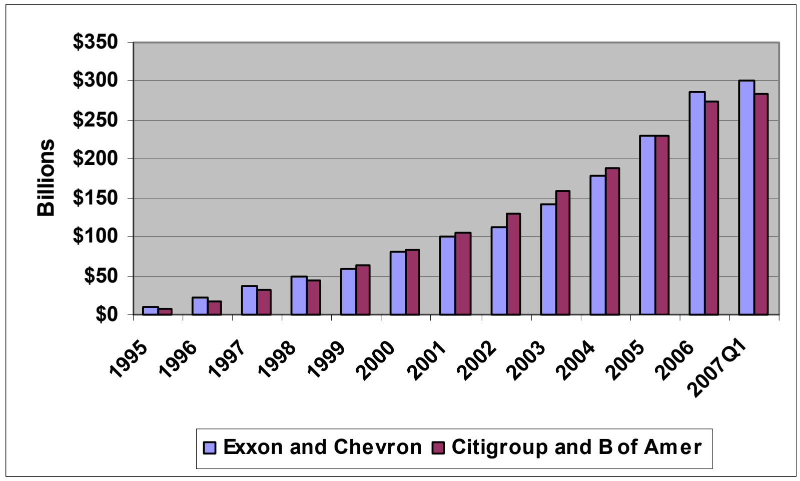


Source: Company documents, PPHB

From 1995 until 2005, the banks made more money than the oil companies

More interesting is to compare the cumulative earnings of these two pairs of companies over the period. (See Exhibit 11, next page) From 1995 until 2005, the banks made more money than the oil companies. Since then, the oil companies have out-earned the banks. But the amazing thing is that over this entire time period, there is only a six percent difference between the two pairs of companies. So one can reasonably ask: Why are politicians so intent on taxing illusionary windfall profits of oil companies when the banks are equally as profitable? I think we all know the answer, but it doesn't make it right.

Exhibit 11. Before 2006 Banks Out-earned Oil Companies



Source: Company documents, PPHB

Canada Gets on the Greenhouse Gases Bandwagon

Polls show that global warming is one of the most important issues for Canadians

The Conservative Government in Canada is trying to develop a new environmental policy after being criticized for its earlier attempt. When Prime Minister Stephen Harper's government was elected in January 2006, climate change was not a priority for the Conservatives. Now, polls show that it is one of the most important issues for Canadians. The previous Liberal government had committed the country to the Kyoto Protocol that calls for Canada to reduce greenhouse gas emissions by six percent below 1990's level by 2012. However, today emissions are 30% ahead of 1990 levels. The new leader of the Liberals has pledged to honor Kyoto if he unseats Harper in the next election.

The plan calls first for stopping the rise in greenhouse gas emissions within the next three to five years

Environmental Minister John Baird outlined the government's proposals in a speech last week that was leaked to the media the day before. The plan calls first for stopping the rise in greenhouse gas emissions within the next three to five years. Once they have stopped rising, then the government plans to reduce them by 150 million tons by 2020, or about 20% below the level of current emissions. This plan would still leave Canada 11% above its obligations under Kyoto.

Minister Baird stated that Canadian industry is now on notice that it will have to become more efficient in order to reduce greenhouse gases and air pollution. The government will mandate strict targets for industry. Firms will have a few tools to meet their targets including: making in-house reductions; taking advantage of domestic emissions trading; purchase carbon offsets; using the Clean Development Mechanism under the Kyoto Protocol; and investing in a technology fund. Companies will also be given a one-time credit for emission reductions that they have achieved from 1992 through last year.

Companies that cannot meet the emissions reduction timetable can contribute to a technology fund that will be used to develop pollution control technologies. The cost will be established at a C$15 per metric ton of emissions beyond their target. The objective is to seek solutions to produce deep reductions in greenhouse gases over time, especially for electricity generation and oil sands development. Carbon sequestration will be a prime target for technology development. The fund will be capped to ensure it does not become a tax on industry and to ensure that it isn't used by industry to buy its way out of achieving real emissions reductions.

Carbon sequestration will be a prime target for technology development

The government's plan will also target industrial pollutants that are linked to smog and acid rain, including: nitrogen oxides; sulphur oxides; volatile organic compounds; and particulate matter. The government will impose fixed national emissions caps for the four industrial pollutants. The goal is to reduce these air pollutants by half by 2015. Another aspect of the plan is to boost energy efficiency in common consumer and commercial products such as dishwashers, refrigerators and air conditions.

The goal is to reduce these air pollutants by half by 2015

In addition, the government has announced it will ban the sale of incandescent light bulbs by 2012, joining Australia that plans to ban these energy inefficient bulbs by 2010. The province of Ontario announced earlier in April that it was banning incandescent light bulbs by 2012. Natural Resource Minister Gary Lunn, who announced the incandescent light bulb ban the day prior to Mr. Baird's talk, said the ban will reduce greenhouse gas emissions by more than six million tons a year, saving homeowners about C$60 per year in electricity costs. A critic of the plan, Matthew Bramley, director of the Pembina Institute's climate change policy group, pointed out that lighting accounts for only 1.5% of Canada's greenhouse gas emissions so the impact from the ban will be minimal.

It will ban the sale of incandescent light bulbs by 2012

The cost to the Canadian economy for meeting these greenhouse gas emissions targets is estimated at C$7 billion to C$8 billion per year according to Mr. Baird. Other analysts suggest this estimate may prove to be conservative. A major challenge will be what impact the plan may have on the pace of development of the country's oil sands. This resource requires substantial energy to help in the extraction process, thus creating significant emissions.

The cost to the Canadian economy for meeting these greenhouse gas emissions targets is estimated at C$7 billion to C$8 billion per year

Mr. Bramley is concerned about the Conservative government's emissions control plan because he sees Canada falling well behind its commitment to Kyoto. According to Mr. Bramley, industrialized countries need to be 80% below their 1990 emissions levels by 2050. To be on track to achieve that target, he believes that industrialized countries need to be at least 25% below 1990's levels by 2020. The Conservative plan, if achieved, would still leave Canada 5% above 1990 levels. Canada is just one more industrialized country finding that attempting to meet the Kyoto targets is proving extremely difficult and will be more costly than many people expected. Will the populations of countries be willing to tolerate the economic impact of the global warming battles? We're not sure.

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