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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

OTC Was All About Being International

Attendance at the OTC set a 25-year record

We spent a considerable amount of time at this year's Offshore Technology Conference (OTC) trying to evaluate where the industry is, but more importantly, where it is headed. Attendance at the OTC set a 25-year record with 67,155 people passing through the doors, up 13% from 2006. The attendees came from 110 countries. There were 2,400 companies exhibiting (no wonder the conference program was a backbreaker!) from 30 countries, up almost 8% from last year. The conference expanded for the first time into the Reliant Stadium and totaled 530,000 square feet of exhibit space. It certainly is enjoyable to be in the midst of an industry boom, although no one wants to say it.

There were no Pirelli girls like two years ago

As we walked the floors of the exhibits, we were struck by several things. First, the show seemed to be much less gimmicky than in past years. Yes, there was the occasional golf set up and some professional entertainers, but there was less sex than in the past. There were no Pirelli girls like two years ago. Or at least I didn't see them. (It is interesting how many people asked me whether I saw any "Pirelli girls," and if so, where were they?) There were some young ladies in 'hot pink' tee shirts, but nothing like the Pirelli girls. Bottom line is that the show came across as being more professional this year. Whether that means the show is becoming boring remains to be seen.

The Chinese equipment manufacturers are here to stay

Second, you could tell that the industry is enjoying better times, as the booths looked more professional. This was especially true for many of the foreign exhibitors, in particular the Chinese equipment manufacturers. The message of their booths was that they are here to stay and U.S. suppliers will need to deal with their presence.

The younger audience and older exhibitors truly reflects on the strength of today's oilfield service industry

Lastly, as the attendance figures support, the audience and exhibitors reflected a much greater international flavor. That is clearly one of the overriding themes about the future of the oil and gas industry. The people walking the aisles with me seemed younger. Likewise, industry demographics are supported by my impression that the exhibitors seemed to be older and possessing more gray hair, or little hair. That too is a strong trend permeating the industry. The younger audience and older exhibitors truly reflects on the strength of today's oilfield service industry – the foreign and national oil companies are in need of education and assistance. The older exhibitors have the knowledge and capacity to help them. The environment on the exhibit floor seemed to mirror the underlying industry trends.

The perspectives focused on the eastward movement of the global oil and gas industry

Part of our time at OTC was devoted to listening to talks about industry trends and the future direction of the energy/oil and gas business. There were two particularly interesting panels – the Energy Roundtable that dealt with the question of a new era for the industry and the OPEC-organized panel on the new realities ahead for the energy business. Every speaker had a unique perspective on or way to highlight the challenges facing the energy business and the oilfield service industry, in particular.

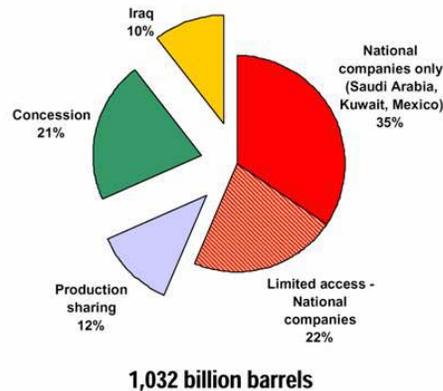
In the main, the perspectives focused on the eastward movement of the global oil and gas industry. Both the demand driver for energy and the future global oil and gas supplies are centered in the Eastern Hemisphere with all the implied issues and challenges. One of the major results of this eastward shift is its impact on the role of oilfield service companies and the future of the international oil companies (IOCs). The most poignant observation was made by Dr. Fatih Birol, the chief economist of the International Energy Agency (IEA), when he remarked that if the IOCs cannot readjust their strategies during the next 10 years, they will become niche players in the global oil industry!

The IOCs are facing a world in which their access to oil and gas resources is shrinking

Trying to get your mind around a world in which companies such as ExxonMobil (XOM-NYSE), Chevron (CVX-NYSE) and ConocoPhillips (COP-NYSE) are niche players in one of the world's largest and most important industries is very difficult, but it is a scenario that could become reality sooner than we can imagine. The IOCs are facing a world in which their access to oil and gas resources is shrinking. The major regions where large undeveloped hydrocarbon resources are located are in countries that have assigned their development to state-owned oil companies (NOCs). In the past, these state-owned oil companies lacked the skills to develop their resources – project management, technology and money. They turned to the IOCs for help and only involved themselves in the sale of the crude oil. Today, these NOCs have gained many of the project management skills and much of the technology as more of their youths are being trained at the leading petroleum universities in the west. The countries certainly have the funds necessary to develop their resources, given the level of oil and gas prices. As the NOCs' dependence on IOCs is weakened, what

are they to do? Oh, to be a fly on the wall in the boardrooms of the IOCs as their leaders discuss strategy.

Exhibit 1. Access to Estimated Global Oil Reserves



Source: EIA

IOCs are struggling to develop new business strategies

The reality is that the geopolitical developments of the past 12-24 months have highlighted a future for the IOCs where they will have increasingly less control over their operating environment. The recent actions by the Venezuelan and Russian governments to re-nationalize their petroleum resources, with little compensation paid to the IOC-developers, points out the challenge IOCs face in developing different strategies for growth. While the IOCs are struggling to develop new business strategies, the underlying trends of the petroleum industry are changing rapidly.

Forecasters of China's economic growth have been getting it wrong for the past eight years – always underestimating it

As Mr. Birol said in his presentation, there are three key drivers shaping the future of the global oil and gas industry. First is the pace and nature of the Chinese economic development. According to Mr. Birol, forecasters of China's economic growth have been getting it wrong for the past eight years – always underestimating it. Virtually all the international forecasting agencies – IMF, OECD, IEA and EIA – have settled on estimates similar to the IEA's official forecast of 6.7% per year for China, with a commensurate growth rate for oil consumption. But with the country producing 10% to 11% annual growth rates over the past several years, the IEA's 6.7% forecast is at risk of being wrong. What does that mean? A two percentage point difference in the growth rate equates to a change of 3 million barrels per day (b/d) in oil demand. Thus, if China's annual economic growth is 2% higher than the 6.7% forecast it will need an additional 3 million b/d of oil. That additional oil equals the demand increase forecast for the OECD.

Mr. Birol's second point was that better data on producing oil field decline rates is needed if forecasts are to become better. As he pointed out, if the underlying decline rate for producing fields is 1% higher than currently believed, the additional oil necessary to sustain

The world is probably looking at much higher oil prices in the future

current production would equal the total volume of new oil necessary to meet forecasted demand growth. In other words, if we are off on the underlying decline rate, the world may need twice as much new oil production to meet demand forecasts as presently anticipated. With finding and development costs escalating and questions about where new fields will be found and developed, the world is probably looking at much higher oil prices in the future.

Transportation needs are projected to consume 90% of the projected growth of OECD oil consumption

His last point was that price elasticities influencing oil demand are changing, and how they evolve will impact oil demand forecasts. For example, as people become wealthier, the cost of oil becomes a smaller portion of their income, so they are inclined to consume more, or are less sensitive to higher oil prices. Additionally, economic growth has accelerated in countries, especially in Asia, where energy consumption is heavily subsidized. What happens to energy demand if subsidies are reduced or eliminated? Lastly, the growth in transportation consumption has become extremely important to global oil demand forecasts. Transportation needs are projected to consume 90% of the projected growth of OECD oil consumption. If one or all of these price elasticities change, energy demand forecasts may be materially different than presently projected.

Oilfield service companies will challenge the IOCs in their role as critical advisors to the NOCs

There were a number of other points made by the panelists participating in the Energy Roundtable. Peter Goode, formerly the head of Vetco, discussed the change in the business model for oilfield service companies from pre-1996 to now. The important difference is that oilfield service companies will challenge the IOCs in their role as critical advisors to the NOCs. With the oil in the Middle East becoming increasingly more important to the global supply, the oilfield service industry will need to move closer to its markets. In addition, the needs of the NOCs will drive further consolidation within the oilfield service industry as companies strive to be able to supply more and more products and services to these monolithic oil companies.

Technology used to come from the IOCs to the NOCs, but is now coming from the oilfield service companies

Joe Bryant, now with Cobalt and formerly with Unocal, talked about the ease the NOCs have in accessing capital markets today. Money is no longer a limiting factor on resource development internationally. He also highlighted how technology used to come from the IOCs to the NOCs, but is now coming from the oilfield service companies. For him, the biggest change will be the development of new technology. He believes that enhanced computer and communications systems will enable technology to be increasingly developed in virtual space and transferred to customers more easily.

David Dunlap of BJ Services (BJS-NYSE) talked about the oilfield service industry's challenge in dealing with people issues. Historically, he pointed out, oilfield service companies would enter new foreign markets with an ex-patriot labor force. He believes those days are over, and oilfield service companies will need to develop and retain local labor forces. This will place new burdens

Populations of foreign countries have a greater emotional attachment to their natural resources

on the oilfield service companies, as they must develop new training and technology transfer programs in international locations. They will have to work harder on developing management training programs and to develop more supervisory talent. It would seem that these challenges might provide a further impetus for American oilfield service companies to relocate abroad.

In passing, Mr. Dunlap made an interesting point about the role of NOCs. He pointed out that the populations of foreign countries have a greater emotional attachment to their natural resources. This attachment may influence their willingness to develop their resources, or the pace of that development. It could also influence their attitude toward the use of new technology. There are two ways that attitude could play out. On the one hand, technology is known to accelerate the rate of producing reserves, so resources might be depleted more quickly. But on the other hand, technology enables the extraction of more of the ultimate recoverable reserves, making it more likely that more resources can be extracted for a longer time, thus helping the local economy to grow. How the people's attitude may evolve toward the use of technology is unclear, but it seems NOCs are more willing to try new technologies sooner than IOCs who always want them to be perfected first in another company's wells. If true, this bodes well for the increased R&D efforts of the larger oilfield service companies.

During the question and answer portion of the Energy Roundtable panel, some additional points were made to further amplify some of the points in the opening presentations:

- Oilfield service industry consolidation will be largely focused among the single product suppliers, especially as the oilfield service companies partner up with NOCs.
- Economic development for natural resource-rich countries will become less about selling a barrel of crude oil and more about the development of the supply and or value chain.
- Natural gas use will become more important in meeting the world's future energy needs, but the bulk of the reserves are located in a couple of countries that may use them for geopolitical purposes.
- Coal is coming back with all its implications – both good and bad. The drivers for coal consumption are natural gas prices and availability, and China's energy demand growth. In addition, there are 1.6 billion people in the world without access to electricity. Coal is the least costly and most available fuel source for new power plants.
- The world will need to develop 150 million b/d of new supply in the future due to the combination of depletion and demand growth. Of a hypothetical investment of \$4 in this effort, \$1 will be dedicated to finding new supplies to meet growth requirements, and \$3 to overcome depletion.
- Climate change will impact the industry through new government policies. These policies will change the energy

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game – how is unclear. Consumers and producers will have to negotiate more in the future to accommodate the structural changes from the new policies.

During the session, there were some questions posed for the audience to answer. The responses provided some interesting insights to what audience participants (energy people) think about critical issues facing the business. The questions and answers, along with the percentage of the audience who agreed with the answer are listed below.

- Q. What really drives or inhibits the global energy business?
- 1) Demand from emerging markets – 24%
 - 2) Competition for supplies among consumer markets – 5%
 - 3) Hydrocarbon resource availability – 32%
 - 4) Environment and climate change – 0%
 - 5) Geopolitics – 38%

The moderator suggested there certainly were no environmental representatives in the audience

The biggest laugh of the day came when the above voting percentages were displayed, as the moderator suggested there certainly were no environmental representatives in the audience.

While it was interesting to see that geopolitics is considered the greatest factor impacting the industry's future, followed by resource availability, the results are not really surprising. Demand, as the third most important factor might be considered a surprise, since it implies people are more concerned about future resource development than demand.

- Q. Who will dictate the market "rules of the game"?
- 1) IOCs – 15%
 - 2) NOCs – 69%
 - 3) Owners of breakthrough technologies – 12%
 - 4) Owners of assets, rigs, large vessels, etc. – 3%

The interesting point about these answers is the overwhelming conviction that NOCs are the greatest force in shaping the market place of the future. This view is becoming conventional wisdom (which might prove wrong, as conventional wisdom often does) and is driving the strategies of IOCs, oilfield service companies and investors. The low percentage of the audience that believe equipment owners will control the game reflects the conviction that over time, the oilfield service industry will add sufficient capacity to meet producers' needs.

We were even more convinced that the energy industry and the oilfield service industry are at tipping points in their evolution

As we left the OTC, we were even more convinced that the energy industry and the oilfield service industry are at tipping points in their evolution. While we are not sure what changes to these businesses will occur, we are convinced that the industries, as we know them today, will look different 5-10 years from now.

Senate Energy Bill: Be Prepared to Walk

The thrust of the legislation is to reduce future energy demand growth through increased efficiency

The two senators from New Mexico, Democrat Jeff Bingaman and Republican Pete Domenici, the head of and the ranking member of the Senate Energy Committee, are jointly sponsoring a new energy bill called The Energy Efficiency Promotion Act of 2007. The thrust of the legislation is to reduce future energy demand growth through increased efficiency. A side benefit of reduced energy consumption will be lowered climate change emissions.

In the transportation area, the bill mandates that the U.S. reduce its gasoline consumption, compared with current projected amounts by 20% by 2017, 35% by 2025 and 45% by 2030. These goals are measured against the Energy Information Administration (EIA) reference case forecast contained in the Annual Energy Outlook 2007. Based on the gasoline consumption estimates for the target years, the amount of gasoline to be consumed will start a downward trend by 2017 if the targets are met. One has to wonder how these gasoline reduction goals will be achieved without forcing people to resort to telecommuting, walking and depending upon mass transit, which is woefully lacking in many regions of the United States. Can ethanol satisfy the shortfall? You need 32 billion gallons in 2017, and 54 billion, or 68% more a short eight years later in 2025.

Exhibit 2. Senate Bill Mandates Smaller Gasoline Supplies

	<u>2017</u>	<u>2025</u>	<u>2030</u>
Motor gasoline	10.48	11.71	12.53
Reduction %	20%	30%	45%
Reduction volume	2.10	3.51	5.64
Net gasoline	8.38	8.20	6.89
Equal to year demand	1999	1998	1985

Source: EIA, Sen. Bingaman web site, PPHB

The national goal will be a rapid substitution of more-efficient CFL bulbs for the less-efficient incandescent bulbs

Other goals of the energy legislation include improving the ratio of gross domestic product (GDP) per unit of energy output by 2.5% by 2012. In the lighting area, the national goal will be a rapid substitution of more-efficient compact fluorescent lamp (CFL) bulbs for the less-efficient incandescent bulbs. The annual projected savings goals from all the bill's recommended actions are \$18 billion, 158 million tons of emissions and the amount of electricity produced by 80 base-load coal-fired power plants.

Savings of at least 50 billion kilowatt hours (Kwh) per year, or roughly the power consumption of 4.8 million typical U.S. households

The legislation also calls for improving appliance standards. These improvements project significant energy savings. For electricity: savings of at least 50 billion kilowatt hours (Kwh) per year, or roughly the power consumption of 4.8 million typical U.S. households. For natural gas: reduction of 170 million therms per year, or the heat equivalent for about 250,000 typical U.S. households. For water: saving at least 560 million gallons per day or about 1.3% of total daily potable water use. All of these savings are supposed to provide \$12 billion in net present value benefits.

UK Asks: What Aging Oil and Gas Workforce?

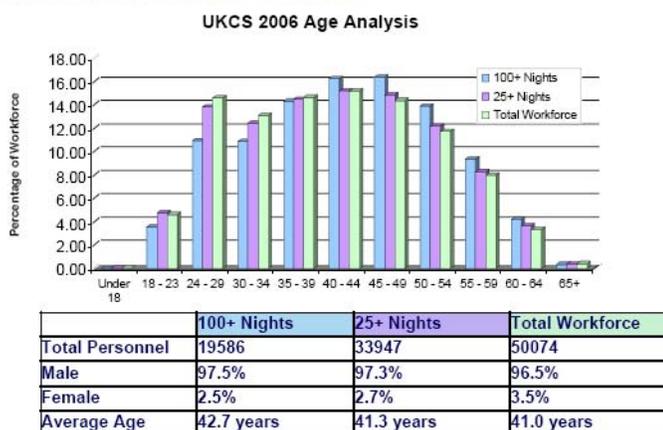
A new study refutes the common belief that the UK oil and gas industry is facing a rapidly aging offshore workforce

A new study carried out by Oil & Gas UK refutes the common belief that the UK oil and gas industry is facing a rapidly aging offshore workforce due to fewer young people being recruited for positions with operators and contractors working there. The study was undertaken to accurately identify the current workforce demographics and highlight any areas that may need to be addressed to insure the sustainability of the industry and its skills base. The study utilized data taken from the Vantage POB (Personnel On Board) system, which is an internet-enabled personnel tracking system employed by the UK offshore industry. The Vantage POB system tracks all movements offshore and holds a large quantity of data on the UK offshore workforce.

The study examined the Vantage POB data for all trips over the last 12 months, divided into male/female personnel and separate occupation categories. The data enabled researchers to develop an age profile for the industry as a whole, and for a select group of key occupations. The data was segmented by the number of nights offshore (25+ and 100+) and by employer (oil company or contractor). The study also examined specific data about female offshore workers and performed a comparison between various offshore sectors.

Exhibit 3. Average Age of UK Workers is Normal

Figure 1: Age Profile for the entire UKCS



Source: Oil & Gas UK

The average age of the total workforce on the UK Continental Shelf is 41.0 years, essentially “normal”

The most interesting data point to emerge from this study was that the average age of the total workforce on the UK Continental Shelf (UKCS) is 41.0 years. This is the average age one would expect for a workforce that spans from 20 to 60 years old. Thus, the offshore workforce is essentially “normal.” The average age for workers who spend 100+ nights offshore was slightly higher at 42.7 years, as well as for people directly employed by oil companies (42.4 years), but these differences are generally considered within the “typical” range.

There were just about 1,800 females who traveled offshore in 2006, with an average age of 34.1 years

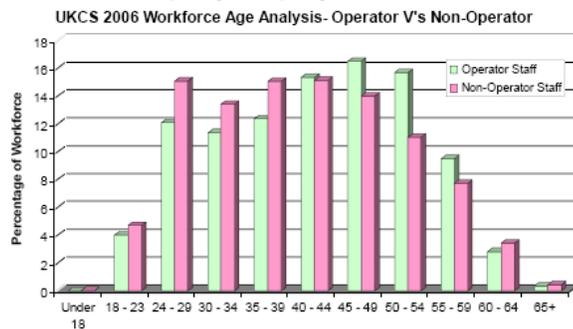
The study also showed that the UKCS workforce is becoming more diversified. There were just about 1,800 females who traveled offshore in 2006, with an average age of 34.1 years, but most of them worked in the catering sector. The data showed that there were 117 nationalities present in the 2006 workforce, with the UK supplying 85.1%. The UK, along with two other North Sea countries, Norway and the Netherlands, accounted for almost 90% of the offshore workforce.

There is an ongoing need for recruitment if the industry is not to encounter future workforce issues. All occupations need to do a better job recruiting in the under-24 year old category, and special attention needs to be paid by certain occupational categories to recruitment efforts within the 30-34 year old span in order to have and develop sufficient supervisory talent.

Oil company staff is clearly weighted towards the higher ages, but followed with a steep decline above 60 years old

Oil company staff is clearly weighted towards the higher ages, but followed with a steep decline above 60 years old. The oil company staff only account for 15.5% of the total offshore workforce. The contractor staff is clearly weighted towards the lower age bands, with a steady decline above the age of 44. Contractors need to be concerned about the lower number of staff in the 30-34 age-band and its implications for supervisory needs.

Exhibit 4. Oil Company Employees Are Older



	Operator	Non Operator
Total Personnel	7719	42320
Male	94.8%	96.8%
Female	5.2%	3.2%
Average Age	42.4 years	40.7 years

Source: Oil & Gas UK

The industry needs to focus more on attracting and keeping young workers

The conclusion one has to draw from this study is that the UKCS workforce is not unusually old. This is a positive for the industry's health and the supply of workers to staff offshore facilities. However, the lack of younger workers and the need for more 30-34-year old workers for supervisory training, suggest that the industry needs to focus more on attracting and keeping young workers. This may require companies to spend more time understanding the social and cultural desires of younger workers, something many companies have failed to do, but are now recognizing.

Hurricane Expert Challenges Global Warming

A recent study suggests that global warming might make it more difficult for hurricanes to form because it causes more vertical wind shear that can weaken hurricanes

Colorado State University Professor William Gray said in a speech in Denver recently that global ocean currents, not human-produced carbon dioxide, are responsible for global warming and hurricanes and that the Earth may begin to cool on its own in five to 10 years. A recent study suggests that global warming might make it more difficult for hurricanes to form because it causes more vertical wind shear that can weaken hurricanes. What the study's authors were not sure of was whether the dampening effects of wind shear would cancel out the boost that warmer water gives to the formation and strength of hurricanes.

Dr. Gray criticized the study because, in his view, it is ocean circulation patterns that are behind a decades-long warming cycle. The strength of these patterns can affect how much cold water rises to the surface, which in turn affects how warm or cold the atmosphere is. He disputes the belief, generated from computer models, that increased carbon dioxide levels are responsible for the increased number of hurricanes and their strength in recent years. Dr. Gray pointed out that over the past 40 years the number of major hurricanes making landfall on the U.S. Atlantic coast declined compared with the previous 40 years, even though carbon dioxide levels have risen.

The earlier-than-normal formation of an Atlantic basin hurricane will ignite the debate over whether global warming is the cause of more and stronger hurricanes

The earlier-than-normal formation of an Atlantic basin hurricane will ignite the debate over whether global warming is the cause of more and stronger hurricanes. In this case, the cold Atlantic Ocean waters were not conducive for the storm strengthening. However, the fact that the storm could form suggests that some areas of the ocean are receptive for storm formation. In fairness, the forecasts for storms and hurricanes this year are above normal, but that too only feeds the debate.

A fellow Colorado researcher, Kevin Trenberth, head of climate analysis at the National Center for Atmospheric Research in Boulder, said that over the past 35 years, the rise in global temperatures have been outside the range of natural variability. According to Trenberth, "Global warming is pervasive. It has an influence on everything. It has an influence on ocean currents. It has an influence on hurricanes. It has an influence on rainfall." It is these beliefs that are driving the tsunami of climate change legislation that will change the world. The only question is might unintended consequences create greater problems than our ongoing efforts to slow global warming.

A Giant Leaves the Canadian Stage

Last Thursday, Precision Drilling Trust (PDS-NYSE) announced a change in its management that marks a significant watershed event for the Canadian oilfield service industry. Mr. Hank Swartout,

With Hank Swartout's retirement, the Canadian oilfield service industry will change dramatically

Executive Chairman and a Director of Precision Drilling Corporation, the administrator of the Precision Drilling Trust, announced that he would be retiring from the company. The company has begun a search for his replacement, and Mr. Swartout will stay on until the new CEO is in place. The company's current president and chief operating officer, Gene Stahl, who is also Mr. Swartout's son-in-law, announced that he would not seek the CEO's position.

With Mr. Swartout's retirement, the Canadian oilfield service industry, and the Canadian energy industry in general, will change dramatically. Hank Swartout is one of those corporate titans who periodically come along in the evolution of an industry, and whose impact on the business is measured and evaluated for many years to come. As the leader of a \$3.3 billion market capitalization oilfield service income trust, one of the largest in Canada, Mr. Swartout has been known for marching to his own drummer, while often times drumming others into the ground. He built the largest contract drilling and well servicing company in Canada, but he also had the nerve to take on the biggest of the industry's oil service companies when he backed a group of executives to develop rotary steerable, measurement-while-drilling and other technology-oriented drilling tools. Despite struggling for some years to develop these tools and build a service business, Precision Drilling's technology was recognized for its potential by Mr. Bernard Duroc-Danner of Weatherford International (WFT-NYSE) who paid Mr. Swartout \$2.28 billion in cash and stock to buy the business. The purchase provided the catalyst for Precision to morph from a corporation into an income trust. The transition created a taxable event for Mr. Swartout, which contributed roughly C\$55 million of his C\$75 million take-home pay for 2005. The transaction vaulted Mr. Swartout to the top of the Canadian executive pay hill for that year.

Hank Swartout didn't enter the picture until 1987 when he led his company, Cypress Drilling Ltd., in a reverse takeover of Precision Drilling

While Precision traces its corporate roots to 1951 when it began business as an oil and gas drilling contractor, Hank Swartout didn't enter the picture until 1987 when he led his company, Cypress Drilling Ltd., in a reverse takeover of Precision Drilling and quadrupled the size of the company to 19 drilling rigs. From that point forward, Hank Swartout never looked back. Through a string of company and asset purchases (Spartan Drilling, Sierra Drilling, Taro Drilling, Duranco Drilling, Arrowstar Drilling, LRG Oilfield Services, Geosearch Drilling, EnServ, Gram Well Servicing, Rostel Industries, Brelco Drilling, Ducharme Oilfield Rentals, Kenting Energy Services, Columbia Oilfield Supply, Capital Oilfield Equipment, Brinkerhoff Drilling, Northland Energy, Inter Tech Drilling Solutions, Widney Well Service, Computalog, Underbalanced Drilling Systems, AQRIT Industries, Plains Energy Services, CenAlta Energy Services, United Diamond, Norward Energy Services, Geoservices' EM-MWD technology, Premium Pump, BecField Drilling Services, MacKenzie Caterers, the land drilling business of GlobalSantaFe and Reeves Oilfield Services), Precision grew from just one-of-many contract drilling companies in Canada to the dominant oilfield service company.

The rumor has Kohlberg Kravis Roberts & Co. (KKR) driving the deal to acquire Precision Drilling

The rumor in the Canadian oil patch is that Precision, possibly with the assistance of Mr. Swartout, is the target of a private equity takeover. The rumor has Kohlberg Kravis Roberts & Co. (KKR) driving the deal. According to *The Globe and Mail*, there have been frequent sightings of KKR employees in Calgary that are keeping the rumor alive, although there is also a potential Canadian utility spin-off rumor cited for the KKR presence. However, we have heard that Mr. Swartout is about to try to become “Mr. Nuclear Power” in Canada with plans to build a nuclear power plant to provide electricity for oil sands extraction rather than using Mackenzie Valley natural gas.

The driller panel with Hank Swartout drew a standing-room-only audience, as many oilfield service company execs came to enjoy the spectacle, along with a bevy of media

Personally, I have known Hank Swartout for almost 20 years. I have followed Precision Drilling for all of that time. Mr. Swartout was often right about the course of the industry, but sometimes he was wrong. One thing, though, he was always confident in his judgment and willing to put his money where his mouth was. In several of his transactions, I and my then employer were on the other side, but that never altered our personal relationship. In the heat of one deal, I was publicly browbeaten by Mr. Swartout, but he ultimately paid me the greatest compliment by paying what I thought the target company was worth.

One of my fondest memories of Hank Swartout was being the moderator of a panel of contract drillers at a Petroleum Equipment Suppliers Association of Canada (PESAC) investor conference some years ago. In addition to Hank on the panel was Denny Smith from Nabors Industries, with a large presence in the Canadian drilling market and internationally, and Bob Geddes of Ensign, the number two Canadian land driller and largest well service company with a small international drilling presence. This panel drew a standing-room-only audience, as many oilfield service company execs came to enjoy the spectacle, along with a bevy of media. No one was disappointed as these three pros jabbed, elbowed and humored each other, along with the audience. There was no winner, but certainly no loser! Everyone was entertained and, I’d like to think, learned something about what it takes to be successful in the land drilling business. Hank, I tip my hat to you as you walk out the door; may our paths cross in the future.

Oil Sands Production Boost Key to U.S. Energy Plan

A Houston energy summit in 2006 called for a five-fold expansion in oil sands production in a relatively “short time span”

According to a story on the Canadian Broadcasting Corporation’s French-language network, Radio-Canada, a two-day energy summit held in Houston in January 2006 involving U.S. and Canadian oil executives and government officials, called for a five-fold expansion in oil sands production in a relatively “short time span.” The meeting was organized by Natural Resources Canada and the U.S. Department of Energy.

A five-fold increase in oil sands production would lift volumes from one million barrels per day (b/d) to 5 million b/d. That volume would

In order to boost oil sands production on the scale envisioned, the Canadian government would need to relax some of its environmental regulations

supply roughly a quarter of current daily U.S. oil consumption. The story is playing a role in the Canadian government's debate over its environmental program. In order to boost oil sands production on the scale envisioned, the Canadian government would need to relax some of its environmental regulations. This relaxation would come at the same time Prime Minister Stephen Harper has pledged to make the environment one of his top priorities, vowing that Canadians deserve more action on climate change, which is their number one concern as reflected by public opinion polls.

The government's Environment Department posted on its web site two weeks ago an exemption for the oil sands industry's efforts to reduce emissions of the two chemicals associated with creating smog: volatile organic compounds and nitrous oxides. Shortly after the posting, an Environment Canada document was provided to non-government groups that forecast a 60% rise in the emission of volatiles from oil sands production by 2015, and a 5% increase in nitrous oxides over the same period.

The battle lines are being drawn over the pace of oil sands development

A spokesman for the Prime Minister's office said that there will not be a streamlining of environmental assessments to speed up oil sands development. Representatives of the oil industry and its lobbying group said there is no pledge to increase oil sands production by five-fold. Clearly the battle lines are being drawn over the pace of oil sands development, and implicitly, the ability of the U.S. to increasingly rely on North American oil resources rather than imported Middle East or African crude oils.

Bloodbath in Canadian Oil Patch?

A small item in a business column in last Thursday's *Globe and Mail* newspaper in Canada discussed the anticipated "carnage" among small energy companies as a result of the fall in natural gas prices from the lofty levels of a year ago. The columnist questioned an unnamed "Calgary investment banker type" about the financial problems that are slowly becoming evident within the industry. She pointed out the problems of two junior producers that ran into problems (or out of options) on the same day in April. One small producer found its way into creditor protection, while the other saw its bank financing cut and is facing a review of its loan position in a couple of months.

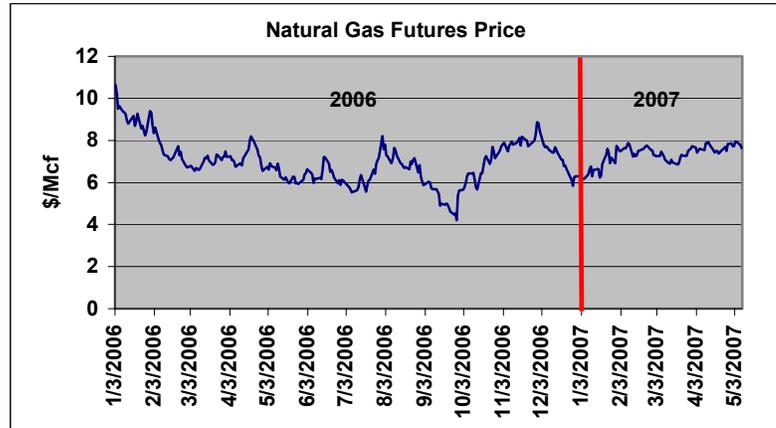
The biggest problem for the Canadian oil patch this winter was that the rig count never rose as high as expected

As we have pointed out previously, the biggest problem for the Canadian oil patch during this winter and spring breakup was that the rig count never rose as high as expected, while the total number of available drilling rigs (and other types of equipment) grew. The resulting lower fleet utilization pressured day rates and pricing for services across the board. Adding to the financial pressure on the companies was an earlier than usual spring breakup.

The fall in natural gas prices during the summer of 2006, coupled with expectations that they would remain low into 2007 forced

Canadian producers to cut drilling programs for winter 2006-7. A more normal winter has helped support natural gas prices at higher levels than anticipated, but the die was already cast. Now the producers are trying to use the weakness to push oilfield service costs lower.

Exhibit 5. Weak Summer Gas Prices Have Cut 2007 Drilling



Source: NYMEX, EIA, PPHB

As the industry entered 2006, expectations were that natural gas prices would remain in the \$10-12 per mcf range with the possibility that hurricane season in 2006 could drive them to \$20

The turmoil in the natural gas markets that had started early in 2005 and was magnified by hurricanes Katrina and Rita in the fall of that year sent prices sky-high. As the industry entered 2006, expectations were that natural gas prices would remain in the \$10-12 per mcf range with the possibility that hurricane season in 2006 could drive them to \$20. The quick recovery in Gulf of Mexico natural gas production and the boost in onshore production from unconventional resources helped ease supply concerns. The cool summer pressured gas prices, which have now begun to recover and track the long-term upward trend in gas prices established in the late 1990s.

Exhibit 6. Gas Prices Back On Long-term Trend

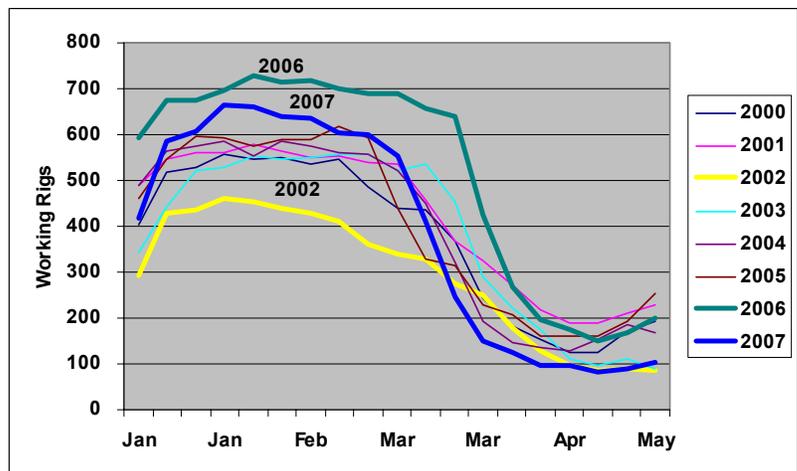


Source: Energy and Capital, Super Charts

What has been different about this year's spring breakup is that the slope of the decline has been steeper than almost any other year, with the exception of 2006

As can be seen from the graph in Exhibit 7, the 2007 weekly Canadian drilling rig count, as reported by Baker Hughes, never approached the active count experienced in 2006, yet it was comfortably ahead of every other year since 2000. While industry participants talk about the impact of an earlier than usual spring breakup, when we look at the general timing of the 2007 seasonal downturn, it actually came later than most other years in this decade with the exception of 2006. What has been different about this year's spring breakup is that the slope of the decline has been steeper than almost any other year, with the exception of 2006. That year, the industry was trying to squeeze out every possible working day until the rigs couldn't operate any more, thus its very steep decline in late March of last year.

Exhibit 7. 2007 Rig Count Reaches Recent Historic Low



Source: Baker Hughes, PPHB

Drilling and service companies are scrambling to move equipment out of Canada or idling it more permanently

On the downside, the 2007 drilling rig count has reached the lowest number of working rigs since 2002, but it reached that point by the middle of March, earlier than the late April time frame, which appears to be the more normal arrival time. As a result of a surplus of oilfield equipment and the resulting pressure on profit margins due to lower prices and rising costs, drilling and service companies are scrambling to move equipment out of Canada or idling it more permanently. Profits for oilfield service companies in the second quarter are going to be dismal, at best.

According to the column, the story making the rounds in Calgary is that there are more than 50 default letters on the streets for junior producers, signifying that the blood is about to really flow. Two observations about this impending bloodbath: 1) the change in the income trust tax ruling has cut off financing options for some of these rumored distressed companies, and 2) aggressive lenders are heeding the experience of Canadian banks in the 1980s, who were the last to arrive at the great energy party of the 1970s and were nearly wiped out by the 1980s oil price collapse, and are pulling back their lending rapidly.

**“Buy when the blood is running
in the streets”**

There is an old investment axiom that says, “Buy when the blood is running in the streets.” From our long experience around this industry, that is a good axiom to live by – although it is not fun waiting for the blood to start running. Watch for Canada to be a hot spot for energy company takeovers and asset purchases this summer. The big question is whether the deals will be driven by industry participants or private equity and vulture equity buyers?

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