PARKS PATON HOEPFL & BROWN

ENERGY INVESTMENT BANKING, LP

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

Barron's 500 Reflects Strong Showing of Oil Service Stocks

There were ten oilfield service companies in the rankings and all were in within the top 200 companies

The *Barron's* newspaper listing of its top 500 companies publicly traded in the United States and Canada, ranked by sales, reflected a strong showing by a handful of large oilfield service companies. There were ten oilfield service companies in the rankings and all were in within the top 200 companies. With the exception of U.S. land driller, Nabors Industries (NBR-NYSE), all the companies were in the top 80 companies in the list.

The survey is prepared annually for *Barron's* by Credit Suisse Holt, a unit of Credit Suisse Group. It compares companies on the basis of four equally-weighted measures and grades and ranks the companies. For each company, Holt calculates sales growth in the latest fiscal year adjusted for divestitures. It calculates stock-price performance relative to the Standard & Poor's 500 Index for the 52-weeks ended May 2nd. It also measures the median three-year cash-flow return on investment (CFROI) stripped of the effects of inflation and accounting practices and the one-year change in CFROI compared to the three-year historical median. The companies are graded A through F on these performance measures.

The key to performance is the measurement of recent profitability measured by the amount of capital the company has available

Each company is graded in the four categories and the top quintile in each category receives an A and the bottom quintile receives an F. Holt calculates a GPA from the four scores. In the case of a tie in GPAs, the "winner" is the company with the greatest change in cash-flow return on investment or equity in the past year. Thus, the key to performance is the measurement of recent profitability measured by the amount of capital the company has available.

Exhibit 1. Oilfield Service Companies Ranked Well Last Year

Rank	Last Year's Rank	Name	52-Week Total Return (Vs. S&P 500)	Cash Flow Return on Inv. 3-Year Median	Cash Flow Return on Inv. 2006 Vs. Median	Sales Growth 2006	GPA
3	10	National Oilwell Varco	A	A	A	A	4.00
4	40	Schlumberger	A	A	A	**A**	4.00
7	14	Smith International	A	A	A	**A**	4.00
10	N/A	McDermott International	A	B	A	**A**	3.75
22	215	Halliburton	A	B	A	**B**	3.50
37	N/A	Transocean	A	D	A	**A**	3.25
62	71	Weatherford	A	B	B	**B**	3.25
76	76	Baker Hughes	C	B	A	**B**	3.00
79	N/A	BJ Services	C	A	A	**C**	3.00
196	116	Nabors Industries	A	C	C	**D**	2.25

Source: Barron's, PPHB

This group of companies performed quite well the prior year with seven of the ten making the top 500 ranking

It is not surprising that oilfield service companies performed well in the most recent survey given the dynamics of the industry and the stock market's rewarding of the companies. It is interesting to note that this group of companies performed quite well the prior year with seven of the ten making the top 500 ranking and only one of those falling outside of the top 200. The oil service stocks have been strong performers for several years because the industry's dynamics have allowed the companies to earn outstanding returns. Let's hope 2008 will provide another year of outstanding performance, as the first part of the year has clearly demonstrated.

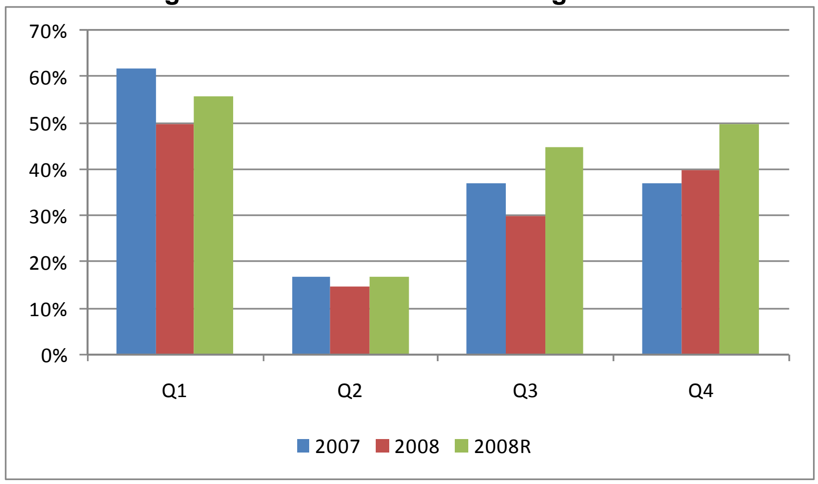
Break Out The Champagne – Canada Forecasts Upped

The new forecast calls for 24% more active rigs, an eight percentage point increase in rig fleet utilization and 33.5% more rig days

Last week the Canadian Association of Oilwell Drilling Contractors (CAODC) announced a revision to its forecast for 2008 activity after assessing the better than expected first quarter of the year activity and higher than expected natural gas prices. The new forecast calls for 24% more active rigs, an eight percentage point increase in rig fleet utilization and 33.5% more rig days than the prior forecast. Based on their well count, the new forecast calls for 4,300 additional wells, although the count still will be down from 2007's total. The outlook is further helped by a changed attitude toward its new royalty scheme by the province of Alberta. The province's royalty change is a reaction to the shift in oil and gas industry spending outside its borders and the industry's recent E&P successes due to that spending. The impact is likely to help boost Alberta activity further.

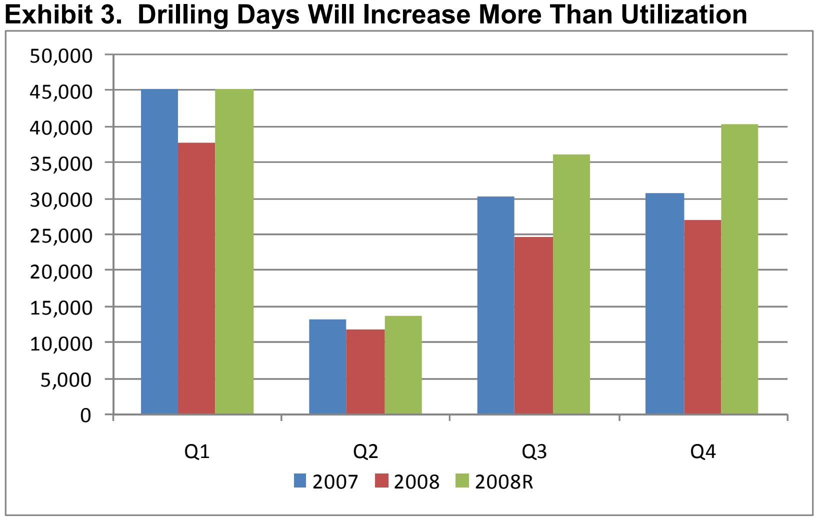
The revised forecast calls for the fleet rig utilization rate to reach 42%, about 10% higher than the utilization rate achieved in 2007. Exhibits 2 and 3 show the estimated fleet utilization rate and drilling days by quarter for 2007, the original CAODC 2008 forecast and its recently revised 2008 forecast. The net result of the new forecast is that industry activity is likely to be higher than experienced in 2007. While the first quarter of 2008 activity was markedly better than previously expected, it was well short of the activity experienced in the same quarter of 2007. The 2007 first quarter activity reflected the tail end of the surge in drilling activity that had begun several years before due to higher commodity prices but soon peaked as natural gas prices collapsed. Following spring break-up proposed changes in Alberta's royalty program forced the petroleum industry to slow its activity until the new plan's details became clear.

Exhibit 2. Rig Utilization To Be Much Stronger in 2H2008



Source: CAODC, PPHB

Exhibit 3. Drilling Days Will Increase More Than Utilization

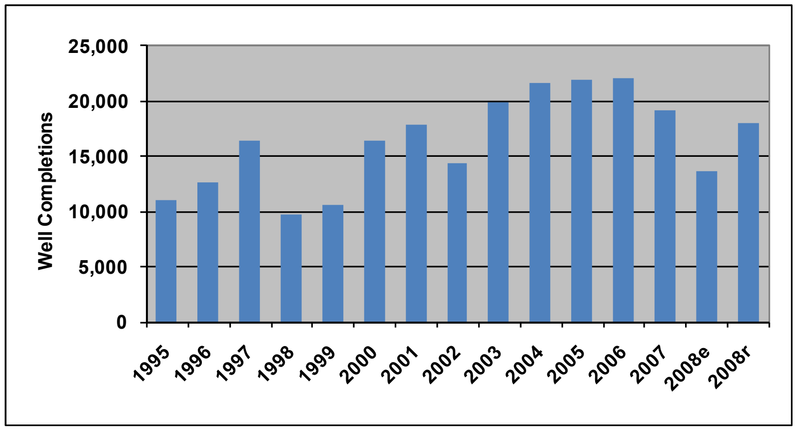


Source: CAODC, PPHB

The newly revised forecast projects only an 11% decline in wells this year to 16,500

The Petroleum Services Association of Canada (PSAC) also revised its 2008 forecast recently. A key result of the revision was a significant boost in the rig-released well count. From 18,557 wells in 2007, the original PSAC 2008 forecast foresaw only 14,500 wells, a drop of 21%. The newly revised forecast projects only an 11% decline in wells this year to 16,500. That improvement in wells reflects a 9% increase in Manitoba (350 wells), a 4% gain in Saskatchewan (3,525), a 9% decline in British Columbia (800) wells and a whopping 15% reduction in Alberta wells (11,748). The PSAC forecast was revised before the release of Alberta's proposed changes for deep-well drilling royalties. This change could help boost second half of 2008 drilling activity and potentially add to the projected well count in the province that would further shrink some of the year-over-year decline.

Exhibit 4. Revised PSAC Forecast Calls For More Wells



Source: PSAC, PPHB

The key will be the second half trend in natural gas prices in North America, which is dependent upon liquefied natural gas (LNG) shipments to the continent

The gas shale developments in British Columbia and the oil shale play in southern Saskatchewan are likely to further boost drilling and oilfield activity in those provinces beyond what was assumed earlier in the year. This could make the comparison against 2007's activity even greater. The key will be the second half trend in natural gas prices in North America, which is dependent upon liquefied natural gas (LNG) shipments to the continent. So far this year, the colder winter in Europe and Asia and the continued power plant outage in Japan has contributed to stronger gas prices outside of North America. As a result, LNG shipments to North America are below forecasts. The growth in U.S. natural gas production has reduced the need for the industry to bid aggressively for LNG supplies.

It appears that U.S. natural gas futures prices are at a slight premium to European prices signaling that more LNG supplies are likely to be flowing to North America

At the present time, it appears that U.S. natural gas futures prices are at a slight premium to European prices signaling that more LNG supplies are likely to be flowing to North America. While those supplies could, coupled with greater domestic gas supplies and possibly more Canadian gas imports, lead to a softening in natural gas prices in the near term, there is a growing recognition that the underlying strength of the global gas market will make LNG supplies coming to North America potentially more volatile in the future. This means that gas drillers may be less willing to cut off their activity at the first signs of gas prices weakening. Besides, the delayed start-up of Canadian oil sands production will help boost gas consumption and likely limit exports to the United States.

At the end of the day, the 2008 oilfield market in Canada is looking better this week than was assumed as recently as a few weeks ago. The better performance of Canadian energy and oilfield service stocks during the past few months reflects investor expectations that the industry was going to recover faster than believed late last year. This is good news for the Canadian industry and investors, but also good news for the U.S. oilfield service companies who can look forward to probably less Canadian competition fleeing a weak Canadian oilfield industry.

EnCana Announcement Has Ring of April Fool's Day Joke

Since the TSX's January low, the index has climbed by about 21%, largely on the back of the surge in global crude oil prices and the sharp rise in North American natural gas prices

The May 13 announcement that EnCana (ECA-TO), Canada's largest energy company, was going to split itself into two more focused units had the feel of an April Fool's Day joke. The announcement the board of directors of the company approved the splitting of the company into two units – one focused on its oil sands holdings and the other concentrating on the company's crude oil and natural gas assets – sent the stock price soaring 6.6% that helped the Toronto Stock Exchange climb by almost 145 points, or 1%, to a record close of 14,666.07. Since the TSX's January low, the index has climbed by about 21%, largely on the back of the surge in global crude oil prices and the sharp rise in North American natural gas prices. The rise in gold prices has also helped. The previous high for the TSX was last July 19th prior to the onset of the credit crisis.

EnCana was a company born out of the fear of Canadian oil and gas assets being scooped up by a non-Canadian company

The decision to split EnCana into two units has overtones of Austrian economist Joseph Schumpeter's view of the capitalist economy being in a perpetual state of creating destruction whereby large lumbering corporations are replaced by smaller, nimble units. EnCana was a company born out of the fear of Canadian oil and gas assets being scooped up by a non-Canadian company, to the detriment of the country. To prevent that possible eventuality, the predecessor companies – PanCanadian Petroleum and Alberta Energy Company – joined forces about six years ago with the belief that size was critical both for defense and to be able to take on the increasingly larger and more expensive energy projects that are coming to dominate the industry.

Mr. O'Brien believed that the sum of parts of PanCanadian would be more valuable than the value of the holding company

EnCana was the vision of two significant Canadian executives. One was a leader in the energy business – Gwyn Morgan of Alberta Energy Co., while the other was a lawyer and leading corporate executive – David O'Brien of PanCanadian Energy Corp. Mr. O'Brien had previously built and then broke up Canadian Pacific Ltd., a holding company with five distinct businesses. Canadian Pacific was involved in oil and gas, coal, shipping, railroads and hotels. At the time of splitting up the company, Mr. O'Brien believed that each of PanCanadian Energy's independent units would be sufficiently large and strong enough to survive on its own. He also believed that the sum of parts would be more valuable than the value of the holding company. Before long one of these beliefs proved wrong as the energy company combined with Alberta Energy and the CP Hotel spinoff company was acquired by an international hotel entity. Alberta Energy Company was also a spin-off pure play energy company created out of a former provincially-owned grab bag of resource entities.

Combined through the merger, the two smallish energy companies

According to media reports in 2006, the new EnCana CEO, Randy Eresman, said he saw a "compelling argument" for a stand-alone oil sands company because of the higher valuations for oil sands companies

evolved into the new EnCana. In 2003 and 2004, EnCana embarked on a series of strategic moves designed to focus the company on North American natural gas, the mainstay of Canada's Western Canadian Sedimentary Basin. EnCana aggressively moved to exploit its natural gas holdings and acreage and to acquire additional properties. In 2005, Gwyn Morgan retired setting the stage for another transformational event. According to media reports in 2006, the new EnCana CEO, Randy Eresman, said he saw a "compelling argument" for a stand-alone oil sands company because of the higher valuations for oil sands companies.

Before he could engineer that transaction, Mr. Eresman focused on another transaction involving ConocoPhillips (COP-NYSE). In an $11 billion deal, COP purchased a 50% interest in EnCana's two main oil sands holdings while EnCana got stakes in several refineries. By connecting the refineries in the United States with the raw material production of the oil sands, the risk of a stand-alone company was lowered.

By splitting the company into separate companies focused on oil sands and natural gas, the belief was that the total valuation of the parts would be greater than the prior value of the whole

In recent years the issue confronting the board of directors was how best to manage the largest energy company in Canada. The belief was that the growing size of the company was making it increasingly difficult to manage and that its size (C$65 billion market cap) was holding back EnCana's market valuation. By splitting the company into separate companies focused on oil sands and natural gas, the belief was that the total valuation of the parts would be greater than the prior value of the whole. Based on the C$5.68 hike in EnCana's stock price to $92.20 on the first day of trading following the announcement, it would seem that this expectation is proving true. Since that day, EnCana's stock price has climbed to a high of C$97.81 before settling at C$92.10. From the price prior to the corporate announcement to the recent stock price high, EnCana's stock price has climbed in excess of 12% suggesting that investors believe the corporation's view about valuation is pretty much correct.

An interesting side point about this transaction is that the current chief financial officer, Brian Ferguson, who will become the head of the oil focused company, started his career at Alberta Energy in the investor relations position. From there he moved into the position as head of corporate development for the company. That put Mr. Ferguson smack in the middle of all the strategic moves of Alberta Energy including the merger to create EnCana, the purchase of U.S. natural gas-oriented Tom Brown, and the sale of the company's non-North American oil and gas assets. His performance impressed people and led to his appointment as CFO.

"Brian Ferguson understands employees, but he also understands shareholders and why people buy and sell company stock. A lot of senior executives don't have that."

An observation about Mr. Ferguson's career and its role in this transaction was characterized by Jim Estey, chairman of UBS Securities Canada, when he said, "Brian Ferguson understands employees, but he also understands shareholders and why people buy and sell company stock. A lot of senior executives don't have that." In essence, Mr. Estey was identifying the challenge facing executives who struggle with balancing the pressures of long-term versus short-term investor motivations. That balance has often been the undoing of some high-visibility CEOs and could prove the same for these two new EnCana spin-offs.

It was interesting that EnCana management made the announcement about the proposed split-up on a Sunday and then held a conference call that afternoon with analysts and investors. While this unusual announcement timing ruined a tranquil Sunday for Wall Street and Bay Street pros, by disclosing the details and the news well before foreign stock markets opened, the information and analysis of the transaction to be disseminated in a less than frantic environment often associated with the typical early Monday morning merger and acquisition news.

The decision also shows that the board has concluded that valuation is more important than size in the business

The EnCana move clearly reflects a Schumpeterian decision by its board. The decision also shows that the board has concluded that valuation is more important than size in the business. The question for the managements of each of the two entities is whether their size after the split-up is sufficient to enable them to remain independent. If the answer is no, then the board's conclusion means that investors will be rewarded with a further market premium in a transaction while Canada will lose its pre-eminent energy company.

Impressions From Our Annual Drive to Rhode Island

It has been almost two weeks since my wife and I started out on our annual drive to our summer home in Charlestown, Rhode Island. This trip took place a couple of months ahead of when we normally would make the trip since our vacation home is undergoing a massive reconstruction project. Traditionally, we would fly up in May and stay for three to four weeks, and then return for the month of August and early September. In the interim period we would rent the house. This year, due to the construction project and our fear that it wouldn't be completed in time for our renters, we changed our summer vacation plan, driving up in May rather than flying. We are planning on spending about two and a half months based in Rhode Island making sure everything is complete at the house before our renters arrive.

We noticed on this trip that traffic was fairly light compared to the drives in previous years

With that background, you can appreciate that some of our observations about our trip might be different merely due to the difference in the timing of our drive. What we noticed on this trip, however, was that traffic was fairly light compared to the drives in previous years. There were a number of trucks, but not nearly as many as in the past. We noticed this trend both in geographic areas where truck traffic has been particularly heavy in the past and even in areas where traffic is traditionally lighter. We also noticed that the number of trucks parked at rest stops and truck stops was down from past years. We believe we have to attribute this reduction in truck traffic to the weakening of the economy.

We also noticed that trucks owned by certain firms that we read

We also noticed that trucks owned by certain firms that we read have modified downward the settings of their speed governors were traveling slower and almost always in the right-hand lane

have modified downward the settings of their speed governors were traveling slower and almost always in the right-hand lane. The corporate effort to economize on diesel fuel was evident by the behavior of these trucks. The primary impact of this trend was that we seldom felt we were being run over or off the road by speeding trucks. That wasn't necessarily true about other vehicles, especially a number of SUVs that seemed to have taken over the role previously held by trucks, but we put that down to conspicuous consumption.

Our stops for dinner at Cracker Barrel restaurant locations were marked by fairly crowded dining rooms, albeit never a wait line as in past years

Our stops for dinner at Cracker Barrel restaurant locations were marked by fairly crowded dining rooms, albeit never a waiting line as in past years. We have to say that being outside of the traditional summer vacation period may account for the absence of waiting lines, but we can't confirm that. The only real problem we encountered was not being able to find a hotel room in the Wilkes Barrie area in central Pennsylvania. We concluded, after a discussion with one hotel desk clerk that there must have been some function going on in the area, although he had no idea if that was correct. The result of our search was that we didn't get into a hotel room until about 2:45 am when we had targeted stopping by midnight (the one hour time change from the Central to the Eastern Time Zone established our target stopping time).

We saw more police vehicles and officers in action, by a significant magnitude, than on any of our previous trips

The other traffic related issue we observed was that the respective state police forces seemed to be very active. We saw more police vehicles and officers in action, by a significant magnitude, than on any of our previous trips. What was interesting was that the police in certain states seemed only to be targeting autos; while in other states – Tennessee and Virginia – were almost always after trucks. Our most amazing scene was coming across a stopped vehicle along with two state police cars and seeing an officer and a dog inspecting the auto. We are used to seeing the customs and immigration service dogs at work on I-59 highway in south Texas, but we have never seen drug dogs working a traffic stop in Alabama. Maybe we discovered a new drug route we never knew about.

We have noticed that store traffic is down in the area, and the economic statistics for the state of Rhode Island point to a weakening economy that is complicating both the state's and various municipalities' budget planning

Since we arrived in Rhode Island and have had discussions with several subcontractors working on our house and other residents in the area, it appears that the weak economy is taking hold, unfortunately not necessarily in the housing market. Driving around our area has uncovered a large number of new homes under construction – largely, we suspect, the result of the boom times on Wall Street. However, we have noticed that store traffic is down in the area, and the economic statistics for the state of Rhode Island point to a weakening economy that is complicating both the state's and various municipalities' budget planning.

This is the season for town and city budget approvals and the lack of tax revenues is forcing some localities to confront difficult choices between government worker salaries and benefits and the normal cost of operating the government. High fuel bills are playing great havoc with police and fire department budgets along with the cost to operate municipal services such as garbage pickup, pot hole repair and plowing during the winter. One neighboring town just held its second referendum on its proposed FY2009 budget. The second proposed budget was cut by $850,000 to $54.7 million. The new budget represented a 1.62% increase in spending, but a 2.84% increase in taxpayer spending since state reimbursement funds have been reduced. The town's city counselors were to meet and make further cuts before sending the budget back to the taxpayers for approval. The current budget means the loss of two employees.

In an economy where more than half the employed workforce is made up of government or educational employees, finding new tax revenues is proving to be a serious challenge

The state of Rhode Island bureaucracy is facing a calamitous economic situation. When the governor first proposed his budget some three months ago, there was about a $60 million deficit. That has exploded to about a $438 million deficit and is continuing to grow. The problem began several years ago when the state government's spending commitments pointed in the direction of a serious imbalance with revenues. At that point the state received about $500 million in money from the national tobacco settlement that state legislators put into the operating budget to eliminate the need to raise taxes or modify spending. Now that the one-time tobacco funds infusion has been spent, the state needs to look for other sources of funds. In an economy where more than half the employed workforce is made up of government or educational employees, finding new tax revenues is proving to be a serious challenge.

The conclusion we draw from our travels east and our first few days in the area is that the economy is much weaker than we see or experience in Houston

The conclusion we draw from our travels east and our first few days in the area is that the economy is much weaker than we see or experience in Houston. In fact, we saw one seasonal store holding a 20% off everything sale on Memorial Day weekend. This becomes one more reminder of the divergence in economic fortunes experienced by the petroleum-centric and non-petroleum-centric regions of the country in the 1970s. What we cannot get out of our minds was the reversal of fortunes that occurred in the 1980s. Today, we hear people tell us of the permanent changes underway in our economy due to peak oil, but we have in the back of our minds the memory of these types of claims at the end of the 1970s. We may be proven wrong, but we still believe changes are underway that will alter the growing consensus view of our economic future. Exactly how it changes is unknown, but we are confident it will change, much like Mark Twain's comment about New England's weather – "If you don't like the weather in New England just wait a few minutes."

The Ying and Yang of Asian Energy Consumption

Asian energy markets appear to be caught between short-term and long-term trends that are at cross patterns at the present time. Asian economies have been growing at very high rates for the past few years, basking in the glow of the strength of the U.S. and European economies. The cheap labor available in Asia has enabled their economies to develop low-cost manufacturing capacity

The sharp rise in crude oil prices coupled with an explosion in food costs is putting the Asian governments in a difficult position

that helped overcome the rising cost of raw materials and transportation costs to supply cheap goods to those economies. The governments of Asian countries have maintained policies of subsidizing fuel and electricity costs for its citizens to encourage the populace not to demand higher wages. Now, the sharp rise in crude oil prices coupled with an explosion in food costs is putting the Asian governments in a difficult position. The governments can either allow some of the price pressures to flow through to the citizens or continue to subsidize the higher costs with dire financial consequences.

In recent days, a story in the *Financial Times* highlighted that a number of Asian governments were about to lower fuel subsidies. Last Saturday, the Indonesian government boosted fuel prices. It raised gasoline prices to 6,000 rupiah ($0.65) per liter and diesel prices to 5,500 rupiah ($0.60) per liter. These new prices reflect 33.3% and 27.9% hikes, respectively. The impact of these fuel price increases, accomplished through reductions in the fuel subsidies, sent citizens to wait for hours in lines at gasoline stations on Friday. But on Saturday, rioters were rallying in various Indonesian cities and throwing Molotov cocktails at the police arrayed against them.

India's Petroleum Ministry said an increase in the price of domestic fuel was inevitable

Last week, India's Petroleum Ministry said an increase in the price of domestic fuel was inevitable because of the financial costs the government was absorbing due to the sharply higher crude oil price. The ministry reportedly will ask to raise gasoline prices by 22% and the price of diesel fuel by 16%. The government has not indicated when it expects to announce the price hikes, but one has to be sure it is trying to time the move to produce the least political reaction.

At the present time, inflation in China is running at record levels, and the impact on energy supplies due to the earthquake will put even greater pressure on the government

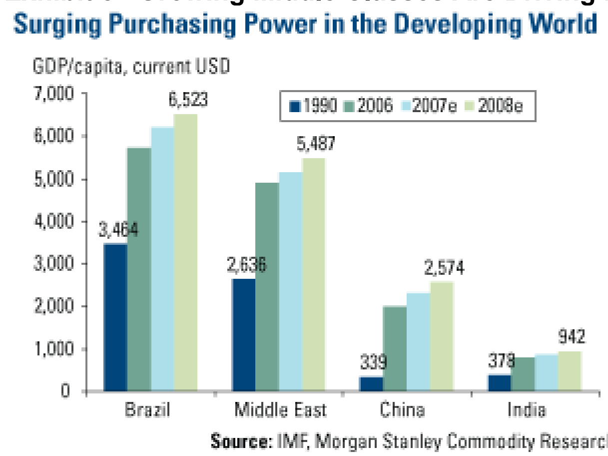
At the same time India is wrestling with its energy prices, the Chinese government has discussed the need to establish an energy or petroleum department in an attempt to coordinate policies between the national government and its provincial governments. The series of natural disasters that have befallen China so far this year – the huge spring snow storm and the devastating earthquake – combined with the government's preparation for the upcoming Olympics, is making controlling inflation a major concern. At the present time, inflation in China is running at record levels, and the impact on energy supplies due to the earthquake will put even greater pressure on the government. There are a reported 70 dams in danger of collapse. The government has ordered water to be emptied from behind the dams to reduce the risk of their collapse, but that means less hydroelectric power. The government has also ordered the shutting down of coal mines, petrochemical plants and electric power plants. To offset the reduced domestic supply of energy, China has been forced to boost is purchases of diesel fuel to run electric generators. These purchases are coming at the same time the Chinese government is buying extra fuel for stockpiles in advance of the Olympics.

At the same time it appears that certain Asian governments are taking steps that may result in a reduction in energy consumption in

This newly arrived middle class populace desires the same standards of living that we enjoy – a nice home, plenty of appliances and electronic gadgets and automobiles

the short term, the long-term fundamentals for energy consumption appear well entrenched. One of the principal forces behind energy demand growth is the expansion of the middle classes in many Asian, Latin American and Middle East countries. This newly arrived middle class populace desires the same standards of living that we enjoy – a nice home, plenty of appliances and electronic gadgets and automobiles. That means increases in energy consumption. As shown by Exhibit 5, the growth in gross domestic purchasing power per capita has increased the least in Brazil over the period 1990 to 2008 with only an 88.3% gain. In contrast, China's growth is 659.3% while the gains in the Middle East and India are more modest at 108.2% and 149.2%, respectively. It is the growth of these respective country's or region's populations that is contributing to the explosion in energy demand.

Exhibit 5. Growing Middle Classes Are Driving Energy Demand



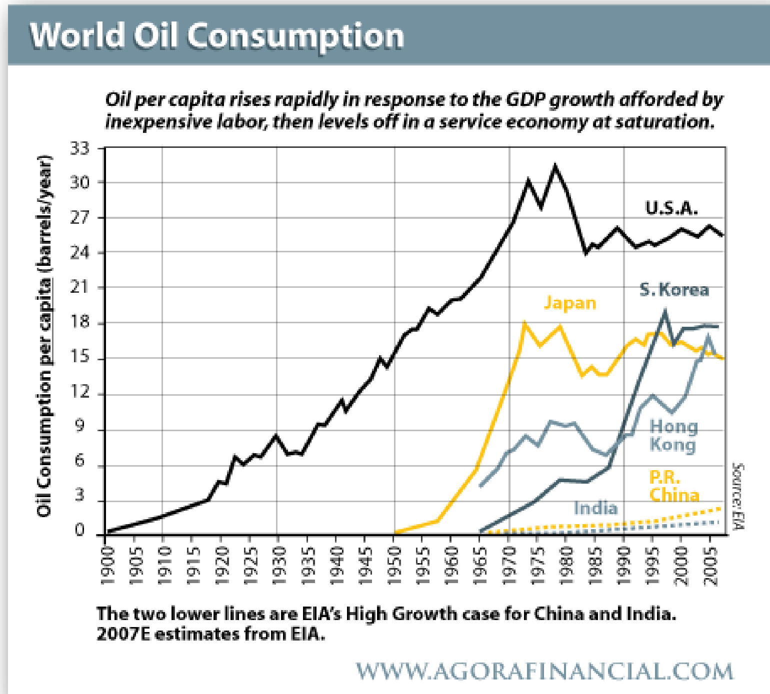
Source: U.S. Global Investors

It is this growing middle class that is behind the expectation that Chinese and Indian oil demand will eventually follow the paths of the United States, Japan, South Korea and Hong Kong. Given where China and India are on the chart of oil demand, the expectations are that they will follow paths of energy consumption similar to that of the more developed countries. Whether that will happen remains to be seen and is clearly subject to the impact of new energy technologies and efficiency trends. In simple terms, however, everyone believes that China's and India's energy consumption will soar just as other developed economies did in the past.

China accounts for a significant share of global consumption of raw material demand

The growth in China is the primary driver of energy and raw material demand growth. As shown in Exhibit 7, China accounts for a significant share of global consumption of raw material demand. The chart shows the amount of global consumption of copper, zinc and nickel represented by China. As displayed by the chart, since the early 2000s, China's share of consumption of these minerals has soared compared to its use in earlier years. China has increased its consumption since 1990 to 2007 of copper from about 5% to close to 30%; for zinc from 2-3% to close to 35% and for nickel from 4% to

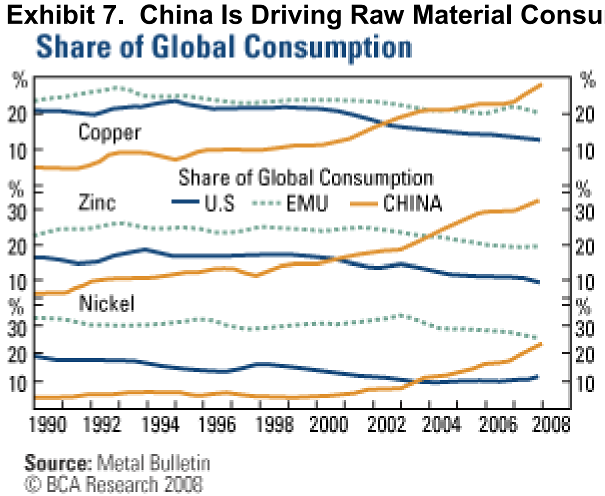
Exhibit 6. Will China and India Follow Developed Economies?



Source: AgoraFinancial.com

about 22-24%. These are dramatic increases in demand and are largely the reason why the price of these commodities on world markets has soared so much in recent years.

Exhibit 7. China Is Driving Raw Material Consumption



Source: U.S. Global Investors

While China and other developing economies – especially those in Asia – are accounting for a significant portion of global demand growth for energy and raw materials, there is also significant room

The measure of energy intensity of economies such as China and Korea compared to that of the U.S. and Japan indicate that there is considerable room for conservation to impact the consumption of energy by those large and developing economies

for savings going forward. As some have pointed out, the high level of energy consumption per unit of economic production suggests that there is significant room for reduction in demand just through conservation. As shown by the chart in Exhibit 8, the measure of energy intensity of economies such as China and Korea compared to that of the U.S. and Japan indicate that there is considerable room for conservation to impact the consumption of energy by those large and developing economies. That is the great hope for global energy demand (and environmental concerns) in the future. If the rate of growth in energy needs in these developing economies can be lowered, the world may be able to meet future energy needs more easily than presently anticipated, which should translate into lower oil prices in the future.

Exhibit 8. High Consumption Leaves Room For Conservation

Oil Intensity of GDP for Asian Economies, 2006 (Tones of Oil/US$mn GDP)

	Oil Consumption (Mn tons)	GDP (US$ bn)	Oil Intensity (Ton/US$ mn GDP)
China	349.8	2658	131.6
Hong Kong	13.2	190	69.4
India	120.3	877	137.1
Indonesia	48.7	365	133.4
Korea	105.3	888	118.7
Malaysia	23.0	157	146.7
Philippines	14.4	118	122.6
Singapore	15.4	130	118.6
Taiwan	52.5	365	143.6
Thailand	44.3	207	214.3
Japan	235.0	4376	53.7
US	938.8	13195	71.1

Note: Oil consumption for Singapore excludes those for the refinery as most of the finished goods are exported in the end.
Source: BP and Citi.

Source: U.S. Global Investors

Just as the price pendulum has swung too far to the upside, falling demand will send it much lower than people can imagine

So while there is likely to be an interruption in the pattern of demand growth for crude oil and petroleum products in the near term, the long term fundamentals appear solid. However, when, and if, the short-term variables come into play and drive demand down and oil prices follow, the rate of decline will probably be dramatic and shock investors and industry analysts. Just as the price pendulum has swung too far to the upside, falling demand will send it much lower than people can imagine. The strength of the long-term fundamentals will put a floor under how far oil prices can fall and how quickly the price will return to a more normal level. As this happens, beware the instant analysis of the talking heads on Wall Street money shows.

Recent Oil Price Spike May Have Tripped U.S. Economy

The recent spike in oil prices has darkened the outlook for the economy

It wasn't too long ago that investment pundits and high ranking government officials were declaring the worst of the economic problems for the U.S. economy behind us. They were speculating that the country would avoid the dreaded prospect of a full-blown recession. However, the recent spike in oil prices has darkened the outlook for the economy. As Peter Boockvar, equity strategist for broker Miller Tabak & Co., put it, "We may finally have crossed the line where the price of crude actually matters for most companies. The stock market has been in la-la land when it comes to oil, but they got a pretty good dose of reality the last few days." His observation was in response to the 4% loss experienced by the DJIA last week as crude oil futures prices climbed by $9 to reach a record high of $135 per barrel.

Ford Motor Company announced it was abandoning its prior hope that it could earn a profit this year or next

Last Thursday, Ford Motor Company (F-NYSE) announced it was abandoning its prior hope that it could earn a profit this year or next. As the sales of gas-guzzling and significantly profitable pickups and Explorer SUVs have plunged leaving the company with few hybrid or high-mileage offerings other than its Focus, Ford's profitability has been dealt a severe blow. There are serious question being raised whether GM (GM-NYSE) and Chrysler are in worse shape. According to several media articles interviewing Toyota Motor Corp. (TM-NYSE) executives and dealers, its sales of trucks and SUVs are also falling, but its hybrid cars have backlogs of waiting customers who are willing to pay a premium to get them. So while Toyota's profitability is being shaved by lower sales of higher profit margin vehicles, it does have a red-hot series of vehicles that are earning respectable profit margins.

AMR announced it was parking 75 high fuel-consuming planes, mostly regional jets and the company's fleet of MD-80s, due to skyrocketing jet fuel costs

American Airlines (AMR-NYSE) made a dramatic announcement last week, also. The company announced it was going to begin charging $15 per bag each way for the first bag checked by passengers traveling on discounted tickets, and $25 per bag for the second and subsequent bags. It also announced it was parking 75 high fuel-consuming planes, mostly regional jets and the company's fleet of MD-80s, due to skyrocketing jet fuel costs. By parking these planes, the airline is admitting it cannot afford to fly these planes without losing money on each route. According to American Airlines, for each $10 per barrel increase in the price of jet fuel, the company's annual fuel bill increases by $800 million. So far this year, the rise in jet fuel prices has driven up American Airlines' annual fuel bill by $3 billion.

The result of the decision to reduce its flying capacity by 11% to 12%, American Airlines will be laying off workers. Since the airline has never gone through a bankruptcy, it has about the highest labor cost in the domestic industry – an untenable situation in the face of soaring fuel costs and a weakening economy. Some Wall Street airline analysts believe the domestic airline industry may ultimately have to reduce its capacity by 20%, or the equivalent of shutting

To counter rising fuel costs, Japan Airlines has been forced to increase it fuel surcharge on tickets by 40% this year

down two major airlines. American Airlines is anticipating reducing its international capacity by only 0.5%. However, British Airways (BS-NYSE) has prepared an analysis for operating in a zero profit year after posting profits of close to $1.8 billion last year. To counter rising fuel costs, Japan Airlines has been forced to increase it fuel surcharge on tickets by 40% so far this year. If you think planes are full now and ticket prices expensive, the future looks even worse on both counts.

Other corporate announcements offer further support for the belief that the U.S. economy is already in a recession. SanDisk Corporation (SNDK-NASDAQ), a manufacturer of flash storage cards used in digital cameras, cell phones, electronic games and other electronic products, said its sales are slowing due to consumer spending on electronic products falling due to a weakening economy.

The Department of Transportation reported that the number of highway miles traveled during March was down 4.3% from the prior year, a reduction of 11 billion miles

Recent government figures about the transportation outlook suggest that a major slowing in fuel consumption is happening. Last week, the Department of Energy's weekly petroleum industry report pointed out that fuel consumption dropped by 2.3% from a year ago. In addition, on Thursday, the Department of Transportation reported that the number of highway miles traveled during March was down 4.3% from the prior year, a reduction of 11 billion miles. This represents the first year-on-year decline since the 1979 oil shock. This was also the largest drop in driving since the government began keeping records during World War II.

Because of the nature of consumer vehicle purchasing decisions, the shift in buying habits will establish a decade-long reduction in fuel consumption growth

If crude oil prices continue to trade above $130 per barrel – and even above $100 per barrel – further weakening in motor fuel demand will become more evident, along with further weakening in the domestic economy. As Robert DiClemente, chief U.S. economist at Citigroup (C-NYSE) remarked, "The economic outlook has been taken hostage by the relentless surge in oil prices." The outcome of this hostage situation is a growing recognition that a shift in consumer buying habits for automobiles and trucks is underway. That shift suggests automobile fuel consumption patterns will change in the future. Because of the nature of consumer vehicle purchasing decisions, the shift in buying habits will establish a decade-long reduction in fuel consumption growth. It is possible that there might even be an absolute reduction in fuel consumption at some point in the future. In our view, a tipping point has been reached and our future energy consumption patterns are changing. Exactly what they will look like in the future is still unclear, but less energy consumption has to be considered the likely outcome.

Clowns To The Left Of Me, Jokers To The Right – Congress Deals With Energy

Our wonderful Congress decided right before Memorial Day, the official start of summer and the driving season, to address the rapid climb in petroleum prices. Let's see, the first effort was to pass energy legislation that allows the U.S. Department of Justice to sue the Organization of Petroleum Exporting Countries (OPEC) for colluding to raise oil prices. That will have the same impact as a prostitute suing her pimp because he wants too much protection money or a junkie suing his drug supplier for charging too much for the heroin. But from the politician's perspective, score one for the do-nothing Congress.

The second major push was for Congress to reconvene its April Fool's Day hearings with oil company executives on high oil prices. As in virtually every one of the previous "high oil price hearings," the questions were underwhelming for their naivety.

For example, Senator Richard Durbin (D-IL) asked the subpoenaed representatives from ExxonMobil (XOM-NYSE), ConocoPhillips (COP-NYSE), Shell (RDS-A-NYSE), Chevron (CVX-NYSE) and BP (BP-NYSE) if they were troubled when they saw what they were doing to the American public. So what exactly are they doing? How about meeting consumer needs for gasoline, diesel, heating oil and natural gas. Yes the price is higher, but who decreed that it needs to be low? Besides, the profit margin earned by major integrated oil companies is barely above the average of all industrial companies in the Dow Jones Industrial Index.

Senator Arlen Specter (R-PA) wanted to know why ExxonMobil's annual earnings increased from $11.5 billion to $40.6 billion over the past five years

Another amazing question came from Senator Arlen Specter (R-PA), a former Philadelphia prosecutor, who wanted to know why ExxonMobil's annual earnings increased from $11.5 billion to $40.6 billion over the past five years. A quick visit to the Energy Information Administration (EIA) web site would have shown that global energy demand over the period 2002 to 2007 was almost 10% higher, rising from 78.04 million b/d to 85.35 million b/d. From January 2, 2002, to mid May, the spot price of West Texas Intermediate crude oil had increased over six fold from $21.13 per barrel to $128.93. With these industry dynamics is there any question about why ExxonMobil's earnings have exploded during the period. The better question, but one that most senators fail to grasp is that if the true measure of profitability is return on assets or return on invested capital, not absolute dollars of revenues or profits, what are the companies doing with their investments. The executives tossed back the restrictions on acreage available for exploration, which the politicians failed to catch. High prices and high profits make dramatic sound-bites for constituent consumption.

When Sen. Sheldon Whitehouse was Attorney General of Rhode Island he found many company profits obscene, yet he never had a problem with the huge awards for plaintive attorneys

Senator Sheldon Whitehouse (D-RI) contrasted the pain Rhode Islanders and others are feeling at the gasoline pumps with the obscene profits of oil companies. His description was interesting since when he was Attorney General of Rhode Island he found most company profits obscene, yet he never had a problem with the huge awards for plaintive attorneys suing on things such as possible lead in paint. Maybe his perspective is a reason why his state has been among the largest loser of manufacturing jobs and is clearly mired in a recession that may prove extremely difficult to exit.

In another venue, Representative Edward Markey (D-MA) said he didn't understand why the President wasn't releasing oil from the Strategic Petroleum Storage (SPR) facility to force down oil prices. President Bill Clinton had done that once with little impact. And the last we knew, the SPR was designed to ensure the country with some 80-90 days of oil supplies to offset a physical shortage of crude oil from a political act, a natural disaster or some other physical disruption of supply.

But the greater Congressional folly was the passage of legislation restricting the government's purchase and storage of 70,000 barrels per day (b/d) of crude oil in the SPR in an attempt to lower gasoline pump prices. Since the U.S. consumes roughly 21 million b/d of petroleum product, stopping the government from injecting about 0.0035 percent of our daily consumption is likely to have little impact on global oil prices.

When confronted with real issues about oil supply and demand such as opening up offshore acreage or onshore restricted drilling areas or even confronting the challenge of increasing automobile fuel consumption efficiency or energy conservation measures, the Congress takes a pass.

With clowns and jokers making our national energy policy, is it any wonder that the approval rating of Congress is near record lows of only 18% as of mid-May? Until we have either a serious debate about measures to significantly reduce our energy consumption or we enable domestic energy markets to function without subsidies or restrictions, the United States will remain a profligate energy consumer. The pain and suffering of reaching a market equilibrium that balances energy supplies reflecting their true cost with domestic demand will always entice politicians to act in ways that enable them to hold themselves out as saviors of their constituents' lifestyles. The sad news is that it will take a national energy crisis to hold that debate.

With clowns and jokers making our national energy policy, is it any wonder that the approval rating of Congress is near record lows of only 18% as of mid-May?

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