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ENERGY INVESTMENT BANKING, LP

MUSINGS FROM THE OIL PATCH
May 29, 2007

Allen Brooks
Managing Director

Note: *Musings from the Oil Patch reflects an eclectic collection of stories and analyses dealing with issues and developments within the energy industry that I feel have potentially significant implications for executives operating oilfield service companies. The newsletter currently anticipates a semi-monthly publishing schedule, but periodically the event and news flow may dictate a more frequent schedule. As always, I welcome your comments and observations.* Allen Brooks

Will Selling Gasoline Become a Crime?

The U.S. House of Representatives just passed by a 284-141 margin, HR1252, the Federal Price Gouging Protection Act sponsored by Rep. Bart Stupak (D-Mich.) who has been trying to get this legislation enacted since shortly after Hurricane Katrina devastated the Gulf Coast refining industry. His co-sponsor in the United States Senate is Sen. Maria Cantwell (D-Wash.) who has been assured by Sen. Harry Reid (D-Nev.), the Senate majority leader, that her bill, which received approval from the Senate Energy Committee earlier in May, will be put up for a vote June 6 along with other energy legislation. Sen. Cantwell has been joined by Sen. Diane Feinstein (D-Calif.) in pushing her bill since September 2005.

The bills call for stiff penalties for oil companies, traders or retail operators

The bills call for stiff penalties for oil companies, traders or retail operators if they take "unfair advantage" or charge "unconscionably excessive" prices for gasoline or heating oil. As columnist George Will noted, this bill is full of emotionally charged language, which, however, is extremely ambiguous. The lack of clarity may make it dangerous to be selling gasoline during periods of extreme volatility such as we are now experiencing.

The legislation would only be enforceable if the president has declared a national emergency

The legislation, as currently approved by the House, would only be enforceable if the president has declared a national emergency. President George Bush has already indicated through White House spokesmen that he will veto the legislation should it make it as far as his desk. It is quite likely that the legislation will not be passed by the Senate as the Democrats only hold a one-vote majority and a number of Democrats from oil producing states will probably oppose the bill.

That said, the bill directs the Federal Trade Commission (FTC) and the Justice Department to pursue complaints of profiteering and any activity that "indicates that the seller is taking unfair advantage of unusual market conditions," whether real or perceived. Both the House and Sen. Cantwell's bill instruct federal investigators to look for a "gross disparity" between prices before and after a supply emergency. Yet the bills fail to define "gross." The investigators are to look for prices that represent "unfair leverage or unconscionable means" by a fuel supplier during an emergency. Again, the legislation fails to define "unfair" or "unconscionable." This bill marks a milestone in legislation as it makes price gouging a federal crime for the first time ever. If convicted, violators of the law could be sentenced to up to 10 years in prison and a fine of up to $2 million for an individual and $150 million for a corporation.

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The problem with these bills, which Democrats have tried to enact since 2005, and did get passed in the House last year, but not the Senate, is that they open up the field for regulation by "the eye of the beholder." Not only do these bills open the doors for lawsuits, they almost scream out for businessmen to need to carry a dictionary with them every day they open their doors for business. This legislation, in a world where the oil industry and the retailing of gasoline have been scrutinized innumerable times with no findings of fault by the industry, means that businessmen have a new, undefined risk. The most recent industry study was conducted by the FTC in 2004 who examined price changes in gasoline from 1991 through late 2003. They found that about 85% of the price variability, both up and down, reflected changes in the price of oil. So much for evil intentions.

Businessmen have a new, undefined risk

Recently, pundit George Will, a word maven, wrote a column about the gasoline price gouging bills and their lack of clear definitions of the terms by which people are going to have to operate and will be judged. Mr. Will also discussed the dilemma of Raj Bhandair, the owner of a BP (BP-NYSE) gasoline station in Merrill, Wisconsin. Mr. Bhandair decided to grant two-cents a gallon discount to senior citizens and three-cents a gallon discount to people who support local youth sports programs. Under Wisconsin's Unfair Sales Act, he is required to sell gasoline for 9.18% above the wholesale price, and therefore his discounts were illegal. The Wisconsin Department of Agriculture, Trade and Consumer Protection forced Mr. Bhandair to raise his prices. Since he eliminated the discounts, some of his customers think he is now engaging in price gouging. Wisconsin legislators are looking into revising the law to enable discounts to support social programs that they believe should be supported. What a wonderful world where selling a product cheaper is considered a crime!

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Sen. Cantwell is troubled by rising gasoline pump prices when it appears there is adequate supply. She asked, "We have four refineries in Washington State, so why are our prices so high?" Based on that logic, those of us who live in Houston should be entitled to very cheap, or maybe even free gasoline. Could we convince ExxonMobil to actually pay us to use its gasoline because we have so many refineries in the area?

If the Cantwell-Stupak legislation becomes law, some observers suggest that gasoline retailers and oil companies may be advised by their attorneys to shut down their gasoline sales during periods of price volatility to avoid risking prosecution. Would the resulting gasoline lines qualify as an unintended consequence of the legislation?

If these new ethanol mandates become law, then some of the currently planned oil industry investment in new gasoline refining capacity may be deferred

What may be a bigger problem for the oil industry and gasoline suppliers, and ultimately consumers, is the wild scramble in Congress by its members to expand the current ethanol fuel use mandate. The stakes in this battle have already been raised by President Bush in his January State of the Union Address. Now, farm-belt congressional representatives and environmental leaders are pushing to up the president's production goal by substantial amounts. If these new ethanol mandates become law, then some of the currently planned oil industry investment in new gasoline refining capacity may be deferred as oil executives question whether the projected returns on their investment are worth the investment. Several government officials have already alerted Congress to this potential. If conventional gasoline refining capacity fails to grow, consumers may be worse off down the road than they are now.

Energy Ranks Low in Dividend Payouts

In 2006, gross repurchases of stocks by corporations were more than twice the amount of dividends paid to shareholders

A couple of weeks ago, *Barron's* carried an article on the stinginess of corporate America in paying dividends. The argument over how most efficiently and effectively to give surplus corporate cash back to shareholders continues with stock buybacks overwhelming dividend payouts as the vehicle of choice. In 2006, gross repurchases of stocks by corporations, which are members of Standard & Poor's 500 Index, was estimated at $494 billion, more than twice the amount of dividends these corporations paid to shareholders. It is interesting that between 2005 and 2006, the net amount of stock repurchases grew by 54% versus an 11% increase in dividends.

Exhibit 1. Buyouts Over Dividends

Buybacks Dominate

While the amount that S&P 500 companies paid out in dividends rose 10% last year, the sum they spent on buybacks jumped by almost 29%.

S&P 500	2005	2006	2007E
Gross Repurchases (bil)	$351	$494	$430
Equity Issuance (bil)	$110	123	125
Net Repurchases (bil)	241	371	305
Net Repurchase Yield	2.1%	2.9%	2.2%
Dividends Paid (bil)	$202	$224	$252
Dividend Yield	2.1%	1.8%	1.8%
Total Yield*	4.2%	4.7%	4.0%

* Dividend yield plus net repurchase yield. E=Estimate.
Source: Morgan Stanley, Strategas

Source: *Barron's*

"A lot of corporations are missing the seismic shift in retail demand for yield."

Americans over 65 years old have equity portfolios with an average yield of 2.6% compared with a 0.8% yield for those under 65

The energy sector had been a great source of dividends, but as earnings have soared, the payout ratio has fallen dramatically to under 20%

Henry McVey, chief investment strategist at Morgan Stanley (MS-NYSE), was interviewed for the article. Based on his quotes, he is clearly a believer in dividends and questions whether corporations are failing to recognize trends within the investing public. According to Mr. McVey, "A lot of corporations are missing the seismic shift in retail demand for yield." When one looks at the stock market sectors that have been performing the best in the past two years, they all provide substantial current income to their investors. These sectors include: electric utilities; real estate investment trusts; cigarette manufacturers; telecommunications providers; and energy-oriented master limited partnerships. Importantly, up until the Canadian government's decision to change the tax status of income trusts, this was one of the hottest investment sectors in Canada, and was particularly attractive for non-Canadian, largely American, investors seeking high monthly income returns. As Mr. McVey pointed out, Americans over 65 years old have equity portfolios with an average yield of 2.6% compared with a 0.8% yield for those under 65. Personally, I have talked with investors 60 years or older who have commented that they are selling their non-dividend paying holdings and replacing them with dividend paying stocks.

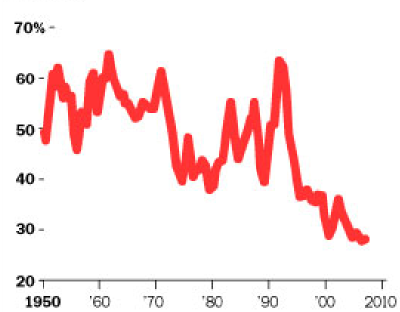
In the article, there was a table showing the dividend yield and payout ratio for the ten industry sectors that make up the S&P 500. The energy sector had the third lowest yield and the second lowest payout ratio. As the article pointed out, the energy sector had been a great source of dividends, but as earnings have soared, the payout ratio has fallen dramatically to under 20%. Energy dividends highlight the challenge company managements in cyclical industries face when earnings climb, but the risk of them falling at some point in the future remains. Should managements boost their dividends in keeping with their rising earnings, or should they keep them extremely conservative and use surplus cash to repurchase shares? What about the use of special cash dividends as a way to reward investors? There are strong arguments on both sides of this issue.

Exhibit 2. Dividend Payout Ratios Steadily Fall

Headed South

The percentage of earnings that S&P 500 stocks pay out as dividends now stands at half the level reached during the 1980s. Instead, corporations have been pouring money into share buybacks.

S&P 500 Dividend Payout Ratio
(operating)



S&P 500 Sector	– Dividend – Yield	Payout Ratio*
Telecom	3.2%	52%
Utilities	2.9	51
Financials	2.5	33
Basic Materials	2.3	35
Consumer Staples	2.3	42
Industrials	1.9	36
Health Care	1.6	31
Energy	1.5	17
Consumer Discretionary	1.1	24
Technology	0.6	15
S&P 500	1.8	30

*Dividends as percentage of annual earnings. Source: Morgan Stanley

Source: *Barron's*

By reducing shares, management can generate faster earnings per share growth than the underlying increase in net income

Managers prefer share buybacks because they stand to benefit from them more than from increased dividends. Stock repurchases shrink the number of shares outstanding. If the company has been granting large numbers of options, reducing outstanding shares through buybacks helps to offset the potential dilution from the options. By reducing shares, management can generate faster earnings per share growth than the underlying increase in net income. If a stock's valuation (the multiple of its earnings per share) remains the same, the share price should also climb faster than net income with fewer outstanding shares. For corporate managers, this is a positive because most of them hold stock options and they are usually awarded annual bonuses that often are keyed to earnings per share growth. Lastly, stock buybacks offer increased flexibility for management to stop them should business and/or market conditions change.

Lifting dividend payments is a statement that management anticipates it will continue to generate solid earnings growth

The case for dividends is more about what they say about the confidence management has in the sustainability of its business. Investors expect dividends to be maintained, short of a financial catastrophe. Companies are reluctant to cut dividends. Therefore, lifting dividend payments is a statement that management anticipates it will continue to generate solid earnings growth, or at least sustain earnings around the company's current level. As Edward von der Linde, portfolio manager of the Lord Abbett Mid-Cap Value Fund who was interviewed in the *Barron's* article, said, "Shareholders own the company. The earnings are their cash. Give it back." When challenged about the potential that the next U.S. government may wish to change the favorable taxation of dividends, he said that corporate managers should not concern themselves with the tax status of their shareholders.

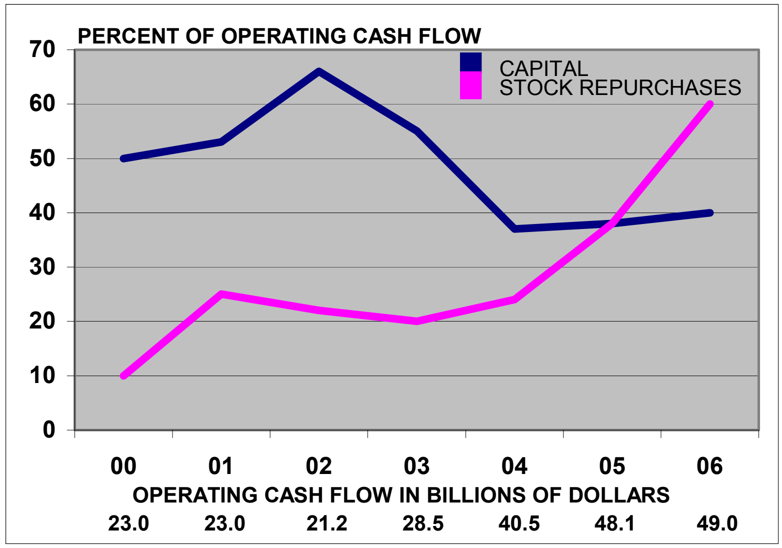
Institutional investors view stocks as a vehicle for generating capital gains

The problem with the position that cash earnings should be paid out to shareholders in the form of dividends is challenged by the impact in the stock market of the rapid growth of institutional investors. This phenomenon has altered the debate about how best to return surplus cash to shareholders for managers. Institutional investors view stocks as a vehicle for generating capital gains, but not necessarily long-term gains as studies show their average holding period is seven months. These investors are more interested in actions that can create rapid stock price appreciation. This bias is reinforced by professional money manager compensation schemes that reward them for increasing the value of their funds over short-term periods. Therefore, institutional investors tend to favor stock buybacks over dividend income because they see the former helping to accelerate stock price appreciation.

Since 1928, equities have returned 10.4% annually, with 40% of that generated by dividends

The institutional investor bias for stock buybacks runs contrary to the historic composition of the returns from equities. Since 1928, equities have returned 10.4% annually, with 40% of that generated by dividends. An interesting study of this new bias for share repurchases is the Exxon Mobil Corp. (XOM-NYSE). In 2006, ExxonMobil generated $49 billion in operating cash flow and was the most profitable corporation in America when measured by absolute dollars of profit. But the company has been slow to ramp up its capital spending as crude oil prices have climbed in recent years, engendering bitter attacks from politicians in light of the sharp rise in gasoline prices.

Exhibit 3. ExxonMobil Emphasizes Stock Buybacks



Source: *Business Week*, ExxonMobil, PPHB

The amount of money ExxonMobil spent in stock repurchases is up tenfold since 2000

Last year, ExxonMobil invested only 40%, or $20 billion, of its operating cash flow in new capital expenditures while spending almost 60%, or $29 billion, in buying back shares. The amount of money spent in stock repurchases is up tenfold since 2000. Over the past five years, the company has retired 16% of its outstanding shares, adding an estimated $0.88 to earnings of $6.68 per share, a 15% increase. Over the past decade, according to *Business Week*, ExxonMobil's stock price has handily beaten the overall market and its peers with a 15% annual return. At the same time, ExxonMobil's current yield is a mere 1.7%. Although ExxonMobil's current yield exceeds the yield of the entire Energy sector of the S&P 500, it pales in comparison to other major oil companies such as BP's (BP-NYSE) 3.7%, Royal Dutch Shell's (RDS.B-NYSE) 2.9%, Chevron Corp.' (CVX-NYSE) 2.9% and ConocoPhillips' (COP-NYSE) 2.2%.

The S&P 500 payout ratio – the percentage of earnings paid out to shareholders – has been in an almost steady decline since the mid-1980s

When we consider the present dividend outlook for the S&P 500, its current yield is about 1.8%. The yield on the Dow Jones Industrial Average group of stocks is slightly higher at 2.1%. On the other hand, the growth stocks represented in the S&P small- and mid-cap stock indexes yield only about 1%. These low yields reflect the focus managements have put on stock buybacks and in some cases more aggressive capital expenditures, over dividends. The S&P 500 payout ratio – the percentage of earnings paid out to shareholders – has been in an almost steady decline since the mid-1980s. Prior to the 1980s, stock repurchases were rare and companies paid out over half their earnings in dividends.

We have previously discussed the use of special dividends as a strategy for returning cash as it relates to the offshore contract drillers. Diamond Offshore (DO-NYSE) has been using that technique for the past two years, as Chairman James Tisch wants to enable shareholders to determine what to do with the cash – pocket it or use it to buy more shares. It was pointed out in the *Barron's* article that special annual dividends were common among cyclical companies in the 1950s and 1960s. As University of Pennsylvania professor Jeremy Siegel notes, "General Motors (GM-NYSE) used to do it all the time. It was like a Christmas present to shareholders."

Special annual dividends were common among cyclical companies in the 1950s and 1960s

In 1980, 94% of the companies in the S&P 500 paid dividends, but today that ratio is down to 77%. Only 387 companies of the 500 in the index pay dividends. As *Barron's* points out in its article, of the 6,000 companies listed for trading on the New York Stock Exchange, the NASDAQ or the American Stock Exchange that aren't included the S&P 500, only 40% pay dividends. So despite the favorable taxation treatment of dividends and the decision by some major corporations to institute dividend payouts after having been long-term holdouts, Microsoft (MSFT-NASDAQ) being the classic example, dividends remain out of favor. However, as the Baby Boomer generation ages and increasingly shifts its portfolios into dividend-paying stocks, as my friends and relatives are doing, will there develop a noticeable difference in the price-performance of dividend-paying versus non-dividend-paying stocks? If so, companies may want to reconsider their dividend versus stock repurchase strategies. In fact, they may want to actually develop a defined dividend payout policy as a signal to potential future shareholders of their investment attractiveness.

Companies may want to actually develop a defined dividend payout policy

Halliburton Targets Opportunities in the East

Several weeks ago, Halliburton Company (HAL-NYSE) CEO David Lesar announced that he would be moving his office and the corporate headquarters to Dubai. The announcement generated significant outcries from Washington politicians who accused the company of running away from its responsibilities related to Iraq, even though the separation of KBR (KBR-NYSE) from Halliburton removed its involvement in those contracts, and abandoning the U.S. and avoiding taxes, all of which are false. Halliburton is remaining a U.S. corporation and will pay U.S. taxes, although Mr. Lesar and certain subsidiaries of the company will face reduced taxes by living and conducting business in Dubai. What is true is that Halliburton is aggressively acting to reposition the company into the center of what will become its dominant future profit center – the Eastern Hemisphere.

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In an interview with a group of financial reporters, some of which was reported in a story in last week's *Wall Street Journal*, Mr. Lesar disclosed several other corporate objectives that may raise further questions about the company's long-term corporate strategy. Mr. Lesar indicated that the company was exploring dually listing its

Dave Lesar's other stated desire is attracting Middle East investors to take a "major" stake in Halliburton

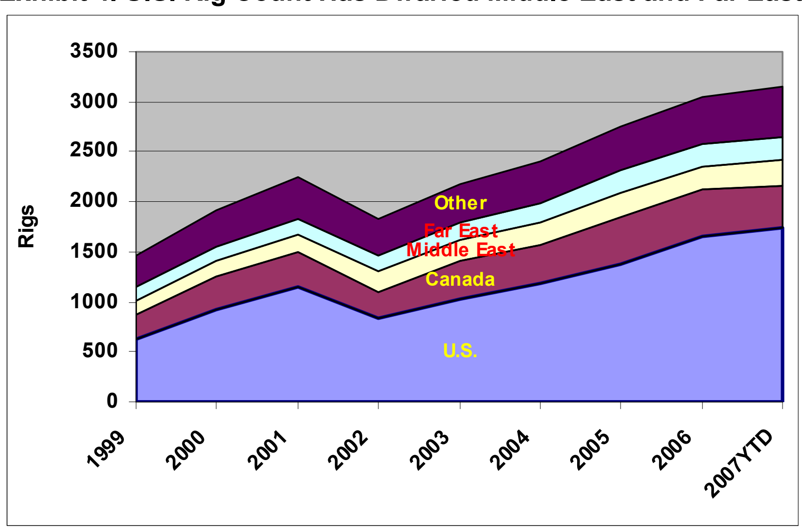
shares on the Dubai stock exchange along with maintaining its New York Stock Exchange listing. This move is likely designed to accommodate his other stated desire of attracting Middle East investors to take a "major" stake in Halliburton. The goal in attracting one or more large Middle East investors is partly to soften the company's American image and also to help it gain business in this increasingly competitive market.

In contrast to its larger global competitor, Halliburton earned only 15% of its operating income, or $506 million, from the Middle East and Asia region in 2006, compared to Schlumberger Ltd.'s (SLB-NYSE) 28%, or $1.29 billion. Mr. Lesar pointed out that Halliburton is targeting $80 billion of new oilfield projects over the next five years with 75% in the Eastern Hemisphere, mostly in the Middle East. To secure and execute these projects, the company will need to hire thousands of new engineers and workers, many of whom will come from the region, along with investing in significant additional operational capabilities. Mr. Lesar said that Halliburton has already hired 4,800 of its planned 14,000 new workers this year, with a vast majority from Eastern Hemisphere countries.

The average annual Middle East drilling rig count since the last oil industry bust experienced in 1998 has advanced by 83% through April 2007

As the Middle East and Far East regions gain in importance in the future of the global oilfield industry, it is instructive to examine the role these regions have played in the growth of oilfield activity in recent years. If we look at the average annual Middle East drilling rig count, as reported by Baker Hughes (BHI-NYSE), since the last oil industry bust experienced in 1998, it has advanced by 83% through April 2007. While the region's rig gain has been impressive, and is destined to rise further due to new long-term contracts that have been secured in the region but for which rigs have yet to arrive, the worldwide rig count is up 113% over the same time period. The rig growth rate difference is due to the 180% increase in the U.S. rig count.

Exhibit 4. U.S. Rig Count Has Dwarfed Middle East and Far East

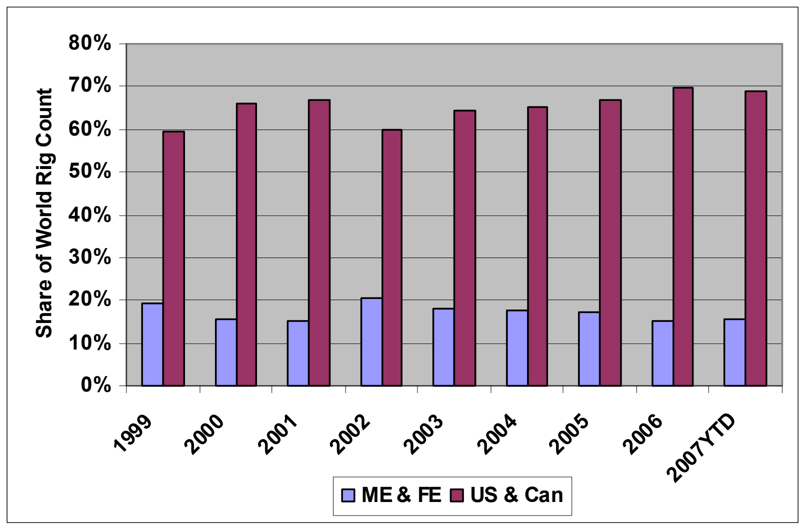


Source: Baker Hughes, PPHB

Over the past eight years, not only has the U.S. rig count increased 180%, but the North American share of the world rig count has expanded from 60% in 1999 to 69%, currently

One of the criticisms of Halliburton's corporate strategy is that the company has relied too heavily on its North American business to drive its profitability. While true, there is little doubt that the growth in unconventional natural gas resources in the United States has been helped by the increased use of pressure pumping services. These services have been at the core of Halliburton's business since its founding in the 1920s, and remain its primary business. Over the past eight years, not only has the U.S. rig count increased 180%, but the North American share of the world rig count has expanded from 60% in 1999 to 69%, currently. The importance of the combined Middle East and Far East markets in the worldwide rig market has ranged between 15% and 19%. The interesting trend is that in years when the North American market share has dipped, the steady growth of the combined Middle East and Far East markets has boosted its relative share. This explains the wide range in market share these regions account for in the worldwide total.

Exhibit 5. Middle East and Far East Market Share Lags



Source: Baker Hughes, PPHB

As Middle East and Far East oilfields age, the state oil companies that control the bulk of these reserves will be employing more technology, which plays to Halliburton's business strengths. For instance, there will be more horizontal drilling and lower quality reservoirs will need more stimulation to help them flow. These are just two of the technologies where Halliburton excels.

Oilfield service companies will increasingly need to align themselves with national oil companies

We have stated before, the history of the oilfield service industry can often provide insight as to its future. As the industry emerged in the first half of the last century from the oil fields of Pennsylvania, Oklahoma, East Texas and California, it followed its customers beyond the U.S. shores to foreign locations. Now that western oil companies are less able to participate in many of the growing new petroleum markets around the world, oilfield service companies will increasingly need to align themselves with national oil companies.

Managements may want to move closer to the action, and that will encourage more companies to make the move Halliburton is undertaking

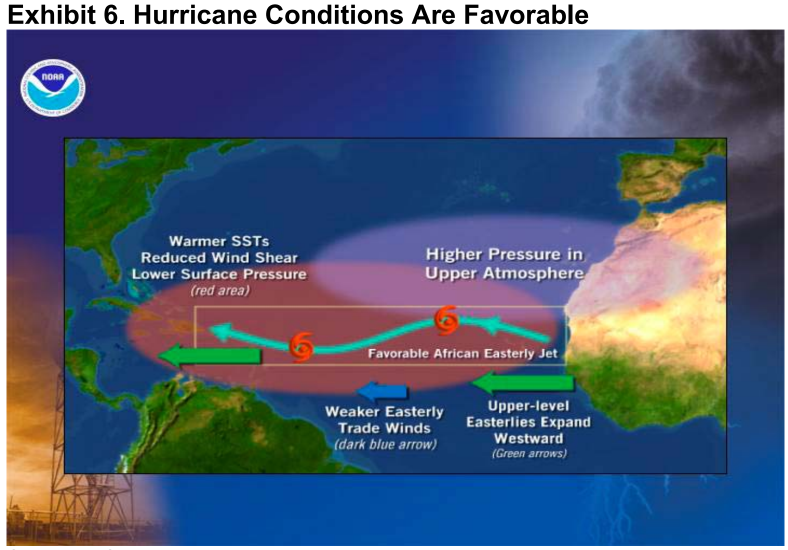
The oil industry shift from the Western Hemisphere to the east will push more and more of the oilfield service industry's assets and intellectual capital eastward, too. As that shift occurs, managements may want to move closer to the action, and that will encourage more companies to make the move Halliburton is undertaking. As oilfield service company managements retire and new managers assume leadership, watch for the pace of this shift to pick up speed. (As an aside, we noted a news item last week that pointed out more Chinese analysts will sit for this year's Chartered Financial Analyst exam than U.S. analysts. Even Wall Street is seeing the eastward shift of its business.)

More Hurricane Forecasts; Same Conclusion

NOAA and Accuweather.com have similar hurricane predictions

Last week two more weather forecasters weighed in with their 2007 Atlantic hurricane season predictions. They do not differ materially from the earlier forecast from Colorado State University. Both the National Oceanic and Atmospheric Administration (NOAA) and Accuweather.com have similar predictions for the number of named storms and major hurricanes to be experienced this year. The forecasts are similar because all the weather forecasters are looking at the same sets of data: the ongoing multi-decadal signal that reflects the ocean and atmospheric conditions that influence the formation of hurricanes; the warmer water temperatures of the Atlantic Ocean; and the El Niño/La Niña cycle.

Exhibit 6. Hurricane Conditions Are Favorable



Source: NOAA

NOAA's forecast says there is a 75% probability of an above-normal hurricane season and it calls for 13-17 named storms, 7-10 of them becoming hurricanes and 3-5 of those becoming major hurricanes of Category 3 or greater. Joe Bastardi, Accuweather.com's hurricane forecaster anticipates 13-14 named storms with at least 3 major hurricanes. He is more focused on the potential for hurricane landfall on various parts of the Atlantic and Gulf coasts. Mr. Bastardi expects the prime target landfall area to extend from the mouth of the Mississippi River eastward and then north to Cape Hatteras, North Carolina, with the central focus being Florida.

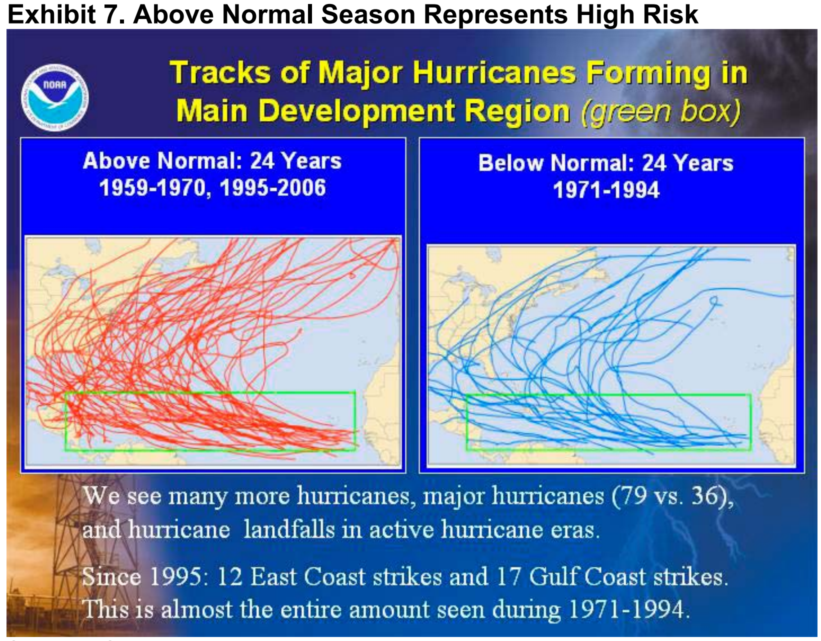
The ability to project storm courses a long time before they unfold is virtually impossible

Spokesmen for NOAA admit that it does not attempt to project the landfall exposure of the American coast line. Although they recognize that this is a very important consideration, they believe the ability to project storm courses a long time before they unfold is virtually impossible. However, for residents, first responders and insurance companies, having this knowledge would greatly improve their ability to absorb storm hits with minimal loss of life and reduced damage. It is the importance of this forecasting need that has led long-time hurricane forecaster, Dr. William Gray of Colorado State University, to turn over primary hurricane forecasting to his partner, Phil Klotzbach, while concentrating on improving the center's landfall prediction model. Improving our hurricane landfall forecasting ability could actually prove of greater value than improving the forecasting of the number of hurricanes each year.

If La Niña forms, NOAA believes the number of storms and hurricanes experienced this season would be at the upper end of its forecast range

The 2007 hurricane season may represent a challenge for forecasters due to the issue of the emergence of La Niña. As NOAA forecasters said, there is the potential for the formation of La Niña within the next one to three months. If it forms, NOAA believes the number of storms and hurricanes experienced this season would be at the upper end of its forecast range, or possibly above it. However, they believe that even if La Niña doesn't form, 2007 will still experience an active storm season.

Exhibit 7. Above Normal Season Represents High Risk



Source: NOAA

An important point NOAA makes about an above normal storm season is the impact for storm landfalls. Last year, as Joe Bastardi predicted, there was a greater risk of storms hitting the East Coast rather than the Gulf Coast as occurred in 2005. Notice, as the charts in Exhibit 7 show, during above-normal years, more storms track over the U. S. coast, while in below-normal years fewer storms hit land. We experienced a below-normal hurricane season last year, which was even more unusual as no storm landed on the U.S. coast and most of the storms tracked further eastward and became exhausted over the North Atlantic. NOAA cautions that this year's sub-tropical storm, Andrea, which formed in May, is not a predictor of the strength of the 2007 hurricane season that starts June 1. An active hurricane season will help support high oil and gas prices as commodity traders fear the potential impact on supply from production disruptions and longer term outages due to facility damages. If these fears become reality, we will clearly experience oil and gas price spikes that will provide a challenge for the U.S. economy.

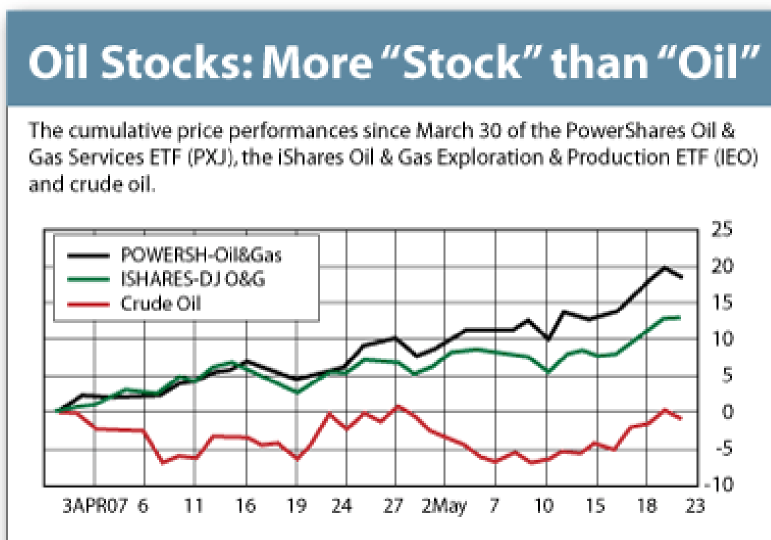
An active hurricane season will help support high oil and gas prices

Warning Flags for Oil Investments?

The performance of oil stock investments is diverging from the short-term trend in crude oil prices

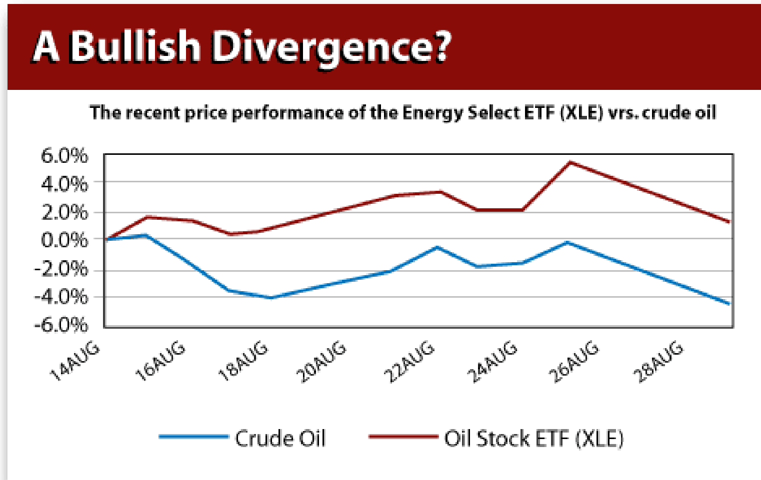
A financial newsletter recently pointed out that the performance of oil stock investments, in this case the PowerShares Oil & Gas Services ETF (PXJ) and the iShares Oil & Gas Exploration & Production ETF (IEO), is diverging from the short-term trend in crude oil prices. They pointed out that this also happened in August 2006 when they plotted the performance of the Energy Select ETF (XLE) against crude oil prices. The authors of the newsletter speculated on how to possibly explain this divergent performance. They offered up three explanations: 1) Just because; 2) Oil stocks are "anticipating" higher future oil and gas prices; and 3) Crude oil has nothing to do with the performance of oil stocks for the moment.

Exhibit 8. Oil Stocks and Crude Oil Diverge



Source: Energy and Capital

Exhibit 9. The 2006 Oil vs. Oil Stock Performance

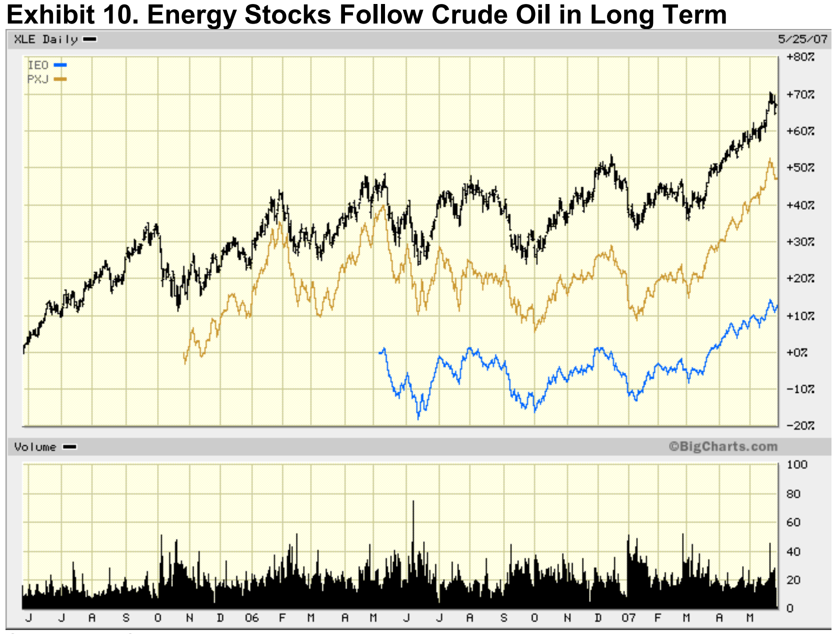


Source: Energy and Capital

It is impossible to imagine that oil and oil service stocks can diverge for any extended time period from the strength or weakness of crude oil and natural gas prices

When one looks at the short-term performance of oil stock investments, or almost any stock sector, it often may diverge from the performance of its underlying fundamental drivers for short periods of time. It is impossible to imagine that oil and oil service stocks can diverge for any extended time period from the strength or weakness of crude oil and natural gas prices, since these commodities generate the cash flows and provide the investment opportunities that drive the business and generate the profits of energy companies. However, for short-term energy investors, i.e., traders, these divergent performance patterns can often provide signals for trading the stocks.

Exhibit 10. Energy Stocks Follow Crude Oil in Long Term



Source: Big Charts, PPHB

When one examines the long-term price trend for these three oil and oil service ETFs, it becomes clearer that the stocks do follow the general trend in oil and gas prices. On August 14, 2006, the near-month crude oil futures price was $73.53 per barrel, which subsequently declined to $70.03 on August 30. But more importantly for investors was the fact that crude oil futures declined to a low of $55.81 on November 17, and closed out 2006 at $61.05. When one looks at the stock market performance of all three ETFs (Exhibit 10), they peaked out in August and followed crude oil down in September, but bottomed out and began to move higher starting in October and continued up until mid December. Clearly, investors who were buying oil and oil service stocks in the early fall of 2006 were focused more on future oil and gas prices (they usually strengthen as we move into winter), the lack of surplus crude oil supply to meet rising global demand and the scenario that stronger oil and gas prices would encourage the oil industry to ramp up its capital spending, benefiting the oil service companies. Those investors proved right on all counts, and energy stock prices rose.

Investors who were buying oil and oil service stocks in the early fall of 2006 were focused more on future oil and gas prices

At the present time, global geopolitical trends continue to support high crude oil prices. The big question mark is whether high crude oil and natural gas prices will begin to undercut demand growth. In the short-term, sharply higher oil and gas prices often do not impact demand materially. It is only as consumers sense that high product prices are becoming the norm that they adjust their consumption habits. History shows that the explosion in oil prices experienced by the world in the mid- and late-1970s ultimately led to a four-year period of falling energy consumption in the early 1980s. That fall in demand, coupled with growing in new oil supplies from non-OPEC sources, created the oil price collapse in the mid-1980s as OPEC tried to establish production discipline among its members.

We should not be surprised if Wall Street decides to take some of its energy investment profits

The bottom line from this examination of the performance of oil stocks versus crude oil prices suggests we should not be surprised if Wall Street decides to take some of its energy investment profits and goes home for the summer.

Another Industry Giant Steps Down

Carl Thorne had led offshore driller Ensco for the past 20 years since the company's emergence from the ashes of former land-driller, Blocker Energy

Last week following its annual meeting, Ensco International (ESV-NYSE) directors selected a new chairman to replace the retiring former non-executive chairman, Carl Thorne. Mr. Thorne had led the offshore drilling contractor for the past 20 years since the company's emergence from the ashes of former land driller, Blocker Energy, a company with a colorful history. (In full disclosure, I worked for Ensco for three years in the early 1990s, holding the title of Corporate Secretary along with having various responsibilities within the finance department, headed by now Halliburton Company CFO Cris Gaut.) At the time, Ensco was struggling to acquire the offshore drilling rig fleet of the Penrod Drilling Company that had been one of the key assets of the H. L. Hunt Empire, controlled by bothers Bunker and Nelson, which had failed in the oil and metals market collapse in the late 1980s. The Penrod transaction became the defining event in the transformation of Ensco from a tiny factor in the oilfield service industry to its position as a major player in the global offshore drilling business.

From managing the insurance function to spearheading the growth of the company's Middle Eastern drilling operations up until the fall of the Shah of Iran in 1979, Carl Thorne played an important role in the growth of Sedco

Most readers probably only know Carl Thorne from his intimidating presence and deep, gruff voice, but he is one of the most caring and kindhearted men I have ever known and had the pleasure of working with and for. Most readers may not know that Carl Thorne came from the oilfield by way of Baylor Law School and stopped in Dallas to interview with a then small drilling company while on the way with his wife, Rosella, to a fellowship to study tax law in New York City. (Can anyone imagine Carl Thorne living in New York City?) The small Texas driller, Southeast Drilling Company, founded by Bill Clements, evolved into one of the world's leading drilling companies known as Sedco. From managing the insurance function to spearheading the growth of the company's Middle Eastern drilling operations up until the fall of the Shah of Iran in 1979, Carl Thorne played an important role in the growth of Sedco. Sedco was known for its drilling innovations and its focus on establishing long-term markets and solid customer relations.

Sedco was also known for its conservative financial strategy. New offshore drilling rigs were only built with long-term contracts in place that returned most of the initial cost of construction. As the cost of new rigs escalated, the length of Sedco's contracts grew. From two years to three to five and even ten years, the contracting strategy never wavered. At the end, Sedco created its last class of rigs – the 700 series – in partnerships with many of its oil company customers. Sedco was known for its attention to detail, and the terms of contracts was one of those areas overseen by Mr. Thorne. With the industry recession in the mid-1980s, Sedco was the only offshore driller I knew not to have its contracts broken by the oil companies.

As Mr. Thorne enjoyed telling investors in the early years of Ensco's existence, they didn't start in a hole, they started under a hole!

In the early 1980s, Sedco was purchased by Schlumberger for about $1.2 billion, only to have about $800 million of the value written off several years later after the collapse in global oil prices. It was not too long after his contractual commitment with Schlumberger was over that Ft. Worth investor Richard Rainwater approached Mr. Thorne about participating in some potential oil company takeover ventures he was contemplating. During their discussions, Mr. Rainwater tabled the idea of creating a new, world-class drilling contractor. The next thing Carl Thorne knew was that Richard Rainwater called him to announce he had gained control of Blocker Drilling and needed him to run it. As Mr. Thorne enjoyed telling investors in the early years of Ensco's existence, when its business consisted of a few highly mobile, land-drilling rigs in South Texas, an oilfield supply business, a directional drilling company and a small offshore supply vessel fleet, they didn't start in a hole, they started under a hole!

I had become acquainted with Mr. Thorne when he was a part of the

Sedco management, as I followed the company as a Wall Street oil service analyst. After Sedco was sold, I watched for Mr. Thorne to resurface, and when he did at Blocker, I seized the opportunity to establish research coverage on the company before it morphed into Ensco. My friendship with many of Ensco's managers and my analyst position provided me a unique perspective on Carl Thorne's vision for the company, and when the opportunity to join him developed, I made the move. It was a great learning experience, and I thank him for that education.

Methodically, and with incredible patience and vision, Carl Thorne set about, with the help of a small group of incredibly loyal friends, advisors and co-workers, to build Ensco into a world-class offshore contract driller

Methodically, and with incredible patience and vision, Carl Thorne set about, with the help of a small group of incredibly loyal friends, advisors and co-workers, to build Ensco into a world-class offshore contract driller. Regardless of the condition of the oil industry, Ensco was always managed with a view toward long-term wealth creation. That meant making sure the financial condition of the company was sound. It meant investing wisely in the company's assets – both people and equipment. It meant maintaining solid relationships with customers. It meant maintaining integrity with all the company's stakeholders. And it meant that the interests of the shareholders remained uppermost in the minds and actions of the management.

These principals have guided the operation and growth of Ensco over its 20-year existence. The people Carl Thorne attracted to Ensco are well schooled in these principals and I expect they will continue to adhere to them in the future. Personally, it is a sad day to see my great friend, Carl Thorne, leave the Ensco stage. But I am sure that no longer having to bear the burden of making those tough decisions that CEO's are called upon to make will enable him to relax and enjoy life. Happy trails, Carl!

Gasoline Prices Soar – Public Upset

In a shocking move, gasoline prices jumped 25% overnight last Tuesday and drivers were caught by surprise and were very angry. Downtown Houston? No. Downtown Tehran! But the more important consideration may be that the Iranian government is finalizing quotas to implement gasoline rationing in the country, although newspaper and intelligence agency reports since last February have discussed that rationing – official and unofficial – has been underway in more remote areas of the country.

Mr. Simmons outlined his view that Americans are headed for a critical summer in which gasoline consumption outruns the oil industry's ability to supply it

According to Matt Simmons' outlook for the U.S. gasoline market, the scene we are witnessing in Iran may be repeated here sometime after Labor Day if our gasoline demand continues to soar as it has been so far this year and supplies remain restricted. Mr. Simmons authored an article in mid May outlining his view that Americans are headed for a critical summer in which gasoline consumption outruns the oil industry's ability to supply it. The potential for fuel shortages will only be alleviated if gasoline pump prices are allowed to rise, cutting demand. At the moment gasoline prices certainly are on the rise! Since the start of this year, the average unleaded regular gasoline pump price has jumped 39.5% through last week.

We needed an increase of 4 million barrels last week to merely match the lowest pre-Memorial Day gasoline inventory experienced during the past 17 years

Mr. Simmons used recent gasoline inventory figures and their trend since earlier in the year to highlight the problem. He compared inventory trends to the level of pre-Memorial Day inventories in previous years. While we still have one more week's gasoline inventory data to be released (for the week of May 25), the figures suggest that we needed an increase of 4 million barrels to merely match the lowest pre-Memorial Day inventory experienced during the past 17 years (200.7 million barrels at May 30, 1997).

Exhibit 11. Pre-Memorial Day Gasoline Inventory

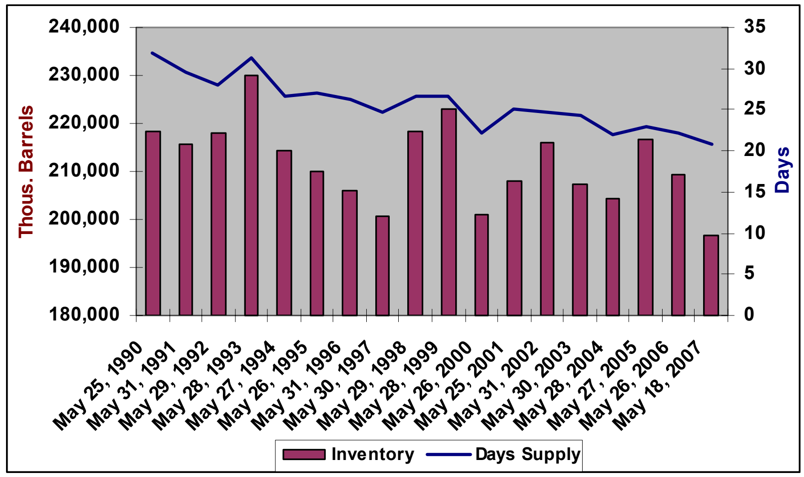
Date	MM Bbls
May 25, 1990	218.5
May 31, 1991	215.7
May 29, 1992	218.0
May 28, 1993	229.9
May 27, 1994	214.4
May 26, 1995	210.0
May 31, 1996	206.1
May 30, 1997	200.7
May 29, 1998	218.2
May 28, 1999	223.0
May 26, 2000	201.1
May 25, 2001	208.0
May 31, 2002	215.9
May 30, 2003	207.3
May 28, 2004	204.3
May 27, 2005	216.7
May 26, 2006	209.3
May 18, 2007	196.7

Source: EIA, PPHB

We have lost almost one and a half days of supply since this time last year

A potentially greater problem is the numbers of days of supply available today. It is the Minimum Operating level of our gasoline supply system that Mr. Simmons focused on. That number represents the point at which the entire gasoline distribution chain begins to break down. That number hasn't been rigorously updated since the National Petroleum Council study completed in 1988. The scary thing about the latest gasoline inventory figures is that the days of supply (total inventory divided by weekly consumption) suggests that we have lost almost one and a half days of supply since this time last year. As the composition of gasoline becomes more complex due to the increased use of ethanol and other boutique fuel requirements, the ability to supply all markets with their desired volumes may become impossible. That means gasoline station shutdowns along with sharply higher prices are a distinct possibility.

Exhibit 12. Days Supply of Gasoline Continue to Fall



Source: EIA, PPHB

Will we find that once again heroic efforts by the petroleum industry will enable the system to muddle through with no real suffering for consumers?

Should we be as concerned about the gasoline supply situation as Mr. Simmons, who also announced he drove a diesel vehicle and thus was less at risk of fuel shortages? Or will we find that once again heroic efforts by the petroleum industry will enable the system to muddle through with no real suffering for consumers? There is little doubt that our gasoline supply chain is fragile and at risk of a major problem if some component of the chain fails. Mr. Simmons argues that the industry needs to take several steps, plus have some good luck, in order to muddle through. One action is for the industry to ramp up its refinery output to 16 million b/d from the early May run-rate of barely 15 million b/d. (Last week, we saw refinery output at 15.7 million b/d, and a 91.1% national refinery utilization rate.) Another action is to increase gasoline imports to 1-1.5 million b/d, which would reach the historic import peak experienced last year. (Last week, we imported 1.3 million b/d.) We also cannot be hit by any hurricanes. Lastly, we will need to draw down our stocks of gasoline as a last resort to meet demand. One of the greatest problems with this prescription is that the lower we draw inventories to meet gasoline demand this summer, the greater the hurdle we face in building them up before the 2008 driving season starts.

It is impossible to assure that the entire aging gasoline infrastructure will function without a hitch throughout this summer

The odds are very high that we will have spot gasoline outages as it is impossible to assure that the entire aging gasoline infrastructure will function without a hitch throughout this summer. Several years ago there was a gasoline pipeline rupture in a line that supplied Phoenix. To supply that market, gasoline had to be trucked in coupled with reversing the flow of a pipeline that moved gasoline volumes westward into Southern California. Shortages developed in both regions. Those sorts of emergency supply responses can only work as long as the gasoline specifications in each market are similar. One may remember that the Bush Administration ordered the suspension of specific fuel mandates following Hurricane Katrina in order to ease the immediate gasoline supply problems caused by the Gulf Coast refinery shutdowns had on national fuel supplies.

The regulatory system that has allowed the proliferation of boutique motor fuels across the country has upped the odds that our gasoline supply system will fail somewhere, sometime. Cross your fingers and toes and hold your breath for the next three months. Of course, if you do that, you probably won't drive much, which will certainly help ease our supply/demand tightness.

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

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