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ENERGY INVESTMENT BANKING, LP

MUSINGS FROM THE OIL PATCH
July 10, 2007

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

Mexico's Outlook: Calderon versus Standard & Poor's

Does S&P know something neither we nor Mr. Calderón know?

Last week Standard & Poor's (S&P) revised its ratings outlook for Mexico's state-owned oil company, Pemex, to positive from stable. This upgrade was similar to its previous action boosting the country's sovereign ratings. S&P said in a statement that the ratings of Pemex and Mexico are linked because of the government's ownership of the company, the importance of Pemex to the Mexican economy and the government's heavy dependence on oil-related revenue. We found S&P's action both interesting and intriguing, given a speech the president of Mexico made only a few days before. Does S&P know something neither we nor Mr. Calderón know?

Is S&P ignoring the long-term outlook for Mexico's petroleum industry, and its potentially devastating economic, financial and social impact on the country?

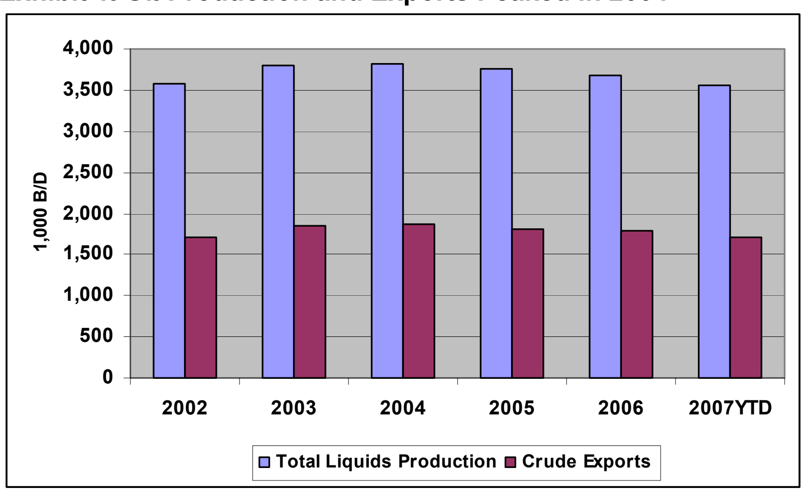
In that speech, President Felipe Calderón said he expected Mexico's crude oil exports to slip further this year and next, underscoring the need for fiscal reform to make the country less dependent on oil revenues. One has to wonder how S&P can be increasing the credit ratings of Mexico and Pemex while the country's president is suggesting that the strength justifying the upgrade is actually a weakness that needs correcting. Has S&P succumbed to the short-term-focused mentality of Wall Street? Do they have their head down looking only at the current financial numbers, which clearly have to look good given current oil prices, while ignoring the long-term outlook for Mexico's petroleum industry, and its potentially devastating economic, financial and social impact on the country?

In his speech, Mr. Calderón stated, "Starting in 2006, the volume of our [oil] exports has been falling at an alarming rate and from what we have observed up until now, this year and the next will be no exception." He went on to say, "It's time we transformed this dependence on oil before it's too late. It's essential that we find more stable sources of financing." Since Mr. Calderón was the energy minister under the previous government, he has a clear understanding of the challenge Pemex faces in trying to sustain its production. Moreover, we suspect, Mr. Calderón has a greater appreciation for the potentially explosive economic and social situation Mexico will confront if Pemex cannot stem the decline in its oil production and oil exports.

The primary reason for the lower crude oil production is the deteriorating outlook for Mexico's principal oil field, Cantarell

Mexico's production appears to have peaked in 2004 when it averaged 3.383 million barrels per day (b/d) of crude oil, but excluding the roughly 400,000 b/d of natural gas liquids (NGLs). By 2006, oil production had fallen by 3.7% from the 2004 average. The average production for the first five months of 2007 experienced a 5.8% decline from the same period in 2006, and the May year-over-year decline was 6.6%. The primary reason for the lower crude oil production is the deteriorating outlook for Mexico's principal oil field, Cantarell. In mid 2006, Pemex disclosed that it was forecasting a 6% decline in Cantarell's production to 1.905 million b/d for that year, and it anticipated production in 2007 and 2008 to average 1.683 and 1.430 million b/d, respectively. Earlier this year, Mexico's oil minister announced that Cantarell's production actually was 1.788 million b/d for 2006 and that he expected it to fall to 1.526 million b/d for 2007.

Exhibit 1. Oil Production and Exports Peaked in 2004

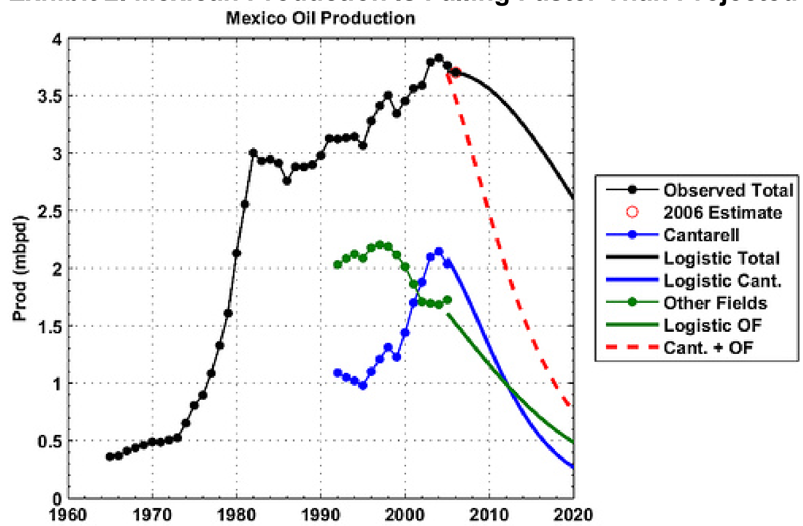


Source: Pemex, PPHB

Mexico's oil production is falling faster than projected in Pemex's 2005 forecast

As shown in Exhibit 2, Mexico's oil production is falling faster than projected in Pemex's 2005 forecast. The red circle shows the 2006 estimate, which was slightly higher than actually reported for crude oil and NGLs. So far for the first five months of 2007, the total liquids production average of 3.566 million b/d is about on the dotted red line, and considerably below the black line forecast. May's total production was 43,000 b/d below the five-month average. Looking at the decline in production suggested by the dotted red, total production will only be 2.5 million b/d in 2010. If we assume NGLs remain at roughly 400,000 b/d and that domestic consumption grows by 2% (it averaged a 1.9% annual increase over 2002-2007) per year in 2008-2010, that would leave about 230,000 b/d for export.

Exhibit 2. Mexican Production Is Falling Faster Than Projected



Source: TheOilDrum.com

Pemex plans to start drilling its sixth deepwater well immediately following completion of the fifth

The collapse in Cantarell's production is placing great pressure on Pemex to step up its deepwater drilling program where the company believes the bulk of the country's remaining undiscovered oil and gas reserves are located. Pemex plans to start drilling its sixth deepwater well immediately following completion of the fifth well, which is currently being drilled. So far, the first four wells have discovered oil and gas, although the exact amounts and any plans for their development have not been disclosed.

Pemex is accelerating its program of revamping older producing fields

At the same time, Pemex is accelerating its program of revamping older producing fields. The latest program calls for drilling new wells and employing technologies to limit the amount of sand and water being produced in its southern oil fields. The fields in this area are generally about 30 years old and the total production of 469,000 b/d is off by about 80,000 b/d since 2000. The plan for this work is scheduled to be ready for tender before the end of the year.

The result of declining oil production has been a fall in oil exports. After peaking in 2004 at 1.87 million b/d, exports dropped slightly in 2005, but primarily due to impacts from the hurricanes. But starting in 2006 and continuing up to now, crude oil exports have been dropping. The average volume of oil exports for the first five months of this year shows a 156,000 b/d decline from the average for 2004, or an 8.3% decline. The decline in oil exports to the United States has been 147,000 b/d, or nearly a 9% drop over this same period.

Mexico represents the second largest source of imports for the United States, and certain Gulf Coast refineries have been specially designed to process the heavy, high metallic-content Maya crude oil, which accounts for slightly over 86% of Mexico's export volumes. The loss of this oil would be a serious blow to U.S. petroleum supply, along with creating a significant refining capacity challenge.

Pemex's revenues account for 40% of the federal budget

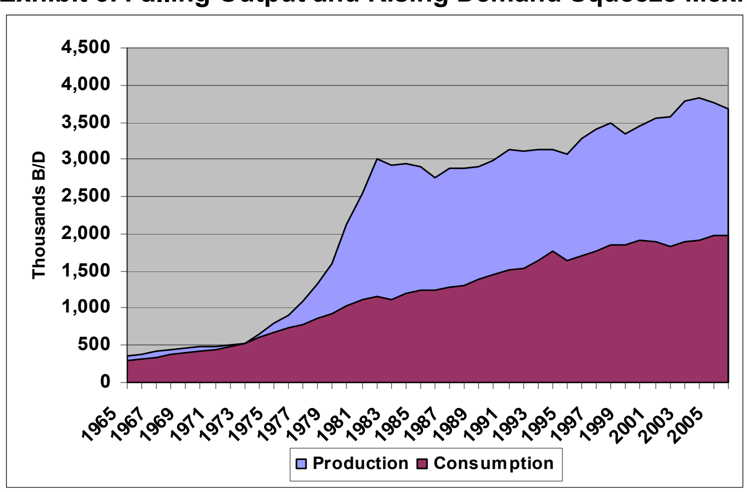
The big problem for Mexico is the implication for its economy if this accelerating decline in the country's crude oil production continues, or worsens as has been the case for the past year or more. In 2006, Pemex's revenues were $97 billion, of which $79 billion went to the government, accounting for 40% of the federal budget. Unless crude oil prices climb at a faster rate than oil production falls, the Mexican government could be looking at evaporating income from Pemex.

Pemex has set an exploration and development budget of $14 billion for 2007, but this is probably not sufficient if it wants to sustain its production. Because the Mexican constitution prohibits the involvement of private companies, Pemex has a difficult time gaining access to the technologies and talents needed to find and develop new deepwater fields and sustain onshore oil and gas production. This situation almost guarantees that Mexico will face financial pressures in the future from its declining oil production. As these financial pressures mount, the government might have to cut social welfare spending.

Mr. Calderón has been forced to send in military troops and federal police to back up, or replace, local police in various cities in the northern provinces of Mexico

Since Mr. Calderón assumed office in 2006, his focus has been on controlling the country's drug lords. He has purged 284 commanders from the top ranks of Mexico's federal police forces as part of an effort to contain corruption and halt the underground war between drug traffickers. As a result of the battles between rival drug lords and their attacks on the press and police, Mr. Calderón has been forced to send in military troops and federal police to back up, or replace, local police in various cities in the northern provinces of Mexico. These actions against the drug traffickers have unleashed the worst wave of drug-related violence in Mexico's history.

Exhibit 3. Falling Output and Rising Demand Squeeze Mexico



Source: BP, PPHB

The scenario of declining oil income pressuring welfare spending, coupled with an escalating war between drug lords and the government, suggest that living conditions in Mexico could deteriorate rapidly. At the same time, Mr. Andrés Manuel López Obrador, the socialist former mayor of Mexico City, who lost by less than one percent of the vote to Mr. Calderón in last year's election, is still holding rallies among his supporters. Although Mr. Calderón's popularity has climbed to 65% due to his fighting the drug lords, it could evaporate if the government's financial health is compromised and he is forced to cut social welfare spending. Mexico could be on the brink of a revolution. In that scenario, it is not hard to imagine a greater than normal number of Mexicans heading for the U.S. border. Given the political battle in the U.S. over securing the Mexican border, could a wave of additional illegal immigrants provoke a border clash between Mexico and the United States? Our guess is that S&P has either never thought about this scenario or has dismissed it, as it would certainly impact our view of the credit worthiness of Mexico and Pemex.

Mexico could be on the brink of a revolution

Energy Executive Compensation in the Houston News

The enhanced rules for public company financial disclosure of executive compensation have exposed more about the make up and magnitude of current and potential pay. The debate about the perceived income equality gap has become front page news. With this greater attention has come increased scrutiny by Congress. Recently, in hearings before the House Financial Services Committee, Chairman Barney Frank (D-Mass) argued that Congress should get involved in regulating executive compensation, which may have brought cheers from the compensation consultants until they realized the amount of money they get paid by corporations and the compensation committees of boards of directors.

Given the recent focus on executive pay, this year's *Houston Chronicle* analysis of the compensation of the 100 highest paid executives of publicly-held companies based in Houston provided interesting and enlightening reading. It was no surprise that executives with energy companies dominated the list. Based on our count, there were only 19 executives that worked for Houston-based companies that did virtually no business with energy companies. Drawing that distinction becomes challenging at times. For example, we did not include the executives from Continental Airlines (CAL-NYSE), although we all know that a substantial number of their passengers are energy company employees and their families. And Continental is a major buyer of jet fuel. But one has to draw the line somewhere!

It was no surprise that executives with energy companies dominated the list of Houston executive compensation

We identified five executives that work for pipeline and utility companies, but they are still part of the energy industry. There are two executives with Lyondell Chemical (LYO-NYSE) and one with Kirby Corp, (KEX-NYSE) who would also be included in a broadly-defined energy industry, although they are not oil and gas producers or oilfield service companies. When we finished analyzing the energy component of the top paid executives, the industry accounted for 81% of the total executives.

To make this year's compensation list, you had to earn over $3 million. The top paid executive was Gene Isenberg of Nabors Industries (NBR-NYSE) at $29,542,620, while James Scarborough of Stage Stores (SSI-NYSE), a non-energy executive, was number 100 with total compensation of $3,075,484. We thought it would be interesting to see how the non-energy executives were dispersed throughout the ranking of the 100 executives. When we divided the list into quartiles, there were two non-energy executives listed in the top quartile, seven in the second, two in the third, while eight were in the bottom quarter. Since most companies represented had two executives listed, the conclusion that might be drawn from this distribution is that energy company compensation was significantly higher last year than non-energy company compensation, which accounts for the low number of non-energy executives in the first quartile. Since non-energy compensation was lower, it would make sense that their top people would more heavily populate the second quartile. The same pattern of energy and non-energy executives showed up in the third and fourth quartiles, appearing to substantiate our view of this compensation pattern.

There were two non-energy executives listed in the top quartile, seven in the second, two in the third, while eight were in the bottom quarter

One interesting table prepared by the *Houston Chronicle* (and reproduced in Exhibit 4) was the comparison of average executive compensation by category between 2006 and 2005. The average total compensation for 2006 was actually lower than in 2005 by 10%. Because the average salary, bonus and other compensation categories were higher in 2006, the entire decline in total average compensation is explained by the 28% decline in the stock-based and other long-term compensation category. This category is the estimated value of long-term equity pay such as stock options and restricted stock grants, and its decline may be more a function of the cycle of company grants of options and restricted stock rather than any meaningful change in compensation practices. From the table, it is impossible to tell if this observation is correct, but it just feels like the correct conclusion.

The average total compensation for 2006 was actually lower than in 2005 by 10%

Exhibit 4. Total Compensation Declined in 2006

	Base Salary	Bonus	Stock-based and Other L-T Compensation	Other Compensation	Total Compensation
2005	$663,180	$1,160,061	$4,702,384	$410,180	$6,922,113
2006	$669,469	$1,738,648	$3,405,881	$568,186	$6,198,665
Change	1%	50%	-28%	39%	-10%

Source: Longnecker & Assoc., *Houston Chronicle*, PPHB

It was interesting that the newspaper had not caught up with industry changes as Schlumberger (SLB-NYSE) relocated its corporate headquarters from New York City to Houston late last year. As a result, it should have been included in the compilation. Based on

Schlumberger's CEO Andrew Gould, at $17,530,995 of total compensation, would have ranked third on the list

reading the company's proxy statement, several Schlumberger executives would have made the *Houston Chronicle* table. In fact, four of them would have been in the top 100, kicking at least two non-energy executives off that top 100 list. Schlumberger's CEO Andrew Gould, at $17,530,995 of total compensation, would have ranked third on the list after the top two Nabors Industries executives. However, three other Schlumberger executives would have made the list, displacing others and boosting the energy dominance of the top paid executives.

Based on our calculations, including the four Schlumberger executives would have boosted the energy dominance from 81% to 83%, as they would have displaced two energy and two non-energy executives. The four top paid Schlumberger executives would have ranked number 3, 47, 81 and 100 on the list.

Texas boards of directors have tended to be a bit more conservative than their peers nationally in recent years

The firm that compiled the data for the *Houston Chronicle* report, Longnecker & Associates, was surprised by the year-to-year decline in total compensation as it ran counter to the national trend, which saw an average overall compensation increase of 8.9%. According to the representative of the firm, he believes that Texas boards of directors have tended to be a bit more conservative than their peers nationally in recent years. We wonder if the conservative actions reflect directors' memories of the Enron experience, which has continued to be in the local news as the various trials and sentencing hearings went on, or the recognition that commodity businesses go up and down and some of the financial success of associated companies is tied to the movement in the underlying commodity price rather than management's skill? We may only know the answer in a couple of years as Enron becomes a distant memory and/or commodity prices correct and company earnings are hit regardless of the steps taken by managements to preserve them.

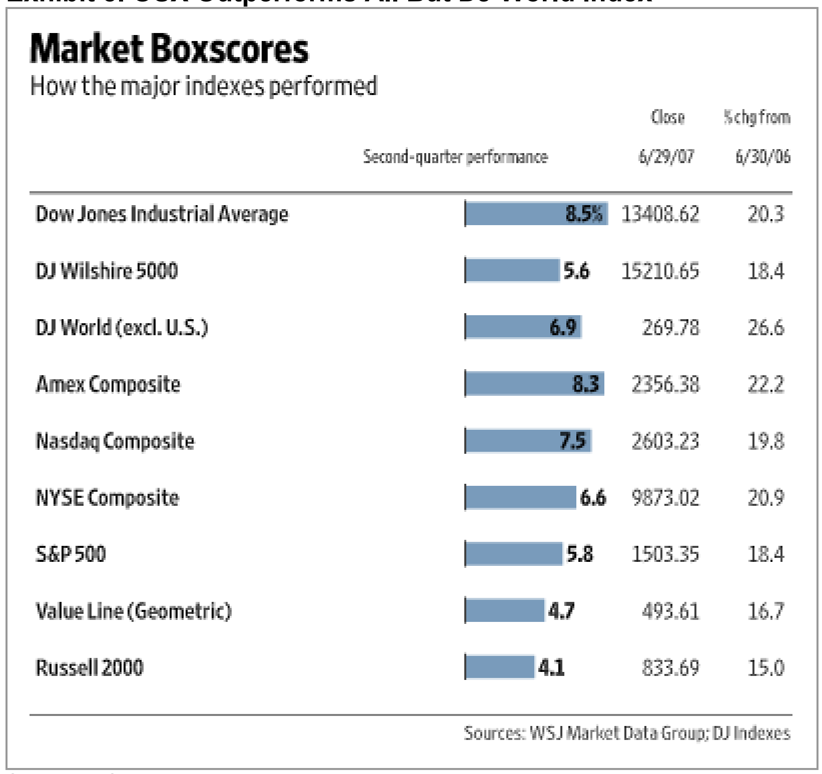
Can Energy Stocks Keep Going Up?

Stock market indices performances were blown away by the quarterly results of the OSX, which recorded a 22.8% jump

Investors have been fascinated with the ever rising stock market as it roared ahead during the second quarter posting repeated record closing prices. The weakness at the end of June, due to the jump in interest rates and the widening in interest rate spreads caused by the subprime debt market woes, trimmed some of the quarter's performance. However, virtually every stock market index moved higher in the quarter and when annualized, produced satisfactory to outstanding performance. The lowest performing index was the Russell 2000 with a 4.1% quarterly gain, while the best performer was the Dow Jones Industrial Average with an 8.5% rise. But these performances were blown away by the quarterly results of the Philadelphia Oil Service Stock Index (OSX), which recorded a 22.8% jump.

When we look at the stock market performance over the past 12 months, the relative performance of the OSX versus the major stock market indices is not as dramatic. Again, for the major indices, the weakest yearly performance came from the Russell 2000 with a 15.0% increase. The best performing index was the DJ World, excluding the United States, with a 27% gain. Most of the better known indices turned in yearly gains ranging from 18% to 22%. The OSX handily beat those indices, although not the DJ World index, with a 25% increase.

Exhibit 5. OSX Outperforms All But DJ World Index



Market Boxscores

How the major indexes performed

	Second-quarter performance	Close 6/29/07	%chg from 6/30/06
Dow Jones Industrial Average	8.5%	13408.62	20.3
DJ Wilshire 5000	5.6	15210.65	18.4
DJ World (excl. U.S.)	6.9	269.78	26.6
Amex Composite	8.3	2356.38	22.2
Nasdaq Composite	7.5	2603.23	19.8
NYSE Composite	6.6	9873.02	20.9
S&P 500	5.8	1503.35	18.4
Value Line (Geometric)	4.7	493.61	16.7
Russell 2000	4.1	833.69	15.0

Sources: WSJ Market Data Group; DJ Indexes

Source: WSJ

As the saying goes, past performance is not an indicator of future performance, so what can we expect for energy in future quarters? A major driver for stock performance is earnings growth. While we have not had many companies report their second quarter earnings, the current estimate by First Call is for an overall 4.3% gain for companies in the S&P 500 Index. The major positive contributors to this quarter's anticipated gain are Industrials (+14%), Technology (+9%) and Health Care (+7%). These strong sectors will be offset somewhat by the forecasted 9% decline in earnings of Consumer Discretionary companies. Energy is forecast to produce a 2% earnings improvement over the results of the same quarter a year ago. The most intriguing aspect to the earnings forecast is the 'surprise adjustment factor' and 'earnings upside guidance determination' made by Thomson Financial, the financial information reporting firm. Mr. Mike Thomson, in an interview on CNBC early on July 2nd, predicted that 2Q earnings would be up more like 7.0% to 7.2% compared to First Call's 4.3% estimate.

The major positive contributors to this quarter's anticipated gain are Industrials (+14%), Technology (+9%) and Health Care (+7%)

Exhibit 6. Earnings Outlook for S&P 500 Companies

	Est Chg From Year-Earlier Level			
Sector	2Q	3Q	4Q	All '07
Financial	5.0%	9.0%	10.0%	8.0%
Energy	2.0	-2.0	10.0	3.0
Technolgy	9.0	9.0	19.0	14.0
Industrials	14.0	13.0	11.0	12.0
Health Care	7.0	11.0	15.0	12.0
Cons Staples	4.0	6.0	6.0	6.0
Cons Discret	-9.0	3.0	26.0	3.0
Materials	4.0	2.0	1.0	5.0
Telecom	2.0	3.0	7.0	3.0
Utilities	4.0	3.0	12.0	6.0
Total:	4.3	6.3	12.3	7.8

Source: WSJ, Thompson Financial, PPHB

Expectations for future energy company earnings are beginning to be revised upward as oil prices are now above $70 per barrel and economic activity appears to be gaining strength

If 2Q earnings results, soon to be reported, actually generate a 7% year over year improvement, then what does it suggest about the rate of earnings improvement for future quarters? Based on the First Call estimates, energy earnings should be down from last year's 3Q by 2%, but then jump to reflect a 10% year-over-year gain in 4Q. How can that be? Basically, the earnings estimates for quarters three and four reflect the analysts' estimates made much earlier in the year when crude oil and natural gas prices were lower than they are now, and certainly the expectations for commodity prices during the second half of 2007 were much more modest than now given the conventional view that the U.S. and possibly the world economy would experience a significant slowing. Expectations for future energy company earnings are beginning to be revised upward as oil prices are now above $70 per barrel and economic activity appears to be gaining strength – both in Europe and the United States. So far this year, the revision in the outlook for energy earnings has taken the full year 2007 earnings change from a loss of 5% to a gain of 3%. We bet they go higher after 2Q earnings are announced.

Since 2007's 1Q earnings showed a 7.9% increase over the prior year's quarter, the sharply lower First Call 2Q estimate of a gain of only 4.3% reflects the conventional view that the U.S. economy would experience a first half slowdown to be followed by a pickup as the second half of the year unfolded. That view is the explanation for the 12.3% increase in earnings for this year's 4Q. If, as we suspect, energy company earnings are ratcheted up for 3Q and 4Q, then both of those quarterly estimates may prove low along with the estimate of the earnings gain for all of 2007. Increases in 2007 energy earnings may not be sufficient to boost overall S&P 500 earnings to double digits, but they will have a positive impact.

If the oil industry fundamentals that were lifting stock prices during the second quarter hold, then energy stocks remain a place Wall Street will have to put more money

If nothing happens on either the supply or demand side of the equation for oil and gas, and company managements properly manage their businesses, then energy stocks could continue their advance of 2007. Just how high stock prices may climb is purely conjecture at this point. We used to be in the business of predicting target prices for stocks – an exercise we found challenging and often worthless. Suffice it to say, if the oil industry fundamentals that were lifting stock prices during the second quarter hold, then energy stocks remain a place Wall Street will have to put more money.

Is The IEA Beginning to Acknowledge Peak Oil?

The IEA may be starting to doubt its own assumptions of unlimited oil production growth in the future

The French newspaper, *Le Monde*, recently carried an interview with Fatih Birol, the International Energy Agency's (IEA) chief economist. Mr. Birol's outspoken comments have raised questions about the degree to which the IEA may be starting to doubt its own assumptions of unlimited oil production growth in the future. The chief economist was quoted as saying, "If Iraqi production does not rise exponentially by 2015, we have a very big problem, even if Saudi Arabia fulfills all its promises. The numbers are very simple, there's no need to be an expert."

Mr. Birol also made a strong statement about the need for greater transparency about reserves and productive capacity of Middle Eastern oil producing countries. His statement was consistent with those previously made by other senior executives of the IEA, and in fact, are reiterations of statements we heard Mr. Birol make at two meetings in Houston during the past six months. He said, "Saudi Arabia – as well as other producing countries and oil companies – should be more transparent in their numbers. Oil is a crucial good for all of us and we have the right to know how much oil, as per international standards, is left." So far, the IEA's pleadings have fallen on deaf ears, or are merely ignored because to disclose the truth could do greater harm to the government than remaining silent.

Mr. Birol is tacitly acknowledging that there are "unofficial" doubts about the size of Saudi's oil reserves

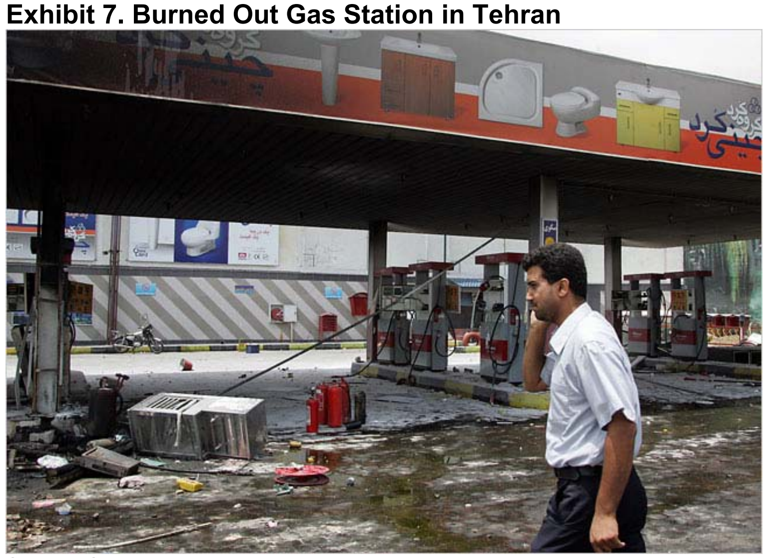
He also made an interesting statement about Saudi Arabia's reserves, which, in the context, would suggest greater concern within the IEA that peak oil might be much nearer than it has previously alluded to. Mr. Birol stated, "I understand the Saudi government claims 230 billion barrels of reserves, and I have no official reason not to believe these numbers." It is this huge official reserve figure that underlies Saudi's claim that it can boost production to 15 million b/d by 2015 and sustain that level of production indefinitely. By using the term "official" Mr. Birol is tacitly acknowledging that there are "unofficial" doubts about the size of Saudi's oil reserves. One might conclude that the concern at the IEA is growing if we factor in Mr. Birol's statement about the importance of Iraqi oil production. His statement recognizes that Iraq is the only country with meaningful oil production that has enough potential to substantially boost it in the next 5-10 years.

Iran's Gas Stations Ablaze

"It's not nice to fool Mother Nature"

There once was a margarine commercial for a product called: I Can't Believe It's Not Butter, in which an actress, depicting Mother Nature, chides the purveyors of the new product with the statement: "It's not nice to fool Mother Nature." She was referring to the fact that the artificial product tasted similar to real butter and clearly Mother Nature would never allow such a thing to happen. We were reminded of the ad's tag line when we heard about, and saw, the pictures of Iranians attacking and burning several service stations over the government's surprise move to institute gasoline rationing.

Exhibit 7. Burned Out Gas Station in Tehran



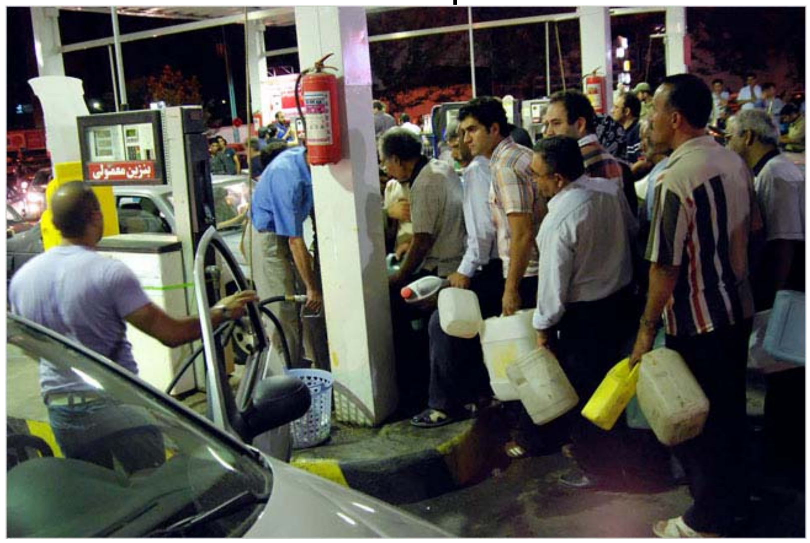
Source: Getty Images

Iran provides the highest subsidy for gasoline in the Middle East, as it buys foreign gasoline for over $2.00 a gallon and resells it for 34¢

In a Musings article earlier this year ("Gasoline Prices Soar – Public Upset," May 29, 2007), we wrote about the shock to Tehran's citizens when they discovered that gasoline prices had been hiked 25% overnight on May 22. The price of a subsidized gallon of gasoline was raised to 34¢. Iran provides the highest subsidy for gasoline in the Middle East, as it buys foreign gasoline for over $2.00 a gallon and resells it for 34¢. Due to this subsidy, Iran has experienced a huge financial drain in recent years because it does not have sufficient domestic refining capacity to meet its needs, even as the country exports huge volumes of crude oil. The lack of refining capacity is a direct result of the destruction caused during the Iran-Iraq war in the 1980s.

Iran is currently producing 3.9 million barrels per day (b/d) according to the International Energy Agency (IEA), but due to rising domestic consumption (currently about 1.2 million b/d), the country can only export about 2.5 million b/d. While this makes Iran the second largest OPEC exporter, that position could be challenged as the country suffers from an accelerating production decline rate that could reduce its annual output by 500,000 b/d. The production

Exhibit 8. Citizens of Tehran Line Up for Gasoline



Source: AP

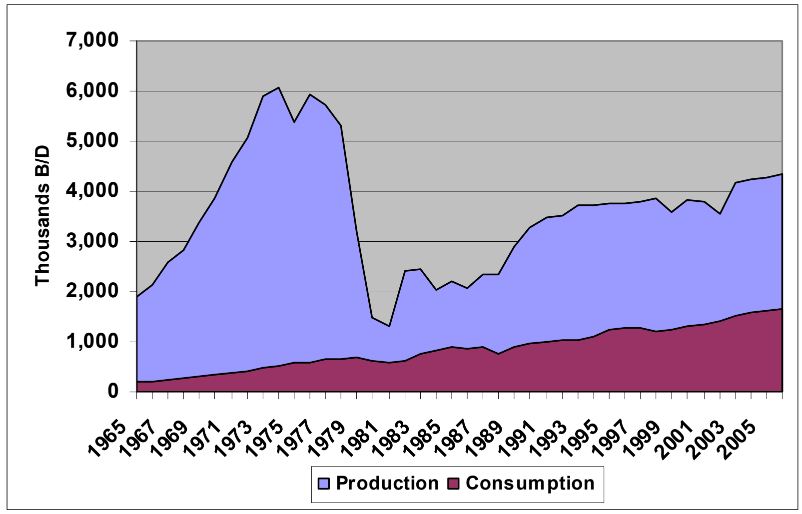
Exhibit 9. Cars Jam Gas Station Seeking Fuel

Source: Getty Images

There has been speculation that Iran's dire petroleum outlook is behind the government's push to develop a domestic nuclear power industry

decline is pressuring Iran's oil industry to boost the rate of recovery from existing fields while also forcing it to step up exploration activity seeking new fields. Can Iran accomplish these objectives in the face of ongoing, and possibly new, more severe, international economic sanctions? There has been speculation that Iran's dire petroleum outlook is behind the government's push to develop a domestic nuclear power industry. However, the militant nature of the ruling government under President Mahmoud Ahmadinejad might point to a different motivator.

Exhibit 10. Refining Capacity Is Iran's Problem, Not Crude Oil



Source: BP, PPHB

The timing and mechanics of the rationing system, coupled with the speed in which it was instituted, turned out to be a surprise

In that same Musings article, we highlighted the intelligence emanating from Tehran that the government was working on finalizing quota determinations before implementing a formal gasoline rationing scheme. The use of rationing as a way to control energy use surfaced last February after parliament balked at providing the necessary funds needed to continue the heavy subsidization of gasoline prices. However, when confronted with the initial rationing plan, the Iranian parliament objected, so the plan was not implemented. Contemporaneous media and intelligence reports talked about official, or unofficial, rationing in other parts of Iran, so the prospect of gasoline rationing in Tehran should not have been a surprise. The timing and mechanics of the rationing system, coupled with the speed in which it was instituted, turned out to be a surprise, and just like Mother Nature; the Iranians didn't like being fooled!

Gasoline station attacks turned out to be only the first acts of violence in Tehran, and may reflect greater dissatisfaction with the ruling government than the act of rationing

One has to question the rationality of burning the service station where you get your gasoline just because you can't get as much of it as you once did. On the other hand, anger is often irrational. As we then witnessed, gasoline station attacks turned out to be only the first acts of violence in Tehran, and may reflect greater dissatisfaction with the ruling government than the act of rationing. Reportedly, state-run banks and business centers came under attack as well as gas stations in other cities around the country. Iranians believe they are entitled to cheap fuel!

The media reported that immediately after the rioting started, the minister of oil and the minister of intelligence met privately with members of parliament to discuss the effects of the gasoline rationing decision. Afterward, the speaker of parliament told reporters that the parliament would back the government in its rationing decision. The speaker referred to the impact that rationing would have on reducing consumption, and that it would also help

Iran become more independent and less vulnerable to moves by the international community to impose more stringent economic sanctions. As Iran faces the prospect of greater international pressure over its nuclear policy, the country's lack of domestic refining capacity means it is a hostage to the 16 countries that supply it fuel.

What is interesting is that the Iranian parliament approved a plan last month to roughly double the price of gasoline to 64¢ a gallon, which its studies showed would lead to a meaningful decline in consumption. But Mr. Ahmadinejad rejected that plan and proceeded with rationing, potentially destroying more of his political support. Under his plan, private cars are allowed 26 gallons of gasoline a month at the subsidized price of 34¢ a gallon. Taxis are allowed 211 gallons a month. A problem for many unemployed Iranians is that they often use their cars as taxis or delivery services to earn money to support their families.

The Iranian government plans to move forward with a plan to invest $18 billion by 2012 to almost double existing domestic refining capacity

Faced with importing more than 40% of its gasoline consumption at an annual cost in excess of $5 billion, the Iranian government plans to move forward with a plan to invest $18 billion by 2012 to almost double existing domestic refining capacity to slightly over 3 million b/d. The plan involves constructing four new refineries and upgrading existing refineries. The question is whether Iran can accomplish such an ambitious plan within the targeted five-year time frame. Until it does, Iran will be a possible hostage to fuel cutoffs by its existing suppliers. One source of help appears to be coming from Venezuela as supposedly an agreement was signed last Thursday by visiting President Hugo Chavez to begin supplying Iran with subsidized gasoline.

If current production is beginning to decline at a faster rate than in past years, then the prospective financial hit to the Iranian government from the trifecta of falling production, rising demand and growing subsidies will increase

The greater problem Iran confronts is the lower level of production following its halcyon days in the 1970s when the country produced 6 million b/d. Iran's production collapsed during its war with neighbor Iraq, but then slowly increased in the 1990s. However, because Iran is one of the OPEC countries with a large and growing population, its energy consumption continues to increase. The growth in oil demand has been further helped by the government's decision to provide significant fuel subsidies. It is the shrinking gap between production and consumption, so evident in Exhibit 10, which has the government's attention. If current production is beginning to decline at a faster rate than experienced n past years, then the prospective financial hit to the Iranian government from the trifecta of falling production, rising demand and growing subsidies will increase. Attempts to try to forestall this financial calamity are what lie behind the government's decision to hike gasoline prices and institute rationing. However, as the Iranian government is learning from the violence and protests, not getting the population on board with its rationale for these actions could endanger the government's future existence.

Consumer Spending At Risk With Higher Gas Prices

80% of Americans find their car very important to their everyday lives

A new survey conducted by Discover Financial Services shows that consumers are more willing to cut discretionary spending than cut back on driving as gasoline prices climb. According to the survey, 80% of Americans find their car very important to their everyday lives. This dependence drives how they are coping, and expect to cope, with higher gasoline pump prices. Nine out of ten American adults claim they are paying close attention to the rising cost of gasoline. Two-thirds can even tell you the price per gallon within 30¢, which was within about a 10% margin of error for the actual pump price at the time the survey was conducted.

According to the survey, 70% of car owners said they will cut back on entertainment spending if gas prices were to increase by $1 per gallon, while 66% said they will change their vacation plans and 64% said they will postpone major purchases. While it appears that expense management is the first line of defense against rising gasoline prices, some 52% of those polled said they were somewhat or very likely to cut back on grocery spending to offset a $1 hike in the gas price.

75% of car owners said they were likely to drive less if gas prices increased $1, but they are not willing to try alternative transportation

The importance of the automobile in people's lives was shown by the fact that 75% of car owners said they were likely to drive less if gas prices increased $1, but they are not willing to try alternative transportation. The survey showed that 61% of people polled were not very or at all likely to walk or ride a bicycle, and only 24% were somewhat or very likely to take public transportation. Of those willing to consider alternative forms of transportation, carpooling was the most popular option with 45% of those surveyed saying they were somewhat or very likely to carpool. The survey also showed that women are more willing to drive less then men (59% versus 41%), and are more likely to use carpools (29% to 21%).

Rising gasoline prices will have an impact on consumer selection of their next vehicle. Currently half of car owners are driving vehicles that get less than 20 miles per gallon. According to the survey, 47% said they are somewhat or very likely to buy a more fuel efficient car if gas prices rose by $1. That should be an encouraging statistic for the car manufacturers who are still fighting the increase in CAFE standards. If gasoline prices do climb by another dollar, it may produce an environment of "build it and they will come."

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