MUSINGS FROM THE OIL PATCH

July 26, 2005

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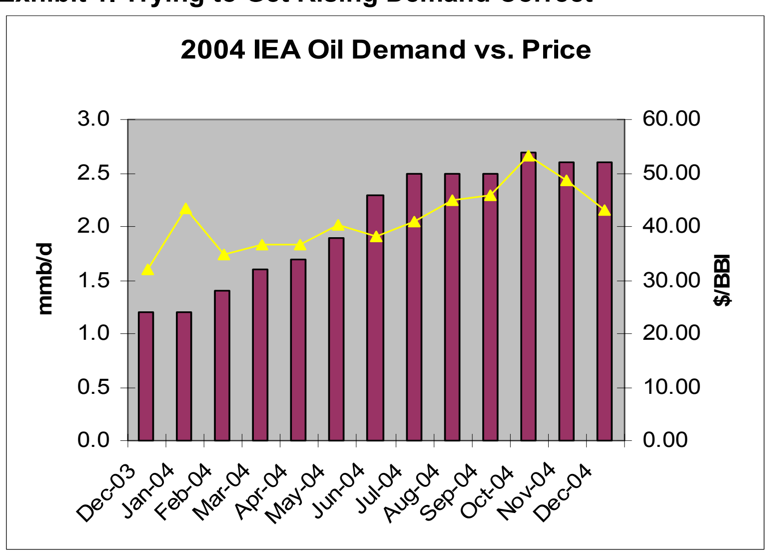
Note: *Musings from the Oil Patch reflects an eclectic collection of stories and analyses dealing with issues and developments within the energy industry that I feel have potentially significant implications for executives operating oilfield service companies. The newsletter currently anticipates a semi-monthly 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

Oil Demand Projections Cut – World Doesn't End

The IEA, OPEC and the API have all weighed in with reduced views of oil demand growth in 2005

Over the past two weeks, the International Energy Agency (IEA), OPEC and the American Petroleum Institute (API) have all weighed in with reduced views of oil demand growth in 2005. The IEA reduced its growth estimate by 200,000 b/d, reducing the annual gain to 1.58 million b/d, or a 1.9% increase, to 83.9 million b/d. They had previously reduced their demand forecast by 50,000 b/d in April and then held firm with that view for the two ensuing months. Prior to April, the IEA had been increasing its demand forecast, essentially repeating the pattern of revisions made to their 2004 forecast. During this similar period the IEA boosted its original demand (December 2003) forecast by 400,000 b/d.

Exhibit 1. Trying to Get Rising Demand Correct

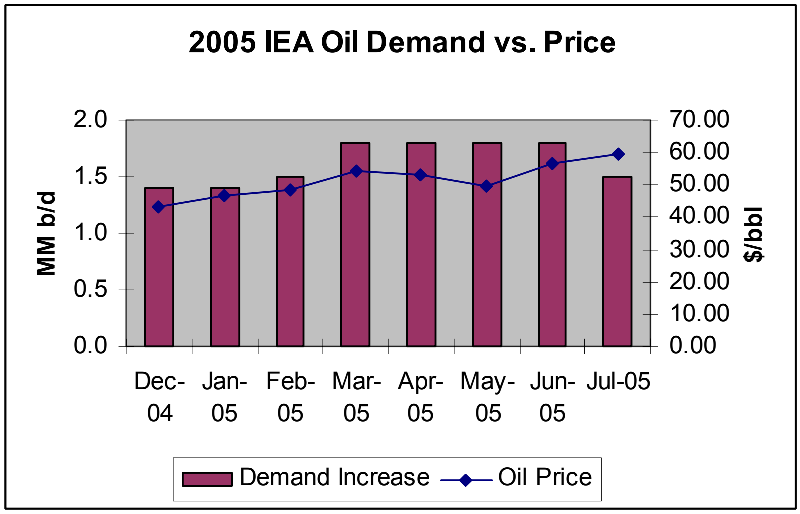


Source: IEA; EIA; PPHB

The IEA still sees 2005 demand growing by 1.9% and 1.58 million b/d

As we pointed out earlier this year, by March 2005 the IEA had actually revised upward by 600,000 b/d its 2005 oil demand forecast. Over the December 2004 to March 2005 period, the IEA increased its total demand forecast from 83.7 million b/d to 84.3 million b/d. The growth rate in demand was raised from 1.7% to 2.2%. So even after this month's demand forecast reduction, the IEA still sees 2005 demand growing by 1.9% and 1.58 million b/d, still more than it had forecast demand growth to be last December (1.7%, 1.4 million b/d).

Exhibit 2. Demand Growth Still Above Early Forecast



Source: IEA; EIA; PPHB

The principal reason for the demand cut is slower growth in oil consumption in the United States and China. The reduced U.S. consumption is tied to a cyclical peak in economic activity associated with rising interest rates, the likelihood of a slowing housing market and a squeeze on consumer spending from limited wage growth and high petroleum prices.

While 1.9% global oil demand growth is down sharply from last year's 3.4%, it is still well above the trend that existed from the late 1980s to the early 2000s of 1.2% per year

For all the concern expressed by economists, the U.S. economy is still turning in a strong performance. However, China remains an enigma because the official statistics are showing a different pattern than anticipated. Whether this weaker performance reflects a deteriorating economy, the impact of official actions to minimize inflation or more sophisticated oil buying strategies, is impossible to discern. While 1.9% global oil demand growth is down sharply from last year's 3.4%, it is still well above the trend that existed from the late 1980s to the early 2000s of 1.2% per year. The petroleum industry is going to continue to struggle to meet this reduced, yet still healthy, demand growth. It is our view that the commodity and stock markets have figured this out following the initial knee-jerk negative reaction to the demand cut announcements.

Why An Active Hurricane Season?

All the forecasts for the 2005 hurricane season called for an "active" year

All the forecasts for the 2005 hurricane season called for an "active" year. Professor William Gray of Colorado State University, in the last forecast he issued before the start of the season, called for 15 named storms and 8 hurricanes. The National Oceanic and Atmospheric Administration (NOAA) weighed in with a forecast of 12-15 tropical storms and 7-9 hurricanes. They anticipate that 3-5 storms would become major storms with wind speed of greater than 110 mph. Most other public projections seem to be in line with these two leading forecasters.

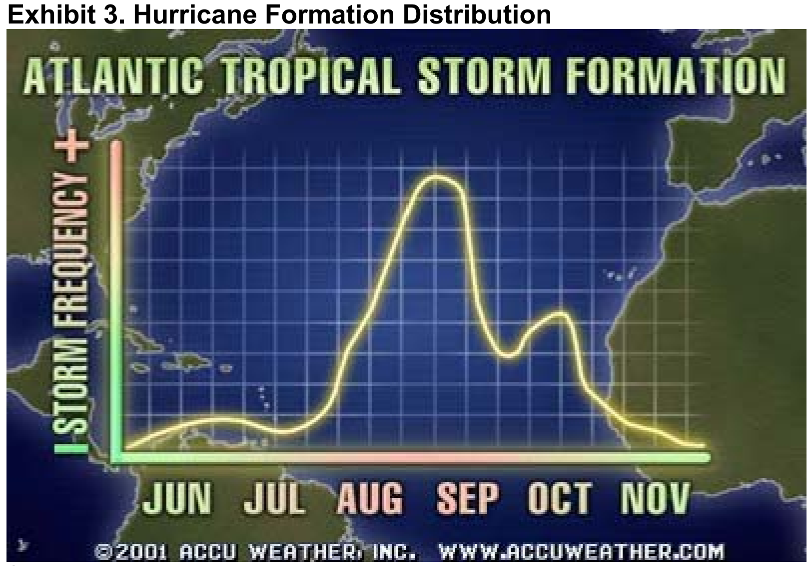
So here we are approaching the end of July, almost 60 days into the hurricane season (June 1 through October 30). We have had seven named storms so far this season and two of the storms have grown into hurricanes. Both hurricanes ultimately became major storms.

When the prior six-storm record was set, the full hurricane season produced 15 tropical storms and six hurricanes

Seven named storms so early in the hurricane season is a record. The prior record for the early formation of storms was six by August 5, 1936. This year, the sixth storm formed by July 21, or more than two weeks ahead of the prior record, while the seventh storm date is even earlier. Interestingly, when the prior six-storm record was set, the full hurricane season produced 15 tropical storms and six hurricanes.

The most amazing fact about the 2005 hurricane season is how active it has been so early in the season. As can be seen from the AccuWeather chart, which has not been updated for the last several years of hurricane data, the prime time for hurricane formation is in late August. That is due to that period representing the peak time for warm water in the Atlantic basin, which provides the energy for storms.

Exhibit 3. Hurricane Formation Distribution



Source: AccuWeather

Conditions in the Atlantic basin are supporting the development of storms

Just why has this season been so active? Why have some of the storms been so strong so early this season? It becomes clear when one looks at the conditions in the Atlantic basin that are supporting the development of storms: warm waters and a strong Atlantic high.

Exhibit 4. Warm Caribbean Waters Aids Hurricane Development

Source: AccuWeather

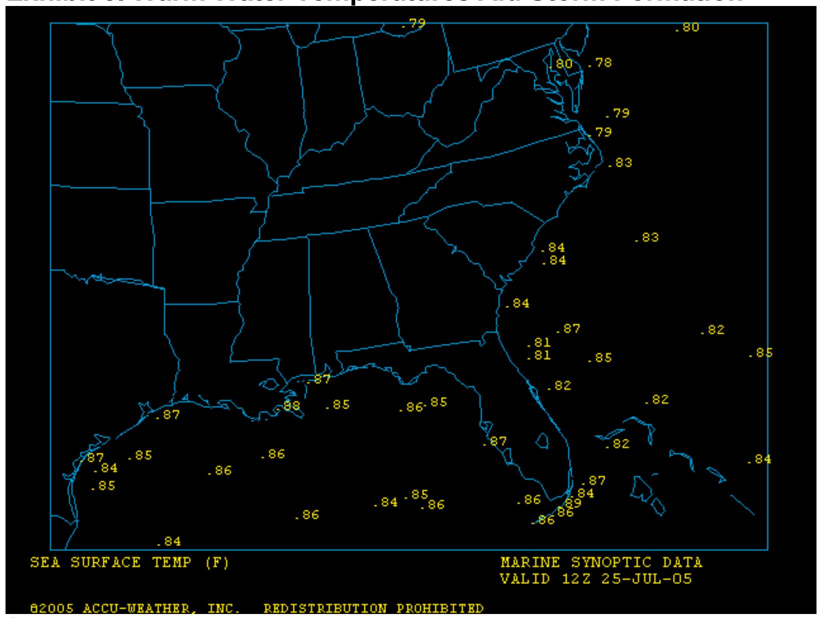
In the Gulf of Mexico water temperatures are in the upper 80s

AccuWeather has recently published another graphic that illustrates their concern about the balance of the hurricane season. Current warm temperatures in both the Atlantic and Caribbean waters provide the energy for tropical storm generation. In the Gulf of Mexico water temperatures are in the upper 80s. Water temperatures in the mid-Atlantic are hitting the low 80s. These water temperatures are similar to those experienced in the 1930s through the early 1950s. The developing storms are not being knocked down by traditional upper level wind shears since atmospheric conditions are not conducive for their formation. Until the gulf waters begin to cool, the Atlantic high moves or upper level wind shears develop that can knock down storms, it is hard to expect much of a slowing of this early storm trend. As a result of these patterns, Joe Bastardi of AccuWeather has just upped his storm forecast to 18 from 15.

Mid-Atlantic water temperatures are comparable to those of the summer of 1954 when three major hurricanes, Carol, Edna and Hazel, hit the United States

Bastardi points out that the mid-Atlantic water temperatures are comparable to those of the summer of 1954 when three major hurricanes, Carol, Edna and Hazel, hit the United States. Hazel was the 15th most deadly storm (95 deaths total) ever to hit the U.S. and it eventually slammed through Canada killing 80 in Toronto before dying over Hudson's Bay.

Exhibit 5. Warm Water Temperatures Aid Storm Formation



Source: AccuWeather

Today's warm waters are similar to temperatures experienced in the 1930s, 1940s and early 1950s when there was an unusually large number of tropical storms and hurricanes each year

Despite AccuWeather's concern, one should remain cautious about assuming that the balance of this hurricane season will be a continuation of this early season trend. That said, today's warm waters are similar to temperatures experienced in the 1930s, 1940s and early 1950s when there was an unusually large number of tropical storms and hurricanes each year. We found it quite amusing when Bastardi of AccuWeather explained the relationship of today's warm water and storm formation to the analogous past period, only to have the newscaster say it must be global warming.

Exhibit 6. 1950s Major Hurricanes

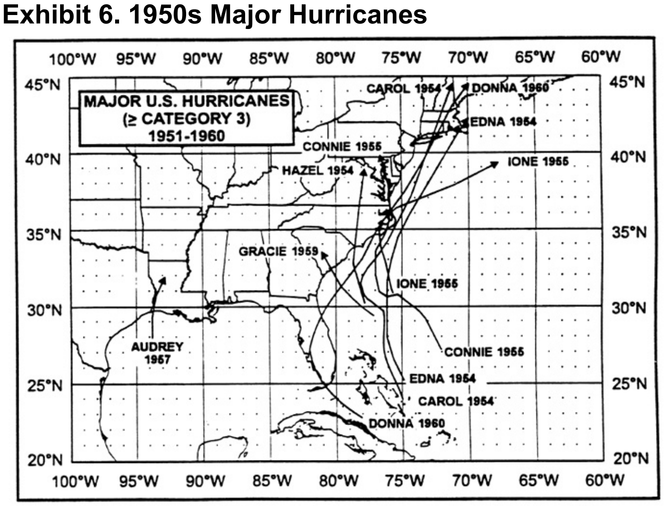


Figure 6. Landfalling United States major hurricanes (stronger than or equal to a category 3) during the period 1951-1960.

Source: NOAA

On the other hand, if this pattern of a large number and strong storms continues, the number of shut-in days for petroleum production in the Gulf of Mexico (and possibly the Gulf of Campeche of Mexico) could exceed forecasts further reducing available oil and gas supplies. We have been fortunate that the gulf storms so far have mostly avoided the heart of the petroleum producing area and when they have reached this region they have been fast moving and have not caused much damage. However, as the disclaimer says: Recent performance is not a guarantee of future results.

OSX Meets First Prediction; Must Wait for Second

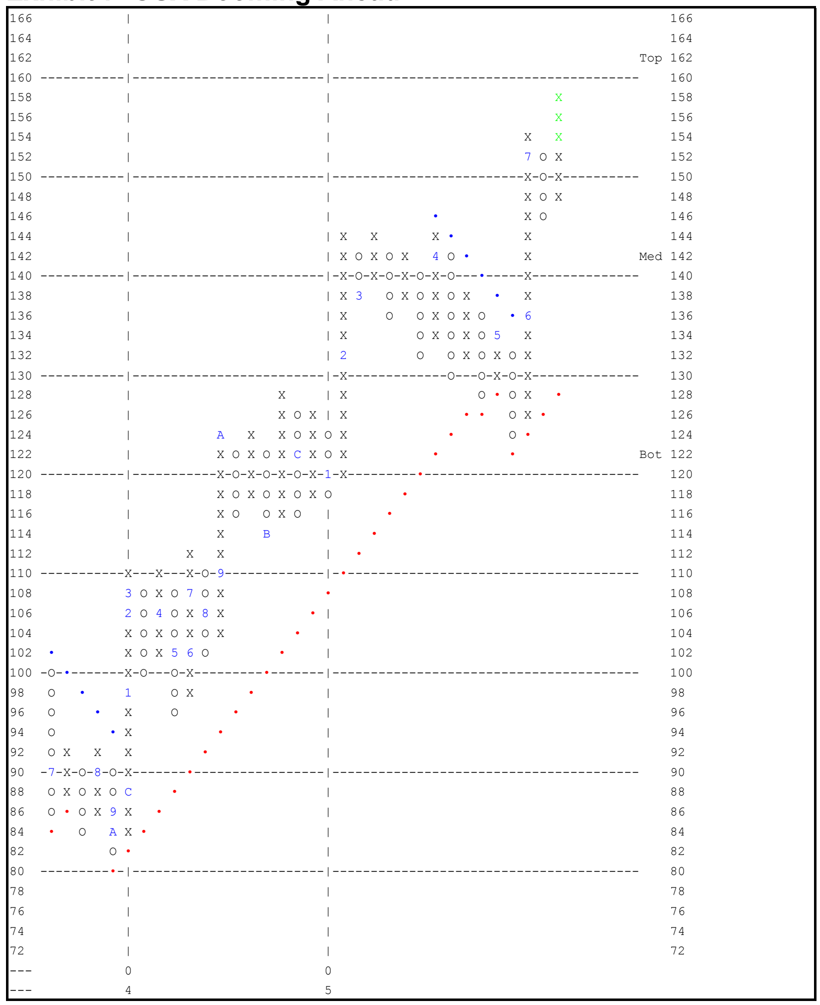
In mid-June we published a point and figure chart of the Philadelphia Oil Service Index (OSX) showing that it had established a bearish trend reversal pattern. As we pointed out at that time, based on research by Dorsey, Wright & Associates, when a stock or index demonstrates this bearish trend reversal pattern, 92% of the time the stock or index can advance by 24% from the most recent low point established. We showed that for the OSX, the bearish trend reversal pattern would take the index from 124 to 154. As can be seen from the current chart (Exhibit 7), the OSX did climb to 154 before correcting and falling back into a row of O's signifying a bearish trend. That bearish pattern for the index needed to stabilize before it could reverse and turn bullish. Once the index stabilized and turned up, it would have to climb by six points in this case (or trade at 152) before establishing that next up-trend. When the index re-established a bullish pattern, we would expect the OSX to attack the 166 level based on its having previously broken a triple spread pattern, which was our second prediction.

When the index re-established a bullish pattern, we would expect the OSX to attack the 165 level based on its having previously broken a triple spread pattern

As can be seen from Exhibit 7, the OSX did stabilize and turn up. The up-trend was re-established as oilfield service companies began to report strong second quarter earnings and commodity prices strengthened, helped by the latest hurricane, Emily.

The downturn pattern was caused by a spate of bad news for energy. First, Hurricane Dennis did little damage to the oil and gas production facilities in the Gulf of Mexico. Then the IEA cut its forecast for global oil demand in its latest monthly report due to weaker China consumption. That demand reduction was followed by a reduction by OPEC and statements by the API about demand growth being undermined by high oil prices. A last negative emerged when Hurricane Emily took a storm track that appeared to keep it out of the main Gulf of Mexico oil and gas producing area. At the last minute, however, some investors recognized that Emily's course might take it through Mexico's Bay of Campeche where the Cantarelle field is located. That field produces about 2.5% of global oil supply. This recognition helped boost crude oil futures prices.

Exhibit 7. OSX Booming Ahead



Source: Courtesy Dorsey, Wright & Associates, Inc.

This range of movement, or volatility, in the OSX is not atypical of the recent performance of the energy sector

From the close of July 12, the OSX index fell by 6.67 points to 146.97, or a drop of 4.3%. Intraday on July 12, the OSX reached its all time high of 154.76, before closing at 153.64. On Friday, July 15, the OSX hit its low for the week of 146.83 before closing up 0.14 points. If we measure the movement of the OSX from the weekly high to low, there was a drop of 7.93 points, or down 5.1%. This range of movement, or volatility, is not atypical of the recent performance of the energy sector as we pointed out in our last issue in a study of the volatility of crude oil futures prices.

After such a long bull market for energy, it is not surprising that we have entered a stage of increased volatility since many investors have substantial profits and are wary of giving them up if industry fundamentals falter. On the other hand, investors who have been underweight energy and have thus underperformed this year, have been jumping in, but are suddenly faced with the possibility that one of the tenants of the future strength of energy, (demand) might have been over-estimated; therefore they may be quick to cut their losses adding to stock price volatility.

As the first of the oilfield service company earnings reports arrived, investors began to feel better. As more companies reported, the strength of earnings became evident. Moreover, the management comments indicated that there were no signs of softening in future activity. In fact, statements from management reflected optimistic outlooks. On Friday, both Halliburton and Schlumberger reported extremely strong earnings and held very upbeat conference calls. With commodity markets suddenly becoming concerned about the emergence of two potential storms that might enter the Gulf of Mexico, they bid up crude oil futures prices by $1 per barrel. The combination of strengthening oil prices and bullish earnings, the OSX jumped by 8 points to almost 160. While we haven't yet seen our second prediction for the OSX come to pass, it appears that we are well on the way to achieving it.

While we haven't seen our second prediction for the OSX come to pass, it appears that we may be well on the way to achieving it

Royal Dutch Shell Confronts Sakhalin Bad News

Last Monday the United Kingdom's High Court approved the merger of the two companies that made up the Royal Dutch/Shell Oil complex. Two days later the merger was reflected in the initial trading of shares of Royal Dutch Shell PLC (RDS-A-NYSE) (Shell), a new holding company for the British and Dutch petroleum complex founded in 1907. Previously, there were two companies trading: Royal Dutch Petroleum NV, headquartered in the Hague, the Netherlands, and Shell Transport and Trading PLC, headquartered in London, England. Now these companies are combined into one company.

The management of Shell will have to answer questions from investors and analysts about the cost overrun at the Sakhalin II project

This week Shell will report its second quarter earnings that are expected to increase 47% over the comparable quarter of 2004. The earnings increase reflects the impact of the higher oil and gas prices that have prevailed over the past year. However, the management of Shell, headed by CEO Jeroen van der Veer, will have to answer questions from investors and analysts about the cost overrun at the Sakhalin II project. The company announced on July 17 that this high profile LNG project is $10 billion over budget. Now the investment required to complete the field's development will be $20 billion. Deliveries of the gas to be turned into liquefied natural gas (LNG) will be delayed to the summer of 2008 from the estimated late 2007 date. Investors are concerned that Shell may have cost overruns at other high-profile fields such as Bonga in Nigeria and the gas-to-liquids project in Qatar.

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The investor questioning will focus on Shell's operational management and capital investment plans. The recent guidance for capital expenditures has been $15 billion a year. But if the Sakhalin II project needs an additional $10 billion, how will that fit into the capital expenditure plans? With rising industry finding and development costs due to higher oilfield service costs and more marginal fields, in order for Shell to meet its production goals it may need to step up spending. Shell's goal is to add 14 billion barrels of oil equivalent reserves over 2006-2009, in order to lift the company's production from the 3.8 million b/d reported in the first quarter of 2005 to 5 million b/d by 2015.

Shell announced in early July that it has agreed to swap some of its interest in Sakhalin II for an interest in a Gazprom field in Siberia

Shell announced in early July that it has agreed to swap some of its interest in Sakhalin II for an interest in a Gazprom (OGZPF.PK) field in Siberia. The transaction, expected to close sometime in 2006, means that Russian-controlled energy company, Gazprom, will get 25% plus one share in Sakhalin II while Shell will receive 50% of Gazprom's Zapolyarnoye Neocomias field in Western Siberia. The field is located about 200 kilometers northeast of Urengoi in northern Russia. Shell already is active in the region with its Salym project. The difference in the value of the two assets will be made up with a package of cash and other assets.

Exhibit 8. Sakhalin II Project

Source: EIA

The history of the Sakhalin II field is interesting. The project was the first Russian venture using a PSA structure. There are two fields in the project. The Piltun-Astokhskoye field is primarily oil and is estimated to contain one billion barrels of reserves. The Lunskoye field is a reservoir with an estimated 510 billion cubic meters of natural gas. Ownership originally consisted of Marathon Oil (MRO-NYSE) (37.5%), McDermott International (MDR-NYSE) (37.5%) and Mitsui & Co. (MITSY-NASDAQ) (25%). The project commenced in 1994 with first oil flowing in July 1999 and the first oil shipment in September 1999. Oil is produced six months a year when the field is ice-free. Plans to develop the gas field involve constructing pipelines from the field located in the northern end of the island to an ice-free port in the south where the LNG and oil can be loaded on a year-round basis. The original plans called for the natural gas to be flowing by 2006. It now looks like that date will be two years late.

In the late 1990s, McDermott exited the project by selling its interest to Shell Oil and Mitsubishi Corp. (MSBHF.PK). Later, Marathon and Shell swapped assets. Shell acquired Marathon's 37.5% interest in Sakhalin II in exchange for some of Shell's North Sea producing assets. Mitsubishi purchased 7.5% of Shell's interest. Thus the ownership of the field has been Shell with 55% and Mitsui with 25% and Mitsubishi with 20%. Next year the ownership will shift with Gazprom entering the partnership.

This move is consistent with other steps Gazprom is taking to gain access to the Pacific region of Russia and ultimately to be able to tap the U.S. market

This move is consistent with other steps Gazprom is taking to gain access to the Pacific region of Russia and ultimately to be able to export to the U.S. market. Gazprom plans to buy 20% of Sakhalin I from state-owned Rosneft. Sakhalin I is estimated to contain 2.3 billion barrels of oil and 480 billion cubic meters of gas. Gazprom also plans to compete for the Sakhalin III lease when it comes up for bid. The bidding will be competitive as ExxonMobil (XOM-NYSE) and Chevron (CVX-NYSE) have indicated they both plan to bid. Gazprom is on track to become a global energy player.

It's Good To Be An Oilfield Service Company

High commodity prices are driving increased oilfield activity. Higher activity has produced high equipment utilization that has generated strong incremental profit margins for oilfield service companies thus enabling them to raise their prices. Prices are also being driven higher by pressure from oil and gas companies who want new equipment, new technology and high levels of service. The result of these conditions is beginning to show up in oilfield service company earnings results. In fact, the results have proven uniformly stronger than investors and analysts expected.

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The first six oilfield service companies to report second quarter earnings have beaten the Wall Street consensus earnings estimates by 16%. Based on the earnings reports, one company missed the consensus estimate by a penny, while the other companies exceeded by anywhere from 4.4% to 35.7%.

Exhibit 9. 2Q Earnings Results for Oilfield Service Companies

Company	2Q2005 EPS	First Call Consensus	Performance vs. Estimate
Noble Corp.	$0.53	$0.54	-1.9%
Lone Star Technologies	$2.09	$1.65	26.7%
Lufkin Industries	$0.71	$0.68	4.4%
Cooper Cameron	$0.70	$0.61	14.8%
Schlumberger Ltd.	$0.78	$0.67	16.4%
Halliburton Company	$0.76	$0.56	35.7%
Average			16.0%

Source: Yahoo Finance; PPHB

Had Lufkin not increased its earnings guidance, the company would have blown away the consensus estimate by 47.9% with its reported results

The low overachiever in the early reporting group, Lufkin Industries (LUFK-NASDAQ), beat its consensus estimate even after increasing its previous earnings guidance. Several weeks before reporting, Lufkin announced that it expected to report second quarter earnings of between $0.68 and $0.72, compared to the company's prior guidance of between $0.45 and $0.55. The Wall Street analysts raised their estimates and jumped the consensus estimate from $0.48 to $0.68. Yet Lufkin still beat the revised consensus by 4.4%. Had Lufkin not increased its earnings guidance, the company would have blown away the consensus estimate by 47.9% with its reported results. That upside surprise would have boosted the average margin of the group to 23.3%.

Both Halliburton (HAL-NYSE) and Schlumberger (SLB-NYSE) reported 40% or better incremental profit margins in their quarters. This is phenomenal performance and reflects the impact of high equipment utilization and strong pricing. However, Schlumberger Chairman Andrew Gould stated that while the company has considerable pricing power, they are starting to see considerable inflation, which is expected to go faster in the future. The inflation, he said, is showing up in both materials and labor, but particularly in the latter. So far they have been able to pass on the inflation costs.

Poaching of oilfield service company employees is becoming much more prevalent today. Employees are being hired away not just by competitors, but by oil company clients, too. These hires are the more difficult to confront because the oil companies are targeting niche specialties and are willing to pay huge salaries – well beyond the capability of the service company to compete.

We expect to hear positive comments from the CEOs of other oilfield service companies during the balance of earnings season

What we expect to hear from the CEOs of other oilfield service companies during the balance of earnings season is likely to reflect a continuation of the positive outlook demonstrated so far. Clearly earnings estimates for 2005 will be increased by Wall Street analysts. Given the positive comments about more large multi-well projects to be bid in the second half of 2005 that will become work next year and the strength of pricing power, it is hard not to expect the analysts to boost their 2006 EPS estimates, too. With higher earnings estimates, the analysts will have to delay their view of the timing of peak earnings (a concept we personally hate) and keep forward price/earnings multiples higher than they have been using in establishing new price targets for the stocks. Higher stock price targets will encourage more investors to buy oilfield service stocks, despite the recent jump in prices. The good times are here. Enjoy them!

Just Who Is Trying To Buy Unocal?

The battle for ownership of California-based Unocal (UCL-NYSE) continues with Wall Street, politicians and government officials struggling with the potential long-term impact of this transaction. There are numerous strategic issues involved. However, we have become amused, and confused, about just who is trying to buy Unocal.

Chevron, you may remember, is the former ChevronTexaco, who adopted that name following the merger of the two companies in 2001

Chevron Corporation has reached an agreement with Unocal's management and had its recently increased takeover offer endorsed by Unocal's Board of Directors. Chevron, you may remember, is the former ChevronTexaco, who adopted that name following the merger of the two companies in 2001. The company's official name was changed in May to provide a new streamlined image.

The greater challenge is to understand who the competing bidder is that has lobbed in an all-cash bid that remains superior in value to the Chevron offer. The Chinese bidder is a 70%-owned subsidiary of the Chinese National Offshore Oil Company, which is a state-owned company. Many in the media use the acronym CNOOC to identify that company and to save on having to write out the full name each time they reference it in their stories. However, the official name of the subsidiary that has actually made the bid is CNOOC Ltd. (CEO-NYSE), as stated in the company's 20-F filing with the Securities Exchange Commission.

The WSJ's guideline is that when a company capitalizes more than four letters in its name, the WSJ arbitrarily capitalizes only the first letter

At the time of the Unocal bid by CNOOC Ltd., we noticed that many of the business and popular media began referring to the company as Cnooc. We had a problem with that name as it is not the official name of the company. Prominent in the use of Cnooc was *The Wall Street Journal* (*WSJ*). So we sent an email question to the paper asking why they used Cnooc rather than the proper name CNOOC. Several days later we received an answer from Paul Martin, the Stylebook Editor of the *WSJ*. He stated that the *WSJ*'s guideline is that when a company capitalizes more than four letters in its name, the *WSJ* arbitrarily capitalizes only the first letter. Mr. Martin pointed out that the *WSJ* also does this with acronyms like Unicef. As Mr. Martin put it, the rule is designed "to limit overcapitalization that stands out in print and can distract the reader." Thus, it is more pleasing to the reader's eye not to have all those capital letters. Unfortunately, from my point of view, I think this editorial rule sacrifices accuracy for style, something the media should be rethinking.

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