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MUSINGS FROM THE OIL PATCH

August 5, 2008

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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

It's Summertime, Summertime Sum-Sum-Summertime*

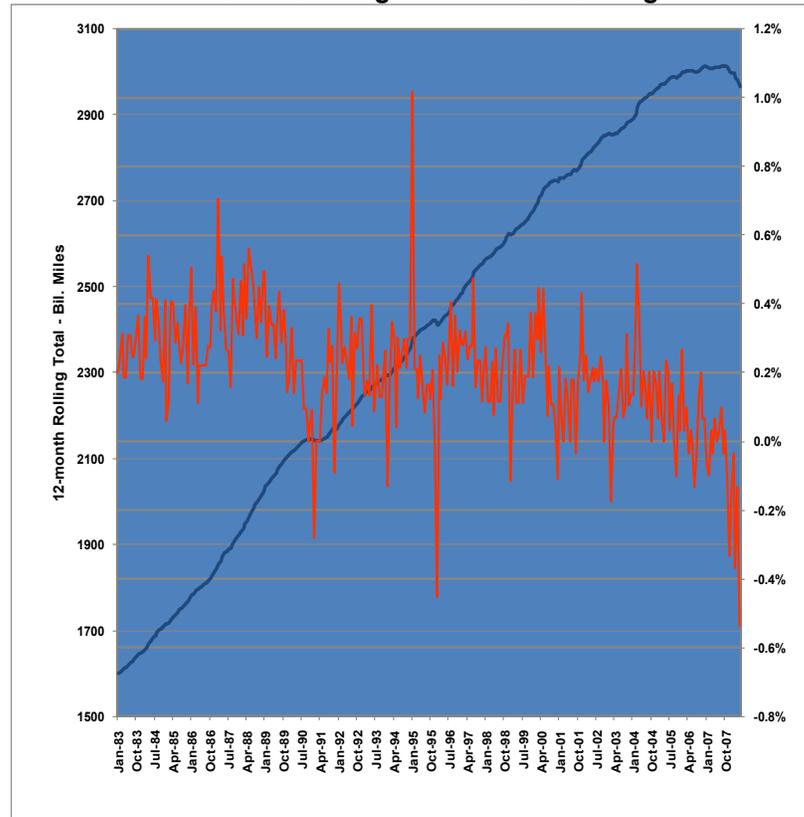
I'm not sure how many fewer drivers there are on the roads

According to the media, Americans are driving less. In fact, they drove less in May for the seventh straight month, and they drove 3.7% fewer miles than in May a year ago. Having just returned from our summer home in Rhode Island, a 1,900 mile road-trip, we're not sure how many fewer drivers there are on the roads. Maybe they all started on their vacation trips two weekends ago, as the traffic, especially along certain stretches of our travels, seemed heavier than when we drove north in mid-May. But that was only one of the observations about traveling, gasoline consumption and the health of the U.S. economy that we drew from the trip.

As we found in May, all the trucks were driving in the right-hand lane and all were staying well below their maximum speed, except when they needed to pass

At one point on route I-81 in Pennsylvania just below Wilkes Barre, we laughed when we saw a state highway sign proclaiming: Stay Alert, Heavy Truck Traffic. We had been on the road for about five hours and we could almost count on our fingers and toes the number of trucks we had seen on the road. As we found in May, and commented on at that time, all the trucks were driving in the right-hand lane and all were staying well below their maximum speed, except when they needed to pass. Clearly the speed governors that were regulated to slow the trucks down to save on diesel fuel were working. Our question about the sign was: What heavy truck traffic? It seemed that the truckers were either on holiday, different roads or unemployed. Given the state of the economy in the northeast, it could have been any one of those explanations.

Exhibit 1. Vehicle Miles Being Driven Are Declining



Source: Federal Highway Administration, PPHB

As a result of the weak economy in Rhode Island, the local gambling facilities are suffering and not kicking in as much money as anticipated in the budget assumptions

The current hot debate topic in Rhode Island, which has just passed a balanced budget, accomplished with the use of mirrors and aggressive financial assumptions, is the idea of placing toll booths on I-95 that traverses the state. The thought is to tax those native Rhode Islanders who work out of state, or who elect to head to the Connecticut casinos to gamble rather than stay at home in the local gambling parlors. As a result of the weak economy in Rhode Island, the local gambling facilities are suffering and not kicking in as much money as anticipated in the budget assumptions.

State politicians and many in the public, based on our reading of local newspaper editorials and letters to the editors, think that these travelers are easy prey for tax revenues to help the state close the chasm that has opened up in Rhode Island's financial condition. The state has some serious infrastructure problems due to its underfunding of bridge and highway repair needs. There are two major bridges in the Providence area – one on I-95 – that have serious weight restriction limitations. In the case of one of the bridges, school busses, ambulances and fire trucks are banned from using the roadway because of the bridge's condition. This creates extra hardship and expense for city and state emergency vehicles and local citizens.

How to build and maintain roads and bridges with less money coming in and more of the funds flowing to mass transit systems will become a challenge

The deteriorating condition of the nation's highway and bridge infrastructure due to lower tax revenues as a result of reduced gasoline purchases as people drive less has been highlighted as a growing problem. This will become a greater problem as the nation adopts higher fuel efficiency guidelines for our vehicle population and as more commuters elect to use mass transit systems. How to build and maintain roads and bridges with less money coming in and more of the funds flowing to mass transit systems will become a challenge. Tapping general tax revenues will become the conventional solution, unless alternative taxing plans are developed. Therein lies the Rhode Island interstate highway toll proposal. If the state can raise revenues by taxing people driving into or out of the state, or merely passing through, it may be possible not to have to tap the state's general revenue fund to help maintain the road system.

Another observation on our trip was that in the Virginia I-81 corridor and the I-12 passage from Slidell, Louisiana to Baton Rouge, it looked like high gasoline and diesel fuel prices were having no impact on drivers. It may have been that it was a Saturday in July that brought out all the people, but when we stopped for dinner in Wytheville, Virginia, there was a 20 minute waiting line at the local Cracker Barrel restaurant. That is the first time in several years since we have had to wait to eat at one of these fine restaurants. From the crowd lounging around the front door and the empty tour bus that drove by, most of these people were fellow travelers and not locals out for dinner. What struck us was that our wait was tied to having shown up for dinner at almost 7 pm, an hour that we thought would be behind the general traveling crowd.

We fully expected gasoline prices to decline more slowly than the drop in crude oil prices, but we weren't sure how much they might lag

The last surprise on the drive home was the price of gasoline. With crude oil futures prices dipping almost daily during the past several weeks, lower gasoline prices would seem to have naturally followed. But, just as banks make more money when their cost of funds drops quickly and they reduce loan charges slowly, gasoline retailers are doing the same thing. That's because they have been struggling of late to rebuild their profit margins that have been squeezed during this recent period of high oil prices. We fully expected gasoline prices to decline more slowly than the drop in crude oil prices, but we weren't sure how much they might lag. Then again, we had become accustomed to seeing high gasoline prices as the Mobil gas station down the road from our Rhode Island house was cited by the media in late May for having the highest gasoline pump prices in the entire state. Their gasoline prices never changed once they reached \$4.25 a gallon for regular. The price was still at \$4.25 as we drove by on our way home, some two months later. We guess they retained their number one ranking.

We paid less than \$4 a gallon for premium gasoline

We found that the gasoline prices we encountered were lower on the trip home than on the one north, but that was not a surprise as we know that pump prices normally climb as we approach the start of the summer driving season. What was surprising, however, was that we paid less than \$4 a gallon for premium gasoline in both

The highest pump prices we paid were in Pennsylvania and Louisiana

Virginia (\$3.95) and West Virginia (\$3.99). On the other hand, the highest pump prices we paid were in Pennsylvania and Louisiana. Wondering whether the price differential versus the per gallon prices we paid in other states was due to taxes, we looked up the combined federal, state and local taxes per gallon to compare the states and to determine the net gasoline price. The data is in Exhibit 2, and besides the purchases along the way, we included the prices paid in our last purchase in Rhode Island and our first purchase in Texas. We also included the gasoline tax burden for California and Connecticut for comparison.

Exhibit 2. Gas Prices Vary Partly Due to Taxes

State	Pump Price	Combined Federal, State & Local Tax	Net Gas Price
Pennsylvania	\$4.299	\$0.507	\$3.792
West Virginia	\$3.999	\$0.506	\$3.493
Virginia	\$3.959	\$0.380	\$3.579
Georgia	\$4.029	\$0.464	\$3.565
Mississippi	\$4.099	\$0.372	\$3.727
Louisiana	\$4.189	\$0.384	\$3.805
Rhode Island	\$4.299	\$0.494	\$3.805
Connecticut		\$0.708	
California		\$0.749	
Texas	\$3.999	\$0.384	\$3.615

Source: API, PPHB

The Connecticut legislature had enacted a bill to increase the tax rate from 7% to 7.5% on the wholesale price of gasoline that would have made Connecticut the highest taxing state in the nation

Connecticut received a lot of local media attention because Governor Jody Rell has been forced to call two special sessions of the state legislature after the body had recessed for the summer to deal with energy issues. One session dealt with the state's planned increase in its tax rate for the wholesale price of gasoline, while the other was to raise funds to help citizens deal with high home heating bills this coming winter. The Connecticut legislature had enacted a bill to increase the tax rate from 7% to 7.5% on the wholesale price of gasoline that would have made Connecticut the highest taxing state in the nation. Gov. Rell vetoed the bill and got the legislature to agree not to increase the gasoline tax rate. With high pump prices cutting driving and the sales of gasoline, it means less tax revenues for the state, which means funds will have to be taken from other sources to pay for highway construction, maintenance and mass transit in the state.

When we looked at the state tax burdens and the gasoline pump prices we paid, we found that the two states with sub-\$4 a gallon gasoline had very different tax rates. West Virginia was almost the highest at \$0.506 a gallon while Virginia was almost the lowest at \$0.380. It is also interesting to see from the table above that the

This battle over energy taxation is only the start of our dealing with the challenges of prolonged high energy prices

price of gasoline without taxes and how that varies among the states. It is our guess that state taxation of gasoline, and other energy fuels, will become more of a focus of citizens as time moves forward. Remember that it was in Europe and Asia where demonstrations and riots have been held over high fuel prices and, in particular, high fuel taxes. This battle over energy taxation is only the start of our dealing with the challenges of prolonged high energy prices.

* From the song written and recorded by The Jamies, 1958

With Energy, Money Talks as States Find Out

Interest in the grant money was higher than in the past, largely because the General Assembly increased the maximum grant from \$3,000 to \$10,000

The weak U.S. economy has state legislatures and governors scrambling to find money for various programs as tax collections falter. In Maryland, the state's Energy Administration has a program to assist homeowners with the cost of installing solar and geothermal energy systems. Maryland Energy Administrator Malcolm Woolf reported that the entire \$591,000 of grant money that became available on July 1st (the start of the state's new fiscal year) had been awarded in a matter of days. According to Mr. Woolf, interest in the grant money was higher than in the past, largely because the General Assembly increased the maximum grant from \$3,000 to \$10,000. The Energy Administration did not disclose the number of awards, so we are left to wonder whether the increased grant maximum was responsible for the speed with which the fund total was depleted, or whether high energy costs are motivating more people to install energy-saving systems. Maybe the answer is both.

The state hopes to have more funds available this fall that would come from Maryland's share of the auction proceeds of regional greenhouse gas allowances for power plants scheduled for September 25th.

Budget crunches are creating other pressures on states, especially those whose citizens depend heavily on oil for heating their homes in the winter

Budget crunches are creating other pressures on states, especially those whose citizens depend heavily on oil for heating their homes in the winter. Since heating oil is essentially the same as diesel, the jump in prices since last year will take a huge bite out of consumer budgets this winter. Unless there is a significant drop in heating oil prices, homeowners, primarily in the northeast United States, will be facing winter heating bills this year that may be one-third to fifty percent greater than last year. For lower income families this will be a huge burden and federal, state and local governments, along with charitable organizations, are working hard to find money to help ease the financial pressure these families may experience.

In Connecticut, the governor has called the state legislature back into an emergency session to approve an increased budget for heating oil supplements for low income families. The challenge for Connecticut, and other Northeast states that are in recessionary economic environments, is where to find the money for these funds.

Connecticut has recently rolled back its scheduled tax increase on the wholesale price of gasoline to help consumers confronting high gasoline pump prices. As a result, the state is missing tax revenues it might otherwise have had available to fund the heating oil fund. We suspect that over the next several months there will be increased media coverage of the challenges various state governments are having in finding money to help provide financial support for low income citizens facing high and rising energy bills.

Are Discount Airlines A Relic of The Low Cost Oil Era?

While the global automobile industry struggles to re-design its product lineup and restructure manufacturing operations in the face of changing consumer demand in response to high gasoline prices in an attempt to fix its business model, the model of the airline industry seems almost totally broken. This broken airline industry model appears most evident amongst the discount airlines, and recent European airline industry developments highlight these problems.

What may be the most daunting challenge for Ryanair is the growing success of high-speed rail lines in Europe

One of the most successful European discount airlines – Ryanair (RYAOF-OTC) – has recently acknowledged the challenges it is facing. In the matter of weeks, the company has had to warn shareholders of impending financial losses and the grounding of 12 planes for the winter season. Moreover, this leading discount airline is facing increased pressure from high jet fuel prices, weakening passenger demand due to the growing economic problems of Europe and now the prospect of its chief establishment rival, British Airways (BAIRY-OTC) merging with the Spanish airline, Iberia (IBRLF-OTC). But what may be the most daunting challenge for Ryanair is the growing success of high-speed rail lines in Europe.

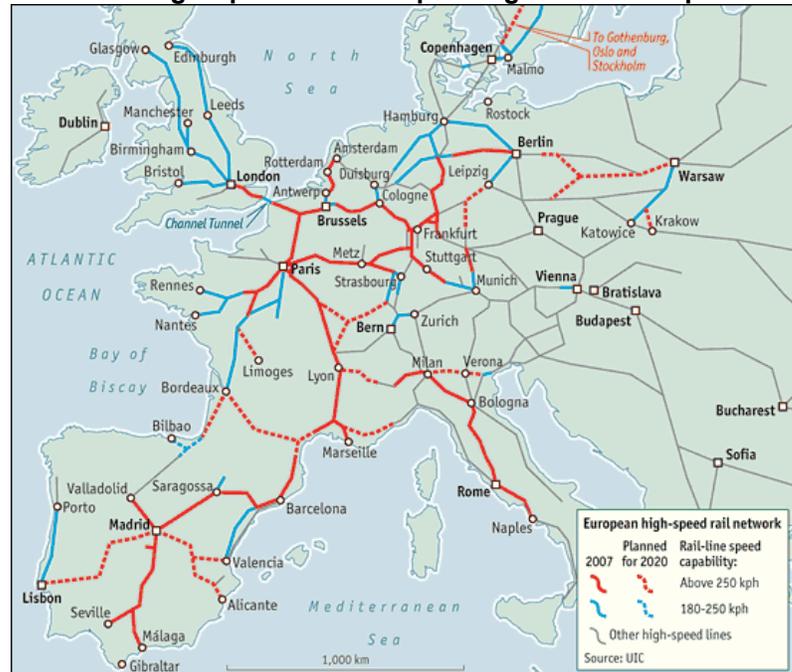
Eurostar ridership in the first half of this year grew by 18% to 4.63 million passengers, and revenue grew by 25%

The best example of the impact the growing high-speed rail lines are having on discount airlines is the success Eurostar, the operator of the London-Paris train route, is having this year by opening a revamped St. Pancras station that has allowed the train to cut 15 minutes off the length of the trip, bringing down the time to travel between the city centers to 2 ¼ hours. The result of these changes is that Eurostar ridership in the first half of this year grew by 18% to 4.63 million passengers, and revenue grew by 25%. Equally impressive is that the ridership growth has spurred Eurostar to bring forward the start of its 18th daily train, London-Paris, to September 8th from the planned start-up in the first part of 2009.

On the continent, the opening of the French TGV (for train à grande vitesse) Est Européen network last summer, which added 200 miles to the continent's existing 3,100 miles of high-speed track, has further expanded the traveling choice of the public. The ten European countries with existing high-speed track are projecting to grow their systems to 4,100 miles by 2010 and to 9,300 miles by 2020, assuming all the currently planned projects are completed. These expansions will cost roughly \$200 billion.

What is happening, though, is that transportation traffic patterns are shifting, something being dubbed the “TGV effect.” Since the TGV Mediterranean service started in 2001, cutting the travel time from Paris to Marseilles to three hours, rail’s share on that route has jumped from 22% to 69% in 2006. In response, discount airline company, EasyJet (EJETF-OTC), abandoned its Paris-Marseilles flights.

Exhibit 3. High-Speed Rail Is Expanding Across Europe



Source: Eurorail

A competitive advantage for the TGV service is that the trains are electric

A competitive advantage for the TGV service is that the trains are electric. With France’s low-cost electricity market due to the high percentage of the country’s power that is generated by nuclear plants, one major operating cost variable for TGV is being kept well under control. The success of the European trains demonstrates another benefit that can be derived from the increased use of electric power in our future transportation industry.

A 375-miles Madrid to Barcelona link has cut the journey time down to under three hours from over seven on one of the continent’s busiest rail routes

The TGV effect has happened on other city routes. Even before start of the TGV Est service between Paris and Strasbourg, which cut the travel time from four hours to two hours and 20 minutes, Air France (AFLYY-OTC) had reduced its daily flights from 12 to eight and canceled all flights between Paris and Metz. There are other new high-speed lines in Belgium, the Netherlands and Spain, where a 375-miles Madrid to Barcelona link has cut the journey time down to under three hours from over seven on one of the continent’s busiest rail routes. With the high-speed service between Paris and Brussels making the journey only one hour and 22 minutes, there is now only one direct flight between those cities. The Eurostar line has captured 69% of the London-Paris market and 64% of travelers

between London and Brussels. As Guillaume Pépy, the CEO of France's state-owned railway SNCF put it, "As air travel becomes more of a hassle, high-speed rail is winning 50% of the traffic where rail journeys are 4 ½ hours or less."

Exhibit 4. Short Travel Distances Belong To Railroads Now



Source: Eurorail

According to Michael O'Leary, the Ryanair CEO, "Fuel now represents almost 50% of our total operating costs compared to 36% last year"

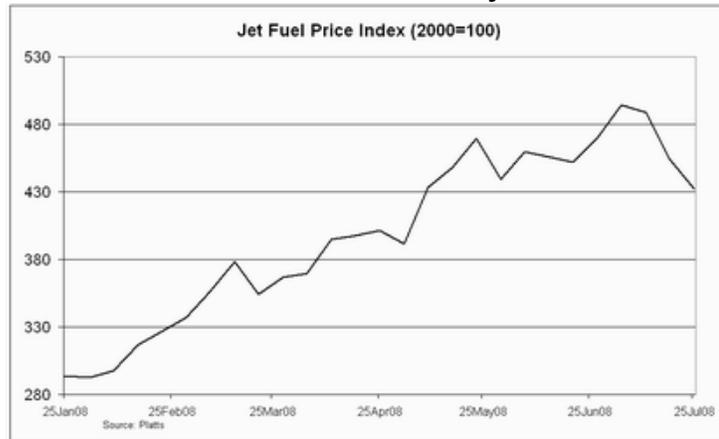
Couple this growing high-speed rail challenge with high jet fuel prices and a weakening economy in Europe and you have disaster written all over the airline industry, and the discount airlines in particular. Ryanair recently reported that its first fiscal quarter's earnings had fallen to \$33 million from \$185 million a year earlier, even though revenues rose 12% to \$1.2 billion. A 19% increase in passenger traffic, to 12.6 million, could not offset the impact of an 8% decline in average fares and an 18% increase in overall costs. "Oil prices almost doubled in the first quarter from \$61 to \$117 per barrel, as our fuel bill rose 93% to 367 million Euros (\$577 million)" said Michael O'Leary, the Ryanair CEO. "Fuel now represents almost 50% of our total operating costs compared to 36% last year."

"The outlook for the remainder of the fiscal year, which is entirely dependent on fares and fuel price, remains poor," commented Mr.

After predicting that average fares would climb by 5% this year barely two months ago, Ryanair is now projecting that they will fall by 5%, quite a dramatic swing

O’Leary. “The emerging economic recession in the U.K. and Ireland caused by the global credit crisis and high oil prices means that consumer confidence is plummeting, and we believe this will have an adverse impact on fares for the rest of the year.” As a result, after predicting that average fares would climb by 5% this year barely two months ago, Ryanair is now projecting that they will fall by 5%, quite a dramatic swing.

Exhibit 5. Jet Fuel Prices Have Destroyed Airline Economics

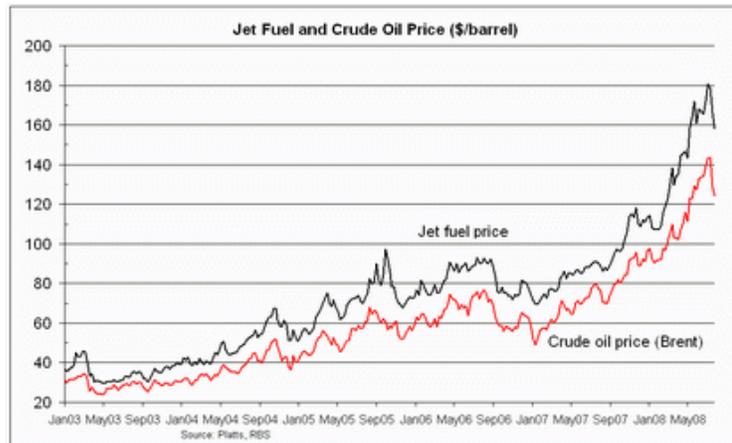


Source: Platts for IATA

Jet fuel prices in Europe last week were \$161.80 per barrel, up 76.6% over the past year

The impact of rising jet fuel prices in recent months and years is taking its toll on the airline industry. The fall in oil prices in the past few weeks has eased somewhat the cost pressure on airlines, but the chart of the jet fuel price index compiled by Platts for the International Air Transport Association (IATA) shows the damage done to the airline industry’s cost structure this year. (The index is set to 100 in 2000 when the price of jet fuel was \$0.87 per gallon.) Jet fuel prices in Europe last week were \$161.80 per barrel, up 76.6% over the past year. Since January 2003, jet fuel prices have climbed from about \$35 per barrel to \$161, with the bulk of the rise experienced over the past year.

Exhibit 6. Jet Fuel Prices Have Been A Problem For Years



Source: Platts for IATA

Ryanair has concluded it needs to ground 12 planes for this winter since passengers are not willing to pay the prices necessary to make the flights profitable given the price of jet fuel

As the discount airlines are finding, their cost structures are climbing at the same time their passenger loads are falling. Ryanair has concluded it needs to ground 12 planes for this winter since passengers are not willing to pay the prices necessary to make the flights profitable given the price of jet fuel. But this is not just a discount airline problem as it is hitting the large state-owned and legacy airlines as well. It is becoming an especially difficult challenge for the really long flights the industry has been flying and planning to add with the advent of the new, efficient, large passenger capacity planes the air plane manufacturers are building.

Several U.S. air carriers are delaying the start of new flights to China and Russia, and overseas airlines are ditching even longer flights due to record high fuel prices and softening traffic demand. US Airways Group (LCC-NYSE) received permission to postpone by one year its planned launch of a 13-hour flight linking Philadelphia and Beijing. The airline said that the annual cost of running the one daily jet on the flight had risen to \$90 million from \$50 million when it applied for the route about the end of last year. Northwest Airlines Corp. (NWA-NYSE) has been granted permission to suspend for a year seven weekly all-cargo flights it was operating between the U.S. and Guangzhou, China. UAL Corp.'s (UAUA-OTC) United Airlines asked for permission to delay the launch of its Washington-Moscow route until next March. It earlier this year received permission to delay launching its San Francisco-Guangzhou flights.

To cover the rising fuel cost, the plane would need to fly at 120% of capacity

Internationally, Aer Lingus Group PLC (AERL.L) has announced plans to drop its 12-hour Dublin-Los Angeles service. Thai Airways International ended its 17-hour Bangkok-New York route launched in 2005 and reduced the number of Bangkok-Los Angeles flights. Thai Airways' CEO Apinan Sumanaseni said that even with an 80% load factor the route is losing money. In fact, with jet fuel prices at current levels, he offered, the route would still lose money even if every seat were filled. To cover the rising fuel cost, the plane would need to fly at 120% of capacity – bringing up memories of those cartoons of planes flying with passengers strapped to the wings.

A passenger on a 15-hour flight uses more fuel for each mile of the trip than someone on an eight-hour trip, but the airfare revenue per passenger mile generally doesn't rise proportionally

The problem of the long-haul flights is the physics of flying people very long distances versus the revenue earned. A passenger on a 15-hour flight uses more fuel for each mile of the trip than someone on an eight-hour trip, but the airfare revenue per passenger mile generally doesn't rise proportionally. When fuel is cheap and passenger traffic strong, airlines can absorb the difference. To fly far, a plane needs lots of fuel onboard, and to carry all that fuel, it needs even more fuel. According to an analysis prepared for Britain's Royal Aeronautical Society, flying 18 hours in one hop could double the cost of flying the same route with three stops. Of course the air plane manufacturers point out that despite the fuel cost, nonstop flights are efficient. They reduce the wear-and-tear on a plane that comes with each landing and the time lost when it's on the ground. They also point out that takeoffs and landings use lots of fuel, which they believe counters the rise in fuel costs and the additional fuel needs for long-haul flights.

The discount airlines expanded the market for air service by offering cheap flights that were subsidized by low cost fuel and cheap debt-financing of planes

The bottom line seems to be that in Europe at least, the discount airlines really didn't steal their passengers from the established airlines. Rather, they expanded the market for air service by offering cheap flights that were subsidized by low cost fuel and cheap debt-financing of planes. Today's oil and credit markets have destroyed these key ingredients for the success of the discount airline business. That business model is being further hammered by the growth of high-speed rail service and a faltering economy. This will be another adjustment to the future lifestyle of the world's population.

In Spain Is 80 km/h The New Double-Nickel?

Spanish Energy Minister Miguel Sebastián's plan, involving a number of actions, is driven by his view that "the era of cheap energy has passed"

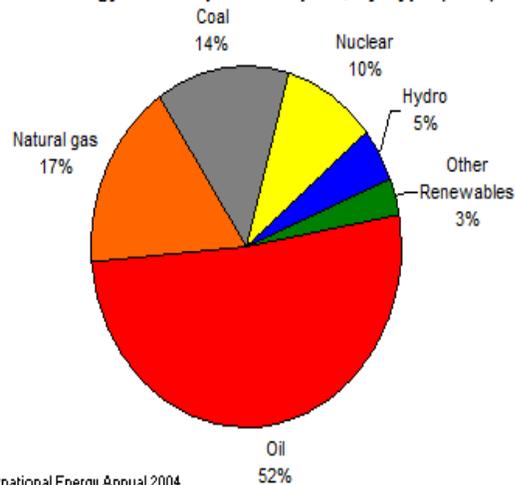
The Spanish government has launched an ambitious plan to cut energy consumption, save millions of Euros on oil imports and help reduce greenhouse gas emissions, although that is a secondary goal. Spain's socialist government hopes to reduce the country's oil imports by 10% per year between now and 2014, cutting oil consumption by 44 million barrels and save €4.14 billion (\$6.46 billion). The plan, targeted to cost €245 million (\$382 million), was introduced by Energy Minister Miguel Sebastián and involves a number of actions, all of which are driven by his view that "the era of cheap energy has passed."

The speed limit on dual-lane highways in the country will be reduced to 80 kilometers per hour, or 50 miles per hour, rivaling the notorious U.S. double-nickel (55 mph) speed limit that existed from the mid 1970s until the late 1980s. Already a straw poll of Spanish motorists conducted by Spanish television channel Telecinco found that the majority of drivers were opposed to the move. As one motorist in Madrid put it, "Tell the minister that things are just fine as they are. We don't want to cut our speed. People would be honking their horns all the time if they had to go that slow."

Spain has the highest dependence on fossil fuels of any country in Europe, using them to meet almost 87% of its energy needs in 2007

Part of the motivation for the new energy savings plan is Spain's high dependence on hydrocarbon fuels, much of which is imported. Among European countries, Spain has the highest dependence on fossil fuels of any country in Europe, using them to meet almost 87% of its energy needs in 2007 as reported by the *2008 BP Statistical Review of Energy*. More importantly, today the country is importing almost all the oil and natural gas it consumes, which amounts to close to 73% of its total energy consumption.

The government plans to hand out 49 million free energy-saving light bulbs - two for each household - to try to convince Spaniards to reduce energy consumption. By law, by 2012 all light bulbs are expected to be low-energy consuming. Other big societal changes involve mandating that air conditioning temperatures in public buildings be set no lower than 26C (79F). In winter, they will not be allowed to go above 21C (70F), with hospitals being the only exception. Street lighting will be reduced by 50% and the metro system in many cities will stay open later at night on weekends to

Exhibit 7. Hydrocarbons Are Important To Spain**Total Energy Consumption in Spain, by Type (2004)**

Source: EIA International Energy Annual 2004

Source: CIA

encourage people to leave their cars home. The government is attacking auto fuel consumption by mandating that all government vehicles are to meet at least 20% of their fuel needs through biofuels. In addition, the Spanish government plans to introduce a pilot project for the manufacture of 1 million electric or hybrid cars. Lastly, the government, in an unprecedented move, will allow commercial airlines to use military air routes to make journeys 20% shorter. This comes after both Ryanair and EasyJet have announced plans to cut routes to Spain due to rising jet fuel prices.

Minister Sebastián created a stir by appearing before the Spanish legislature without a tie

In an attempt to drive home the point about the need to conserve energy by cutting air conditioning temperatures, Minister Sebastián created a stir by appearing before the Spanish legislature without a tie. He was ordered by the speaker to dress properly.

In 1994, the Japanese prime minister appeared in his short sleeve suit, something he has continued to do since retiring from office

Much of the Spanish plan brings to mind the efforts of the Japanese government starting as far back as 1994 to try to get its citizens to buy into higher air conditioning temperatures and lower winter settings. At that time, the prime minister appeared in his short sleeve suit, something he has continued to do since retiring from office. Since then, other prime ministers have sported shirt and slack combinations and even Hawaiian-styled floral shirts in efforts to sell the government's plans.

It took almost a decade for the Japanese to begin to change their sartorial ways. The shift was helped along by a program initiated by the government called "Cool Biz" that was designed to introduce new fashions, cooler and more breathable fabrics, and fewer clothes at the office (no jackets or ties, for example). Since the government had mandated that air conditioning be set no lower than 28C (82F) the success of the new clothes style initiative was foreordained.

Exhibit 8. Former PM In Half-Sleeve Suit

政治家としての人気は上々だが、半袖
スーツの評判はいまひとつ。羽田孜氏。

Source: AVP

Unfortunately, the former prime minister's half sleeve suit never caught on, although we understand you can have one made in China. The Japanese government followed up its summer temperature initiative the following winter with a "Warm Biz" clothing program to provide warmer, more stylish clothing, especially for women working in offices, as it mandated that office heating systems could not be set higher than 20c (70F).

Exhibit 9. The Famous Half-Sleeve Suit

Source: AVP

Just as business casual is permeating the offices of North America, we expect to see more fashion shifts as governments mandate and companies embrace, energy saving steps that create some discomfort for employees. This is just another of the many shifts underway that will help constrain the growth of, or reduce, our energy consumption.

Will The Olympics Change China's Energy Consumption?

For the next two months, Beijing will demonstrate real energy demand destruction – mandated by the government in order to try to clean up the city's air quality during the Olympics in August and the Paralympics in September

Many discussions about the future direction for crude oil prices have focused on the disconnect between energy demand destruction underway in the United States and Europe in response to high oil prices and the growing oil demand in the developing economies of Asia. For the next two months, Beijing will demonstrate real energy demand destruction – mandated by the government in order to try to clean up the city's air quality during the Olympics in August and the Paralympics in September. But an interesting question is what will be the reaction of the public and the government leaders following this massive experiment with restricting energy consumption in favor of environmental quality improvement.

Last week the first of the mandatory restrictions on travel and industry operations in and around Beijing commenced. As the first several days provided no air quality improvement, the government announced a "just-in-case" plan. The initial transportation restrictions commenced July 1st when trucks producing high emissions were blocked from entering the city. Many of these trucks were stopped at roadblocks and were forced to transfer their loads to other trucks with cleaner-burning engines that have permits to circulate in the city. Another restriction has limited the entry into Beijing of big trucks to between midnight and six in the morning. This restriction will hurt the continued operation of some manufacturing plants that are dependent on trucks for delivery of supplies and components. It will also have a knock-on effect on manufacturing plants dependent upon Beijing plants for their components. Some Chinese businessmen have suggested that this two-month restriction on trucks operating in the Beijing area will hurt product availability for the upcoming Christmas season.

To compensate for the shutdowns, some of the plants had stepped up their production in prior months by as much as 30%, which certainly boosted energy and commodity demand this spring

The government planned to shut down many businesses in the neighboring region and in the city that were significant polluters and to send the workers home, including the requirement for migrants to go back to their home provinces. To compensate for the shutdowns, some of the plants had stepped up their production in prior months by as much as 30%, which certainly boosted energy and commodity demand this spring. Most construction sites in Beijing were ordered shut so that dust due to cement production and other construction-related actions would cease.

Exhibit 10. Beijing Traffic Jam

Source: AVP

As a result of the special lanes, even with the initial traffic ban, there have been greater traffic jams than anticipated

Car travel in Beijing is being restricted by the implementation of an odd-even driving ban during this Olympic period. Depending upon the last digit of the car's license plate, vehicles could travel on alternate dates. With over 3.3 million cars in the city and the fleet population growing by about 1,000 vehicles a day, the odd-even restriction is taking about half the cars off the road each day. But another travel restriction designed to ease travel around the city for Olympians and visiting journalists appears to have backfired and forced the government to develop its "just-in-case" plan. The government established special Olympic travel lanes to speed buses and official vehicles, but it has had the impact of shrinking road capacity more than anticipated even with the removal of half the city's vehicle fleet under the odd-even driving plan. As a result of the special lanes, even with the initial traffic ban, there have been greater traffic jams than anticipated. This surprise was another factor in the development of new restrictions, which include that vehicles with their last two digits on their license plate matching the calendar date will also be restricted from driving that day.

Another aspect of the new air quality plan was the closing of an additional 220 factories, coal-fired power plants and steel plants in Beijing, as well as in nearby Tianjin city and in the surrounding Hebei province if air quality is forecast to be poor for any 48-hour period. Under this condition, all construction activity in Beijing would also be shut down.

Part of the solution was to build three new subways to ease traffic problems, to designate special Olympic travel lanes and to plant trees to help absorb carbon dioxide

In planning for the Olympics, Beijing knew it had an air quality challenge that needed to be addressed. Part of the solution was to build three new subways to ease traffic problems, to designate special Olympic travel lanes and to plant trees to help absorb carbon dioxide. They also have constructed a new high-speed train connecting Beijing and Tianjin where some Olympic events are scheduled to be held. The train commenced operation last week and cut the 120-kilometer trip from 70 minutes to 30 minutes.

Exhibit 11. Beijing Starts New High-Speed Train Service

The first intercity train between Beijing and Tianjin departs from Beijing South Railway Station for Tianjin, Beijing, capital of China, Aug. 1, 2008. The intercity rail line between Beijing and Tianjin is a high-speed rail. The new train service would cut the 120-km journey from the current 70 minutes to about 30 minutes. (Xinhua/Gong Lei)

Source: Peak Oil News

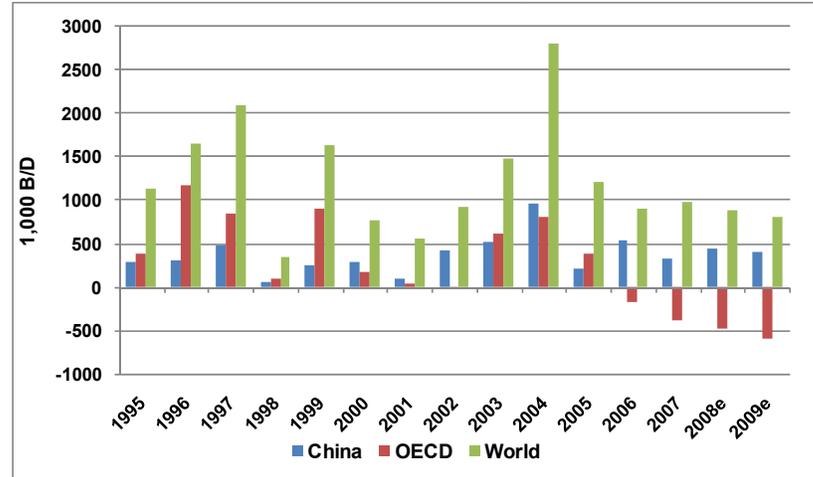
The big questions will be how much the government is willing to subsidize energy costs for its citizens and how the government will deal with pollution and its impact on the population and its economy

It seems to us that following the 60-day experiment in cleaning up the air of Beijing, China may have some true soul-searching to do about how it plans to operate its economy in the future. The government has already raised certain fuel prices, while capping others, in order to guarantee that adequate supplies of gasoline and diesel would be available for the Olympic period. The big questions will be how much the government is willing to subsidize energy costs for its citizens and how the government will deal with pollution and its impact on the population and its economy. We do know the government is planning for nuclear power and liquefied natural gas (LNG) to play a greater role in the country's future energy supply mix. What it does about the country's heavy dependence upon coal for fuel remains to be seen. But judging from the combined use of diplomatic, commercial and energy policy in foreign affairs, China's actions suggest it knows it will need oil and gas resources from many locations around the world to satisfy its domestic oil requirements. The government has also become an aggressive proponent of renewable fuels such as wind and solar and expects them to play a significant role in its future energy mix.

What we find quite interesting is the recent projections calling for China's economic growth to slow in 2008 and 2009 appreciably from the double-digit rate it has been expanding at, to a rate closer to 9% per year. If we look at the annual growth in oil consumption since 1995 through 2007 as reported by the *2008 BP Statistical Review* and the projected increases for 2008 and 2009 forecast by the International Energy Agency (IEA), we find an interesting pattern. The IEA forecasts call for stronger annual oil consumption growth than reported for 2007, but a slower rate of increase than experienced in 2006. What is interesting is to see how China's demand growth has compared, and is projected to compare, with the

annual consumption growth for the developed economies that make up the OECD countries and the world in total.

Exhibit 12. Annual Oil Growth for China, the OECD and World



Source: BP, IEA, PPHB

In 2009, the IEA is forecasting OECD consumption to fall by 1 ½ times the amount of projected oil consumption growth for China

According to the IEA, China's oil consumption growth will account for about half of the projected world growth. But interestingly, OECD consumption has fallen the past two years and is forecast to continue to fall in 2008 and 2009. In fact in 2009, the IEA is forecasting OECD consumption to fall by 1 ½ times the amount of projected oil consumption growth for China. So while China's oil demand continues to grow, it appears that it is starting to play a smaller role in global oil demand growth. If China's economic growth slows and the government becomes more concerned about its environmental image, possibly the country's oil consumption growth will become less of a global concern than most forecasters have been suggesting. How the government deals with energy and pollution in the time period following the Olympics may be one of the more important variables in forecasting future oil demand and the course of future oil prices. We are not going to make any predictions, but only offer the idea that we should all be watching China's economy and its government's actions this fall, maybe more than we watch the U.S. presidential election.

Northeast Cartoons Reflect Changing View of Energy

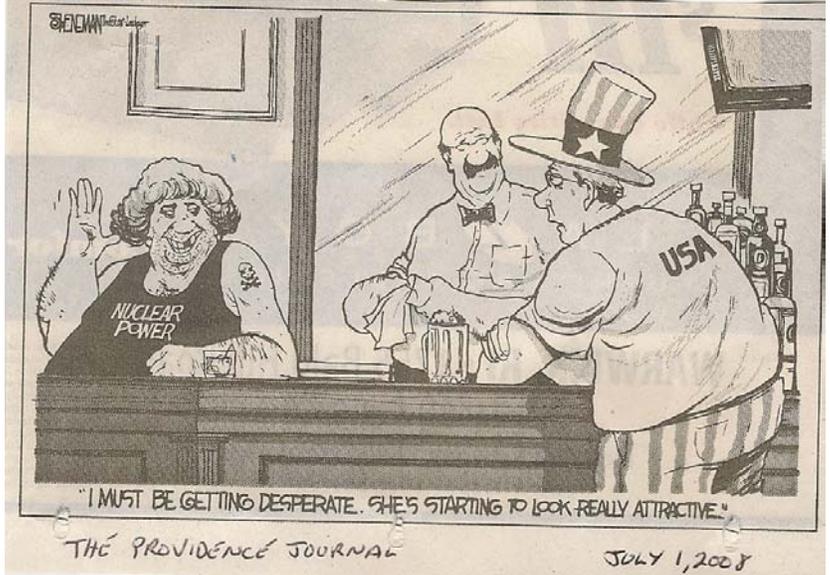
We thought it would be helpful to our readers to gain a better understanding of how the energy debate is being viewed in the Northeast

While we were at our summer home in Rhode Island, we found the local papers focusing increasingly on the energy situation – high gasoline and heating oil prices and how the country is supposed to deal with these conditions. While it is possible that these cartoons appeared in other newspapers, we thought it would be helpful to our readers to gain a better understanding of how the energy debate is being viewed in the Northeast, which may partially explain why public sentiment is shifting so rapidly. There is little doubt but that last week's congressional battle over a vote to allow more domestic

We found these cartoons instructive in our view that the public clearly is getting ahead of the politicians on energy policy

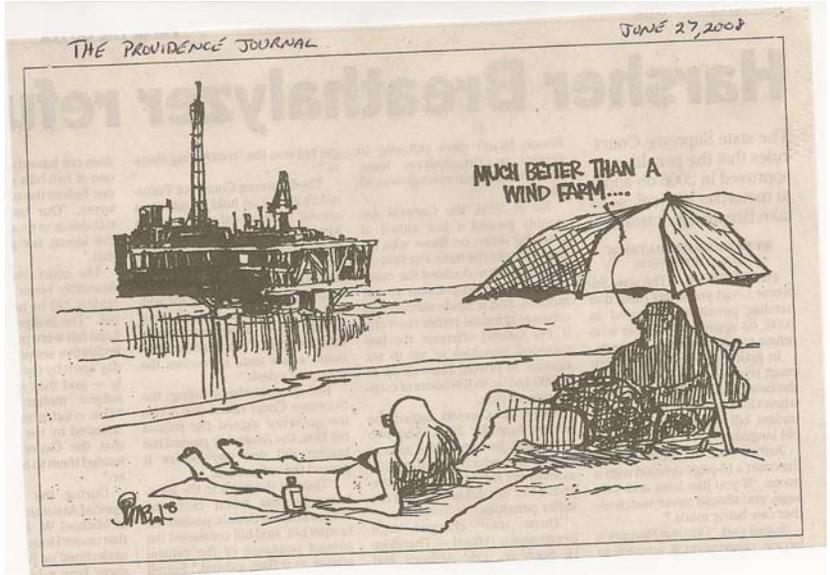
drilling on federal lands on- and offshore, plus this weekend's policy shift by Barack Obama in agreeing to allow more of the Outer Continental Shelf to be opened for drilling is reflective of the public mood forcing politicians to act. We found these cartoons instructive in our view that the public clearly is getting ahead of the politicians on energy policy. The fallout, in our view, is that federal energy laws will change faster than anyone may imagine. We appear to be on the cusp of that change now.

Exhibit 13.



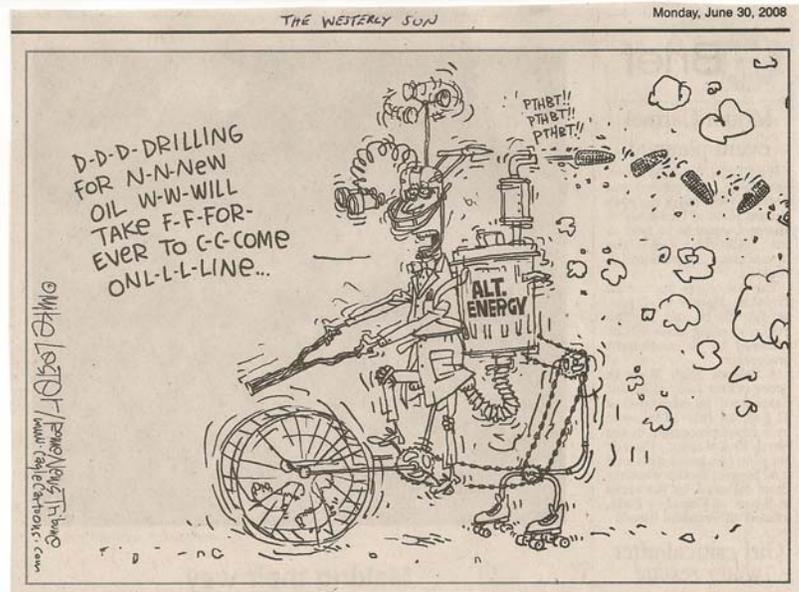
Source: *The Providence Journal*

Exhibit 14.



Source: *The Providence Journal*

Exhibit 15.



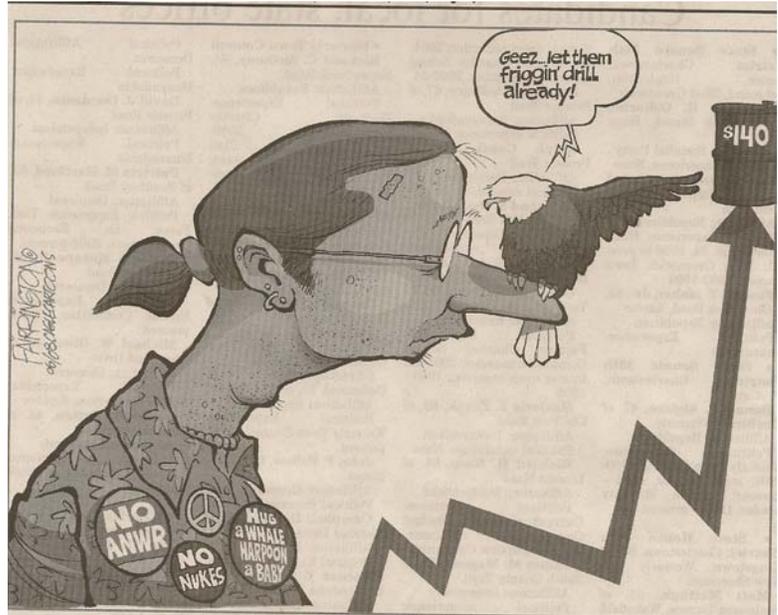
Source: *The Westerly Sun*

Exhibit 16.



Source: *The Providence Journal*

Exhibit 17.



Source: *The Providence Journal*

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