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MUSINGS FROM THE OIL PATCH

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

Impressions From A Road Trip

My wife and I recently made our eighth annual driving trip from our home in Houston to our second home in Rhode Island. Because we rent the Rhode Island house for July, our trips are always scheduled for the same time – the last days of July. As a result of this consistent travel pattern, we can make some observations about motor travel and the health of the economy.

The huge increase in traffic we encountered resulted in us having a slightly slower average speed than in past years

The trip requires driving between 1,800-1,900 miles, depending upon the particular route we take. The trip use to be a two-day driving marathon, but lately it has morphed into a two-and-a-half-day trip. In making this year's trip, I think I gained a better understanding of what has been happening in the domestic fuels market plus more insight about the U.S. economy. First, both my wife and I commented on the huge increase in traffic we encountered that resulted in us having a slightly slower average speed than in past years. That helps to explain why gasoline demand is up about 1.1% based on the latest 4-week average this year over last. In addition, the number of trucks we encountered was mind-boggling. At every truck stop, highway rest area and state truck-weighing location there were trucks galore. Not only did we have to fight the trucks on our side of the road, we watched caravans of them on the other side. So now we can begin to explain the sharp increase in diesel fuel consumption. Distillate fuel consumption, which includes transportation diesel is up 4.2% for the latest 4-week period compared to last year.

The number of trucks we encountered was mind-boggling

Another trend we found interesting was in the price of gasoline. Until we hit Pennsylvania, New York and Rhode Island, it seemed that gasoline was the same price everywhere. Whether it was Texas, Louisiana, Mississippi, Tennessee or Virginia, the price of premium gasoline (my wife's car demands that fuel) was \$2.36 to \$2.39 per gallon. And it almost didn't matter whether it was a major

gasoline retailer (Chevron (CVX-NYSE), ExxonMobil (XOM-NYSE), or Texaco) or a discounter (Race Trac), the price was the same. When we reached the northeast, however, gasoline prices jumped by \$0.20 to \$0.30 per gallon. While we understand that some of this price increase is due to higher state gasoline taxes, there is clearly a higher price range in this region. That is just another sign of the higher cost of living in the region.

There has been only a limited negative impact on fuel consumption, and economic activity, due to high petroleum prices

The high level of automobile and truck traffic confirms the strength in economic activity. It also means that this strong economic activity is continuing. Clearly there has been only a limited negative impact on fuel consumption, and economic activity, due to high petroleum prices. Implicit in this picture is that the increase in transportation petroleum demand helps explain why oil prices are where they are. The large volume of trucks on the road is testimony to growing consumer consumption – the primary driver for economic growth so far this year. The second quarter GDP estimate was reported at 3.4%, down from the 3.8% of the first quarter. Given this positive second quarter economic report, GDP estimates for the third quarter are being raised to over 4% and even some as high as 5%. With that level of economic activity, we expect to see a very high vehicle flow rate when we drive back to Houston in early September.

People are opting to spend more of their limited vacation dollars on fuel and less on housing and eating out

The other interesting data point we learned was that the vacation market in New England is down from last year. How this market is evolving presents interesting insights into consumer spending (economic activity) and petroleum spending patterns. According to my wife's cousin, our real estate agent, many vacation homes in our area have, or had, empty weeks this summer. That reflects both more competition due to higher real estate taxes and reduced Wall Street bonuses, and less vacation money available generally. Our niece, a local lawyer, told us that at a recent Chamber of Commerce meeting owners of hotels and motels and restaurants reported that their business was off from last year. However, other Chamber members noted that vehicle traffic coming into the area is higher than last year. Our interpretation of this data suggests that more people are electing to take their vacation by the day rather than weekly. It appears that people are opting to spend more of their limited vacation dollars on fuel and less on housing and eating out. What we don't know yet, but suspect, is that beach attendance is up and that nearby fast-food and beach-oriented food expenditures are higher, while upper scale restaurants in the area are down.

While all of this information is antidotal, we believe it helps to explain why economic activity is relatively strong, albeit not as strong as forecasters originally anticipated, but also why fuel consumption remains strong despite high prices. As economists know, given time, consumers adjust their spending habits to get what they want despite higher prices that would seem to sap income and spending. How much longer these types of spending adjustments can accommodate high petroleum prices is unknowable. As we have suspected and stated, at the margin, high petroleum prices have to be having some negative economic impact.

An Abnormal Hurricane Season

The National Oceanic and Atmospheric Administration (NOAA) has revised its forecast for the 2005 hurricane season. While NOAA appears to be the last organization to update and raise its forecast, it has taken the estimate of the number of storms and hurricanes to the highest level. That reminds us of the old adage in sports of making sure your team gets the ball last.

NOAA now projects a total of 18-21 tropical storms against an average of 10 with 9-11 storms becoming hurricanes

NOAA now estimates that there is a 95% to 100% chance of an "above-normal hurricane season." This is up from their May 16 forecast that called for a 70% chance of an above-normal hurricane season. NOAA now projects a total of 18-21 tropical storms against an average of 10; with 9-11 storms becoming hurricanes (average is 6). Of those hurricanes, NOAA anticipates 5-7 will become major storms (average is 2-3) with winds of 111 miles per hour or greater (Category 3-4-5). The most active Atlantic basin hurricane season was in 1933 with 21 storms, followed by 1995 with 19 storms. The most hurricanes in a season was 12 in 1969, and the highest number of major hurricanes was eight in 1950.

Professor William Gray at the Department of Atmospheric Science of the Colorado State University has also revised his hurricane forecast. Gray now sees 20 tropical storms with 10 becoming hurricanes and six as major storms. This increased forecast is up from his May projection of 15 storms, with eight hurricanes and four major storms. Importantly, Gray has raised his estimate of landfall for the entire U.S. coast to a 77% probability compared to a 52% average for the past century. He expects that the East Coast has a 58% probability of a hit (31% average) with the Gulf Coast, from Brownsville, Texas to the Panhandle of Florida, rating a 44% probability (30% average).

Exhibit 1. Prof. Gray's New Hurricane Forecast

Forecast Parameter and 1950-2000 Climatology (in parentheses)	Issue Date	Issue Date	Issue Date	Observed Forecast		Total Seasonal
	3-Dec 2004	1-Apr 2005	31-May 2005	Activity Through Jul-05	Activity After 1-Aug	
Named Storms (NS) (9.6)	11	13	15	7	13	20
Named Storm Days (NSD) (49.1)	55	65	75	28	67	95
Hurricanes (H)(5.9)	6	7	8	2	8	10
Hurricane Days (HD)(24.5)	25	35	45	11	44	55
Intense Hurricanes (IH) (2.3)	3	3	4	2	4	6
Intense Hurricane Days (IHD)(5.0)	6	7	11	6	12	18
Net Tropical Cyclone Activity (NTC)(100%)	115	135	170	68	167	235

Source: Colorado State University

Bastardi now believes that the focus of storms will shift from the Gulf of Mexico to the East Coast of the US

The first forecaster to raise his storm total was Dr. Joe Bastardi of AccuWeather who increased his estimate to 18 storms with six projected to hit the United States. Of these hurricanes, Bastardi expects three of the storms to become major storms. Importantly, Bastardi now believes that the focus of storms will shift from the Gulf of Mexico to the East Coast of the United States. That shift, if it occurs, has significant implications for the domestic energy industry, and indirectly for oil and natural gas prices.

All of these revised forecasts are incorporating the storms of this

season so far. As a result, all the forecasters have raised their projections of the number of storms this year and the number of hurricanes. The forecasts are also incorporating the latest atmospheric and oceanic condition data. "Warmer-than-normal sea-surface temperatures (SST) and low wind shear are among the culprits behind these stronger and more numerous storms," according to Gerry Bell, lead meteorologist on NOAA's Atlantic Hurricane Seasonal Outlook.

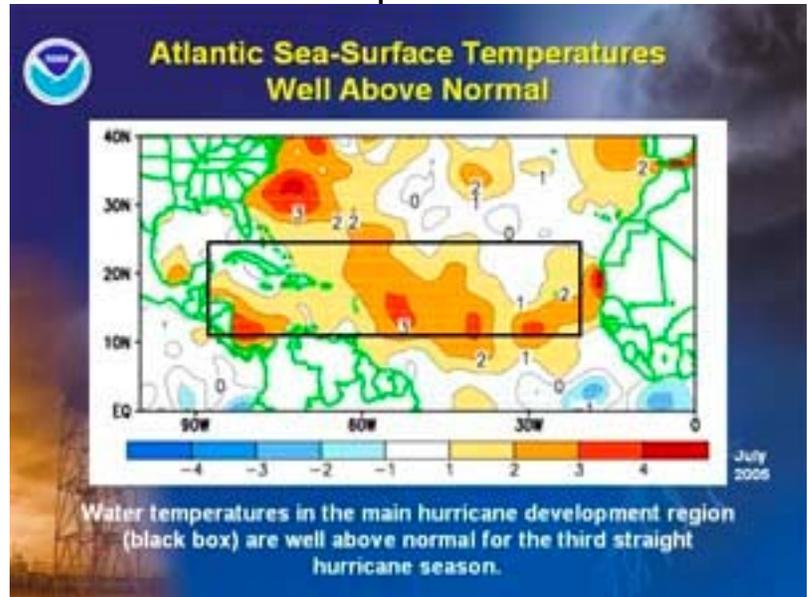
Exhibit 2. Hurricane Conditions Are Favorable

Hurricane formation conditions are extremely favorable for both formation and intensity

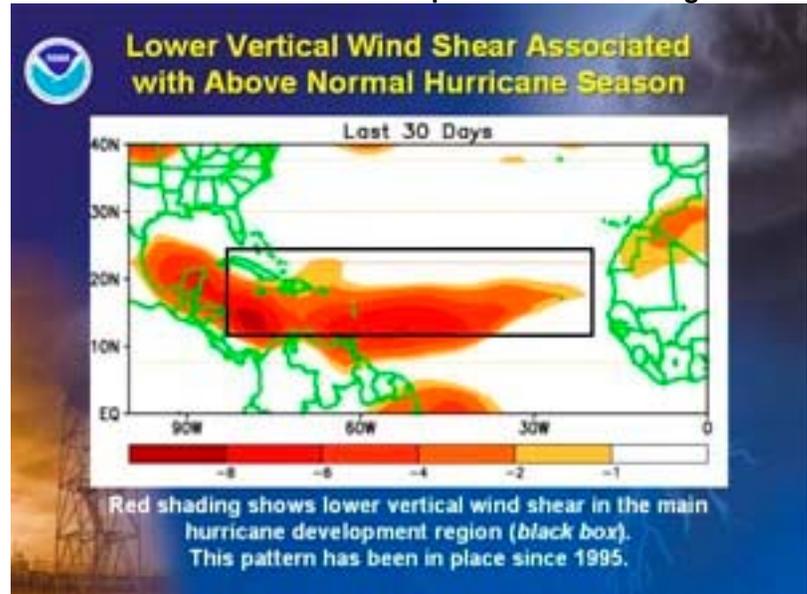


Source: NOAA

Exhibit 3. Favorable Sea Temperatures



Source: NOAA

Exhibit 4. Lack of Wind Shear Helps Hurricanes Strengthen

Source: NOAA

A new climate report is drawing a statistical relationship between global warming and hurricane ferocity

By the time you read this, there will have been nine tropical storms with three having become hurricanes and two of those major storms. The season is continuing the above-normal storm activity that began in 1995, and will likely be the seventh extremely active season since 1995. As all the new forecasts were being introduced, a new climate report from a scientist, Kerry Emanuel, at the Massachusetts Institute of Technology was published in *Nature* magazine drawing a statistical relationship between global warming and hurricane ferocity.

NOAA believes the Atlantic basin is likely to experience another decade or so of these optimal tropical storm formation conditions

According to the study, the accumulated power of Atlantic hurricanes has more than doubled in the past 30 years, with a particularly dramatic spike since 1995. The article attributes this rise in ferocity to global warming; however, the article did not shed any light on the effect of global warming on the number of storms. What NOAA and most storm forecasters acknowledge is that the optimal ocean and atmospheric conditions that have been known to produce increased tropical storm activity operate in multi-decadal cycles of approximately 20-30 years. As a result of this pattern, NOAA believes the Atlantic basin is likely to experience another decade or so of these optimal tropical storm formation conditions.

Emanuel's study has drawn conclusions about the increased intensity of winds associated with hurricanes during the past ten years due to an increase of about one degree in the average SST. "It sounds like a small amount, but we know that as waters get even a little bit warmer, the potential exists for hurricanes to get dramatically stronger," said Chris Landsea, a NOAA scientist.

Landsea noted that the accumulated hurricane power spike of 1995-04 correlated precisely with the beginning of the period of increased

hurricane formation. "It's very difficult to separate out what's caused by this natural cycle of activity versus man-made warming," Landsea said. He did question some of the statistical analysis conducted by Emanuel.

"This is a serious study and it needs to be taken seriously," said Landsea. "But when you take a close look at it, there's a lot of caveats. So, at this point, I'm not convinced he's found the smoking gun between global warming and hurricanes." The timing of Emanuel's study was to coincide with the release of the revised hurricane forecasts to try to further cement the view that global warming is the cause of the upward revision in storms forecast. We still recall that it wasn't that many years ago that the scientific debate was over the coming ice-age.

Are We Going Back to The Age of Wood?

Soria has identified oil grades that could someday replace gasoline, tar, glues and resins

Is bio-oil the solution to our energy crisis? A graduate student at the University of Idaho's College of Natural Resources, Juan Andres Soria, believes that by heating a mixture of sawdust and methanol to 900 degrees Fahrenheit you can create bio-oil. Once bio-oil is produced, it can be separated by boiling points, or grades, according to the research. So far Soria has identified oil grades that could someday replace gasoline, tar, glues and resins for use in making things like lawn furniture.

With industry backing, Soria estimates that an industrial-size bio refinery could be constructed in five years

Soria, in conjunction with an associate professor of wood chemistry and composites, is testing this idea of creating bio-oil. So far they have only used sawdust from Ponderosa pine trees, but they believe that other varieties, including fast-growing trees currently being cultivated for wood pulp. The significant fact is that only about two percent of the mass is lost in the heating process. Unfortunately, they estimate that bio-oil will only be competitive when the cost of crude oil reaches \$80 per barrel. With industry backing, and there is none yet, Soria estimates that an industrial-size bio refinery could be constructed in five years.

If Soria could get the federal government to subsidize the development of a bio-oil industry, we can picture the thousands of acres of fast-growing trees that will join the acres of cornfields and soybeans being planted to produce the raw material for ethanol and biodiesel production. If one wants to take this image a step further, we could see this industry being used to employ unemployed workers (youths) much like the initial Civilian Corps Youth Reforestation Movement that morphed into the Civilian Conservation Corps (CCC) in 1933 during the Great Depression.

Shifting Investment Landscape In Russia

Buried in the Total (TOT-NYSE) earnings press release issued on August 4, 2005, the company disclosed that it had withdrawn an application for approval to purchase an interest in a Russian energy

Total expresses frustration with the delays because it obviously was not informed of the reasons for them

company. The disclosure was reported in the last paragraph of page six of the 24 page press release. The disclosure seemed to be presented almost as an afterthought, yet the proposed acquisition involved significant political capital of the presidents of two countries.

The press release paragraph stated: "Finally, as a result of the numerous delays, which are difficult to understand, that have occurred since the filing of the application in September 2004, Total has just informed Russian antitrust authorities of its decision to withdraw its application concerning the acquisition of 25% plus one share of Novatek." The language of the paragraph is interesting in that Total expresses frustration with the delays because it obviously was not informed of the reasons for them.

The transaction for the investment in Novatek, a Russian natural gas-oriented company, would have cost Total \$1 billion. This was a pet project of French President Jacques Chirac who has wanted to develop stronger commercial relationships with Russia. The project received the blessing of Russian President Vladimir Putin in September 2004. Total continued to hold on to the thought it would eventually be able to complete the transaction, most likely based on assurances from Chirac. Unfortunately, Russia's Federal Anti-Monopoly Service (FAS) continued to delay the approval. For some reason, unexplained, Total decided to throw in the towel on this deal.

Total's withdrawal of its Russian purchase reflects a realization that the investment landscape in the country has changed

This is the second major European-championed investment deal that has been derailed by Russian authorities. In April, the FAS rejected an effort by Germany's Siemens (SI-NYSE) to acquire 73% of Russia's Power Machines, a large manufacturer of power-generating equipment. Mr. Putin had promised German Chancellor Gerhard Schroeder that he would see the deal through in early 2005. The FAS blocked the deal on grounds that the company produces equipment relevant to Russian national security.

Total's withdrawal of its Russian purchase reflects a realization that the investment landscape in the country has changed. Most likely, Total knew it was facing a strong state-controlled Gazprom (OGZPF.PK) in the battle for the ownership interest. After watching what Gazprom had done to Royal Dutch Shell (RDS-A-NYSE) in western Russia, Total probably decided that fighting this battle was not worthwhile. Gazprom secured a 25% interest plus one share in the Sakhalin –II project, a well-developed project with an opportunity for unparalleled technology transfer for a 50% interest in the smaller Zapolyarnoye gas field in Siberia that Shell needs to develop from scratch.

Gazprom has gone from the 800-pound gorilla to King Kong

Gazprom has gone from the 800-pound gorilla to King Kong following the sale of a 10.74% interest to the Kremlin. With billions of dollars in its pocket, Gazprom is either a kid in a candy store or a bull in a china shop in trying to fulfill the company's goal of becoming a global energy power. That status will be achieved either by buying oil and gas companies in Russia or elsewhere, and Novatek is a likely candidate.

In the energy sector, this shift will likely further retard the pace of western investment

The defeat of high profile investment plans by the two major European powers with whom Putin has been attempting to develop better relations reflects the greater difficulty Putin is having in keeping a hold on the Russian bureaucracy. The Total investment decision will prove damaging to French-Russian relations. These relations will survive, but clearly the investing landscape in Russia has changed from the halcyon days when western companies targeted Russia as the next great investment frontier. In the energy sector, this shift will likely further retard the pace of western investment. Some analysts are speculating that the new head of ExxonMobil, Rex Tillerson, who once ran its Russian operations, will target opportunities in that country for the company's \$30 billion cash horde. We are not so sure.

Perils of Forecasting New Oil Production Growth

The net result of these three announcements is more crude oil production sooner

We were intrigued recently when we saw three headlines on an internet energy news source that talked about the status of different field development projects. The three projects are scattered around the globe. Two of the field announcements reflected delays in startups, one for oil and one for gas, while the third called for an earlier than planned start for a major offshore deepwater oil field. The net result of these three announcements is more crude oil production sooner than previously anticipated, but future planned production of oil and gas will be reduced.

The three projects reported on included ExxonMobil's Kizomba B field in Angola that has come on stream five months early. On the other hand, Sonatrach's In Amenas gas project in Algeria will be delayed from a late 2005 start to sometime in 2006. This field will produce both gas and oil. The other field was Royal Dutch Shell's Sakhalin-II project where year-round oil production will be delayed until 2007 from 2006 and the second oil platform will be delayed until 2008 from 2007.

Forecasting future global oil supply based on the amount of planned production associated with new fields can easily be thrown off schedule by changes in development schedules

Our reason for pointing out this series of announcements is to highlight the risk in forecasting future oil production by counting on the anticipated start up dates of planned fields. The development of many of these new international fields has been challenged in recent years by technology and politics. With global oilfield activity climbing, despite maturing technology, the risk of field development delays would seem to be increasing, not declining. Therefore, forecasting future global oil supply based on the amount of planned production associated with new fields can easily be thrown off schedule by changes in development schedules.

How High Does The OSX Go?

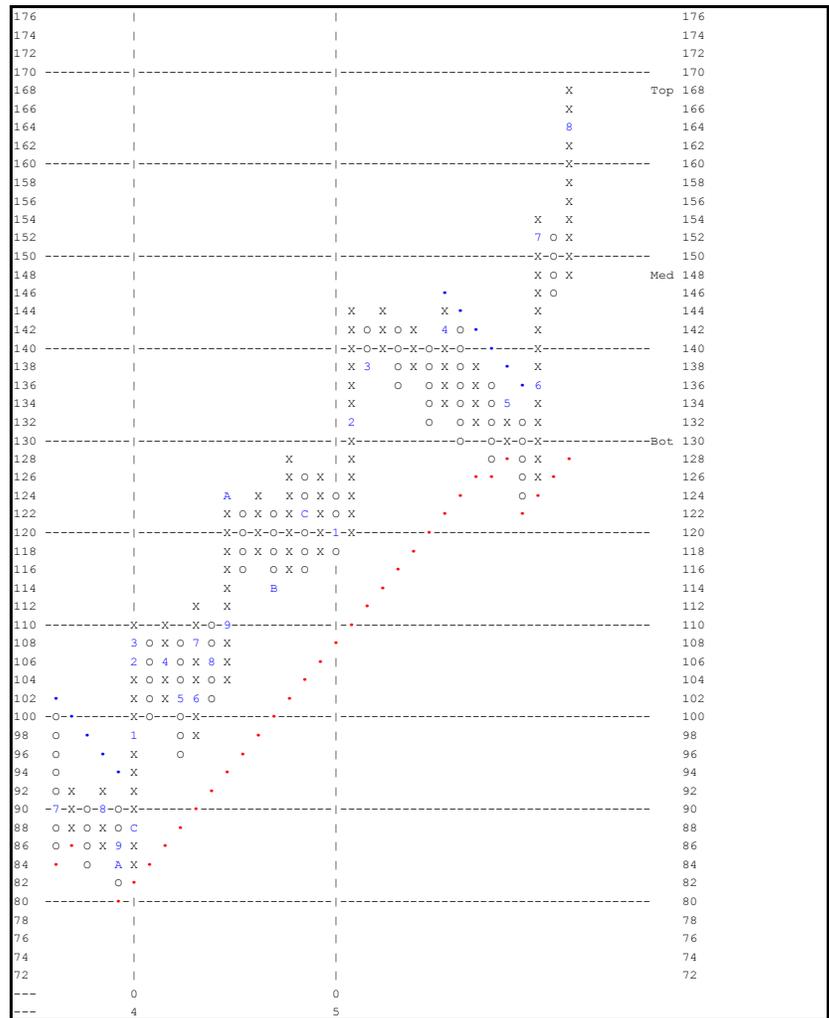
In the past few issues of *Musings From The Oil Patch*, we have talked about the trading pattern of the Philadelphia Oil Service Index (OSX). When the index created a bear trend reversal pattern in May, we speculated that the OSX could move as high as 154. The

The OSX has gone straight up from 148 to 168

OSX was then at 134. The OSX did climb toward 154, but along the way, the index created a new pattern by breaking a triple top wide spread at 144. We said then, that by breaking that pattern, the OSX had the potential of going substantially higher than our 154, and we suggested 166 as a target.

After hitting 154, industry events turned negative. Crude oil prices slumped and investor funds began to shift toward a rallying technology sector. The OSX retreated to 146 before reversing back up following the start of second quarter earnings reporting season. The stronger-than-expected second quarter earnings results for the oilfield service companies caused analysts to boost earnings forecasts for 2005 and 2006 and lift their price targets for the stocks. Investors, watching another surge in crude oil and natural gas prices while seeing exploding earnings and hearing very positive management outlooks, jumped on the oilfield service stocks. The OSX has gone straight up from 148 to 168. So, where does it go?

Exhibit 5. The OSX Continues to Move Higher



Source: Courtesy of Dorsey, Wright and Associates

Oilfield service stocks don't have to go down, but they might experience a rest period

Stocks seldom go straight up for long periods of time. That doesn't mean that oilfield service stocks have to go down, but they might experience a rest period. If we look at Exhibit 5, the point and figure chart of the OSX from Dorsey, Wright and Associates, it shows several time periods when the OSX appeared to go straight up. The chart covers the OSX performance from the summer of 2003 to last week. In the current run-up in the OSX, there have been 11 X's (each X represents a \$2 per share change in the index), or \$22. The prior run-up lasted for 15 X's (\$30). The one beginning in January 2005 lasted 13 X's (\$26). The early fall 2004 move was 11 X's (\$22) and the December 2003-March 2004 move lasted 14 X's (\$28).

Hurricanes during the back half of the season may target the East Coast more than the Gulf of Mexico could weigh down oil and gas prices

If the current move repeats the pattern of the most recent run-up, then we have another 4 X's (\$8), or up to 176, for the index. On the other hand, all the prior upward moves were less than 15 X's. It is very difficult to predict how high the OSX might go, but we have to believe that the lack of company news, now that earnings season is largely over, eliminates the key ingredient to drive the index substantially higher. In addition, the stock split of Smith International (two for one) will dampen the volatility of the OSX index, something it needs to make two point moves on the chart. Crude oil and natural gas prices will remain a potential driver, but that market may be over-bought temporarily. While hurricanes could play havoc with commodity prices, the possibility, as suggested by Joe Bastardi of AccuWeather, that hurricanes during the back half of the season will target the East Coast more than the Gulf of Mexico could weigh prices down as temperatures drop and transportation demand weakens.

We now need to be watchful of analyst expectations beginning to outrun future company performance

While the OSX may continue to surprise us on the upside, we think the odds are that the OSX goes sideways from here for a while. We think the OSX still has further upside before the industry cycle ends, but stock splits (and we expect more) will dampen the index's upside potential. In addition, the string of oilfield service company dividends, either special awards or increased quarterly rates, portends an industry being run by managers more cautious about adding capacity. While that helps near-term earnings and returns on investment performance, peak earnings analysis, a favorite of many Wall Street pros, is hurt. If key companies are not adding new drilling rigs, then the ability for peak earnings to be higher in the future is muted. In addition, as dividends become a greater portion of investor returns, look for them to be more willing to jump off the stocks once they think the move has gone as far as it can.

For the past year we have been living in a world where Wall Street's earnings expectations have been behind the curve with respect to oilfield service industry trends and their bottom-line impact on company results. We now need to be watchful of analyst expectations beginning to outrun future company performance. That might not be happening now, but once energy conference season starts in September, we might begin to see the seeds of the expectations game shift. Taking some oilfield service money off the table now might not be a bad move.

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