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E N E R G Y I N V E S T M E N T B A N K I N G , L P

## MUSINGS FROM THE OIL PATCH

September 6, 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

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## Take Me Out To The Ball Game

**For investors, the perennial question is: What inning are we in?**

Whenever fans rise to their feet to belt out this popular song at a baseball game, they know it is the middle of the seventh inning. If the home team is ahead, then the fans are wondering if the team can hold the lead for two more at-bats by the visitors. If behind, the home team is encouraged by the fans to try to score more runs during its upcoming three at-bats. But all fans know the end of the game is approaching. For investors, the perennial question is: What inning are we in? Investors always want the answer so they can figure out timing their exit from their holdings in a given industry. So in what inning are oilfield service stocks?

**We believe Katrina's impact may become a watershed event for energy stocks much like the seizure of the U.S. embassy in Iran was in November 1979**

Crude oil prices hover near \$68 per barrel. Natural gas prices are well over \$10 per mcf. The drilling rig count continues to climb to recent record levels, and Hurricane Katrina's ravaging of the Gulf of Mexico offshore drilling rig fleet is easing concerns about the growing supply of newbuild drilling rigs. All said, investment fundamentals support the outlook for stronger earnings for oilfield service companies. That outlook should drive oilfield service stock prices higher. However, we believe Katrina's impact may become a watershed event for energy stocks much like the seizure of the U.S. embassy in Iran was in November 1979. That seizure happened barely 14 months before the top in the 1970s decade-long bull market in energy stock prices.

While some may call me a Cassandra, the reality is that Katrina is marking a shift in consumer psychology about energy, a change that could materially impact underlying energy demand and alter the current and expected balance of supply and demand. While the attitude shift is in response to the explosion of retail gasoline prices, once underway, it will develop a life of its own. That attitude shift will last longer than many of us currently imagine. In 1979, the Iranian embassy seizure was the political lightning rod associated with an

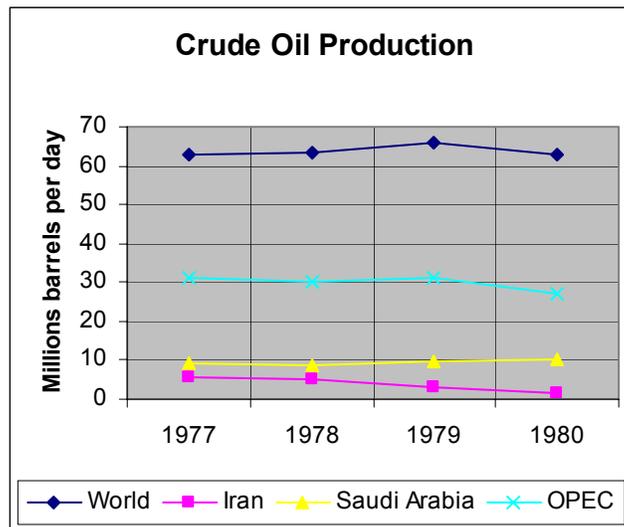
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**Hurricane Andrew appeared to mark the revival of the energy business, but natural gas fundamentals had improved months ahead of the storm's arrival**

explosion in global crude oil prices. High profile events mark our view of industry trends, but often the fundamentals have already begun to shift before the event. For example, Hurricane Andrew in late August 1992 appeared to mark the revival of the energy business, but the reality was that natural gas fundamentals had started to improve months ahead of the storm's arrival. Yes, Andrew helped propel the oilfield service industry's recovery, but the storm's ravaging of the offshore infrastructure merely accelerated what had already begun.

Let's review the events of 1979 and compare them to 2005. In January 1979, under pressure from civilian protests about his regime and its repressive conditions, the ailing Shah of Iran, Mohammad Reza Pahlavi, abandoned the Peacock throne. His leaving enabled exiled religious leader Ayatollah Ruhollah Khomeini to return from France and establish the Islamic state of Iran. Prior to and after Khomeini's return, the unrest in the country hurt the country's oil industry operations. Crude oil production fell, exports were spotty and at a lower level than earlier. As Iran's oil production and exports fell, Saudi Arabia and other OPEC members stepped up their production. The total decline in Iran's oil production was about 4 percent.

**Exhibit 1. As Iran's Production Fell Saudi Stepped Up**



Source: BP Statistical Review, PPHB

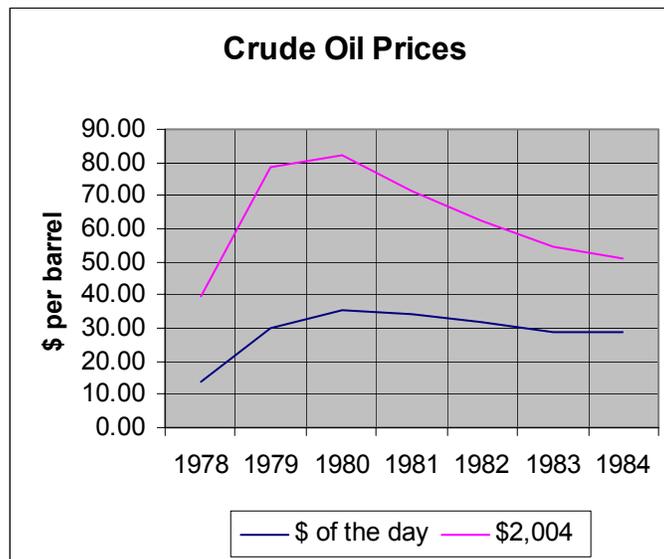
**On November 4, a mob of Iranian students overran the Marine guards at the U.S. embassy in Tehran**

While the Iranian oil industry struggled, the political situation in the country deteriorated as supporters of the Shah escaped and supporters of Khomeini seized control of the government and its bureaucracy and raged against the evils of the United States for its support of Israel. On November 4, a mob of Iranian students overran the Marine guards at the U.S. embassy in Tehran. Initially, 66 hostages were seized. After a few weeks, 13 hostages were able to leave. The remaining 53 Americans remained hostages in the embassy for a total of 444 days. They were released on the day that Ronald Reagan assumed the U.S. presidency in January 1981.

**After the hostages were seized, the United States ended its oil imports from Iran on November 12**

After the hostages were seized, the United States ended its oil imports from Iran on November 12. President Jimmy Carter took a number of steps to deal with the reduced oil flow, including instituting gasoline price controls, as crude oil prices jumped. From an average of \$13.60 per barrel in 1978, oil averaged \$30.03 in 1979. Prices continued to rise slowly in subsequent years. In current dollars, the explosion in oil prices was not quite as dramatic – from \$39.55 to \$78.46 per barrel. Unfortunately, we don't fill gas tanks in constant dollars.

**Exhibit 2. Oil Prices Exploded in Late 1970s**

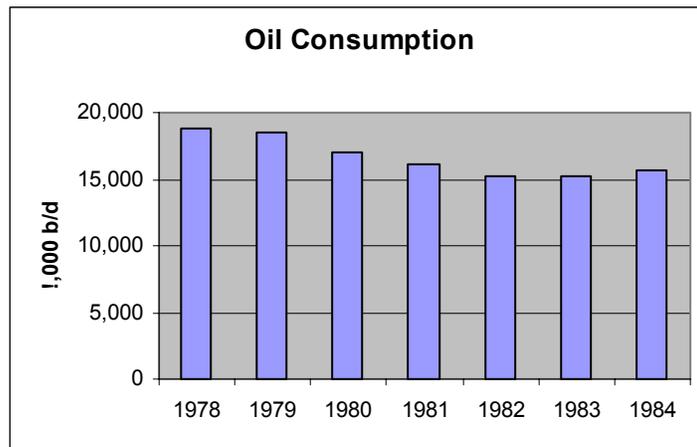


Source: EIA, PPHB

**Pres. Carter, in one speech to the nation, called this energy crisis the “moral equivalent of war.”**

As a result of the explosion in gasoline prices and its reduced supply, the U.S. government went so far as to print gasoline rationing coupons, however, they were never used. Pres. Carter took a number of symbolic actions in an attempt to impress on the public the severity of the energy crisis including wearing sweaters in his office, installing solar panels on the roof of the White House and installing a wood burning stove in the family quarters of the White House. Pres. Carter, in one speech to the nation, called this energy crisis the “moral equivalent of war.”

What happened in the country was a sea-change in consumer psychology. Shortage mentality gripped the country as people waited in gasoline lines, such as occurred in 1973, and feared the impact of a severely cold winter. They contemplated how they would adjust their lifestyle. New car purchases emphasized more efficient vehicles. Home thermostats were pushed down in winter and up in summer to conserve energy. The impact of these lifestyle changes was the first drop in U.S. oil consumption in 1979. However, it marked the beginning of a five-year period of declining U.S. consumption. That consumption change set the stage for the end of the energy boom of the 1970s.

**Exhibit 3. A Five Year Period of Falling Consumption**

Source: EIA, PPHB

**Although the end of the energy boom in terms of stock prices came in early 1981, the energy industry continued to expand**

Although the end of the energy boom in terms of stock prices came in early 1981, the energy industry continued to expand, building more rigs and putting them to work. The U.S. rig count did not peak until the end of 1982. The industry was lulled into thinking that we were only experiencing a brief pause in activity in 1983. That belief was reinforced by the industry's response to the introduction of area-wide leasing in the Gulf of Mexico. However, the impact of conservation and the growth in non-OPEC production in response to the decade long rise in oil prices, OPEC began to lose control of the oil market. By 1985, the internal struggles within OPEC led to a total price collapse dropping oil to \$10 per barrel, which shut down global oil and gas industry activity.

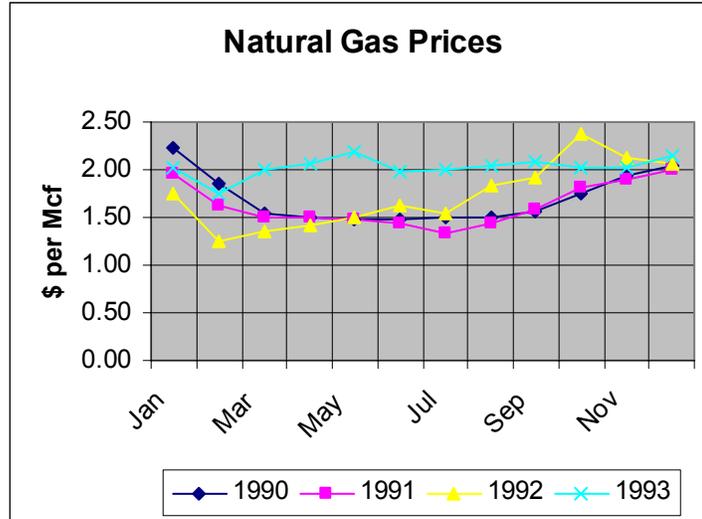
From 1985 to 1992, the domestic oil and gas industry struggled with equipment overcapacity, low levels of activity, weak pricing and inadequate revenues and profits. Deteriorating company finances led to a huge number of bankruptcies, forcing a major restructuring of the oilfield service industry. As the oilfield service industry struggled to regain its balance, the overall energy industry was beginning to recover. Oil and gas demand started to climb. The restructuring of the oilfield service industry gave companies greater control over the expanded capacity, helping to restore pricing power.

**In May 1992, natural gas prices surpassed those received in the same month in the prior two years**

Despite the improving activity trends, the overall impression of the oilfield service industry's health was not positive. The shock of the recent industry depression overhung management attitudes and actions. But by the early 1990s, the nascent improvement in U.S. natural gas prices began to stimulate oil and gas company spending. That is best demonstrated by Exhibit 4, which shows that in May 1992, the natural gas price surpassed the prices received in the same month for the prior two years. As that happened, the economic recovery of the oilfield service industry was underway. Hurricane Andrew, that hit the east coast of Florida on August 23 and the core of the Gulf of Mexico oil industry two days later, clearly was the most visible event one could associate with the recovery of

the oilfield service industry. According to the Minerals Management Service, Andrew damaged 166 platforms – toppling 34 and causing 28 to lean – and knocked down 22 drilling rigs. Some 83 pipeline segments were damaged, also. At the height of the storm, 13 Bcf/d of gas and 750,000 b/d of oil in the Gulf of Mexico were shut in. Some two weeks later, some 2.5-2.75 Bcf/d of gas and 260,000-280,000 b/d of oil production were shut in. These volumes represented 5% of U.S. gas and 3.5% of U.S. oil production.

**Exhibit 4. Gas Prices Recovered Before Andrew Arrived**



Source: EIA, PPHB

**Today, we are 13 years into that upturn**

**The end of the 1970s energy stock price boom came in early 1981 despite fundamentals remaining strong for another few years**

The recovery in natural gas prices in the spring of 1992, coupled with the impact of the damage to the offshore oil and gas drilling and producing infrastructure, set the stage for the next up-cycle for the energy industry. Today, we are 13 years into that upturn. Many forecasters, focused on the changing global energy supply/demand fundamentals, are debating when sufficient global surplus productive capacity will be established to ease the high current oil and gas prices. In Economics 101, we are taught that rising prices will cause demand to slow or decline. To date that has not happened. However, slowing demand growth, and its eventual fall, was not obvious during the late 1970s, either. It was only with hindsight that we realized demand did adjust to high oil prices.

While the current global energy supply/demand dynamics suggest that it may be a number of years before a reasonable balance between supply and demand is established, investors need to remember that stock prices discount changes in earnings outlooks for companies. The end of the 1970s energy stock price boom came in early 1981 despite fundamentals remaining strong for another few years before collapsing in the mid 1980s.

The impact of the ending of the energy stock boom can be clearly demonstrated by the expansion in the energy sector weighting within the S&P 500 index from the late 1960s to the early 1980s. However,

after almost doubling in importance in the index, the energy weighting was cut about in half in a matter of two years. Since late in 2004, the S&P 500 energy weighting has climbed from 5% to about 9.5%. We doubt the weighting will grow much more.

#### Exhibit 5. Energy Weightings in S&P 500 Index

	1968	1980	1982	1984	1986
Materials	15%	8%	8%	7%	7%
Industrials	17	13	13	13	13
Telecom Services	10	6	7	8	8
Consumer Discretionary	13	10	14	14	14
Consumer Staples	8	8	10	10	12
Energy	14	27	15	14	12
Health Care	3	6	6	6	7
Information Technology	7	10	12	12	9
Utilities	6	6	7	8	8
Financials	7	6	8	8	10
Total	100%	100%	100%	100%	100%

Source: S&P, CIBC, PPHB

#### The end of the energy game may be in sight

If investors had understood the fundamental changes in energy demand underway in 1979 as a result of the Iranian revolution, marked by the seizure of the U.S. embassy, they would have recognized that end in the stock price run was drawing near. For this reason, we believe that Hurricane Katrina will be examined in history as a similar turning point for the energy business. So while you belt out Take Me Out to the Ballgame, remember the end of the energy game may be in sight.

## Katrina Wrecks Havoc on the Offshore Industry

#### Hurricane Katrina damaged a dozen rigs and 30 platforms

Updates on the damage to the oil and gas producing infrastructure will arrive daily, but the information from the companies and the Minerals Management Service will never be totally current. Based on the latest information we could collect at the end of last week, Hurricane Katrina damaged a dozen rigs and 30 platforms. Estimates are that about 100 pipelines also sustained damage. We are not going to follow the volume of shut-in offshore oil and gas production or refining capacity off-line because these numbers are extremely volatile.

Beginning with the hurricane force winds and the storm surge on Monday, the damage to the oil industry's Gulf of Mexico's infrastructure has been significant. The latest reports suggest that of the 62 offshore drilling rigs located in the path of Katrina, 55 experienced tropical storm force winds. About 12 rigs reported notable damage. These included Rowan Companies' (RDC-NYSE) *New Orleans* jackup rig (250', IS), which is reported missing and presumed to have been toppled and sunk. It's ironic that a rig named *New Orleans* should be lost as its namesake city also appears to have been dealt a near fatal blow. Diamond Offshore's (DO-NYSE) *Ocean Warwick* jackup (300', IC) was blown 66 miles

from its drilling location and beached on Dauphin Island off the Alabama coast with significant damage. Four platform drilling rigs have suffered significant damage and are probably total losses. These rigs are part of the fleets of Ensco International (ESV-NYSE), Helmerich & Payne (HP-NYSE), Nabors Industries (NBR-NYSE) and Pride International (PDE-NYSE). The Transocean (RIG-NYSE) rig *Deepwater Nautilus* was blown 80 miles off location resulting in the loss of 2,300' of riser and subsea drilling equipment. Despite these losses, the amount of damage to the offshore drilling fleet is relatively mild given the magnitude of the Katrina's fury.

**Exhibit 6. Katrina's Path Targeted Numerous Rigs**



Source: RigZone.com

**18 platforms have been lost and 12 have experienced significant damage**

While all the reports for offshore producers have not been collected, at least 30 producing platforms have been damaged. Of this total,

**Exhibit 7. Shell's Mars Platform with H&P Rig 201**



Source: Chouest Offshore

18 platforms have been lost and 12 have experienced significant

damage. A major victim of the damage was Apache Corp. (APA-NYSE) that lost 8 platforms producing 7,158 b/d of oil and 12.1 mmcf/d of gas before the storm. The other major victim was Shell that suffered significant damage to its *Mars* tension leg platform that was producing 147,000 b/d of oil and 157 mmcf/d of gas before Katrina's arrival. The *Mars* platform held Helmerich & Payne's platform rig 201 that appears to be a total loss.

**Offshore supply boat and helicopter fleets appear to have been spared by the hurricane**

All the offshore supply boat and helicopter fleets appear to have been spared by the hurricane. These companies, however, have suffered significant damage to base facilities on the point of land supporting Venice, Port Fourchon and Grand Isle. The loss of, or

**Exhibit 8. Fourchon/Grand Isle Damage**



Source: Cal Dive, Chouest Offshore

**Damage photos of Fourchon and Venice shortly after Hurricane Katrina passed by**

**Exhibit 9. Venice, Louisiana Damage**



Source: ERA, Chouest Offshore

significant damage to, these support bases will result in an increase

in distance for boat trips to move people and supplies to the offshore work sites. That will increase costs for operators working in the eastern and central regions of the Gulf of Mexico.

As the petroleum industry recovers from Katrina's aftermath, the oilfield service industry will be called upon to repair offshore producing infrastructure damage. In addition, it will need to re-drill lost wells. The destruction of several jackup drilling rigs may give some hope to investors who are concerned about the growth of the orderbook for newbuild offshore rigs. We are not sure that will ultimately prove true, but the impact of Katrina in the near-term will tighten the offshore drilling rig market as operators, both in the Gulf of Mexico and internationally, bid for fewer available rigs.

## Venezuela in the News

### **Venezuela has a new oil industry expansion plan and the country is strengthening its ties with China**

We won't begin to offer our opinion of the Rev. Pat Robertson's comments on what we should do with Venezuelan President Hugo Chavez, but we wonder if Robertson was suffering from a "senior moment." The more important news from Venezuela is the newly announced oil industry expansion plan and the country's growing efforts to strengthen its economic ties with China. With respect to the latter point, Chavez's dislike of the United States and our leadership is no secret. This hatred is deep-seated and reflects Chavez's view toward our opposition to his efforts to export his Bolivarian revolution through out all of the Caribbean and South America. To demonstrate his displeasure, Chavez has attempted to reduce his country's close association and dependence on the United States. This association has a long history and has significant economic implications. Venezuela supplies about 14% of U.S. oil imports, but much of the oil goes to Petroleos de Venezuela S. A. (PdVSA) owned, or joint-ventured, refineries and gasoline stations here in the United States. A large number of U.S.-based oil companies provide PdVSA with the technical and financial resources to exploit Venezuela's oil and gas resources. Given this symbiotic relationship, it is hard to envision that Chavez can easily, or quickly, sever his ties to the U.S. economy. While he may want to irritate the United States, he is limited in his near-term actions without risking significant financial damage to the Venezuelan economy.

### **Chavez has begun a campaign to reduce his country's economic dependence on the United States**

Chavez has begun a campaign to reduce his country's economic dependence on the United States. He has started by seeking new geographic markets for his oil output and establishing new oil non-U.S. oil company associations. Venezuela has been helped in its efforts in recent years by the explosion of oil demand in China and India that has forced both countries to send out their oil companies seeking new global oil and gas supplies. Venezuelan oil shipments to China have surpassed 68,000 b/d on average for 2005 so far, or 3% of the country's exports, compared to the 12,300 b/d exported in 2004. PdVSA is presently targeting supplying 15%-20% of China's imports. According to Asdrubal Chavez, the head of PdVSA sales and shipping, the company's goal is 300,000 b/d of exports to Asia, including China, by 2012.

**PdVSA and CNPC signed a preliminary agreement to create a joint venture to develop oil fields in eastern Venezuela**

PdVSA has recently opened an office in Beijing to help tighten the initial ties between the two countries. In addition, PdVSA and China National Petroleum Corp. (CNPC) signed a preliminary agreement to create a joint venture to develop oil fields in eastern Venezuela. The focus will be on oil and natural gas deposits in Zumano, south of the oil-rich state of Anzoategui. This target region is estimated to have upwards of 400 million barrels of oil and 4 trillion cubic feet of natural gas in place.

Besides the exploration agreement, PdVSA and CNPC agreed to conduct a survey of Junin 4, a 640-square kilometer block within the Orinoco Belt. That region contains an estimated 20 billion barrels of heavy oil and bitumen. China and Venezuela also agreed to build 42 new oil tankers for PdVSA's fleet by utilizing the shipbuilding assets of both countries. We expect further announcements of alliances such as these between Venezuela and other countries and national oil companies.

**Exhibit 10. Venezuela Has Substantial Reserves in Orinoco**



Source: CIA

**PdVSA still retains a significant asset base in the United States**

While Chavez is developing new energy industry associations and new consuming markets for his oil, PdVSA still retains a significant asset base in the United States. These assets are producing significant current income for the government, but the refineries require maintaining a significant flow of Venezuelan oil to the United States. We envision, whenever Chavez believes he has established new oil markets that could utilize Venezuela's oil volumes currently going to the U.S., he will consider selling his Citgo refineries here. While possible buyers may want to continue the existing Venezuelan crude oil supply arrangements, Chavez likely will force them to seek out their own supply. While this might appear to be a short-sighted action by Chavez, it is the type of move we should anticipate since it would provide him a huge public relations opportunity to show his abandonment of the United States market.

The other recent news was the announcement of PdVSA's strategic expansion plan calling for \$56 billion in investment over the next seven years to increase Venezuela's crude oil production capacity to 5.8 million b/d in 2012. PdVSA would account for 4.0 million b/d of

**The new plan calls for achieving a 2.8 times increase in daily production at a reduction in per barrel cost of 40% compared to the 1990s performance**

this expanded production, with another 460,000 b/d from joint ventures between PdVSA and foreign oil companies. Existing Orinoco Belt projects would produce 622,000 b/d, while new Orinoco Belt projects should contribute an addition 615,000 b/d. Risk-sharing projects would produce 121,000 b/d. Is this expansion plan realistic?

Currently, PdVSA claims the country produces more than 3.2 million b/d, which means the expansion plan would increase Venezuela's total crude oil production capacity by 2.6 million b/d over a seven year period. That would mean an average annual increase of 371,000 b/d. Between 1991 and 1998, before Chavez became president, PdVSA invested \$31.8 billion to increase production by 915,000 b/d, or an annual average increase of 133,000 b/d. The cost per daily barrel of increased production was about \$35,000. Based on the new PdVSA plan, the projected cost per daily barrel would be \$21,500. Thus, the new plan calls for achieving a 2.8 times increase in daily production at a reduction in per barrel cost of 40% compared to the achievement of 1990s. Is that feasible? Not likely, especially given the inflation in oilfield service costs, the reluctance of service companies to want to work for PdVSA given its payment history and the inability to get U.S. dollars for local currency. Lastly, there is the question of the capability of PdVSA's professional and technical staff to undertake and complete a plan such as this.

Another consideration about the plan is that the \$56 billion cost estimate includes other investments. For example, projected investments in natural gas production will cost \$17 billion, three new refineries at a cost of \$7 billion and the construction of a new \$6 billion oil-working city near the Orinoco Belt. If one subtracts these investments, PdVSA is left with \$26 billion for its oil production capacity expansion. That means the production capacity expansion would be achieved for \$10,000 per daily barrel, or less than one-third of the cost of the 1991-1998 expansion. Even if we assume that PdVSA could expand its production capacity at the same cost as its 1990s expansion, then the total expansion program has a cost of \$121 billion, or more than twice that of the announced plan.

**Chavez encouraged this announcement of the proposed production capacity plan to encourage China and India to focus on Venezuela as a new supply source**

We have to believe that Chavez encouraged this announcement of the proposed production capacity plan to encourage China and India to focus on Venezuela as a new supply source. If Chavez could hook these countries as new oil buyers, then potentially he might secure the necessary funds and technical assistance needed to exploit Venezuela's vast potential resources.

## Gasoline Prices Confound Consumers

**As consumers grew frustrated with the rise in gasoline prices, political outcries began**

Even before the impact of the devastation from Hurricane Katrina was felt in petroleum markets, gasoline prices had been climbing in tandem with the rise in crude oil prices. As consumers grew frustrated with the rise, political outcries began. In early August when the Energy Bill was being finalized for President George

**Hawaii no longer has the honor of having the highest gasoline prices in the nation according to the AAA**

Bush's signature, analyst Michelle Foss commented on the bill. "The best thing is that no one tried to control prices or put caps on gasoline or natural gas. There was a lot of fear that there would be something like that." No sooner were those words uttered than the State of Hawaii moved to cap wholesale gasoline prices.

In 2002, Hawaii's legislators enacted a wide-ranging law that regulated wholesale and retail gasoline prices. That law proved unworkable, so it was modified in 2004. In mid August, the state decided to enact its price cap on gasoline effective September 2 in response to a belief that the local refiners were manipulating the market to achieve high prices. Partly due to the newly enacted gas cap, Hawaii no longer has the honor of having the highest gasoline prices in the nation according to the AAA. Hawaii's average gasoline price was \$2.95 per gallon last week, while Michigan's price of \$3.13 put it at the top of the state list.

The Hawaii cap controls the price that gasoline wholesalers, including Chevron Corp. (CVX-NYSE) and Tesoro Corp. (TSO-NYSE), the owners of the two island refineries, and a small handful of companies that buy fuel in bulk and distribute it to retailers, can charge. The cap, in theory, is designed to restrain refiner profits without hurting the small profit margins of retailers. The cap establishes a baseline price for a gallon of gasoline by averaging spot prices in Los Angeles, New York and along the U.S. Gulf Coast. To that baseline price, the Hawaii Public Utility Commission adds a margin of between \$0.28 to \$0.62 per gallon to account for the difference in delivery costs and other costs. The state has established eight pricing zones.

The lowest cost price zone in the state is Oahu, the home of the city of Honolulu. The baseline price with its allowed margin for September 2 was established at \$2.158, to which will be added \$0.58 in federal, state and local taxes to bring the allowed wholesale price to \$2.74. If the normal \$0.12 retail margin is added to the wholesale price, the retail price would be \$2.86, which was marginally above the current average price on the island of \$2.823. However, gasoline prices will be going substantially higher next week when the average takes into account the impact of exploding Gulf Coast and New York gasoline prices.

**The Hawaii response to high gasoline prices is being closely watched by politicians in other states**

The Hawaii response to high gasoline prices is being closely watched by politicians in other states. In California, State Senator Joe Dunn (D-Santa Ana) reintroduced legislation to give the California Public Utility Commission the power to regulate gasoline prices. "Hawaii is taking the absolute correct approach to the gasoline industry," according to Dunn. "The more states that follow Hawaii's lead, the sooner we'll be able to face this industry to get back to normal market behavior that benefits the consumer but also allows them a reasonable profit."

The state of Michigan is looking at capping its gasoline sales tax to help ease the financial burden of escalating prices on consumers. The state, one of seven including Illinois and Indiana, levies a six

percent per gallon sales tax in addition to the regular \$0.19 per gallon gasoline tax. The sales tax comes into play when the price per gallon goes above \$2.30. Sales tax revenues go to public education in the state. The tax generates \$3 million of tax revenues for every penny that the price of gasoline exceeds \$2.30 per gallon.

In other moves, the Governor of Georgia has signed a law waiving the state's \$0.075 per gallon tax. Other states are considering tax holidays. Connecticut has moved to waive all its stricter environmental rules for transportation fuels to help ease consumer prices. While not having a significant impact on prices, these various actions will provide some relief to consumers.

**The American public believes the oil industry is taking advantage of the Katrina damage to gouge the public**

Last Friday, a new public opinion poll by the Associated Press and NBC News said that 72% of the American public believes the oil industry is taking advantage of the Katrina damage to gouge the public. That is a prevalent attitude and emerges every time the price of gasoline jumps due to any disaster or geopolitical event. Despite the best efforts of the petroleum industry, its public image remains that of robber barons grabbing greedily for profits.

#### Exhibit 11. More Poignant Today



Source: azurelunatic.livejournal.com

**The gasoline industry is to be probed once again by a team of 30 state Attorneys General**

The industry's image will be tarnished further by a Senate hearing on gasoline prices scheduled for Tuesday and a House Energy Subcommittee hearing on Wednesday. While it will be difficult to prove that the industry has engaged in any illegal activities, the complexity of the gasoline and refining market makes it difficult to explain in layman's terms why prices move. All the past government and regulatory probes of the gasoline market have failed to uncover any illegal rigging actions. The gasoline industry is to be probed once again by a team of 30 state Attorneys General. They will be looking at the movement of gasoline prices during the thirty days prior to August 27. These government actions further cement our view that today's unfolding events increasingly reflect a replay of the 1970s, which was not a particularly good time for the oil production industry.

Given our experience in the 1970s with price regulation and rationing of gasoline, one would think that politicians have learned that these actions will do nothing but damage the gasoline market for all their constituents. Maybe it is a congenital deficiency of politicians. Or maybe it is their need for publicity. Whatever, they

need only to look at the gasoline lines in China where the government has instituted price controls to understand the implications of their proposed actions. I guess the noble regulatory experiment will need to fail in modern times before politicians learn the lesson of ill advised price regulations. Hopefully it will fail quickly before too much damage is done to the market.

## Gazprom Strives to Open US LNG Market

**Gazprom's long-term strategy is designed to promote the Russian government's geopolitical interests**

**The plan is to turn Gazprom, which has been primarily a domestic natural gas company, into a world-scale energy company through acquisitions**

Gazprom (OGZPF.PK) has sold its first load of LNG to Shell (RDS-NYSE). The gas was delivered to the Cove Point LNG re-gasification terminal in Maryland on September 2. Shell owns a one-third interest in the terminal. Both companies want to gain a greater share of the U.S. LNG market, so this first cargo may have significant long-term implications. It should be remembered that Shell recently sold to Gazprom an interest in its Sakhalin II project and purchased from it an undeveloped field in Western Siberia. While Shell may be attempting to curry favor with the Russian energy company, Gazprom's long-term strategy is designed to promote the Russian government's geopolitical interests.

Over the past two years as the Yukos drama has played out, the maneuvering of the Kremlin to restructure the Russian oil industry has become obvious. Gazprom is a major part of that restructuring and is growing with the help of increased ownership, i.e., cash infusion, from the Russian government. The plan is to turn Gazprom, which has been primarily a domestic natural gas company, into a world-scale energy company through acquisitions. Another chapter in that transformation is the commencement of construction of a Baltic Sea pipeline designed to skirt the Eastern European transit states that are not politically secure from Russia's point of view.

Gazprom, the world's largest gas producer, supplies the Russian government with one-quarter of the country's income. In addition, because of price regulations, Gazprom supplies 71% of its gas volumes to domestic markets at essentially cost. Therefore, the company struggles to be profitable and has to earn all its profits and tax revenues from its gas exports.

In 2002, Gazprom participated in the construction of the Blue Stream pipeline under the Black Sea to Turkey. This was one of the world's most demanding pipeline construction projects because it involved laying pipe in several thousands of feet of water and up a highly inclined seafloor. To cover the cost of the pipeline, Gazprom had to boost the price of the gas. When the Turkish government uncovered what they thought were kickbacks involved in the financing and construction of the pipeline, Ankara walked away from the pipeline leaving Gazprom with a huge white elephant.

On August 19, Gazprom announced that it had begun construction on a new 1,200-kilometer pipeline under the Baltic Sea. When completed, it will be the longest subsea pipeline in the world. The

**On August 19, Gazprom announced that it had begun construction on a new 1,200-kilometer pipeline under the Baltic Sea**

pipeline will carry natural gas from Vyborg, Russia to Greifswald, Germany. The line is being designed to carry between 10 billion and 55 billion cubic meters of gas and is estimated to cost between \$2 billion and \$12 billion to construct. Given the cost and project's economics, there has been no European or global financial support for the line. Even E.ON-Ruhrgas (EON-NYSE) that owns 6.5% of Gazprom has not offered to support the project. The only official support has come from German Chancellor Gerhard Schroeder who has been trying to curry favor with Russian President Vladimir Putin and the Kremlin, but even he has not offered any Euros for the project.

#### **Exhibit 12. Gazprom's New Baltic Sea Pipeline**

##### **RUSSIA'S NORTH EUROPEAN NATURAL GAS PIPELINE**



Source: Stratfor

Gazprom has begun construction of the land segment of the pipeline extending from its gas infrastructure to the Baltic coast, or about 100 km. That project will require about six months to complete. The plan is then to build the remainder of the pipeline within two to three years. Why this leisurely time schedule? Obviously Gazprom is hoping that financial support will be forthcoming from somewhere.

**Russia would like to avoid unfriendly states in building its gas export business**

More than likely, if this project is built, it will be done with the aid of the Russian government. The pipeline will be built because it fits the Russian government's geopolitical strategy. At the present time, Gazprom's gas exports flow through the Ukraine, Poland, Romania and other less than friendly countries to Russia on their way to Western Europe. Russia would like to avoid these states in building its gas export business. Interestingly, during the 2004 Orange Revolution in the Ukraine, only Germany was not a vocal supporter of the government rebelling against the influence of Russia.

As Gazprom grows, it has several objectives. First, it is attempting to transform itself into a global energy company, balanced in both its gas and oil production/reserves and with the ability to become a more profitable company. Second, the company wants to become a

more international company with substantial gas and oil exports, i.e., increased earnings and profits. Third, it wants to secure markets in important consumer markets that may be politically important for Russia. Markets such as Germany, the United States, India, China and Japan are important targets due to their political importance and their insatiable energy demand.

**The significance of Gazprom's evolution may be greater than the demise of Yukos**

Watching the evolution of Gazprom will likely become as much of an energy and investor spectator sport in 2005-2006 as the Yukos drama was in 2004. The transformation of Gazprom involves not merely the creation of a new global energy company, but it also has implications for the global energy market. The significance of Gazprom's evolution may be greater than the demise of Yukos, but that conclusion will depend on events yet to transpire. In the next couple of years, Gazprom may prove to have more strategic importance in the energy market than the travails of Venezuela and even Chinese energy demand.

## Correction

In our August 23, issue we misspelled the name of the firm that Ed McGaughey is associated with. The firm is Pearl Meyer & Partners. We regret the error.

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