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ENERGY INVESTMENT BANKING, LP

MUSINGS FROM THE OIL PATCH

October 16, 2007

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

Alberta Royalty Battle Waged to Industry's Detriment

Big and small oil and gas companies have weighed in with their reactions, planned responses and threats

The ink was barely dry on the Alberta Royalty Review Panel's report recommending sharply higher payments when the industry started tossing out threats to future oil and gas spending in the province. Big and small oil and gas companies have weighed in with their reactions, planned responses and threats. The investment brokers also have become vocal, as the stocks have sagged in response to the prospect of reduced future profitability. So far, the only assurance the prime minister has made is that he will render a verdict on the panel's recommendations by the middle of October – although there have been reports he really means by the end of the month.

The three-and-a-half-fold increase in Canadian crude oil prices since 2000 has created one of the greatest energy booms of all time in northern Alberta

The panel's conclusion about the current Alberta royalty structure is that the government (presented as Albertans) is not getting its fair share of the spoils that have come with the jump in oil and gas prices since the turn of the decade. The three-and-a-half-fold increase in Canadian crude oil prices since 2000 has created one of the greatest energy booms of all time in northern Alberta as the province's heavy oil deposits have finally become economically viable. Coupled with the dramatic improvement in heavy oil economics, their safe location and close proximity to the world's largest oil-consuming market, the United States, has made them a target of increased industry focus. With that paradigm shift has come an explosion of investment, jobs and government revenues, all of which have directly benefited Albertans.

What is most unnerving about the panel's report is its timing. Most rational industry participants accept that they should be paying something more to the province to help it sustain the lifestyle of its citizens, many of whom are employees, or are indirect beneficiaries of the oil and gas business. Like last year's Halloween night financial bombshell terminating the tax holiday for income trusts, this royalty review report appears to continue this October tradition of the Canadian government springing financial surprises on the oil and gas industry.

Uncertainty as to the royalty and tax structure makes calculating economic returns on capital investment programs almost impossible

The royalty review timing is also difficult because it finds companies well into their 2008 budgeting cycle. By injecting a high level of uncertainty as to the royalty and tax structure, calculating the economic returns of capital investment programs has become almost impossible. The immediate reaction by certain companies was to do a quick, back-of-the-envelope calculation of the proposed royalty impact on their drilling economics and announce expenditure slashes, as if politicians would be dissuaded by pointing out the fundamental economic flaws of popular policies.

77% of Albertans said how they vote in the next election will be influenced by the premier's decision

Two local newspapers, the *Edmonton Journal* and the *Calgary Herald* conducted a joint poll of Albertans shortly after the panel's report was issued and found, not surprisingly, that 88% of respondents felt they were not getting their fair share of the royalties. Some 67% of those surveyed believe the government should enact the full measure of the royalty review panel's recommendations and a further 77% said how they vote in the next election will be influenced by the premier's decision. Importantly, 62% of the poll respondents believe a royalty hike will have a positive impact on their families through increased government spending due to the higher income. So now we have a critical political challenge for a rookie premier who won office in a three-way election.

Drilling for natural gas accounts for roughly 70% of all wells drilled in Alberta

The biggest challenge for the Alberta Royalty Review Panel is dealing with revising natural gas royalties. While the economics for natural gas exploration and development have improved over the past half dozen years, today those economics are in the tank due to a warm winter across North America, a cool summer in the United States, a boost in U.S. gas production and a surge in liquefied natural gas (LNG) imports contributing to record high volumes of natural gas in storage and depressed spot and futures gas prices. Drilling for natural gas accounts for roughly 70% of all wells drilled in Alberta. With gas-related oilfield activity already down due to low wellhead prices, the prospect of sharply higher royalties on the more prolific gas wells in the province, even with supposed royalty relief for the low-productivity wells, the industry is confronting a major change in its economics. However, until those economics become clear, producers will do what they almost always do during periods of uncertainty – stop drilling!

The threats to spending cuts hurled at the government by the heads of oil and gas companies signal that oilfield activity in Canada is about to suffer another blow – one that will cost Albertans jobs and the province revenues. An unintended consequence of implementing the proposed royalty changes could be a push by Canadian producers and service companies to seek future growth

It would ignite a time-bomb for an eventual explosion in natural gas prices when falling production and growing North American demand collide

initiatives outside of the Western Canadian Sedimentary Basin (WCSB). Were that to happen, it would ignite a time-bomb for an eventual explosion in natural gas prices when falling production and growing North American demand collide. The resulting collision would drive gas prices high enough to attract a new wave of exploration and exploitation funds. When that investment wave might come is difficult to predict, but rest assured, it will come. The bigger question is how sustainable would that revival be? Operators and service company executives will not quickly forget how willing the Alberta government was to toss the industry over the side in a search for increased revenues.

Even though we dealt with the royalty review issue in our last Musings From the Oil Patch, its timeliness and significance to the overall North American oilfield market in 2008 demands that we continue to follow the developments of this topic. Let's briefly summarize the panel's recommendations:

For Oil Sands:

1) Increase the post-payout net royalty rate from 25% to 33%, and maintain the current base royalty rate of 1% gross.
2) Impose a new Oil Sands Severance Tax, which starts at 1% when WTI oil is at US$40 per barrel and increases to 9% when WTI prices reach US$120 per barrel.
3) No grandfathering of prior royalty relief schemes.
4) Reclassify existing and future primary oil sands wells as conventional heavy oil wells.
5) Give royalty credit to encourage construction of new Alberta upgraders up to a limit of $2 billion.

For Conventional Oil and Gas:

1) Eliminate the tiers in natural gas and conventional oil that distinguish "vintages" based on the discovery date.
2) Raise the rate caps on the price for natural gas to $17.50 per million Btu and for conventional oil to $120 per barrel.
3) Eliminate several special royalty programs.
4) Change the royalty formulas to be both price and volume sensitive with a maximum rate of 50%. Under the current royalty regime, existing caps are so low that effective royalties are not price sensitive.
5) Eliminate the choice of using a corporate average price to determine natural gas royalties and instead use the natural gas reference price for royalty determination.
6) Reclassify existing and future primary oil sands wells as conventional heavy oil wells.
7) Increase the freehold mineral tax to a flat 6% from the current effective rate of 4% for natural gas and 3% for conventional oil.

57% of Alberta's conventional oil and 82% of its natural gas wells will pay less in royalties

The bottom line of these proposed changes is, according to the panel's report, that 57% of Alberta's conventional oil and 82% of its natural gas wells will pay less in royalties under the proposed plan than they do currently. This is one conclusion, among many, that

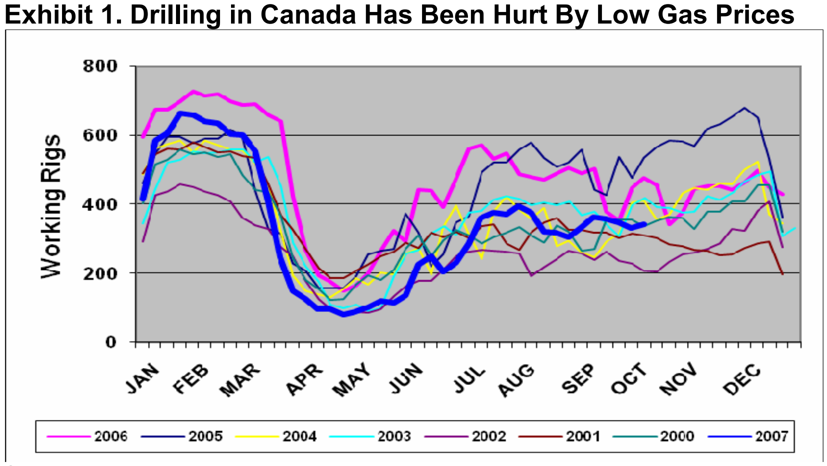
The primary challenge is that the panel used faulty data and assumptions that have led to bad recommendations

the Canadian oil and gas industry challenges. The primary challenge is that the panel used faulty data and assumptions that have led to bad recommendations. In fact, since the panel used natural gas prices below the current depressed level to get to its royalty relief calculations, actual gas prices assure that all operators will pay higher royalties, not less.

When the CAODC met with the panel in late May, the rig count was down to 61, employing only 1,525 workers, one-third the level of activity experienced in May of 2006

The Canadian oil and gas and oilfield service associations have all issued releases questioning the rationale for the royalty changes. The Canadian Association of Petroleum Producers (CAPP) put out a release encompassing points made by a number of producers and investment brokers. Both the Canadian Association of Oilwell Drilling Contractors (CAODC) and the Petroleum Services Association of Canada (PSAC) issued releases urging the government of Prime Minister Ed Stelmach to go slow in implementing any royalty and tax changes as they would likely cause another body blow to an oilfield service industry already reeling from the impact on drilling of low natural gas prices. As the CAODC pointed out, it had advised the royalty review panel that the industry averaged 373 drilling rigs working in Alberta during 2006, employing 9,400 workers. By the time the association met with the panel in late May, the rig count was down to 61, employing only 1,525 workers, one-third the level of activity experienced in May of 2006. CAODC went on to point out that natural gas drilling accounts for 70% of the province's activity and gas prices on September 27, 2007, were only $5.07 per thousand cubic feet (Mcf), and the strength of the Canadian dollar has further eroded the returns to producers. Drilling in Alberta in 2007 is down by 35% as of September 18, 2007, compared to the previous year.

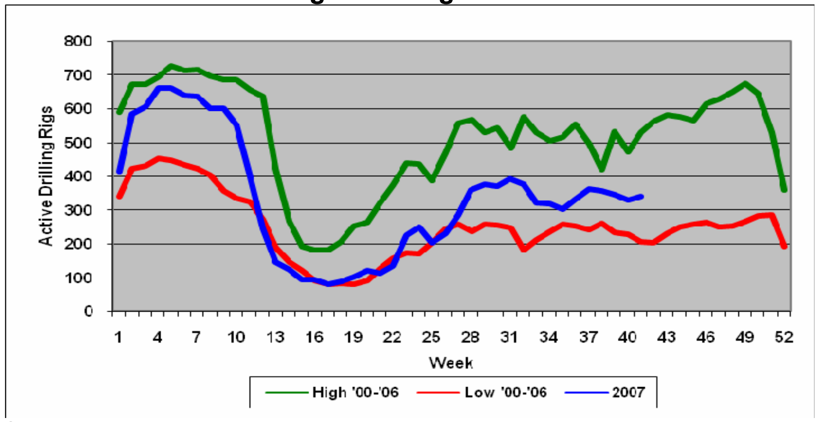
Exhibit 1. Drilling in Canada Has Been Hurt By Low Gas Prices



Source: Baker Hughes, PPHB

One can see the impact of the poor drilling economics on the 2007 rig count compared to the 2006 count and to other yearly counts back to 2000. When one looks at the rig count compared to the high and low counts for the 2000-2006 time period, one can see how close current activity is to the worst drilling environments of this decade.

Exhibit 2. Current Drilling Is Among Worst of Past Six Years

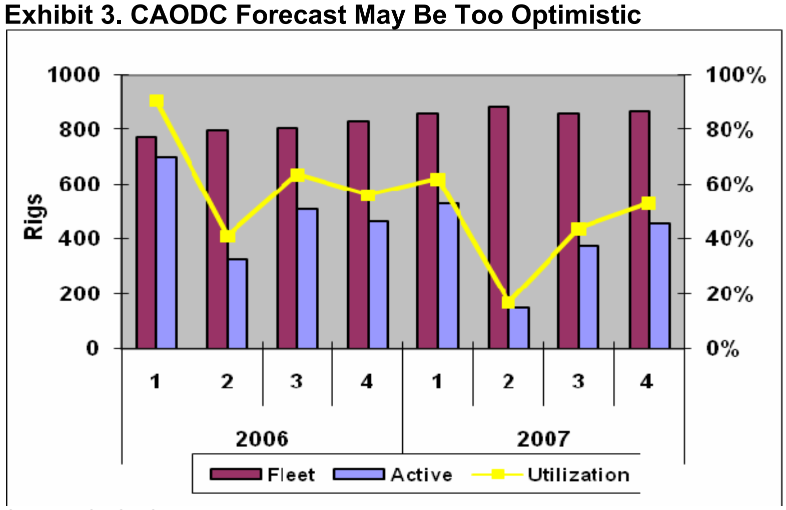


Source: Baker Hughes, PPHB

We also looked at the CAODC drilling rig forecast, revised at July 2007, and compared it against drilling activity in 2006. One can see that the forecast calls for a tough second half of 2007. What is interesting is that when we averaged the Baker Hughes (BHI-NYSE) Canadian rig count for the third quarter, including the 2-3 offshore rigs, we arrived at an active rig count almost 30 below the CAODC estimate, or even more if we focus only on western Canada. Admittedly, different rig counts are not always comparable. However, if we use the lower active rig count and the same fleet size as in the second quarter, the industry utilization rate in the third quarter would be 39% rather then the CAODC's expected 44%. But recent rig data suggest the fleet has grown during the third quarter by a half dozen more rigs, further depressing fleet utilization, and with it industry pricing power. The big question is whether the uncertain fiscal regime will take a toll on the estimated number of active rigs for the fourth quarter, which assumes a healthy seasonal rebound. If so, the drilling industry will be limping into its peak winter activity period, not a good scenario for service company earnings.

The big question is whether the uncertain fiscal regime will take a toll on the estimated number of active rigs for the fourth quarter

Exhibit 3. CAODC Forecast May Be Too Optimistic



Source: CAODC, PPHB

A number of industry leaders have spoken out against the royalty review panel's recommendations. Two executives, Jim Buckee, recently retired CEO of Talisman Energy Inc. (TLM-NYSE), and Ron Brenneman, President and CEO of Petro-Canada (PCZ-NYSE), have written public letters to the prime minister of Alberta expressing their reservations about the underlying facts and assumptions used by the panel in reaching its conclusions and cautioning against any hasty implementation of the recommendations without further consideration of their broader economic implications. These letters were well written and set a balanced tone between the government's need for greater revenues, especially in light of high oil and gas prices, and the companies' requirement for a royalty and tax structure that does not destroy the economics of exploring and developing resources in the basin.

Canadian Natural believes that the cost assumptions used by the panel reflected only half the actual costs being incurred by the industry today

Quite possibly the best company response was contained in an October 9th press release from Canadian Natural Resources Limited (CNQ-NYSE), in which it provided a detailed response to the proposed new royalty structure along with an analysis of the likely impact on the company's activity next year and the knock-on effect on Albertans. The company begins its response with the observation that the panel was disadvantaged by not having accurate cost information that would have swayed their conclusions. Canadian Natural believes that the cost assumptions used by the panel reflected only half the actual costs being incurred by the industry today. The company further points out that the panel's analysis did not consider the impacts of new environmental levies and recent taxation changes.

A major problem with the proposed royalty structure is that it extracts a disproportionately greater cash flow in the early years of a well's useful life

Canadian Natural says that the panel's recommendations are inconsistent with the reality of the WCSB - it is a mature, high cost basin. The mischaracterization of the basin's economics leads to serious problems when the royalty structure is redesigned to compete against lower-cost, higher-productivity basins. That royalty inequity, coupled with regional finding and development and operating costs based on smaller reservoirs, means Alberta's oilfield activity will be curtailed in the future with a loss of significant local jobs. A major problem with the proposed royalty structure is that it extracts a disproportionately greater cash flow in the early years of a well's useful life, which significantly erodes a company's return on capital. For Canadian Natural, this is a serious structural failing in the proposed royalty scheme as it acts to erode the economics of oil sands developments and general drilling activity given the associated risks that cannot be offset in the early years of activity. As a result, reduced company revenue streams and increased costs will become an incentive for companies to accelerate development projects faster at the expense of doing them right to maximize the long-term recovery of resources and to control costs.

Canadian Natural is also bothered by the dictum against grandfathering of projects. This action ignores the rationale for prior investment decisions. By outlawing grandfathering and ignoring past investments, Canadian Natural questions the fairness of the

With the proposed royalty program, Canadian Natural will drill 65% fewer natural gas wells, 15% fewer oil wells and 84% fewer stratigraphic test and service wells next year

proposed royalty scheme. The company went on to show the history of its drilling activity in Alberta from 2004 through its forecast for 2007. The company also showed the number of wells it plans to drill in 2008, assuming the proposed royalty program is enacted in its entirety. The bottom line is that Canadian Natural will drill 65% fewer natural gas wells, 15% fewer oil wells and 84% fewer stratigraphic test and service wells next year. The company also suggests that the economics of certain long-term in-situ development projects must be re-evaluated. Preliminarily, based on reasonable price decks and the uncertain fiscal environment, Canadian Natural said it expects to cancel its Kirby, Birch Mountain and Gregoire Lake Projects resulting in over 3 billion barrels of oil sands resources not being developed, eliminating approximately 235,000 barrels per day of new production scheduled to come on stream over the next 15 years and preventing $7 billion of capital investment funds from being spent.

Exhibit 4. Alberta Royalty Program to Cut CNQ's 2008 Activity

Drilling activity (number of wells) in Alberta

	2004	2005	2006[1]	2007F	2008 Panel[2]	Reduction 2008 / 2007
Natural gas						
Conventional	365	425	427	253	88	(65%)
Shallow	164	167	65	76	20	(73%)
Coal Bed Methane (CBM)	39	100	51	40	20	(50%)
Total natural gas	568	692	543	369	128	(65%)
Total crude oil	244	462	425	480	410	(15%)
Total stratigraphic test / service wells	330	236	370	244	40	(84%)

(1) *Excludes natural gas wells drilled by Anadarko Canada Corporation prior to its acquisition by Canadian Natural in November, 2006.*

(2) *This represents the forecast number of wells to be drilled in 2008 by Canadian Natural in Alberta, if the Panel's proposals are adopted.*

Source: Canadian Natural Resources Limited press release, Oct. 9, 2007

The final paragraph of the Canadian Natural press release sums up how its management plans to operate going forward. "The Company's emphasis on creating shareholder value will continue to guide its investment decisions and judicious review of capital allocations. If no economic projects are identified, the Company will use free cash flow to increase its debt retirement profile and return cash to shareholders." Albertan shareholders will be the only locals who will benefit under that business strategy.

The timing of the decision guarantees that the winter drilling season will be less than previously expected, regardless of the winter's weather

While the political dust-up from the royalty review panel's recommendations is making oil and gas and service company executives nervous, the timing of the report is likely to prevent significant reworking of the proposals. Our best guess (and hope) is that some sort of phase-in of the proposed royalties is enacted and that there is some grandfathering of past royalties. The timing of the decision guarantees that the winter drilling season will be less than previously expected, regardless of the winter's weather. A lack of drilling will prevent the industry from overcoming the power of depletion. At some point, declining gas volumes will drive prices higher. It's like that old transmission commercial on TV used to say: Pay me now, or pay me later. The WCSB will rise again. The question is when?

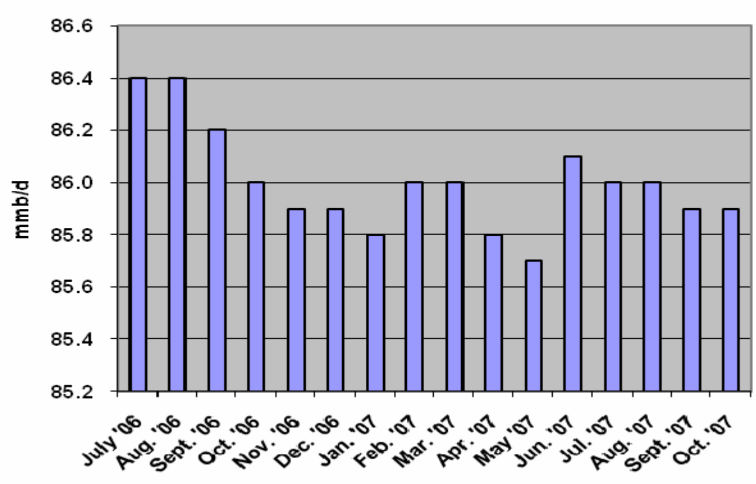
Oil Over $80 With Demand Forecasts Cut?

The world's authoritative energy agencies – the IEA, the EIA and OPEC – have been cutting their oil demand forecasts for this winter and 2008

The great Democratic spinmeister, James Carville, propelled Bill Clinton to the White House on the back of the phrase: It's the economy, stupid! Crude oil futures prices, currently well over $80 per barrel, may be merely resting before soaring to $100, at least if you believe commodity speculators. On the other hand, the world's authoritative energy agencies – the International Energy Agency (IEA), the Energy Information Administration (EIA) and the Organization of Petroleum Exporting Countries (OPEC) – have been cutting their oil demand forecasts for this winter and 2008. And these demand reductions are before taking into account the recent revisions to U.S. economic growth projections from a number of leading economists and before the International Monetary Fund releases its revised 2008 outlook that reportedly will cut the world's economic growth projection from 5.2% to 4.8%. So how does one square demand down and prices up?

For many years we have been monitoring demand forecasting revisions over the intervening months from the introduction of the initial yearly forecast and actual results. Forecasting is always tricky, so there are two axioms that successful economists live by. First is to forecast often. And secondly, provide either a number with no date associated with it, or a date but no definitive number. In recent years, Alan Greenspan of the Fed invented a third rule, which is to make your explanation so convoluted that everybody thinks the forecast agrees with what they believe.

Exhibit 5. IEA 2007 Demand Forecast Has Changed Many Times



Source: IEA, PPHB

Economic forecasting is always challenging at inflection points in the economy. That seems to be the norm for energy, because not only do you have to worry about economically-related demand factors, but you have all the seasonal influences that are compounded by

The IEA has adjusted its 2008 oil demand estimate frequently since it introduced its initial forecast in June 2006

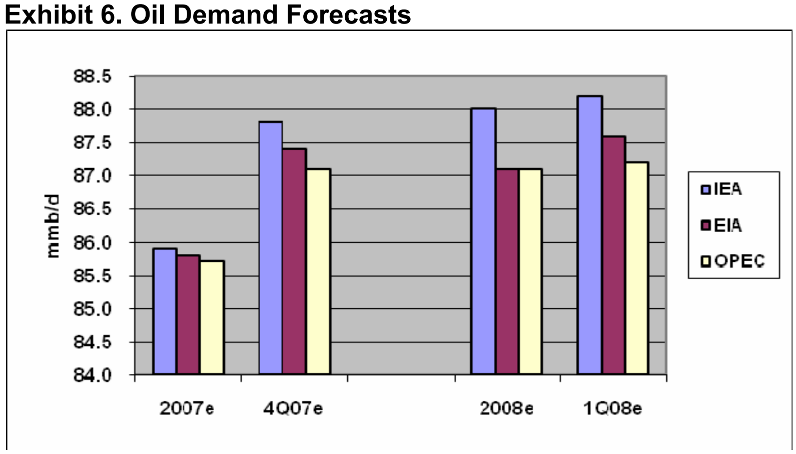
weather events. As we present in Exhibit 5, the IEA has adjusted its 2008 oil demand estimate frequently since it introduced its initial forecast in June 2006. We would not be surprised to see the 2008 estimate move around further as we reach the end of 2007 and move into the early months of 2008. By then the pace of economic activity should become clearer and the impact of winter weather will begin to pass.

What is important to recognize about the most recent forecast is that the demand cuts incorporate the view of a warmer than normal winter and some demand impact from a likely slowing of U.S. economic activity due to the sub prime lending fiasco. Unfortunately, we don't know whether these recent reductions fully captured the impact of $80+ oil prices and a weakening economy on crude oil demand.

The IEA is clearly the most optimistic about energy demand growth, while OPEC is the most pessimistic

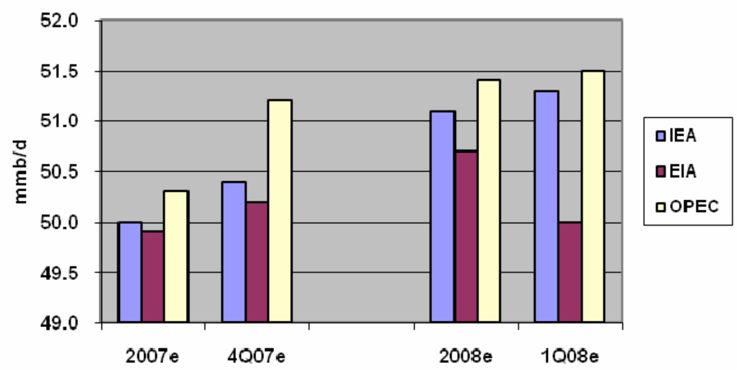
What may be more telling about the energy world we will experience in 2008 is to compare the forecasts for the three agencies. We have shown the September forecasts for oil demand, non-OPEC oil supply and the implied call on OPEC, NGLs and inventories for 2007, 2008, and the fourth and first quarters of each year, covering the winter demand period, for each of the three agencies. The IEA is clearly the most optimistic about energy demand growth, while OPEC is the most pessimistic. On the other hand, OPEC is the most optimistic about the growth of non-OPEC oil supplies. As a result of these views, the IEA and the EIA (both representing the consumers of the world) are predicting the greatest burden on OPEC's members and oil stocks. OPEC, because of its more pessimistic demand scenario and more optimistic view about non-OPEC oil supply growth, sees little need for its members to significantly boost production, one reason why you continue to hear OPEC ministers refer to the global oil market as being well supplied.

Exhibit 6. Oil Demand Forecasts



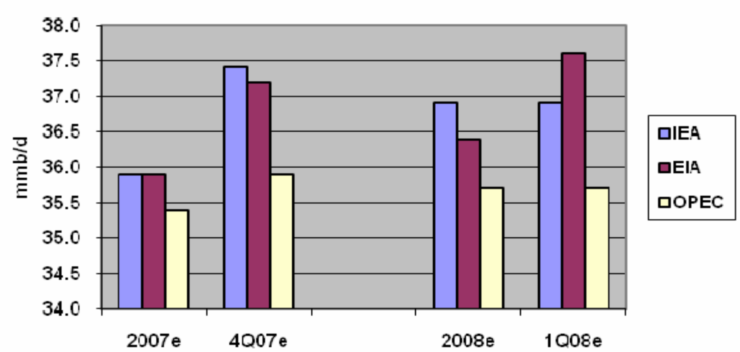
Source: IEA, EIA, OPEC, PPHB

Exhibit 7. Non-OPEC Supply Forecasts



Source: IEA, EIA, OPEC, PPHB

Exhibit 8. Call on OPEC, NGLs and Inventory Forecasts



Source: IEA, EIA, OPEC, PPHB

These different views of the energy world offer significant fodder for both bulls and bears about the direction of future oil prices. At the moment, investors appear to be mostly focused on the possibility that there will be a shortage of supply of oil this winter, and that is why crude oil futures prices traded at a record price of $84.05 per barrel last Friday. Will they be right? History will be their judge.

Reading Too Much Into Insider Trading Activity?

Oilfield service executives are demonstrating their belief in ever higher oil and gas prices and higher prices for their own shares by not selling stock

A recent article in *The Wall Street Journal* discussed a report by Thomson Financial that showed oilfield service executives are demonstrating their belief in ever higher oil and gas prices and higher prices for their own shares by not selling stock. The conclusion is based on an analysis of insider trading activity – the buying and selling of shares by senior managers of the companies. According to Mark LoPresti, vice president of quantitative research at Thomson, "if all of them [oilfield executives] are believing that we would see lower oil prices, you would see massive selling right now to take advantage of the high prices. We're just not seeing it."

Mr. LoPresti points to the lack of insider selling by executives at National Oilwell Varco (NOV-NYSE), one of the best performing stocks in the industry this year, up 169% through October 12, as support for his thesis. He takes this lack of selling as a statement of conviction about better times ahead for the industry, the company and its share price. "The top performer, no sales, holding on tight: That's pretty indicative of a broader statement," he opined.

Exhibit 9. NOV Has Outperformed The OSX and S&P 500

Source: Big Charts

Recent sales by oilfield insiders has been in connection with the exercise of stock options

The article pointed out that most of the recent sales by oilfield insiders has been in connection with the exercise of stock options, and that much of the selling has been by executives in the drilling sector, and in particular, it has been dominated by the one large sale by Nabors Industries (NBR-NYSE) CEO Gene Isenberg. Mr. Isenberg exercised 4.87 million expiring options, sold 4.14 million of the acquired shares back to the company to pay for the exercise price and taxes, and retained 700,000 shares, which Mr. LoPresti said is another positive sign.

The lack of insider selling conveys the positive outlook held by executives even without share purchases

A cautionary sign, as the article pointed out, is that there have been few large insider share purchases, except for some executives at Schlumberger (SLB-NYSE) and RPC Inc. (RES-NYSE). But Mr. LoPresti says the lack of insider selling conveys the positive outlook held by executives even without share purchases. "The lack of insider activity here tends to really be as indicative of the positive sentiment that they're expressing just as if they were buying on the open market," said Mr. LoPresti.

While we agree that there is latent optimism about the outlook for the oilfield service industry, which is supported by the Philadelphia Oil Service Stock Index (OSX) climbing to a new, all-time high, one should be careful about blindly following insider buying and selling activity. Rules of the Securities and Exchange Commission (SEC) govern when insiders can trade shares. The restrictions are tied to knowledge about internal corporate developments that has not been released to the general public. The issue revolves around materiality, i.e., a judgment about the amount of impact a development might have on a company's earnings or its value that could influence an investor to either buy or sell the stock. For example, a merger or acquisition could fit that definition, depending upon the size of the transaction. So while a management considers a possible transaction that it judges could be potentially material, the window for insiders to trade the company's stock is shut.

The opening and closing of the insider trading window often governs buying and selling by executives

The opening and closing of the insider trading window often governs buying and selling by executives. If executives work for an active acquirer, their ability to trade could be restricted for extended time periods – even years. When this situation happens you will often see a flurry of insider activity when the window opens, not because there is a change in the company's outlook, but merely because this is the only time the executives can buy or sell for a whole host of reasons. Might this be part of the explanation of the lack of insider selling at NOV; clearly a company possessing an aggressive acquisition track record?

On the other hand, maybe every NOV executive believes the upbeat industry assessment of their boss, CEO Pete Miller, who recently presented his outlook at the Emerging Leaders' meeting of the Petroleum Equipment Suppliers Association (PESA). As quoted in the association's recent newsletter, Mr. Miller likened the current oilfield equipment market to that of the early 1980s with one major difference – "we can't overbuild; we can't kill ourselves." With that optimism, supported by charts showing ever increasing drilling activity and the need for more new rigs and other oilfield equipment, NOV controls its own destiny, so why would you ever sell?

We are more impressed when executives ante up their own cold, hard cash to buy shares

At the end of the day, we take much of the focus on insider buying and selling with a grain of salt. Yes, it conveys a view about what executives think about the future of their industry and companies, but personal issues often dictate insider trading activity, and the restrictions make passing judgment on the motives imprecise. We are more impressed when executives ante up their own cold, hard cash to buy shares. Then they are really making a statement! Unfortunately, as the article pointed out, there hasn't been as much of that activity in contrast to executives merely holding on to their positions.

Chesapeake vs. Connecticut: Gloves Off; Leaders Born!

At one point several years ago, there was a school of thought on Wall Street that held that the large independent oil and gas producers such as Anadarko Petroleum (APC-NYSE), Apache Corp. (APA-NYSE), Devon Energy (DVN-NYSE) and EOG Resources (EOG-NYSE), to name a few, would evolve into the next major international oil companies (IOCs). People thought that despite their smaller size, their more nimble organizations, their better strategic position to grow reserves and production, and their solid balance sheets, these companies would emerge as the new leaders of the industry. One variable that wasn't considered was how they would perform in the political arena. Fortunately, because of their size and lack of retail operations (they don't market gasoline); they largely have been spared from the public spotlight.

In November 2006, the leaders of five major oil companies were summoned to Washington to justify their earnings

In November 2006, after reporting huge third quarter profits, the leaders of five major oil companies were summoned to Washington to justify their earnings and explain why they should not be viewed as 'ripping off the American consumer.' The chief executives of ExxonMobil (XOM-NYSE), Chevron Corp. (CVX-NYSE), ConocoPhillips (COP-NYSE), BP America Inc. (BP-NYSE), and Shell Oil Company (RDS.A-NYSE), who collectively had reported more than $25 billion in profits for the quarter as crude oil prices were hitting $70 per barrel, were challenged by the Congressional questioners to explain why their profits were so large. According to Sen. Pete Domenici (R-N.M.) there is a "growing suspicion that oil companies are taking unfair advantage." He declared, "The oil companies owe the American people an explanation."

In response to this demand, then-ExxonMobil Chairman Lee Raymond responded that petroleum earnings "go up and down" from year to year, as if to say this was a normal occurrence. CEOs James Mulva of ConocoPhillips and David O'Reilly of Chevron defended their companies' profits by comparing them against historic industry and general corporate profit margins and by highlighting the magnitude of their spending on projects to find new energy supplies. At the end of the day, consumers had to swallow hard and pay their inflated energy bills while the talk of windfall profits taxes evaporated.

The traveling sideshows did little to convince a skeptical public that oil companies were good corporate citizens looking out for the welfare of consumers

After that Capitol Hill show, several oil company executives began campaigns to crisscross the country talking to the public about the challenges of finding and developing new energy resources and attempting to explain why oil and gasoline prices were high and likely to stay high. The problem for the oil industry is that these traveling sideshows did little to convince a skeptical public that oil companies were good corporate citizens looking out for the welfare of consumers. In other words, they did little to alter the generally poor public image of the oil industry.

A new chapter of oil industry public relations may be dawning. And if what we are seeing continues, then the oil and gas industry has a new generation of leaders who appear unafraid of taking on the political establishment and demanding that politicians learn more about the business in order to make responsible criticisms. Part of that chutzpa is that these executives have been instrumental in helping create significant investor wealth through their intellect and grit.

The first act of this new age began on September 13, when Connecticut Governor M. Jodi Rell sent a letter to the chairmen and ranking members of the U.S. Senate and House committees with oversight of the energy industry asking them to begin an immediate investigation into possible manipulation of natural gas prices. The governor also issued a press release (Surprise! Surprise!) to highlight her action, which was driven by Chesapeake Energy Corporation's (CHK-NYSE) announcement earlier in the month that it was curtailing some natural gas production due to low wellhead prices and reducing future drilling activity to bring its spending in line with its future projected cash flows.

Connecticut Gov. Rell said, there are strong signs the natural gas industry is manipulating the market

According to Gov. Rell, the country had been assured that high natural gas prices that impact heating bills and electricity generation costs have not been due to market manipulation. However, as Gov. Rell said, there are strong signs that this is exactly what is happening. As evidence, she cites a September 6, 2007, market watch report that "states that the level of gas moving into storage is 23 billion cubic feet lower than the five year average." She goes on to reference the Chesapeake announcement regarding shutting in 200 million cubic feet per day of production "due to weak prices." She then went on to cite how Chesapeake has "elected" to reduce its operating drilling rigs by 10% to save the company money.

As Gov. Rell puts it, "This practice, if true, is an unconscionable fleecing of U.S. citizens by natural gas suppliers who 'elect' to reduce production to drive up prices paid by their captive customers." She goes on to contrast the actions of natural gas producers with the members of OPEC who had announced following their September 12th meeting a modest increase in production in order not to be blamed for creating further global economic problems due to high oil prices.

The governor attempted to demonstrate how natural gas producers have fleeced the American public by quoting statistics from the EIA

The governor attempted to demonstrate how natural gas producers have fleeced the American public by quoting statistics from the EIA that the wellhead price of natural gas in June 2002 was $2.96 per thousand cubic feet and by June 2006 had risen to $5.80; and by June 2007 was up to $6.86. Given this price increase, she questioned Chesapeake's rationale for shutting in gas production.

Before asking the Congress to investigate the matter and to bring action against any company found to be manipulating the supply, delivery or discovery of natural gas to maintain high prices, she invokes a timeworn technique of invoking the pain and suffering of the citizens. She states: "The American people have sacrificed enough in the name of natural disaster, market forces and the vagaries of supply and demand. To ask them to continue to sacrifice in the name of corporate profit is reprehensible."

We suspect that Gov. Rell was not prepared for the firestorm that blew back into her face

We suspect that Gov. Rell was not prepared for the firestorm that blew back into her face. Chesapeake's Chairman and CEO, Aubrey McClendon, fired off a five-page letter challenging the governor on her claims and incorrect use of industry statistics that, to him, demonstrated a total lack of understanding of the issue. Mr. McClendon referred to the letter and press release and said, "Each contains incorrect and reckless statements that demonstrate a lack of understanding of the natural gas market and Chesapeake Energy Corporation's role in that market." After explaining the history of the company and the performance of Chesapeake in boosting U.S. gas production over the past 12 months and how natural gas prices have fallen in recent months (since the June 2007 data the governor quoted) that have left the industry with only a 50% five-year increase rather than the 132% her letter suggests, Mr. McClendon points out that natural gas finding and producing costs have risen by more than 100% over this period reducing profit margins below where they were some years ago.

Mr. McClendon takes on the governor for refusing to approve any new LNG importation facilities in the state that actually puts upward pressure on natural gas prices

In a bold, and somewhat refreshing, move, Mr. McClendon takes on the governor for refusing to approve any new LNG importation facilities in the state that actually puts upward pressure on natural gas prices. But in his most aggressive act, Mr. McClendon discussed the role that hedge funds are believed to have played in depressing natural gas prices while boosting crude oil prices. Since many of these hedge funds are residents of Connecticut, he examined Gov. Rell's campaign contributions and found donations from principals and employees of many of these hedge funds. He then points out to the governor that her fellow governors from natural gas producing states that rely on taxes from wellhead prices of natural gas might be interested in having Congress examine the role of these Connecticut-based hedge funds, which he calls "speculators," in artificially depressing the gas price and hurting their economies.

At the end of his letter, Mr. McClendon says that he believes the 6,000 employees and 300,000 shareholders of Chesapeake deserve an apology from the governor. He also re-stated his willingness to meet with the governor. As he put it, "Given the complexity of the issues, the seriousness of your allegations and the stated importance of these issues to your constituents, I do not understand why you do not want to learn more about our industry and the errors in your public statements." Welcome to the hardball of the new generation of oil executives.

Mr. Farris takes on the agendas of private equity firms who he believes are more interested in short-term profit realizations than developing long-term business strategies to find and develop oil and gas resources

This new age was further defined by the recent letter from Apache Corporation's CEO Steve Farris to the Securities and Exchange Commission (SEC) about its proposed rule relaxing the restrictions regarding allowing shareholders to put forth candidates for election to the board of directors of companies and other shareholder resolutions. In his letter, Mr. Farris takes on the agendas of private equity firms who he believes are more interested in short-term profit realizations than developing long-term business strategies to find and develop oil and gas resources.

As Mr. Farris put it: "Private equity investors and other hostile takeover artists would be delighted to buy U.S. public oil and gas companies, deplete their resources, fire all the employees, and cash out. By neglecting investment in future production and firing those who know how to find and recover oil and gas, these predators could get rich quick, but at the expense of America's future energy security. He went on to question why the SEC was abandoning the historic role for directors of overseeing the business of companies. As he put it, "Who knows better how to run such a business, ExxonMobil's board of directors or ISS [Institutional Shareholders Service, a proxy advisory firm]? What happened to the business judgment rule that deferred business decisions to those who have the expertise to run such a business?"

Younger CEOs of more dynamic oil and gas companies are coming out swinging at the political and financial players who want to shape the world the companies must operate in

While this issue may appear to be more esoteric, it represents another example where younger CEOs of more dynamic oil and gas companies are coming out swinging at the political and financial players who want to shape the world the companies must operate in, which will do little to help the industry's ability to successfully find and develop future energy resources for America. Left unchallenged, the world of U.S. energy will become a less profitable, less attractive and less successful place to operate. For the good of the country, that cannot be an acceptable scenario and people in the industry should be happy to have industry executives who are willing to take the gloves off and challenge the critics.

Massachusetts Seeks Funds From Congestion Pricing

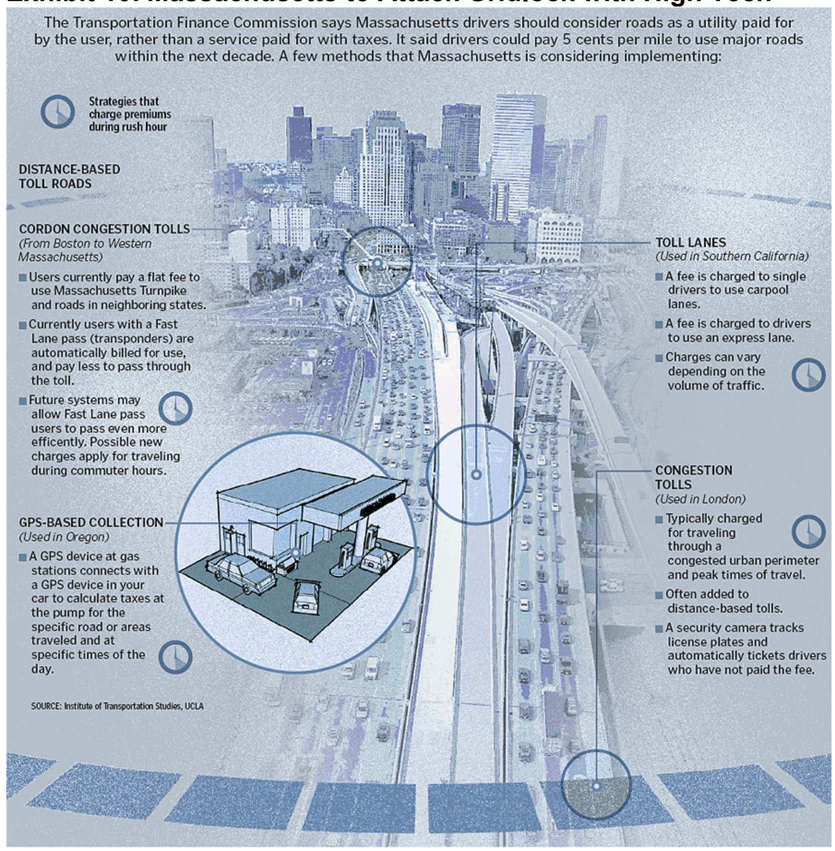
The plan envisions a 5-cents-per-mile fee on major roads to replace, or minimize, gasoline taxes paid by drivers

The Massachusetts Transportation Finance Commission has released a report on how to raise the estimated $15 billion to $19 billion needed to fix the state's crumbling roads and bridges over the next two decades, which encompasses a radical philosophical shift in how the existing road structure is viewed. The plan envisions a 5-cents-per-mile fee on major roads to replace, or minimize, gasoline taxes paid by drivers. This sweeping change would employ all the various technologies being tried in cities around the nation to deal with traffic congestion.

The plan would mirror an experimental program underway in Oregon that we have written about where volunteer drivers have GPS systems installed in their vehicles to track where they drive and calculate their per-mile fee. The fee exempts the driver from paying state gasoline taxes when he fills up his vehicle at specially equipped service stations. This system, which is still in a test mode, reflects a philosophy that roads should be paid for by their users and that the cost should more accurately reflect the road use by individual drivers. Thus, people who drive significant miles on Oregon highways would, and should, pay more than the occasional driver.

Massachusetts is also considering employing other congestion-attacking techniques such as instituting high occupancy vehicle lanes that charge varying fees based on time of day travel. The state is also considering installing license plate cameras at their toll booths for tracking violators, but that is one step away from the London, England system of charging a daily fee for vehicles entering certain areas of the City of London. Massachusetts is also thinking of upgrading its Fast Lane equipment to read vehicle transponders at highway speeds rather than requiring them to slow to 15 miles per hour. These new technologies, coupled with existing ones in place elsewhere would give the Massachusetts Turnpike Authority more options to set aside high vehicle occupancy lanes and charge time-sensitive rates.

Exhibit 10. Massachusetts to Attack Gridlock with High Tech



Source: *The Boston Globe*

While the government is offering innovative solutions to an age-old problem, the public is not totally convinced about the philosophical shift in road-pricing

The Bush administration has embraced congestion pricing. In September, the U.S. Transportation Department awarded $848 million to the cities of Miami, Minneapolis, New York, San Francisco and Seattle to fight gridlock with strategies that include high-priced rush hour traffic lanes. While the government is offering innovative solutions to an age-old problem, the public is not totally convinced about the philosophical shift in road-pricing. Individuals interviewed by *The Boston Globe* reacted to the change in the usual way. "The taxpayers pay taxes to build the roads, we pay tolls to use the roads, and now they want to hit the taxpayers again," said Phyllis Lachman of Concord, Massachusetts.

On the other hand, Gabriel Roth, a research fellow at the Independent Institute and the editor of the book "Street Smart," made the point "We use economic markets for electricity, for telephones, for food, for water…the question is why roads should be excluded." But as Art Kinsman, the director of government affairs for the Southern New England section of the American Automobile Association put it, drivers will expect better service if roads are to be treated as utilities. They will want to know whether the highway authority is going "to come out and fix it [a pothole] tomorrow?" rather than tolerating the holes for months as they do now. Shifting attitudes about how we fund our highway infrastructure will require adjustments – one of which may have an impact on energy consumption.

A New Dawn For Nuclear Power?

On September 24, NRG Energy (NRG-NYSE) filed the first full application for a new nuclear power plant since the partial meltdown of Pennsylvania's Three Mile Island plant in 1979

On September 24, NRG Energy (NRG-NYSE) filed the first full application for a new nuclear power plant since the partial meltdown of Pennsylvania's Three Mile Island plant in 1979. Shortly thereafter, the Tennessee Valley Authority approved plans to build two new reactors in northern Alabama, where it abandoned two mostly finished units in 1988 after electricity demand growth failed to meet forecasts. So are we about to enter a new age for nuclear power in this country?

Several factors seem to be at work influencing a revival for nuclear power. First is the recognition that the U.S. needs more electricity generation capacity. Second is the growing concern about how to meet the country's future electricity needs while at the same time lowering our greenhouse gas emissions. Third is that environmentally-friendly natural gas prices have become extremely volatile. Lastly, electricity produced by nuclear power plants is relatively cheap and once a carbon tax policy is instituted, it will become even more economical.

While nuclear power is still a highly controversial choice for new electric generation plants, attitudes may be slowly starting to change. A Gallup poll in March 2007 found that 53% of Americans surveyed favored the use of nuclear energy, little changed from the 57% who favored it when Gallup first asked the question in 1994. But a recent survey conducted for the Saint Index© on attitudes toward real estate development showed that more Americans now are supporting the building of power plants, although not necessarily nuclear plants.

While 57% of American adults still oppose construction of new power plants in their community that is way down from the 74% who opposed them last year

The Saint Index results showed that 38% of American adults support a local power plant project, compared to 23% in 2006 – a 15 percentage point improvement. While 57% of American adults still oppose construction of new power plants in their community that is way down from the 74% who opposed them last year. According to Patrick Fox, president of The Saint Consulting Group, an international land use political consultancy that created The Saint Index, "Americans are accepting the reality that we need more power generation." However, as he also pointed out, "Power plants certainly remain among the least-desired types of development."

Landfills remained the most reviled local land use by Americans, matched by casinos this year

Where power plants and quarries were the second most-opposed land uses a year ago, even Wal-Mart (WMT-NYSE), shopping malls and casinos drew more opposition as local development projects this year. Landfills remained the most reviled local land use by Americans, matched by casinos this year.

With regard to power plants, men (48%) are more likely to support a power plant in general than women (29%). Women (72%) are much more opposed to nuclear power plants than men (52%). Wind farms (76%) are by far the most preferred type of power plant, ahead of hydroelectric (53%) and biodiesel (50%). Nuclear was the least favored at 31% support.

While one could argue that the poll results don't appear particularly encouraging for the outlook for more nuclear power plants, we would counter that the shifting sentiment toward new power plants is the more significant development at this point. The nuclear power industry currently has a window of opportunity that was opened by provisions of the Energy Policy Act of 2005 that provides tax breaks, loan guarantees and other subsidies for new projects. For each nuclear plant seeking federal approval before the end of 2008, the act provides tax credits of up to $125 million for eight years, loan guarantees for up to 80% of the plant's cost, shared application costs and insurance that would cover the cost of regulatory delay. As a result of this legislation, the Nuclear Regulatory Commission anticipates receiving applications to build as many as 32 new nuclear reactors before the window closes.

The nation needs to build about 30 or so more plants by 2025 to maintain the same relative contribution from nuclear power

At the present time, the U.S. has 104 nuclear plants operating in 31 states, and they provide about 20% of the nation's electricity. With projections for electricity consumption to continue to grow, the nation needs to build about 30 or so more plants by 2025 to maintain the same relative contribution from nuclear power. If climate change is the bigger driver, then we need even more plants. Princeton University professors Robert Socolow and Stephen Pacala estimate that to solve one-seventh of the global greenhouse gas emissions problem, the world needs to triple its current nuclear capacity and the U.S. share of that program would require building about five nuclear reactors a year for 50 years.

Nuclear plants recently built in Japan have been cheaper than those built in the United States 20 or 30 years ago

While the cost of building nuclear power plants is very high, the industry believes it can reduce them by using standard designs. That concept is being tested in China at the present time where four Westinghouse reactors are being built at once. Additionally, nuclear plants recently built in Japan have been cheaper than those built in the United States 20 or 30 years ago. Although there doesn't appear to be a groundswell for new nuclear power plants at the present time, the positive shift in Americans' attitudes toward the need for more power plants, the expected economic impact from rising hydrocarbon fuel prices and increased restrictions on the use of these fuels due to greenhouse gas emissions concerns will stimulate greater interest in, and acceptance of, new nuclear power plants.

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