MUSINGS FROM THE OIL PATCH

November 14, 2006

Allen Brooks
Managing Director

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

Canada's Halloween Surprise and the Cost of Capital

The government was closing the tax loophole that enabled the "income trust" corporate structure

Late on Halloween afternoon as government employees and politicians were scurrying home early to handle the trick or treaters, the Conservative Party's Finance Minister, Jim Flaherty, offered the Canadian government's own trick or treat option. Mr. Flaherty announced that the government was closing the tax loophole that enabled the "income trust" corporate structure that has become very popular in Canada. The tax advantage allowed this business structure to "flow through" income to its unit holders from pre-tax earnings rather than taxed profits. The income trust had become quite popular because of its method of distributing greater earnings and for providing the income on a monthly basis that appealed to individual investors. Who would have thought that Canada would now join the list of politically suspect countries?

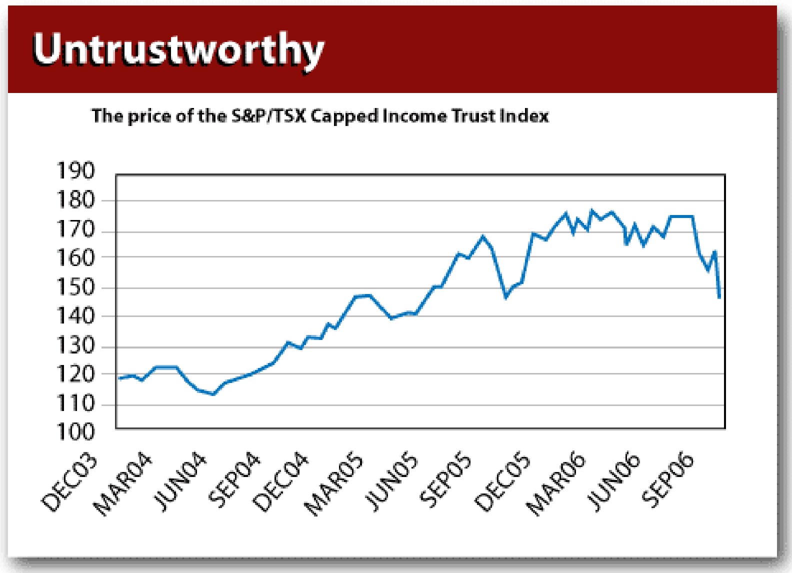
Income trusts were hammered by between 10% and 20% of their value as a result of investors telling their brokers to "get me out of these trusts."

The Conservative government had campaigned on a pledge of not raising taxes on trusts; a pledge it felt required breaking in order to prevent a spiraling government spending deficit. The impact of the Halloween surprise was a 2.38% drop in the value of the entire Toronto Stock Exchange (TSX) on November 1. Income trusts were hammered by between 10% and 20% of their value as a result of investors telling their brokers to "get me out of these trusts." On November 2, the TSX rose by 0.67% as value investors perceived that the selling of the previous day had been overdone. However, since the announcement, the income trust sector of the TSX has underperformed the overall market.

The popularity of income trusts has expanded in Canada well beyond the real estate and natural resource sectors that originally popularized them. It was the spread of the income trust business model to a broad range of economic sectors and fear that the spread was getting out of control that propelled the government's action.

The value of income trusts grew to where they accounted for 11% of the total TSX market value, or approximately C$230 billion ($205 billion). The carnage from the Halloween surprise cost the stock market about $25 billion.

Exhibit 1. Canada Income Trusts Take a Big Hit



Source: The Rude Awakening

The issue of income trust taxation had surfaced once before and cost the market roughly C$20 billion of lost value. Back then, the government threatened to alter taxes after rumors that the major Canadian banks were actively looking at the potential of converting to income trusts. Because the banks are major taxpayers, the possible loss of that revenue stream concerned the Canadian government. The Canadian banks have been in a struggle with the government over possible changes to banking regulations that would allow them to merge. This is an issue that has grown in importance to the banks as their diminishing role in global financing has become evident since they cannot grow their asset bases significantly from local deposit growth only. As a result, the Canadian banks have dropped precipitously in the global ranking of financial institutions.

The current tax change proposal was driven by the recent announcement by Canadian telecommunications giant, Telus that it was planning to convert to an income trust

The current tax change proposal was driven by the recent announcement by Canadian telecommunications giant, Telus (T-TSX) that it was planning to convert to an income trust. That announcement precipitated rival BCE (BCE-TSX) to also announce it was going to convert. Again, the threat of losing a significant revenue stream motivated the government to act. Canada is currently facing roughly a C$500 million deficit between its spending and tax revenues that would have jumped to about C$800 million if the Telus and BCE conversions to income trusts were allowed.

To soften the negative impact for retired individual holders of these income trust investments, the Canadian government is offering to enact changes in its tax regime that would enable pensioners to split their income and lower their combined tax bills. The government is also planning to reduce its corporate tax rate by one percentage point beginning in 2011 as a way to soften the impact of the corporate conversion that income trusts will be forced to undergo. Under the proposed tax law change, income trusts will be allowed a four-year time frame to convert. This window also provides time for the sharp-eyed tax accountants and lawyers to try to find alternative corporate structures that will provide all, or some of the tax advantages of the income trust structure. In addition, there is the possibility that the current government might change within that time frame, especially given the history of coalition governments.

Under the proposed tax law change, income trusts will be allowed a four-year time frame to convert

One of the great challenges of this tax law change is the impact it will have on the cost of capital of Canadian industries. By reinstating taxes on those companies that have converted to or started business as an income trust, their cost of capital has been raised overnight. It had been lowered by the elimination of the corporate tax. The favorable tax structure and business outlooks for many of the income trusts had produced a huge inflow of foreign capital seeking the high returns of the income trusts and the monthly income feature for foreign pensioners. The capital flows into Canada also had strengthened the Canadian dollar, which had risen to almost \$0.92 to the U.S. dollar, but currently sits at around \$0.89.

The income trusts' cost of capital has been raised overnight

The absence of this capital flow may hurt spending plans of oil and gas companies, although the Conservative government would argue that the income trust structure had already altered capital allocation decisions by companies to the detriment of growth. They have argued that because the tax exemption applied only to distributed earnings and not those earnings retained, companies had elected to defer capital investment in their businesses that was reducing spending on equipment and the hiring of people. While this may have been true for companies involved in corporate sectors other than real estate and natural resources, it would be hard to argue that the boom in natural resource businesses, and especially oil and gas, reflected a lack of capital investment in their respective businesses.

The decision by Finance Minister Flaherty was wrong because there were less draconian measures that could have been taken to protect the government's tax revenues

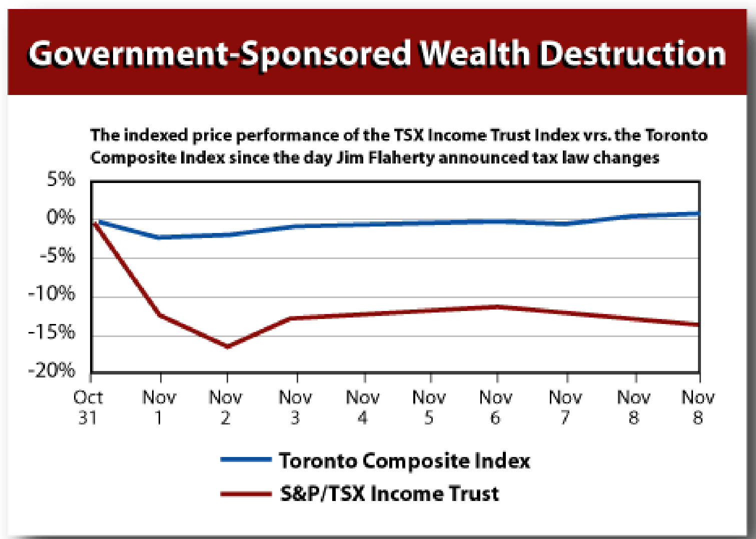
We believe the decision by Finance Minister Flaherty was wrong because there were less draconian measures that could have been taken to protect the government's tax revenues. For example, the government could have walled off the income trust option for future conversions, or it could have limited future conversions to certain industries. The Canadian government has been very worried about the capital allocation decisions within certain industries – telecommunications and banking – as these businesses have been used historically for employment policies. For example, the Canadian banks have huge numbers of branch banks that employ workers while U.S. banks employ more ATMs rather than clerks.

The tax decision has done nothing for oil and gas trusts but reduced their stock prices and increased their cost of capital. It will diminish their attractiveness in securing funds for future exploration and development activity. Since this announcement comes as the oil and gas industry is gearing up for the winter drilling season, there probably won't be much near-term impact on oilfield activity, but certainly the outlook for E&P spending from spring breakup onward has to be questioned. While reduced spending in 2007 would be bad for the oilfield service companies, the steep treadmill that Canadian natural gas production is on should push gas prices higher in the future.

The sharp drop in stock market values has turned many of the trusts into severely undervalued entities that are ripe for acquisition or being taken private

The fallout from the government's decision, however, may be opening the gates to barbarians from the south. Since operational cash flow hasn't been impacted by the tax decision, the sharp drop in stock market values has turned many of the trusts into severely undervalued entities that are ripe for acquisition or being taken private by private equity buyers. According to *The Globe and Mail*, the CEO of KCP Income Fund (KCP.UN-TSX) received half a dozen emails on his Blackberry while heading home on Halloween evening inquiring about his willingness to go private.

Exhibit 2. Income Trusts Continue to Underperform



Source: The Rude Awakening

The difficult thing to fathom is will the private equity guys follow what appears to be the new business model for making money or the old model? Under the old model, private equity funds bought companies and helped them grow and develop before taking them public. The new model seems to be to buy a company, lever it with debt, slash costs and limit capital investments, strip the company of money through dividends to the owners and then taking the company public. The reserve and production treadmill might limit the ability to fully exercise the new private equity business model.

While the Conservative government has said it will not back down from the tax law change, possibly saner heads will prevail and limit the change to businesses other than real estate and oil and gas. According to reports we have received from the analysts at the two largest Canadian banks, the possibility of the law being changed is probably zero. But then again, they all gave the chance of a tax law change on October 30 a roughly zero chance.

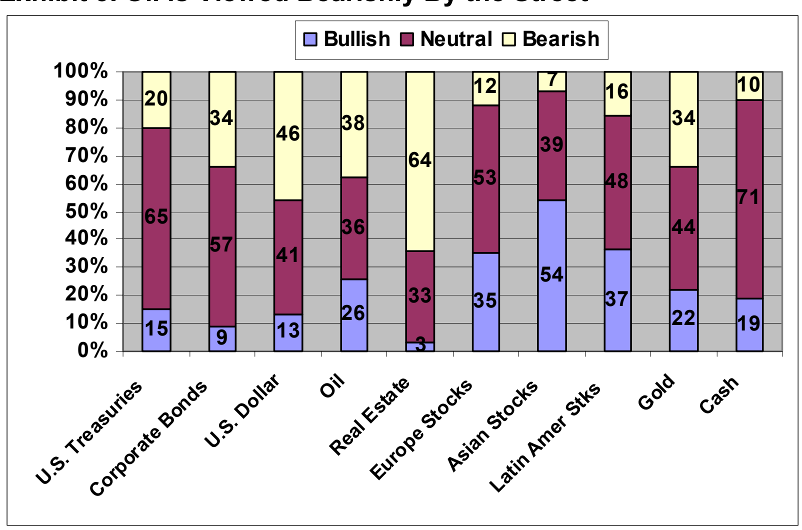
Wall Street's Positive View of Energy

Barron's has just published its semi-annual Big Money poll, which is a survey of professional investors about their views of the economy and financial markets. The latest survey received responses from 106 money managers across the country, whose portfolios vary by size and investment orientation. The poll has a decidedly bullish tone as only 16% of respondents describe themselves as bearish or very bearish in their stock-market outlook. What we found quite interesting was the discrepancy in views about the outlook for oil and energy stocks.

There was a fairly bearish tone to their view about the outlook for crude oil prices

When asked whether they were bullish, bearish or neutral about a number of types of assets, there was a fairly bearish tone to their view about the outlook for crude oil prices. Their most bearish asset class assessment was for real estate at 64% followed by the U.S. dollar at 46% and oil at 38%. The most bullish manager *Barron's* highlighted, Art Nunes, market strategist for IMS Capital Management in Portland, Oregon, said he believes the U.S. economy will grow at an above-average rate fueled by greater productivity and corporate profitability. He believes the Dow Jones average will reach 14,842 by mid 2007, up from its current 12,108 level. He also predicts that crude oil, currently trading about $59 per barrel, will decline to $42 by June.

Exhibit 3. Oil is Viewed Bearishly By the Street



Source: Barron's, PPHB

Mr. Nunes' view of oil prices is at odds with the Big Money managers' mean price predictions for crude oil of $59.08 by December 2006 and $58.11 by the end of June 2007. Only 26% of the poll respondents are bullish on crude oil, which is down from the 35% who were bullish in the spring Big Money survey.

Exhibit 4. Energy Is A Favored Sector

Industry Picks and Pans for the coming 6-12 months

	Market	
	Leaders	Laggards
Basic Materials	27.3 %	8.7 %
Capital Goods	15.2	8.7
Consumer Cyclical	28.3	13.0
Consumer Staples	7.6	16.3
Energy	33.7	19.6
Financial	31.5	31.5
Health Care	6.5	43.5
Technology	20.7	42.4
Transportation	4.3	3.3
Utilities	14.1	3.3

Source: Barron's, PPHB

When asked to select the market sectors that would lead and lag the market over the next six to 12 months they picked energy to lead once again

What seems somewhat surprising is that when the money managers were asked to select the market sectors that would lead and lag the market over the next six to 12 months they picked energy to lead once again. *Barron's* made the point that early-to-mid-cycle sectors such as financials and consumer cyclicals rose in the rankings while defensive sectors such as health care and consumer staples sank. According to those money managers, the two worst sectors should be health care and technology. This latter sector offers a unique opportunity for the oilfield service stocks. Historically, oilfield service and technology stocks are alter egos of each other in the stock market. Investor funds tend to flow from one sector to the other over time. Whenever one sector is doing well, then the other tends to be lagging behind. If technology performs as predicted by the participants in the Big Money poll it should be a favorable omen for the stock market performance of oilfield service stocks.

What is the Outlook for Energy Profit Margins?

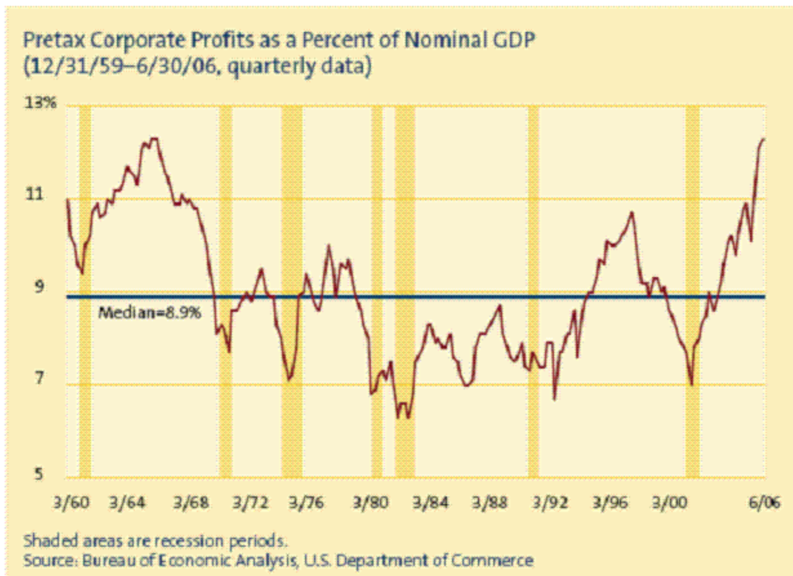
The oilfield service industry is returning to a more normal business environment after two plus years of unprecedented growth

In our last Musings we posed the question of whether oilfield service company profit margins were peaking given the drilling slowdown currently being experienced throughout North America. There are a number of reasons for this slowdown: lower commodity prices; inflated oilfield service costs; and producers running through their budget-money and not feeling pressured to seek more near-term budget funds. In essence, the oilfield service industry is returning to a more normal business environment after two plus years of unprecedented growth.

The ultimate determination of value is profitability

The money management firm T. Rowe Price (TROW-OTC) has recently published an article about the stock market risk for investors from a possible decline in overall corporate profit margins, which have soared in recent years. As T. Rowe Price points out, interest rates can influence corporate valuations, but the ultimate determination of value is profitability. Corporate profitability in this economic expansion has climbed to the highest level in 40 years. Pre-tax profits for U.S. companies in the second quarter of 2006 reached 12.3% of gross domestic product (GDP) compared with a median of 8.9% since 1960. If profit margins come under pressure, corporate earnings will be hurt.

Exhibit 5. Corporate Profit Margins at Record Level



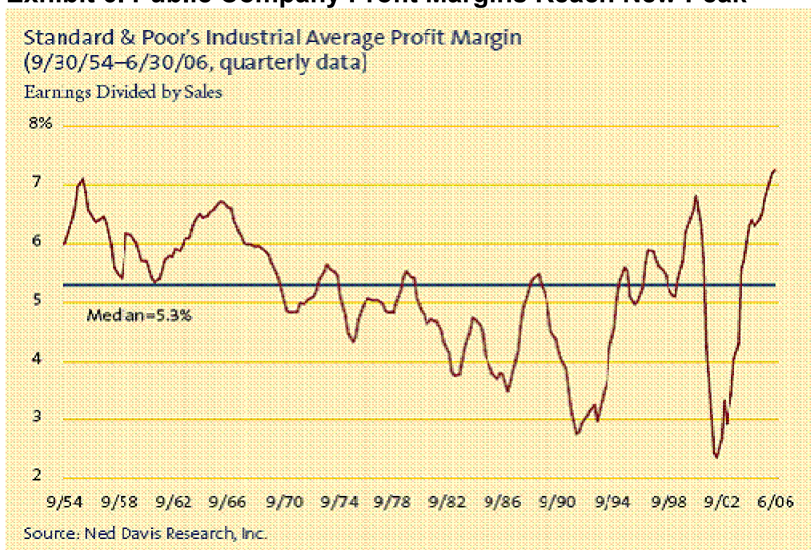
Source: T. Rowe Price

"Profit margins currently are about as high as they ever get"

When contemplating the profitability of publicly-traded companies, it is instructive to look at the performance of profits for the Standard & Poor's Industrial Composite. The average profit margin (operating earnings as a percent of sales) hit about 7.2% in the second quarter, well above the median profit margin of 5.3% since the mid-1950s, according to Ned Davis Research. The president of the firm, Ned Davis, commented, "Profit margins currently are about as high as they ever get. They are comparable to the 'Bubble of 2000' peak as well as the secular high in 1966." The expansion in profit margins has helped drive robust earnings growth.

Several keys to the profit margin expansion have been cost control and productivity growth. As Jim Floyd, a senior research analyst with The Leuthold Group, which provides market research and analysis, put it, "While the current economic expansion has been below average in terms of growth, the profit expansion over this time frame has been explosive. Companies have slashed costs over and over, riding a wave of strong productivity improvement while keeping the head count down and profit margins up." The problem is that productivity growth appears to be lagging and unit labor costs are rising at a much faster rate (5.0% annualized rate) over the past four quarters than they were climbing earlier in the economic cycle. Productivity growth has helped offset the rising cost of production inputs such as energy and materials.

Exhibit 6. Public Company Profit Margins Reach New Peak

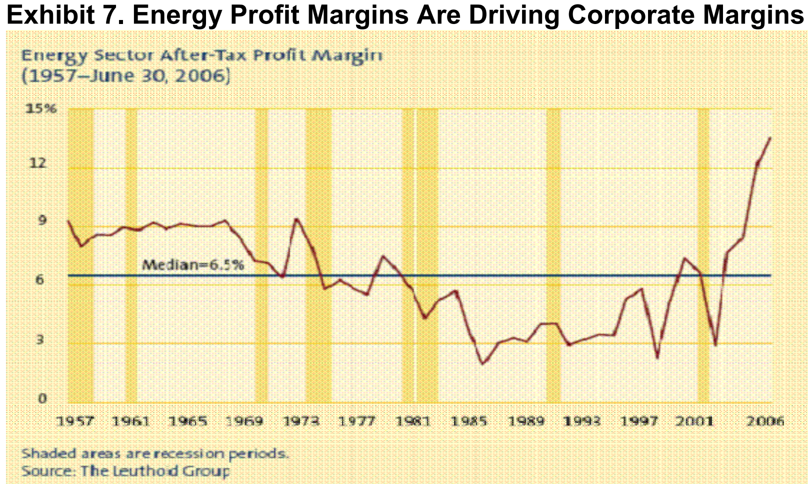


Source: T. Rowe Price

Virtually all the energy industry sub-sectors have enjoyed pricing power that has contributed to the explosion in after-tax profit margins

With respect to energy, it is clear that virtually all the industry sub-sectors have enjoyed pricing power that has contributed to the explosion in after-tax profit margins for the industry taking them to levels not experienced in modern times. The energy sector profit margin growth, driven by the rise in oil prices, has been a major contributor to the overall market growth. But where do energy industry profit margins go from here and what will be their impact on overall market profitability?

Exhibit 7. Energy Profit Margins Are Driving Corporate Margins



Source: T. Rowe Price

A few years from now Tim Parker anticipates lower commodity prices that combined with the cost pressures will drive margins down materially

According to Tim Parker, an energy analyst with T. Rowe Price, "these times of higher prices don't tend to last. Moreover, neither does the cost structure. So, these profit margins will likely be eroded over time as costs filter through." Mr. Parker believes that profit margins have peaked and are headed lower. While he doesn't think cost pressures will drive margins down to more historical levels, a few years from now he anticipates lower commodity prices that combined with the cost pressures will drive margins down materially. He believes that by the end of the decade, we will have more oil supply than demand as result of either a recession in the western world or because more supply is developed, or possibly a combination of both factors. That eventuality would send prices back to the $40 to $60 per barrel range and profit margins for producers "hurtling back to historical levels, and probably below the historical median, simply because of the greater cost pressures in finding the resource and producing it."

If profit margins for the energy business have peaked, one has to wonder how the stock prices can climb higher

If profit margins for the energy business have peaked, one has to wonder how the stock prices can climb higher. It is possible for absolute profit levels to grow even while profit margins shrink. So energy stock prices could reach new all-time highs driven by higher earnings even though the earnings will sport lower valuations that reflect the profit margin decline. If this pattern occurs over the next few years, it would create a bi-modal energy stock price performance pattern during the 2000s decade and mirror the performance of energy stocks experienced in the 1970s. Maybe history will repeat.

IEA: Same Song, Different Refrain

The IEA released its November 2006 *Monthly Oil Report* and once again cut its estimate for oil demand growth for 2006 due to the weaker than expected fuel use growth for the first nine months of the year. The new IEA forecast for 2006 oil demand calls for an increase of 900,000 b/d, down by 130,000 b/d from the prior forecast. This will bring total demand for 2006 to an estimated 84.45 million b/d. Their 2007 outlook for oil demand growth is unchanged.

Do you ever notice that when things are looking bad in the immediate future, projections beyond the near-term are always better

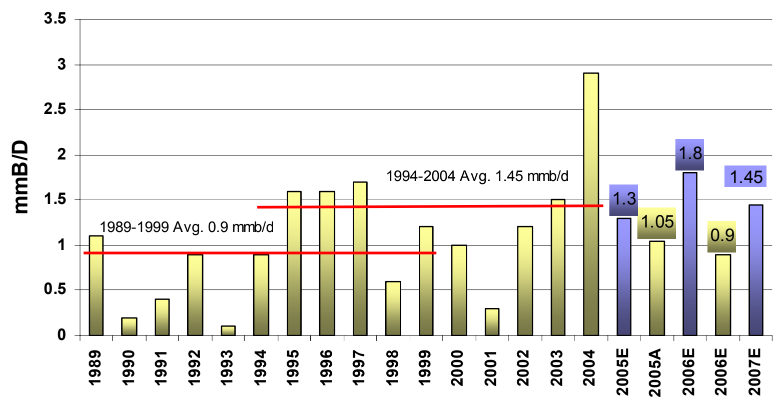
The IEA is optimistic about oil demand growth in the fourth quarter. Mr. Lawrence Eagles, the head of the IEA's Oil Industry and Markets division, was quoted as saying, "Demand growth in the fourth quarter is expected to be exceptionally strong. And that is not even allowing for a cold winter. If we see a cold winter it will be even stronger." Is this another 'over-the-horizon' forecast? Do you ever notice that when things are looking bad in the immediate future, projections beyond the near-term are always better. Admittedly it reflects the optimistic nature of humans, but sometimes it reflects the fact that we can't deal with the possibility that things could get worse before they get better.

The new oil demand growth projection for 2006 of less than one million b/d brings this year's demand growth forecast in line with the

We have not had a year in excess of 1.5 million b/d demand growth since 1997

world's average growth over the decade of the 1990's. From 1994 through 2004, the global average annual demand growth was about 1.45 million b/d. However, with the exception of 2004 when global oil demand growth was close to 2.9 million b/d, we have not had a year in excess of 1.5 million b/d demand growth since 1997. The three years 1995 through 1997 all experienced annual demand growth in excess of 1.5 million b/d. That was a period when U.S. economic growth was very healthy, but more importantly, Asian demand was very strong until the currency crisis in Thailand in 1997 ended the Asian growth miracle.

Exhibit 8. Oil Demand Continues to be Marked Down



Source: IEA, PPHB

In the December 2005 IEA *Monthly Oil Report,* the world oil demand growth for 2006 was estimated to increase at a 2.2% rate, or a 1.8 million b/d gain. That monthly forecast had been increased by 200,000 b/d from prior month projection. Today, the 2006 demand growth forecast calls for half the rate of increase initially forecasted. The IEA attributes the continual ratcheting down of its 2006 demand growth forecast to warmer weather this past winter and a cooler summer in the Northeast, the impact of high gasoline prices on U.S. consumption and slowing economic growth. What we do know is that gasoline demand growth reached a record the week of July 4th, but it did flatten through the remainder of the driving season, so there is some truth to the impact of high pump prices on gasoline consumption. A big question in the IEA forecast for 2007 is what gasoline prices are they factoring in to their demand projections? Since they recently raised their crude oil price forecast by 50%, one has to think that gasoline prices will be higher than they currently are.

A big question in the IEA forecast for 2007 is what gasoline prices are they factoring in to their demand projections?

While demand growth projections are merely estimates, we believe people should begin looking at the trend in annual global oil demand growth. We used to think the annual growth rate was about 1 million b/d, or the rate experienced during the 1990s. However, many forecasters have adopted a rate closer to 1.5 million b/d, which compared with the rate experienced during the last half of the 1990s and the first few years of the 2000s decade. That higher growth rate was significantly influenced by the huge oil demand growth experienced in 2004. Given the record of energy demand growth since 2004, one has to consider the industry outlook if the 1-million b/d demand growth rate proves to be the more typical future growth rate than the assumed 1.5-million b/d rate.

Many people would question that scenario because of the accepted belief that the economic growth of China and India will drive faster global demand growth. We would offer two thoughts to contemplate: First, China and India have demonstrated substantial economic growth without having driven up meaningfully their per capita oil consumption; and second, what happens to global energy consumption as the leading oil-consuming countries' population age? We don't have the answer to this latter question, but these are trends and issues that need to be considered in estimating one side of the energy supply/demand equation.

What happens to global energy consumption as the leading oil-consuming countries' population age?

A Unique, Or Dumb Shareholder Return Plan?

EnCana announced it will look to cut its annual production-growth targets to free up cash for share repurchases and other programs

The management of the Canadian independent and the country's largest petroleum producer, EnCana (ECA-TSX), announced last Monday that it will look to cut its annual production-growth targets to free up cash for share repurchases and other programs. EnCana will now look to grow its oil and natural gas production by five percent per year, rather than its long-term target of 10% annual gains.

Mr. Randy Eresman, EnCana's chief executive, told the media following a presentation to investors and analysts, that the company may also look at its dividend policy and its debt-management program with the new production growth target in place. This suggests that management may be thinking about paying off debt faster than it would have under its prior growth plan and maybe considering starting to pay a dividend.

According to reports, EnCana has identified 43,000 potential drilling targets on its leaseholds. It believed that to achieve the 10% per year production growth, it would need to drill 6,000 wells per year. At that rate, EnCana would drill up its current inventory of drillable prospects in seven years. Now, with a production growth target at half its prior rate, the company will only need to drill 4,000 wells per year, prolonging its prospect inventory for a decade.

EnCana believes that it will quell the rampant oilfield service inflation that rose last year when the drilling boom started

By cutting its production growth target, EnCana believes that it will quell the rampant oilfield service inflation that rose last year when the drilling boom started in response to record high natural gas prices. Mr. Eresman described the oilfield service industry's conditions as currently suffering from "hyper-inflation." He believes by cutting the company's production growth rate in half and reducing the amount of drilling it will need to undertake to meet its target, oilfield service costs will moderate.

On the same day EnCana was announcing this lower future production growth target, the company also disclosed that it had asked the Canada Revenue Agency in the summer of 2005 for a ruling on the tax implications of creating an income trust for the company's mature natural gas producing assets. This would have been the largest Canadian income trust with an estimated value of C$20 billion ($18 billion). EnCana has withdrawn its request in light of the announcement Halloween evening of changes to the Canadian tax provisions enabling income trusts. It is interesting that the Canadian tax authorities had taken well over a year to review EnCana's proposal yet had not rendered an opinion. Did the tax authorities know something the public didn't?

It is interesting that EnCana's management believes it can deliver greater shareholder value by cutting its long-standing production growth target

We find it very interesting that EnCana's management believes it can deliver greater shareholder value by cutting its long-standing production growth target. That is the antithesis of what shareholders supposedly desire. Cutting its long-term growth target seems like a most unlikely management strategy; although maybe this new strategy is an admission about the challenges the company felt it was incapable of meeting.

The cardinal investment rule is you sell the shares of companies that build office towers (monuments) for themselves

As we have written about before, academic studies have shown that the long-term shareholder value creation impact from share buybacks is not as great as from dividends and increases in dividends. If EnCana can boost its free cash flow by cutting it's spending and return more of that cash to shareholders directly through dividends rather than indirectly through share repurchases, maybe they will be able to boost the share price significantly. Unfortunately for shareholders, EnCana management announced a few weeks ago that it will build Canada's second tallest office tower (only because the City of Calgary restricted the new building's height) at an estimated cost of C$850 million. For those who have been around the stock market for any length of time know, the cardinal investment rule is you sell the shares of companies that build office towers (monuments) for themselves.

IEA Offers a New World Energy Blueprint

Claude Mandil characterized today's energy future as "doomed to failure"

Last week the International Energy Agency (IEA) introduced its annual energy report, The World Energy Outlook 2006 (WEO-2006), which was prepared in response to the G8 finance ministers call for a sustainable energy blueprint. Mr. Claude Mandil, executive director of the IEA, an advisor to 26 industrialized countries, characterized today's energy future as "doomed to failure."

The Reference Scenario, which provides a baseline vision of how energy markets are likely to evolve without new government initiatives to alter underlying energy trends, projects a 53% increase in energy demand by 2030, with over 70% of the increase coming from developing countries led by China and India. World oil demand in this scenario would rise to 116 million b/d in 2030 from 84 million b/d in 2005. Crude oil prices could soar to $130.30 per barrel due to

The IEA foresees China overtaking the United States as the leading emitter of CO2 before 2010

Increased oil demand, especially because only a few members of OPEC would be able to supply the incremental oil required. Worse, however, is the IEA's projected 55% increase in global carbon dioxide (CO_2) emissions by 2030. The IEA foresees China overtaking the United States as the leading emitter of CO_2 before 2010.

Mr. Mandil and his team suggest that there are various steps countries can take that would materially alter the world energy and pollution outlook. While these steps require strong actions, according to the IEA they entail minimal cost. The Alternative Policy Scenario could cut global energy demand by 10%, equal to the current energy consumption of China. It could cut global CO_2 emissions by 16%, equal to the combined emissions of the United States and Canada. The key to this Alternative Policy Scenario is increased use of nuclear power and improved efficiency of energy use.

The IEA seems to view nuclear power as the silver bullet for energy demand and CO2 emissions

The strong endorsement of increased use of nuclear power by the IEA marks the first time since its founding following the 1973-74 energy crisis that it has taken this stand. The IEA seems to view nuclear power as the silver bullet for energy demand and CO_2 emissions. Nuclear power is a non-polluting energy source, although it creates other environmental and security issues. Its increased usage would lower OECD countries' dependence on coal and natural gas to fuel power generation plants, and thereby cutting greenhouse-gas emissions.

The IEA also has a positive outlook on the role that biofuels can play in meeting future road-transportation fuel needs. Today, biofuels account for about 1% of road-fuel use, but the IEA sees that share growing to 4% under the Reference Scenario and 7% in the Alternative Policy Scenario. Their big concerns about the ability of biofuels to capture a greater share of the energy markets is the competition for existing arable and pasture land with demand for food globally, plus the fact that the technologies require subsidies to be competitive with alternative fuels in many locations around the world. The IEA believes that new biofuel technologies could alter its role in meeting global energy demand if they deliver on their supposed economic benefits.

Does this mean that the IEA senses that the oil, gas and coal supply equations are beginning to work against continued rapid hydrocarbon consumption growth?

We were fascinated with several things in the IEA's press release and comments made by Mr. Mandil and others in interviews announcing the introduction of the World Energy Outlook 2006. The sudden embrace of nuclear power as the salvation for OECD member country pollution and energy needs we found startling. Does this mean that the IEA senses that the oil, gas and coal supply equations are beginning to work against continued rapid hydrocarbon consumption growth? Is the IEA's stance a recognition that the environmental movement is emerging as the new power over energy policy?

Mr. Mandil was quoted in the IEA's press release as saying, "WEO-

2006 reveals that the energy future we are facing today, based on projections of current trends, is dirty, insecure and expensive. But it also shows how new government policies can create an alternative energy future which is clean, clever and competitive – the challenge posed to the IEA by the G8 leaders and IEA ministers." We thought the choice of adjectives to describe the two scenarios were interesting.

Does this mean that relying on nuclear power, biofuels and deferred demand will be cheaper than the alternative?

By adopting the IEA's recommended policies, the stay-the-course scenario that is "dirty" becomes "clean." Well, yes. We know that nuclear power is more environmentally friendly. Clearly demand-side investment in more energy-efficiency electrical goods will reduce power consumption that would reduce the demand for more dirty energy. However, the "insecure and expensive" trends under the new policies become "clever and competitive." Does this mean that relying on nuclear power, biofuels and deferred demand will be cheaper than the alternative? We are not so sure. If the environmental damage caused by greater CO2 emissions is factored in, depending on how the cost is assessed, then "expensive" might be replaced by "competitive." A most interesting question is does "clever" suggest that there are ways of dealing with the uncertainty about future energy supplies other than implied by the use of the word "insecure?" What really are Mr. Mandil and the IEA trying to tell the world?

Global Warming Debate Intensifies

If there is an issue that has gripped the news and is motivating governments and citizens into action, other than Iraq, it has to be the debate over global warming and what to do about it. While most people are embracing the scientific evidence that the globe is warming, the linkage to the cause being man-made is less clear. However, the evidence seems to be growing more overwhelming every day that the release of carbon dioxide into the air is principally caused by the burning of hydrocarbon fuels to power our modern society. The debate continues to intensify with passions running high on both sides.

The movie begins with the belief that the global warming evidence is overwhelming and anyone who doesn't believe it must be an idiot

We were surprised to see a review of a new global warming movie, The Great Warming, playing in movie theaters across the country. This movie is similar to An Inconvenient Truth, the recent Al Gore effort to promote the issue of global warming and the need to act quickly before the world is lost to melting ice caps, rising oceans and temperatures that burn up our crops. This film, and we admit to not having seen it, is sponsored by Phil Anschutz, the conservative former oil and gas man and Denver billionaire owner of the Regal Cinemas chain that is the movie's sole distributor. The movie attempts to examine the global warming evidence from a slightly less emotional basis than the Gore film, but it begins with the belief that the evidence is overwhelming and anyone who doesn't believe it must be an idiot. The movie also tries to make the case that even the Evangelical Christian movement is getting on board the global warming cart with its Creation Care program, and as a result, the Republican administration can no longer avoid the issue. Of course last week's election of the Democrats to power in Congress may have made this point mute.

It was shortly after we read the movie review that we heard Tim Reid, the Washington editor of *The London Times* speak, at the fall meeting of the National Ocean Industries Association (NOIA). Mr. Reid's talk was focused on his view of the relationship of Europe, and especially Great Britain, toward the United States and its present government. He believes that President Bush is viewed poorly by Britons, and most Europeans, because he is perceived as a cowboy and one who loves to mangle the King's English.

Mr. Reid has been troubled by what he saw and heard as he traveled around the country covering the midterm elections for his paper. He viewed the growing belief that the best solution for the Iraq war is an immediate escape as troublesome. He had begun his talk at NOIA by admitting that it was late, but nevertheless, he felt it necessary to say he was sorry for the burning of Washington, D.C. during the War of 1812. He reminded the audience that the United States had rescued Great Britain during both World War I and World War II. The U.S. rebuilt both Germany and Japan in 1946. He also pointed out that the U.S. had saved millions of Germans during the Berlin Blockade. Given this level of commitment to helping Europe and America's allies, the thought that our foreign policy would become isolationist after the election was troublesome. And he ended his talk with the point that with the upcoming change in U.S. leadership in 2008, relations with Europe would improve since most their animosity is directed toward President Bush personally and not the United States.

Tim Reid believes that whoever wins the White House in 2008 will have a view of global warming more like the European view than the present administration

In response to a question from the audience following the talk, Mr. Reid acknowledged that the United States was well behind Europe in its view of the global warming issue. He believes that whoever wins the White House in 2008 will have a view of global warming more like the European view than the present administration. There have been a number of new climate change developments in the past week that we haven't had time to fully digest. We will be researching those developments and reading the reports. What we do know is that the reshaping of the U.S. political view about global warming and climate change starts next January when the Democrats assume power on Capitol Hill and can focus legislation on their more "green agenda."

Contact PPHB:
1900 St. James Place, Suite 125
Houston, Texas 77056
Main Tel: (713) 621-8100
Main Fax: (713) 621-8166
www.pphb.com