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MUSINGS FROM THE OIL PATCH

November 15, 2005

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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

Washington's Theatre of the Absurd May be a Watershed Event

Last week we witnessed a clash between facts and logic versus politics and emotion

Last week we witnessed a clash between facts and logic versus politics and emotion. The oil industry believes it met and mastered the challenge of the inquisition tactics of the members of the Senate Energy and Commerce Committee in Washington, especially the Democratic members. The theatrics began when the Republicans got the hearing started without having the witnesses (the leaders of the five largest U.S. oil companies) swear to an oath. This maneuver eliminated the photo-op of all these executives in a line with their right hands held high, a picture that continues to haunt the CEOs of the tobacco companies. In addition, the amount of time allocated to each Senator was restricted, which insured that the pontificating speeches/questions were limited. The motivation for the hearings was the explosion in gasoline and heating oil prices that has occurred this year and especially following the arrival of the three hurricanes this fall. A poll taken earlier this year reported that 4 out of 5 Americans favor a windfall profits tax on the oil companies. The third quarter profit reports for ExxonMobil (XOM-NYSE) and Royal Dutch Shell (RDSA-NYSE), both set quarterly records for the companies.

The U.S. consumer's mindset will determine how he stimulates his political representatives and how he spends his money

While we watched last week's events with interest, we suggest that readers sit back and examine them with a view to understanding the shifting mindset of the U.S. consumer. His mindset will determine how he stimulates his political representatives and how he spends his money. Both of these outcomes can change the world in which energy companies operate. Our thrust in this examination is not to convince you of impending doom for your business, but merely to suggest that shifting attitudes toward the forces that drive energy demand, prices and profits could alter the market in which you operate quickly.

There are three Senate and eight House bills dealing with re-imposing a windfall profits tax on the petroleum industry

In Washington, the battle over the impact of energy prices on the consumer has been underway since spring when oil prices began to climb sharply. Today, there are three Senate and eight House bills dealing with re-imposing a windfall profits tax on the petroleum industry. While many of these bills are merely variations of each other, their basic thrust is to tax oil companies based on the premise that high crude oil prices have boosted their profits to 'obscene' levels. The mechanics of these bills include rigid price triggers, i.e., oil prices exceed \$40 per barrel, or exceeding acceptable profit measures as determined by a board of disinterested officials. The difference in the bills is what happens to the windfall tax revenue. The proposals range from direct rebates to citizens to providing money for home heating oil relief. Other proposals suggest funding energy relief for low income people with the balance of funds going for additional highway or mass transit construction. As we read the bills, they all will add to the size of the government's bureaucracy and, based on our experience, those sticky fingers in Washington will siphon off some portion of these newfound revenues.

Oil industry executives tried to deal with the emotional reactions to high oil prices with logic and facts

The problem of the Washington hearings for the oil industry is that its executives tried to deal with the emotional reactions to high oil prices with logic and facts. We read the testimony of four of the five executives (Royal Dutch Shell's prepared remarks were not on its web site). The length of the prepared testimonies of the CEOs was interesting as three of the four were quite short. However, Jim Mulva's, of ConocoPhillips (COP-NYSE), comments ran to 35 printed pages and included a substantial number of facts and figures. While the shorter presentations had some facts they were more interested in making a limited number of points – oil prices are set in competitive world markets; every company has invested cumulatively as much as it has earned over various time periods; energy investments require long time periods to mature and thus are not driven by near-term industry conditions; and the industry has done a yeoman's job to minimize the economic impact for U.S. consumers caused by the hurricanes. While all these points are valid, they fail to impress the consumer who only knows that it costs substantially more to fill up his vehicle's tank now than it did a year ago. The consumer is being warned that his winter heating bill will cost substantially more than last winter, but since he hasn't gotten those bills yet so hasn't felt that pain.

Windfall profits: I'll know it when I see it

Windfall profits are much like Supreme Court Justice Potter Stewart's definition of pornography – I'll know it when I see it. The recent focus on windfall profits has been driven largely by the increase in oil prices and the magnitude of ExxonMobil's third quarter \$9.9 billion profit. That quarterly profit exceeded the amount earned by any U.S. corporation in history. ExxonMobil has been battling the public relations aspect of the magnitude of their profit in advertisements. They have made the point that based on second quarter profits of the oil and natural gas industry, as measured by cents per dollar of sales, the industry is slightly below (7.7 cents vs. 7.9 cents) the earnings rate of all U.S. industry. In contrast, ConocoPhillips showed that over the period 1990 to 2002, the

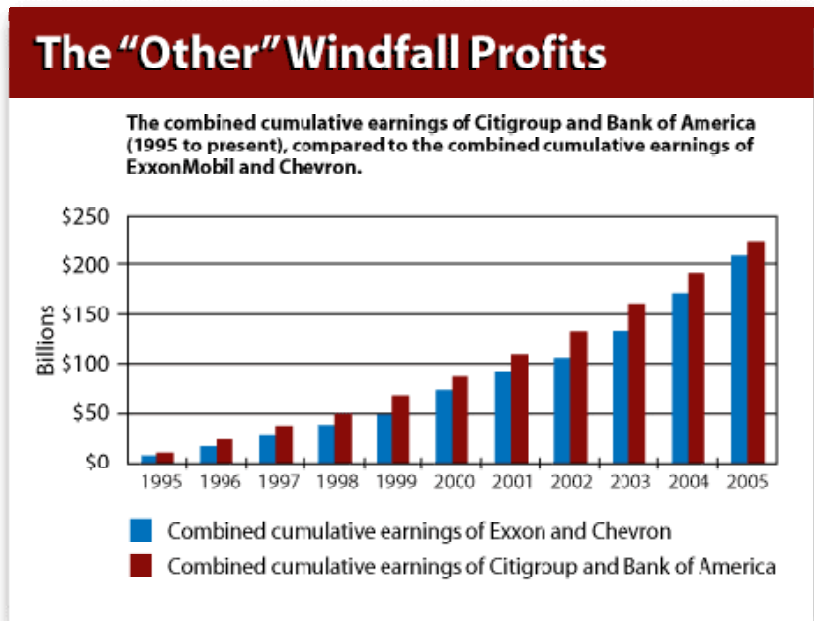
average return on equity of the petroleum industry was 11.3%, which was lower on average than the 12.6% return for the S&P 500. There have been other comparisons to show how middling the financial performance of the petroleum industry has been. But that begs the question of the perception by consumers.

ExxonMobil also points out in its ads that it invested \$15 billion in capex in 1998 when oil prices were \$11 and \$15 billion this year with prices around \$60, trying to make the point that it doesn't alter its investment spending based on current oil prices. To us, the ExxonMobil ad begs the question of how come, with oil prices five times greater, the company can't find more investment opportunities.

Why we are not questioning the earnings of the big banks?

The most interesting analysis we have seen about windfall profits is the chart below that shows a comparison of the combined earnings of ExxonMobil and Chevron compared to Bank of America and Citicorp over the time period 1995 to 2005. Notice that the combined earnings are similar, which begs the question of why we are not questioning the earnings of the big banks? Unfortunately, we are trying to use logic and facts just like the executives.

Exhibit 1. Oil Companies vs. Banks



Source: The Rude Awakening

It is important to understand that the political response to upset constituents may be legislation

We believe that the recent drop in crude oil prices that has led to a fall in gasoline prices will blunt the windfall profits tax movement. But it is important to understand that the political response to upset constituents may be legislation. A recent presentation we attended by Phil Wedemeyer, Director of the Office of Research and Analysis of the PCAOB, about auditing regulations under Sarbanes-Oxley, made the point that for every issue that was raised at the Enron, WorldCom, Imclone and Tyco Congressional hearings, there was a

If Washington decides it wants to tax windfall profits, the oil companies will act to minimize their taxable income

corresponding paragraph of regulations in that legislation. Could this happen to energy? Possibly, although we would hope the history of energy regulation in the 1970s and 1980s would provide sufficient ammunition to blunt adverse regulation. As Mr. Mulva pointed out in his testimony, a Congressional Research Service study showed that the windfall profits tax of 1980 drained \$79 billion of revenues from the industry over the eight years it was in place; revenues that contributed to a 6% decline in domestic production and a 16% increase in oil imports.

If Washington decides it wants to tax windfall profits, the oil companies will act to minimize their taxable income. There are several ways to do this. They could go out and buy small E&P companies that have reserves but little in profits to dilute their profits. They could spend away their profits through increased capital spending, but that might produce greater oilfield inflation and/or force them into building facilities that provide marginal profits. They could accelerate their stock buyback programs and/or increase their dividends – either by increasing regular dividends or issuing special payouts. Or the oil companies might respond by sitting on their hands and reducing their activity until they know what the rules are, since they don't want to make any mistakes. Any or all of these actions would upset the current expectations of how the energy industry will evolve over the next five quarters.

IEA's new long-term energy outlook to 2030 cut its oil growth projection by 6%

While the windfall profits issue is of concern, the bigger problem may prove to be all the other events that occurred last week. We saw crude oil prices falling that could signal the start of further declines in coming months. (See our story on page 6.) The latest report from the International Energy Agency (IEA) cut, once again, its 2005 oil demand by 70,000 b/d to an increase of 1.2 million b/d. The IEA also cut its 2006 demand growth to 1.66 million b/d, a drop of 90,000 b/d. It seems that the IEA has returned to its pre-2003 pattern for forecasting when energy projections were consistently reduced rather than increased such as in the 2003-2005 period. We would also note that the IEA's new long-term world energy outlook to 2030 cut its oil growth projection by 6% to reflect their interpretation of the impact of higher oil prices on demand.

While these energy legislative initiatives are not dead yet, they are in trouble and reflect the public backlash against the energy industry

Two other events late last week also present concerns. First was the dispute within the Congress over legislation that included the authorization to open up the Arctic National Wildlife Reserve (ANWR) for drilling and granting states the power to opt out of the ban on offshore exploration. Both of these provisions had been previously approved, but had been killed by legislative maneuvers. This time those provisions were being included in budgetary and tax legislation that were exempt from filibusters, but the perceived political weakness of the Bush Administration and the problems of former House speaker Tom DeLay emboldened Republican moderates to challenge their party's leadership. While these legislative initiatives are not dead yet, they are in trouble and reflect the public backlash against the energy industry. The public believes that the oil industry has been handed substantial tax

benefits and regulatory relief that now appear overly generous in light of the industry's profits and current high oil and gas prices.

Public support for terrorism may be on the wane

The bombing of three western hotels in Jordan produced a backlash of outrage in that country, and throughout the Middle East, against the al Qaeda organization that claimed responsibility for the action. A massive public demonstration in Jordan against al Qaeda with chants of 'death to Ali al Zarqawi,' the leader of the group, suggest that possibly the pendulum of public support for the terrorist organization in the Middle East may have peaked. If so, then public support for terrorism may be on the wane. That could cause speculators to abandon the crude oil market, helping to eliminate whatever terrorism premium is in the futures price. That would add further support for lower crude oil prices. The issue for the oilfield service industry is how will your customers react to falling oil prices?

Don't Underestimate Ingenuity

BP's shuttle tanker effort focused on getting production from its Marlin platform

An article in Saturday's *Houston Chronicle* focused on the efforts oil and gas companies have employed to bring Gulf of Mexico production back on stream following the recent hurricanes. We were particularly intrigued by the effort of BP plc. (BP-NYSE) to employ shuttle tankers to move crude oil to shore after some of their pipeline connections were shut down. The shuttle tanker effort focused on getting production from BP's Marlin platform to a terminal up the Mississippi River in St. James, Louisiana. What was interesting about the story was the challenges BP faced in getting the offshore equipment set up to unload the oil into a tanker connection.

BP also needed to lease a shuttle tanker that had a high degree of maneuverability

BP had to install new equipment on the Main Pass 225 hub platform to allow for a connection to a tanker. BP was fortunate that it was actually testing a system on another platform so they avoided the normal 14-16 week delivery time for a new system. They also had to find a 1,100-foot-long section of 12-inch hose that could float and that contained a valve that would automatically shut off if the connection with the tanker was lost. This valve works to prevent an oil spill. Lastly, they had to connect the system to a floating buoy.

BP was granted a 90-day waiver from the Jones Act

BP also needed to lease a shuttle tanker that had a high degree of maneuverability. They turned to Teekay Shipping (TK-NYSE) that has extensive experience in operating shuttle tankers in the North Sea. Teekay is supplying its *Nordic Trym* that is equipped with both bow and stern thrusters. BP also installed three different positioning systems to ensure accuracy and safety for the tanker and the platform. The operation of the tanker involves two standby vessels to keep other vessels away and to handle any emergency such as a fire or spill, or to move the tanker away from the platform should it lose power.

BP was granted a 90-day waiver from the Jones Act provision requiring U.S. ownership and operation of vessels involved in coastal trade. Because an offshore platform is considered a port,

only vessels that meet the Jones Act provisions can haul cargo between two U.S. ports. This waiver was part of the action by the Bush Administration in response to Hurricane Katrina and the damage done to the petroleum industry. The waiver was really targeted at enabling foreign-flagged vessels to transport petroleum products from refineries to markets where the traditional distribution system had been interrupted. The Minerals Management Service and the U.S. Coast Guard have reviewed the use of shuttle tankers and have agreed that under certain situations they will allow their use in the Gulf of Mexico. The Jones Act restrictions have been one of the major limitations on the earlier use of shuttle tankers to solve offshore production challenges.

Will the BP experience be a catalyst for increased use of shuttle tankers in the Gulf of Mexico?

Will the BP experience be a catalyst for increased use of shuttle tankers in the Gulf of Mexico? Will the Jones Act waiver become permanent, something that other marine-oriented countries have demanded to eliminate the unfair trade barrier? Whether the U.S. government will think that the need to gain access to more and different vessels that are not a part of the U.S.-flag-fleet is enough to challenge the traditional argument that we need to protect our maritime and shipbuilding industries remains to be seen. It is an interesting issue to ponder for it could reshape the U.S. maritime businesses.

Are Oil Prices Heading Significantly Lower?

Last week, T. Boone Pickens predicted that we are headed toward a \$50 per barrel oil price

Last week, T. Boone Pickens, the noted oilman and now hedge fund operator, predicted that we are headed toward a \$50 per barrel oil price. Pickens received tremendous notoriety earlier this year when he said that we would see \$60 oil before we saw \$40, and then when he predicted \$70 oil before \$50. As the commodity markets took oil prices consistently higher in late summer, peaking at \$71.57 per barrel on August 29, the debate shifted to when we would see \$80 or higher oil. While oil prices have remained volatile and subject to weather and production and consumption data, the trend has been clearly lower since that late August peak. Last week, crude oil futures prices fell by more than 5%.

A significant technical measure of the trend in crude oil prices was violated on Thursday and that may signal to oil traders that prices are headed lower

Where will crude oil prices go from here? A significant technical measure of the trend in crude oil prices was violated on Thursday and that may signal to oil traders that prices are headed lower. That measure is the 200-day simple moving average (SMA). It smoothes the day-to-day swings in the market and allows investors and traders to assess the long-term trend at work in a market. This measure is often used to signal whether a stock or commodity is in a bull or bear market. The 200-day SMA can also be used to signal support or resistance price levels.

On Monday, December crude's low was \$58.60 versus the 200-day average at the time of \$58.44. After bouncing up on Tuesday, crude hit a low of \$58.60 on Wednesday as the 200-day was at \$58.58.

Many traders say that a 10% pullback is an official correction, and a 20% pullback is a bear market

On Thursday, crude closed the regular session down \$1.13 at \$57.80, well below the 200-day average that was up to \$58.64. With Thursday's close, crude had fallen below the 200-day SMA for the first time in over 2 ½ years. On Friday, crude dropped further to close at \$57.53, still below the 200-day average.

One technical trading service pointed out that on Thursday crude's actual low price during the trading session was \$57.40, the lowest price since June 13. At that price, the front month crude oil futures contract had lost about 20% of its value from its all-time high of \$71.57. Many traders say that a 10% pullback is an official correction, and a 20% pullback is a bear market. This service is reluctant to say that a new bear market for crude has been established, but they feel safe in saying that the uptrend has ended. This conclusion would appear to support Boone Pickens' view. Is \$50 the stopping point, or do we have to wring out the \$20 premium in current crude oil price that Lee Raymond of ExxonMobil suggested when he testified before Congress?

Exhibit 2. Crude Oil Prices vs. Moving Averages



Arctic Canada Gas Pipeline May Move Forward

Substantial progress on the financial issues holding up the Arctic pipeline has been made in recent weeks

Imperial Oil Limited (IMO-TO) is slated to tell Canada's National Energy Board on November 18 how close it is to putting the public hearing process for the delayed Arctic gas pipeline back on schedule. The C\$7 billion (\$5.9 billion) Canadian Arctic gas pipeline is designed to move upwards of 1.9 billion cubic feet a day of gas from the reserves on the coast of the Beaufort Sea to Canadian and U.S. markets. Comments made by participants close to the negotiations over the troublesome financial issues that have held up agreements between the pipeline sponsors and the native groups whose land must be crossed suggest that substantial progress on this issue has been made in recent weeks.

Last Tuesday, Rex Tillerson, president of ExxonMobil, a participant in the Mackenzie Valley Pipeline group, the sponsor of the project, said he believed there had been progress on the major sticking points and that he expected the group will move the project “across the finish line.” Additionally, Nellie Cournoyea, chief executive of the Inuvialuit Regional Corp., which represents native communities on a large portion of the Northwest Territories land that the pipeline will transit, said, “Many of the items they felt that they had to get off the table are getting close to finalization.” She went on to say, “We want to get on with the pipeline, and we feel a lot of the issues that are important to us have been dealt with.”

Exhibit 3. Location of Arctic Pipeline Project



Source: CIA

The National Energy Board has said that it would take 60 days from getting a positive response from the pipeline sponsors to prepare for the start of the lengthy hearings into the project

In April, Imperial Oil had put the brakes on all physical work on the development, saying that the partners needed to address spiraling cash demands from native groups in exchange for allowing the pipeline to cross their lands. The pipeline partners, including Imperial, ExxonMobil, Shell Canada Ltd. (SHC-TO) and ConocoPhillips also wanted to find ways to cut the costly regulatory maze of approvals. They had asked the Canadian government for a royalty regime that reflects the project’s high initial cost. Imperial, however, cautions that there is nothing mysterious about the November 18 date, and that the company may simply inform the regulator that it needs more time before deciding whether or not to move forward. The National Energy Board has said that it would take 60 days from getting a positive response from the pipeline sponsors to prepare for the start of the lengthy hearings into the project. The hearings had originally been anticipated to start in September, but now it looks like the hearings might start early next year.

On October 6, Imperial Oil chief executive, Tim Hearn, warned the Arctic gas pipeline project could be stalled for years unless the financial issues were sorted out in short order. He had said that more delays could allow another project, meaning the Alaska

The Mackenzie Valley line is closer to taking another step forward on the long road toward construction

Highway pipeline, to overtake the Mackenzie Valley line. Cournoyea doubts that would be possible. "Even though we have some difficulties, they (Alaska proponents) have a great deal more to come through, and even if they were told 'Yes, go ahead today,' I would say it takes seven or eight years just to get where we are," she said. Given the bickering among the State of Alaska and the oil companies it is likely Cournoyea's observation is right. What is clear about these developments in Canada is that the Mackenzie Valley line is closer to taking another step forward on the long road toward construction. This is an important development since all the long-term energy forecasts for North America project the need for this gas in order to meet natural gas demand forecasts, and importantly, the development of Canada's oil sands reserves.

Exhibit 4. Mackenzie Valley Pipeline Route



Source: CIA

Pemex Gets Its Needed Tax Relief

The new tax rules will scrap a flat tax rate of 61% on Pemex's total revenues and instead tax the company on its oil and gas profits

Last week Mexico's Senate approved a measure to reduce the tax bill of Petroleos Mexicanos (Pemex). The Senate approved a bill, which had already been approved by the lower House of Deputies, by 96 votes to zero. The new tax rules will scrap a flat tax rate of 61% on Pemex's total revenues and instead tax the company on its oil and gas profits, easing the burden on its less profitable divisions like refining and petrochemicals. The tax reduction, a long-delayed effort by Mexican President Vicente Fox, will save Pemex more than 107 billion pesos (\$10 billion) over the next four years. The provisions of the bill will save the company 23.5 billion pesos (\$2.2 billion) on its 2006 taxes, and will gradually rise to reach annual savings of 40 billion pesos (\$3.7 billion) in three years. This bill was revised after Fox surprised the country by vetoing an earlier bill that would have allowed Pemex to pay 25.6 billion pesos less in taxes next year. The tax break was seen as a cautious first step in

The Mexican Finance Ministry depends heavily upon Pemex, as the company's taxes account for about one-third of the government's income

transforming Pemex into a modern company. The rejection by Fox dismayed oil executives.

Fox initially sent the tax bill back to Congress and asked it to reduce the loss to the federal treasury by stretching out the transition period and reducing Pemex's tax forgiveness at the beginning to about 17 billion pesos (\$1.6 billion) in 2006, but rising quickly to between 60 billion pesos (\$5.6 billion) and 70 billion pesos (\$6.6 billion) by 2009. The Mexican Finance Ministry depends heavily upon Pemex, as the company's taxes account for about one-third of the government's income. Fox wanted to restructure Pemex's tax relief in order to minimize the impact on the government's revenues. Fox also proposed a more significant and less politically palatable change for Pemex, including the opening of some natural gas exploration and production areas to private investment. This proposed change set off an outcry from both political parties who rejected the plan. They characterized Fox's plan as the first step toward an eventual sale of Pemex and an assault on national sovereignty.

Pemex was founded in 1938 and its monopoly rights are enshrined in the Mexican constitution, and therein lay the root of the company's problems. Being unable to invite private foreign investment into the country, or having control over its revenues, Pemex is unable to search for the vast new reserves that its chief executive, Luis Ramirez Corzo, says lie beneath the deep waters of the Gulf of Mexico. Pemex is projected to spend \$11.2 billion on capital investment this year, most of which is borrowed, but analysts and Ramirez Corzo say it actually needs around \$20 billion a year to become a world-class oil company. Pemex is facing a difficult period over the next few years. Current production is running about 3.3 million barrels per day (b/d), but that could begin to decline by the end of the decade. This situation is of importance for the United States as Mexico is its number two supplier of crude oil and ranks as the fifth largest oil producer in the world.

Mexico now imports about 20% of the country's natural gas needs and as much as 25% of its gasoline from the United States

As a result of its financial position, Pemex has for years channeled its investment into increasing its oil production over the past quarter-century. Pemex neglected investing in its refineries and natural gas production. The result has been that Mexico now imports about 20% of the country's natural gas needs and as much as 25% of its gasoline from the United States. With a reduced tax burden, hopefully Pemex can step up its investment in developing new reserves since the company's production trails its projections. Pemex says it will produce 4.0 million b/d in 2006, but the budget that Fox sent to Congress in September projected 3.48 million b/d. The country's main oil field, Cantarell, which produces 2.2 million b/d or 75% of Pemex's total output, will begin to decline by 2% next year. The question is whether new projects will come on line in time to make up for the shortfall.

A major question mark for Mexico's financial health is whether Cantarell's decline rate might be greater than officially projected. Guillermo Dominguez, an engineer who retired as vice-president of

technology at Pemex's exploration and production subsidiary in 2003, said that Cantarell could begin to decline by as much as 15%-20% by 2008. "If production in two or three years begins to decline, particularly because of Cantarell, and it takes five to eight years to develop new fields, it will catch up with you," Dominguez said. The only option, he said, echoing Pemex's Ramirez Corzo, is to explore in the deep waters of the Gulf of Mexico. Having more money available should help Pemex meet its future production challenges.

Kyoto Protocol to Cost Europe Dearly

A new study shows that the European Union countries will suffer economically from meeting the Kyoto Protocol standards for emissions reductions

A new study prepared by the International Council for Capital Formation (ICCF) shows that the European Union countries will suffer economically from meeting the Kyoto Protocol standards for emissions reductions. The study supports the view of UK Prime Minister Tony Blair that EU countries are "nervous" about emission targets and "would not sacrifice economic growth for external agreements." As a result of this view, Blair has suggested that the EU countries should move away from the "target and timetable" approach to climate policy. He believes that an alternative approach is urgently needed for both the developed and developing world. A cooperative global approach to reducing emission growth is more likely to produce real emissions reductions without damaging economic growth in the EU and elsewhere.

The study showed a significant rise in energy costs for consumers and businesses

The study focused on the economic repercussions, and in particular the impact on energy prices, economic growth and jobs, of adopting Kyoto for the UK, Germany, Italy and Spain. The study showed a significant rise in energy costs for consumers and businesses. The average price increase for electricity and natural gas for the four countries in 2010 was 26% and 41%, respectively. In terms of the impact on the countries' economies, gross domestic production (GDP) declines by as little as 0.8% for Germany in 2010 to as much as 3.1% for Spain. Each country also suffers job losses ranging from at least 200,000 in Italy, Germany and the UK, rising to over 600,000 jobs by Spain. While the study didn't address the economic impact on France, one would have to assume that, given the impact on the other major economies of the EU, it too would suffer significant economic distress. In light of the social unrest currently plaguing France, which is partially explained by the high unemployment rate among the Muslim youth population, any cut in economic growth and job losses could prove debilitating.

Exhibit 5. Energy Cost Impact of Kyoto Protocol

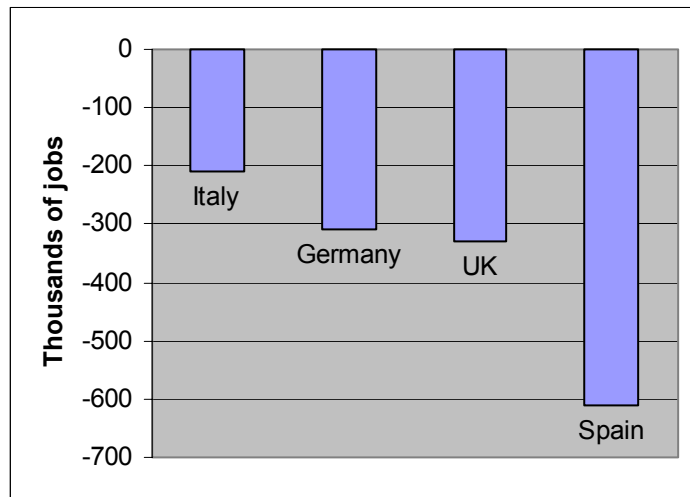
	Electricity		Natural Gas	
	2010	2020	2010	2020
Italy	13%	14%	44%	54%
UK	35%	34%	46%	57%
Spain	23%	27%	42%	51%
Germany	<u>31%</u>	<u>32%</u>	<u>30%</u>	<u>39%</u>
Average	26%	27%	41%	50%

Source: ICCF

Economic growth should be victorious over the environment

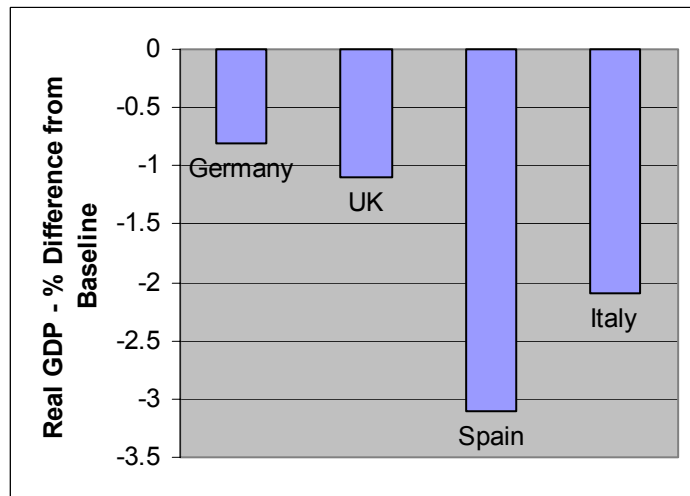
In light of these results, Blair's efforts to convince the other leaders within the EU that a cooperative effort to cut emissions is likely to be stepped up. If the EU adheres to its current schedule for countries meeting the Kyoto Protocol reduction in emission levels, economic growth in the region could be cut significantly. That would likely create greater pressures on the social fabric of the countries. Combined, these pressures and economic declines would cut energy demand. We expect that the governments of the EU countries will continue to work toward meeting the Kyoto goals but they will not meet the timetable because each will recognize the economic cost of trying to do it. At the end of the day, economic growth should be victorious over the environment.

Exhibit 6. Job Losses Under Kyoto Protocol



Source: ICCF

Exhibit 7. Economic Impact of Kyoto Protocol



Source: ICCF

Russian-China Pipeline Moving Forward

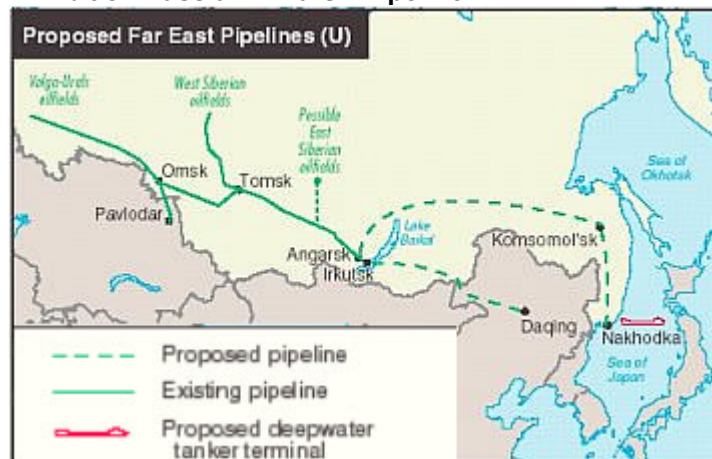
Russia has been planning to build a line from Eastern Siberia to Perevoznaya on the Pacific coast of Russia

The decision of which line to build revolves around both political and economic considerations

The prime ministers of Russia and China met and agreed to speed up the negotiations for building an oil pipeline to move production from Siberia's oil fields. Russia has been planning to build a line from Eastern Siberia to Perevoznaya on the Pacific coast of Russia, some 2,566 miles away. The pipeline will be four-feet in diameter and capable of carrying between 56 and 80 million tons a year (1.125 million to 1.6 million b/d) when combined with railway infrastructure. Russia's objective in building the line is to gain export markets in the Pacific, principally Japan and South Korea, and eventually in North America.

The Japanese have been negotiating to build the line with its terminus at the Pacific port of Nakhodka. Japan has proposed funding the construction of the line, estimated to cost upwards of \$16 billion. Construction of the line is projected to commence in December 2005 with completion in 2008. China has proposed an alternative of building a pipeline from Angarsk in Russia to interconnect with China's pipeline system just northeast of Daqing, near where the country's major oil fields and refining capacity are located. The decision of which line to build revolves around both political and economic considerations. Politics would favor a China line, but economics would appear to favor the Pacific Coast line. The decision Russia makes will, in our opinion, be important for telegraphing the evolution of Russia's energy business. Equally important it will influence the future global flow of crude oil. We would watch this project closely.

Exhibit 8. Russia-China Oil Pipeline



Source: EIA

Shell Criticized by Putin

Russian President Vladimir Putin, on a state visit to the Netherlands, dropped in on executives of Royal Dutch Shell (RDSA-NYSE) and

Russian President Vladimir Putin criticized Royal Dutch Shell for its cost overruns at the Sakhalin-2 project

criticized the company for its cost overruns at the Sakhalin-2 project in Russia. Shell announced late this summer that the cost to develop this oil and gas project would increase by \$10 billion to \$20 billion. Putin reportedly told Royal Dutch Shell CEO Jeroen van der Veer that the Kremlin won't allow the investment to double. The reason is that under the deal struck over the development of the field reflected that Moscow owned the oil and gas and Shell and its partners footed the investment. The investors would receive the initial returns but then Moscow would receive a slice of the profits. If Shell boosts its investment in Sakhalin-2, it would delay when Russia begins to earn big profits. According to Citigroup, the limitation of investment would depress their estimate of the internal rate of return for the project to 8.5% from an already low 12%.

Putin's stance with Royal Dutch Shell reflects his strong political position

Putin also urged Shell to go forward with its swap with Gazprom (GAZ) of an interest in Sakhalin-2 for a partially developed gas field in Siberia. One has to conclude that Putin's stance with Royal Dutch Shell reflects his strong political position and his objective of strengthening Russia's claim over its natural resources.

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