

Energy Industry Brief

J. Marshall Adkins
(713) 789-3551
Marshall.Adkins@RaymondJames.com

James M. Rollyson
(713) 278-5254
Jim.Rollyson@RaymondJames.com

EQUITY RESEARCH

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Raymond James Energy "Stat of the Week" Are Oil Prices Headed for a Correction?

Energy analysts are paid to worry when everything is going perfectly. With energy prices and energy stocks hitting all time highs, the ghosts of the 1998 and 2001 downturns are very clear in almost every energy investor's mind. We are no different. Over the past year we have spent much more time looking for the things that could go wrong than we spent looking for the things that are going right. So far, it has been virtually impossible to shoot any holes in the bullish energy outlook.

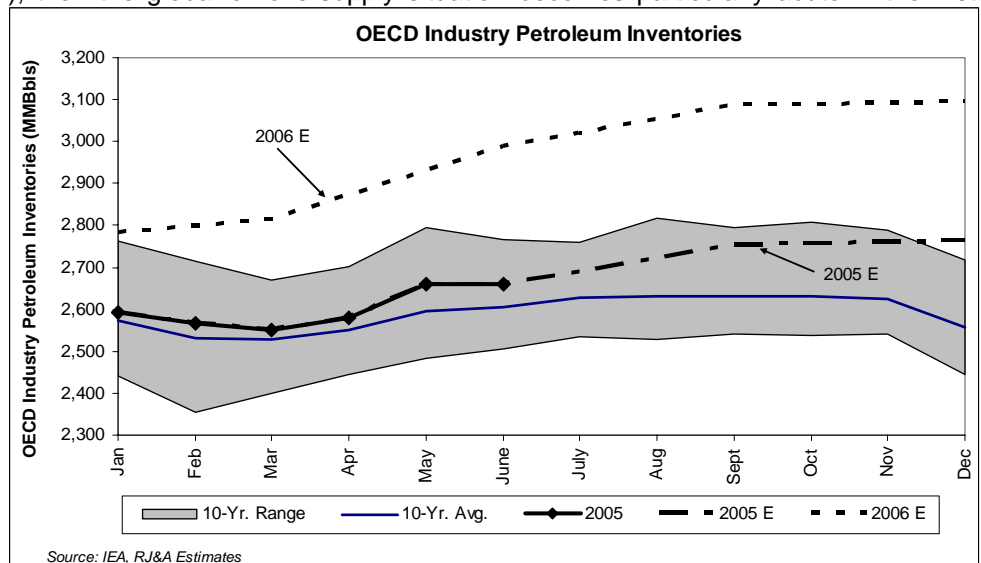
At least that was the case until now. After updating our oil models with recently revised IEA (International Energy Administration) oil supply/demand data, we are now mildly concerned that we could see higher than normal oil inventory builds over the next six to nine months. Given the relatively high current oil inventories, such a contra-seasonal inventory build could drive oil prices down to the level where OPEC is forced to once again cut production and maintain a floor on oil prices. If our oil model is anywhere near being correct (and we emphasize the word **if**), then the global oil oversupply situation becomes particularly acute in the first quarter of 2006. The adjacent graph shows that our oil model is currently projecting OECD inventories to climb well above previous highs over the next year.

The problem with this forecast is that recent oil supply/demand data that drives our model is very suspect; thus, our oil crystal ball is very hazy. In fact, we do not recall a period where the oil supply/demand

variables that drive the inventory numbers above have been less certain. We are seeing more mixed signals and uncorrelated data points than we have ever seen in the global oil markets. This creates a very different forecasting environment from many of our prior fundamental calls where we have been very bullish (such as our natural gas call in June) or bearish (such as our temporary group downgrade late last fall).

Given the lack of clarity on these oil supply/demand drivers, we are *not* saying it is time to bail out of the energy stocks. In fact, we are still convinced that the bullish fundamentals far outweigh the potential negatives that these oil numbers may imply is coming down the road. We are merely pointing out that a potential problem *could* be developing on the oil front. There is simply not enough reliable data to make a definitive call at this time. In an effort to give investors a little more clarity on these

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points, we think it would be worthwhile to review the potential bear case that these numbers may represent in the context of the bullish fundamentals that are driving the secular upturn and the uncertainties surrounding both the bullish and the bear case data.

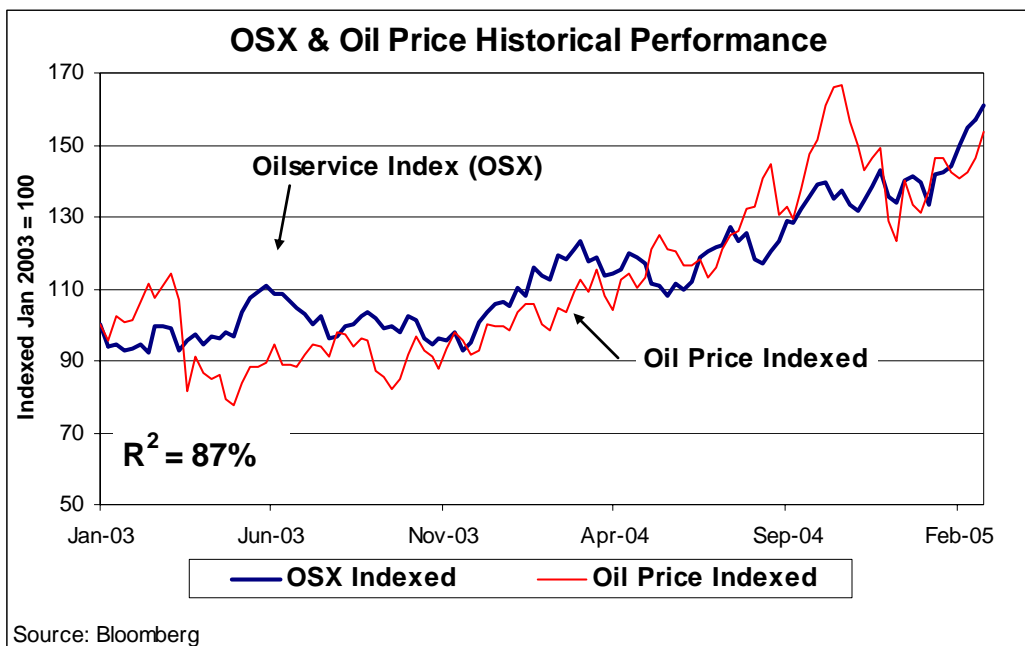
What are we worried about?

Recently, both the U.S. Department of Energy (DOE) and the IEA revised their historical numbers for U.S. and Global oil supply/demand. Following these revisions, these two different data sources suggest that second quarter 2005 demand in both the US and in China did not grow at all on a year-over-year basis. This would represent a significant slowdown in global oil demand growth, given that these two countries have amounted to over half of the global oil demand increases during the past several years.

Even if we assume that year-over-year global oil demand growth recovers to a healthy 1½ million barrels per day of year-over-year growth for the rest of this year and all of 2006, these recently revised numbers suggest that global oil supply growth is likely meet or exceed this demand growth for the next **six** quarters. From the new numbers, it appears there is a substantial amount of non-OPEC oil poised to hit the market over the next six to twelve months. Specifically, solid year-over-year oil supply growth in North America (due to Hurricane Ivan's impact from last year), growth in Brazil and substantial increases in Angola overwhelm declines that we expect to see in the North Sea and Alaska. The end result is that we expect non-OPEC supply to grow by 800,000 to 1.5 million barrels a day (on a year-over-year basis) during the next four quarters.

Additionally, year-over-year production out of OPEC is poised to **explode** in the first quarter of 2006 unless OPEC cuts production in a manner similar to what they did in the first quarter of 2005. This oversupply of oil in the first quarter of 2006 would be particularly problematic since it is seasonally the peak oil demand period of the year when oil inventories typically fall sharply. The bottom line is that currently available data suggests we may see substantial oil inventory builds in the first quarter of 2006 unless OPEC curtails production.

If we do see this type of oil inventory build, the next question will be what oil floor price will OPEC try to defend? Will OPEC cut production if oil prices are above \$60/bbl? Probably not. Will OPEC cut if oil prices fall below \$50/bbl? Probably so. Even though an oil price move from the mid \$60's to the mid \$40's would probably not affect drilling activity (or Oilservice earnings), it probably would affect the energy stock prices. As shown in the graph below, the Oilservice Index (OSX) has tracked very closely with the price of crude over the past few years (R squared of .87).



With global oil inventories already above average and well above five-year averages for many parts of the world, consistent inventory builds over the next six quarters would take oil inventories to record high levels. Even though the market is currently overlooking these higher than normal inventories, at some point in time it would be forced to recognize the bearish reality of these contra-seasonal oil inventory builds.

Why not sell the stocks?

While the numbers and the trends described above are potentially worrisome, it is very important to note that our confidence level in the numbers described above is **very low**. In fact, there are numerous conflicting indicators suggesting that the historical supply/demand numbers offered by the IEA and the DOE are simply wrong. For example, does it really make sense that the U.S. economy is growing at 3½%, China's economy is growing at nearly 10% and energy demand from both countries is dead flat? We don't think so. More importantly, we still remain convinced we are in a secular bull market for energy and the bullish fundamental reasons to own these stocks far outweighs the potential negative implications of these supply/demand numbers that may or may not be correct. A list of the bullish factors that we think supersedes the one potential negative are as follows:

1. Global economies appear to be booming despite higher oil prices.
2. Inflation does not appear to be growing with higher energy prices (so far).
3. Both U.S. and OECD oil inventories do not appear to be building as fast as the IEA supply/demand numbers would suggest.
4. Even though oil inventories are at the high end of the historical range, they are **below** average on a days-of-supply basis.
5. With the disappearance of the oil bubble over the past several years, there has been a very bullish structural change to the oil market.
6. There have been numerous speculations that Chinese oil inventories were building in 2004 but being drawn down over the past six months. If these low Chinese oil inventory levels are rebuilt over the next year, then oil demand will be much higher than we are assuming.
7. Even if our oil supply/demand numbers are correct, OPEC will likely cut production at a much higher price than they have in the past. Our current belief is that OPEC will try to support an oil price in the \$45 to \$50 price range.
8. The refinery shortage could lead to higher product prices and higher light, sweet oil prices despite oil inventory builds. In this case, heavy, sour crude prices would be forced lower while WTI prices would continue to move higher or stay at current levels.
9. Energy stocks have already seen a meaningful correction in both prices and earnings multiples (i.e., the bad news is already priced into the stocks).
10. If oil prices do retreat, oilfield service earnings would not be negatively impacted and oil demand would quickly return, thus rebalancing the system.
11. Our oil model does not assume any meaningful oil supply disruptions.

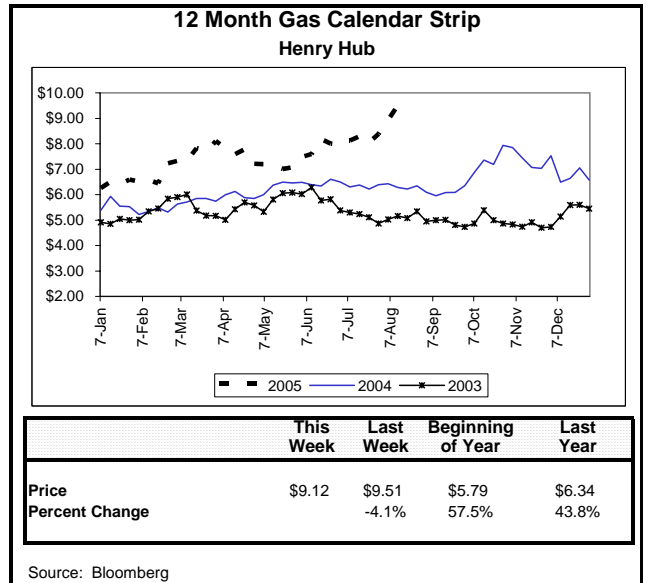
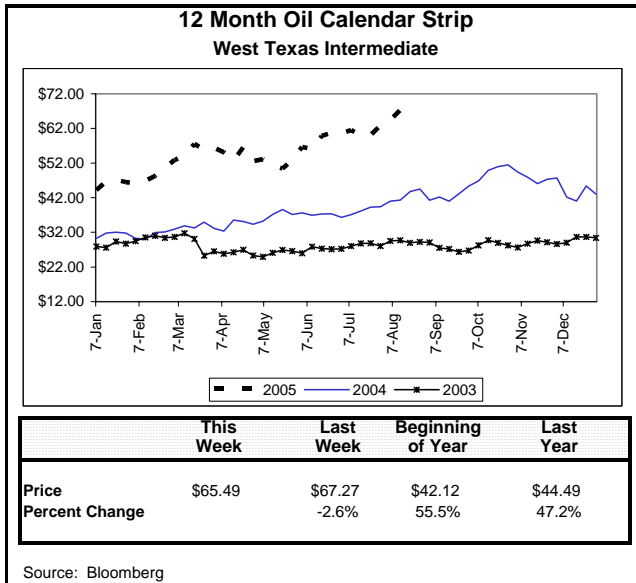
Conclusion

From the list above, it is clear to us that the current reasons to own energy stocks far outweigh the one **potential** reason not to own the stocks. That said, being employed as an energy analyst over the past decade has induced a unique paranoia that seems to flare up whenever the group is doing well. There is a flashing light in the distance. We are just not sure whether or not it is a green light or a red light. Over the coming months we will be closely watching oil inventory changes to get a clearer sign that either supports or dismisses the case for an over-supplied oil market this winter. In the meantime, investors should view the recent pullback in energy stocks as a healthy dose of profit taking that should set the group up for another upward surge. Take advantage of the sale prices and stay tuned for more data on the oil inventory front.



Raymond James Weekly Oilfield Review

For Week Ending: 19-Aug-05



	19-Aug-05	12-Aug-05	20-Aug-04	Change From:	
	This Week	Last Week	Last Year	Last Week	Last Year
1. U.S. Rig Activity					
U.S. Oil	207	197	174	5.1%	19.0%
U.S. Gas	1,221	1,230	1,055	-0.7%	15.7%
U.S. Miscellaneous	5	2	1		
U.S. Total	1,433	1,429	1,230	0.3%	16.5%
U.S. Horizontal	190	187	150	1.6%	26.7%
U.S. Directional	356	347	324	2.6%	9.9%
U.S. Offshore	103	101	95	2.0%	8.4%
U.S. Offshore Gulf of Mexico					
Fleet Size	154	154	157	0.0%	-1.9%
# Contracted	133	132	119	0.8%	11.8%
Utilization	86.4%	85.7%	75.8%	0.8%	14.0%
U.S. Weekly Rig Permits *	1145	1258	999	NA	NA
2. Canadian Activity					
Rig Count	511	579	391	-11.7%	30.7%
Oil Well Completions (cum.)	NA	1,926	1,491	NA	#VALUE!
Gas Well Completions (cum.)	NA	7,857	6,660	NA	#VALUE!
Dry Wells	NA	710	641	NA	#VALUE!
Total Well Completions (Incl. Dry)	0	10,493	8,792	NA	-100.0%
3. Stock Prices (8/19/05)					
OSX	162.3	168.0	107.1	-3.4%	51.5%
S&P 500	1,219.7	1,230.4	1,098.4	-0.9%	11.0%
DJIA	10,559.2	10,600.3	10,110.1	-0.4%	4.4%
S&P 1500 E&P Index	357.9	371.8	214.4	-3.7%	67.0%
4. Inventories					
U.S. Gas Storage (Bcf)	2,515	2,463	2,530	2.1%	-0.6%
Canadian Gas Storage (Bcf)	373	365	410	2.1%	-9.1%
Total Petroleum Inventories ('000 bbls)	684,500	689,200	623,300	-0.7%	9.8%
5. Spot Prices (US\$)					
Oil (W.T.I. Cushing)	\$65.35	\$66.86	\$47.86	-2.3%	36.5%
Oil (Hardisty Med.)	\$43.01	\$44.79	\$36.25	-4.0%	18.7%
Gas (Henry Hub)	\$9.38	\$9.60	\$5.34	-2.3%	75.7%
Residual Fuel Oil (New York)	\$7.82	\$7.68	\$4.20	1.8%	86.2%
Gas (AECO)	\$7.42	\$8.15	\$4.61	-9.0%	61.0%

Sources: Baker Hughes, ODS-Petrodata, API, EIA, Oil Week, Bloomberg

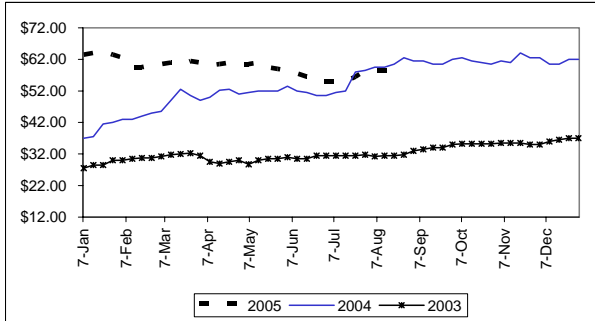
* Note: Weekly rig permits reflect a 1 week lag



Raymond James Weekly Coal Review

For Week Ending: 19-Aug-05

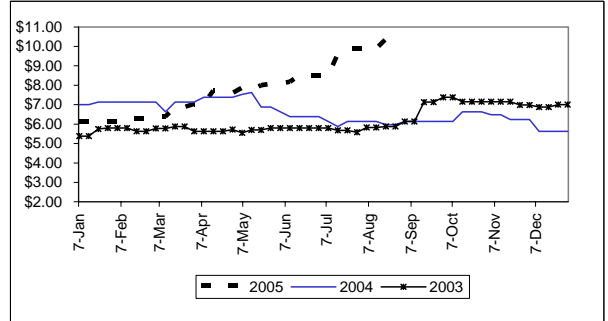
12 Month Big Sandy Barge Prices



	This Week	Last Week	Beginning of Year	Last Year
Price	\$58.50	\$58.50	\$63.50	\$62.50
Percent Change		0.0%	-7.9%	-6.4%

Source: Bloomberg

12 Month Powder River Basin 8800 Prices



	This Week	Last Week	Beginning of Year	Last Year
Price	\$10.38	\$9.88	\$6.13	\$5.98
Percent Change		5.1%	69.3%	73.6%

Source: Bloomberg

1. Coal Prices

- Eastern U.S.
 - Big Sandy Barge
 - Penn. Railcar
 - Illinois Basin Mid Sulfur
 - Illinois Basin High Sulfur
- Western U.S.
 - Powder River 8800
 - Powder River 8400
 - Colorado/Utah 1% Sul

	19-Aug-05 This Week	12-Aug-05 Last Week	20-Aug-04 Last Year
Eastern U.S.			
Big Sandy Barge	\$58.50	\$58.50	\$62.50
Penn. Railcar	\$23.50	\$53.50	\$45.50
Illinois Basin Mid Sulfur	\$37.50	\$38.50	\$30.75
Illinois Basin High Sulfur	\$36.00	\$37.00	\$30.00
Western U.S.			
Powder River 8800	\$10.38	\$9.88	\$5.98
Powder River 8400	\$8.38	\$7.88	\$4.98
Colorado/Utah 1% Sul	\$30.50	\$30.50	\$25.50
2. Production			
Eastern U.S.	9,100	9,233	9,249
Western U.S.	12,040	12,051	12,321
Total	21,140	21,284	21,570

	Change From:	
	Last Week	Last Year
Eastern U.S.		
Big Sandy Barge	0.0%	-6.4%
Penn. Railcar	-56.1%	-48.4%
Illinois Basin Mid Sulfur	-2.6%	22.0%
Illinois Basin High Sulfur	-2.7%	20.0%
Western U.S.		
Powder River 8800	5.1%	73.6%
Powder River 8400	6.3%	68.3%
Colorado/Utah 1% Sul	0.0%	19.6%
2. Production		
Eastern U.S.	-1.4%	-1.6%
Western U.S.	-0.1%	-2.3%
Total	-0.7%	-2.0%

Sources: Bloomberg

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