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The Minnows' Return

Most dot.com start-ups went boom and then bust on the over-inflated hopes of the investment industry. As pundits predict that high energy prices are here to stay, could the same be happening in the oil and gas business?

A rash of new companies has emerged in the last six months that are seeking to cash in on the raised expectations, backed by investors who seem happy to pile risk capital into exploration in exotic places. London's Alternative Investment Market (AIM) saw 17 oil and gas exploration companies float in 2004 — all in the second half of the year — raising a total of £373.9 million ($704.3 million). By comparison, 2003 saw just two oil and gas flotations raise a paltry $52.3 million.

Rather than focus on companies profiting from proven mature fields, such as in the North Sea, investors are throwing caution — and cash — to the wind by investing in high-risk exploration plays. Moves into Kazakhstan, Chad, Sao Tome and Algeria by newly floated minnows such as **Equator Exploration**, **Nelson Resources** and **Gulf Keystone Petroleum** attracted the most cash in 2004, followed by punts on the Falkland Islands, Cameroon, Namibia and Mauritania. Surprise discoveries in places such as Mauritania and Chad have fired up investor expectations of where big finds can be made.

"Companies exploring in Africa have really caught the imagination of the risk capital sector," confirms Barney Gray, head of research for Westhouse Securities, a specialist small-cap corporate adviser that helps companies list on AIM. Still, an investor in an unproven exploration asset has to be prepared to lose everything. "The worldwide success rate of drilling is so poor — around one in seven — that investing in such plays essentially is a bad bet," warns one oil company chief. "Nonetheless, everybody wants to find the next **Cairn Energy**."

But for every Cairn — whose stock soared last year after several significant discoveries in India — there is also a **Ramco**, whose stock plummeted 92% when production stuttered on its Irish Seven Heads field (IPF Apr.,p12). It is retail investors — normally last in and last out — who tend to get stung when things don't work out.

The core source of capital for the new launches is small cap fund managers, who favor oil company investments due to the prevailing bullish outlook for commodities. Although casualties are inevitable, bankers say there are fewer cowboys in the oil business than in the past and the expectations are realistic.

But is there a danger that a drop in crude prices will burst the bubble? Probably not, bankers argue, because oil companies rarely expire overnight. Many minnows do not even want to drill, preferring to sit on prospects in frontier areas while they wait for others to make a find nearby — only then cashing in by selling out to a bigger operator.

"Failed oil companies tend to slowly fade from sight," says one corporate financier, who notes that they often re-appear later under a new name to try again.

In This Issue

Golden Rules For Reserves? 3
The Hedge Fund Blame Game 4
The EdF Question 7
Inchon Trips Up Sinochem 8
US Winners In Libya 9
Prudence's American Admirers 10
Ivan's Insurance Impact 12

Ratings And Reserves Still Troubling Shell

The ghost of 2004 has been very much in evidence for **Royal Dutch/Shell** over the past few weeks, with a fresh cut to reserves exceeding investors' expectations, and a subsequent decision from one leading ratings agency to cut the group's credit rating for a second time in ten months.

There have also been some dissenting noises from within. A recent 'people survey' of Shell's workforce found that only 47% of respondents felt the company was well led; some engineers now feel that the company has gone too far in attempting to comply with regulatory rules on reserves bookings; and questions are being asked about why Shell is now planning to hire 1,000 new technical staff so soon after laying off a large number of experienced petroleum engineers as part of the restructuring of its upstream business.

It has not all been negative, though. Shell was able to unveil at the start of February the largest ever annual profits reported by a UK-listed company, and to announce the restart of its share buyback program. For 2004, Shell reported net income of $18.54 billion, up 48% from $12.5 billion the year before, while for the fourth quarter, it saw net income surge to $4.48 billion, in line with market expectations and more than double

(continued on page 2)

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the $1.92 billion achieved in 2003's fourth quarter. "We come into 2005 in a very strong cash position," Chief Financial Officer Peter Voser commented.

On the back of this windfall, Shell has made an early commitment to buy back $3 billion-$5 billion of its own shares this year, on top of the $10 billion it is expecting to pay out in dividends. This news will come as a relief to Shell investors who feel they have been short-changed in stock repurchases in relation to their peers. Shell bought back no shares in 2003 and a mere $1.7 billion in 2004, in contrast to **BP**, which repurchased $7.5 billion of its own stock, and **Exxon Mobil**, which bought back $9.9 billion in 2004 and $3 billion in the fourth quarter alone.

The financial performance was to a large extent overshadowed, yet again, by reserves. Shell had flagged its likely need to downgrade reserves for a fifth time at the end of October last year (IPF Nov.,p4). More recently, a Shell source had indicated to IPF that the final downgrade was likely to be in the region of 900 million barrels of oil equivalent, but the figure announced earlier this month was considerably higher at 1.4 million boe.

This new reduction leaves Shell's end-2003 proven reserves at just 12.95 billion boe, and certain to fall further when the company finalizes its end-2004 reserves figures later this year. Organic reserve replacement for 2004 is expected to be in the range of 45%-55%, upstream chief Malcolm Brinded said, but the final headline figure — including the impact of asset divestments and regulatory requirements to base bookings on end-2004 prices — is likely to drop to a parlous 15%-25%.

Things are not looking a whole lot better for this year either, Brinded admitted. "It's likely that 2005 reserve replacement will also be below 100%," he said, while insisting that he was still "reasonably confident" that the group could achieve an average reserve replacement ratio (RRR) of 100% for the 2004-08 period. Brinded also tried to offer some reassurance that there would be no need for further downgrades. "I'm confident that we've covered 100% rigorously, scrupulously," he said. "We think we've done as much as we can."

Mind The Gap

The latest downgrade leaves Shell with a forward reserve life, as at end-2003, of just 9.1 years, well adrift of supermajor rivals Exxon, with 14.3 years and end-2003 proven reserves of 22 billion boe, and BP, with 13.7 years and 18 billion boe. With both Exxon and BP expected to have more than replaced production last year, that gap is going to widen.

Shell is also losing ground in production terms. In 2003, Shell produced over 3.9 million barrels of oil equivalent per day, well behind Exxon's 4.2 million boe/d, but well clear of BP's 3.6 million boe/d. Last year, Exxon was steady at 4.2 million boe/d, while BP surged ahead to almost 4 million boe/d and Shell slipped back to 3.77 million boe/d — looking at it another way, there has been a 520,000 boe/d 'swing' from Shell to BP in the space of just twelve months.

These shifts are being reflected in Shell's credit rating. Shell lost its coveted AAA status in April last year as the truth about the reserves overstatements began to emerge (IPF May,p3). In the wake of this month's latest announcement, ratings agency Standard & Poor's announced that it was cutting the rating again, from AA+ to AA because of the "significant" cut to end-2003 reserves, and the accompanying news that organic reserves replacement in 2004 had been only a "poor" 45%-55%.

"This implies that Shell will have replaced only about 70% of its reserves during 2001-05," S&P said in a statement. "In contrast, our affirmation of the ratings on Shell on Jul. 8, 2004, included the assumptions that reserves would not be significantly restated, and that they would be fully replaced during 2004-05."

Until last year's reserves debacle unfolded, Shell was one of only two oil companies — the other was, and remains, Exxon — that enjoyed the rating agencies' premium ranking. Now it finds itself, at least in the eyes of S&P, in third place, behind not only Exxon but also archrival BP, which S&P rates at AA+. At AA, Shell's rating is on par with **Total**, **Eni** and **ChevronTexaco**, an S&P analyst told IPF. S&P has gone out on a limb here, however, since the two other major ratings agencies, Moody's and Fitch, have both affirmed their ratings on Shell at one notch below AAA.

Clearly, with headline 2004 reserves replacement sinking to around 20%, and the 2005 figure also set to fall short of 100%, Shell has got its work cut out to achieve its target of an average 100% RRR for the 2004-08 period. To this end, the group's E&P leadership has been taking steps to improve accountability for delivering key projects, and to identify those projects most likely to deliver its reserves replacement objectives.

Following a meeting in December of Shell's exploration and production leadership forum (EPLF), E&P management resolved to have confirmed by the end of January "single point accountability for each of the material reserves maturation opportunities," an internal email relating to the EPLF said. "The top 20 reserves maturation projects will be further specified, reviewed and resources allocated based upon this priority by May 1, 2005," the email continued.

There is also something of a recruitment drive under

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way, with 50 extra petroleum engineers scheduled to have been hired as contract staff by the middle of January, and a further 120 experienced petroleum engineers to be hired as permanent staff by April. "This is only a small part of the plan to supplement our core technical cadre with over 1,000 additional pensionable and contract staff in the next year," the same email noted.

These steps relate to a 2005 business plan for Shell's exploration and production business, which "is very different from the previous one," according to a separate email circulated amongst some of the company's upstream executives last month.

The 2005 E&P business plan "responds to the very different price environment and to the strategic drive in Shell to create 'More Upstream,'" the email said. "We aim to increase our reserves replacement significantly, to deliver a significant suite of current and new projects and opportunities, to invest at unprecedented levels in the E&P business. The aim is to secure our future and return us to a leading position amongst the majors." **IPF**

Oil Should Follow Mining's Golden Rules

Last year's reserves accounting scandal at **Royal Dutch/Shell** might have been avoided if the oil and gas industry had followed the practice of the mining industry, and provided a field-by-field level of disclosure on reserves.

But far from seeing the Shell debacle as an opportunity to improve investor confidence in the sector by improving the transparency of reserves reporting, both the industry and regulators such as the US Securities & Exchange Commission seem content to continue in the belief that existing reporting practices and guidelines are adequate.

In truth, levels of disclosure on reserves in the oil and gas industry are poor. **Exxon Mobil**, for example, only breaks its reserves numbers down into six categories in its annual report — US, Canada, Europe, Africa, Asia-Pacific and Other. **BP** is even worse, providing just four geographical categories — UK, Rest of Europe, US and Rest of World.

Compare this with the majors' blue chip peers in the mining sector, whose filings offer a level of detail that investors in oil and gas companies can only dream of. In its 2003 annual report, for example, **Rio Tinto**, the world's largest mining firm, provides an asset-by-asset breakdown of proven and probable reserves across its various mineral operations — for its coal operations, this means individual reserves figures for 15 separate coal assets in Australia, and for its gold operations, it means reserves details of 12 different mines worldwide.

Rio Tinto, in common with all major mining firms, reports reserves data in accordance with the standards of the Jorc Code, a set of best practice guidelines for ore and minerals reserves reporting first mooted within the Australian mining industry in the early 1970s, and finally enshrined as a set of rules in 1989.

The Jorc Code — Jorc stands for Joint Ore Reserves Committee — was established, Jorc's website explains, as a result of "considerable concern about unacceptable reporting practices" connected with the **Poseidon** nickel scandal in Australia at the end of the 1960s. The Poseidon affair, which involved false information from Poseidon directors, and which generated a frenzy of spurious mining sector capital raisings, was "the catalyst behind trying to develop a universal classification system for reserves," one UK-based mining analyst explains. And since Jorc's first publication in 1989, the Code has been regularly updated and revised, most notably in 1998-99 in the wake of another mining investment scandal, the **Bre-X** affair in Canada.

The oil industry has now had its very own reserves reporting scandal, but there is as yet little sign of it responding with its own Jorc Code. The tendency instead has been to paint Shell's problems as just that — Shell's, and not the industry's, despite the fact that other curious bookings have emerged. BP and **Norsk Hydro**, for example, were found to have booked reserves from Norway's Ormen Lange field much more aggressively than their partners, and Hydro subsequently restated its bookings as filed to the SEC (IPF Jul.,p13). More recently, it has emerged that not only Shell but also its partner Exxon booked reserves from their deepwater Erha field in Nigeria a long time before project sanction.

Erha Explanations

Erha contains around 500 million barrels of recoverable reserves and is scheduled to come on stream toward the end of this year at a rate of 150,000 barrels per day. Work on the development began in October 2002, following the partners' final investment decision (FID) to proceed with the project, which was taken in June 2002, sources close to the project have told IPF.

The SEC does not have firm rules on the need for FID before bookings are made, but it does offer general guidance, which it clarified in March 2001. "A commitment by the company to develop the necessary production, treatment and transportation infrastructure is essential to the attribution of proved undeveloped reserves," the Commission said, while acknowledging that this commitment can take a number of different forms — another fuzzy regulation, in other words.

The convention widely accepted in the industry, however, and certainly amongst the leading majors, is that FID is a key trigger for bookings reserves — without project sanction or a definite commitment to invest, it is considered premature and over-aggressive to book reserves.

It was exactly this sort of premature booking that was one of the main errors Shell sought to correct with last year's restatements, with the company admitting that it had booked reserves too early for a number of projects, including Ormen Lange, the Gorgon field in Australia, the Pohokura field in New Zealand and various fields in Nigeria.

Post-2004, Shell has adopted an ultra-conservative approach to bookings, biased toward the strictest possible interpretation of SEC guidelines. And other major oil companies have sought to affirm that they are, and have been, equally conservative.

"We book our reserves only after we have made significant funding commitments for a project," an Exxon spokeswoman told IPF last month with regard to Erha. "Exxon Mobil has always taken a rigorous and structured approach to booking proved reserves."

On Erha, however, the approach to bookings was very much less cautious for both Shell and Exxon, with both companies first booking reserves in the field long before the June 2002 FID — Shell in 1999, and Exxon in 2000. For both companies, bookings were made even before appraisal drilling on the field had been completed — the second and final Erha appraisal well was completed in October 2001, but Exxon announced it was booking Erha volumes in a Jan. 30, 2001, statement on its reserves replacement performance for the year 2000.

Exxon is satisfied that its Erha bookings are both compliant with SEC regulations, and consistent with its claims to have a conservative policy on reserves bookings. "In Erha's case we had already made a significant financial commitment by funding project management and design work at the time we booked in 2000," the spokeswoman said. "Furthermore we had a high degree of confidence in Erha, particularly since we were the operator and had drilled the discovery and appraisal wells."

Erha nonetheless formed part of the reserves recategorizations that Shell carried out last year. As at the end of 2001, Shell had booked 150 million barrels from its 43.75% share in the field, but this had been reduced to 130 million bbl as at the end of 2003, in connection with technical rather than FID timing issues, a Shell source said.

Field level disclosures of reserves would have revealed what was going on at Erha — and other key fields such as Ormen Lange, Gorgon and Kashagan in Kazakhstan — as soon as the reserves were booked. The oil industry, however, continues to argue that this level of reserves disclosure would simply be impractical. Field-specific reserves data "is proprietary and often restricted by confidentiality agreements with governments," an Exxon spokesman tells IPF. This is a weak argument, however. Mining companies such as Rio Tinto and **Anglo-American** also have government partners, and seem able to juggle the dual responsibilities. "We have government partners, but I can't think of an instance where that is a problem," a Rio spokeswoman says.

It's not just down to the industry, however. The SEC is reportedly keen to show that it has teeth by pursuing former Shell executives such as Phil Watts and Walter van de Vijver over their role in Shell's reserves overstatements. But it might better serve investors by tightening up some of its own rules, and by obliging the oil and gas industry to adhere to the same reserves disclosure benchmarks as the mining sector. There is even a quid pro quo it could offer industry — you provide greater transparency in bookings, and we will permit you to report probable as well as proven reserves. This would again mirror mining's Jorc Code, which permits the reporting of proven and probable ore reserves, and two further categories, indicated and inferred mineral resources. The oil industry, in contrast, is saddled with the SEC's draconian insistence on proved reserves, despite the fact that probable reserves are a common and relevant reserves measure across the industry, and one endorsed under the reserves reporting standards of the US Society of Petroleum Engineers.

There is "a good case for companies having to disclose their reserves on individual fields," particularly since mining companies already publish details of individual mines, one SEC source tells IPF. "If that's not detrimental to them, why should individual field reserves be detrimental to an oil company?" At present, however, neither the industry nor the regulators seem particularly interested in pursuing this idea any further. **IPF**

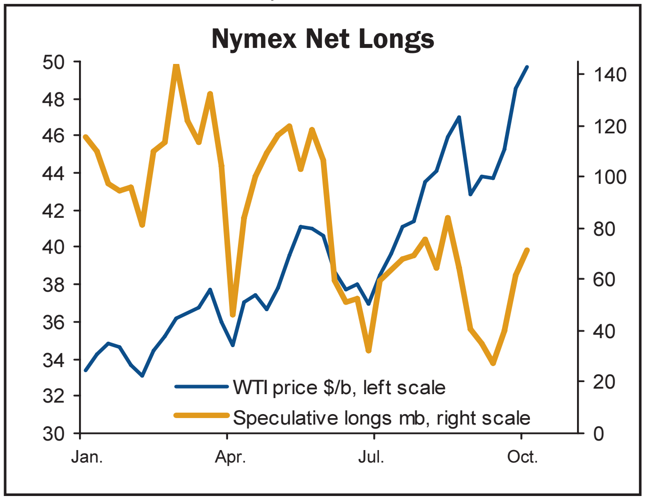
Oil Plays The Hedge Fund Blame Game

The world of hedge funds is seen as secretive, speculative and unregulated. And with good reason — most of it is. Nonetheless a considerable amount of hype and delirium has accompanied the spectacular emergence of hedge funds during the last few years. Most recently 'opportunist' hedge funds were partly blamed for the uncharacteristic volatility of the oil markets in 2004 by commentators, oil traders and organizations as lofty as Opec and the International Monetary Fund. However, many closer to the hedge fund world feel its role in the market continues to be completely misunderstood.

A hedge fund can be loosely defined as an unregulated private investment vehicle domiciled offshore but managed from an onshore financial center. Currently only available to high-net-worth individuals and institutional investors, it can hold long or short positions in virtually any market of its choosing, utilize derivatives and employ more leverage, in terms of banks' willingness to allow it to speculate, than a conventional mutual fund.

Hedge funds seek absolute returns whatever the state of the market, with performance entirely based on the success of each manager's own investment strategy. Famous billionaire managers include George Soros, Julian Robertson of **Tiger Management** and Paul Tudor Jones of **Tudor Investment Corp**.

Although it is a myth that hedge funds have only recently become involved in the oil market, it is undeniable that 2004's potent cocktail of liquidity and volatility attracted an increased volume of speculation. Moreover, the sheer amount of money now swilling around in hedge funds — over $1 trillion under management and growing — means that they have considerable influence over any market in which they choose to participate.



Hedge funds involved in the crude market tend to be one of three types. The first are managed futures funds and commodity trading advisors (CTAs) that focus purely on playing the market (see box). Then there are larger global macro funds, which sporadically make big punts on commodity prices following qualitative analysis of global economic trends and geopolitical events. Lastly, there are the managers — including many CTAs — that employ 'black box' strategies, which are complex individual quantitative models that track markets and signal when to get in and out. Some traditional oil traders distastefully view the latter as 'known unknowns,' arguing that the many factors that affect oil prices — from elections in Iraq to weather conditions — can never be quantified into a computer algorithm.

Adding to the mix are over 200 specialist energy hedge funds that have been set up in the last few years — including many by former traders at US energy merchants **Dynegy**, **Aquila Energy** and **Enron** — to deal not only in oil but also the gas, power, coal and renewable markets (IPF Jan.'04,p12). These include the very successful **Centaurus Energy**, set up by former Enron trading star and gas chief John

Business As Usual For The Trend Followers

For one section of the hedge fund community, the opportunity presented by the bull-run in oil last year was simply business as usual, as Michael Covel, author of the best-selling book Trend Following *explains.*

The involvement of hedge funds in the energy market made headlines last year with a volatile crude oil market drawing all types of market players. Oil volatility equaled opportunity for a large number of traders but for a group of them — trend followers — it was business as usual. The only thing that had changed was the market. Trend followers believe the market goes where the market will go. They never predict market direction of any particular instrument — in fact, they wait for the trend to shift first, then "follow" it.

Their trading decisions are based on a single piece of data — price. Assuming that price trends occur regularly in all markets and that trading systems can profit from these trends, the trend follower's strategy is to capture the majority of a trend, up or down. Theirs is a purely mechanical system designed to "cut losses" and "let profits run." While each trend follower's system may differ in algorithms, position building or stop losses, the overall systems they use to correctly target market direction prove to be remarkably similar, year after year. The 2004 crude oil market was no exception.

Trend following is always a classic targeting of opportunities whenever they occur. But purists, such as **Dunn Capital Management**, trade for absolute returns over the long term. Their systems are designed to avoid short-term "noise." For these classic trend followers the first half of 2004 was lackluster in most markets.

However, Dunn minces no words about the gains they subsequently experienced from crude oil. "Volatile and rising energy prices were the backdrop, producing significant gains in both our long energy and bond positions as high energy and commodity prices continued to put a damper on economies worldwide."

Another immensely successful trend following trader, John W. Henry, outlined his end of year views for 2004: "Sometimes, a single sector or market will define a year's performance. In this case, the key driver of the year was the rising price of oil. Clearly, the addition of geopolitical risk premium extended the oil market's price increase and accentuated the volatility. Underlying this risk premium, the market responded to inventory changes and world growth prospects. Unanticipated inventory increases caused quick declines in price, just as any announcement of stronger economic growth led to price increases."

Great hedge funds look for an opportunity to make money. The big opportunity in 2004 just happened to be oil. As long as crude oil trends up or down, or remains highly volatile, a significant number of hedge funds will be taking long or short positions depending on their time horizon, including trend followers. Some shorter-term hedge funds will trade the pure volatility while others will be looking for longer-term directional moves. How long this will continue is a prediction no trend follower would make. **IPF**

Arnold, and **Fischer-Seitz Capital Partners**, co-founded by former **Anadarko** chief John Seitz (IPF Oct,p7).

Attracted by the still dislocated power market in the US, these niche operations — with other much bigger hedge funds circling above — are active in every link of the energy supply chain, from purchasing physical assets, such as power stations and pipelines, to trading energy credits and commodity futures. Although more liquidity is generally welcome in the US energy market, the question remains whether all these funds have strong enough balance sheets and risk management to avoid falling into the same trap as their now defunct predecessors in the merchant sector.

Meanwhile, the US Securities & Exchange Commission has for the last few years been locked in the throes of a power-struggle between hawks and doves over whether it should increase oversight of these fundamentally unregulated offshore vehicles. The first round was won last October when SEC chairman William Donaldson won a 3-2 vote to force hedge funds to register with the SEC by February 2006, giving it the power to inspect managers on a routine basis. The industry is now anxiously waiting to see what comes next.

Life On The Hedge

So much hot air has been produced over hedge funds that it is difficult to discern the exact impact they have on oil prices. Regular data on long/short crude futures trading on the New York Mercantile Exchange (Nymex) is useful to identify speculative trends, but is too unspecific to tell who is buying what, though hedge funds are believed to typically constitute between 10%-20% of open interest.

Oil traders such as **Vitol** were among the first to suggest that hedge fund involvement had raised the price of crude by several dollars per barrel and that by following one another into a hot market, the hedge funds were exacerbating volatility and distorting prices. "Increasing dominance of funds in the oil market has been a major factor in the price rise this year," Vitol President Ian Taylor said at a conference in May.

However, while many hedge fund managers and investment bankers concede that speculation can magnify an existing trend through accentuation, most insist it was pure market fundamentals that led to rising oil prices.

For example, as a simple benchmark, the number of net long positions on Nymex in May was over 100,000 contracts, each of 1,000 barrels, with crude around the $40 mark. By October the number of longs had crashed by over two-thirds, but WTI was heading toward a historical high of $55. This suggests that the net long positions of speculators — such as hedge funds — had little influence on the price of oil as the market ignored the selling and kept rising. That said, the market throughout 2004 was uncharacteristically choppy with multiple peaks and troughs, and therefore pointing the finger at any one event or factor to explain that market behavior seems a futile exercise (*see graph*). Nonetheless, many hedge fund managers confirm they liquidated their holdings during the summer from record long positions amassed in March, and thus missed out on the peak.

"As net sellers in a rising market, hedge funds actually depressed the market and took the top off, so to say they bumped up the price is complete nonsense," argues Paul Horsnell, head of energy research at Barclays Capital.

"Most hedge funds performed poorly last year, and many participated in the bull market in oil without great success, so I am fairly skeptical their involvement pushed the oil price higher than it should be," agrees David Winton, managing director of $1.6 billion London-based hedge fund firm Winton Capital Management. "Opec and IMF criticism seems a case of blame the messenger, not the message."

Buffing Up Returns

The fuss over hedge fund 'hot money' has been a big distraction from another huge flow of billions of dollars that continues to make its way into the oil market from pension funds, endowments and insurance companies looking to hedge future liabilities via commodities-based index products heavily weighted toward oil and gas futures. Commodity index products essentially represent a safer unleveraged long-only investment for new investors in oil and gas prices than directly playing the physical markets. Some $30 billion is already benchmarked to the **Goldman Sachs** Commodity Index, with more such products on the way.

Indeed, the financial markets are never slow in spotting a good thing and developing new offerings to sell to wealthy clients. **JP Morgan** has created an innovative 'Brent buffer' derivative product for European high-net-worth investors enabling them to profit from rising oil prices, but with more downside protection than direct futures contracts. "During the last two years we've seen a lot of equity and fixed income investors looking to diversify into commodities," says Tim Owens, head of JP Morgan's European Global Currency and Commodities Solutions Group. "So we borrowed the concept of a 'buffer' or 'airbag' product from the equity world and applied it to commodities. It's just a matter of time before other firms begin offering something similar."

Meanwhile, Wall Street banks and brokerage houses continue to launch new or beef-up existing oil and gas trading desks both for clients and their own proprietary use. Benoit de Vitry, head of commodities trading at Barclays Capital in London, is believed to have hired over 20 former Enron energy traders. Investment banks' proprietary trading desks are where most hedge fund managers learn their trading skills before going solo in search of individual riches.

However, will this growing influx of funds inevitably mean more volatility in the oil markets? Although an increase in liquidity is inevitable, Winton says leaping to the conclusion that the market will continue to increase in volatility is erroneous, pointing out that "speculators can stabilize a commodity market." Eric Sananes of French asset manager Banque d'Orsay adds that the tendency of hedge funds to liquidate their positions earlier than other participants actually provides crucial liquidity at a time when other players are inactive.

"The volatility of crude prices definitely makes oil a market worth trading, but many hedge funds got it wrong last year," says Barclays Capital's Horsnell. "However, they will continue to look for returns in this market, and at some point they will get it right." With some estimating up to $4 trillion will be under hedge fund management by 2010, alongside billions of pension fund dollars slowly viewing oil as a 'bona fide' investment, it can be argued that new market dynamics are now definitely at play. **IPF**

France, Italy Wrestle With The EdF Question

Fresh high-level efforts to reach an accord over the issue of **Electricite de France**'s participation in the Italian power market have been restarted since the start of the year, spearheaded by the French prime minister Jean-Pierre Raffarin and his Italian counterpart Silvio Berlusconi, who had hoped to find a workable solution at a summit in Italy last month. Although an agreement was not reached at that meeting, the two leaders promised to find a solution to the impasse by the end of February. This follows earlier talks between EdF's new chairman Pierre Gadonneix and Italian officials to find a way forward for EdF to overcome Italian resistance to its expansion there in recent years.

The crux of the problem for EdF is its interest in **Edison**, Italy's largest privately-owned power and gas utility and second only in the country to state-owned **Enel**. EdF owns 18% of **Italenergia Bis**, a holding company that in turns owns 62% of Edison.

This on paper gives EdF just over 11% of Edison, but the French company's voting rights are restricted to just 2% by an Italian government decree, adopted in 2001, to halt the advance of EdF in the liberalized Italian market — an advance that was taking place at a time when the French electricity market was still closed to competition. A similar anti-EdF decree was adopted the same year in Spain to halt the French utility's advance there.

Since then, however, Paris insists that it has made progress with liberalization, and that Italy should soften its stance. Since Jul. 1 last year, greater competition has been introduced in France, with all commercial customers now free to switch suppliers. This has allowed new players to challenge EdF's dominance, and EdF has lost around 25% of the market as a result. The company itself is also undergoing a transformation, which will see its part-privatization later this year, thereby removing a second major sticking point. Liberalization will be fully extended to France's residential market by 2007.

Bringing matters to a head is a series of options that EdF has with Italenergia's other shareholders, which could force the French company to acquire 100% of Italenergia by March, which would, under Italian law, then trigger a full takeover bid for Edison.

A full takeover of Edison could cost EdF as much as €12 billion ($15.55 billion), a considerable financial burden for the company as it prepares for partial privatization later this year. Such an outlay could also, in theory, absorb proceeds from the proposed sale of 30% of the company, given that EdF had a stated shareholder equity value of €18.9 billion as at the end of 2003. EdF's debt currently stands at around €21.78 billion, down from an earlier €24.35 billion, thanks to the sale of its 2.34% shareholding in French oil major **Total** in September for €2.57 billion (IPF Oct.,p13). In addition, EdF faces the burden of a pension scheme that could be underfunded by as much as €40 billion, according to some estimates.

Labor unions, which oppose privatization of EdF on the basis of its potential impact on both public services and the company's pension commitments, have staged a series of strikes and protests against the change in EdF's status. Although the government says it's still committed to listing EdF, it has said that the state will retain at least 70% ownership.

EdF wants to avoid being forced into taking full ownership of Edison while its actual control of the company remains limited, and wants the options suspended until Italy amends its anti-EdF decree. In December, EdF initiated an arbitration process to amend its option commitments. It also cited concerns about the potential implications of the so called 'Marzano Law,' which was passed in August, and which gives the Italian government the power to take any action it wants to ensure security of energy supply and competition in the Italian market. EdF's concern is that, should it become the majority shareholder in Edison, it will find itself having to comply with new "detrimental" measures, neither the nature nor extent of which have as yet been specified.

Some of Italenergia's other shareholders, **Banca Intesa**, **Sanpaolo IMI** and **Capitalia**, which together own 37% of the holding company, have also appealed for arbitration to force EdF to honor its options, supported by Italenergia's other two investors — steel maker **Carlo Tassara**, which holds 20%, and automaker **Fiat**, which has 25% — neither of whom want to let EdF off the hook.

These shareholders stand to gain financially if EdF is forced to pay up for its options. Even though Edison's share price has improved in the last few months, partly thanks to the uncertainty surrounding the EdF options, its current trading level of around €1.50 per share is still well below the €2.20 per share that EdF is committed to paying.

It had been hoped that the prospect of increased cooperation between EdF and Enel might have helped defuse anti-EdF sentiment in Rome, but attempts to forge an alliance have so far failed to deliver results. Talks between the two parties on an arrangement that would give Enel access to EdF generation capacity equivalent to around 6%-7% of the French market have become bogged down, although the French may have a new carrot to offer, in the form of a 35% stake in power generator **SNET**, after **Gaz de France** dropped its plan to buy the equity. Enel had bid for the SNET stake last year but lost out to GdF.

One of the most touted solutions to the Franco-Italian impasse, and one suggested by Italian officials, is for EdF to share the spoils of Edison with an Italian industrial partner, a move that EdF has certainly not ruled out. Several companies have been suggested in the Italian press as potential suitors to balance EdF's holding in Edison, including local utilities **AEM**, **ASM Brescia** and **Acea**, as well as refiner **Erg Petroli**, although no one has as yet confirmed any interest. Spain's **Endesa**, which already has a strong position in Italy, has indicated that it might be interested in a stake in Edison.

EdF is also in the process of extending its reach into the Germany power market, having recently exercised an option to acquire an additional 5.94% stake in **Energie Baden-Wuerttemburg (EnBW)** from **Deutsche Bank** and **HSBC Trinkaus & Burkhardt**, thereby raising its stake in Germany's third largest power company to 44.94%. The remainder of the 11% stake in EnBW sold by the banks went to **Zwecksverband Obershwaebische Elektrizitaetswerk OEW**, a federation of nine districts in Baden-Wuerttemburg, in line with a regional policy to keep EbBW at least partly in local hands. This policy could spell future trouble for EdF if it seeks to exercise options over the next few years which could give it control of as much as 82% of EnBW. **IPF**

Sinochem Expansion Stumbles On Inchon

Sinochem Corp. likes to think of itself as China's fourth state-owned oil company, despite its history as an importer of agricultural products and fertilizer. It conducted a reverse takeover at the end of January, gaining a second listing for its subsidiary companies. Sinochem's new Hong Kong listing is already prompting speculation that the parent firm will inject its oil and gas assets some time in the future, potentially generating considerable interest from foreign investors looking to grab a share of China's booming energy sector.

Sinochem Hong Kong bought Sinochem Corp.'s fertilizer assets for a reported $647 million, engineering a backdoor listing for it on the Hong Kong stock exchange. Following completion of the deal, Sinochem will control around 95% of the Hong Kong-listed company, up from about 21% previously. Analysts expect Sinochem to place shares soon to reduce its holding in the Hong Kong firm to about 75% to meet stock exchange rules requiring that at least 25% of a listed firm's shares are publicly floated.

At present, the Hong Kong vehicle is overwhelmingly devoted to Sinochem's fertilizer business, but Sinochem has firm intentions of expanding both upstream and downstream, diversifying away from its core oil trading portfolio.

Bounced Out

The company's downstream plans suffered a blow last month when Sinochem was bounced out of a deal to buy South Korean refiner **Inchon Oil**. Sinochem had seemingly finalized a 630 billion won ($613 million) deal to buy Inchon and operate its 275,000 barrels per day refinery to the west of Seoul in October last year (IPF Oct.,p14). But since then, Inchon's creditors have decided that Sinochem's offer price was too low, and managed to tear the deal apart. In late January, one of Inchon's lead creditors, **Citigroup**, announced an offer of $759 million for the Korean refiner. Citigroup holds 30% of Inchon's unsecured debt, an estimated $109 million, through two investment vehicles — wholly-owned **Blue Two Asset Securitization Specialty** and **Citigroup Global Markets Korea Securities**, creditor sources tell IPF.

"The court did not approve the sale because creditors failed to reach an agreement on the deal," a judge at Inchon District Court told IPF. "There will be no further meetings regarding the sale to Sinochem as the deal fell through. Instead, the court called for a fresh round of the sale process to seek new buyers." The judge said Sinochem had made a fresh offer of about 680 billion won, but Citigroup and other creditors opposed the deal for a third time. "The court wants the new bidding to begin as soon as possible, and aims to complete the sale of the refiner by the end of June," he added.

It is not unheard of for creditors to bid up the price of their own investments, and Citigroup is believed to be negotiating in good faith over the Inchon purchase. "Time is definitely on Citigroup's side," one Hong Hong-based equity analyst said. "Refining margins are high, [Inchon's] cash flow is positive, so as long as Inchon is paying the interest then [the creditors] can afford to wait and sell out at a higher point in the investment cycle."

Sinochem expressed regret over the creditors' decision. "The acquisition of Inchon Oil should have been a win-win act to all parties concerned including the investors, creditors, the refinery itself and its employees and promoted the economic exchanges between China and South Korea and economic development of South Korea," the Chinese firm said in a statement, adding that it remained committed to future acquisitions of overseas refineries.

The acquisition of an Asian refining complex close to China's booming southeastern provinces — but outside the control of integrated giants **PetroChina** and **Sinopec** — is seen as key to Sinochem's overseas downstream strategy. Most of the southeastern provinces are currently supplied by PetroChina and Sinopec refineries, making it difficult for Sinochem to get a foothold in the domestic market, and leaving overseas acquisitions as its main option. Inchon exports mainly high-sulfur fuel oil, as well as light naphtha and gas oil — exactly the product slate most in demand in China's booming southern provinces. However, Inchon is the least sophisticated of Korea's refineries, and Sinochem had announced plans to spend $800 million upgrading its secondary capacity. Inchon had been looking for a buyer for some time, but without success. Apart from being South Korea's smallest and worst performing refinery, it is saddled with over $1.73 billion in debts, against assets of only $1.52 billion.

Sinochem is already one of China's biggest crude importers, and despite stumbling over its downstream expansion in Korea, it has established a modest upstream operation. Just over two years ago, it bought **Atlantis**, a subsidiary of Norway's **Petroleum Geo-Services (PGS)** with estimated gas reserves of 400 billion-500 billion cubic feet offshore Sharjah in the UAE and up to 20 million barrels of oil offshore Tunisia, as well as other concessions in the UAE and Oman. Sinochem followed this up in December 2003 by buying a 14% stake in Block 16 in Ecuador from **ConocoPhillips** for about $100 million, giving it access to current oil production of 57,000 b/d.

At home Sinochem is more established in the energy sector. It has term contracts for crude and products for around 360,000 b/d, and imported 170,000 b/d of crude into China last year. Sinochem is also to take charge of a 32 million bbl tank farm facility in Zhoushan, Zhejiang Province, managing it as part of China's new strategic petroleum reserve.

Total Retail

Sinochem's domestic downstream strategy is tied to **Total**, which is planning to build a network of 200 retail stations in the northeast of China. The companies say the total investment in the project would be $120 million with Sinochem controlling 51% and Total holding 49%. Sinochem and Total plan to create a network of stations around Beijing and Tinajin and in the Hebei and Liaoning provinces, populous areas with some 133 million people.

"The investment is in line with Total's strategy of expanding its oil distribution operations in China, with a medium-term objective of integration between its refining and marketing activities," Total Chairman Thierry Desmarest has said. Total already has a working relationship working with Sinochem through its stake in the 172,000 b/d Dalian refinery in Liaoning province. Sinochem says efforts are under way to increase Dalian's throughput capacity to around 215,000 b/d.

Equity analysts caution that Sinochem's retail venture is problematic. "With retail stations it's always a branding exercise," says one analyst, adding that the Total-Sinochem venture will mainly have to compete through a pricing strategy against more established companies such as Sinopec and PetroChina.

Total is a latecomer to the Chinese retail marketplace compared with supermajors **BP**, **Exxon Mobil** and **Royal Dutch/Shell**, all of whom have plans to build about 500 retail stations through joint ventures with domestic refining giant Sinopec. BP also has a separate venture with PetroChina. The stations planned by BP, Exxon and Shell will be located in southeast China in Zhejian, Jiangsu and Guangdong provinces. China is required to fully open its retail oil markets by the end of this year in order to comply with its World Trade Organization membership, prompting Sinochem to act to secure its place in the sector.

Sinochem's other listed subsidiary, **Sinochem International**, gives a good insight into just how profitable this conglomerate is. The Shanghai-listed subsidiary announced a 316% rise in the net profits of the first nine months of 2004 to $90 million. Revenues grew to $1.06 billion from $1.02 billion in the first nine months of 2003. Its coke, iron ore and fertilizer businesses were the company's top performers, with increasing local demand for raw materials such as rubber, metals and plastics for the auto, manufacturing and construction industries buoying the subsidiary's results. And the company is expecting the fourth quarter to be just as good. **IPF**

US Firms Dominate Libya's Epsa-4 Round

US companies **Occidental**, **ChevronTexaco** and **Amerada Hess** were welcomed back into Libya with open arms at the end of last month, following the results of Tripoli's long-awaited Epsa-4 upstream tender. By contrast, the many European firms that applied for acreage failed to secure a single area from the 15 on offer.

Libyan Prime Minister Shokri Ghanem followed up the event by announcing that a larger auction of 40 blocks would be held in early March, and that further rounds could occur before the year is out. "We would like the larger companies," Ghanem said. "We've been testing the water with the medium size. Next time, we expect the majors to come with a heavier hand."

In this first open round of acreage since US sanctions were lifted last year, the mid-sized companies emerged as victors from a pack of approximately 60 bidding companies, with Oxy doing particularly well.

Oxy acquired a 90% interest in five onshore areas — Blocks 106 and 124 in the highly prospective Sirte Basin, Blocks 131 and 163 in the oil-rich Murzuk Basin, and Block 59 in the Cyrenaica Basin. The remaining 10% of each acreage is held by **Liwa Energy**, a subsidiary of Abu Dhabi investment company **Mubadala Development**. Mubadala and Oxy are already well acquainted, as two of the three consortium members — alongside France's **Total** — that make up the Dolphin Energy pipeline project in the Mideast Gulf.

An Oxy spokesman said the US company had committed itself to a five-year program comprising 7,000 kilometers of 2-D seismic, 1,150 square kilometers of 3-D seismic, and six wells on these five onshore blocks.

Oxy and Liwa also took stakes in four of the more gas-prone offshore areas — Blocks 35, 36, 52 and 53 — alongside Australia's **Woodside**. In these four, Woodside is operator with a 55% interest in each block, while Oxy holds 35% and Liwa 10%. The consortium is committed to a five-year exploration program that includes seismic and four wells. It has previously expressed interest in developing liquefied natural gas (LNG) projects in North Africa.

"We are exceptionally pleased we've been awarded interests in nine of the 15 exploration blocks offered in this bid round and believe they have considerable potential," Oxy Chairman and Chief Executive Ray Irani said. "Occidental has a long and successful history in Libya and we look forward to again working with our Libyan partners to build on that success."

Compatriot Hess achieved sole control of offshore Block 54, while Chevron won 100% ownership of the onshore Murzuk 177 area. Brazil's state-controlled **Petrobras** won a 70% interest in offshore Block 18, east of the Bahr Essalam area that supports **Eni**'s West Libya gas project, in partnership with Australian explorer **Oil Search**.

Canada's **Verenex**, an international offshoot of Canadian energy trust **Vermilion**, won a 50% stake of Block 47 in the Ghadames area near Tunisia, with Indonesian upstream independent **Medco Energi** taking the other 50%. Algeria's state-owned **Sonatrach** also won a block in the Ghadames region, in which it is the sole interest-holder.

Indian state-owned firms **Oil India Ltd. (OIL)** and **Indian Oil Corp.** secured onshore Block 86 in the Sirte basin, in their first such joint foray abroad. Company officials told the Indian press that the two intend to bid for at least two more licenses in Libya's next round.

The notable losers in this round were the European players, which left the prestigious awards ceremony empty-handed. Spain's **Repsol YPF**, Italy's Eni, Austria's **OMV**, Germany's **Wintershall**, **Royal Dutch/Shell**, Total, and Norway's **Norsk Hydro** and **Statoil** all missed out. However, some analysts note that most European firms were less eager than the US companies — and thus likely bid lower — because many are still digesting acreage secured in previous negotiations with Libyan authorities during US sanctions. **Exxon Mobil**, **Marathon** and **ConocoPhillips** are also believed to have put in fruitless bids in this latest round.

Deutsche Bank analyst Jay Saunders told IPF that although Oxy was certainly the most active in this round, "the key to profitability is in the terms, and they are not thought to be very lenient."

Each of the 15 blocks awarded in fact consists of two to four smaller blocks of defined acreage. Awards were based on two main factors — the percentage of future production the bidder offered to Libya's state-owned **National Oil Corp. (NOC)** — which varied in successful awards from 60%-90% — and the size of signature bonus offered, with most thought to have ranged from \$5 million to \$10 million (IPF Nov.,p1). An Oxy spokesman confirmed that the company's total expenditure on signature bonuses for its nine blocks totaled less than \$100 million.

Prime Minister Ghanem also urged international oil companies to assist in making the business of exploration and production in Libya as honest as possible. "Transparency does not mean it should be on our side alone," he said. "It must also be the obligation on the side of the companies that they should be transparent."

Separately, Ghanem announced that negotiations over the terms for the return of the Oasis Group of Conoco, Marathon and Hess to the Libyan acreage it abandoned following the implementation of US sanctions should be concluded soon. An Oxy spokesman said that separate discussions over its return to Libya were "making progress." **IPF**

Prudence Still US Majors' Best Friend

Don't look for the US-based major oil companies to do anything wild or even slightly risky with the mountains of cash that continue to pile up. This year will likely shape up to look like 2004, with share buybacks continuing at a consistent pace, dividends being raised according to plan, and for a few, capital budgets have been increased, but not as much as could be expected given the amount of free cash being generated.

Most oil company executives are singing the same tune, saying that their existing growth plans are sound, which rules out the need for a drastic rise in capital spending. Nor is any merger and acquisition activity on the radar screens of the US majors, who again feel comfortable with their current oil and gas output targets.

There is little temptation to grow through acquisitions for companies like **ChevronTexaco**, **Exxon Mobil** or any of the other big Western oil companies. Those firms will likely eschew major acquisition activity because growth strategies are in place over the next three to five years. But the large integrateds could become big buyers if their growth plans fail to materialize and cash continues to pile up, suggests Friedman Billings Ramsey analyst Jacques Rousseau. "If earnings stay high, that is likely to increase the M&A activity … especially if internal plans are not living up to expectations," Rousseau says. "There will be more potential to buy growth."

Buybacks Continue

Leading the share buyback pack continues to be Exxon, which earned a record \$8.4 billion, or \$1.30 per share, in the fourth quarter and a whopping \$25.3 billion (\$3.91/share) for the full year 2004, up 18% on 2003. With oil prices continuing to hover around \$50 per barrel, Exxon's first quarter also is expected to impress, which will only add to its already huge cash pile.

Regarding share buybacks, the company has been purchasing about $3 billion worth of its own shares every quarter for several quarters, and that rate of share buybacks is expected to continue in 2005. Exxon repurchased $9.9 billion worth of its stock in 2004, accounting for roughly 3% of the shares outstanding. As another way to return cash to shareholders, Exxon also expects to raise its annual dividend payment in 2005 much as it has done for each of the last 22 years.

Exxon's capital spending in 2004 was $14.9 billion, slightly below earlier guidance of $15 billion. When asked if Exxon's spending plans for 2005 have changed, given that 2004's spending was lower than anticipated, an Exxon executive said that spending below the plan shouldn't always be viewed negatively.

"Having a decrease in capital expenditures, as long as you're delivering all the projects — on schedule and on or below budget — that's a good thing," said Henry Hubble, Exxon's vice president of investor relations. Exxon's 2005 capital expenditures will total $15 billion-$16 billion, roughly flat compared with its 2004 spending.

Like Exxon, Chevron's 2005 share buyback program will look a lot like 2004's. Chevron — which initiated its buyback program mid-year 2004 — will continue buying back about $750 million worth of its stock every quarter for several years. The California-based major repurchased $2.1 billion of its own shares in 2004, with the ultimate buyback total to reach $5 billion. Chevron's 2005 capital budget has been set at $10 billion, an 18% rise from 2004 spending of $8.3 billion, but within what has been the company's spending range for several years.

ConocoPhillips continues to lag its rivals in the share buyback game. Conoco's buybacks are extremely modest compared with its peers, with the Houston-based company only repurchasing shares in a bid to keep the number of shares outstanding at around 700 million. Conoco plans to spend $5.1 billion on exploration and production projects in 2005, a 13% increase from expected spending of $4.5 billion this year. Although 2005 spending rises by $600 million versus 2004 levels, half of that increase is due to increases in service costs and changes in exchange rates. Conoco's overall 2005 capital spending has been set at $7.4 billion.

Downstream Surprise

Analysts and investors are quick to point to sky-high oil prices as the key driver behind the record earnings reported for the fourth quarter and 2004 as a whole. Oil prices have played an obvious role in pushing profits to record levels, but in the most recent quarter, it was the downstream strength that surprised many Wall Street analysts.

Chevron's refining and marketing business in Asia — where the company benefited from higher margins and sales — played the biggest role in the company's stronger-than-expected fourth-quarter earnings. In the period, Chevron's international downstream unit earned $704 million, up 350% from a year earlier and 80% higher than the third quarter of 2004.

"Refining and marketing results were much stronger than expected," said Lehman Brothers analyst Paul Cheng. "Apparently, we grossly underestimated the company's benefit from light-heavy differentials." Cheng expected Chevron's international downstream unit to post earnings of $388 million, sharply lower than the actual figure.

Having such a strong position in Asia — where Singapore refining margins surged in the fourth quarter — drove Chevron's downstream profits. According to A.G. Edwards analyst Bruce Lanni, Singapore refining margins hovered around $12/bbl in early November. By comparison, US margins hit a quarterly high of $6/bbl and European margins were $3/bbl in early November.

Chevron's margins in Singapore averaged $9.25/bbl in the fourth quarter, $3 higher than the third quarter and more than double the year-ago level. Singapore margins have since dropped to around $4/bbl, according to Lanni, but the sharp slide in local margins doesn't worry Chevron executives, who say that demand in the region remains robust.

"We're still very bullish on Asia and the outlook for Asia," said Chevron Chief Executive Dave O'Reilly. "We think it's the right place to be and we're happy that we've increased our exposure there," he said, referring to the company's decision last year to increase its stake in **Singapore Refining Co.** to 50%.

Chevron is also exploring ways to win a larger share of China's retail business. In January, **Caltex**, Chevron's downstream division in Asia, signed a deal with China's **CITIC Resources Holdings** to expand its retail presence in south China.

For Exxon, its fourth-quarter profits were helped by the company's strong presence in the chemicals business, which is in the midst of a turnaround. In the fourth quarter, Exxon's chemicals profits were up 162% compared with a year earlier at $1.25 billion. Strong chemicals profits are expected to continue, according to Bank of America analyst Daniel Barcelo. "We have yet to reach the cyclical peak in this business line and we expect stronger performances to come in 2005," Barcelo said.

Like their larger counterparts, the smaller integrated oil companies have benefited from high oil prices, and strong US and international refining margins. **Marathon Oil**, **Occidental Petroleum** and **Amerada Hess** are using their financial strength to more comfortably increase 2005 capital spending. In most cases, the money is being used to fund a handful of high-profile projects expected to fuel the companies' longer term growth plans.

Marathon plans to spend $3 billion in 2005, a sharp 19% rise over last year's capital expenditures. The increase is due primarily to anticipated spending in Norway and Equatorial Guinea, where the company has several large projects in development. Oxy and Hess have each earmarked $2.1 billion for 2005 spending. Oxy spent $1.8 billion in 2004, while Hess spent $1.5 billion last year. About one-quarter — $540 million — of Oxy's 2005 overall spending is going toward development of the company's giant Dolphin gas project in the Middle East, which is slated for start-up in 2006. **IPF**

Ivan Effect Hits Insurance Premiums

The ghost of devastating Hurricane Ivan is coming back to haunt US Gulf of Mexico producers in the form of drastically higher insurance premiums for their offshore infrastructure. Offshore production policy rates for 2005 are going up by as much as 20% in the wake of Ivan, which has so far cost the industry $2.7 billion, the highest financial loss for offshore production facilities in history.

By comparison, the 1988 explosion of the Piper Alpha production platform in the North Sea that killed 167 people cost $1.5 billion, of which the insurance industry covered roughly $1 billion. And the cost of the 1989 explosion at a petrochemical plant in Texas owned by the former **Phillips Petroleum** came in at $2 billion, of which the insurance industry covered half, according to data from **Aon**, a risk management and insurance brokerage based in London.

Ivan tops these events. "The size of this loss, the largest the energy market has ever suffered, is expected to produce a number of changes," said Charlie Cantlay, deputy vice chairman of reinsurance at Aon. "The market is, in general, looking to impose rises of 10% to 15% on Gulf of Mexico exposures." However, a few underwriters have reportedly raised premiums by as much as 20% for January renewals, a level of increase that is "at the top end of any underwriter's wish list," Cantlay said.

The Gulf of Mexico has been singled out as a high-risk area. As a result, many US Gulf producers planning to renew their insurance coverage this year will have to dig deeper into their pockets. A typical annual premium for a drilling rig — with a value of some $60 million — in the US Gulf of Mexico is about 1.25% of the value, or $750,000. The premium could climb by up to $150,000 for 2005.

Cantlay said insurance companies were still assessing the Gulf Coast damages, especially the cost of business interruption, and suggested those costs could bump up the currently estimated $2.7 billion. He noted that policy underwriters are trying to calculate new premiums based on today's high oil prices — which would jack up payments in case of business interruptions. As a result, these new premiums are also likely to be higher than before.

Several US producers are so large that they are traditionally self-insured, with **Exxon Mobil** being the prime example. The reasoning behind this is that they are better off setting aside the premium they would otherwise have paid an insurance company, and dig into this fund in case of a loss, as this is cheaper than having a third party taking care of the coverage. Sources say that **BP** and **ChevronTexaco** have also self-insured their offshore facilities in an attempt to mitigate the impact of higher premiums on their bottom line.

Hurricane Ivan struck the US Gulf on Sep. 11, 2004, destroying seven production platforms and one rig, extensively damaging six others, in addition to damaging more than 12 pipelines, causing several leaks. That week, the US Minerals Management Service (MMS) reported oil production shut-ins of 1.4 million barrels per day, or 82% of total Gulf of Mexico output. Refiners shut in 2.2 million b/d of refining capacity due to Ivan. Since then, most Gulf output has been restored, although about 140,500 b/d, or 8% of daily oil output, remained shut in as of the second half of January.

Gulf Coast oil and gas producers have been counting their losses lately. Chevron said lost production due to Ivan cost it $165 million during both the third and fourth quarters, plus an additional $50 million in clean-up costs. The company is still struggling to bring back on line its 50,000 b/d Petronius platform in the Viosca Knoll area on Block 786, which was extensively damaged by the storm. "We hope to bring it back on line by the end of the first quarter of this year," company spokesman Matt Carmichael said.

Royal Dutch/Shell said clean-up and repairs after Ivan have cost $20 million. The company has also been forced to shut in 54,000 b/d of production for the past four months, although it has not publicly estimated the impact of this shutdown on earnings.

BP's fourth quarter earnings, meanwhile, released at the start of this month, reflect an increase of about $250 million in exploration write-offs and repair costs resulting from Ivan, the company said.

Several oil firms whose rigs were destroyed by Ivan said that they were still repairing the facilities months after the storm. Among these were BP, Shell, Chevron and **Ensco**, a Dallas-based oil services firm. The damage to one of Ensco's rigs was extensive because the rig was directly in the path of the storm, company spokesman Richard LeBlanc said. That jack-up rig on Main Pass Block No. 280 was insured for $65 million with a $5 million deductible. The insurance policy will be renewed in June, LeBlanc added. **IPF**

IN BRIEF

Rosneft's Chinese Finance

Moscow has confirmed that China played a central role in helping state oil company **Rosneft** finance the $9.4 billion purchase of **Yuganskneftegas**, after the **Yukos** production arm was forcibly sold by the government late last month (IPF Jan.,p3).

The head of Russia's Federal Energy Agency, Sergei Oganesyan, confirmed that $6 billion was provided by state-owned **China National Petroleum Corp. (CNPC)** as pre-payment under a long-term oil supply deal signed with Rosneft. Domestic banks were also tapped.

"First, Rosneft agreed with Russian banks for loans, which it has paid back," Oganesyan said of Rosneft's acquisition. "Second, the company has agreed on pre-payment with China, in accordance with which crude will be supplied. The contract has been signed and the money disbursed. Further, it is possible that Rosneft would like to have a partner — it could be the same, CNPC, or some other company — which would agree to a certain share in this asset."

Russian Finance Minister Alexei Kudrin also confirmed this month that Russia's **Vneshtorgbank** borrowed $6 billion from Chinese entities as part of China's agreement to import crude from Rosneft. Kudrin said the money then made its way to Rosneft to help finance the purchase of Yugansk.

BP Upsets Tehran

Comments last month by **BP** CEO John Browne that the supermajor would not make any significant investments in Iran until US sanctions are lifted have incurred the wrath of Iran's Oil Minister Bijan Zanganeh, who says the company has "ruined its long-term chances" in his country.

Late last year, BP quietly gave up its quest for upstream riches in Iran after several years of fruitless negotiations on major oil and gas projects (IPF Dec.,p13).

But the latest furor was stirred by comments in two separate interviews, with Bloomberg TV and the UK's *Sunday Times*. "Politically, Iran is not a flyer," Browne told the *Sunday Times*. "Right now it is impractical for BP, because 40% of BP is in the US and we are the largest producer of oil and gas in the US."

These last comments appeared to rile the Iranians, who have had a love-hate relationship with BP ever since the company struck its first well in Iran in the 1920s. "We don't consider this attitude friendly," Zanganeh said. "We won't forget it and it is a gesture by BP for the benefit of US interests."

Iraq Studies Awarded

Iraq's oil ministry has awarded contracts for reservoir studies at its giant Kirkuk and Rumaila oil fields to **BP** and UK-based **Exploration Consultants Ltd. (ECL)**.

Royal Dutch/Shell will also play a supporting role to the oil ministry on the Kirkuk study under a technical service agreement, which will include the Anglo-Dutch major financing that field's reservoir work.

ECL came out as the big winner in the tender, which was first issued last June. It was shortlisted in November for both studies and was chosen last month to conduct both the Kirkuk reservoir study and front-end data management work for Rumaila, before BP takes over the second stage of the latter.

"We have awarded the contracts to BP and ECL because they had the best technical offer, the shortest period in time and the cheapest price," Hazem Sultan, director general of the ministry's reservoirs and field development department, told IPF.

Progress On Petroplus

US private equity funds **Carlyle Group** and **Riverstone Holdings** are finally expected to launch their share offer for Dutch refiner Petroplus later this month, but the funds have had to sweeten their offer to both the company's debt and equity investors, raising the overall price for the deal to €523 million ($683 million) from an original €474 million — an increase of €49 million or more than 10%.

The increase has worked, however, with Carlyle and Riverstone having now received irrevocable undertakings representing 85% of Petroplus debt and 81% of its shares.

Carlyle and Riverstone are now paying a premium of 8.75% to the company's debt investors for Petroplus' 10.5% senior notes due in 2010, compared with the 1% originally offered (IPF Jan.,p13). This raises the value of the offer for Petroplus' debt to €245 million from €227 million. Carlyle and Riverstone have also had to improve the terms of their offer to Petroplus' equity investors, raising their offer price from €8 to €9 per share, and also offering the option of equity participation in Riverstone rather than cash (IPF Jun.,p3)

Repsol's New Structure

Repsol YPF's new chairman and CEO Antonio Brufau has restructured the Spanish major into three core divisions, each with its own executive director (IPF Dec.,p5). And to lead a new Latin America arm, Brufau has tapped the chief executive of Spain's leading gas supplier **Gas Natural (GN)**.

The core Latin America unit will cover Argentina, Bolivia and Brazil, and will be led by GN managing director Enrique Locutura. The other two divisions will involve refining, downstream and chemicals, led by Pedro Fernandez, and upstream operations, including Peru, Ecuador and Chile, led by Nemesio Fernandez-Cuesta, who will also head Repsol's LNG midstream and marketing operations. Rafael Villaseca has meanwhile been nominated to succeed Locutura at GN.

"The new organogram creates three large strategic business areas, directed by professionals who have many years of experience inside the company, and who will be completely responsible with respect to earnings," Repsol said. "At the same time, the corporate center of the company will be streamlined."

Vattenfall Enters Elsam Fray

The proposed merger of Danish power company **Elsam** with state-owned oil and gas firm **Dong** may not go ahead, following the acceptance earlier this month by 35% of Elsam's shareholders — comprising Danish grid companies — of a rival cash offer from state-owned Swedish utility **Vattenfall**.

Vattenfall offered 1,260 kroner ($219) per share, for a total of $1.5 billion. Through this acquisition, Vattenfall will become the single largest shareholder in Elsam.

The Danish government and Elsam's board still want to create a Danish national champion through the merger with Dong, however, and Copenhagen may try to block the Vattenfall deal by invoking a shareholder agreement whereby any Elsam shareholder selling its stock must first offer the stake to its fellow shareholders at the same price as the outside offer. This process could drag on for weeks.

Under the terms of the December merger agreement, which values Dong at $3.7 billion and Elsam at $4.9 billion, shareholders of the latter are being offered equity in the merged entity, which would be 44.7% owned by these shareholders and 55.3% by the government prior to a planned listing.

Conoco Joins Lukoil Board

Russian major **Lukoil** has elected the first **ConocoPhillips** representative to its board of directors, cementing an alliance forged in an equity deal last year (IPF Oct.,p1).

The two partners are also moving ahead with joint upstream plans in the oil-rich Timan-Pechora province of northern Russia, but remain reluctant to comment on downstream cooperation in Europe or the US. Lukoil is keen to expand its presence in the US market.

Kevin Meyers, president of Conoco's operations in Russia and the Caspian region, was elected to Lukoil's 11-member board at an extraordinary shareholders' meeting last month.

The meeting also approved changes in the company's charter requiring unanimous board approval for key issues relating to the oil producer's activities, including the signing of major deals, sale of assets or company liquidation. This effectively gives Conoco veto rights on such matters.

Bank Demand For Rosneft

Western banks have hit **Rosneft** with a demand for immediate payment of $525 million of borrowings that were guaranteed by former **Yukos** producer **Yuganskneftegas**, the Russian state oil company has confirmed.

The suspension of Yukos' crude exports has deprived a group of international banks led by **Societe Generale** of repayments under two loans worth a combined $2.6 billion, which were secured by Yuganskneftegas exports. Proceeds first went into "passport accounts", from which the lenders took their dues, before the remainder went on to a holding company. Yukos had paid back about $1 billion of these loans.

A Yukos spokesperson said that Yukos stopped repayments after it filed for Chapter 11 bankruptcy in the US on Dec. 14 (IPF Jan.,p3).

Rosneft said it had taken all risks into consideration when it decided to buy Yugansk. "Yuganskneftegas together with Rosneft are currently holding talks with representatives of creditors on confirmation of the validity of this demand and on regulating the situation in line with generally accepted business practices," a Rosneft spokesperson said.

M&A Values Up In 2004

Last year was one of the most active upstream merger and acquisition periods in the post-mega merger era, with the combined value of all deals worldwide totaling $68.5 billion, according to a new report by consultant John S. Herold.

The 2004 total deal value year blew away 2003's total of $41.7 billion and 2002's $46.3 billion. In recent years, the 2004 total was only surpassed by 2001's total of $89.2 billion, when mergers among major oil companies were still occurring.

Buying properties or companies continued to be costly last year — in the fourth quarter, US reserves were snapped up for $10.51/boe, versus $5.02/boe a year earlier, Herold said. Canada was more expensive too, with reserve values there a pricey $14.32/boe in last year's fourth quarter versus $12.92/boe a year earlier.

Outside of North America, North Sea transaction values spiked to $8.44/boe in the fourth quarter following two high-profile deals for stakes in the Buzzard and Ormen Lange fields.

Citgo For Sale?

With new rumors swirling around that **Petroleos de Venezuela (PDV)** could sell US refining subsidiary **Citgo**, analysts are questioning the financial reasoning behind such a move for Venezuela while weighing the potential opportunities for acquisitive US refiners.

Newly designated Citgo President Felix Rodriguez said earlier this month that no decision has been taken with regard to the sale of Citgo, countering reports from some media outlets saying Venezuelan President Hugo Chavez intended to sell it.

"There has been no announcement of a sale of Citgo," Rodriguez said, adding that PDV is evaluating ways to align Citgo's operations with Venezuela's plan to develop new markets — such as China — to diversify away from the US.

Venezuela sends about 1.5 million b/d of crude oil and products to the US, a fact that irks left-wing leader Chavez, who says this business arrangement is akin to "subsidizing Mr. Bush." However, as much as Chavez dislikes the arrangement, analysts say he would be hard-pressed to find a better business partner than the US and that Venezuela would be foolish to divest Citgo.

Ecuador Plans Reforms

In a bid to grow foreign investment in his country's crucial oil sector, Ecuador's President Lucio Gutierrez plans to launch ambitious reforms this year that include the restructuring of state oil company **Petroecuador** and the introduction of investor-friendly legislation that would increase the number of oil and gas fields available to foreign oil companies.

Relations between the Ecuadorian government and private oil companies have been tainted by an ongoing dispute over the reimbursement of value-added taxes (VAT) requested by US **Occidental** and Canada's **EnCana**, which the government refuses to pay.

But Gutierrez knows he cannot reform the oil sector without private money. Oil production in Ecuador surged 32% in 2004 to 555,000 b/d, with the privately financed OCP pipeline responsible for much of that expansion. State-owned Petroecuador's own production, hurt by dwindling reserves, stagnated at about 200,000 b/d.

"We are drafting a law that will encourage competition in the country," Gutierrez said last month in New York. The legislation, much like the bills rejected by an opposition-led Congress back in October, would allow foreign companies to invest in and operate Petroecuador fields.

Medco Weighs IPO

Indonesia's largest private E&P company **Medco Energi** is considering offering shares through an initial public offering (IPO) in the next six months. The funds would support Medco's long-term expansion plans .

The company would launch the IPO on both the London and Singapore stock exchanges, as the issue price for a domestic listing would be too low, Medco founder Arifin Panigoro said.

A Medco spokesman said that the IPO is only one of a couple of options that the company is considering for funding its expansion program. The company also has Indonesian treasury shares that it could sell to raise about $50 million. A final decision on which path to take will be made later in February, the spokesman said, adding that the IPO would likely float about 45% of the company.

EQUITY MARKETS

Oil Equities Rebound In January After Subdued End To 2004

Oil shares rebounded in January following a poor showing in the final weeks of 2004, driven by stronger benchmark oil prices that moved $5 per barrel higher during the month.

The US-listed oil companies tracked by IPF all inched higher in January, with **Unocal** posting the biggest percentage gain. The only companies to fall during the month were European firms who suffer when the dollar's value improves versus the euro.

As a whole, oil equities outperformed the broader market in January, with the IPF Index rising 1.1% compared with a decline of 2.5% in the S&P 500 Index and a 2.2% drop in the FT World Index.

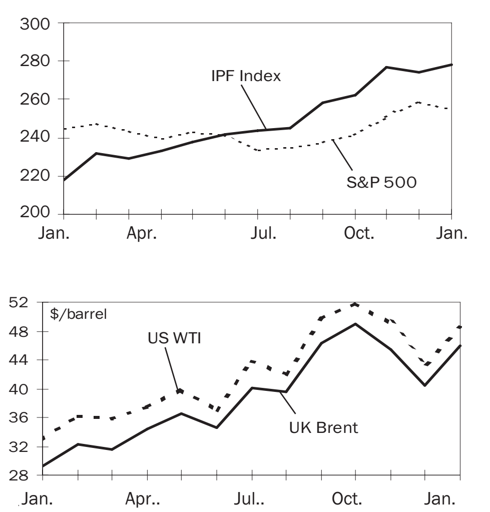
Speculation of a takeover by one of China's top oil companies pushed Unocal's share price 9.4% higher in January. News that **China National Offshore Oil Corp. (CNOOC)** was mulling a $13 billion takeover sent the California-based company's shares higher in the early part of the month, with CNOOC reportedly interested in Unocal's Asian assets.

Worldwide oil prices climbed in January, with West Texas Intermediate rising 11% to end the month at $48.30/bbl and Brent crude in London jumping 14% to end January at $45.92/bbl.

European oil companies that offer American Depositary Receipts (ADR) on US exchanges stumbled in January as a result of a US dollar that strengthened against the euro.

US-listed shares of foreign companies, or ADRs, trade in dollars, which means that when the dollar's value rises versus the listed company's home currency, the ADR's dollar value falls. The opposite is true when the dollar strengthens, with the value of the ADR then slipping.

Trends in Oil Equities and Prices



French oil giant **Total**, for example, watched the value of its ADRs slip 2.3% in US markets, but on the Paris bourse, the company's share price rose 2%. The other European oil companies moved similarly in January, with shares on their home stock exchange rising, but the value of the ADRs dipping.

With US benchmark crude ending the month at nearly $50/bbl — and pushing up the value of oil company shares in the process — there is some concern among Wall Street analysts that moving higher could be tough and continuing to outperform the broader market could also prove difficult.

With the elections in Iraq having gone smoothly, coupled with a late January Opec meeting that produced no change, some think oil prices are pointing downward. "The potential is for the oil market to trade down hard from its cold weather/Iraq election/Opec meeting peaks, and this should allow the broader equity market to rally at the relative expense of the oils," said Deutsche Bank analyst Paul Sankey.

Shares of **Exxon Mobil** ended January up a modest 0.8%. However, February is already shaping up well for the Texas-based supermajor, with the company's shares up 6% in the first week of the month.

Analysts and investors were stunned by Exxon's fourth-quarter earnings statement, which saw the company blowing away the Wall Street consensus estimate (px). In fact, Sankey wondered if Exxon's fourth-quarter profit of $1.30 per share versus the consensus estimate of $1.07/share was the biggest "street beat" ever. "What is so impressive about this enormous result is that it may not be a peak," Sankey said.

Several analysts increased their price target for Exxon after the company delivered such strong fourth-quarter earnings. Bear Stearns analyst Fred Leuffer raised his stock rating on Exxon to outperform from peer perform. Leuffer now sees Exxon's shares trading in a range of $43-$60/share compared with an earlier range of $37-$50/share. Similarly, Lehman Brothers analyst Paul Cheng raised his Exxon target price to $54/share from $48/share.

Along with Exxon, **ConocoPhillips** remains a top pick for several analysts, following a strong fourth-quarter, which also trumped Wall Street expectations. Conoco remains a favorite because it continues to trade at a steep discount compared with its peers, has a strong list of upstream projects and continues to benefit, on its downstream business, from wide crude oil differentials. me. **IPF**

Oil Equities in Key Worldwide Markets

		At End	Monthly Chg.		52-Wk.		52-Wk. Chg.		Chg. From 12/31/04	
Market	Index	January	Level	% Chg.	High	Low	Level	% Chg.	Level	% Chg.
US	IPF Global Oil & Gas ($)*	277	+3	+1.1	277	218	+59	+27.2	+3	+1.1
US	S&P 500 ($)	1,181	-31	-2.5	1,214	1,063	+50	+4.4	-31	-2.5
All	FT-World Actuaries Index ($)	319	-7	-2.2	326	276	+27	+9.2	-7	-2.2

* Market capitalization weighted index of the 15 largest oil and gas equities traded in US markets: Exxon Mobil, Royal Dutch, Shell Transport, BP, TotalFinaElf, Chevron Texaco, ENI, BG, Conoco Phillips, Repsol YPF, Norsk Hydro, Statoil, USX-Marathon, Unocal and Anadarko.

EMERGING MARKETS

China Aviation Creditors Unhappy With Debt Plan

Major creditors of **China Aviation Oil (CAO)** have started to express openly their unhappiness with the company's proposed debt restructuring plan, which would see them repaid a 41.5% slice of amounts owing, and are reviewing their options for getting more than has been offered, sources have told IPF.

At a creditors' meeting on Jun. 10, CAO will need at least 75% of unsecured creditors to support the proposal to complete the restructuring.

Under the scheme of arrangement, CAO's repayment rate of 41.5% would return $220 million to creditors on the list. State-owned **China Aviation Oil Holding Co. (CAOHC)**, which holds 60% in Singapore-listed CAO, and a new investor would provide $100 million in "fresh equity" to pay for working capital and cash distributions to creditors.

The creditors would be paid $100 million upfront, with $70 million from the fresh equity and $30 million from existing assets. They would then get another $120 million over eight years, paid from operating cash flow, dividends from investment assets, and any asset sales.

Sumitomo Mitsui Banking Corp. (SMBC) recently filed a lawsuit against CAO, parent CAOHC, and suspended Chief Executive Chen Jiulin, claiming fraud and conspiracy in relation to the $26.1 million in loans that CAO racked up with the bank in the second half of 2004, according to Singapore newspaper *The Business Times*.

SMBC said its debts should be paid back in full since CAO failed to reveal its mounting losses when it applied for credit with the bank. SMBC is the sixth-largest external creditor in a list released with CAO's debt restructuring proposal (IPF Jan.,p14).

Another major creditor, **Standard Bank London**, has also expressed its unhappiness and wants a better offer than that currently on the table. The bank in November issued a letter of statutory demand under the Companies Act of Singapore to recover $34.1 million from CAO.

South Korean refiner **SK Corp.**, parent of creditor **SK Energy Asia**, has slammed the proposal as "unreasonable" and "unacceptable." SK Energy Asia is owed $14.3 million and is the 14th largest creditor.

"We are not pleased with the proposal and we would like to stick to our current demand for [CAO] to pay back the full amount of $14.3 million owed to us," a SK representative in Seoul told IPF. "We are looking into the legal options we have and will take it from there," the representative added, while declining to reveal what possible routes SK has in mind to recover its debt.

Earlier, **Morgan Stanley Capital Group**, which is owed $3.9 million by CAO in losses on derivative positions, said it "would like to improve that [debt repayment] number," and that it was being advised by in-house counsel on the matter.

Beijing's state Assets Supervisory and Administrative Commission (SASAC), which oversees state-owned companies including CAO parent CAOHC, said in late January that it would not provide any financial assistance to CAO for its debt restructuring proposal, as it does not wish to interfere in commercial decisions made by state companies. The SASAC is evaluating the proposed scheme of arrangement and its approval is required for implementation of the plan.

In an interview with the *Beijing Youth Daily* newspaper, suspended CAO chief Chen said he "was not aware of the company's derivatives trading" until March 2004, nine months after it was launched in June 2003. He claimed that the company's risk management committee did not inform him of the trading during that nine months and it was an Australian employee who "began the speculative trading strategy."

The newspaper report suggested that Chen was referring to Gerard Rigby, who is CAO's head of oil trading. Rigby is an experienced trader and previously worked for **ChevronTexaco** subsidiary **Caltex Singapore**. In the report, Rigby said Chen's claim was "not correct."

Despite all its legal woes, CAO's newly created subsidiary **China Aviation Oil Trading (CAOT)** has successfully closed its second physical tender to supply the Chinese market with jet fuel this year. CAO said the latest tender for 350,000 tons of jet A-1 fuel for delivery in March-April attracted bids from 10 suppliers totaling five times the required volume. **IPF**

Oil and Gas Equities in Emerging Markets

Company/Country		30 Day	52 Week		% State	Market
Asia	**Latest**	**% Chg**	**High**	**Low**	**Held**	**Cap**
PetroChina	4.32	+4.2	4.37	3.20	80	97,499
Zhenhai Refining (China)	8.00	-0.6	9.90	4.60	75	2,589
Bharat (India)	424.80	-7.4	506.95	296.00	66	2,921
Hindustan (India)	363.00	-9.4	530.30	282.65	51	2,823
Indian Oil Corp.	454.50	-11.4	569.05	319.70	91	12,167
Petronas Gas (Malaysia)	7.05	-0.7	7.80	6.55	100	3,672
Petron (Philippines)	4.00	+23.1	4.10	2.42	40	681
Singapore Petro.	4.32	+14.3	4.32	1.57	55	1,133
Ssangyong (S. Korea)	66,000	-1.5	69,200	37,600	0	7,400
SK Corp. (S. Korea)	54,500	-4.2	69,300	35,600	0	6,901
PTTEP (Thailand)	288	-0.7	330	238	100	4,896

Company/Country		30 Day	52 Week		% State	Market
FSU/Europe	**Latest**	**% Chg.**	**High**	**Low**	**Held**	**Cap.**
Mol Magyar (Hungary)	12,580	-1.0	12,945	6,590	25	7,281
Gazprom (Russia)	56.50	0.0	63.00	36.5	38	47,744
Lukoil (Russia)	870.43	+3.5	949.49	712.20	27	25,857
Surgutneftegas (Russia)	21.25	+2.2	23.73	16.06	0	30,783
Tupras (Turkey)	16.00	+16.8	16.00	9.00	66	2,999
Petrol Ofisi (Turkey)	5.00	+20.5	5.00	4.00	42	1,330
Latin America						
Perez Companc (Arg.)	3.40	-4.0	4.13	2.65	0	2,509
Repsol-YPF (Arg.)	19.60	+2.3	19.60	16.17	21	30,969
Petrobras (Brazil)	170	-4.5	199.98	121.05	52	605

All figures in local currency. Market capitalization in US$million.

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