

September 5, 2005

Dear Client:

Re: The Impacts from Hurricane Katrina

A week ago today, Hurricane Katrina struck the Gulf of Mexico coastline of Alabama, Mississippi, and Louisiana. This event from forces of nature was the most devastating storm to hit the land mass of the United States in modern times (2+ centuries). There are immediate consequences, and there will also be short, intermediate, and long-term impacts that will create changes in future expectations and trends for our nation and the world. Some of these new possible conditions will be addressed in this letter.

In most respects, the human suffering and the physical damage from this August 29, 2005, tragic event are and will be far greater than the highly depressing fallout from the 9/11/01 attacks on New York and Washington, D.C. The financial markets in the U.S. immediately repriced equities down about 15%-20% from their 9/10/01 levels. Nonetheless, this 2005 storm-related blast did not shake the confidence of investors in common stocks in post-hurricane event trading. The stock market acted like it normally would when the adverse costs from the situation at hand are deemed to have a fairly short-term impact upon the country as a whole -- a one calendar quarter glitch in the long-term upward trend. In some respects, perhaps from many viewpoints, this relatively tranquil price movement for common stocks can be a correct assessment.

However, the stories related to the Hurricane Katrina tragedies are likely to be far more long-lasting and pervasive than the 9/11/01 news coverage, and frustrations and latent angers are already in the public discourse with much of the outrages yet to be expressed. There is the potential to break confidence in energy companies and governmental institutions similar to and yet different from the negative moods that developed in 2002.

The issues beginning to form will be all about the government's incompetence versus effective leadership during the recovery efforts. There will be assertions about global warming as a primary cause for the increased frequency and intensity of hurricanes in the Atlantic Ocean. Enhanced conservation practices and the development of non-hydrocarbon sources of energy as the solution for shortages of supplies will be strategies that are espoused against the possibly more substantive choices to initiate nuclear power generation facilities again and to open up of discovered oil reserves whose production has been blocked by environmental restrictions. Refining expansion at new sites around the nation will also become a necessity to build excess supplies of gasoline, diesel fuel, jet fuel, and heavy heating oil inventories above minimally necessary levels that have become our energy policy by default.

Some persons have described the chaotic conditions in New Orleans from the aftermath of the flooding as evidence that the U.S. was no better than a third world country. The slowness to complete evacuation recovery efforts and to deliver supplies to stranded persons along with looters and shooters earned that condemnation. However, the magnificent efforts of persons from all walks of life to pitch in and help is the real story of this disaster. There is good media coverage of this wonderful aspect of the recovery from the horror that preoccupied the middle days of last week. Hopefully, the images of goodness, heroism, and personal sacrifices for the betterment of neighbors will emerge as the dominant theme for our nation's public discourse and psyche. We are anything but a third world nation, and confident appreciation of this fact will need to support actions in the financial markets and legislative bodies as we move forward.

There will be a future time to comment in depth about the matters raised in the two preceding paragraphs. When we do have time to make comments, the title for the incompetence/leadership subject is likely to be: Can Perfect Hypothetical Results Really Be the Standard in Catastrophic Situations? For global warming as the cause for this hurricane, the lead-in banner should read: Reputable Scientific Research Does Not Prove the Hypothesis, and the Long-Term Economic Consequences of the Kyoto Treaty on the United States Would Be Devastating. A third theme for a solution to the energy crisis will be: America must have all of the above -- conservation, new sources of energy, a renewal of existing licenses and a resumption of construction of nuclear electricity generating power plants, opening of new oil fields for exploration and development, the authorization to construct refineries at new locations for geographic diversification and expansion of capacity to handle more crude oil. In short, a constructive linkage and balance between the imperatives for adequate energy supplies and environmental concerns must be established in the United States. The environmental lobbies at all levels of government from local to federal have created a stranglehold in progress toward solutions that could have alleviated the present predicaments faced by our country, with particular reference to inventory shortages of natural gas and petroleum products that generate sky-high prices.

This letter will provide anecdotal evidence on our current petroleum products situation as gathered from the American Petroleum Institute and other sources that are regularly published in the Wall Street Journal pages that I have saved in my library at home over the last several years in order to be able to make an analysis of the kind about to be described below.

There are eight refineries in the southeast Louisiana/southwest Mississippi area that were vulnerable to Hurricane Katrina. Collectively, they represent about 10% of total U.S. refinery capacity. Some of these plants need only restoration of electricity to be able to operate. Some are damaged by wind. Others are partially flooded. There is limited information on this date about their anticipated schedules to resume production.

Two major product pipelines carry gasoline and distillate east and northeast to densely populated areas in the South, Mid-Atlantic, and Northeast. Our understanding is that the larger of the two lines was operating at 50% capacity following the storm, and the smaller operation could generate about 20%-25% of normal levels by the end of last week.

Crude oil and product imports through the Gulf Coast ports, especially New Orleans, may represent as much as 20% of the total U.S. supplies from those sources. The status of gathering connections to bring normal volumes through to the mainland is unknown, and accurate findings about these concerns will be delayed for weeks until some degree of normal operating conditions can be restored.

These fact sets infer the probability of a maldistribution of petroleum products within the nation that could result in a general malaise in many sections of our country. Fortunately, we began this period of stress with a satisfactory supply of crude oil and imported products as shown in Table 1.

Table 1: Average Daily Supply Activities  
(Based Upon Weekly Results)

	<u>08/31/05</u>	<u>08/31/04</u>	<u>08/31/03</u>
U.S. Crude Production	5,314,000	5,368,000	5,721,000
Imported Crude	10,374,000	9,922,000	9,869,000
Imported Products	<u>2,973,000</u>	<u>2,936,000</u>	<u>2,282,000</u>
Total Supply	18,661,000	18,226,000	17,872,000

Please note that 18.66 million barrels of supply in 2005 is 2.4% above 2004 and is 4.4% greater than 2003 levels.

Table 2 records the average days of crude oil supply available for refinery processing.

Table 2: Days' Supply in Crude Oil Inventories

	<u>08/31/05</u>	<u>08/31/04</u>	<u>08/31/03</u>
Crude	522,666,000	281,374,000	284,839,000
Refinery Runs	16,110,000	16,275,000	15,571,000
Days' Supply	20.03	17.29	18.29

The 20.03 days' supply for August 31, 2005, is the best condition within the three-year comparisons.

The average daily refinery production statistics for gasoline, light fuel oil distillates, heavy fuel oil, and jet fuel are set forth in Table 3.

Table 3: Average Daily Refinery Production  
(Based Upon Weekly Results)  
(000 Omitted in Barrels)

<u>Product</u>	<u>08/26/05</u>	<u>08/31/04</u>	<u>08/31/03</u>
Gasoline	59,353	60,305	62,370
Light Fuel Oil	29,932	27,125	25,655
Heavy Fuel Oil	4,292	4,228	4,172
Jet Fuel	11,623	11,410	11,165
Total (Wk)	105,200	103,068	103,362
Divided by 7 Days	15,028	14,725	14,766
Refinery Runs	16,110	16,275	15,571
Difference Amount	1,082	1,550	805

The difference amount between the refinery run totals and the product yield totals varies widely. These variances may be explained by additions to or subtractions from inventories, residuals that are sold as feed stocks to chemical plants, inventories held in process, refinery fuel that is burned, and/or other applications too minor to segregate and report. The total yield for gasoline and distillates is stable at about 85% of the total barrel that is refined. The ratio between the two products is allowed to vary depending upon seasonal needs and inventory levels that need replenishment. The variability of these yields is presented in Table 3(a).

Table 3(a): Product Yield Percentages

<u>Product</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Gasoline	56.5	58.5	60.3
Light Fuel Oil	28.5	26.3	24.9
Heavy Fuel Oil	3.8	4.1	4.0
Jet Fuel	11.2	11.1	10.8
Production	100.0	100.0	100.0

Table 4 sets forth the days' supply, presumably in the control of refiners, for the four major petroleum products:

Table 4: Days' Supply in Product Inventories

<u>Product</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Gasoline	3.32	3.49	3.12
Light Fuel Oil	4.44	4.59	4.78
Heavy Fuel Oil	7.82	8.06	7.92
Jet Fuel	3.44	3.40	3.37

The days' supply in inventory numbers are surprisingly low. In part, they explain why prices at wholesale and retail are highly volatile, and that prices are changed very frequently. At this point in time, our Firm does not possess data for inventory levels in the distribution and retail channels to make realistic assessments of their vulnerability to shortages.

There are some dramatic differences between 2003, 2004, and 2005 with respect to crude oil and product prices as shown in Table 5.

Table 5: Crude Oil and Product Price Levels

<u>Petroleum Product</u>	<u>Prices Expressed in Gallons</u>		
	<u>08/31/05</u>	<u>08/31/04</u>	<u>09/01/03</u>
NY Unleaded Non Oxygenated/Gal	\$2.8045	\$1.1803	\$0.8897
W.Texas Crude Oil 68.95 divided by 42 (05)	<u>1.6417</u>	---	
W.Texas Crude Oil 44.01 divided by 42		<u>1.0479</u>	
W.Texas Crude Oil 29.48 divided by 42			<u>0.7019</u>
Calculated Refiners' Spread	\$1.1628	\$0.1324	\$0.1878
Gasoline CARBOR/LA/gel	\$2.5750	\$1.3200	N.A.
Price Difference to NY Unleaded	\$-0.2295	\$+0.1397	N.A.

N.A. = Not Available

The data for 2003 and 2004 points toward a normal range in refiners' spreads per gallon of gasoline in the spot market of \$.10 to \$.20. The \$1.16 per gallon calculated spread indicates a major shortage somewhere in the system. The CARBOR/LA gasoline price per gallon of \$2.57 on 08/31/05 is 23 cents below New York's unleaded price, which is a reversal of normal market patterns, and this relationship tends to confirm that the shortages are likely to be in the Central and Eastern sections of our country.

Since Table 5 did not portray refiners' spreads for crude oil prices in the mid-\$50 per barrel range, a spot check was made of July 20, 2005, and July 20, 2004. prices. Crude oil was \$56.73 and \$40.83 per barrel respectively on those dates. Gasoline was priced at \$1.80 and \$1.45 per gallon. The refiner's spread was \$.0173 in 2005 and \$.1063 in 2004. The numbers show extreme volatility in profitability, and, it is likely that they do not reflect long-term supply contracts, reduced supplies, or the moving average prices for appropriate measurement periods that may be a month, a quarter, or a year.

The spot market prices for crude oil and petroleum products are valid for reaching decisions about replacement costs and for finding the means to fund depleted inventories. A perplexing question for the refining and marketing organizations: where do we find the cash to supply the gasoline volume units we normally sell at twice the price it cost us just two years ago? The corollary question is: how do we gather cash to pay all other operating expenses unrelated to petroleum inventories if our volume declined, perhaps 25%, as a result of shortages? The answer is to raise prices on the remaining lower volume of product inventories.

The retail price charged above the unleaded gasoline refiners' price carries about \$.40 per gallon in typical state, federal, and local gasoline taxes plus an additional \$.10-\$.20 per gallon for the pipeline, terminal delivery, and retail stations mark up. The \$3.30 per gallon price at our local gasoline station today actually may reflect a refinery selling price of about \$2.70 per gallon.

Americans go to work in their automobiles. A reliable, affordable supply of gasoline to permit employment and salary income streams to remain stable and grow over time is an economic imperative. The data in this letter shows that the affordable component of this equation has been shattered. Prices will come down as shortages are resolved, but the era of cheap crude oil is gone. Our forecast would be that a range of \$40-\$60 per barrel will prevail in the U.S. over the next five years.

Under these circumstances, consumer discretionary spending will be squeezed down, with adverse consequences for the automobile, hotel, transportation, and entertainment industries and their suppliers. Aggregate demand in the economy will be weakened, so that slower production growth and weaker earnings for cyclical companies are probable. The general level of wholesale and consumer goods prices will advance where competitive conditions are not extreme. Interest rates should go up with stronger inflationary trends, but such income yield opportunities for fixed income investors may not materialize due to economic recession tendencies and the existence of a huge pool of surplus dollars in the hands of major exporters of goods and petroleum to the United States.

In conclusion, the Hurricane Katrina experience can be highly constructive in the sense that American compassion, can-do attitude, creative energy, and vast human and financial resources are coordinated to establish new communities to replace those that have been destroyed. We could be even more hopeful if legislative and government administrators come together to encourage expanded local and national supply-oriented energy policies and an effective homeland security network.

Please contact me if you have questions or constructive comments about matters raised in this letter. I trust that the information herein sets forth a useful context for recent events and a sharp focus on the energy supply linchpin factor.

Sincerely,

Edson L. Bridges II  
President

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