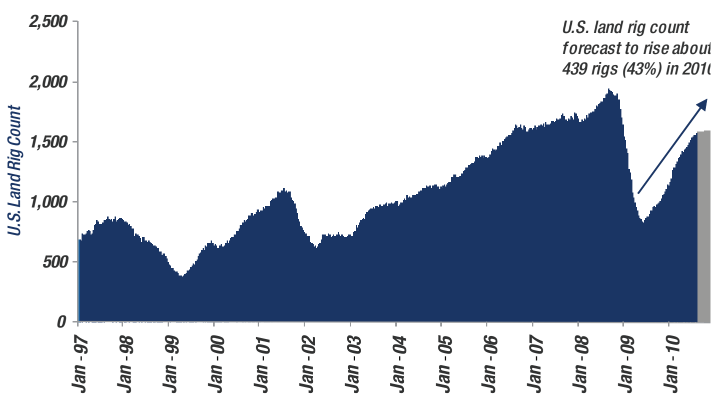
Increase Capital Spending By E&P Firms Has Led to a Strong Rise in U.S. Rig Demand

At the end of last year as initial drilling plans were being announced for 2010, we took a sampling of approximately 30 E&P firms to get a gauge of capital spending budgets and their likely impact on rig activity. Original plans of these sampled firms called for exploration and development budgets to increase ten percent in aggregate. Factoring in 2009 service cost declines, drilling efficiency gains, and our belief that commodity prices appeared sustainable; we surmised that U.S. land rig activity in 2010 would rise 20% on average or double the pace of proposed spending increases.

Six months later, recent earnings' reports from E&P firms paint a glowing picture in general for continued capital budget increases. However, service providers have raised prices, especially in the faster growing shale regions; as the availability of both equipment and labor has not been able to keep pace. Additionally, the growth of uncompleted wells is yielding way to an ever increasing backlog for cementation and stimulation service providers. Based on our re-sampling of budgeted capital spending plans following the second quarter; we found that the planned pace of spending now points to 27% budget growth in 2010. Across the 30 firms we tracked year to date, domestic land rig counts are also up 27%. According to Baker Hughes, the overall U.S. land rig count is 1640, up 38% YTD. We anticipate the rising service costs will eat away at a small portion of the growth trajectory for land rigs. Essentially suggesting that most of the rig count growth for 2010 is already behind us.

While the current momentum would suggest a gradual increase in rig demand over the remainder of the year, some discipline has begun to enter the market. This takes the form of delayed natural gas projects, which we believe will provide another slight offset to the pace of rig count improvement. On the whole, consensus remains centered on the view that the number of natural gas wells coming online this year is too high and is thus discouraging for natural gas prices. Proprietary forecasts prepared by our RigOutlook modeling team also project a continued rise in the U.S. land rig count over the remainder of 2010. Specifically, RigOutlook expects that the average annual 2010 rig count will be 1473, surpassing 2009's average of 1033 by 440 rigs or 42.5% year-to-year.

Historical & Projected U.S. Land Rig Count

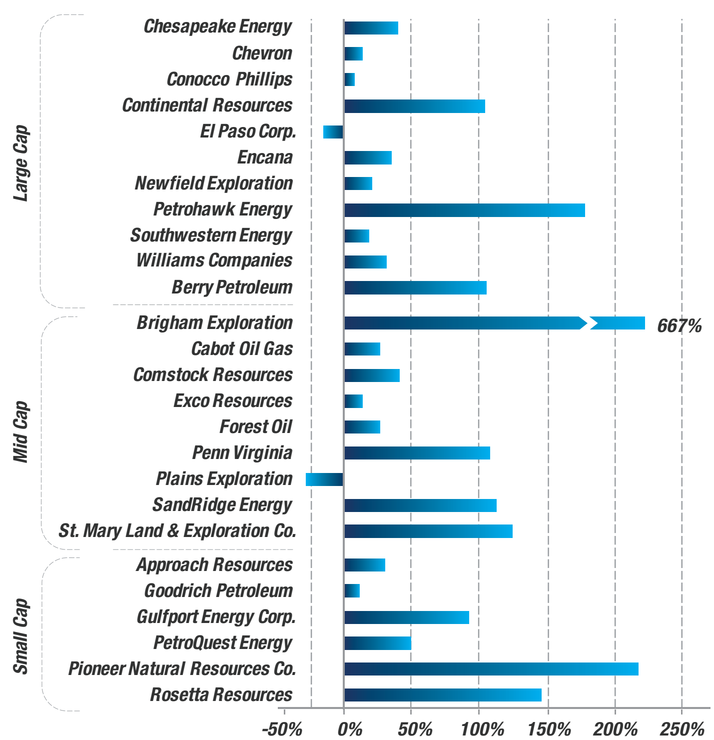


Source: Baker Hughes, RigOutlook

Where the CAPEX Dollars Are Going?

A vocal majority of E&P firms reiterated their intentions to shift more capital budgets to oil and NGL-rich plays. Not surprising to anyone considering that oil prices are trading at 17 times natural gas even though the energy equivalency ratio is more like six times. Furthermore, the conventional view that natural gas markets are oversupplied is another factor shaping some reallocation. Even with some instances of cutbacks to rig deployments on the natural gas side, as we previously mentioned; capex budgets are growing relative to 2009. Looking at our sample of small, mid, and large cap firms we see that the overwhelming majority are spending more this year than last.

U.S. E&P Budget Change: 2009-2010



Source: Baker Hughes, RigOutlook

After listening to several conference calls (hosted by E&P management teams' discussing their recent quarterly results and their outlooks for the remainder of the year), we compiled a few commentaries regarding the well economics for natural gas plays:

- *Exco Resources – Shut down rigs in four areas as gas prices dropped below $5, have no plans to return these rigs to work at current natural gas prices. They "...believe...that probably 80% of the gas drilling that's going on right now has a low rate of return...there's a lot of guys drilling for other than pure economics right now."*

- *SandRidge – Plans to reduce natural gas rig count from eight to five. Company could reduce their natural gas rig count further if prices warrant.*

- *Chesapeake – "Unless gas prices increase over $6 per MCF, Chesapeake is committed to continuing to reduce its gas drilling CapEx, increase its liquids drilling CapEx…"*

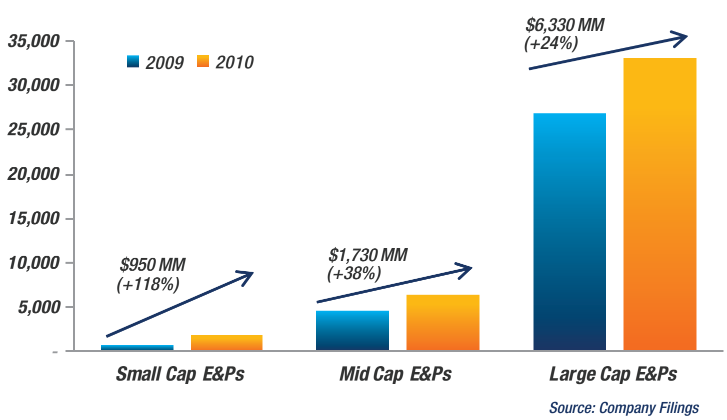
- *Newfield – "Apparently the need to hold acreage by production precedes economics and gas supply remains stubbornly high today."*

Over the long run we believe views expressed like those above will actually lead to an improvement in natural gas prices. In our opinion, this growing sentiment (i.e. that the returns on many gas wells are not sufficient) will likely cause a greater number of operators to drop gas rigs and ultimately serve as the correcting mechanism for the current gas oversupply.

Who Is Growing the Most?

In terms of increased capital spending, smaller firms are raising their budgets at four times the rate of the largest firms in the industry. At the root of this growth disparity phenomenon is the fact that drilling programs are inherently capital intensive. A secondary factor that also impacts smaller players to a greater level is that drilling and service cost are on the rise. Without the luxury that economies of scale afforded a larger operators; we believe that these rising costs, especially well completions, are causing smaller operators to increase its budgets in order to maintain the original targets.

U.S. E&P 2009/2010 Capital Budget Comparison By Operator Type



Speaking to service cost inflation, we have provided a summarized commentary of E&P management teams' discussing what is transpiring. The comments below were also taken from second quarter conference calls:

- *Cabot Oil & Gas – Speaking to the Haynesville/Bossier region, "we've seen cementing costs up 30%-35% and frac services costs up 50%-60% plus."*

- *El Paso – Pressure pumping and stimulation services are tight. Now expect drilling costs to be 5%-7% higher than originally anticipated.*

- *Exco Resources – Speaking about the Haynesville the company said that dayrates are averaging slightly above $20,000 and that frac-stimulation service costs are on the rise.*

- *PetroHawk – "Keep in mind that every year, there's a certain inventory of wells that have been drilled, but not yet completed at year end. This year, that inventory is a little larger because of the scarcity of these frac fleets and frac crews."*

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