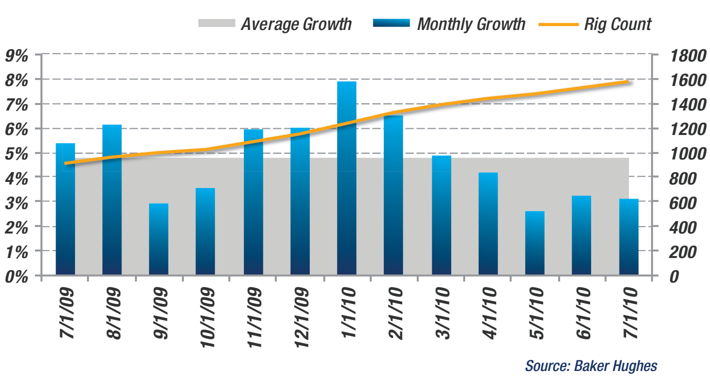
Increase Capital Spending By E&P Firms Has Led to a Strong Rise in U.S. Rig Demand

U.S. Land Rig Count Trends

The most recent average monthly U.S. land rig count increased sequentially to 1558 rigs in July (+3%). Since bottoming out during early June 2009, a steady upward trend has ensued with sequential growth averaging 5% from month to month. But over the past four months, while still growing, the pace of the U.S. land rig count has slowed to less than the average.

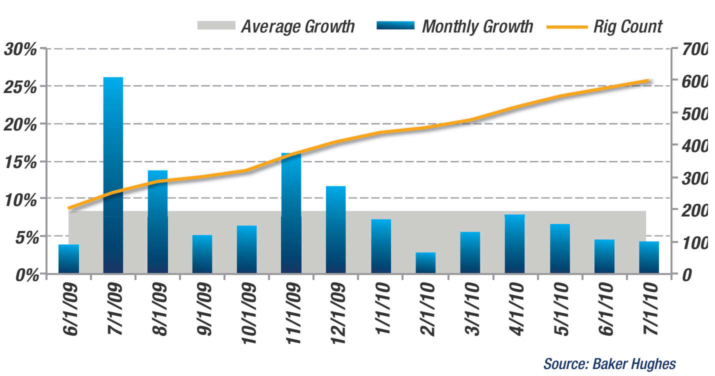
U.S. Land Rigs - Sequential Monthly Growth



Dynamics of the U.S. Oil Rigs

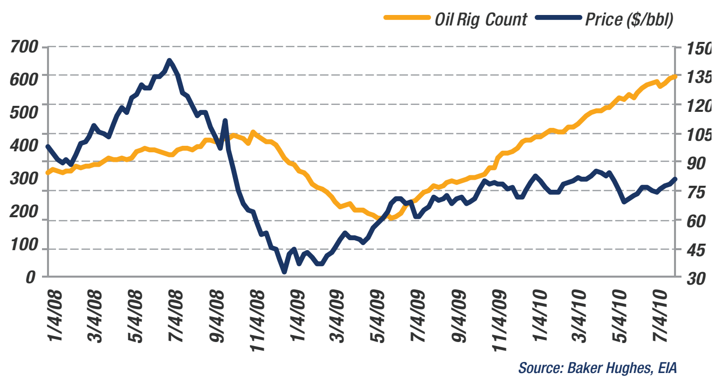
Stratified by the type of drilling; the majority of the solidly upward growth trend in the U.S. land rig count has come as a direct result of more activity in oil-rich regions. In fact, although oil prices are off 43% from the high of 2008, oil directed activities as measured by rig count are up 38% from the last peak in November 2008. Historically, the last time rigs drilling for oil in the U.S. mirrored current levels was 1998. On a month-to-month basis, the oil rig count is averaging a growth rate of 9% while the number of rigs drilling for natural gas is growing at a sequential rate of 5%.

U.S. Oil Rigs - Sequential Monthly Growth



We have previously expressed the opinion that sustainable crude oil prices at +$60/bbl yields an environment that promotes domestic drilling activities for oil. Although lagging commodity prices by a few months, we note that a comparison between U.S. oil rig count and WTI spot prices provides some credence for this opinion. WTI spot prices have averaged over $75/bbl year-to-date and the U.S. oil rig count has risen steadily over this timeframe. Currently the U.S. oil rig count stands at 611.

U.S. Oil Rig Count & Prices

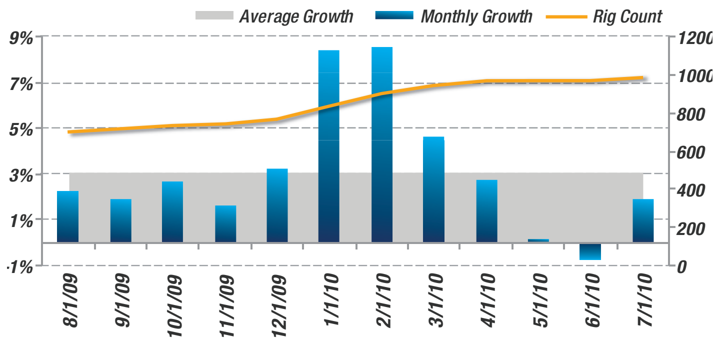


Looking back to when oil hit its peak (nearly $150 in early July 2008), the U.S. oil rig count continued to climb until November reaching a peak of 442 rigs. In the subsequent months the U.S. oil rig count declined by 60%, hitting its trough during the summer of 2009. Although oil prices have only appreciated 18% since the oil rig count troughed, we believe the current perception that prices are sustainable going forward is providing investors with the necessary enticements for activity levels to continue upward.

Dynamics of the U.S. Natural Gas Rigs

The average monthly natural gas rig count recently established a 17-month high at 971 rigs in July. This is still below 39% below the peak count set back in September 2008. Since bottoming out in July 2009, the natural gas rig count has averaged sequential monthly improvements of 3%. From a growth stand-point the best months occurred at the beginning of the year. While July's growth of 2% is encouraging considering it stalled in May and proceeded to drop slightly in June, this surge may be more related to reallocating assets due to the drilling ban in the GOM in order to hold productions levels than a signal of increased activity over the remainder of 2010.

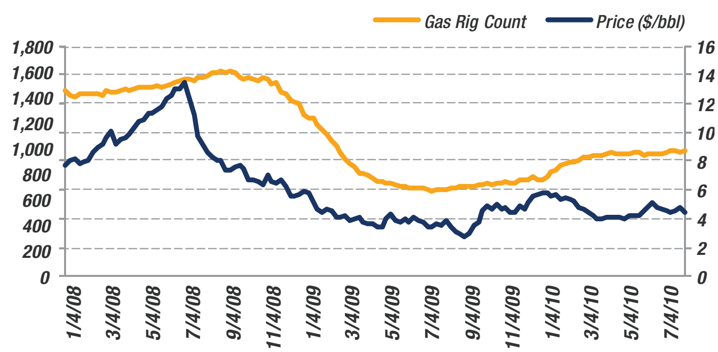
U.S. Nat. Gas Rigs - Sequential Monthly Growth



Source: Baker Hughes

The front month natural gas futures have declined 12% in the month of August alone (as of August 13th close). In addition to unfavorable near-term commodity price trends, the overall sentiment for natural gas remains weak with the combination of strong production and high storage levels seen as the primary factor discouraging pricing on the horizon.

U.S. Nat Gas Rig Count & Prices



Source: Baker Hughes, EIA

To find the silver lining in this dark cloud, we note that some operators are voting with their checkbooks. These operators have been showing less appetite for hedging future production and in some cases are closing out existing positions. We note that most recently Sandridge's management indicated that they had closed their 2010 natural gas hedges. While likely driven more by cash flow management strategy, we doubt that management would have closed out their positions if they thought futures would drop significantly. Their decision to sell suggests that the bottom for natural gas prices is near.

Although we expect both U.S. oil and natural gas rig counts to climb over the remainder of the year, the trajectory of growth is clearly starting to flatten out. Based on fundamentals, we would anticipate that an industry-wide decision to lay down rigs will first occur in the natural gas industry and that the risks to this occurrence are rising daily. For oil rig counts to drop we would need to see a resounding drop in crude prices like what occurred in 2008. So far futures prices are signaling continued stability in oil prices over the next twelve months.