

## INDUSTRY REPORT: ENERGY

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OIL & GAS OPERATIONS, OIL WELL SERVICES & EQUIPMENT, OIL & GAS - INTEGRATED

### Oil and Gas Prices Continue to Present a Volatile Environment

Fluctuating commodity prices are presenting challenges for oil and gas companies. Factors such as militant attacks in Nigeria, tensions between Israel and Iran, and renewed credit fears pushing investors into oil futures, have helped push crude oil prices into higher territory. But other events, including a strengthening dollar, slowing global growth and weakening domestic demand, rising natural gas reserves, and Gustav largely sparing the Gulf of Mexico's offshore infrastructure, have all recently impacted oil and gas prices downward. It's difficult to predict which set of market forces will prevail in the longer run, but meanwhile, upstream oil and gas companies will have to manage in this constantly changing environment. Here's how the different segments of the energy sector are faring:

- **Exploration & Production**

Exploration & Production (E&P) companies have been generating record-high profits, as they benefit from crude oil prices that have averaged slightly less than \$125 a barrel in the quarter, 25% higher than the previous quarter and nearly double prices from the previous year. However, some recent market indications point to a reverse trend with potential price softening, and E&P companies may not be able to enjoy such high levels of profits indefinitely. This week, NYMEX's oil futures price dropped to a low of \$109.71 a barrel, the lowest close in nearly five months and down 25% from a current year high of \$145 in July.

Analyst expectations are that U.S. oil demand will continue drop this year and next year, in response to the heavy toll high prices have taken on the economy. With the exception of China, India, and other developing countries, global oil demand is also anticipated to slow in European countries as well, due to their corresponding economic slowdown. In addition, commercial oil inventories, as reported by the Energy Department's Energy Information Administration, have shown a recent buildup in crude stocks. U.S. commercial crude oil inventories (excluding those in the Strategic Petroleum Reserve) were at 305.9 million barrels last week, increased by 9.4 million barrels from the previous week. The U.S. Dollar, the weakness of which had been boosting oil prices earlier this year, has showed signs of strength as well, rising to a seven-month high against the euro. Last month, the US Dollar index closed just above its 200-day moving average for the first time since October 2006, and also just above its high from mid-June.

Drilling and production costs, which have more than doubled in recent years, also could hurt margins and restrict production growth. Offshore rigs, in particular, are in short supply, with reports of deepwater floats being 100% committed through 2009-2011 and with day rates now reaching over \$600,000.

With profits being driven primarily by rising oil prices, a sustained and significant fall in oil prices would hurt most exploration and production companies. Among the top five oil companies, declines in production volumes of oil and gas are being reported, which is following a decade of underinvestment in the 1990s while plowing profits into stock buybacks. A shrinking influence globally is evident with their struggle against foreign state-owned oil companies, which is further undermining their ability to increase production.

- **Natural Gas Producers**

Natural gas producers have been enjoying rising natural gas prices, buoyed by gains in crude oil prices and low imports of liquefied natural gas (LNG) imports. In contrast with oil production, however, domestic natural gas production this year has been rising, with new horizontal drill technology for shale rock resulting in much more substantial output than the previous vertical well technology. This increased production, in combination with anticipation of increased liquefied natural gas (LNG) imports, have led to a sharp drop in NYMEX natural gas futures prices most recently. After reaching a high of \$13.57 per million BTUs in early July 2008, average natural gas futures prices have since dropped 13% in the current quarter to date.

In addition, last week the Energy Department's Energy Information Administration said the Lower 48 States natural gas storage rose beyond analysts' expectations, up 102 billion cubic feet to about 2.76 trillion cubic feet. Shares of gas-related companies fell accordingly. With domestic output on track to increase 8% this year, the highest growth rate in four decades, and expectation that LNG imports will rise, it is possible that natural-gas prices could weaken further.

- **Drillers**

Drillers are also benefiting from the record high oil and gas prices, with increased day rates and fleet utilization levels. They also are experiencing significant increases in production costs though, primarily for steel, the price of which has risen 60 to 70 percent in the past 12 months, and labor, the supply of which is extremely tight.

- **Refiners**

Refiners have been hit hard by the narrowing spread between purchased crude oil and refined product sales, otherwise known as the crack spread. Although the price of crude oil has skyrocketed, the price of refined products has not risen proportionately, and refiners have struggled to pass the higher crude prices to their customers. While crude oil prices have increased nearly double from a year earlier, gasoline prices rose only 25 percent during that same period. Production margins have plummeted accordingly and share values have dropped by as much as a third or more.

Some companies inevitably handle market turmoil more transparently and responsibly than others, which ultimately will affect equity returns. Audit Integrity's Accounting and Governance Risk (AGR®) and Equity Factor (EQF) models are able to identify these companies that are at both ends of the risk spectrum. Our quantitative models utilize forensic analysis of accounting practices and corporate governance practices. Revenue recognition, expense recognition, and asset-liability valuation, in combination with corporate governance and high-risk events, have verifiable value in differentiation between the relative risks of companies. Companies which are forthcoming to their stakeholders will consistently have full and accurate disclosure of their financial position, with proper accounting treatment and governance practices, and are able to produce positive returns. In contrast, companies which have misled stakeholders with obfuscation and aggressive accounting and corporate governance are putting investors at substantial risk, and can result in negative returns. Notwithstanding the current market stresses, our AGR and EQF models are effectual in either the presence or absence of strained economic conditions.

Below, Audit Integrity presents the top-ranked and bottom-ranked groups of companies as of Q2 2008, based on AGR ratings and Equity Factor rankings. Companies in the top-ranked Conservative AGR category with the highest Equity Factor ranking of "5" have had consistently transparent financial reporting, strong corporate governance, and as a group are expected to surpass the market over the next 3 months on a total return basis. Conversely, companies in the bottom-ranked Very Aggressive AGR category with the lowest Equity Factor ranking of "1" have had consistently opaque financial reporting, weak corporate governance, and as a group are expected to have returns inferior to the market over the next 3 months on a total return basis.

For 1-year returns, companies in the top-ranked Conservative AGR and Equity Factor 5 category have been 23.8%. Companies in the bottom-ranked Very Aggressive AGR and Equity Factor 1 categories have been -13.0%. In addition to this current demarcation in returns, we expect continued lower returns from the Very Aggressive AGR category, in contrast with their higher ranked Conservative peers.

#### Highest Ranked by AGR Rating

| Company                        | Ticker | Industry                      | Market Cap(\$m) | Period Ending | AGR Rating   | AGR Score | Financial Condition | Models |     |      | 1-year return |
|--------------------------------|--------|-------------------------------|-----------------|---------------|--------------|-----------|---------------------|--------|-----|------|---------------|
|                                |        |                               |                 |               |              |           |                     | EQ     | LIT | REST |               |
| Enterprise GP Holdings L.P.    | EPE    | Oil & Gas Operations          | 3,889           | 6/30/2008     | Conservative | 88        | Average             | 5      | 4   | 4    | -19.8%        |
| Opti Canada Inc.               | OPC    | Oil Well Services & Equipment | 3,210           | 6/30/2008     | Conservative | 88        | Average             | 5      | 3   | 4    | -3.5%         |
| Concho Resources Inc.          | CXO    | Oil & Gas Operations          | 2,475           | 6/30/2008     | Conservative | 81        | Average             | 5      | 2   | 4    | 154.3%        |
| UTS Energy Corporation         | UTS    | Oil & Gas Operations          | 1,792           | 6/30/2008     | Conservative | 88        | Weak                | 5      | 3   | 5    | -21.2%        |
| RPC, Inc.                      | RES    | Oil Well Services & Equipment | 1,708           | 6/30/2008     | Conservative | 81        | Strong              | 5      | 3   | 4    | 45.1%         |
| Advantage Energy Income Fund   | AVN.UN | Oil & Gas Operations          | 1,482           | 6/30/2008     | Conservative | 88        | Average             | 5      | 4   | 4    | 12.8%         |
| Sunoco Logistics Partners L.P. | SXL    | Oil Well Services & Equipment | 1,337           | 6/30/2008     | Conservative | 83        | Average             | 5      | 3   | 4    | -0.7%         |

Average Return = **23.8%**

#### Lowest Ranked by AGR Rating

| Company                       | Ticker | Industry                      | Market Cap(\$m) | Period Ending | AGR Rating      | AGR Score | Financial Condition | Models |     |      | 1-year return |
|-------------------------------|--------|-------------------------------|-----------------|---------------|-----------------|-----------|---------------------|--------|-----|------|---------------|
|                               |        |                               |                 |               |                 |           |                     | EQ     | LIT | REST |               |
| Transocean Inc.               | RIG    | Oil Well Services & Equipment | 39,528          | 6/30/2008     | Very Aggressive | 12        | Average             | 1      | 1   | 1    | 29.7%         |
| Chesapeake Energy Corporation | CHK    | Oil & Gas Operations          | 26,016          | 3/31/2008     | Very Aggressive | 30        | Average             | 1      | 2   | 1    | 55.4%         |
| Linn Energy, LLC              | LINE   | Oil & Gas Operations          | 2,359           | 6/30/2008     | Very Aggressive | 21        | Weak                | 1      | 2   | 1    | -29.7%        |
| Hercules Offshore, Inc.       | HERO   | Oil Well Services & Equipment | 1,840           | 6/30/2008     | Very Aggressive | 20        | Average             | 1      | 1   | 1    | -13.7%        |
| Holly Energy Partners, L.P.   | HEP    | Oil Well Services & Equipment | 496             | 6/30/2008     | Very Aggressive | 16        | Weak                | 1      | 2   | 2    | -19.8%        |
| Trico Marine Services Inc     | TRMA   | Oil Well Services & Equipment | 374             | 6/30/2008     | Very Aggressive | 23        | Weak                | 1      | 2   | 3    | -23.3%        |
| Cheniere Energy, Inc.         | LNG    | Oil Well Services & Equipment | 252             | 6/30/2008     | Very Aggressive | 21        | Weak                | 1      | 3   | 2    | -89.5%        |

Average Return = **-13.0%**

## LOWEST RANKED COMPANIES BY AGR RATING

### **Transocean Inc. (RIG)**

Offshore driller Transocean Inc. reported that its second quarter net income nearly doubled to \$1 billion, boosted by last year's acquisition of competitor GlobalSantaFe Corp. and exceeding analysts' expectations. For the three months ended June 30, Houston-based Transocean reported earnings of \$1.1 billion, or \$3.45 per share, compared with earnings per share of \$549 million, or \$2.63 per share, in last year's second quarter.

#### **Red Flags**

Asset Turnover  
 Deferred Income Tax Assets Current over Operating Expenses  
 Ratio of CEO to CFO Total Compensation  
 Officer Number of Changes, Trailing 12 Mths  
 Goodwill over Total Assets

### **Chesapeake Energy (CHK)**

Independent natural-gas producer Chesapeake Energy reported a net loss in the quarter of \$1.6 billion, or \$3.17 per share, compared with a profit of \$492 million, or \$1.01 per share, in the same period a year earlier. The latest results include a \$2.06 billion mark-to-market loss on energy and interest rate hedges triggered by sharply higher gas and oil prices. Excluding one-time items, the company earned \$479 million, or 89 cents a share.

#### **Red Flags**

Asset Turnover  
 Deferred Income Tax Assets Current over Operating Expenses  
 Ratio of CEO to CFO Total Compensation  
 Board Chairman is also CEO  
 Depreciation Expense over Property, Plant and Equipment

### **Linn Energy, LLC (LINE)**

Independent oil and gas company Linn Energy LLC reported a second-quarter loss that nearly tripled from a year ago on a significantly higher loss on oil and gas derivatives. The company reported a net loss of \$725.4 million, or \$6.35 per share, in the second quarter of 2007 compared to a loss of \$259 million, or \$2.28 per share, in the second quarter of 2007. Linn Energy said that when excluding one-time items, its 2008 second-quarter net income would have been \$80.4 million, or 70 cents per share, beating analysts' expectations.

#### **Red Flags**

Ratio of CEO to CFO Total Compensation  
 Officer Number of Changes, Trailing 12 Mths  
 Board Chairman is also CEO  
 Depreciation Expense over Property, Plant and Equipment  
 Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO

### **Hercules Offshore (HERO)**

Offshore driller Hercules Offshore reported second-quarter profit below analysts' estimates, hurt by a steep escalation in costs and expenses. For the second-quarter, Hercules reported net income of \$16.4 million, or 18 cents a share, compared with \$23.5 million, or 72 cents a share, a year ago. For the quarter, the company's costs and expenses rose 249 percent to \$230.1 million. Costs and expenses as a percentage of revenue rose to 85 percent from 67 percent, a year ago.

#### **Red Flags**

Goodwill over Total Assets  
 Asset Turnover  
 Depreciation Expense over Property, Plant and Equipment  
 Officer Number of Changes, Trailing 12 Mths  
 Prepaid Expenses over Operating Expenses

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**LOWEST RANKED COMPANIES BY AGR RATING cont'd.****Holly Corporation (HOC)**

Independent refiner Holly Corporation posted a 92 percent decline in its quarterly profit, missing analysts' average estimate, hurt by high crude oil prices and lower production due to unplanned outages at its refineries. The company's net income for the second quarter fell to \$11.5 million, or 23 cents a share, from \$158.6 million, or \$2.84 a share, a year ago. Holly said its refinery production level decreased 15 percent from last year.

**Red Flags**

Depreciation Expense over Property, Plant and Equipment  
Ratio of CEO to CFO Total Compensation  
Board Chairman is also CEO  
Corporate Number of Share Repurchases, Trailing 12 Mths  
Asset Turnover

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**Trico Marine Services Inc (TRMA)**

Provider of marine support vessels and services Trico Marine Services Inc reported a net loss for the second quarter of 2008, which includes the effect of the approximate \$690 million acquisition of DeepOcean and CTC Marine. On a consolidated basis, giving effect only to the portion of the second quarter during which Trico owned DeepOcean and CTC Marine, the Company reported a quarterly net loss of \$3.0 million, or \$0.20 loss per share (diluted), after giving effect to non-cash charges totaling \$4.0 million, net of taxes, or \$0.27 earnings per share (diluted). Net income without the effect of non-cash charges would have been \$1.0 million or \$0.07 earnings per share (diluted).

**Red Flags**

Ratio of CEO to CFO Total Compensation  
Depreciation Expense over Property, Plant and Equipment  
Board Chairman is also CEO  
Corporate Number of Share Repurchases, Trailing 12 Mths  
Accounts Receivable over Sales

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**Cheniere Energy, Inc. (LNG)**

Originally an oil and gas exploration company, but now a developer and owner of LNG terminals, Cheniere Energy, Inc. reported a net loss for the second quarter of 2008. Its net loss of \$132.3 million, or \$2.81 per share (basic and diluted), was more than triple for the second quarter of 2008 compared with a net loss of \$41.1 million, or \$0.76 per share (basic and diluted), during the corresponding period in 2007. Not including the impact of restructuring charges in the second quarter of 2008 associated with the previously announced downsizing of natural gas marketing and corporate operations and cancellation of two ship charters, the net loss would have been \$53.7 million.

**Red Flags**

Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO  
Board Chairman is also CEO  
Corporate Number of Share Repurchases, Trailing 12 Mths  
Accounts Receivable over Sales  
Prepaid Expenses over Operating Expenses

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### **The Audit Integrity Accounting & Governance Risk (AGR®) Model**

*Audit Integrity is the leading provider of accounting and governance risk analysis on public companies. Through the forensic study of the factors behind fraud, Audit Integrity proprietary modeling effectively detects and measures fraud and transparency-related risks in approximately 8,000 publicly traded corporations.*

*The proprietary Accounting & Governance Risk (AGR) rating is a measure of corporate integrity based on forensic accounting and corporate governance metrics, and is an indicator of aggressive corporate behavior which can put stakeholders at risk. The AGR Score is based on a quantitative model which weights specific accounting and governance metrics derived from corporate reporting. The score ranges from 0 to 100, with lower scores indicating higher risk.*

*The AGR Equity Factor (EQF) is based solely on the AGR score, plus additional variables related to AGR persistence and volatility, to provide a better measure of equity risk than the AGR on a stand-alone basis. Extensive research has shown a clear relationship between Audit Integrity's primary risk measure, the AGR rating, and equity returns. Consistently, the lowest-rated companies underperform the market and highest-rated companies outperform. The results are consistent with prior research showing that corporate integrity, as measured by the AGR rating, is a significant factor in equity returns, with low correlation to other factors.*

*To validate the AGR Equity Factor, the model was back-tested over the time period of 1998-2007. Key findings include large and persistent equity returns spread between the highest and lowest-rated companies, with a 17.5% spread between the best and worst decile over the prior 10 years. From a quantitative modeling standpoint, the Equity Factor provides risk-adjusted, well behaved returns, as validated through key statistical measures.*



**Audit Integrity Client Services**

**Phone: (877) 880-8820**

**Email: [support@auditintegrity.com](mailto:support@auditintegrity.com)**

**Website: [www.auditintegrity.com](http://www.auditintegrity.com)**

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