



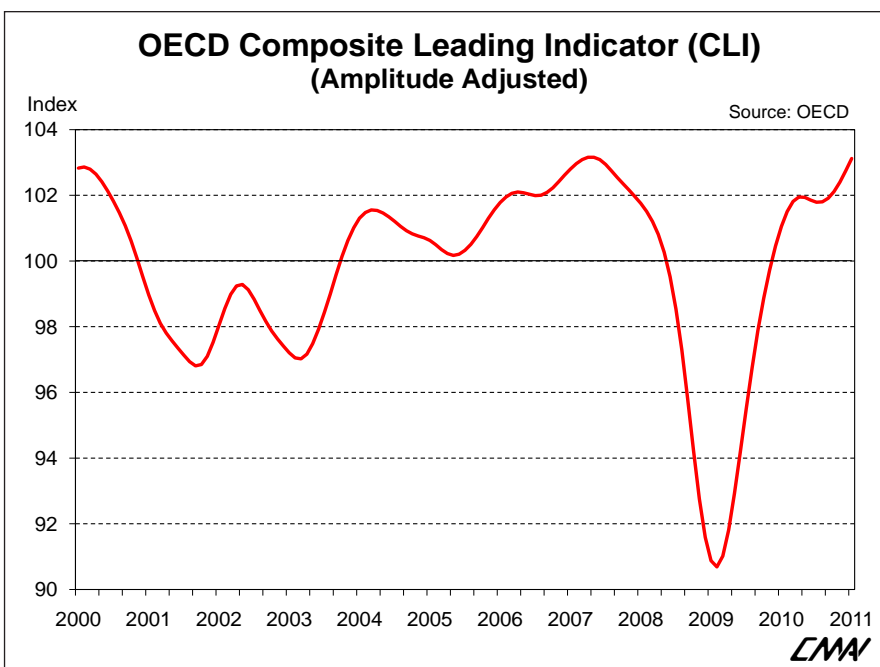
**THE WORLD ECONOMY**

Very little has changed over the course of the last month with regards to fundamental economic activity. However, there appears to be a growing divide between this activity and perceptions of risk around the world. Tensions have increased in the Middle East & North Africa along with an escalation of violence. An earthquake in Japan has spooked the markets even further. However, there remains little evidence that underlying trend growth has changed course from just a few weeks ago. Thus, while the risks have certainly continued to mount and we continue to monitor events, we will resist the temptation to adjust the core forecast at this time. This issue will be devoted to reexamining fundamentals as well as reassessing the current risks to the forecast.

*The Growth Story*

The global economy finished 2010 with near four percent growth and this year is heading in the direction of about 3.5 percent. However, in spite of this consolidation, fundamentals continue to reflect a strengthening economy, not a weakening one. It's against this backdrop of improving performance that persistent uncertainties have established themselves and call into question the trend rate of growth. We will examine underlying conditions in each major region of the world and then turn to the risks and their potential impact on global GDP.

It is difficult to open a newspaper or turn on the television today without hearing the latest nuanced development in the fight to contain the various radiation leaks at the Fukushima Daiichi nuclear plant or the latest events and efforts in the Middle East & North African region. In fact, this excessive transparency tends to dilute our attention making it difficult to discern economic trends from market gyrations. However, it is helpful to take a broader view and abstract from the present risks for a moment to better understand where the economy is heading.



The first region we will examine is North America. The U.S. and Canada have experienced slightly different recoveries since the last recession, with Canada outperforming the U.S. economy on several fronts. Some of the underlying reasons for this outperformance stem from Canada's milder recession experience relative to its Southern neighbor. Housing activity was not nearly as damaged in Canada and much of the industrial sector also withstood the worst of the decline. Canada also benefited from rising commodity prices and its trade ties to the swiftly recovering Asian markets. Today, one could say that Canada didn't fall as far into recession as the U.S. and therefore had less ground to recover afterwards. This has left Canada in a position of relative strength and has even induced its central bank to begin the rate increase cycle. Housing markets in Canada are more robust than in the U.S. and sectors such as business investment, consumer spending and job growth are all moving strongly upwards.

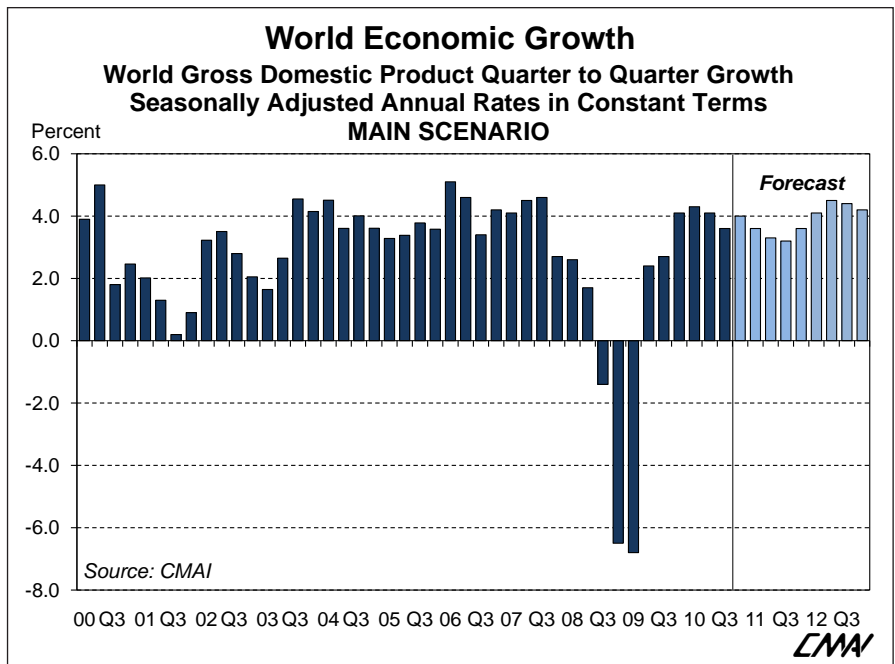
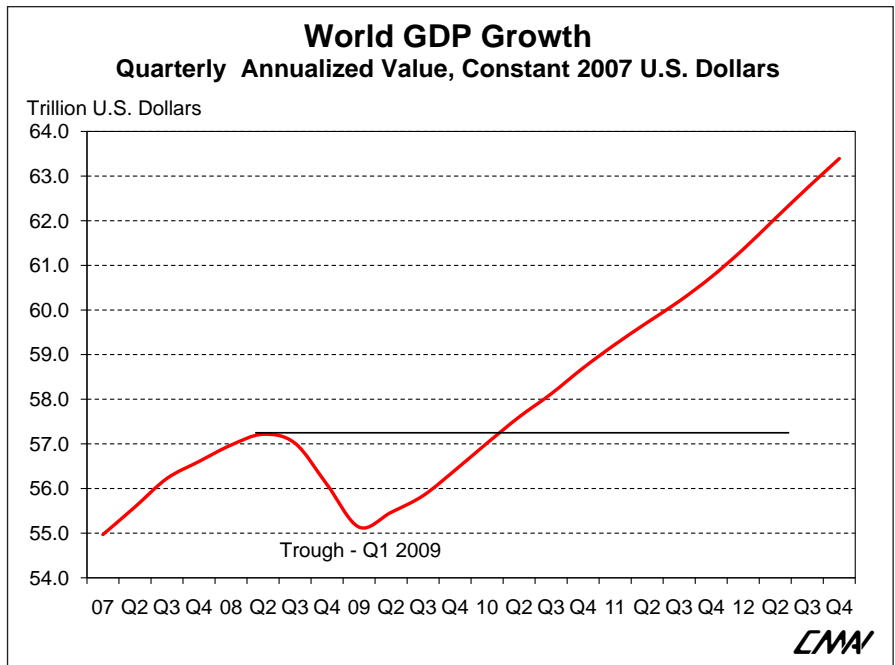
Activity in the U.S. only began to gain traction towards the end of last year. Until that point, employment and income growth had been minimal and perceptions about the economy were generally muted with much of the blame being cast on regulatory and state and federal budget concerns as the primary cause of the slow economic recovery. However, those uncertainties are fading into the background leaving stronger fundamentals in control. In fact, the environment needed to support growth is in place, from accommodative interest rates to profitable businesses to consumers that are spending.

The business community has used this recession to clean up the balance sheet and squeeze every last ounce of fat from the bottom line. Cost cutting has dramatically improved productivity and profitability. Layoffs, plant closures, renegotiated contracts, salary cuts and freezes have all played a part in this painful story. Today, unit labor costs in the U.S. are well below their pre-recession levels at the same time that wages have continued to climb in many of its main trading partners, namely China. Consequently, the decision of where to place new capital and labor investment is not as cut and dried as it was a just few years ago. Production is moving from higher to lower wage economies. On the one hand, the U.S.

is receiving this benefit from European manufacturers, and on the other hand, U.S. manufacturing is not moving to Asia as fast as it once did. Some are choosing to stay in the U.S. and some are going across the border to Mexico's Maquiladora plants.

Likewise, sentiment at the CEO level in the U.S. has continued to rise in spite of the seeming increase in global risks. Capital expenditures are also rebounding which is a precursor to stronger employment growth. Combined with improvements in consumer spending, fundamentals in North America are pointing almost uniformly in a positive direction. Our expectations call for an average growth rate this year of around 3.2 percent, accelerating to roughly 3.7 percent in 2012.

Europe as a whole is lower on the growth curve than North America; however, in the aggregate it is moving slowly in the right direction. Much of the reason for slower growth on the continent stems from structural



issues that were uncovered last year by the rolling financial crisis that claimed both Greece and Ireland. The stabilization fund created after Ireland's collapse is supposed to prevent such an event in the future and calm financial markets in the mean time. But the Europeans still need time to work through the details. That was the expectation for much of this year, leaving the Eurozone area with an average growth rate just above one and a half percent through December.

This scenario was called into question last week when the Prime Minister of Portugal resigned after his party's budget proposals, including the fourth round of government spending cuts, was rejected by the country's parliament. While it is too early to tell whether Portugal will end up in the same situation as Greece and Ireland, the risks are rising dramatically. The direct impact of a debt failure or a debt restructuring by Portugal would be marginal given the country's economic size; however, the impact on finance markets, uncertainty and average borrowing costs would lead us to reduce our expected growth rate for the region.

Growth in Asia will be impacted by events in Japan relative to its supply chain connection and trade patterns. Thus certain Southeast Asian countries will experience the effects of the earthquake much harder and sooner than others. Australia and the Philippines fall into this category. On the other end of the spectrum, South Korea will experience relatively little overflow from Japan. Thus, in a sense, Asia could be viewed in a bifurcated manner, with several countries continuing to outperform the world averages and others experiencing the drag of reduced demand and trade from Japan. This has caused us to shave a few tenths of a percent off of the Asian region's average growth rate this year, but it was added to the following year to reflect the increase we will see once Japan enters its full rebuilding mode. Outside of this event, growth in the region remains on the same track it was on over the past several months.

*Risks are Rising*

The earthquake, tsunami and subsequent nuclear disaster in Japan are the latest events to grip our attention and raise uncertainty about the global economy. It remains to be seen just how strong an impact this event will have on the global economy and that of Japan; however, it is still important to assess. On one hand, there is a direct impact on the Japanese economy and a spillover effect to global GDP through the supply chain, financial market gyrations and changing energy demand. On the other hand, there is a tremendous impact simply through the increase in uncertainty. We will examine both of these avenues.

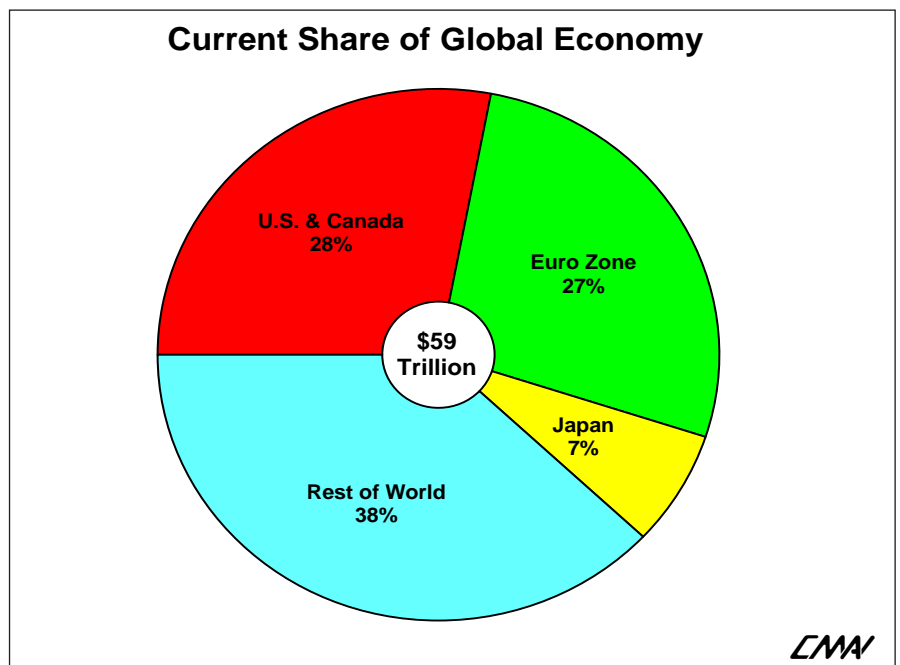
<b>MAIN FORECAST</b>				
	<b>WORLD</b>		<b>U.S.</b>	
	Billions of 2007 Dollars		Billions of 2005 Dollars	
2009				
I	55133.4	-6.8%	12832.6	-4.9%
II	55464.2	2.4%	12810.0	-0.7%
III	55838.6	2.7%	12860.8	1.6%
IV	56410.9	4.1%	13019.0	5.0%
AVG	55711.8	-2.0%	12880.6	-2.6%
2010				
I	57017.3	4.3%	13138.8	3.7%
II	57601.7	4.1%	13194.9	1.7%
III	58120.2	3.6%	13278.5	2.6%
IV	58701.4	4.0%	13380.7	3.1%
AVG	57860.2	3.9%	13248.2	2.9%
2011				
I	59229.7	3.6%	13494.7	3.4%
II	59718.3	3.3%	13594.5	3.0%
III	60196.1	3.2%	13710.7	3.4%
IV	60737.8	3.6%	13828.9	3.4%
AVG	59970.5	3.6%	13657.2	3.1%
2012				
I	61360.4	4.1%	13967.5	4.0%
II	62050.7	4.5%	14093.9	3.6%
III	62733.3	4.4%	14231.3	3.9%
IV	63392.0	4.2%	14365.0	3.8%
AVG	62384.1	4.0%	14164.4	3.7%

Source: CMAI; except U.S. data as revised through 4Q10 by U.S. Government on 03-25-11

First, it is important to acknowledge that the loss of life is by far the greatest toll of this tragedy. The psychological damage that accompanies this type of event is tremendous in its ability to disrupt personal lives and cultural traditions. However, the Japanese are a resilient people and they will rebuild. In fact, they will rebuild their infrastructure and economy long before the psychological damage is healed.

From an economic perspective, we must first put Japan's performance into context. For several decades Japan has been the second largest economy in the world, eclipsed only last year by China. As such, it is an integral part of the global supply chain and source of demand for much of the world's output. However, structural problems have meant that Japan has grown only sluggishly for two decades. The result of this change in trend growth has two consequences. First the Japanese economy is shrinking in relative size to the rest of the world. At its peak, Japan represented nearly 11 percent of the entire world economy, second only to the U.S. which has represented about 25 percent evenly since the middle part of the last century. Today, Japan has shrunk in relative size to about 7 percent of the world and is moving swiftly in the direction of 6 percent. The second consequence of slow growth is the relative importance of that growth in the world. If the Japanese economy is not growing, then world growth will not miss an absent Japan. Said another way, China is growing at a rate of nearly 10 percent per year. If they suddenly stopped growing, the world economy would feel that impact immediately. In the case of Japan, there will effectively be no growth impact on the global economy. The sole impact will come through the existing supply chain.

Inside the country, the economy will experience severe recessionary forces over the next 90 days or so as people's attentions are focused on recovery, assessment and containment of the existing tragedy. However, this period will be followed by strong stimulus related growth as the full spending power of the Japanese government and other governments and aid agencies comes to bear on this effort. Consequently, we can easily expect a percent or two boost to GDP over the following four to six quarters as construction spending spreads through the economy. Thus, our mid-term expectations for Japan are actually improved based on this event.



However, this expectation is based on an assumption of no long term lasting impact from the nuclear disaster. If this is not the case, then downside risks must increase dramatically. The spectrum of possibilities would range from local contamination to widespread damage as far away as Tokyo. In this case, the initial recovery period would extend beyond the initial 90 days or so as the full impact of the nuclear disaster is absorbed. At this point, the impact on the global economy would also need to be reassessed.

The spread of this event through the global economy is already occurring through the existing supply chain and through financial market gyrations. General Motors has already announced plant closures as has Toyota USA, Honda, Nissan and Subaru. Japanese chemical capacity as a percentage of Asian capacity ranges in the 60 percent to 80 percent category for products such as butyl rubber, acetaldehyde and polychloroprene and significant proportions of products such as high purity isobutylene, metaxylene and EDC among others. This is impacting production in several sectors such as medical equipment, cell phones and even the popular iPad.

The primary trade impact is falling on several Southeast Asian countries with the direct impact to the U.S. and Europe very small outside of the automotive sector.

The impact on oil and natural gas markets will be positive in demand and price. We estimate that roughly 10 percent of electricity generation was impacted by the nuclear crisis either in terms of direct shutdowns or precautionary shutdowns. This effect will erode with time as healthy reactors are brought on line again, but the debate about nuclear power will increase and undoubtedly create greater demand for fossil fuels. The current Japanese refining infrastructure should generally be able to handle marginal increases to demand since operating rates across the country were not high. We expect near term and medium term increases to both oil based and natural gas based imports. If the net economic impact to global growth is negligible, then this chain of events should create a marginal increase in oil demand.

Possibly more important than the supply chain effects is that of rising uncertainty. The global economy has been emerging from a painfully slow recovery and moving into an expansion cycle. The recovery has been hampered by tremendous uncertainty in various areas such as regulatory debate, budget and debt questions at the sovereign level and slow employment growth in much of the industrialized world and financial distress in several European countries. While these issues are slowly unwinding, which is allowing the stronger economic fundamentals to take over, events in Japan will tend to slow that transition process stunting growth during the first part of the year.

Finally, if the medium term impact to economic growth is positive for Japan, the long run story doesn't change. Japan remains in a position of structural weakness and slow growth and nothing about this tragedy has yet changed those factors. Until Japan changes its spending patterns and lowers its debt to GDP ratio, it will be destined to slow growth.

Tensions in the Middle East & North Africa have been raging for a few weeks longer than the events in Japan. Importantly, however, the potential impacts on the global economy are far greater. Since our update last month, violence in Libya has increased dramatically and the United Nations has authorized a coalition effort to protect Libyan citizens from Kaddafi's armed forces. Violence has also increased in Yemen and Syria along with further unrest in several other countries.

However, economically, the trajectory this region found itself on since last month has not changed course. Prevailing oil prices are essentially rangebound and the various political questions are still unanswered. Consequently, we continue to expect the current oil price environment to accommodate further growth while acknowledging that risks are rising and could possibly alter the course of the global expansion.

## CRUDE OIL

<b>CRUDE OIL</b>	<b>Current Price*</b>	-----2010-----				-----2011-----				-----2012-----			
		<b>1st</b>	<b>2nd</b>	<b>3rd</b>	<b>4th</b>	<b>1st</b>	<b>2nd</b>	<b>3rd</b>	<b>4th</b>	<b>1st</b>	<b>2nd</b>	<b>3rd</b>	<b>4th</b>
\$ per barrel													
ARAC (1)	99.81	75.41	75.38	74.05	81.52	87.69	99.72	96.50	100.14	102.45	105.86	108.00	105.95
Brent	114.69	76.83	78.90	76.98	86.96	105.24	111.37	103.82	104.80	106.62	109.85	112.06	110.29
Dubai	110.00	75.82	78.18	74.06	84.27	98.49	107.33	101.00	102.08	103.91	107.28	109.25	107.27
West Texas Intermediate (Spot)	102.81	78.67	77.78	76.12	85.06	93.92	102.72	99.50	103.14	105.45	108.86	111.00	108.95

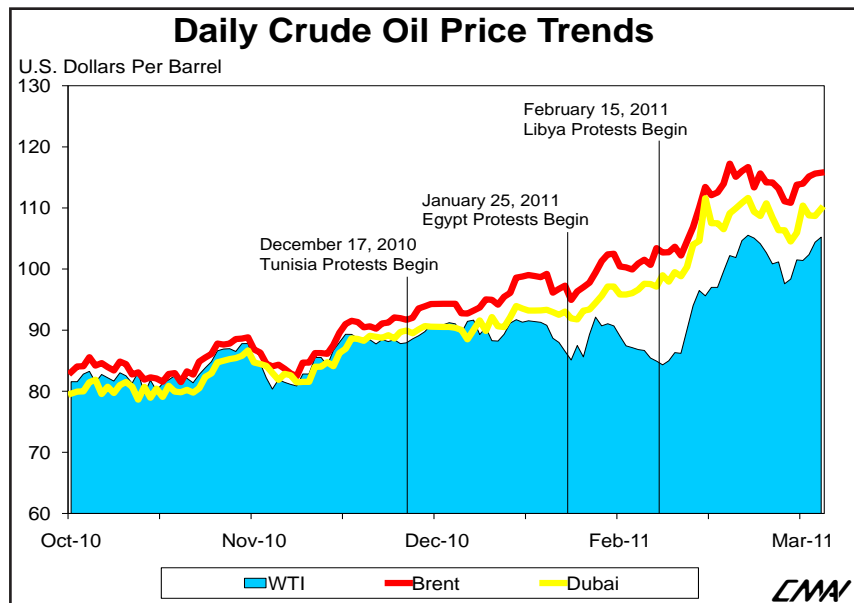
*The current and forecast prices presented herein are strictly the opinion of CMAI and Purvin & Gertz and are based on information within the public sector and on assessments by the CMAI and Purvin & Gertz staffs. CMAI makes no guarantee or warranty and assumes no liability as to their use.*

(1) Average of contract, spot, domestic and imported crude oil delivered to U.S. refineries.  
 \* Current Month-to-Date Average Price

*Summary*

The geopolitical uncertainty brought on first by the protests in North Africa and now the enforcement of the United Nations' no fly zone over Libya has helped support higher crude oil prices. An additional layer of uncertainty was added with the massive earthquake, tsunami and subsequent nuclear disaster in Japan. WTI prices have also reacted, going up despite continued length in the Cushing, Oklahoma trading hub. It remains unclear how long prices will remain at this elevated level or whether they will go higher in the near term.

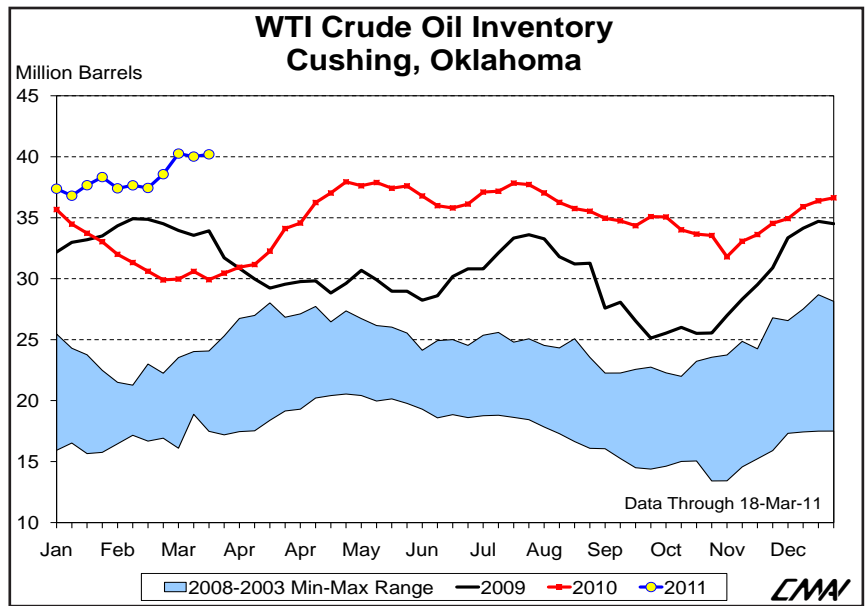
The nearby graph tracks the impact of unrest in North Africa since December 2010 on crude oil prices. When the Tunisia protests began on December 17, 2010, crude oil prices were already slightly increasing, with Brent having increased \$5.80 per barrel between November 30 and December 16. In the time between the start of the Tunisia protests and the start of the Egypt protests, Brent prices increased \$6.83 per barrel. This increase was driven by upward momentum in the overall markets and by the concern of protests spreading. The changing government in Tunisia had little impact on the global crude oil markets.



Between January 25 when the unrest in Egypt began and February 15, when the unrest in Libya began, Brent crude oil prices increased another \$7.76 per barrel. This increase was due to the concerns about transportation through the Suez Canal should widespread violence break out in Egypt. Egypt is not a major producer of crude oil, but the Suez Canal is one of the most important transportation spots in the world. The protests in that nation were mostly peaceful with much less violence than in other nations.

With the start of the protests and violence in Libya, crude oil prices began to react at a much faster pace. Libya produces roughly two percent of the world's crude oil, supplying much of it to European refineries. In addition, the crude oil is a light, sweet crude which is considered higher quality and more easily refined than a heavier, sour crude (containing more sulfur). Although Saudi Arabia has increased production of crude oil to make up for the lost volume, the additional crude oil is of the heavy, sour variety. The protests in Tunisia and Egypt led to relatively peaceful transfers of power. Although not all is settled in these countries, the transition is going to be much smoother than in Libya where the government is actively fighting rebels and a United Nations no-fly zone. Because of this conflict, many of the crude oil wells and export terminals have reportedly been affected. And as a result, Brent crude oil prices have increased \$13.07 since the start of protests in Libya. After the UN declared a no fly zone over Libya, prices (which had started decreasing) began to increase further. Not only does the crude oil price include a factor for the problems in Libya, but the price also includes a premium for fears that the unrest will spread to other nations in the North Africa and Middle East region. To summarize, Brent crude oil prices have gone up nearly 26 percent since December 16, 2010.

The story for WTI crude oil prices, on the other hand is different. Unlike Brent prices, WTI prices did not start increasing (and were actually decreasing) until after the unrest in Libya developed. WTI prices have been dominated by supply/demand factors affecting the Cushing, Oklahoma market. Specifically, storage levels are at all time record highs and are not expected to decrease. The increase of supply to the region from Canadian oil sands, Bakken shale and other sources has not been met with an increase in demand. In fact, it has been met with an increase in storage capacity. As a result, changing world crude oil prices are having less of an impact on WTI prices. However, since mid-February, WTI prices have been increasing, a testament to the importance of the North African oil producing region. Overall though, the lag in reaction of WTI prices to the global crude oil prices is another indicator of how this marker is becoming less effective as a gauge for understanding global energy markets. It is still effective for determining U.S. mid-Continent prices; however, beyond that, the market has less meaning.



In terms of Japan’s impact on crude oil markets, the story still seems to be emerging. Immediately, there was a slight decrease in crude oil prices as several refineries shut down, and demand was expected to go down. In the medium term, as the power generated from the nuclear power plant is required, crude oil demand is likely to increase as refineries and other sources of energy are required.

*Supply/Demand*

The outlook for crude oil supply/demand is relatively unchanged from last month’s view. At the current time, there is no expectation that higher crude oil prices will dampen demand growth, especially in nations such as China and India. The largest risk for demand contraction is in Japan, West Europe and the U.S. where the economies are on track for recovery but could be challenged with higher prices. Much of the risk for demand growth or contraction depends on how long crude oil prices remain high and how high they go neither of which are certain at the current time.

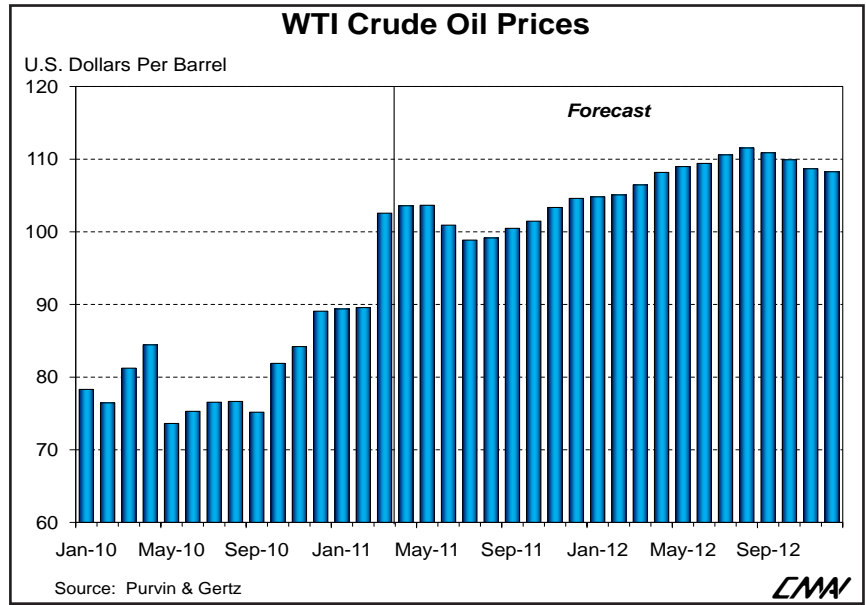
<b>World Petroleum Supply/Demand Balance</b>							
<b>Million barrels per day</b>							
<b>DEMAND</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
North America	25.33	25.44	24.16	23.21	23.63	23.98	24.35
OECD Europe	15.90	15.38	15.24	14.76	14.73	14.80	14.88
OECD Pacific	8.70	8.74	8.24	8.09	8.17	8.16	8.11
Total OECD	49.93	49.57	47.65	46.06	46.53	46.94	47.35
Total Non-OECD	35.13	36.80	37.73	38.80	40.83	42.22	43.58
<b>Grand Total World</b>	<b>85.05</b>	<b>86.36</b>	<b>85.39</b>	<b>84.86</b>	<b>87.36</b>	<b>89.16</b>	<b>90.93</b>
<b>SUPPLY</b>							
OPEC Crude *	31.77	31.32	32.35	29.48	30.07	30.57	31.54
OPEC NGL, Condensates	4.99	5.14	5.41	5.34	5.47	5.54	5.60
Non-OPEC Crude *	41.40	41.70	40.93	40.80	42.45	43.41	44.10
Non-OPEC NGL, etc	8.86	9.04	9.22	9.58	9.79	10.00	10.24
<b>Total World Supply</b>	<b>87.02</b>	<b>87.20</b>	<b>87.90</b>	<b>85.20</b>	<b>87.78</b>	<b>89.53</b>	<b>91.49</b>
Inventory Change & Misc.	1.97	0.84	2.52	0.34	0.41	0.37	0.56

\* OPEC crude includes and Non-OPEC crude excludes Angola and Ecuador for all time periods

Source: Purvin & Gertz

*Forecast*

The Purvin & Gertz forecast for crude oil has increased again since the end of February as crude oil prices ventured into higher territory. Our current forecast for WTI prices, shown in the nearby graph, is for prices to be higher in April before going down in May. The timing of the decrease is predicated on a cooling of the situation in Libya and based on an assumption that there is no spread of unrest into other oil producing countries. For the remainder of the forecast period, crude oil prices are expected to increase, going up as stronger demand growth tightens supply and reduces spare OPEC capacity.



**NATURAL GAS**

<b>U.S. NATURAL GAS</b> \$ per Million Btu	<b>Monthly Average</b>	-----2010-----				-----2011-----				-----2012-----			
		<b>1st</b>	<b>2nd</b>	<b>3rd</b>	<b>4th</b>	<b>1st</b>	<b>2nd</b>	<b>3rd</b>	<b>4th</b>	<b>1st</b>	<b>2nd</b>	<b>3rd</b>	<b>4th</b>
Gulf Coast Burner Tip Contract	3.89	5.41	4.17	4.42	3.82	4.19	3.92	3.80	4.45	4.93	4.68	4.32	4.92
Gulf Coast Wellhead Spot	3.74	5.26	4.02	4.27	3.67	4.04	3.77	3.65	4.30	4.78	4.53	4.17	4.77

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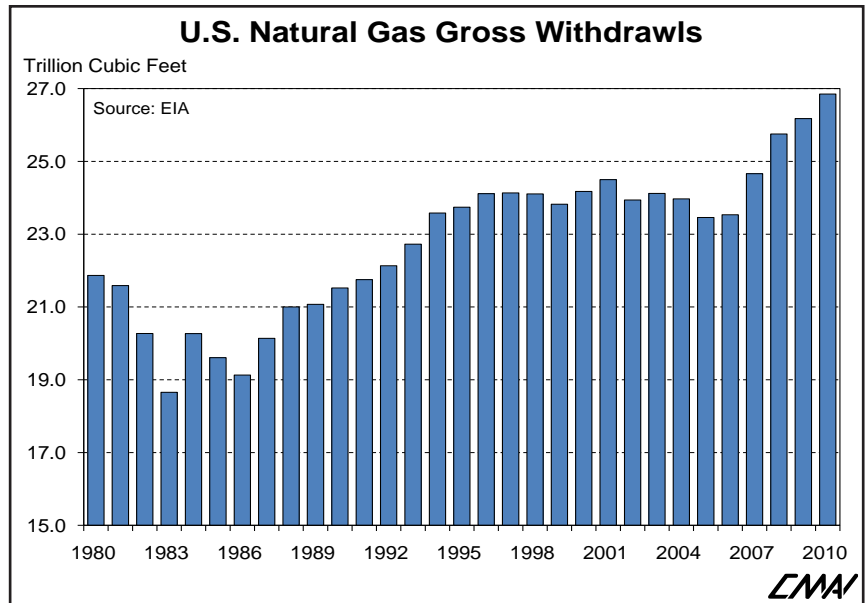
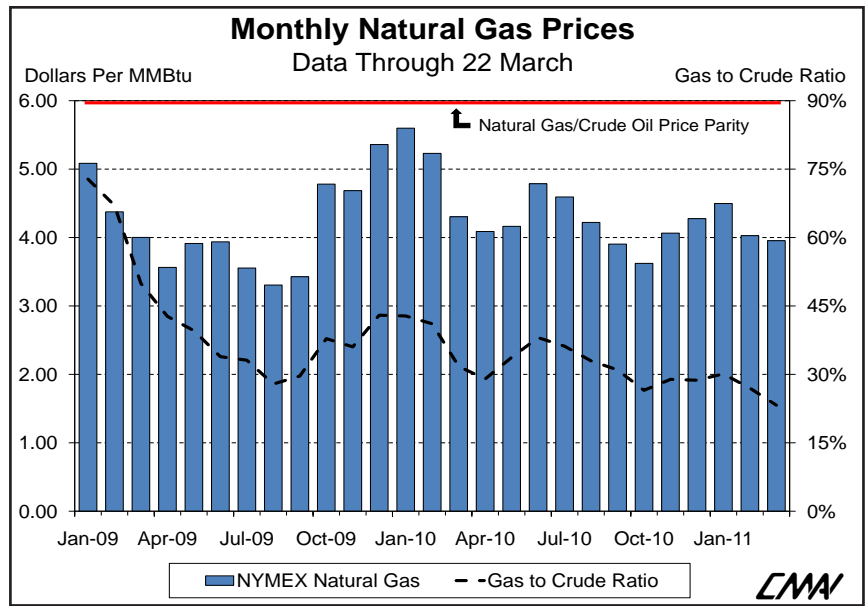
*Recent Developments*

Natural gas prices decreased in March as the typical shoulder month weather left demand lower than in recent months. That said, a storm in the Northeastern United States in the last full week of the month helped pull gas prices higher at the end of March. Prices on the NYMEX decreased, averaging two percent lower than in February. This is typical for this time of year. March is referred to as a shoulder month since it is the month between the peak pricing of winter and the lower prices of the summer. In addition, demand during the month is often uncertain, depending ultimately on the length of the winter season.

Even with the changes this month, natural gas prices are moving at a snail’s pace compared to crude oil prices. In fact, the ratio between natural gas and crude oil fell further in March as crude oil prices increased and natural gas prices decreased. The ratio was at 0.23 for March, one of the lowest levels on record. This is because the natural gas market is fundamentally balanced to long. Going into the summer months, inventory levels are within the five year average; however, with high production numbers, strong summer demand will be needed to keep inventories at a reasonable level. In addition, any price increases will likely be met by increases in supply since there are so many new shale wells that can be brought online in case of a higher prices. Because of this, it is difficult to imagine a scenario where natural gas prices stay elevated for too long, especially during the spring and fall. If this summer is very hot (similar to last summer), demand for natural gas going into power generation will increase, keeping storage levels from going too high in the summer months.

Since natural gas from shale is one of the newer sources of natural gas, there are still many questions surrounding the subject. CMAI gets asked one question in particular: Is all the hype justified? The following paragraphs will review some market data to show there is a lot of natural gas in shale formations around the U.S.

The graph titled **U.S. Natural Gas Gross Withdrawals** shows the historical supply of natural gas in the U.S. As shown in the graph, there was a sharp step upward in natural gas supply in 2007 which has continued since then. This sharp step upward was due to increased coal bed methane supply, and a price driven supply response from other segments. In 2008, production of natural gas from shale accounted for roughly 11 percent of total natural gas production. In 2010, roughly 23 percent of total natural gas production came from shale. In terms of overall growth rates, production of natural gas from shale has increased 47 percent per year between 2008 and 2010. This has led to an increase in total U.S. production of three percent per year. While this increase may not seem very high, it is important to keep in mind that as recently as 2007, there were many who believed the U.S. was “running out” of affordable natural gas. As a result, many LNG terminals were constructed to help bring additional gas into the U.S. Now, the opposite is true.

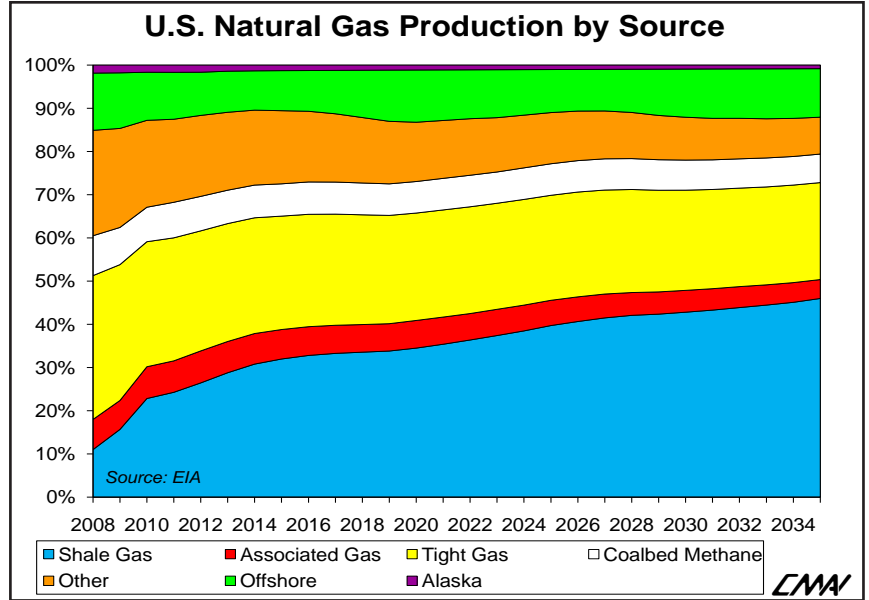


During the past three years while natural gas supply has grown so rapidly, demand for natural gas has grown, but at a much slower rate of roughly 1.7 percent per year. Demand in 2010 was higher than expected due to a very cold January and February and a very hot summer. Demand growth is a major limitation for the growth in shale gas production over the coming years. In the major sectors of residential, commercial and industrial-demand, there seems to be only limited potential for growth. The power generation segment is the one most likely to see more rapid growth. Given the low price of natural gas, there is potential for additional power plants to be built based on natural gas and switching of existing facilities.

Although demand growth has not been extremely rapid, demand for imports has shrunk tremendously. The U.S. has major natural gas pipeline imports from Canada and also imports material via LNG terminals. In 2007, roughly 15 percent of U.S. natural gas came from imported material. Between 2007 and 2010, imports decreased by 16 percent per year on an average annual basis and now only account for 8 percent of total natural gas supply. This has helped keep the market balanced.

So, the recent data indicates that the hype about the current market is real, but now the question is whether or not shale gas will be able to sustain the market in the future. In 2009, U.S. proven reserves of natural gas increased 11 percent to their highest level since 1971 according to the EIA. At this time, the U.S. has enough gas in proven reserves to supply the market for at least 100 years. This increase was due to the increase in proven shale reserves. When data is released for 2010, this number should increase further as new shale reserves are proven.

What does this mean in terms of production? The latest EIA long term forecast for production is shown in the nearby graph, **U.S. Natural Gas Production by Source**. This graph shows production by sources a percent of total production from 2008 through 2035. The percent of total natural gas production from shale is forecast to increase from roughly 10 percent of total production in 2008 to 46 percent of production in 2035. It is important to note that the EIA’s forecast assumes relatively slow growth in overall natural gas production of less than one percent per year. If there are changes in natural gas demand such as new technology for consuming natural gas or perhaps exports of natural gas via LNG from the U.S., production of natural gas from shale might increase at a more rapid pace.



In conclusion, so far there is little reason to doubt that shale gas production will continue to expand in the coming years. The major concern regarding the rate of increase is potential environmental regulations. Overall, however, the outlook is extremely positive for this resource.