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# Energy Investment Ideas for Growth, Inflation and Deflation

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# Summary and Recommendation

- Invest in Energy for Real Return with Inflation Protection, Deflation Resistance and Tax Efficiency
- Oil is Underpriced and Natural Gas is Clean
- Value Stocks for Energy Resources on Unlevered Basis
- Buy Canadian Oil Sands Trust (COSWF), Anadarko (APC) and Marathon Oil (MRO)
- Sell Kinder Morgan (KMI, KMR, KMP)

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# Outline

- Investment Strategy
- Industry Outlook
- Valuation Method
- Buy Ideas
- Sell Ideas

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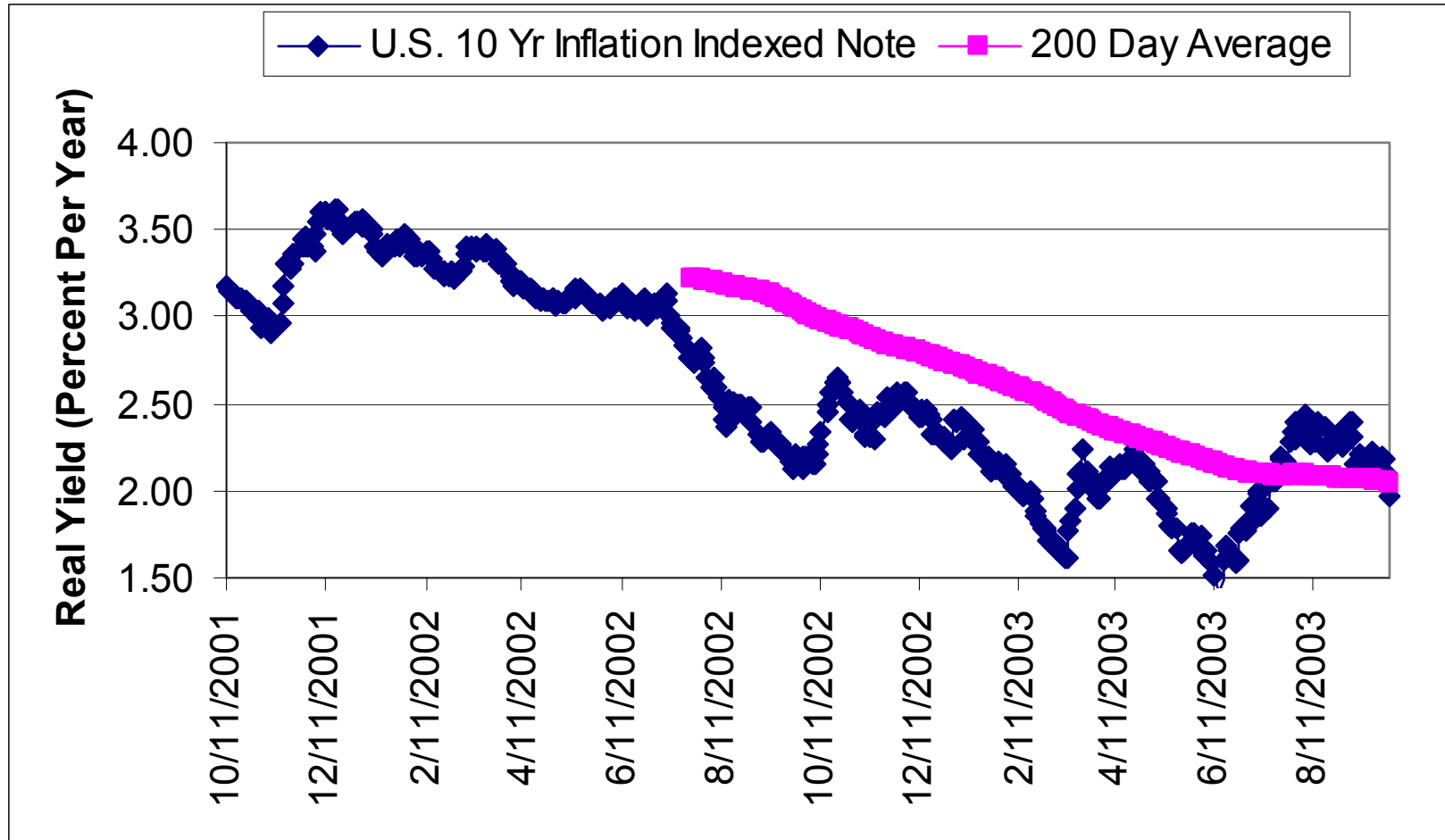
# Investment Strategy

- Real Return
  - Bond Benchmarks
  - Real Rates Trend Lower
- Inflation Protection
  - Inflation Expectations Trend Higher
  - Free Money Spawns Inflation
  - Twin Deficits Are Back to Spawn Inflation
- Deflation Resistance
  - Chronic Deflation Concerns Wane
  - Accidental Deflation Possible Any Time
- Tax Efficiency

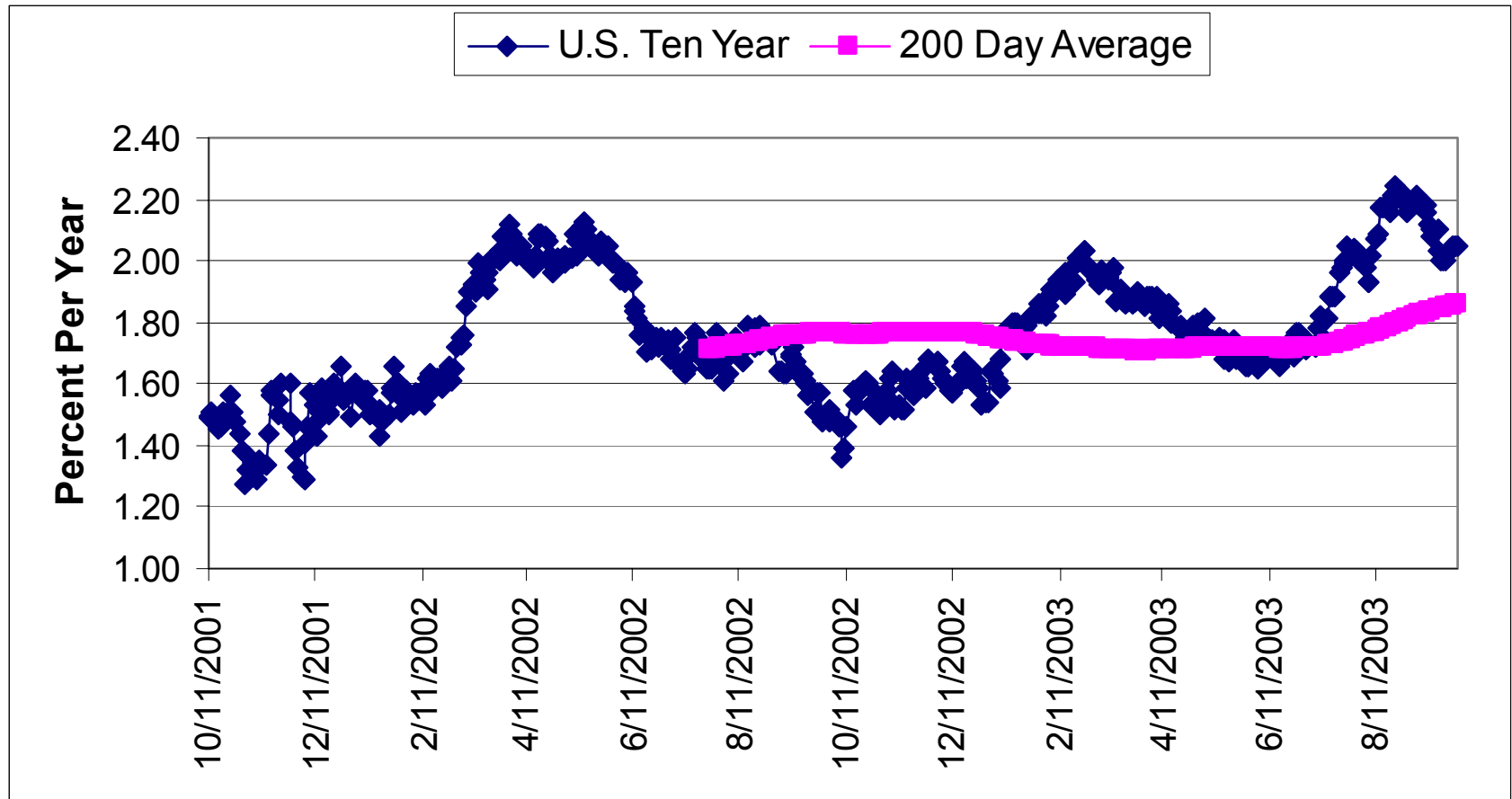
# Bond Benchmarks

U.S. Treasury Securities	Current Ten-Year Expectation	20 <sup>th</sup> Century Actual (Dimson, Marsh & Staunton)
Real Bond Return (%/yr)	2.0	1.6
Implied Inflation (%/yr)	2.0	3.2
Nominal Bond Return (%/yr)	4.0	4.8

# Real Interest Rate May Drop More



# Inflation Expectations Trend Up



# Free Money Spawns Inflation

Periods of T-Bill Rate below Inflation	Annual Inflation
1914-1918	10%
1933-1951	4%
1970-1980	8%
2002- ?	?

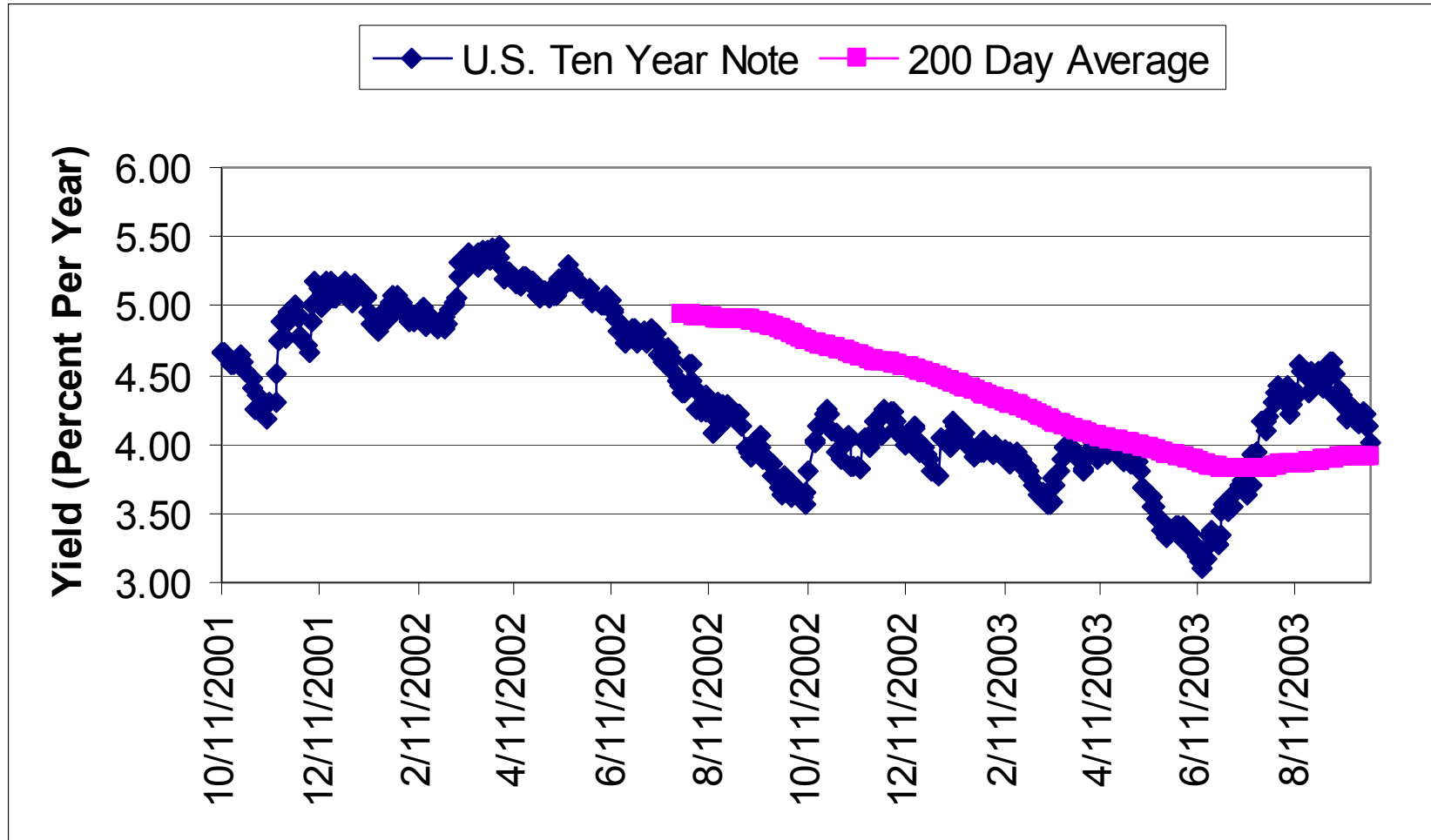


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# Twin Deficits are Back to Spawn Inflation

- Trade deficit on the order of a half trillion dollars may signal weaker dollar and higher priced imports
- Dollar exchange rate decline limited by inflation in other currencies
- Federal budget deficit also on the order of a half trillion dollars
  - Military spending
  - Social spending

# Resistance to Chronic Deflation Builds



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# Deflation Accidents Possible Any Time

- High debt carries high risk
  - Mortgage market?
  - Derivatives abuse?
  - Securities fraud?
  - Hedge fund speculation?
  - Country defaults?
  - Utility deregulation?
- Be wary of high-leverage entities

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# New Tax-Efficiency Favors Equity

- Investors taxed at half or less the rate on stocks compared to bonds
- Reducing tax on dividends and capital gains reduces tax on inflation which logically should not be taxed
- Improvement in relative appeal of equity helps overly leveraged companies to substitute equity for debt

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# Industry Outlook – Natural Gas and Oil

## Most Valuable Energy Resources

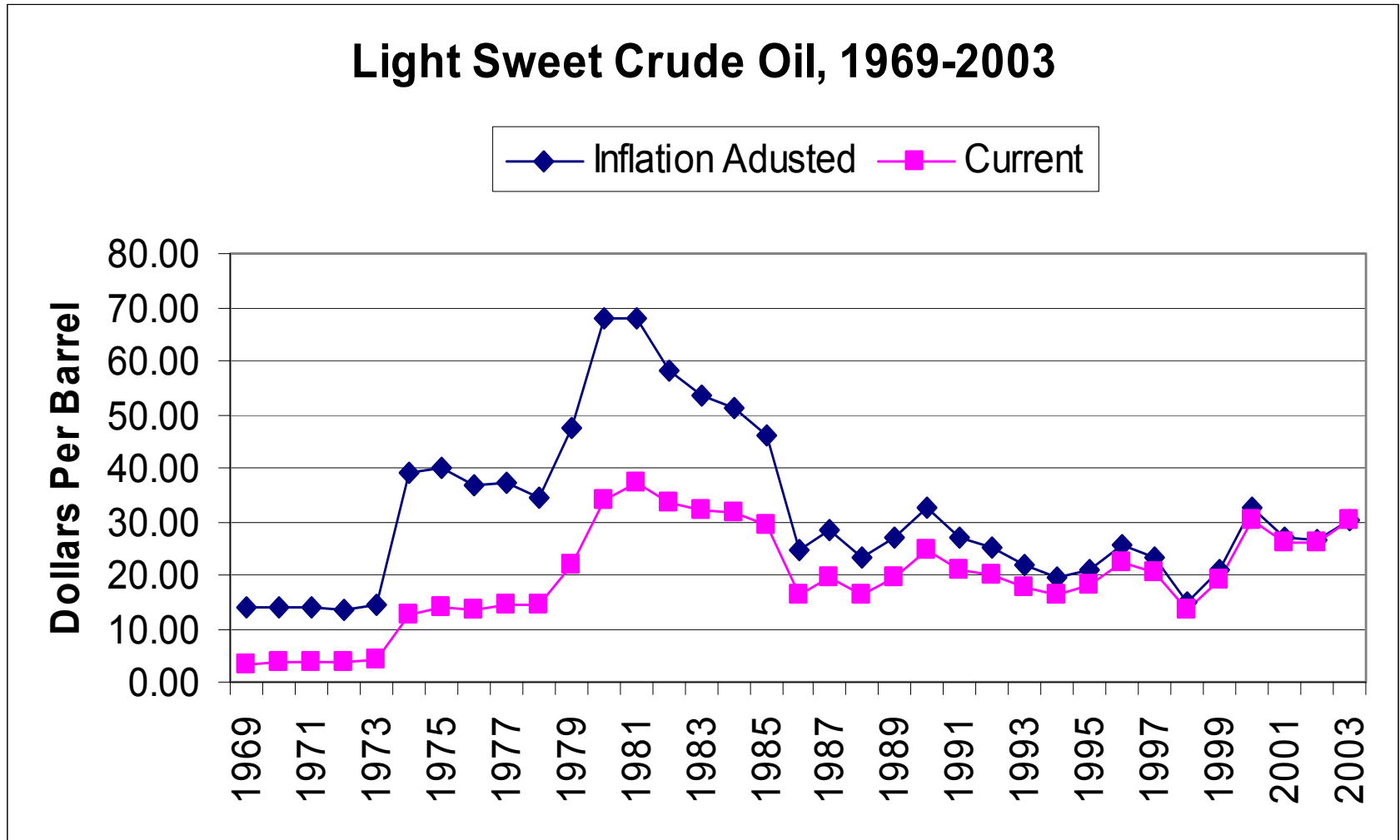
- Oil
  - Demand, Supply and Price
  - Price Cycle Turning Up
  - 2006 Oil Rising 10% Per Year
  - Six-Year and One-Year Futures for Price Forecast
- Natural Gas
  - Reliable and Clean
  - Convenient and Economic
  - Discount to oil historical prices
  - Premium to oil in futures prices
- Refining/Marketing
- Power

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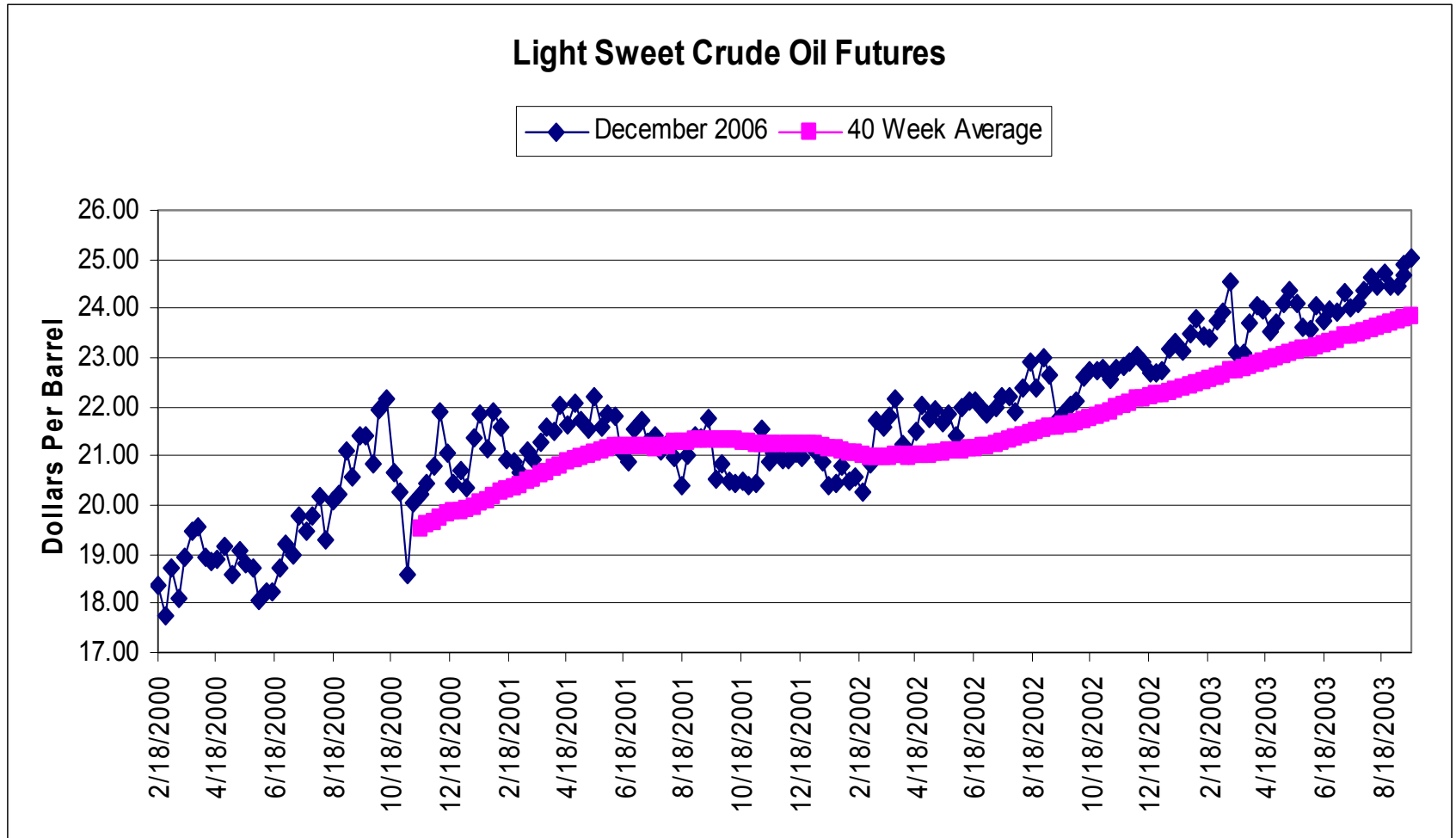
# Oil is Cheap

- Demand linked to economic growth
- Demand artificially suppressed
  - Fuel taxes
  - Rationing
  - Acceptance of dirtier fuels
- Spare production capacity minimal
- Middle East Religion and Politics
- Futures prices low

# Oil Price Cycle Turning Up

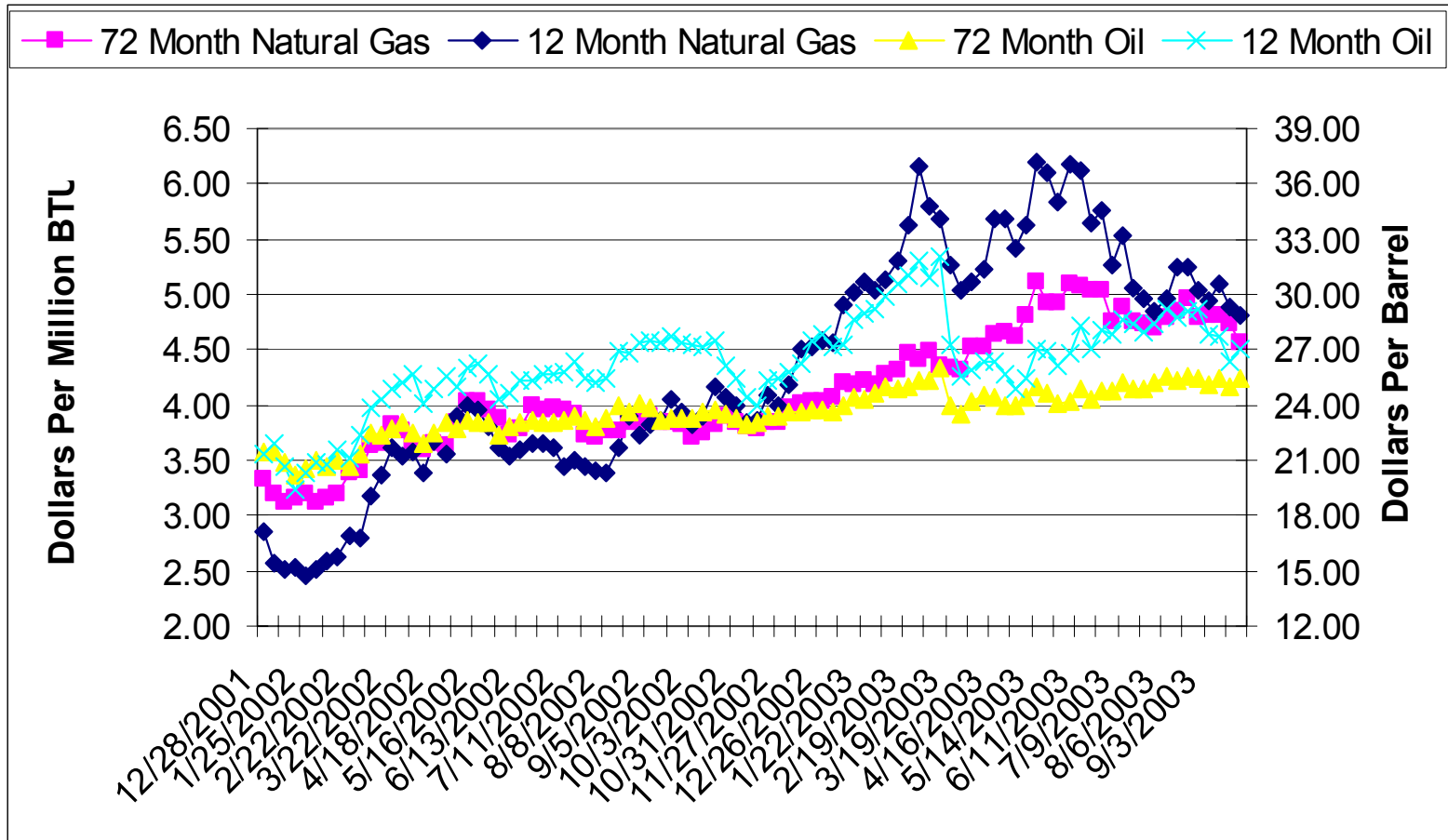


# 2006 Oil Rising 10% Per Year





# Rolling Six-Year and One-Year Futures Input to Fundamental Analysis



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# Natural Gas Reliable and Clean

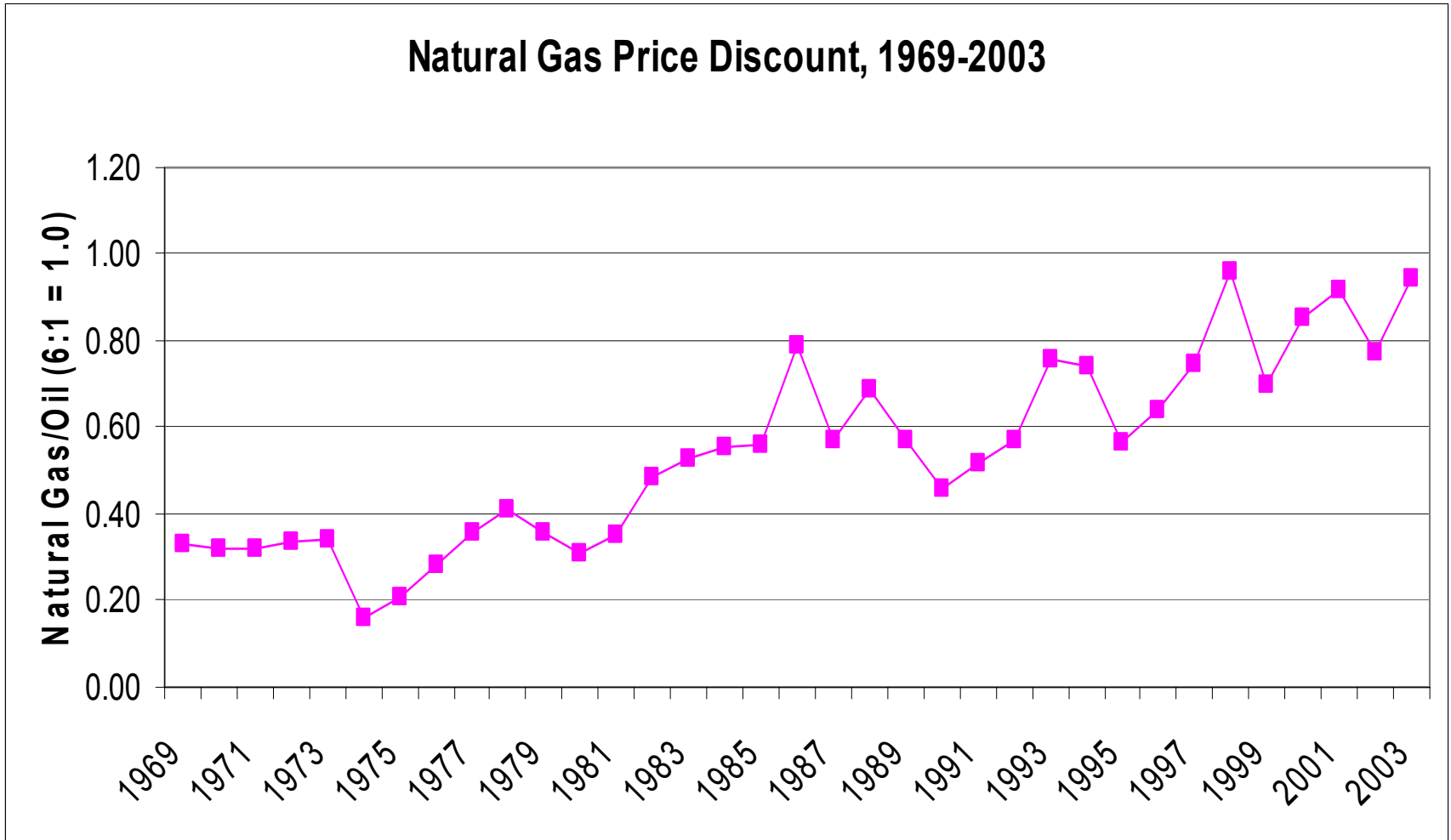
- No blackouts because of primitive transmission along wires strung on unsightly poles
- No discharge of excessive waste heat into rivers and waterways, especially during hot months
- No windless days or bird kills from whirring turbine blades on poles
- No particulates or sulfur dioxide and far less carbon dioxide than from coal
- No flooding of human or wildlife habitat behind dams

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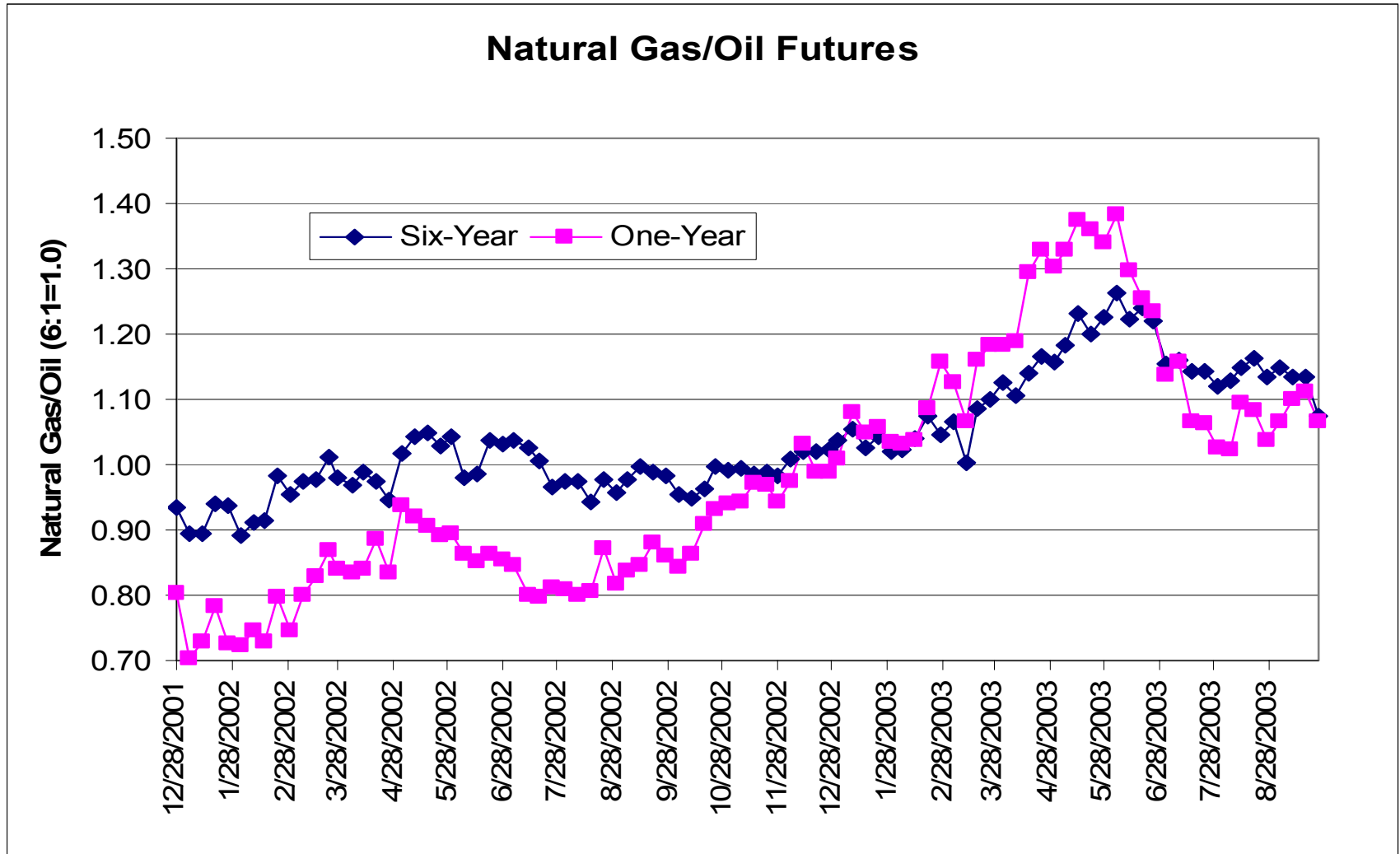
# Natural Gas Convenient and Economic

- Turbine driven with waste heat recovery (combined cycle) most efficient generation of electricity from heat
- Distributable underground to point of use
  - Coal and nuclear like obsolescing mainframe computers
  - Natural gas like personal computers
- Highly refined oil most competitive alternative turbine and heating fuel
- Strong demand drives up natural gas price
- Oil a backup for natural gas

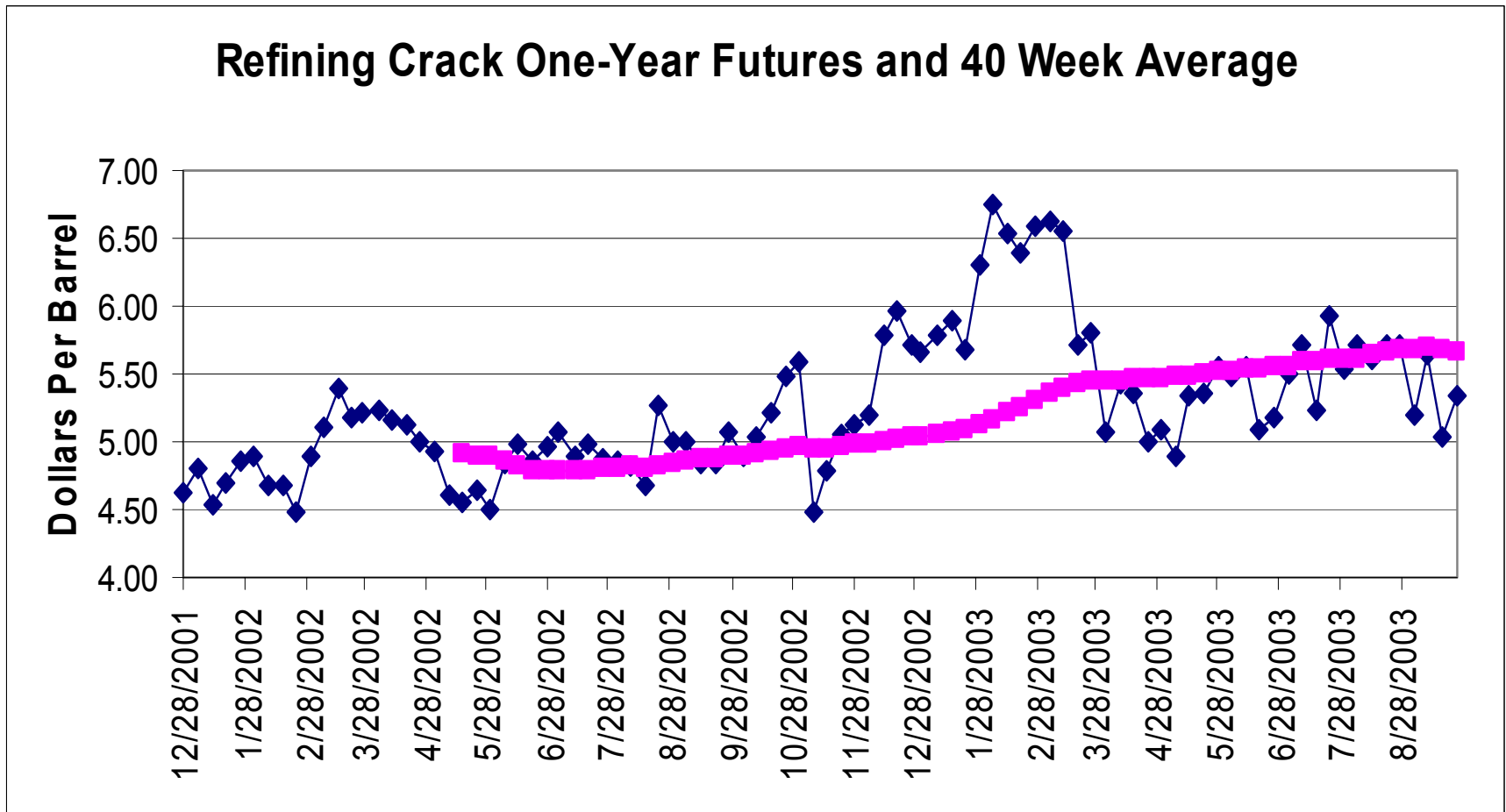
# Natural Gas Historical Discount to Oil



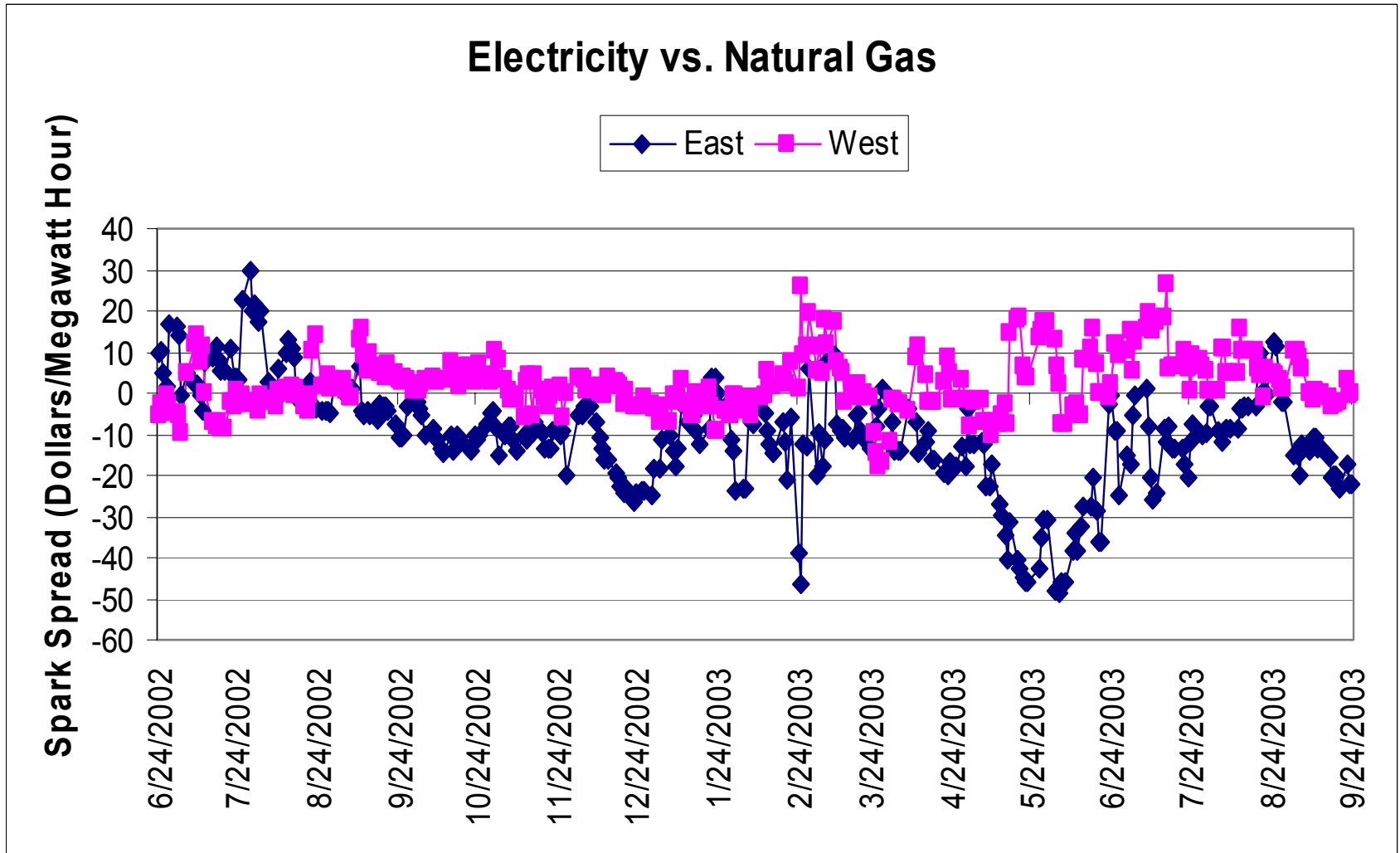
# Natural Gas Futures Premium



# Refining Margin Improving



# Power Underpriced – Dirt for Dollars



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# McDep Ratio measures unlevered value

- Market Cap and Debt to Present Value
- Unlevered – counters the distortion of debt
- Present value depends on interest rates, inflation, commodity prices, reserve life, investment requirements, operating costs
  - Weekly calculations for natural gas royalty trusts
  - Periodic reconciliation of cash flow multiple assessments with reserve life



# Weight Portfolio Positions on Unlevered Basis - Example

	CNOOC Limited	Kinder Morgan, Inc.
Symbol	CEO	KMI
Rating	Buy	Sell
Price Change 2003	31%	27%
Debt/Present Value	-	0.80
Portfolio Weight (Equal Unlevered PV)	83%	17%
Weighted Gain	26%	-5%

Portfolio Gain = 21%

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# Buy energy producers

- ❑ Mega Cap – CVX, RD
  - Dividends above TIPS real return
  - Dividends likely to adjust for inflation
  - Low debt offers deflation resistance
  - New lower tax rate makes dividends more valuable
- ❑ Producer/Refiners – COP, MRO, PTR
- ❑ North Am Natural Gas – ECA, BR, APC, XTO, SJT
- ❑ Oil – CEO, EAC, COSWF

# Mega Cap Energy Producers

## Dominant Market Cap, Attractive Value

			<i>Price</i> <i>(\$/sh)</i>	<i>Market</i> <i>Cap</i> <i>(\$mm)</i>	<i>Debt/</i> <i>Present</i> <i>Value</i>	<i>McDep</i> <i>Ratio</i>
	<i>Symbol/</i> <i>Rating</i>		<i>24-Sep</i> <i>2003</i>			
Exxon Mobil Corp	XOM		36.90	247,000	0.10	1.05
Total S.A.	TOT		76.84	98,000	0.19	0.92
BP plc	BP		42.65	158,000	0.15	0.87
Royal Dutch/Shell	RD	B	45.00	156,000	0.18	0.85
ChevronTexaco Co	CVX	B	72.33	77,000	0.22	0.82

# Energy Producer/Refiners

## Potential to Outperform Mega Caps

			<i>Price</i> <i>(\$/sh)</i>	<i>Market</i>	<i>Debt/</i>	
	<i>Symbol/</i>		<i>24-Sep</i>	<i>Cap</i>	<i>Present</i>	<i>McDep</i>
	<i>Rating</i>		<i>2003</i>	<i>(\$mm)</i>	<i>Value</i>	<i>Ratio</i>
Murphy Oil Corporation	MUR		59.83	5,530	0.26	1.34
Imperial Oil Limited (30%)	IMO		37.81	4,290	0.12	1.04
Petro-Canada	PCZ		40.35	10,690	0.19	0.92
Norsk Hydro ASA (49%)	NHY		52.74	6,670	0.27	0.91
OAO Lukoil	LUKOY		77.60	16,000	0.12	0.88
ConocoPhillips	COP	B	55.75	38,000	0.38	0.87
Marathon Oil Corporation	MRO	B	28.35	8,790	0.31	0.80
Suncor Energy	SU		18.66	8,880	0.14	0.78
PetroChina Company Ltd (10%)	PTR	B	32.85	5,780	0.11	0.70

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# Opportunity in Marathon Oil (MRO)

## About Every Ten Years

- Double oil production from Yates Field in Texas free from price controls – DLJ Action Recommendation, October 1973
- Leading candidate for financial restructuring – DLJ Action Recommendation, April 1, 1981
- Vote for Spinoff – McDep Action Recommendation, March 19, 1990
- Set It Free from U.S. Steel– McDep Stock Idea, April 16, 2001

# Opportunity in Marathon (MRO) Today

- Acquirable, efficient producer/refiner
- Low multiple of cash flow –  $EV/Ebitda = 5.4$
- Value split approximately
  - 45% oil and overseas natural gas
  - 35% U.S. Midwest refining/marketing
  - 20% North American natural gas
- Competent management
- Stock should trade like peers and offer additional possible upside surprise

# Independent Nat Gas and Oil Producers Concentrated on Higher Potential

	<i>Symbol/ Rating</i>	<i>Price (\$/sh) 24-Sep 2003</i>	<i>Market Cap (\$mm)</i>	<i>Debt/ Present Value</i>	<i>McDep Ratio</i>
Occidental Petroleum Corp.	OXY	35.11	13,500	0.38	1.00
Apache Corporation	APA	69.09	11,000	0.20	0.99
Encana Corporation	ECA B	37.01	17,500	0.20	0.94
XTO Energy Inc.	XTO B	21.27	3,910	0.25	0.91
Unocal Corporation	UCL	31.69	8,100	0.35	0.87
Burlington Resources	BR B	48.48	9,800	0.27	0.86
Devon Energy	DVN	49.14	8,000	0.42	0.86
CNOOC Limited (19%)	CEO B	34.15	2,670	-	0.86
Anadarko Petroleum Corp.	APC B	44.16	11,100	0.32	0.82

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# Anadarko (APC) – Acquirable Producer

- Management ready to sell
- Disenchanted owners
- Strategic complement to LNG
  - 56% North American natural gas
  - Premier Rockies acres (Union Pacific land grant)
- Cost savings in overhead and hedging
- Marketable reserves
- Opportune time in energy commodity cycle



# Income Buys

	<i>Symbol/ Rating</i>		<i>Price (\$/sh) 24-Sep 2003</i>	<i>Market Cap (\$mm)</i>	<i>Annual Income (%)</i>	<i>McDep Ratio</i>
San Juan Basin Royalty Trust	SJT B		17.88	830	10.6	1.03
CNOOC Limited (19%)	CEO B		34.15	2,670	4.7	0.86
Royal Dutch/Shell	RD B		45.00	156,000	4.4	0.85
ChevronTexaco Corporation	CVX B		72.33	77,000	4.0	0.82
Marathon Oil Corporation	MRO B		28.35	8,790	3.5	0.80
Canadian Oil Sands Trust (US\$)	COSWF B		28.95	2,500	5.0	0.71
PetroChina Company Ltd (10%)	PTR B		32.85	5,780	6.2	0.70

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# Canadian Oil Sands Trust (COSWF)

## Premium Characteristics

- Sole asset 35% Syncrude Oil Sands Plant
- Equal economic partner Exxon et al
- Low fee, efficient, administration
- Volume growth – 260mbd, 350mbd, plus
- Reserves last practically forever
- Environmentally desirable product
- Dividend double by 2006, triple by 2007
- Dividend qualifies for 15% U.S. rate

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# Canadian Oil Sands Trust (COSWF)

## Potential Ten-Bagger (10x in 10 years)

- Ten-bagger growth rate: 26%/year
- Canadian Oil Sands Trust Multipliers
  - Volume: 2x
  - EV/Ebitda: 2x
  - Oil Price: 2x, 3x, 4x
  - Dividend/Ebitda: 3x,4x
- Downside: Cash Breakeven at US\$13/barrel

# Sell pipeline partnerships– EEP, EEQ, EPN, KMI, KMR, KMP

- ❑ Real growth valued two to three times buy recommendations
- ❑ Most inflation protection usurped by general partner
- ❑ Limited deflation resistance because of high leverage
- ❑ Accounting misrepresents debt and high compensation to general partner
- ❑ Tax change expands competitive income opportunities

# Pipeline Partnerships

## Unattractive Valuation

			<i>Price</i> <i>(\$/sh)</i>	<i>Market</i> <i>Cap</i> <i>(\$mm)</i>	<i>Debt/</i> <i>Present</i> <i>Value</i>	<i>McDep</i> <i>Ratio</i>
	<i>Symbol/</i> <i>Rating</i>		<i>24-Sep</i> <i>2003</i>			
Kinder Morgan Energy Partners, L.P.	KMP S		42.09	5,790	0.47	2.07
Kinder Morgan Management, LLC	KMR S		37.20	1,710	0.47	1.88
Kinder Morgan, Inc.	KMI S		53.63	6,600	0.80	1.56
Enbridge Energy Partners, L.P.	EEP S		48.99	1,910	0.57	1.68
Gulfterra Energy Partners	GTM S		40.38	2,220	0.56	1.68
Enbridge Energy Management, L.L.C	EEQ S		44.39	420	0.57	1.58

# KMP/COS Side by Side

	Kinder Morgan Energy Partners	Canadian Oil Sands Trust
EV/Ebitda	18	7
Debt/PV	.47	.19
Distribution/ Equity Ebitda	1.61	.31
Distribution Yield	6.2%	5.0%
Notoriety	Arizona Pipe Failure	

# Moral Hazard in Pipeline Partnerships

- General Partner takes up to 50% of cash flow for no capital outlay exploiting moral hazard
  - Partnerships skimp on debt service
  - Partnerships skimp on maintenance and safety
    - Failure of 48-year old Arizona pipeline triggered gasoline shortages in August 2003
- Rating agencies allow outlawed debt pyramids
- SEC exempts partnerships from Sarbanes Oxley
- NYSE facilitates excessive GP compensation
- FERC allows asset stripping at public expense

# What is Contrary Opinion in Energy?

- Oil price likely be to higher than in the futures market, possibly by a lot in a surprise inflationary environment
- Natural gas premium to oil likely to be higher than in the futures market as environmental advantages become more valuable as the politics sort out
- Unlevered present value of cash flow the most useful tool of energy valuation
- The stocks that pay the least amount of fees to managers and financiers may be the among the best opportunities
- The SEC, the NYSE, the Federal Energy Regulatory Administration, and the debt raters do not appear to protect the public interest in pipeline partnerships



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# Wrapup

- Invest in Energy for real return, inflation protection, deflation resistance, tax efficiency
- Oil is cheap, natural gas is clean
- Own stocks on basis of unlevered holdings of energy resources and businesses
- Buy Marathon, Anadarko, Canadian Oil Sands Trust and other energy producers
- Sell Kinder Morgan and other pipeline partnerships

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# Disclaimer and Disclosure

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