

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)

Outline

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

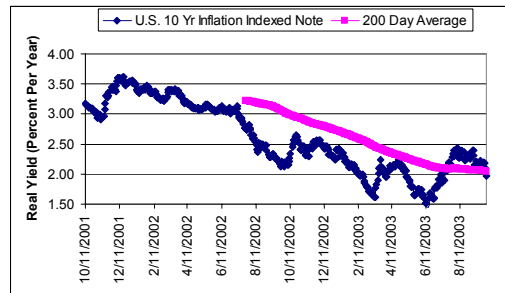
Investment Strategy

- 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

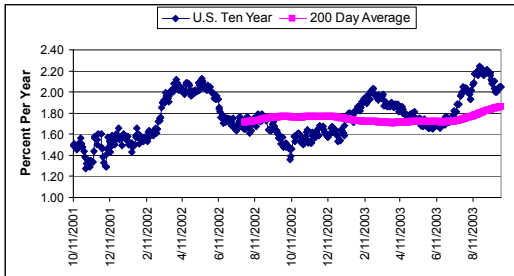
Bond Benchmarks

U.S. Treasury Securities	Current Ten-Year Expectation	20 th Century Actual <small>(Dimson, Marsh & Staunton)</small>
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



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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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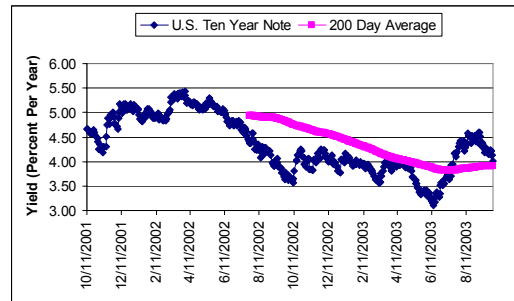
Twin Deficits are Back to Spawn Inflation

- 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

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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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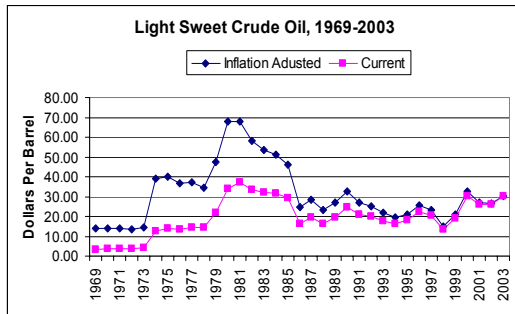
Industry Outlook – Natural Gas and Oil Most Valuable Energy Resources

- 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

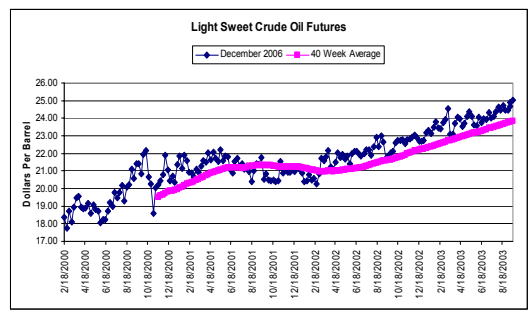
Oil is Cheap

- 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

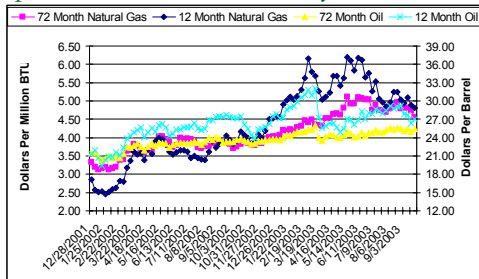
Oil Price Cycle Turning Up



2006 Oil Rising 10% Per Year



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



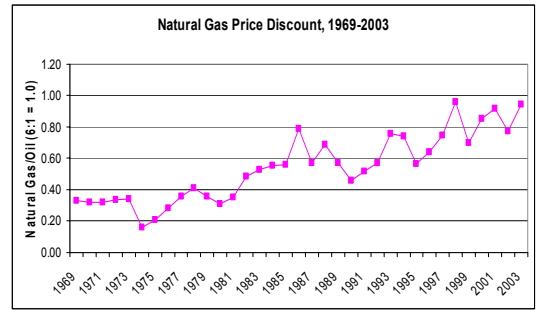
Natural Gas Reliable and Clean

- 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

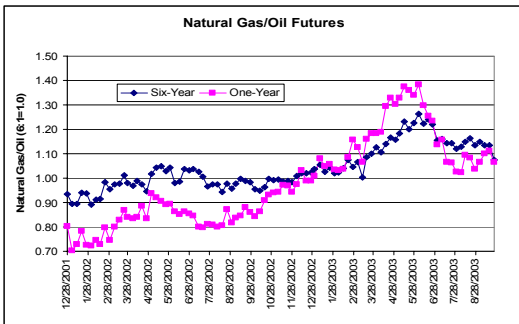
Natural Gas Convenient and Economic

- 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

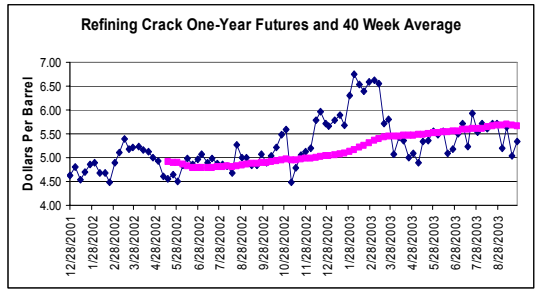
Natural Gas Historical Discount to Oil



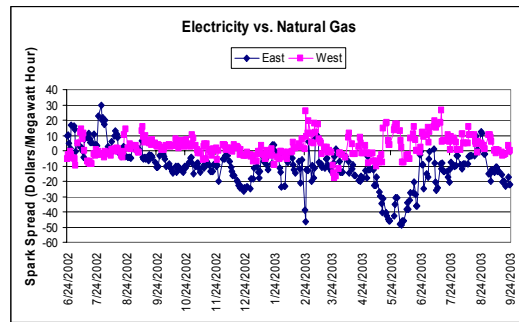
Natural Gas Futures Premium



Refining Margin Improving



Power Underpriced – Dirt for Dollars



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%

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

Symbol/ Rating	Price (\$/sh) 24-Sep 2003	Market Cap (\$mm)	Debt/ Present Value	McDep Ratio
Exxon Mobil Corpo 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 Coi CVX B	72.33	77,000	0.22	0.82

Energy Producer/Refiners Potential to Outperform Mega Caps

Symbol/ Rating	Price (\$/sh) 24-Sep 2003	Market Cap (\$mm)	Debt/ Present Value	McDep Ratio
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

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

			Price (\$/sh)	Market Cap (\$mm)	Debt/ Present Value	McDep Ratio
Symbol/ Rating		24-Sep 2003				
Occidental Petroleum Corp.	OXY	B	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

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Income Buys

			Price (\$/sh)	Market Cap (\$mm)	Annual Income (%)	McDep Ratio
Symbol/ Rating		24-Sep 2003				
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
Chevron/Texaco 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 (USS)	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

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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

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Pipeline Partnerships Unattractive Valuation

			Price (\$/sh)	Market Cap (\$mm)	Debt/ Present Value	McDep Ratio
Symbol/ Rating	24-Sep 2003					
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	
Gulfstream 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

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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