

Rarin' To Renege Again

Summary and Recommendation

Calls by California politicians to renegotiate long term power contracts, or renege on them as we would put it, calls attention to our continuing Sell recommendation of **Calpine Corporation (CPN)**. Skeptical of the company's business model, we estimate the stock could drop another 60% to reach our estimated present value of equity. On a more positive note a second straight week of price strength confirms for now a turn in natural gas price trend that should particularly benefit recommended **PanCanadian Energy (PCX)**, **San Juan Basin Royalty Trust (SJT)** and Strong Buy **Burlington Resources (BR)**. Meanwhile recommended **PetroChina (PTR)**, which has more than 60% appreciation potential to reach present value of equity, just made its semiannual payment to holders on its indicated annual dividend yield of 10.4% (apparently free of withholding tax). Also we are hopeful of favorable exploration news in the next few months for Strong Buy **Marathon Oil (MRO)** and recommended **Energy Partners (EPL)**. For those recommendations and more, as well as possible alternatives, the stats are in the valuation tables (see Table L-1, L-2, S-1 and S-2). Look for Marathon, **Devon Energy** and **Unocal** in the same Large Cap group now as **Anadarko**, Burlington, **Conoco** and **Phillips** instead of those three stocks being classified as Mid Caps.

California Regulators Try to Cheat Once More

The joke around our house is that if the California governor were in our living room, we would probably find him to be a charming guest. That contrasts with our frequent opportunity to view his political leadership on energy issues in the least admirable light. Yet we should not fault the current governor exclusively as the state Public Utility Commission has been continually trying to play tricks on the energy industry for at least three decades. The repeated cycle is to buy spot when prices are low, buy contract when prices are high, then renege on contracts when prices are low again. In natural gas production the cycle included wellhead price controls through the 1970s. When supply got tight buyers signed long term contracts. When supply loosened in the 1980s, buyers reneged on the contracts. When it looked like California needed new pipeline capacity, the PUC approved long-term contracts for capacity. After the new capacity was built, the long-term contracts were held invalid.

The vicious regulatory cycle appears to be repeating in electricity. When supply was ample the California PUC required buyers to make only short-term commitments. That approach backfired big time this past winter. Not liking the price, the state simply refused to pay by letting the utility buyers go into, or threaten, bankruptcy. Then the state induced the suppliers to continue deliveries with the promise of moderately high prices in

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long-term contracts. When the contracts covered more than 100% of current requirements the high spot prices miraculously disappeared. Now that the crisis is past, the time has come for the state to start renegeing on its long-term electricity contracts!

Sure enough, the state's leading newspaper reported last week "State to Seek Renegotiated Energy Deals" (see <http://www.latimes.com/news/local/la-000082983oct18.story>). Of course the suppliers are not stupid. Knowing how untrustworthy the state's energy regulators have been, some suppliers have tried to put strong protection in their contracts. The head of the PUC tries to turn that around by saying such strong terms are evidence that the contracts are unreasonable and therefore inconsistent with Federal Law requiring "just and reasonable" energy prices. We hope that the electricity suppliers get every penny due to them, but more likely the dispute will be dragged out and the energy companies will be cheated again.

Calpine Overpromises

Considering the sorry history of California energy regulation what would you think of a company that reports earnings from past sales in California for which they have not been paid? What would you think of a company that reports positive earnings from sales under long-term contracts that may turn to losses in the future?

The case for Calpine stock is that it sells at a low multiple of earnings and its earnings are growing rapidly. In our opinion, current earnings are overstated because they may be dwarfed by future losses. That in turn implies that rapid growth is an illusion.

The resemblance between Calpine today and Coastal States Gas in the early 1970s may help explain our view. Coastal expanded aggressively by promising to deliver natural gas on long term contracts at prices below what competitors offered. The problem was that after Coastal drove out its competitors, it did not have the gas to deliver. When the price of gas went up surprisingly, Coastal was unable to obtain new supply at a price it could pay and Coastal stock lost most of its value. (The company eventually recovered and today is part of **El Paso Corporation (EPG)**).

Calpine, too, has expanded aggressively by outbidding competitors and promising, in our opinion, natural gas that it will not be able to deliver. The power plants Calpine would build need natural gas for fuel. Calpine is expanding so aggressively that it expects to be buying 10% of U.S. natural gas supply in just a few years. The gas will be there, but electricity generators will have to outbid other users for the supply. The profits Calpine projects are more likely to accrue to natural gas producers.

Now coming back to California, what do you think the state will do? If the price of electricity stays low as it is now, the state will attempt to renege as it is doing now. If the price of natural gas is high, the state will hold Calpine responsible.

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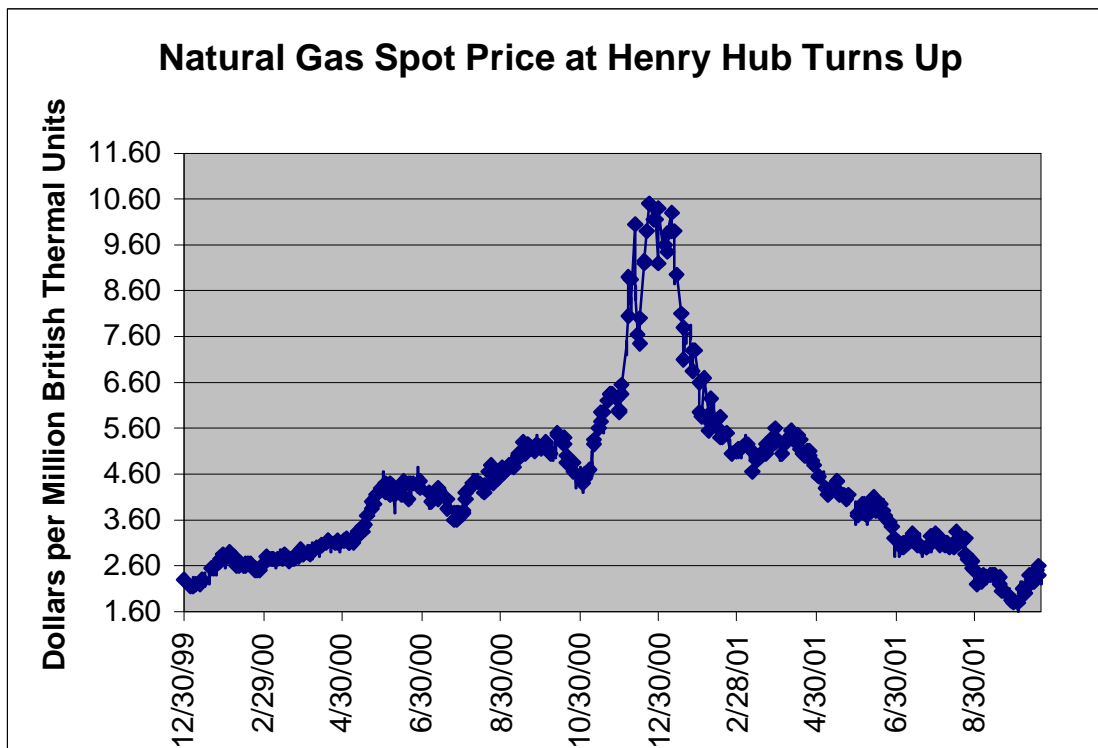
Calpine is also overleveraged, we think. Management targets a 65/35 debt/equity structure apparently on the basis that utilities have succeeded with that much leverage in the past. The difference is that Calpine is building plants primarily for an unregulated market. One of the premises of the regulated market was that ratepayers shared risks with utilities. Since that is not the case in an unregulated market, a lower debt structure would be more appropriate.

We also note that Calpine reports only nominal net interest expense even though it has some \$7 billion of debt on its balance sheet. That is another factor that might lead one to conclude that earnings are overstated.

In the end we come down to Ebitda. Projecting next twelve months results near the current rate, we estimate present value at the same 9.0 times that we use for Mega Cap Energy companies. When subtracting debt and dividing by shares we get about \$11 compared to the current stock price near \$27.

Natural Gas Upside Greater Than Downside

Natural gas spot prices bottomed three weeks ago down 83% from December 21, 2000 (see Chart). The less volatile average of the forward thirty-six months was up 8% last week after a gain of 3% the previous week.



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PetroChina Has High Yield, Low McDep Ratio, and Low Debt

Last week PetroChina paid its interim dividend that had been declared at RMB 0.069535 per share by the Board of Directors in a meeting on August 30, 2001. Considering that each American Depositary Receipt represents 100 ordinary shares, the dividend is equivalent to RMB 6.9535 per ADS. At the fixed rate of exchange the payment was made at \$0.84 per share. Holding our shares in a retirement account exempt from U.S. taxes, we were pleased to see that the headquarters country withheld no tax, as is the case for some European stocks.

Assuming a final dividend next June equal to what was paid this year, investors would receive another \$0.99 per share for a total of \$1.83 for the year 2001. As a result at the current price, the indicated annual dividend yield on the stock is 10.4%.

The dividend yield is so favorable one must question whether it is sound. We believe it is or we would not be recommending the stock. Cash flow covers dividends by a wide margin. Next twelve months Ebitda minus interest and tax is three times the dividend. A low ratio of debt to present value of 0.14 adds reassurance.

Our capsule justification for owning the stock was that PTR had half the oil and gas production of **ExxonMobil** while trading at one eighth the market cap and offering four times the dividend yield. It is now at one ninth the market cap of XOM and four and a half times the dividend yield of XOM.

We are gratified that on his visit to China, President Bush has had an apparently positive meeting with President Jiang Zemin. We are optimistic that close economic and political relations will be mutually beneficial. The better the relationship, the more confident we can be about economic progress and the prospects for PetroChina stock.

Devon, Marathon and Unocal Moved to Large Cap from Mid Cap

Stretching the definition of Large Cap to include possibly Enterprise Value above \$10 billion instead of just Market Cap above \$10 billion we bring MRO and UCL to the same group as Phillips and Conoco, their traditional peers. Devon is now large enough to be classified with Anadarko and Burlington.

Kurt H. Wulff, CFA

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Table L-1
Mega Cap and Large Cap Energy Companies
Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/ Rating	Price (\$/sh) 19-Oct 2001	Shares (mm)	Market Cap (\$mm)	Net Present Value (\$/sh)	Debt/ Present Value	McDep Ratio	
Mega Cap								
Exxon Mobil Corporation	XOM	40.54	6,963	282,000	38.60	0.04	1.05	
Royal Dutch/Shell	RD	2	50.58	3,544	179,000	50.80	0.06	1.00
ChevronTexaco Corporation	CVX	86.74	1,063	92,200	89.40	0.17	0.97	
BP plc	BP	48.36	3,744	181,000	51.50	0.15	0.95	
TotalFinaElf S.A.	TOT	68.05	1,406	96,000	86.80	0.14	0.81	
	<i>Total or Median</i>			<i>830,000</i>		<i>0.14</i>	<i>0.97</i>	
Power								
Dynegy Inc.	DYN	43.64	338	14,800	20.60	0.56	1.50	
Enron Corp.	ENE	26.05	913	23,800	9.50	0.77	1.40	
Calpine Corporation	CPN	4	26.78	318	8,500	11.10	0.72	1.39
Duke Energy Corporation	DUK	39.14	779	30,500	26.40	0.55	1.22	
Mirant Corporation	MIR	28.98	353	10,200	18.60	0.65	1.19	
AES Corporation	AES	14.32	543	7,800	8.80	0.83	1.11	
Williams Companies	WMB	28.45	485	13,800	23.30	0.62	1.08	
El Paso Corporation	EPG	52.85	532	28,100	48.60	0.47	1.05	
American Electric Power Co. Inc.	AEP	2	44.12	322	14,200	46.40	0.61	0.98
Southern Company	SO	25.16	683	17,200	27.40	0.42	0.95	
Dominion Resources	D	61.14	247	15,100	79.40	0.45	0.87	
Exelon Corporation	EXC	2	43.83	324	14,200	87.40	0.39	0.70
	<i>Total or Median</i>			<i>160,000</i>		<i>0.58</i>	<i>1.06</i>	
Natural Gas and Oil								
Occidental Petroleum Corp.	OXY	24.97	372	9,300	32.20	0.46	0.88	
Anadarko Petroleum Corp.	APC	55.13	268	14,800	73.70	0.21	0.80	
Burlington Resources (incl HTR)	BR	1	34.98	205	7,200	50.20	0.31	0.79
Unocal Corporation	UCL	32.27	257	8,300	49.00	0.29	0.76	
Phillips Petroleum Company	P	54.90	383	21,000	82.70	0.28	0.76	
ENI S.p.A.	E	60.60	789	47,800	86.20	0.17	0.75	
Devon Energy (incl MND,AXN)	DVN	36.30	165	6,000	66.40	0.43	0.74	
Conoco Inc.	COC	24.97	636	15,900	46.60	0.30	0.68	
Marathon Oil Corporation	MRO	1	28.19	310	8,700	50.00	0.24	0.67
	<i>Total or Median</i>			<i>130,000</i>		<i>0.29</i>	<i>0.75</i>	
Service								
Baker Hughes Inc.	BHI	31.89	338	10,800	24.50	0.13	1.26	
Schlumberger Ltd.	SLB	47.24	581	27,400	44.00	0.12	1.06	
Halliburton Company	HAL	24.00	430	10,300	27.20	0.13	0.90	

Buy/Sell rating after symbol: 1 - Strong Buy, 2 - Buy, 4 - Sell

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

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Table L-2
Mega Cap and Large Cap Energy Companies
Rank by EV/Ebitda: Enterprise Value to Earnings Before Interest, Tax, Deprec.

	<i>Symbol/ Rating</i>	<i>Price (\$/sh) 19-Oct 2001</i>	<i>EV/ Sales 2001E</i>	<i>EV/ Ebitda NTM</i>	<i>P/E NTM</i>	<i>Dividend or Distribution NTM (%)</i>	<i>PV/ Ebitda NTM</i>	
Mega Cap								
	XOM	40.54	1.3	9.4	19	2.3	9.0	
	RD	2	50.58	1.1	9.0	20	2.8	9.0
	CVX		86.74	1.1	8.8	20	3.0	9.0
	BP		48.36	1.1	8.5	19	2.7	9.0
	TOT		68.05	1.3	7.3	14	2.7	9.0
	<i>Median</i>		<i>1.1</i>	<i>8.8</i>	<i>19</i>	<i>2.7</i>	<i>9.0</i>	
Power								
	DYN		43.64	0.4	13.5	21	0.7	9.0
	ENE		26.05	0.3	12.6	15	1.9	9.0
	CPN	4	26.78	2.7	12.5	14	-	9.0
	DUK		39.14	0.9	10.9	15	2.8	9.0
	MIR		28.98	0.6	10.8	13	-	9.0
	AES		14.32	3.5	10.0	11	-	9.0
	WMB		28.45	3.1	9.8	12	2.1	9.0
	EPG		52.85	1.0	9.4	15	1.6	9.0
	AEP	2	44.12	0.7	8.8	12	5.4	9.0
	SO		25.16	2.8	8.6	15	5.3	9.0
	D		61.14	3.4	7.9	14	4.2	9.0
	EXC	2	43.83	2.2	6.3	9	3.9	9.0
	<i>Median</i>		<i>1.6</i>	<i>9.9</i>	<i>14</i>	<i>2.0</i>	<i>9.0</i>	
Natural Gas and Oil								
	OXY		24.97	1.4	7.9	14	4.0	9.0
	APC		55.13	2.7	7.2	18	0.4	9.0
	BR	1	34.98	4.5	7.1	60	1.6	9.0
	P		54.90	0.7	6.8	13	2.6	9.0
	UCL		17.11	2.4	6.5	24	2.5	8.5
	E		60.60	1.5	6.0	12	3.0	8.0
	DVN		36.30	3.0	5.6	15	0.6	7.5
	COC		24.97	0.8	5.4	11	3.0	8.0
	MRO	1	28.19	0.4	4.3	9	3.3	6.5
	<i>Median</i>		<i>1.5</i>	<i>6.5</i>	<i>14</i>	<i>2.6</i>	<i>8.5</i>	
Service								
	BHI		31.89	2.0	10.1	22	1.4	9.0
	SLB		47.24	2.5	8.5	23	1.6	9.0
	HAL		24.00	0.9	7.2	16	2.1	9.0

EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended September 30, 2002; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses

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Table S-1
Mid Cap and Small Cap Energy Companies
Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/ Rating	Price (\$/sh) 19-Oct 2001	Shares (mm)	Market Cap (\$mm)	Net Present Value (\$/sh)	Debt/ Present Value	McDep Ratio
Power							
Consol Energy Inc.	CNX	25.58	79	2,000	35.90	0.51	0.86
Sempra Energy	SRE	24.30	203	4,900	41.70	0.50	0.79
CMS Energy Corporation	CMS	21.24	128	2,700	48.30	0.62	0.79
Constellation Energy Group	CEG	27.56	152	4,200	56.50	0.35	0.67
<i>Total or Median</i>				13,800		0.51	0.79
Natural Gas and Oil							
Imperial Oil Limited (30%)	IMO	27.50	119	3,300	29.30	0.11	0.94
Ocean Energy, Inc.	OEI	18.10	178	3,200	20.60	0.29	0.91
Murphy Oil Corporation	MUR	79.90	46	3,600	94.60	0.16	0.87
PanCanadian Energy	PCX	26.19	262	6,860	32.10	0.14	0.84
Valero Energy Corp.(with UDS)	VLO	36.70	110	4,000	54.50	0.49	0.83
Petro-Canada	PCZ	25.71	267	6,900	34.40	0.08	0.77
Norsk Hydro ASA (49%)	NHY	35.63	127	4,500	51.90	0.19	0.75
PetroChina Company Ltd (10%)	PTR	17.69	176	3,100	31.70	0.14	0.62
<i>Total or Median</i>				35,500		0.15	0.84
Small Cap							
Quicksilver Resources Inc.	KWK	14.03	19.3	270	5.50	0.73	1.41
Spinnaker Exploration Company	SKE	41.99	28.4	1,190	38.60	-	1.09
Magnum Hunter Resources, Inc.	MHR	10.49	37.0	390	10.40	0.36	1.01
XTO Energy Inc.	XTO	17.11	123.0	2,110	17.70	0.29	0.98
Southwestern Energy Company	SWN	12.50	25.7	320	13.90	0.48	0.95
Louis Dreyfus Natural Gas Corp.	LD	39.66	44.8	1,780	45.10	0.23	0.91
Swift Energy Company	SFY	22.60	25.7	580	28.40	0.24	0.84
Encore Acquisition Corp. (25%)	EAC	12.60	7.5	95	15.60	0.16	0.84
Penn Virginia Corporation	PVA	35.22	8.8	310	47.70	0.19	0.79
Newfield Exploration Company	NFX	32.68	49.3	1,610	49.50	0.17	0.72
Forest Oil Corporation	FST	27.14	50.2	1,360	42.90	0.21	0.71
Stone Energy Company	SGY	35.50	26.5	940	54.60	0.09	0.68
<i>Total or Median</i>				10,960		0.22	0.88
Trusts and Partnerships							
TEPPCO Partners, L.P.	TPP	33.25	38	1,260	18.00	0.58	1.36
Dorchester Hugoton, Ltd.	DHULZ	12.25	10.7	132	11.20	-	1.10
Cross Timbers Royalty Trust	CRT	17.05	6.0	102	16.80	-	1.01
Hugoton RoyaltyTrust	HGT	10.77	40.0	430	14.60	-	0.74
San Juan Basin Royalty Trust	SJT	11.08	46.6	520	15.10	-	0.73
<i>Total or Median</i>				2,440		-	1.01
Micro Cap							
Abraxas Petroleum Corporation	ABP	1.60	23.6	38	0.90	0.94	1.05
Purcell Energy, Ltd. (US\$)	PEL.TO	2.21	26.6	59	3.10	0.10	0.74
Energy Partners Ltd.(30%)	EPL	7.95	8.1	64	12.30	0.10	0.68

Buy/Sell rating after symbol: 1 - Strong Buy, 2 - Buy, 3 - Neutral

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

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Rank by EV/Ebitda: Enterprise Value to Earnings Before Interest, Tax, Deprec.

	Symbol/ Rating	Price (\$/sh) 19-Oct 2001	EV/ Sales 2001E	EV/ Ebitda NTM	P/E NTM	Dividend or Distribution NTM (%)	PV/ Ebitda NTM	
Power								
Consol Energy Inc.	CNX	25.58	2.1	7.7	9	4.4	9.0	
Sempra Energy	SRE	24.30	1.1	7.1	9	4.1	9.0	
CMS Energy Corporation	CMS	21.24	0.8	7.1	8	6.9	9.0	
Constellation Energy Group	CEG	27.56	1.7	6.0	9	1.7	9.0	
	<i>Median</i>		<i>1.4</i>	<i>7.1</i>	<i>9</i>	<i>4.2</i>	<i>9.0</i>	
Natural Gas and Oil								
Imperial Oil Limited (30%)	IMO	27.50	1.1	8.5	19	2.0	9.0	
Murphy Oil Corporation	MUR	79.90	0.9	7.0	25	1.9	8.0	
Ocean Energy, Inc.	OEI	18.10	3.9	6.4	20	0.9	7.0	
PanCanadian Energy	PCX	2	26.19	1.2	5.9	12	1.0	7.0
Valero Energy Corp.(with UDS)	VLO	36.70	0.3	5.8	5	1.1	7.0	
Petro-Canada	PCZ	25.71	1.4	5.4	12	1.0	7.0	
Norsk Hydro ASA (49%)	NHY	35.63	0.7	3.7	9	2.9	5.0	
PetroChina Company Ltd (10%)	PTR	2	17.69	1.5	3.1	7	10.6	5.0
	<i>Median</i>		<i>1.1</i>	<i>5.9</i>	<i>12</i>	<i>1.5</i>	<i>7.0</i>	
Small Cap								
Quicksilver Resources Inc.	KWK	14.03	5.7	19.7		-	14.0	
Magnum Hunter Resources, Inc.	MHR	10.49	5.3	10.1		-	10.0	
Spinnaker Exploration Company	SKE	41.99	8.2	9.8	46	-	9.0	
Louis Dreyfus Natural Gas Corp.	LD	3	39.66	6.1	9.1	32	-	10.0
XTO Energy Inc.	XTO	17.11	5.6	8.8	25	0.2	9.0	
Southwestern Energy Company	SWN	12.50	2.7	8.5	176	-	9.0	
Swift Energy Company	SFY	22.60	5.6	7.6	25	-	9.0	
Encore Acquisition Corp. (25%)	EAC	12.60	4.3	7.6	23	-	9.0	
Penn Virginia Corporation	PVA	35.22	4.5	6.3	11	2.6	8.0	
Forest Oil Corporation	FST	27.14	2.2	5.7	32	-	8.0	
Newfield Exploration Company	NFX	32.68	3.9	5.0	22	-	7.0	
Stone Energy Company	SGY	35.50	3.7	4.8	26	-	7.0	
	<i>Median</i>		<i>4.9</i>	<i>8.1</i>	<i>26</i>	<i>-</i>	<i>9.0</i>	
Trusts and Partnerships								
Dorchester Hugoton, Ltd.	DHULZ	12.25	7.7	11.4	15	23.9	10.4	
TEPPCO Partners, L.P.	TPP	33.25	0.7	12.2	17	6.3	9.0	
Cross Timbers Royalty Trust	CRT	17.05	6.7	11.6	12	8.0	11.5	
San Juan Basin Royalty Trust	SJT	2	11.08	6.2	8.1	12	8.7	11.0
Hugoton RoyaltyTrust	HGT	10.77	5.0	7.7	12	8.7	10.5	
	<i>Median</i>		<i>6.2</i>	<i>11.4</i>	<i>12</i>	<i>8.7</i>	<i>10.5</i>	
Micro Cap								
Abraxas Petroleum Corporation	ABP	1.60	6.3	11.6		-	11.0	
Energy Partners Ltd.(30%)	EPL	2	7.95	2.1	4.5	-	6.6	
Purcell Energy, Ltd. (US\$)	PEL.TO	2.21	3.1	4.4	12	-	6.0	

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