

Meter Reader

A Weekly Analysis of Energy Stocks Using the McDep Ratio

October 5, 2004

Oil Bubble?

Summary and Recommendation

After the tech bubble, the real estate bubble and the bond bubble, why not the oil bubble? As we recall, the typical oil and gas producer stock doubled and redoubled 25 years ago in similar circumstances as today. Does a bubble spell trouble? A doubling of stock price could be reasonable, but a redoubling might be too much temporarily. The insidious implication that provides the air for blowing bubbles is that the dollar isn't what it used to be. Recommended stocks well-positioned for conservative expectations and that might multiply in a bubble include **ChevronTexaco (CVX)**, **ConocoPhillips (COP)**, **CNOOC Ltd (CEO)** and **Encore Acquisition (EAC)**.

Pick Your Oil Price

Current quotes hit \$50 a barrel recently. That is enough for us for now. The futures market says the average price for the next twelve months will be above \$46 a barrel and for the next six years, almost \$39 (see chart [Six-Year and One-Year Natural Gas and Oil Futures](#)). The stock market seems to say that the long term price is under \$30.

Our McDep Ratios and present value estimates are consistent with \$35 oil with some exceptions. Most of our buy recommendations have attractive appreciation potential on \$35 oil (see tables [Rank by McDep Ratio](#) and [Rank by EV/Ebitda](#)).

The consensus is that oil price will recede from current levels. That is a harmless position for investors to take as long as they do not bet too much on that outcome being necessary soon. The reality for most of the past several years has been the opposite.

Often as not, the consensus is confounded. A logical technical upside for oil is \$85 a barrel, the inflation-adjusted peak from 25 years ago. Much of the near-term outlook depends on the upcoming winter weather. A tight supply/demand situation combined with contemplation of cold winter can give price an upward thrust. The important timing distinction is that for the next few months those anticipations cannot be easily refuted until winter actually arrives.

Consumer Inflation Understated

Low interest rates provide little real return after erosion of principal by inflation. Moreover, consumer inflation may be greater than stated by about 1.1% per year as bond manager, Bill Gross, details in a time series back to 1988. On the Pimco website Mr.

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Gross questions the quality adjustments and substitution adjustments applied by the government keepers of the dollar.

U.S. Treasury Ten-Year Notes are priced at a nominal yield of about 4.2% per year while Ten-Year Treasury Inflation Protected Securities are priced at a real yield of about 1.8%. The difference implies expected inflation of 2.4% per year. Yet if inflation is 1.1% higher than that measured by the government, the real yield drops to just 0.7%. We continue to have personal holdings in TIPS on the premise that they are the lowest risk investment while we keep a wary eye on the calculation of inflation. Nonetheless understated consumer inflation appears to be contributing to bond prices that may be artificially high.

Asset Inflation May Exceed Consumer Inflation

Thanks in part to low interest rates, home prices seem to have advanced more than consumer prices for more than the past decade. Asset inflation is largely overlooked in measures of consumer inflation. Characteristically, we may not think our own home is overpriced, but we are impressed at the prices our neighbors have received. Five of the six homes that abut our property have sold in the past year or two. We remind ourselves regularly that it is not so much that real estate has gone up, but that the dollar has gone down.

Perhaps \$50 is Not a High Price for a Barrel of Oil

We point to our moderate oil price scenario that has oil peaking in inflation-adjusted terms at \$50 in 2010 and declining to \$40 a few years later. We remember that the price reached in 1981 could not be sustained. We put that level at about \$85 a barrel.

The calculation might be reproduced by taking the reported refiner acquisition cost of imported oil in January 1981 at \$39 a barrel and adjusting for inflation. The Consumer Price Index last month was 2.2 times the CPI in January 1981. That works out to \$85 a barrel for the inflation-adjusted peak. The annual rate of inflation in CPI from then to now is 3.4 % per year. If the rate is too low by 0.5 % a year, then the inflation-adjusted oil price peak would be \$95 a barrel. If the rate is too low by 1.0 % a year, then the inflation-adjusted oil price peak would be \$106 a barrel.

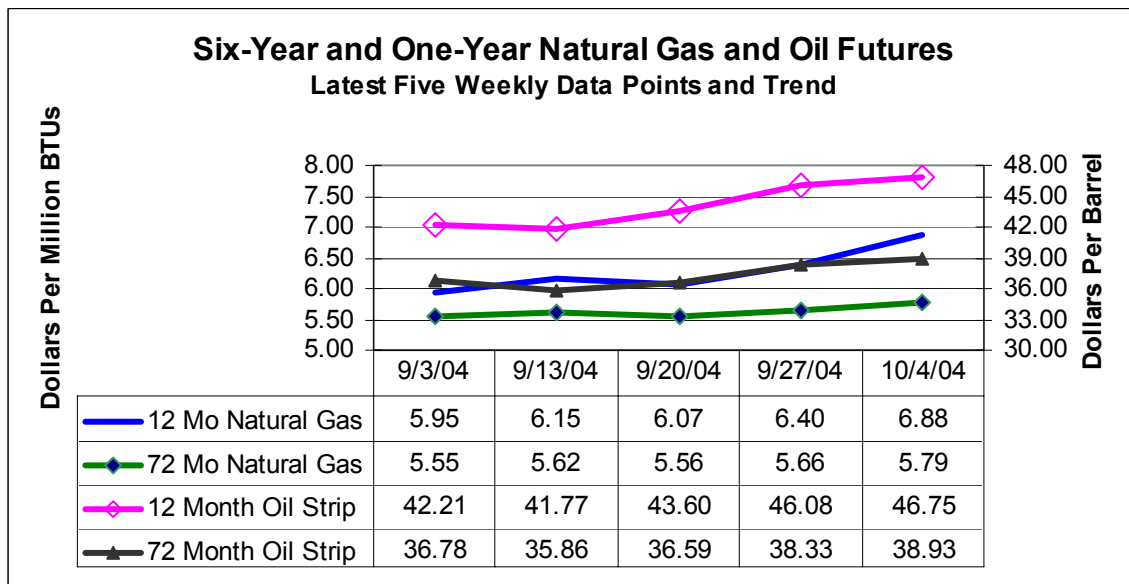
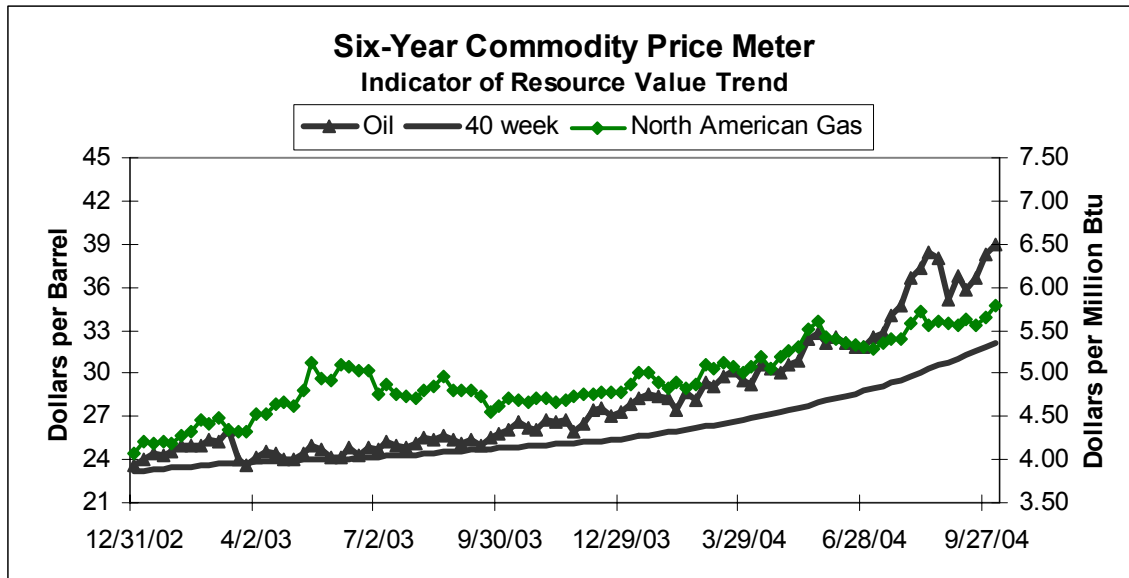
Remember that Europeans pay about \$5 a gallon for gasoline compared to \$2 a gallon in the U.S. Each dollar a gallon corresponds to \$42 a barrel.

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Rated Oil and Gas Producers Rank by McDep Ratio: Market Cap and Debt to Present Value

| | Symbol/ Rating | Price (\$/sh) 4-Oct 2004 | Shares (mm) | Market Cap (\$mm) | Net Present Value (\$/sh) | Debt/ Present Value | McDep Ratio |
|--|-------------------|-----------------------------------|----------------|-------------------------|------------------------------------|---------------------------|----------------|
| Mega Cap | | | | | | | |
| Exxon Mobil Corporation | XOM B3 | 48.92 | 6,547 | 320,000 | 43.00 | 0.08 | 1.13 |
| BP plc | BP B3 | 57.55 | 3,651 | 210,000 | 60.00 | 0.13 | 0.96 |
| Total S.A. | TOT B3 | 102.05 | 1,237 | 126,300 | 113.00 | 0.16 | 0.92 |
| Shell Transport and Trading Co. plc | SC B3 | 44.55 | 1,587 | 71,000 | 51.20 | 0.17 | 0.89 |
| Royal Dutch Petroleum | RD B1 | 51.72 | 2,031 | 105,000 | 60.00 | 0.17 | 0.89 |
| ChevronTexaco Corporation | CVX B1 | 53.86 | 2,130 | 114,700 | 62.50 | 0.14 | 0.88 |
| <i>Total or Median</i> | | | | <i>947,000</i> | | <i>0.15</i> | <i>0.91</i> |
| Producer/Refiners - Large Cap and Mid Cap | | | | | | | |
| Kinder Morgan, Inc. | KMI S2 | 63.34 | 125 | 7,920 | 20.00 | 0.73 | 1.58 |
| Marathon Oil Corporation | MRO B3 | 41.75 | 346 | 14,450 | 41.00 | 0.30 | 1.01 |
| Imperial Oil Limited (30%) | IMO B3 | 52.14 | 108 | 5,620 | 52.00 | 0.11 | 1.00 |
| Suncor Energy | SU B3 | 32.14 | 460 | 14,780 | 38.00 | 0.13 | 0.87 |
| Norsk Hydro ASA | NHY B1 | 75.20 | 256 | 19,210 | 90.00 | 0.16 | 0.86 |
| ConocoPhillips | COP B1 | 84.67 | 699 | 59,200 | 110.00 | 0.25 | 0.83 |
| Petro-Canada | PCZ B3 | 52.05 | 266 | 13,860 | 68.00 | 0.15 | 0.80 |
| PetroChina Company Ltd (10%) | PTR B2 | 54.77 | 176 | 9,630 | 82.00 | 0.06 | 0.69 |
| Lukoil Oil Company | LUKOY B2 | 128.25 | 209 | 27,000 | 208.00 | 0.05 | 0.64 |
| <i>Total or Median</i> | | | | <i>172,000</i> | | <i>0.15</i> | <i>0.86</i> |
| Independent Natural Gas and Oil - Large Cap and Mid Cap | | | | | | | |
| CNOOC Limited (19%) | CEO B2 | 54.42 | 78 | 4,250 | 59.00 | - | 0.92 |
| XTO Energy Inc. | XTO B1 | 32.63 | 276 | 9,010 | 38.00 | 0.21 | 0.89 |
| Unocal Corporation | UCL B3 | 43.03 | 278 | 12,000 | 54.00 | 0.25 | 0.85 |
| Encana Corporation | ECA B1 | 47.05 | 471 | 22,100 | 63.00 | 0.25 | 0.81 |
| Occidental Petroleum Corp. | OXY B3 | 56.37 | 399 | 22,500 | 75.00 | 0.18 | 0.80 |
| Anadarko Petroleum Corp. | APC B1 | 67.17 | 254 | 17,100 | 94.00 | 0.21 | 0.78 |
| Burlington Resources | BR B1 | 41.26 | 397 | 16,400 | 58.00 | 0.14 | 0.75 |
| Devon Energy Corporation | DVN B3 | 71.96 | 249 | 17,900 | 110.00 | 0.24 | 0.74 |
| <i>Total or Median</i> | | | | <i>121,000</i> | | <i>0.21</i> | <i>0.80</i> |
| Independent Natural Gas and Oil - Small Cap | | | | | | | |
| Cimarex Energy Company | XEC B2 | 35.05 | 43 | 1,500 | 38.00 | 0.00 | 0.92 |
| Berry Petroleum Company | BRY B2 | 37.43 | 22 | 840 | 43.00 | 0.06 | 0.88 |
| Encore Acquisition Company | EAC B2 | 34.98 | 33 | 1,140 | 47.00 | 0.20 | 0.79 |
| Energy Partners Ltd. | EPL B3 | 16.25 | 38 | 620 | 22.00 | 0.14 | 0.77 |
| <i>Total or Median</i> | | | | <i>4,100</i> | | <i>0.10</i> | <i>0.84</i> |
| Income | | | | | | | |
| Kinder Morgan Energy Partners, L.P. | KMP S3 | 46.77 | 145 | 6,780 | 15.00 | 0.49 | 2.07 |
| Kinder Morgan Management, LLC | KMR S3 | 41.77 | 54 | 2,260 | 15.00 | 0.49 | 1.90 |
| San Juan Basin Royalty Trust | SJT H | 30.21 | 47 | 1,410 | 22.00 | - | 1.38 |
| Canadian Oil Sands Trust (US\$) | COSWF B1 | 44.60 | 93 | 4,160 | 62.00 | 0.19 | 0.77 |
| <i>Total or Median</i> | | | | <i>14,600</i> | | <i>0.34</i> | <i>1.64</i> |

B1 = Buy full unlevered position, B2 = Buy half unlevered position, B3 = Alternative buy

S2 = Short half unlevered position, S3 = Short quarter unlevered position

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

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Rated Oil and Gas Producers

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

| | Symbol/ Rating | | Price (\$/sh) 4-Oct 2004 | Adjstd Resrvs/ Prod NTM | PV/ Ebitda NTM | EV/ Ebitda NTM | P/E NTM | Divd or Distrib NTM (%) |
|--|-------------------|----|-----------------------------------|----------------------------------|----------------------|----------------------|------------|----------------------------------|
| Mega Cap | | | | | | | | |
| Exxon Mobil Corporation | XOM | B3 | 48.92 | 11.1 | 6.0 | 6.8 | 12 | 2.2 |
| Total S.A. | TOT | B3 | 102.05 | 9.1 | 6.6 | 6.1 | 11 | 2.8 |
| BP plc | BP | B3 | 57.55 | 9.7 | 6.2 | 6.0 | 11 | 3.0 |
| Shell Transport and Trading Co. plc | SC | B3 | 44.55 | 8.2 | 5.3 | 4.7 | 9 | 4.2 |
| Royal Dutch Petroleum | RD | B1 | 51.72 | 8.2 | 5.3 | 4.7 | 9 | 4.2 |
| ChevronTexaco Corporation | CVX | B1 | 53.86 | 11.0 | 5.2 | 4.6 | 8 | 3.0 |
| | <i>Median</i> | | | 9.4 | 5.7 | 5.4 | 10 | 3.0 |
| Producer/Refiners - Large Cap and Mid Cap | | | | | | | | |
| Kinder Morgan, Inc. | KMI | S2 | 63.34 | | 8.5 | 13.4 | 17 | 3.6 |
| Suncor Energy | SU | B3 | 32.14 | 18.3 | 7.4 | 6.4 | 14 | 0.6 |
| Imperial Oil Limited (30%) | IMO | B3 | 52.14 | 10.9 | 5.9 | 5.9 | 10 | 1.3 |
| Marathon Oil Corporation | MRO | B3 | 41.75 | 7.4 | 5.0 | 5.1 | 9 | 2.4 |
| ConocoPhillips | COP | B1 | 84.67 | 11.2 | 5.5 | 4.5 | 7 | 2.0 |
| Norsk Hydro ASA | NHY | B1 | 75.20 | 9.4 | 5.2 | 4.4 | 10 | 2.2 |
| PetroChina Company Ltd (10%) | PTR | B2 | 54.77 | 13.5 | 6.3 | 4.3 | 9 | 4.3 |
| Petro-Canada | PCZ | B3 | 52.05 | 7.7 | 5.0 | 4.0 | 7 | 0.9 |
| Lukoil Oil Company | LUKOY | B2 | 128.25 | 12.2 | 5.3 | 3.4 | 6 | 2.6 |
| | <i>Median</i> | | | 11.0 | 5.5 | 4.5 | 9 | 2.2 |
| Independent Natural Gas and Oil - Large Cap and Mid Cap | | | | | | | | |
| XTO Energy Inc. | XTO | B1 | 32.63 | 11.7 | 6.3 | 5.6 | 11 | 0.1 |
| CNOOC Limited (19%) | CEO | B2 | 54.42 | 10.4 | 5.9 | 5.4 | 10 | 3.3 |
| Unocal Corporation | UCL | B3 | 43.03 | 9.0 | 5.3 | 4.5 | 8 | 1.9 |
| Burlington Resources | BR | B1 | 41.26 | 10.2 | 5.9 | 4.5 | 9 | 0.8 |
| Occidental Petroleum Corp. | OXY | B3 | 56.37 | 11.1 | 5.6 | 4.4 | 7 | 2.0 |
| Anadarko Petroleum Corp. | APC | B1 | 67.17 | 11.4 | 5.7 | 4.4 | 8 | 0.8 |
| Encana Corporation | ECA | B1 | 47.05 | 6.7 | 5.2 | 4.2 | 8 | 0.9 |
| Devon Energy Corporation | DVN | B3 | 71.96 | 6.6 | 4.8 | 3.5 | 6 | 0.6 |
| | <i>Median</i> | | | 10.3 | 5.6 | 4.5 | 8 | 0.8 |
| Independent Natural Gas and Oil - Small Cap | | | | | | | | |
| Encore Acquisition Company | EAC | B2 | 34.98 | 12.0 | 6.7 | 5.4 | 10 | - |
| Berry Petroleum Company | BRP | B2 | 37.43 | 12.8 | 5.5 | 4.8 | 10 | 1.2 |
| Cimarex Energy Company | XEC | B2 | 35.05 | 5.2 | 3.7 | 3.4 | 8 | - |
| Energy Partners Ltd. | EPL | B3 | 16.25 | 5.0 | 3.7 | 2.8 | 8 | - |
| | <i>Median</i> | | | 8.6 | 4.6 | 4.1 | 9 | - |
| Income | | | | | | | | |
| Kinder Morgan Energy Partners, L.P. | KMP | S3 | 46.77 | 12.0 | 7.9 | 16.3 | 23 | 6.1 |
| Kinder Morgan Management, LLC | KMR | S3 | 41.77 | 12.0 | 7.9 | 15.0 | 20 | 6.8 |
| San Juan Basin Royalty Trust | SJT | H | 30.21 | 12.5 | 7.4 | 10.2 | 12 | 8.6 |
| Canadian Oil Sands Trust (US\$) | COSWF | B1 | 44.60 | 20.0 | 7.6 | 5.9 | 7 | 3.5 |
| | <i>Median</i> | | | 12.2 | 7.7 | 12.6 | 16 | 6.4 |

EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended September 30, 2005; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses

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