

## Meter Reader

A Weekly Analysis of Energy Stocks Using the McDep Ratio

March 22, 2005

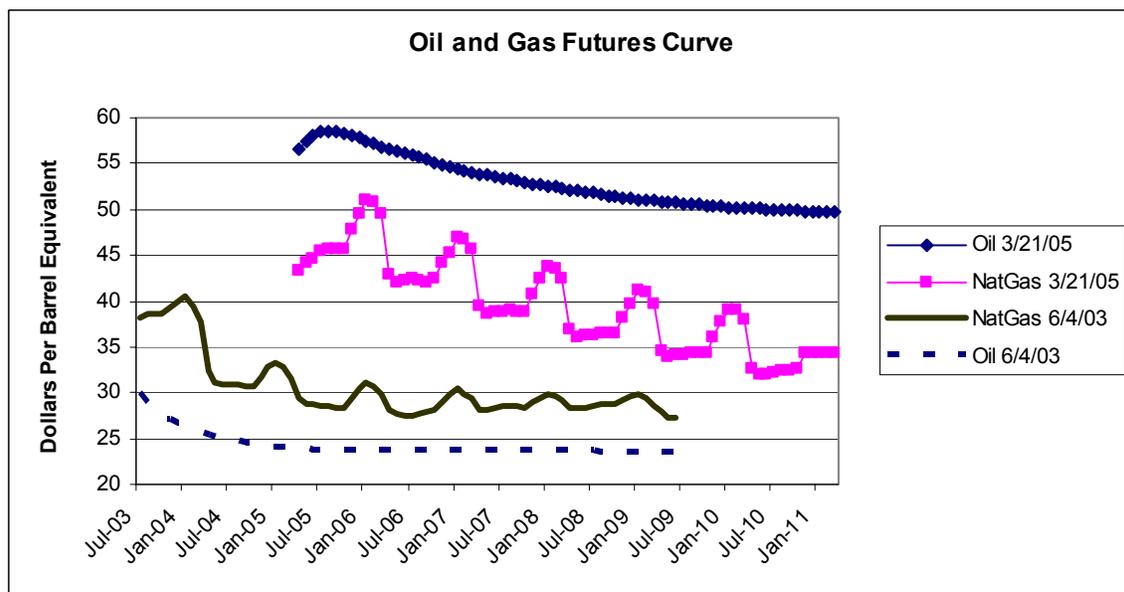
# The Buy Stocks, Sell Commodity Futures Arbitrage

## Summary and Recommendation

Oil futures are pointing to gains ahead for buy-recommended oil and gas stocks. Last time around, thirty years ago, there was no futures market and it was acquisition activity in independent producers that provided the clue to gains ahead for oil and gas stocks. While we think the main implication is to buy recommended stocks, there also appear to be arbitrage opportunities for those inclined to trade. The gap between oil futures and oil stocks is particularly wide for a long-life pure play like **Canadian Oil Sands Trust (COSWF)**. There is also a valuation gap between oil futures and natural gas producers like **Burlington Resources (BR)**, but some of that difference may relate to the gap between oil futures and natural gas futures.

## Oil Futures Point to Investment Future

The oil futures market is sending a strong message. The downward sloping oil futures curve averages \$53 a barrel for the next six years (see chart [Oil and Gas Futures Curve](#)). In contrast oil and gas stocks seem to be priced as though oil price would be less than \$40 a barrel.



Historical independent energy investment analysis by Kurt Wulff doing business as McDep Associates is posted at [www.mcdep.com](http://www.mcdep.com). Analyses are prepared from sources and data believed to be reliable, but no representation is made as to their accuracy or completeness. Mr. Wulff is not paid by covered companies. Neither he nor his spouse trade a subject stock within a week before or after a change in rating.

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Nor does \$53 a barrel seem a high price. It is only about \$1.26 a gallon for the raw material that makes up gasoline priced at perhaps \$2.40 per gallon retail. Europeans pay some \$5 a gallon implying crude oil price could triple from here to bring U.S. gasoline to the European level. Three to five fold gains in crude oil price in five to thirteen years seems indicated by the previous cycle.

Our emphasis on average price for six-years is conservative. Downward sloping curves need not diminish the apparent price outlook. Traders who are willing to exploit the curve might trade a near month, cover and trade the next month in a strategy known as “roll forward”. That hypothetical trader might effectively short futures closer to \$58 rather than at an average \$53.

The proceeds of the short sale could be invested in oil stocks. In the case of Canadian Oil Sands Trust, we think the stock, currently at about US\$70 a unit, would be US\$94 a unit on \$40 oil. If the next twelve months futures price of \$57 were to be sustained, the net present value of the stock might be about US\$180 a unit by the same calculation.

### **Natural Gas Futures Less Strong than Oil Futures**

Notice that the natural gas curve was above the oil curve two years ago. Since then the natural gas curve has seriously lagged as the oil curve has moved up sharply. Over four decades the price of natural gas relative to oil has advanced and that trend should continue, we believe.

When we say Burlington Resources, priced at about \$50 a share currently, has a net present value of \$67 a share, assuming \$40 oil, we are also assuming a higher price of natural gas relative to oil. If the next twelve months futures price for oil of \$57 were to be sustained, the net present value of the stock might be about \$105 by the same calculation.

About 60% of the value in BR is sensitive to natural gas price and the remaining 40% to oil price. As a result, perhaps 60% of the value increment above \$40 a barrel may not be supported by the natural gas futures curve. Nonetheless there is still quite a bit of upside to BR on the futures curves as they now stand.

Alternatively, a trader might sell oil futures and buy natural gas futures. Though we do not make explicit futures recommendations, we recommend a strong natural gas component in a stock portfolio of oil and gas producers.

### **The Two Time Dimensions of Futures**

Commodity futures have a delivery date and a quote date that can seem confusing initially. In the chart above we plot prices for 72 monthly delivery dates as they were

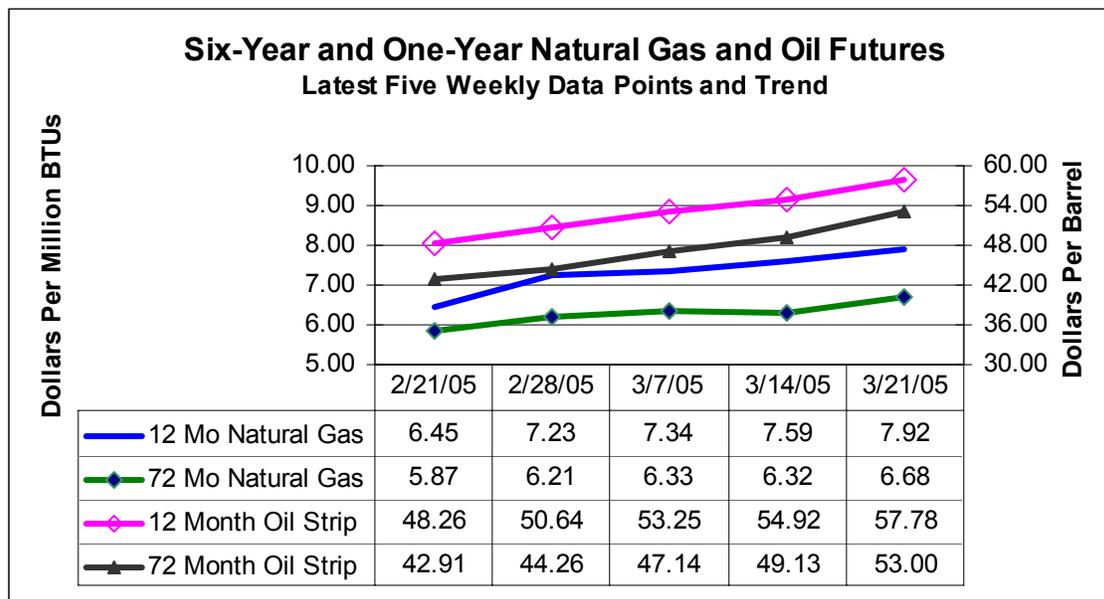
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quoted on 3/21/05 and two years earlier on 6/4/03. The 2003 date happened to be a temporary peak for natural gas futures relative to oil futures. Meanwhile, both oil and natural gas for delivery over the next year and the next six years set new highs in the futures market (see chart Latest Five Weekly Data Points and Trend).



Source: New York Mercantile Exchange, McDep Associates

## Stock Opportunities

McDep Ratios at a median of 0.92 suggest stocks are valued as though oil were less than \$37 (see table Rank by McDep Ratio). The median unlevered cash flow multiple is 4.9 times, median P/E is 9.5 and median dividend yield is 2.4% per year (see table Rank by EV/Ebitda).

Besides the weekly *Meter Reader* we update most of our single stock analyses at least once a quarter (see Index of Recent Research). Also we have a weekly analysis of *U.S. Natural Gas Royalty Trusts* with related single trust analyses.

Kurt H. Wulff, CFA

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

	Symbol/ Rating		Price (\$/sh) 21-Mar 2005	Shares (mm)	Market Cap (\$mm)	Net Present Value (\$/sh)	Debt/ Present Value	McDep Ratio
<b>Mega Cap</b>								
Exxon Mobil Corporation	XOM	B	62.14	6,461	402,000	60.00	0.06	1.03
BP plc	BP	B	64.82	3,601	233,000	64.00	0.12	1.01
Total S.A.	TOT	B	120.09	1,218	146,000	120.00	0.17	1.00
Shell Transport and Trading Co. plc	SC	B	55.83	1,587	89,000	55.90	0.16	1.00
Royal Dutch Petroleum	RD	B	61.91	2,016	125,000	66.00	0.16	0.95
ChevronTexaco Corporation	CVX	B	60.03	2,123	127,000	76.00	0.10	0.81
<i>Total or Median</i>					<i>1,122,000</i>		<i>0.14</i>	<i>1.00</i>
<b>Producer/Refiners - Large Cap and Mid Cap</b>								
Kinder Morgan, Inc.	KMI	S2	77.00	125	9,630	20.00	0.74	1.75
Imperial Oil Limited (30%)	IMO	B	75.13	105	7,920	64.00	0.11	1.15
Marathon Oil Corporation	MRO	B	47.08	347	16,360	42.00	0.30	1.08
Norsk Hydro ASA	NHY	B	87.95	252	22,190	101.00	0.16	0.89
ConocoPhillips	COP	B	109.04	706	77,000	128.00	0.23	0.89
Petro-Canada	PCZ	B	59.61	264	15,740	70.00	0.18	0.88
Suncor Energy	SU	B	40.41	460	18,590	54.00	0.10	0.77
PetroChina Company Ltd (10%)	PTR	B	65.36	176	11,490	94.00	0.05	0.71
Lukoil Oil Company	LUKOY	B	131.25	209	27,000	208.00	0.03	0.64
<i>Total or Median</i>					<i>206,000</i>		<i>0.16</i>	<i>0.89</i>
<b>Independent Natural Gas and Oil - Large Cap and Mid Cap</b>								
XTO Energy Inc.	XTO	B	33.63	349	11,750	33.80	0.17	1.00
Unocal Corporation	UCL	B	61.86	271	16,800	65.00	0.21	0.96
Encana Corporation	ECA	B	69.11	471	32,500	77.00	0.16	0.91
Occidental Petroleum Corp.	OXY	B	72.62	406	29,500	87.00	0.15	0.86
CNOOC Limited (19%)	CEO	B	57.45	78	4,490	67.00	-	0.86
Devon Energy Corporation	DVN	B	47.49	500	23,700	63.00	0.16	0.79
Burlington Resources	BR	B	50.01	391	19,600	67.00	0.12	0.78
Anadarko Petroleum Corp.	APC	B	75.95	246	18,700	113.00	0.14	0.72
<i>Total or Median</i>					<i>157,000</i>		<i>0.15</i>	<i>0.86</i>
<b>Independent Natural Gas and Oil - Small Cap</b>								
Berry Petroleum Company	BRY	B	57.02	22	1,280	50.00	0.12	1.12
Energy Partners Ltd.	EPL	B	26.84	39	1,060	30.00	0.20	0.92
Cimarex Energy Company	XEC	B	39.84	81	3,210	50.00	0.15	0.83
Encore Acquisition Company	EAC	B	42.00	33	1,370	57.00	0.19	0.79
<i>Total or Median</i>					<i>6,900</i>		<i>0.17</i>	<i>0.87</i>
<b>Income</b>								
Kinder Morgan Energy Partners, L.P.	KMP	S3	45.95	150	6,890	15.00	0.52	2.00
Kinder Morgan Management, LLC	KMR	S3	42.30	56	2,380	15.00	0.52	1.88
San Juan Basin Royalty Trust	SJT		36.92	47	1,720	30.00	-	1.23
Pengrowth Energy Trust	PGH		20.74	136	2,820	16.00	0.24	1.22
Enerplus Resources Fund	ERF		38.54	104	4,010	32.00	0.17	1.17
Canadian Oil Sands Trust (US\$)	COSWF	B	70.10	91	6,400	94.00	0.16	0.79
<i>Total or Median</i>					<i>24,200</i>		<i>0.20</i>	<i>1.23</i>

B = 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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#### Oil and Gas Producers

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

	Symbol/ Rating		Price (\$/sh) 21-Mar 2005	Adjstd Resrvs/ Prod NTM	PV/ Ebitda NTM	EV/ Ebitda NTM	P/E NTM	Divd or Distrib NTM (%)
<b>Mega Cap</b>								
Exxon Mobil Corporation	XOM	B	62.14	11.1	6.4	6.6	12	1.7
BP plc	BP	B	64.82	9.4	5.5	5.6	10	3.1
Total S.A.	TOT	B	120.09	8.9	5.5	5.5	11	2.7
Shell Transport and Trading Co. plc	SC	B	55.83	7.6	4.9	4.9	9	3.6
ChevronTexaco Corporation	CVX	B	60.03	9.7	5.8	4.7	8	2.7
Royal Dutch Petroleum	RD	B	61.91	7.6	4.9	4.6	9	3.9
	<i>Median</i>			9.2	5.5	5.2	10	2.9
<b>Producer/Refiners - Large Cap and Mid Cap</b>								
Kinder Morgan, Inc.	KMI	S2	77.00		7.5	13.0	17	3.6
Suncor Energy	SU	B	40.41	18.2	10.3	8.0	19	0.5
Imperial Oil Limited (30%)	IMO	B	75.13	10.6	6.2	7.1	13	1.0
Marathon Oil Corporation	MRO	B	47.08	7.9	4.9	5.3	9	2.4
Petro-Canada	PCZ	B	59.61	7.6	5.1	4.4	8	0.8
ConocoPhillips	COP	B	109.04	11.6	5.0	4.4	7	1.8
Norsk Hydro ASA	NHY	B	87.95	8.5	4.8	4.3	9	3.7
PetroChina Company Ltd (10%)	PTR	B	65.36	13.5	5.7	4.0	7	4.9
Lukoil Oil Company	LUKOY	B	131.25	12.2	3.4	2.2	4	2.7
	<i>Median</i>			11.1	5.1	4.4	9	2.4
<b>Independent Natural Gas and Oil - Large Cap and Mid Cap</b>								
XTO Energy Inc.	XTO	B	33.63	11.6	5.7	5.7	12	0.6
Occidental Petroleum Corp.	OXY	B	72.62	11.3	5.4	4.6	8	1.5
Unocal Corporation	UCL	B	61.86	8.5	4.8	4.6	10	1.3
Encana Corporation	ECA	B	69.11	7.2	5.0	4.5	9	0.6
Burlington Resources	BR	B	50.01	9.8	5.7	4.5	10	0.7
CNOOC Limited (19%)	CEO	B	57.45	9.6	5.2	4.4	8	3.1
Anadarko Petroleum Corp.	APC	B	75.95	11.9	5.5	4.0	7	0.9
Devon Energy Corporation	DVN	B	47.49	7.9	4.8	3.8	9	0.6
	<i>Median</i>			9.7	5.3	4.5	9	0.8
<b>Independent Natural Gas and Oil - Small Cap</b>								
Berry Petroleum Company	BRP	B	57.02	10.9	5.2	5.9	15	0.8
Encore Acquisition Company	EAC	B	42.00	15.6	6.4	5.1	11	-
Cimarex Energy Company	XEC	B	39.84	7.6	4.5	3.7	8	-
Energy Partners Ltd.	EPL	B	26.84	5.3	3.8	3.5	10	-
	<i>Median</i>			9.2	4.9	4.4	10	-
<b>Income</b>								
Kinder Morgan Energy Partners, L.P.	KMP	S3	45.95		7.6	15.1	19	6.4
Kinder Morgan Management, LLC	KMR	S3	42.30		7.6	14.2	18	6.9
San Juan Basin Royalty Trust	SJT		36.92	12.5	8.2	10.0	11	9.1
Canadian Oil Sands Trust (US\$)	COSWF	B	70.10	20.0	8.4	6.6	7	2.4
Enerplus Resources Fund	ERF		38.54	8.3	5.5	6.5	12	9.0
Pengrowth Energy Trust	PGH		20.74	7.9	4.8	5.9	9	11.0
	<i>Median</i>			10.4	7.6	8.3	11	8.0

EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended March 31, 2006; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses

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#### Index of Recent Research

##### Stock Ideas

<u>Date</u>	<u>Symbol</u>	<u>Stock</u>	<u>Theme</u>
21-Mar	PTR	PetroChina Company Limited	West to East Pipeline Flowing
18-Mar	RD	Royal Dutch Petroleum	Transformation Approaching
18-Mar	SC	Shell Transport & Trading Company, p.l.c.	Transformation Approaching
17-Mar	BP	BP p.l.c.	More Cash Flow to Owners
7-Mar	EPL	Energy Partners, Ltd.	Layer Cake
7-Mar	DVN	Devon Energy Corporation	Target Diversification
7-Mar	XEC	Cimarex Energy Company	Raise Net Present Value to \$50 a Share
7-Mar	XOM	Exxon Mobil Corporation	Raise Net Present Value to \$60 a Share
2-Mar	SU	Suncor Energy Inc.	Fire Tests Patience
28-Feb	CVX	ChevronTexaco Corporation	Raise Net Present Value to \$76 a Share
25-Feb	COP	ConocoPhillips	Raise Net Present Value to \$128 a Share
18-Feb	EAC	Encore Acquisition Company	Raise Net Present Value to \$57 a Share
17-Feb	* APC	Anadarko Petroleum Corporation	Raise Net Present Value to \$113 a Share
17-Feb	* XTO	XTO Energy Inc.	Raise Net Present Value to \$45 a Share
14-Feb	* TOT	Total S.A.	Raise Net Present Value to \$120 a Share
10-Feb	* UCL	Unocal Corporation	Raise Net Present Value to \$65 a Share
9-Feb	* EPL	Energy Partners, Ltd.	South Timbalier Thrill
7-Feb	* BRY	Berry Petroleum Company	A Touch of Glamour
7-Feb	* DVN	Devon Energy Corporation	Raise Net Present Value to \$63 a Share
7-Feb	* IMO	Imperial Oil Limited	Raise Net Present Value to US\$64 a Share
3-Feb	* SJT	San Juan Basin Royalty Trust	Real Value with Income
1-Feb	* PCZ	Petro-Canada	Raise Net Present Value to US\$70 a Share
31-Jan	* COSWF	Canadian Oil Sands Trust	Raise Net Present Value to US\$94 a Share
31-Jan	* MRO	Marathon Oil Corporation	Raise Net Present Value to \$42 a Share
26-Jan	* XEC	Cimarex Energy Company	Magnum Hunter Acquisition Adds Value
26-Jan	* OXY	Occidental Petroleum Corporation	Raise Net Present Value to \$87 a Share
25-Jan	* ECA	EnCana Corporation	Raise Net Present Value to US\$77 a Share
19-Jan	* KMP	Kinder Morgan Energy Partners, L.P.	Energy Houdini
19-Jan	* KMI	Kinder Morgan Inc.	Energy Houdini
19-Jan	* KMR	Kinder Morgan Management, LLC	Energy Houdini
13-Jan	* NHY	Norsk Hydro ASA	Oil, Natural Gas and Aluminum
12-Jan	* LUKOY	Lukoil Oil Company	Profits Advance
7-Jan	* BR	Burlington Resources, Inc.	Royalty Trust Candidate
29-Dec	* LUKOY	Lukoil Oil Company	After Yukos
29-Dec	* CEO	CNOOC Ltd	Natural Gas Progress

##### Meter Reader - A Weekly Analysis

22-Mar		
15-Mar	*	Indexing Consequences
8-Mar	*	Powerful Trends
1-Mar	*	Asset Reallocation
22-Feb	*	Wall of Worry
15-Feb	*	Just Buy
8-Feb	*	Happy Birthday to Meter Reader

\* Archived on [www.mcdep.com](http://www.mcdep.com)

Also see

##### U.S. Natural Gas Royalty Trusts - A Weekly Analysis, and Single-Trust Analyses

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