

## Mesa Royalty Trust

### Hugoton Predictability, San Juan Surprise

<i>Symbol</i>	MTR	<i>Ebitda Next Twelve Months ending 12/31/05 (US\$mm)</i>	11
<i>Rating</i>	None	<i>North American Natural Gas/Ebitda (%)</i>	78
<i>Price (US\$/sh)</i>	68.35	<i>Natural Gas and Oil Production/Ebitda (%)</i>	100
<i>Pricing Date</i>	11/19/04	<i>Adjusted Reserves/Production NTM</i>	15.0
<i>Shares (mm)</i>	1.86	<i>EV/Ebitda</i>	11.3
<i>Market Capitalization (US\$mm)</i>	127	<i>PV/Ebitda</i>	9.1
<i>Debt (US\$mm)</i>	0	<i>Undeveloped Reserves (%)</i>	2
<i>Enterprise Value (EV) (US\$mm)</i>	127	<i>Natural Gas and Oil Ebitda (US\$/mcfe)</i>	4.65
<i>Present Value (PV) (US\$mm)</i>	102	<i>Present Value Proven Reserves(US\$/boe)</i>	16.47
<i>Net Present Value (US\$/unit)</i>	55	<i>Present Value Proven Reserves(US\$/mcfe)</i>	2.74
<i>Debt/Present Value</i>	0.00	<i>Earnings Next Twelve Months (US\$/un)</i>	5.83
<i>McDep Ratio - EV/PV</i>	1.24	<i>Price/Earnings Next Twelve Months</i>	12
<i>Distribution Yield (%/year)</i>	8.5	<i>Distribution Next Twelve Months (US\$/sh)</i>	5.83

Note: Estimated cash flow and earnings tied to one-year futures prices for natural gas.

Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

### Summary and Recommendation

Units of small cap **Mesa Royalty Trust (MTR)** offer a high quality income stream from predictable natural gas production in the Hugoton field of Kansas and surprising volume from the San Juan Basin of New Mexico. Hugoton properties operated by Pioneer Natural Resources (PXD) account for about 42% of value while San Juan Basin properties operated by **ConocoPhillips (COP)** account for about 58% of value. The longest reported reserve life index among peers supports a unit price implying a distribution yield of 8.5% a year. Other advantages include free management, no hedges, no debt, no corporate double taxation, and deferral of unitholder income taxation. Units of the trust first traded 25 years ago this month, launching a wave of new trust issues. Coincidentally in our first single-stock analysis of the trust in early 1980 the distribution yield was 8.1% and the gain in the price of the units since then has matched inflation to turn a nominal yield into a real yield.

### Predictable Hugoton Volume

Boone Pickens, the creator of the trust, often proudly emphasized that the trust's properties lie in the heart of the Kansas Hugoton field where the flow rates were highest and operating costs lowest. The Kansas Corporation Commission continues to set allowable rates of production for each well that assure that the field is drained efficiently according to each producer's fair share. Set twice a year for the April to September and October to March period, the maximum allowable rate of production for the field has been reduced about 9% a year for the past three and a half years. The trust's production follows about the same trend.

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A decline rate of 9% a year implies a reserve life index of about 11 years. Production would last longer than that while the rate continually declined. Imputing reserves from the observed decline rate may understate recoverable quantities. Pioneer's reserve estimate for the Hugoton properties of the trust implies a life index of some 13 years. The trust's wells should produce better than for the field as a whole.

Boone Pickens also would point out that ultimately it may be economic to produce the field under vacuum. Recoverable reserves are usually estimated to the point where flowing pressure drops to a nominal level. In a large reservoir such as Hugoton, it may be economic to add the industrial equivalent of a vacuum cleaner that sucks the remaining resources out of the ground.

Investors with a long memory may further recall that Mr. Pickens formed the trust originally with 16.3 million units in 1979. In 1985, Mr. Pickens' Mesa Petroleum reacquired 88.6% of the units leaving the 1.86 million units outstanding that continue to trade today.

### **San Juan Basin Surprises**

In our first single trust analysis in March 1980, we projected that San Juan would account for less than 10% of the trust's net revenue in 2004. As it turns out, San Juan contributed 44% of distributions in the first nine months of this year. Also for a decade or more through 2002, San Juan contributed coal seam gas tax credits for unitholders to use in reducing their income taxes.

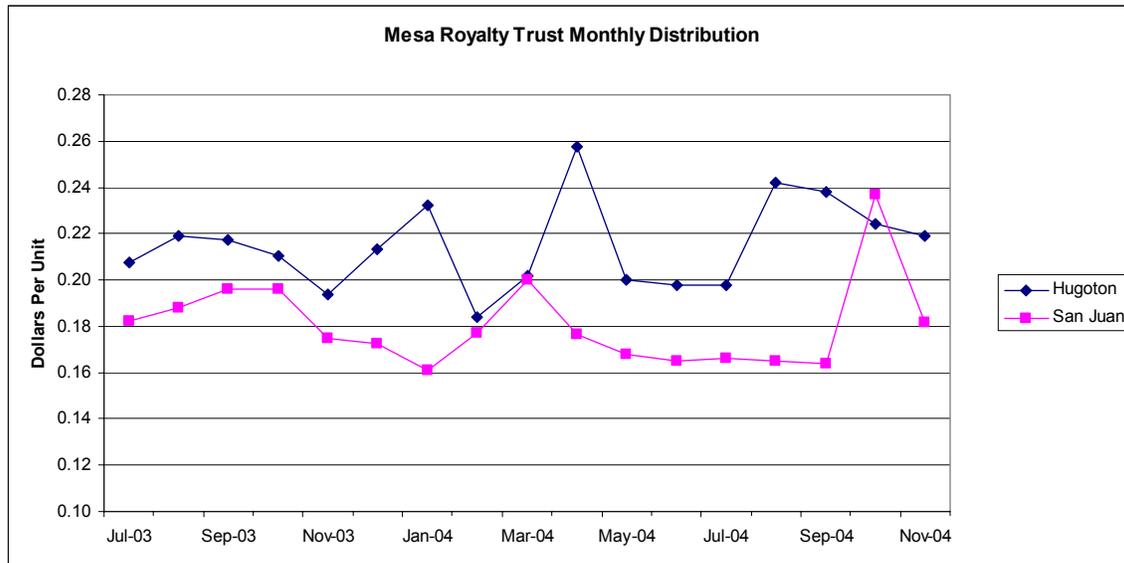
Continued rulings by the New Mexico Oil Conservation Commission allow drilling on denser patterns in the San Juan Basin. Infill wells in both the Kansas Hugoton and San Juan had the greatest initial benefit in qualifying for higher price than the existing wells that were under price controls. Thankfully, price controls are long gone, but infill drilling in San Juan continues because it taps reserves that would otherwise not be produced from the tight formations.

ConocoPhillips, the operator of the trust's properties in New Mexico, estimates a long reserve life index that approaches 17 years. Only a small amount of reserves is classified as undeveloped implying that drilling can add further quantities.

A small portion, less than 5%, of the trust's reserves lie in the Colorado portion of the San Juan Basin. Those properties, operated by **BP (BP)**, have not been distributing cash to unitholders because costs of drilling Fruitland coal seam wells have not yet been recovered. The backlog of unrecovered costs is declining at a rate that suggests the Colorado properties may contribute their 5% beginning perhaps in the middle of 2005.

**Hugoton Leading in Monthly Distribution**

When the trust declares monthly distributions it discloses the amount of royalty income separately for Hugoton and San Juan. No volume, price or development cost detail is available on a monthly basis. On the cash basis of accounting the distributions can fluctuate for non-predictable reasons in addition to industry conditions. Hugoton is still ahead of San Juan in most months despite the higher value the trust discloses for San Juan reserves (see chart Monthly Distribution).



**Commodity Price Drives Higher Distributions**

Natural gas price reached a low point in September 2004 and has climbed sharply since then. MTR’s distribution declarations lag natural gas price by about two months. As a result projected distributions for early next year reflect recent increases and the high winter natural gas prices expected in January and February (see table Next Twelve Months Operating and Financial Performance).

While price is important to all oil and gas investments, volume trends are unique to each stock. MTR’s Hugoton volume has been declining at the rate of some 10% a year for the last six quarters. We slow that rate to 8% a year for the next five quarters. MTR’s San Juan volume has been declining at the rate of almost five percent a year for the last six quarters. We project flat volume for the next five quarters.

Development activity, all in the San Juan Basin, contributes to higher future volume at the same time it subtracts from current distribution. We project a continuation for the next two quarters at the average rate of the past three quarters. Then in the second quarter of 2005 we reduce development by the amount of recent cost recovery from Colorado properties. It is not clear to us how much the Colorado properties are

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producing or whether there is continued spending by BP in addition to cost recovery for past expenditures.

**Mesa Royalty Trust  
Next Twelve Months Operating and Financial Performance**

	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Next Twelve Months</i>
	<i>3/31/04</i>	<i>6/30/04</i>	<i>9/30/04</i>	<i>12/31/04</i>	<i>2004E</i>	<i>3/31/05</i>	<i>6/30/05</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>12/31/05</i>
<b>Volume</b>										
Natural Gas (bcf)	0.51	0.48	0.48	0.48	<b>1.95</b>	0.47	0.47	0.47	0.46	<b>1.87</b>
Natural Gas (mmcf/d)	5.5	5.4	5.3	5.2	<b>5.3</b>	5.2	5.2	5.1	5.0	<b>5.1</b>
Days	92	90	92	92	<b>366</b>	92	89	92	92	<b>365</b>
Oil (mmb)	0.03	0.03	0.02	0.02	<b>0.10</b>	0.02	0.02	0.02	0.02	<b>0.09</b>
Oil (mmbd)	0.30	0.29	0.27	0.27	<b>0.28</b>	0.26	0.26	0.25	0.25	<b>0.25</b>
Total (bcfe)	0.68	0.64	0.63	0.63	<b>2.57</b>	0.62	0.60	0.60	0.60	<b>2.42</b>
Total (mmcf/d)	7.3	7.1	6.9	6.8	<b>7.0</b>	6.7	6.8	6.6	6.5	<b>6.6</b>
<b>Price (Henry Hub and WTI Cushing lagged two months)</b>										
Henry Hub (\$/mmbtu)	5.58	5.49	6.24	5.64	<b>5.74</b>	7.47	7.45	6.66	6.71	<b>7.07</b>
Differential (\$/mmbtu)	1.17	0.55	0.91	0.44	<b>0.78</b>	0.80	0.80	0.71	1.51	<b>0.95</b>
Company (\$/mcf)	4.41	4.94	5.33	5.20	<b>4.96</b>	6.67	6.65	5.95	5.20	<b>6.12</b>
WTI Cushing (\$/bbl)	32.47	36.06	39.71	48.00	<b>39.06</b>	48.46	48.53	47.27	45.92	<b>47.54</b>
Differential	9.46	11.19	14.53	17.56	<b>13.28</b>	17.73	17.76	17.30	16.80	<b>17.39</b>
Company (\$/bbl)	23.01	24.87	25.18	30.43	<b>25.77</b>	30.73	30.77	29.98	29.12	<b>30.16</b>
Total (\$/mcf)	4.27	4.75	5.07	5.17	<b>4.80</b>	6.31	6.31	5.73	5.12	<b>5.87</b>
<b>Revenue (\$mm)</b>										
Natural Gas	2.25	2.38	2.58	2.49	<b>9.70</b>	3.16	3.10	2.77	2.40	<b>11.43</b>
Oil	0.63	0.64	0.63	0.74	<b>2.64</b>	0.74	0.70	0.69	0.66	<b>2.78</b>
Other	0.02	0.00	0.00	0.00	<b>0.03</b>	0.00	0.00	0.00	0.00	<b>0.02</b>
Total	2.90	3.02	3.21	3.24	<b>12.37</b>	3.90	3.80	3.47	3.06	<b>14.23</b>
<b>Expense</b>										
Operating - natural gas	0.55	0.63	0.66	0.66	<b>2.49</b>	0.66	0.66	0.66	0.66	<b>2.64</b>
Operating - oil	0.07	0.07	0.07	0.07	<b>0.29</b>	0.07	0.07	0.07	0.07	<b>0.29</b>
General and administrative	0.01	0.02	0.01	0.01	<b>0.05</b>	0.01	0.01	0.01	0.01	<b>0.04</b>
Total	0.63	0.72	0.74	0.74	<b>2.83</b>	0.74	0.74	0.74	0.74	<b>2.97</b>
<b>Ebitda</b>										
Hugoton	1.15	1.23	1.27	1.12	<b>4.78</b>	1.41	1.33	1.19	1.00	<b>4.92</b>
San Juan	1.11	1.09	1.21	1.37	<b>4.78</b>	1.75	1.73	1.54	1.32	<b>6.34</b>
Total Ebitda	2.27	2.31	2.47	2.49	<b>9.54</b>	3.16	3.06	2.72	2.32	<b>11.26</b>
Development	0.10	0.13	0.28	0.17	<b>0.68</b>	0.17	0.07	0.07	0.07	<b>0.38</b>
<b>Ebit</b>	2.17	2.17	2.19	2.32	<b>8.86</b>	2.99	2.99	2.65	2.25	<b>10.88</b>
Interest	0.02	0.00	0.00	0.00	<b>0.03</b>	0.00	0.00	0.00	0.00	<b>0.01</b>
<b>Distributable Income (\$mm)</b>	2.15	2.17	2.18	2.32	<b>8.83</b>	2.99	2.98	2.65	2.25	<b>10.87</b>
Per Unit (\$)	1.16	1.17	1.17	1.25	<b>4.74</b>	1.60	1.60	1.42	1.21	<b>5.83</b>
<b>Shares (millions)</b>										
Operating (\$/mcf)	0.91	1.10	1.16	1.17	<b>1.08</b>	1.18	1.22	1.21	1.23	<b>1.21</b>
General and admin (\$/mcf)	0.02	0.03	0.02	0.02	<b>0.02</b>	0.02	0.02	0.02	0.02	<b>0.02</b>
Ebitda Margin	78%	76%	77%	77%	<b>77%</b>	81%	80%	79%	76%	<b>79%</b>

**Value Skewed to San Juan Basin**

We initiate a tentative estimate of present value of \$55 a unit. We believe the estimate is consistent with a constant real oil price of \$35 a barrel and a 7% per year real return. As we divide that value into a Hugoton component and a San Juan Basin component we show a higher present value multiple (PV/Ebitda) for the trust's longer-life San Juan natural gas resource (see table Geographic Cash Flow and Present Value).

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**Geographic Cash Flow and Present Value**

	<i>NTM Ebitda</i> <i>(US\$mm)</i>	<i>Adjusted</i> <i>R/P</i>	<i>PV/</i> <i>Ebitda</i>	<i>Present</i> <i>Value</i> <i>(US\$mm)</i>	
Hugoton Field	5.6	13.2	7.6	43	42%
San Juan Basin	5.6	16.5	10.5	59	58%
	11.3	15.0	9.1	102	100%
Debt (US\$mm)				-	
Net Present Value (US\$mm)				102	
Shares (mm)				1.86	
Net Present Value (US\$/sh)				55	

**Good Reasons for Stock Price to Surpass Present Value**

Unit price of MTR exceeds present value as indicated by a McDep Ratio above 1.00. A McDep Ratio of 1.00 relates to a constant real oil price of \$35 a barrel. The current average price for delivery over the next six years is \$41 a barrel. A McDep Ratio of 1.00 relates to a return of 7% a year above inflation. Investors may conclude that the risks in MTR are not as high as in some other stocks and may be willing to accept a lower real return.

The higher recognition could reflect the fact that U.S. royalty trusts are free of high management compensation and have no hedges or derivative agreements that limit appreciation.

Nor do any of our Buy-rated stocks with lower McDep Ratios offer as much current income. The stock market appears to place a high value on current income.

Moreover few stocks have the low financial risk of debt-free trusts. Investors could finance part of their holdings of MTR with debt before financial risk would become comparable to that of most stocks.

The predictability of the Kansas Hugoton may justify higher valuation. There are no other stocks we know of with as much concentration on wells in the heart of what was once the largest natural gas field in the world.

Finally, there is no corporate taxation of the trust's cash flow. MTR income is taxed only at the unitholder level. Taxable unitholders can further reduce or temporarily eliminate current taxation with cost depletion. An older, retired person might defer taxation while collecting high income and then have the deferred tax eliminated as cost basis is stepped up in settlement of an estate. If held in an Individual Retirement Account, for example, there would be no income taxation until funds are withdrawn from the IRA.

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