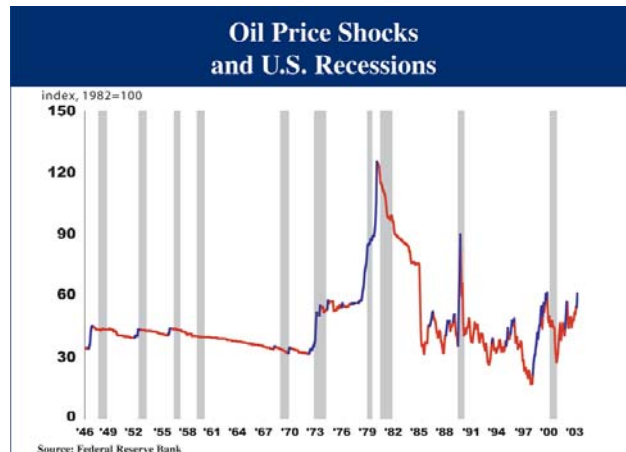


OIL PRICES?

\$30? . . . \$40? . . . \$50? . . .OR



Before we explore the various oil price scenarios for 2005 and beyond (one of which will be the possibility of what Wall Street refers to as a “Super Spike”), we should look at the Federal Reserve’s work with respect to oil price shocks and the economy, which we find quite interesting. Using an inflation adjusted dollar, with 1982 = 100, you can get a historical perspective on “Oil Price Shocks” to our economy, as presented in this first graph. The gray bars indicate recession periods, which generally followed substantial price spikes. Although a \$50 oil price seems high and potentially destructive to the U.S. and world economy, it would appear that relative to prior spikes, this has been a minor event. It might be necessary to reach an oil price in the \$70 to \$90 per barrel range before you would begin seeing oil prices putting some serious brakes on this economy, at least when you consider it in a historical perspective. We believe this means that any price in the range of \$30 to \$50 should be sustainable, and the energy sector will be incredibly profitable. It should generate returns that will compete with any other sector, perhaps for the next decade, similar to the last incoming *Tide* from 1970 through 1981, albeit with plenty of volatility.



OUR FORECAST HISTORY

When MONCRIEF WILLINGHAM ENERGY ADVISERS launched over 6 years ago in January 1999, as a long-only energy asset manager, we laid out a long-term case for investing in the energy sector based on the super cycle we have termed the incoming energy “*Tide*.” Our thesis delineated then our expected new paradigm oil price range of \$22 to \$28 per barrel for West Texas Intermediate (“WTI”). There were some who thought we must be smoking something funny, as oil at the time was in the low teens, and talk of \$5 per barrel oil was in the air (March 1999 – *ECONOMIST* – “*World Awash In Oil*”). Some months after our assertion, which based the oil price forecast on the simple economics of supply/demand (i.e., attracting enough capital to start supply growing again), OPEC published their own target range, based on the needs of government budgets, which, ironically, was also \$22 to \$28. Shortly after we launched our “hedged” energy fund in November 2003, we did a look-back. Oil prices averaged \$27.50 over the five years following our 1999 forecast. Our investment strategy over that five year period coupled our macro view of oil prices with the thesis that well managed small cap E&P companies could consistently grow reserves and production, creating substantial value year after year for investors in this new pricing environment. The result was compounded annual returns just over 26% for investors over five years.

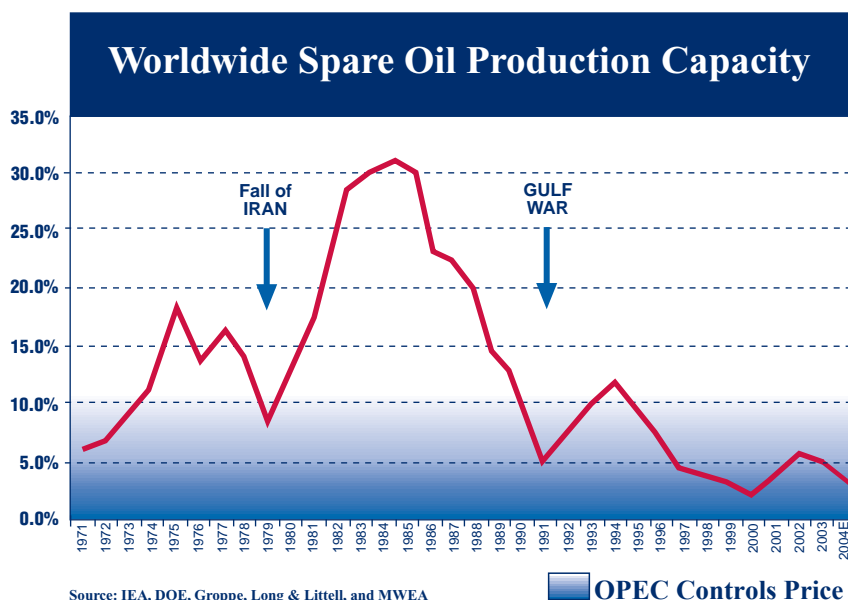
Recently, oil pierced the \$50 per barrel mark and currently resides near that level. Wall Street has now discovered secularly growing demand and limited spare capacity, the scenario we began highlighting in 1999. We think the table here is a powerful tool in explaining the inexorable growth in oil demand. When we started, China was one barrel as an example. And we always like to point out that to get China alone to the level of Mexico would require a 25% increase in world oil production (currently at approximately 83 million Bbls/day). That statement is not meant to be a forecast, rather an indicator of the power of the secular demand growth imbedded in our super cycle “*Tide*” thesis. China is now the second largest consumer of oil in absolute terms behind the U.S. The question is how high do oil prices have to go (and stay) to generate adequate supply growth and a balance between supply and demand (i.e., demand rationalization).

Annual Oil Usage Per Capita

U.S.	26 Barrels
Europe	19 Barrels
Mexico	7 Barrels
China	2 Barrels
India	1 Barrel

MOVING THE FORECAST FORWARD

Our starting point is to look at our original \$22-\$28 per barrel price range in 1999 and adjust it for subsequent changes in economics. First, the decline in the dollar would imply a roughly 20% higher range necessary to keep the OPEC suppliers whole in the basket of goods they buy. Tanker and insurance costs are \$2 to \$3 per barrel higher as well. Finally, international energy service costs are up over 10% from five years ago. Combined, these factors would argue that our range should be raised to \$30 to \$36 per barrel in order to keep the economics the same for producers as when we did that first analysis. The question remains, “is this enough to generate supply growth in today’s environment?” We raise this issue because after now five-and-a-half years of high oil and gas prices, the E&P sector drilling response is still relatively muted, and perhaps our starting range may have been too low.



A second approach to finding the current price paradigm is to look for the price level OPEC chooses to defend. With so little spare capacity in the world (see Worldwide Spare Oil Production capacity chart), they should be able to set the price. In the 1970s, the Persian Gulf states opted to set the price as high as possible. This had two unintended consequences. First, it engendered a huge worldwide drilling boom that dramatically increased supply from places like the North Sea that would not have been economic to develop at prices up \$10 to \$15 rather than up \$25 to \$30 from the 1973 per barrel level. Second, the price shock caused two severe recessions that combined with intense conserva-

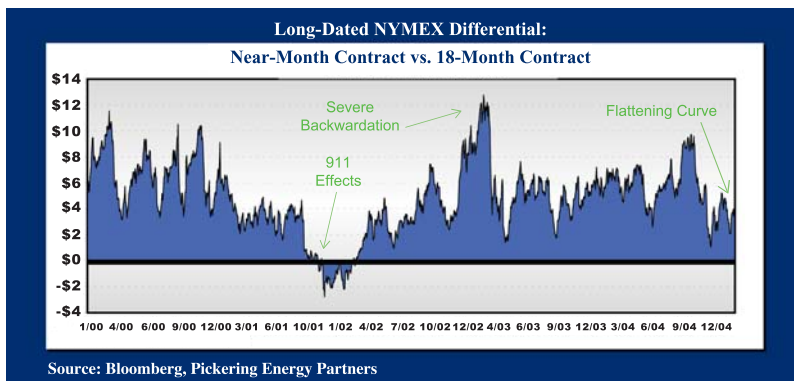
tion efforts to shrink demand dramatically. Put the two factors together, and the outcome was fatal for OPEC. Spare capacity skyrocketed to 30% and prices collapsed.

The ministers to OPEC now (the sons of the sheiks who were there in the 1970s) have MBAs from Harvard, Wharton, and MIT, and clearly understand marginal economics. The language coming out of their meetings is couched in terms of preserving global economic growth. Therefore, oil prices adjusted for inflation are the key and are not particularly high when oil is in the low \$40s or even up to \$50, and should not be a meaningful depressant to world GDP growth at that level.

Finally, there is a third set of arguments to be considered that focus on the concept of “peak oil.” There is a considerable body of literature that expounds the thesis that cumulative world oil production is nearing the halfway point of the total producible original oil in place. Once that point is reached, production must necessarily begin to decline, with severe price and economic implications (the “Super Spike”). We are not doom and gloom proponents. Our analysis leads us to believe that there are lots of available hydrocarbons. The question is, “At what prices?” Massive development of tar sands and oil shales, for example, probably requires prices in the \$50s. With so little spare capacity currently available, excursions into the \$50 range will probably become a regular occurrence as the usual recurring disruptions to supply occur around the world. It is clear that we have moved into a world in which energy price spikes will now more often be up like the 1970s, not down, as was the case in the 1980s and 1990s, as the world worked off its excess spare production capacity.

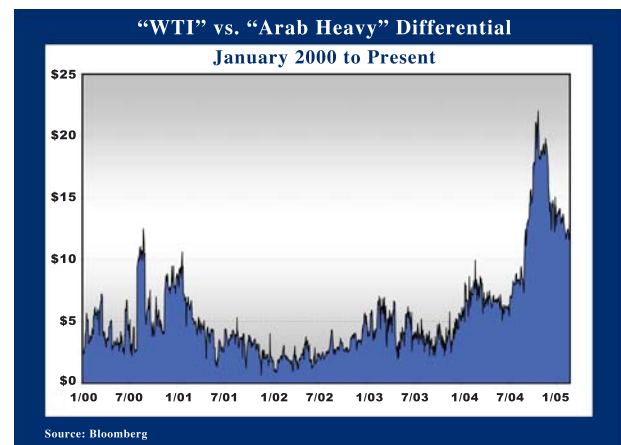
Much of this thinking seems to have seeped into oil pricing. One of the biggest and most important changes versus even a year ago is the disappearance of the extreme backwardation that characterized oil

over the last five plus years. As 2004 began, pricing 12 to 18 months out pointed to an expected price in the \$20 to \$22 range despite a front month level of \$30. As we began 2005, the same out months pointed to \$45 to \$46 versus a front month between \$48 and \$49. This represents a dramatic psychological shift in expectations for the largest of all commodity markets! Not only are the forward curves flat for the rest of this year, high prices extend out multiple years. Natural gas, for example, is trading above \$6/MCF, and for winter months above \$7/MCF, out to



the end of the decade. What is more, the old reliable of forecasting tools, inventories, seems to be losing some of its predictive power as a short term price indicator, as commercial players and financial commodity buyers now factor in the difficulty of bringing on new supply. In a very real sense, the market is guaranteeing economics one, two, three or more years out as inducement to E&P companies to acquire and drill. This is precisely what our *“Tide”* thesis is all about!

Not only is the supply/demand situation for oil tight, the whole supply chain is stretched. From tankers to pipelines, to refineries, the world has under invested in the energy supply chain now for two decades. The lack of refining flexibility (i.e., tight capacity) has created bottlenecks because of the shifting mix of crude types. When OPEC puts on its last barrels, they are heavy sour crudes (“Arab Heavy”) that need specialized refining systems. The price spread between Arab Heavy and WTI (light, sweet) (see chart to the right) shows how hard it is to effectively utilize those “last barrels.” Another way to think of this is that supply chain issues mean that the global supply/demand balance is even tighter than the raw supply capacity numbers would indicate. This leaves OPEC even less able to contain upward spikes in prices by bringing more of their Arab Heavy marginal oil production to the market.



SHORT TERM

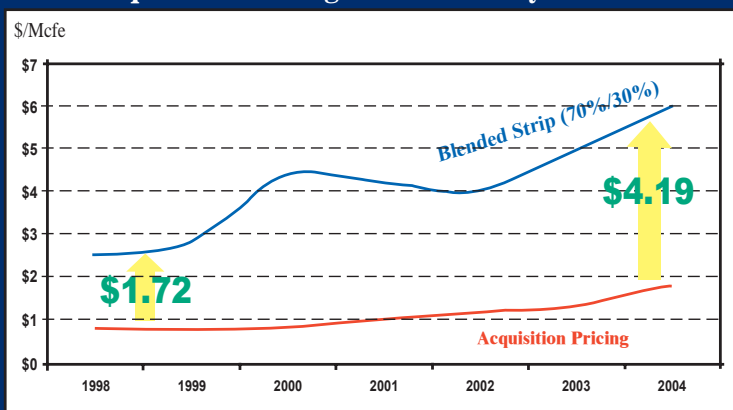
Reviewing the three sets of arguments, and integrating them with our short term analysis of supply/demand statistics (particularly oil on the water and Atlantic basin inventories) leads us to believe the key to near-term pricing is most likely to be the OPEC price point. Rhetoric coming out of Saudi Arabia points to \$40 per barrel, WTI. Several others, Venezuela, for example, argue forcefully for above \$40. Until there is evidence of buildup in spare capacity, either through new supply coming on or global recession, a range of \$35 to \$45, OPEC’s target, is a reasonable expectation. What has changed most, however, is the risk profile. Before, the question marks were all about whether OPEC could hold prices up. Now we worry about whether they can hold them down. At this level, and with this risk profile, the energy sector is exceptionally profitable, and should be one of the best places for investment for the rest of this decade. More important, the shape of the forward curve, as discussed above, has changed the way E&P companies look at their business. Instead of always expecting a cliff ahead, level pricing allows steady, planned exploitation programs for existing or acquired acreage, with excellent economics locked in.

CONVERTING THESIS TO VALUE

For investor purposes, the key is how energy companies “translate” these new, higher price levels into value for shareholders. Our focus has been on small E&P companies capable of consistently growing reserves and production through the drill bit at rates of 20% per year or more. The larger companies certainly participate in revaluation plateaus as the sector moves up; however, the “law of large numbers” provides the smaller E&P companies with considerably more leverage to growth. Frequently, acquisition of properties is a key component of this process. The chart below shows the arbitrage this process sets up for the E&P companies and their investors.

Incremental reserves in the ground, which can now be bought (or found) at prices around \$2 per MCFE, can be sold in the forward strip market for north of \$6 per MCFE. For efficient operators with low to reasonable costs of capital, it may not get any better than this. An important aspect of the last several years is that the spread between cost and market has more than doubled. This is the economics we have

Acquisition Pricing vs. Commodity Prices



Source: Petrie Parkman; Bloomberg

repeatedly referred to as necessary to attract enough capital to the sector to solve the supply shortage issue. The growth in assets (MCFEs) per share translates directly into value. The strip gas price is soundly supported by oil prices anywhere near the middle of the \$30 - \$50 range we have laid out. In other words, with the “new paradigm” in energy prices, energy stocks as a group are still undervalued in the market. We know the sector will still have plenty of volatility, just like it did during the last *Tide* of 1970 - 1981. However, from these stock price levels we expect the biggest surprises to be to the upside.

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