C O M P A N Y   I N T E R V I E W

Contango Oil and Gas Company (MCF)

KENNETH R. PEAK was appointed Chairman of the Board, Chief Executive and Chief Financial Officer of Contango Oil and Gas Company in September 1999. Before joining Contango, Mr. Peak was the President of Peak Enernomics, Incorporated, a natural gas and oil consulting firm that he formed in 1990. Mr. Peak began his energy career in 1973 as a commercial banker in First National Bank of Chicago's energy group. He became Treasurer of Tosco Corporation in 1980 and Chief Financial Officer of Texas International Company in 1982. His tenure with TIC included serving as President of TIPCO, the domestic operating subsidiary of TIC's natural gas and oil operations. Mr. Peak has also served as Chief Financial Officer of Forest Oil Corporation from 1988 to 1989 and as an Investment Banker with Howard Weil from 1989 to 1990. Mr. Peak was an Officer in the U.S. Navy from 1968 to 1971. He received a BS degree in Physics from Ohio University and an MBA from Columbia University. He currently serves as a Director of Patterson-UTI Energy, Inc., a North American provider of onshore contract drilling services to exploration and production companies, and Cellxion, Inc., a privately owned manufacturing and construction company serving the cellular telephone industry.

SECTOR – OIL & GAS DRILLING & EXPLORATION (TAF608) TWST: Let's start with a quick overview of Contango today.

Mr. Peak: Actually I'm very excited about our future. We are a company that can basically be described as operating and focusing on three different business segments within the natural gas industry. The first and the one that's the most mature in terms of what we've built the company on over the last three and a half years is our onshore exploration effort, and at March 31, we had net to us on that date about 23 Bcfe, and it's about 90% natural gas, and those were all proved developed producing reserves, no PUDs or behind pipe reserves in those numbers.

TWST: You say that's onshore — domestic?

Mr. Peak: Onshore South Texas, Jim Hogg and Brooks County, and that program has been really the cornerstone of the company's development, currently throwing off about $2.5 million to $3 million per month in EBITDAX. On our current exploration program, we are now 10 for 14. So that program is doing well and we'll continue to focus in that part of the country. We like South Texas and we've had a fair amount of success down there. Since the beginning of the company, we probably now have drilled about 50 wells in South Texas and about 40 of them have been successful.

Highlights

Contango Oil & Gas is an independent energy company that operates in three different business segments of the natural gas industry; onshore exploration, offshore exploration in the Deep Shelf play of the Gulf of Mexico and a 10% ownership in a proposed liquefied natural gas (LNG) regasification plant in Freeport, Texas. Peak believes the Deep Shelf play and LNG plant are "big ideas", with significant potential value creation that can be financed with only limited additional capital outlays being required from Contango.

TWST: Why is it that you are finding gas and others are having such difficulty?

Mr. Peak: I think others are finding it as well. Speaking as a country or perhaps as an industry, we are just not able to find it in sufficient quantities to replace what is really a very rapid decline rate. I think some folks are estimating that the decline rate on US production is somewhere around 30%. Well, that's a hard number to replace when you are producing around 50 billion cubic feet a day. That's a big number especially when you are not allowed to drill off the East Coast, Florida Coast, the West Coast, the Rocky Mountains and Alaska. What you are left with is drilling in the same old places that the industry has been drilling in for the last 130 years. In our onshore exploration effort we take working interests directly in these wells, but in our business model we outsource the prospect generation and operations effort, and therefore we are running Contango with just four people. So our strong cash flow falls to the bottom line, because annual G&A, without the one-time events that always seem to crop up, only runs about $1.5 — $2 million a year. There are many companies in our peer group that spend that on a per quarter basis.

TWST: So you are essentially running a virtual company?

Mr. Peak: People say that. There is nothing virtual about it, it's real. It's just that we have developed a business model that allows us to do it with a very small number of people and really it's because we outsource and there's certainly nothing novel about outsourcing. I think the biggest strength of the company is that our outsource arrangement, which costs us zero dollars per month, is with exceptionally talented people. We've structured the incentives so that our partners don't make money until we've gotten our risk capital back, and I think that's what makes it unique and such an appealing business model because the people that are our partners are exceptionally talented oil and gas finders. They are also taking a significant amount of ongoing monthly G&A risk. I mean, nobody runs a company without having computers, telephones, FedExs, health plans and salaries for secretaries, etc. All that stuff costs real money every month, but Contango doesn't pay it.

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TWST: What is the arrangement with your drilling partners?

Mr. Peak: It's fairly simple. The geoscientists get a 3.33% override, proportionately reduced to our working interest and our partner who is funding the G&A for that exploration effort gets a 25% back-in on a well-by-well basis after we have recovered our risk capital. So, for example, in the South Texas program that we are currently drilling, where we are nine for 13, we had to risk approximately, $1.8 million or so on a new 3-D seismic shoot to generate these prospects. We get to recover that entire $1.8 million of 3-D seismic costs plus the cost of those nine successful wells prior to our partner ever getting a penny. So it has been a great program for both Contango and our partner too, because as long as we drill successful wells, our partner backs in for a 25% working interest after payout. In addition, our partner puts up 5% of the risk capital for drilling of the wells. So it's a sharing and it's a good deal for both sides.

TWST: Is it good enough that the arrangement is likely to stay in place?

Mr. Peak: Yes, I would say we are both happy and are going to continue to be partners for a long time.

TWST: What benefits have you derived from these seemingly very high gas prices?

Mr. Peak: It's been phenomenal. We produce about 6 Bcf a year and so, every $0.10 in gas prices is $600,000 in annual revenues. At current gas prices our monthly EBITDAX is $2.5 to $3 million a month, or $30 million to $36 million a year in EBITDAX; after a relatively small G&A charge, and our interest costs with $20 million of debt, at an interest rate of 3%, are only $600,000 a year. Interest and G&A which historically have been big detractors from the overall rate of return that companies enjoy really don't detract much. So most of the benefit from high oil and gas prices falls to the bottom line.

TWST: What's your view — are these prices going to stay high?

Mr. Peak: They are going to stay high on an historical basis. They are not going to stay above today's $6/MMBTU level. My guess is we'll see a test at some point in time of $4-$4.50, absent a really hot summer or absent hurricanes. If we have a really hot summer or some hurricanes in the Gulf, where we have to shut in production, all bets are off and we will be back up over $6, perhaps to $8 on spikes. And again if we have a really cold winter, all bets are off and we can be back up over $6. We have, to a large extent, destroyed the demand that comes from the incremental or marginal industrial user, which means that an increasing percentage of the demand that's remaining is used for residential and commercial heating/cooling and electrical generation needs, which really means that it's very much a function of weather. Natural gas has always been a function of weather, but when you take out the aluminum, petrochemical and fertilizer manufacturers and the other industrial users, you are left with a customer base increasingly driven by weather. So when it is really hot or really cold or we have to shut in natural gas because of hurricanes, natural gas prices are going to spike.

TWST: So you have taken those other users out because of price?

Mr. Peak: Yes, they just can't make any money. So, we've exported the jobs associated with fertilizers, petrochemicals, aluminum, etc. It's been devastating to our manufacturing segment, and it's insane that our country is in this situation, but we've got a logical disconnect. Because of greenhouse pollution concerns, we can't build coal plants, nuclear power is absolutely verboten, and we don't want any drilling, but we also demand really cheap energy. This is cognitive dissonance on a national level and at some point, we are going to have to make some tough choices, and if we are not going to let the industry drill anywhere new, then gas prices are going to stay high and we're going to continue to export the manufacturing base of this country until such time as we can bring in more liquefied natural gas and that's a nice little segue to our second segment.

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I mentioned at the beginning we have three segments. One is the onshore exploration program. The second segment is our liquefied natural gas or LNG business, and there we are a 10% owner in a proposed regasification plant in Freeport, Texas, and you may have seen the press release, where Dow Chemical has signed an option to take up to 0.5 Bcf a day of gas from our proposed plant down there. We just filed the FERC permits back in March and there is many a slip between the cup and the lip, but assuming we stay on track with all the permits that have to be done and we continue to enjoy the support of the Administration, the Department of Energy, our two Texas Senators, the local community, the EPA, etc., then this plant could be on stream with revenues sometime in 2007.

"We are a 10% owner in a proposed regasification plant in Freeport, Texas. Within the United States, the largest consuming market is Texas, and within Texas, it's Houston, where about 10% of our nation's daily demand for natural gas is consumed in the Houston region petrochemical complex. That's why our Freeport plant in my mind makes such enormous good sense."

TWST: What's the investment?

Mr. Peak: The investment is going to be huge. Contango has only put in or is only obligated to put in up to $2.33 million prior to construction. It would be my guess that at some point, we'll sign a financing/equity undertaking with a major energy company that will carry this thing forward. Contango will be diluted down from its current 10% equity interest to, say, perhaps 7.5% and our new partner would put up the equity and the required financing. The plant itself will cost about $400 million and I think you could finance that with about $100 million of equity and $300 million of debt, assuming you had contracts to take the gas coming out of our plant and contracts to deliver the LNG coming in. There's an enormous amount of stranded gas along the African coast, Trinidad and Tobago, and the Middle East and the major companies want to bring this gas to the largest natural gas consuming market in the world, which is the United States. Within the United States, the largest consuming market is Texas, and within Texas, it's Houston, where about 10% of our nation's daily demand for natural gas is consumed in the Houston region petrochemical complex. That's why our Freeport plant in my mind makes such enormous good sense. This is where you have the strongest demand, you have deepwater access, and our plant is situated right next door to Dow Chemical. There are lots of reasons why I think this plant is actually going to get built, and if it were built, it would have an enormous impact on Contango.

TWST: I guess the political winds are with you at this point.

Mr. Peak: At this point, with this Administration, the winds are behind our back and pushing. I mean, when you have Greenspan going in front of Congress and saying, "Hey folks, wake up, we've got a significant problem," it's serious. We have a very significant problem here with regard to natural gas supply, and there really aren't a lot of good alternatives other than the three things we are doing, which is drilling onshore, bringing in LNG, and this is a convenient segue into our third business segment in the natural gas business, which is playing the deep shelf of the Gulf of Mexico.

Within the Gulf of Mexico, the conventional production say, from 6,000 feet down to 14,000 feet has all been exploited and explored. The industry is now focusing its attention on the deepwater Gulf and on the Deep Shelf. The deepwater Gulf is just that — water depths from 1,000 to 10,000 feet. In the Deep Shelf it's not the water that's deep, it's the wells that are deep. Deep Shelf wells are from 14,000 feet down to maybe as deep as 26,000 feet. These wells are very expensive and very risky. In terms of big reserves that can be brought on between now and say 2007, when LNG starts playing a more important role, this is where any significant production is going to have to come from. A lot of companies are playing coal bed methane and other tight formation plays in the Rockies, and we have to absolutely do that, but these wells come on at, maybe 100 Mcf to 1,000 Mcf per day — they are not big production. Whereas discoveries in the Deep Shelf can come on at 20, 30, 40 million cubic feet a day. We have had a recent discovery on Eugene Island 110 where we expect each of our two wells to produce at a rate of 10-15 million cubic feet per day. We expect production to begin in the next month or so. The way we structure our offshore exploration segment is we give up 100% of the risk of drilling the well in exchange for a 25% back in. In other words, we don't drill the wells. We generate a prospect, and then we sell it to an industry partner. They drill the well and then after they've recovered 100% of their capital, we back in for 25%, "we" being Contango and our partners.

TWST: Do you find the interest from people to partner up and do that?

Mr. Peak: Oh yes, there is plenty of interest. These are significant reserves. They have six-month payouts and it's one of the few remaining places for significant near-term production increases. There aren't many opportunities left to add in one prospect 20, 30, 40, if you got really lucky maybe 50 Bcf of reserves. Yes, people want to drill these wells.

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TWST: Why do they need Contango? Why don't they just go out and find the prospect themselves?

Mr. Peak: It is not that easy and the industry wants the prospects now. They obviously have very talented staffs, but the Gulf of Mexico is a big place and, we have 3,700 blocks of 3-D seismic and our own reprocessing center. This seismic was shot in the early and mid-1990s. All this data is being reprocessed because we are no longer trying to image prospects between 6 and 14,000 feet — that gas has already been found. We are trying to image seismic anomalies below 14,000 feet. So it's a whole new reprocessing effort. It takes a great deal of computing power, crunching some serious algorithms and it takes geoscientists who've done this before and I'm going to brag a little bit, Contango's geoscientists have probably looked at as much 3-D seismic in the offshore Gulf of Mexico as any group in the industry and they've been extremely successful at it. When you pick exploration partners, you want to pick people who have been successful in the past and that's true of our guys.

TWST: What should investors expect from Contango over the next two or three years?

Mr. Peak: We have high quality, big impact exploration prospects and projects, mainly our LNG and our Deep Shelf Gulf of Mexico exploration program with a nice blend of diversified onshore exploration that will hopefully keep us with a steady monthly cash flow. Our partners have a great deal of technical breadth and depth and a database of 3,700 blocks of offshore data and a state of the art reprocessing center to exploit that asset. We have a very austere culture with annual G&A of only $1.5-2 million. We can double the size of this company and not add a single employee and are committed to keeping our G&A low. We have a conservative balance sheet. We have debt of about $20 million and the SEC PV-10 of our proved developed producing reserves is somewhere around $75-$80 million. We have significant management ownership. I own 16% of the company and over the last nine months have invested another $350,000 of my own after-tax hard earned dollars to buy more of the stock. So I enjoy eating my own cooking. Our top four shareholders who attend every Board meeting own 59% of the stock, so you've got people who care deeply about the success of the company and are directly involved in its stewardship. We are very focused on earnings quality. We follow the successful efforts method of accounting, which means we immediately expense all of our seismic and dry holes. We have expensed $15.6 million of seismic and dry holes through the first nine months of this year. We have a June 30 fiscal year. If we followed the full-cost method of accounting we would have capitalized this $15.6 million and we would be very profitable instead of having a loss this fiscal year. I think, however, that comes at the cost of transparency and earnings quality. We also expense our employee stock options and to my knowledge we may be the only small cap oil and gas company in the business that expenses these options. And we're very returns focused. My bonus is only earned if we are profitable, using the successful efforts method of accounting. And one final thing that probably differentiates us — and this is a change in policy from our first three years — we no longer hedge. I think if you put all of this together and you like natural gas as a commodity, this is a pretty compelling opportunity.

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TWST: If you don't hedge, what's the penalty if prices go down a dollar?

Mr. Peak: Then the price we receive would go down a dollar. If we were hedged and prices went down, we wouldn't suffer as directly. If prices go up or down a dollar that goes directly to our revenue line. We no longer do any hedging. We may sometime buy puts, but to be honest I'm not a fan of buying puts at today's volatility levels. A year ago I made $5 million hedging. This year I lost $5 million on hedging. I've decided to declare victory and stop. We broke even and we consider ourselves lucky. Fortunately we did it in the right order. Last year when we made the $5 million from hedging, we really needed the $5 million. The first six months of this year we have given up the upside in natural gas prices above about $4.75. Being hedged when one of these major price spikes occurs is not fun. I mean it was scary in March. We had that fourth polar pig come down from Canada; it got extremely cold and gas prices went through the roof. One Friday when I went home, gas prices were $6.60. When I looked on the computer Sunday night on Access, they were $9 and the next day, Monday, gas closed at $9. On that next Tuesday, prices traded as high as $13. So when gas can double from $6 to over $12 in 48 hours, hedging can be extremely dangerous. It's dangerous because — it's much more a function of weather than it's ever been and because of the demise of the merchant energy traders such as Enron, El Paso, Aquila, Dynegy etc. All these companies that used to provide a big liquid market in natural gas no longer trade and you can get these wild spikes.

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I've always looked at hedging as just a risk/reward venture. The risk is no longer worth the reward, given a) the overwhelming dependence on weather and the fact that nobody can predict weather, b) the lack of liquidity and c) natural gas which has been a $2.50 commodity for most of my 30 year career can go to $12 in a heart beat. When a commodity doubles, when it's already at an historic high at about 2 standard deviations above the mean and then it goes to 6 or 7 standard deviations, at $13, it tells me that the tails on your Gaussian curve are much fatter than you believe and there's actually more risk in hedging than there is in not hedging. I shouldn't say this because it's the kiss of death, but I'm not overly concerned about natural gas prices going back to $2.50 and staying there for any length of time. I am worried, to be candid, about gas going to $8.50 and killing more of our customers and doing more damage to the US economy. That hurts us in the long run; it convinces people not to burn natural gas. I think it's bad for us when we have these spikes and I'd be much more comfortable with gas at a good boring $4 to $6 and we'll make a lot of money.

TWST: Other than the pricing of gas, what's the risk at Contango? What can go wrong?

Mr. Peak: Oh, Murphy is alive and well and there are many, many things that could go wrong. We could have a blowout on a well that caused environmental problems and perhaps hurt people or a pipeline blow-up that forced us to shut in our production. I don't particularly like to talk about these things because I worry about and think about them all the time. I have tried to structure Contango to reduce the traditional kinds of risk, for example, in our accounting policies where we expense our dry holes right away, by keeping our G&A cost low, by having only four employees, with my salary at $150,000 and no bonus unless we're profitable. Our preferred debt is PIK-able; in other words I can pay-in-kind if we ever got into financial trouble and it is perpetual preferred, i.e. it's $7.5 million of true equity that never has to be repaid. I try to keep our bank leverage moderate.

We've really tried to structure this company to minimize risk, but you can never be 100% successful. There's always enormous risk when you live by the exploration drill bit. We've never drilled a well yet that was a sure thing. And if for some reason we start drilling a whole bunch of dry holes, if we drill enough of them, long enough, we'll get into trouble.

TWST: Do you have the expertise on hand that you need to continue this success?

Mr. Peak: I couldn't find oil at an Exxon service station. I'm a finance guy. We are very dependent upon our outsource partners. If anything ever happened to our partners, we would have to scramble, because we don't have that expertise in-house.

TWST: Speaking of the finance side, is the balance sheet where you want it to be?

Mr. Peak: Yes, it's in good shape, with $20 million of debt and $3 million of monthly EBITDAX; we can handle our bank debt and cap ex program. I would always like to have less debt but I'm comfortable.

TWST: What does the cap ex program look like?

Mr. Peak: We've been spending $25 to $35 million a year in each of the last two years and we'll probably stay in that ballpark.

TWST: And you can finance that out of cash flow?

Mr. Peak: Yes, we have so far. Well, we've added $20 million of debt. We spent $26 million buying proved developed producing reserves last year and $6 million buying our stock back.

TWST: Why did you buy the stock back?

Mr. Peak: It was just an opportunity with one of our major shareholders to repurchase the stock. It was a good deal for them and a good deal for us.

TWST: They didn't want to hold it anymore?

Mr. Peak: Let's put it this way, they were willing sellers at $2.40 and I was a willing buyer. By the way, they made a great investment; they gave us $11 million and in 18 months we gave them $19 million back. We're still good friends and both sides are very happy.

TWST: Is the stock fairly priced today?

Mr. Peak: I never answer that question. I'm buying it personally. I bought yesterday; I think I bought 1,000 shares at $4.04. Fairly priced is a lot like beauty, it's in the eyes of the beholder. But I've spent $350,000 over the last year buying our stock. I'll let everybody else make his or her own decisions.

TWST: Obviously you think it's a bit undervalued. What's the problem? Does the market not understand what you're doing?

Mr. Peak: No, I don't think that's the problem. I just think it's that we're small cap, with an illiquid stock. We're not a stock for everybody. We're too small for most institutional investors and no investment banks follow us so most people have never heard of us. Incidentally, I'm not overly bothered that our stock is illiquid. Having a liquid stock also means you've got lots of people who want to sell your stock and I'm not looking for that type of shareholder. I'm looking for shareholders who want to make an investment. We don't have and don't want a VP of Investor Relations. I'm not out trying to promote our stock. I'll let the market decide. It's a long run game. If we have success, the stock price will take care of itself.

TWST: When you do talk to investors, what's the prime question you're asked these days?

Mr. Peak: Thankfully I really don't talk to many investors. We're out there and we put out press releases and some people will find us and buy us and some won't.

TWST: What are the two or three reasons you would give investors to take a look at Contango?

Mr. Peak: Just to step back for a minute and summarize what I've said, we have two "big ideas" in our LNG investment and in the offshore Deep Shelf where we have the potential for significant value creation. Yet, because of the way we've structured these two investments, we can move forward in both cases with only limited additional capital outlays being required from Contango. The reward/risk ratios are very favorable. On the onshore, we're 40 for 50 and continually on the lookout for more opportunities. I don't know where else you can get that kind of exposure from a company with just four people. If you look at our current EBITDAX rate of, say, $30 million to $36 million a year, versus a company whose market cap is $36 million ($4 per share times 9 million shares outstanding) it would be hard for me to argue that we were significantly overvalued. Probably most importantly I think we're got the right incentive structure matched up with the right people. I'm totally biased, but I like our chances.

TWST: Thank you (TJM).

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