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THE WALL STREET TRANSCRIPT
Questioning Market Leaders For Long Term Investors

Contango Oil & Gas Company (MCF)

KENNETH R. PEAK is Chairman, Chief Executive and Chief Financial Officer of Contango Oil & Gas Company. Mr. Peak is the Founder of and has been Chairman and CEO of Contango since its formation in September 1999. Prior to September 1999, Mr. Peak was President of Peak Enernomics, Incorporated, a company engaged in consulting activities to the natural gas and oil industry. Mr. Peak's energy career began in 1973 as a commercial banker in First Chicago's energy group. In 1980, Mr. Peak became Treasurer of Tosco Corporation and in 1982 Chief Financial Officer of Texas International Company (T.I.). Mr. Peak's tenure included serving as President of TIPCO, the domestic operating subsidiary of T.I.'s oil and gas operations. Mr. Peak has also served as Chief Financial Officer of Forest Oil and as an investment banker with Howard Weil. Mr. Peak served as an officer in the U.S. Navy from 1968 to 1971. Mr. Peak received a BS in Physics from Ohio University and an MBA from Columbia University. He currently serves as a Director of Patterson-UTI Energy, Inc., a provider of onshore contract drilling services to exploration and production companies in North America.

(SAP224) TWST: Please give us a brief overview of your company's operations.

Mr. Peak: We are currently producing around 12-13 Mmcfed, all of it, by the way, from our onshore South Texas properties. Our EBITDAX is around $2 million per month. We've had an enormous amount of activity on several other fronts. We recently put out a press release announcing that ConocoPhillips has joined the Freeport LNG partnership and will be providing substantial funding for our LNG plant to be built in Quintana, Texas, or Freeport, and of course, that's a 1.5 billion cubic feet of gas a day re-gasification facility. We expect to start up, say, some time in 2008, and we have a 10% ownership. Then, just yesterday, I announced that we had made an investment in an alternative energy venture capital firm, Contango Capital Partnership. We've been busy also in our oil and gas business, both onshore and offshore Gulf of Mexico. At the recent MMS offshore sale, we were the high bidder on 24 blocks. All of those blocks have now been awarded by the MMS, the arm of the Department of Interior that manages the United States offshore oil and gas resources. We have an offshore well drilling right now and one onshore well. So we've been very busy, and knock wood, things are going well.

TWST: Could you tell us more about the LNG facilities? How much of a capital outlay in the end will Contango have to put out?

Mr. Peak: We are still waiting to receive the final cost estimates. But, order of magnitude, it looks like it's going to be somewhere around $500 million and the bulk of that will be financed by ConocoPhillips under the agreement that we struck with them, where they take a billion a day of the plant's capacity. On the remaining 500 million a day, Dow Chemical has an option on that capacity. But, assuming the plant's cost came in at $500 million, the amount of money needed from Contango would be less than $5 million. Of course, we could probably finance some of that.

Now, should we be able and desire to expand the plant's capacity, then you'd be talking significantly more capital, and we have to look to see what our capital needs for the expansion would be. I would guess, with any plant expansion, we probably would be able to finance with about 70% debt. And so Contango would only have to come up with 10% of the remaining 30%, which would just be 3% of the entire expansion. So I think it is well within our grasp to maintain our 10% equity ownership.

TWST: Currently, what is the economics of an LNG plant in the United States at the current price of $5 per Mcf?

Mr. Peak: I would say that what some of the pundits and analysts are saying is very much in the ballpark of being correct. It costs about $1 per Mcf to find the gas, and of course, a large part of this gas is stranded gas and it was found a long time ago, or in the case of the North Field in Qatar, probably only costs pennies per Mcf. But let's just say that it costs $1 to find, it costs about $1 to liquefy it (to turn it into LNG), and it costs about $1 to ship it from the Middle East or Africa or Trinidad, and it costs about $0.50 to turn it from a liquid back to natural gas. So order of magnitude, LNG is competitive at around $3.50 per Mcfe. Now, you have to remember when you are doing these cost calculations that once you have built the plant or once the gas is found, those are sunk costs. So even if gas prices were to go down significantly, I think the gas would still come in.

The good news from Contango's perspective is that we never take title to the gas and we have no investment in the gasification facilities or tankers. We are a required variable cost that's at the end of the value chain, converting the liquid into a gas. So I think we'll do quite well.

TWST: Why the foray with this capital partnership into alternative sources of energy?

Mr. Peak: I'm always looking for investment opportunities where, with a little bit of capital, I can do something that has a big impact. Four years ago, people were asking me the same question about why was I investing in an LNG plant, when gas was $2.50. It's a forward-looking investment. And when I look forward, I see an enormous amount of instability in the principal places where crude oil comes from, which is primarily the Mideast and the former Soviet Union countries, Venezuela, and Africa. There's an enormous amount of uncertainty and I expect a significant upset at some point in crude supply. Terrorists will continue to blow up pipelines and I don't see what's going to stop them. I believe there will be an enormous amount of pressure at some point for the United States to actually do something, instead of complaining about our dependence on imported foreign crude oil. I'm expecting a massive effort to invest in things like fuel cells, hydrogen processing, hydrogen storage etc. And so we are making this investment today because I would guess that, in three or four years, these are going to become increasingly important technologies, and we will in fact begin moving to a hydrogen economy, and I'm positioning Contango with a relatively small bet, $500,000, to play in that space. So just like LNG four years ago, I want to have my small oar in the water to try to take advantage of what I think is going to unfold over the next three or four years.

TWST: Meanwhile, as far as your production from conventional sources is concerned, could you comment on your business model and where your current production is coming from?

Mr. Peak: Our business model is fairly unique. We are a publicly traded company on the American Stock Exchange with $20 million plus a year in EBITDAX and we are profitable, using successful efforts accounting, and have only four employees. And the reason we are able to do that is that we outsource all of our exploration and production effort and all of our operations. We have alliance partners to generate the prospects, draw the X, Y, Zs, find the leases, negotiate the contracts for drilling the well, and then our operating partners operate the wells and sell the production. So at the end of the day, we have a very simple business, which is basically writing and collecting checks, which is what we do with four people. There is myself, there is a Treasurer, a Controller and a Secretary, and the four of us run this company. And it's basically, my job as the Chairman and the CEO, to allocate capital. So I try to allocate our capital to a group of very experienced oil and gas finders, and we have a portfolio, if you will, of capital allocation decisions that we make. We spend the bulk of our money in the onshore, and there I have very modest expectations. I expect to grow that modestly. We have made a big bet in the offshore — a $20 million bet, which is a huge bet for our company. But we have now spent about all of the money we need to spend, and our two subsidiaries have 4,000 blocks of 3-D seismic data that we are reprocessing in our own $3 million processing center. To put 4,000 blocks of 3-D in perspective, it is basically the entire Gulf of Mexico from Galveston to New Orleans out to about 300 feet of water. We reprocess that data and then go to lease sales, as we did in March. We bid on 38 blocks, we were the high bidder on 24 of them, and we take those blocks and put together a prospect and sell it to the industry. We are typically carried to the tanks with either a backend working interest or an override, as well as getting all of our money back for our leases. So it's a self-sustaining way to play deep shelf exploration. Deep shelf exploration, as you know; is a very capital-intensive business but our model lets us play in a not very capital-intensive fashion.

TWST: Where is your current production from, and what's going to be your future production?

Mr. Peak: Our current production is all from South Texas, and it's running right at 12 million to 13 million cubic feet a day equivalent. That's with the oil converted to natural gas equivalent, and it's been holding fairly steady there, I guess, for the last couple of months. We have experienced a normal geologic decline in our production over the last year, year and a half. But I think our production now is, I hope at least, bottoming as we begin to bring on some new production that will hold us at this level or maybe even begin to grow a little, as we wait for our offshore production to kick in. An interesting thing is that, even though our production has declined, gas prices and oil prices are so much higher than they were a year ago, we've still got cash flow of about the same amount, which is right around that $2 million of EBITDAX per month.

TWST: Where is the future production going to come from? What exactly are your drilling plans now?

Mr. Peak: I said in a press release, I guess maybe two months ago, that I expected to drill about 20 wells in calendar year 2004, and I think that's still on target. About 10 to 15 of those wells will take place in the onshore, and about four to six of those wells would take place in the offshore Gulf of Mexico, and I would expect that we are going to be very close to that, so maybe five wells in the offshore and maybe 15 on the onshore.

TWST: Does any one of these potential wells excite you more than the others?

Mr. Peak: Yes, sure. Our wells are not all the same; most are kind of bread and butter. But I try to do one to two wells a year that we call a lifestyle changing opportunity. These are very risky, and they are almost certainly going to be dry holes. But every now and then, I like to sow one in there that's potentially very big and would dramatically change our balance sheet and our income statement.

TWST: Is this going to be in offshore?

Mr. Peak: We have these opportunities both onshore and offshore, but, remember in the offshore, we are carried and do not swing for the fences with our capital.

TWST: You're not being very friendly to the idea of hedging your production. Is that still your stance?

Mr. Peak: That is still our stance. I think the idea of hedging is extremely dangerous because, if we do have a major crude supply interruption, you could easily see crude go from $40 to $60 overnight, and natural gas of course would respond likewise. The idea of a hedge sounds great, but there is some finite risk where a cataclysmic event might occur that causes potentially massive margin calls that are not worth, in my opinion, the risk of a fall in prices. The way we hedge the company is to keep our G&A and debt small. If prices fall, you still don't get into trouble if you don't have a lot of G&A costs and owe a bunch of money. If you have a lot of debt, then you can make the argument that you need to hedge. But we try to avoid that situation.

TWST: Translate all that into what the investors should expect from you, from a financial standpoint, in terms of earnings and your long-term goals.

Mr. Peak: I don't give earnings forecasts. The only number I talk about is EBITDAX, and I used the number somewhere around $2 million monthly. Let's say from $1.5 million to $2.5 million for the next three to five months is how I see it. What I would tell investors is that, since we started the company, we have consistently created value. I am the second largest shareholder with 2.8 million shares and options out of 15.6 fully diluted shares. My salary is $150,000 a year. So moving our stock price $0.10 has a major impact on my net worth. My $150,000 a year salary is not why I am in business. Last week, I purchased 50,000 shares at $7.00. I just exercised options for another $500,000 outlay. I think, if you look at our track record, and if you look at how I structured the company, my interests are exactly aligned with the common shareholder. I am driven by earnings per share. That's our goal, to grow earnings per share, and that is how we measure ourselves — again employing successful efforts accounting that require us to immediately expense seismic costs and dry holes. I have this ever-abiding faith that if you are profitable and are growing profits, this will translate into an ever-increasing stock price. And, so far, knock wood, we've achieved that.

TWST: Do you still continue to operate with a staff of four people or has that changed?

Mr. Peak: No, it's just four, and that hasn't changed over the five years, and I think we can get this company much bigger with just four people.

TWST: So that would continue, that policy?

Mr. Peak: Yes.

TWST: How does the balance sheet look from your perspective?

Mr. Peak: Pretty good. Our debt is about $5 million, our bank line is $20 million and we have $2-$3 million in working capital. With $15 million of unused debt capacity, plus or minus $2 million a month coming in and relatively little going out in the way of G&A and interest, we're reasonably capitalized. We've got the cash to live within our budget and our two biggest ideas, which are the offshore Gulf of Mexico and LNG, can both be implemented and executed now with very little additional investment in G&A dollars coming out of our pockets. So with Contango you've got a play on a conventional onshore E&P company, a non-capital-intensive play in the deep shelf offshore, a non-capital-intensive play in LNG, and now, if you get turned on by alternative energy, such as fuel cells and hydrogen processing, you've got another play by owning Contango. So I think you get big ideas with limited downside. That's the reason why I've got 99.99% of my net worth invested in the company.

TWST: When we spoke to you last year, you had purchased in excess of $300,000 worth of your shares that at that time were around $4. So you must be very happy to see your shares at about $7 at this point in time.

Mr. Peak: Exactly. And I just bought 50,000 shares at $7. So I am hoping that when we do this interview a year from now, you'll be saying, "Ken, you must be very happy." That is my hope. We will try to make that come true.

TWST: How does a company as small as yours get your message out to shareholders and potential shareholders?

Mr. Peak: I am not sure we do. I am our VP of Investor Relations, and I don't spend a lot of time worrying about that. If we continue to be profitable and create value, there will be people that find us. I don't worry about our stock price day to day, or quarter to quarter. What I worry about is, are we doing everything we can to create value? If we can create value, the stock price will take care of itself.

TWST: What would be the key investor message that you would like to convey in summary?

Mr. Peak: I think investors should look for managements that are focused on creating value per share. Getting big is not an objective of mine. I would also look for managements that have the bulk of their net worth at risk, and who are buying in on the same basis as shareholders. When I paid $7 a share a week ago, I was paying the same price as everybody else, and I've continued to put my money in the game; as Warren Buffet says, we like to eat our own cooking. That is what I would look for.

TWST: Any other things or developments that are important to note?

Mr. Peak: We've got a lot of ideas that we are working on. Stay tuned and with all this drilling activity, let's hope some of them hit.

TWST: What should be the next benchmark or milestone that investors should be looking for from you?

Mr. Peak: I don't know. I don't think of it that way. I come in every day and try to do something that makes us better off than we were the day before. It is a brick at a time. I mean, obviously, getting FERC approval and getting ConocoPhillips in on our LNG plant is a huge accomplishment for us. The good news from Contango's perspective is that we, Contango, have only got $1 million plus or minus invested in that venture. We spend $0 of G&A trying to manage it. So that's what I am trying to do, and it's the same thing with this alternative energy investment, is to get us in situations where things move forward without additional dollars and management time on Contango's part. And so far, we've done that in the offshore, we've done that in LNG and I am hoping we are going to be able to pull it off in alternative energy.

TWST: Thank you.

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