(Interview of August 27, 2004)

Contango Oil & Gas Company

AMEX: MCF

Kenneth R. Peak
Chairman,
Chief Executive and
Chief Financial Officer

Contango Oil & Gas Company is a natural gas and oil company engaged in the exploration, production and acquisition of natural gas and oil in the United States. The Company's primary source of production is in south Texas. While the south Texas properties account for nearly all of its production, Contango also has interests in producing properties located offshore in the Gulf of Mexico and holds a 10% limited partnership interest in a proposed LNG (liquefied natural gas) terminal in Freeport, Texas.

www.contango.com Phone: 713-960-1901.

Kenneth R. Peak, Chairman, Chief Executive and Chief Financial Officer, spoke with Wall Street Reporter Magazine on August 27, 2004.

WSR: Take a moment to give us an overview of the company.

MCF: We are now five years old. We started in July of 1999. Over the last five years we have raised $20 million net equity. We actually raised $26 million but we did a $6-million stock buyback. So we've raised $20 million net capital. As I sit here today, we have debt of about $3 million but we also have positive working capital of about $3 million. So we have net debt of zero. Our bank revolver is $20 million. We are cash flowing somewhere between $1.5 million and $2 million per month, defining cash flow as EBITDAX. (Earnings before interest, taxes, depreciation, amortization and expensed exploration costs). Most of our production comes from onshore South Texas, where we have been active since the inception of the company. We have made a major investment in the offshore Gulf of Mexico, we have 4,000 blocks of 3D seismic and with another $3 million invested in a reprocessing center to reprocess these 4,000 blocks of seismic. To put the 4,000 blocks in perspective; if we started at Galveston and went to New Orleans and went from the shoreline out to about 300 feet of water depth, that's the area covered by 4,000 blocks. In other words, we have basically the entire shallow water portion, out to 300 feet, covered with 3D seismic that was shot primarily in the 1990's, reprocessed toward the end of the 90's, early 2000, and we are now reprocessing it in-house a third time. This play is characterized in the industry as the deep shelf. The deep refers to the depth of the wells that we're drilling, i.e. wells that are typically deeper than 15,000 feet. The water depth may only be 30 feet. So it's not the deep water Gulf of Mexico, which is an entirely different sort of play, but the deep shelf. We anticipate drilling about four to six of these deep shelf wells this year and about five wells over each of the next two to three years. We have approximately $20 million invested in this play.

We also have a 10% ownership in the Freeport LNG plant. Several months ago the Freeport LNG plant received its FERC approval and a month or so after that ConocoPhillips agreed to become the 50% general partner and to assume the bulk of the financing obligations for the plant. So we are currently in the final stages of getting the final required permits to begin construction on a 1.5 billion cubic feet of gas per day, LNG re-gasification plant, on Quintana Island in Freeport, Texas.

Freeport Texas is 40-50 miles south of Houston and is located in the heart of the Houston petrochemical complex. One of the things that make this plant such an enviable plant is that it has already received FERC approval and it’s the first grassroots LNG plant to receive approval in the last 25 years in the United States. But just as important, is that Conoco and Dow have agreed to take the 1.5 billion cubic feet of capacity. So we’ve already in essence sold out the capacity of the plant and are entertaining discussions to expand it from the 1.5 to perhaps as much as 2.5 billion cubic feet a day. So it’s going to be a major investment. These plants are in essence like long-term annuities. It’s true that the cash flow from this plant won't start until say 2008, and for the first couple of years we'll have debt service, but this is going to be, in my opinion, a superb investment. So those are our three primary areas of focus. I also started a little venture capital firm to invest in alternative energy about a month-and-a-half ago called Contango Venture Capital. My thought process here is that I think the American people are growing weary of sending $400 million a day to people who basically hate us, and, thus regardless of who becomes president, I think there is going to be a major push made by the United States toward alternative energies. I'm trying to position Contango in that space. Now it's only a half-million dollar investment, so even if it doesn't work we've just drilled a half-a-million-dollar dry hole. I'm actually pretty excited about the individual that is running this for us and the technologies that we are looking at.

In summary, I want to keep our focus on conventional onshore drilling, where we take a working interest and the offshore, where we do not typically take a working interest, but rather we farm out and get carried. With respect to LNG, the bulk of the money will be provided by ConocoPhillips. My analogy is if you want to catch a fish, you have to have a lot of hooks baited and in the water. I don’t know which of these ideas will work, but I’m trying to do things that give the Contango shareholder a chance to realize significant value. Of course, we do all of this with just four people -- myself, a secretary, treasurer, and a controller.

WSR: It certainly sounds like you’ve got a well-diversified portfolio right now. You have a “value chain” theory that you’ve assembled and as you just said, you do outsource a lot of the obvious exploration and production activities. Talk a little bit about your strategic approach and how this has worked well for Contango.

MCF: When I analyze an industry or an investment I always look for the driver, the key driver to what is the “value creation event”. The value creation event in the exploration and production business is the “turning of a drill bit to the right” and the discovery of hydrocarbons. What I’m trying to do is to save all of our capital to go toward generating and drilling as many high quality prospects as possible. That’s why we don’t have a big staff. So our onshore and offshore prospect generation is done via alliances with four different groups of geo-scientists that “draw the XYZs;” that pick the drilling locations. Our deep shelf offshore prospects can cost $10 million to $12 million for just dry hole costs, and that’s if everything goes right. If something goes wrong, a well can easily cost $20 million. So the deep shelf exploration model is very capital-intensive, and what we’ve done is put together a financing and outsourcing strategy so that we can have those wells drilled but not risk our capital. It requires us to risk the capital to get the 3D seismic. It requires us to risk the capital to go get the lease. If you don’t own the real estate in this business you have nothing, so we have to go to the lease sale -- the highest bidder wins -- and we have done that and won 41 times because we have 41 leases in the Gulf of Mexico. And out of that lease inventory, these are the prospects that we will be drilling over the next one, two and three years, and of course we’ll go to the lease sale again next year as we continue to reprocess our 4,000 blocks of 3-D seismic. So the value creation event in the E&P business is drilling the wildcat well and once you’ve discovered reserves then you spend a lot more money. You have to operate it prudently, etc. but that’s not really adding value, that’s just preserving value, though you can destroy value if you operate poorly. But you don’t get style points -- to borrow a phrase from the Olympics -- you’re expected to do those routine things well.

On the LNG side, the value creation event is the real estate. It’s much like the shopping center business. You’ve got to have the real estate in the right place. There have been numerous attempts to site LNG plants on the East Coast and the West Coast and in my opinion, most if not all of those are going to fail. There’s an enormous NIMBY (not in my backyard) attitude throughout the United States and therefore I think it’s critically important that you pick the right real estate and fortunately for us, our partners picked the right real estate. We’ve got our project approved. We sit next to the world’s largest chemical plant -- Dow’s Freeport chemical plant. The Houston petro-chemical complex consumes six billion cubic feet of natural gas a day. The entire United States consumes 60 billion cubic feet of natural gas a day so right here, within about a 50-mile radius, 10% of the nation’s natural gas is consumed. So where would you want to be? You’d want to be at a site that you can get permitted and you want to be where the biggest consumers are. It is -- to borrow a real estate phrase -- location, location, location. Obviously in real estate the value creation event is location and the LNG business is a real estate game, so that’s why we are where we are.

Now with respect to our recent alternative energy investment, it's back to trying to identify strategies and alternative energy investments that are going to work. We at Contango are not going to pick the fuel cell that is going to drive General Motors, Ford and Chrysler. That is a very crowded space and a lot of big boys are playing that game so I don't see us playing in that space. I'm looking for niche markets that are maybe a $1 billion to $10 billion a year in revenues, with very specific applications of hydrogen creation, hydrogen processing, hydrogen storage, and fuel cells. We are looking to play in that space and that's what we have our eye on strategically. So we just try to look at every business and figure out the value creation event and what we can bring to the table to have a chance to invest in that space and have success.

WSR: Very interesting. Obviously oil prices were off yesterday but in general they are at fairly significant levels. How has this changed your strategy if at all, both on and offshore and between the split of your resource allocation to both oil and/or natural gas?

MCF: It has allowed us to have significant cash flow even though our production has declined over the last year. We have not done all that well with our reserve replacement, recently, but because of these high prices our cash flow hasn’t dropped. Exploration and production is a numbers game. And by that I mean it’s a lot like going to Vegas and rolling the dice. You hope that through judicious use of geology interpretation and 3-D seismic that you’re able to tip the odds in your favor as opposed to being in the house’s favor, like Vegas. But one must make repeated rolls of the dice or face “gamblers ruin”. These prices have allowed our cash flow to stay up and allowed us to continue to roll the dice without becoming levered, so we’ve been extremely fortunate in our timing. We were very fortunate when we started the company in that we had a large discovery on our first well and that has carried the company’s exploration efforts. But the last year or two with our onshore, we haven’t been as fortunate. But we are continuing to try and I believe ultimately we will be successful, but you’ve got to have faith and you have to have patience. This is a business that if nothing else, demands patience. The high prices have been very beneficial in that regard and they have been very beneficial in really driving the LNG business. That is why our LNG plant is sold out and why we can be in a position to expand it, because if you look at the Lehman Brothers or the Raymond James reports production capacity in the United States is declining somewhere between 3 to 5% per year. This is with an extremely high rig count and the E&P industry is throwing everything we have at trying to increase production. Remember, the industry is a lot more efficient today than we were 5, 10 and 20 years ago, so the rig count doesn't have to be 4,000 because with 2,000 rigs running worldwide, we are four times more efficient than we were 20 years ago. We are drilling a lot of wells and using 3D seismic to avoid drilling a lot of the dumb wells. But we are still not able to replace production in the United States. Additional GNP growth in China and India changes everything. You are going to take two billion people in the space of one generation, 20 years, and move them from poverty to middle class -- middle class being defined as having some personal form of transportation that consumes a hydrocarbon. Not many people realize this, but China now imports more oil than Japan. So worldwide demand for energy is growing and it's only going to continue to grow.

WSR: In conclusion, what would you say to investors as the best reason to keep an eye on Contango and consider the stock a possible long-term investment holding?

MCF: I think the fact that management is in the same boat -- is always very important to me. I want to see management with a major investment and I have 99.99% of my net worth at risk in the common stock of Contango. And the fact that we keep our G&A low and that the alliance partners that we’ve picked are all so good and we are aligned with the common shareholders and we’re working hard to create value. We’ve been successful in the past and the question is, will we be successful in the future? We will find out, but with about 3 million shares I certainly have every incentive to continue to try to create value.

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