Strategic Focus On Exploration, LNG And Alternative Energy Positions Contango Oil & Gas For Big Energy Future

By Tim Beims

HOUSTON–Contango is a term used by NYMEX futures traders to describe anticipated rising future oil and natural gas prices. Contango is also an appropriately descriptive name for a publicly traded Houston-based independent, Contango Oil & Gas Company, with lots of ideas about the country's energy future.

Contango was founded by Ken Peak in September 1999 around a set of core principles that do not always fit the traditional business paradigm for exploration and production companies. The first principle is a single focused strategy to maximize capital available to drill wildcat exploration wells. The company strives to achieve this goal by outsourcing "to the maximum extent possible," while concentrating on only the "E" in E&P. At the same time, however, it houses a multimillion-dollar computing center to conduct all its offshore Gulf of Mexico seismic data processing needs, a function that exploration companies typically farm out to service providers.

"We have a contrarian mindset," Peak asserts. "We do not do things because that is the way they are typically done. We strive to do things as efficiently as possible, and that sometimes means doing things differently."

While the company's exploration emphasis for the near future is the Gulf Coast onshore and offshore Gulf of Mexico deep Shelf exploration, its broader strategy is tied to expectations of rising U.S. need for liquefied natural gas and the continuing march toward the so-called hydrogen economy. Contango's portfolio includes a 10 percent ownership interest in Freeport LNG Development LP, which is preparing to break ground on a 1.5 billion cubic foot-a-day LNG receiving terminal in South Texas, and a 32 percent interest in Contango Capital Management, a venture capital firm that invests in alternative energy.

All three elements–exploration, LNG and alternative energy–are folded into a business plan designed to minimize the size of the corporate structure while maximizing opportunities to create value. All three are also premised, directly or indirectly, on advanced technology.

"Our goals are simple, but audacious," Peak offers. "We seek to have the highest profit margins and revenue dollars per employee in the industry, as well as the lowest general and administrative costs and finding and development costs per unit of production. At the same time, we want to be able to capitalize on early opportunities related to the bigger trends we see emerging for the future, such as the need for LNG and alternative energy technologies."

All this from an organization with a grand total of four employees.

Creating Value

From its streamlined corporate framework to its forward-looking mix of assets, and even to the ways in which it conducts its day-to-day business affairs, Contango is itself something of an "alternative" to the conventional model for building an independent energy company. Not surprisingly, that is exactly what Peak has in mind.

"We organized Contango to set it apart from the pack, not simply for the sake of being different, but because we wanted to build the company around the value creation event of the business," he reasons. "I think of operations as a cost center, and an opportunity to preserve value–and to be candid–to destroy value if done poorly, but that is not where value is created. Thus, we outsource all our drilling, production and marketing functions."

Instead, Contango's game plan is to concentrate exclusively on what Peak considers the strategic point in the E&P value chain. "The signal value-creating event in our industry is taking risk capital and putting a drill bit in the ground, turning it to the right, and discovering reserves that did not exist before," Peak holds. "Value creation starts with an idea–an exploration concept in a geologist's mind–that becomes a lead, then a prospect, and then hopefully, a discovery. We concentrate exclusively on this one link in the value chain because that is where virtually all the value is created."

But rather than hire a team of geologists and geophysicists to delineate prospects in which to invest corporate dollars, Peak decided there was a better way to get in on the ground floor of the exploration value-building process. "The key is to align our interests with some of the brightest and most successful oil and gas finders in the business," he relates.

So another cardinal rule for Contango is to keep the corporate structure lean and leave prospect generation and evaluation to proven explorationists. "The decision to outsource the geological and geophysical function to alliance partners was really driven by the desire to retain the very best available exploration talent," Peak offers. "The best geoscientists, at their core, are creative individuals, and many creative people want to work for themselves. Many are not interested in the security of a monthly paycheck and a health plan, because they cherish their creative freedom and know they can earn a lot more money working on an override basis."

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> **Chairman, CEO and CFO, Contango Oil & Gas**

Contango collaborates with a network of about 10 geoscientists with four small, privately held alliance partners. "Our partners are not afraid to eat their own cooking. In all our deals, our alliance partners have capital at risk with us in the prospects they generate," he says. "Since an override is worthless unless a discovery is made, they are highly motivated to find oil and gas."

For Contango, bigger is not necessarily better. With only four names on the payroll, the company obviously places a premium on low overhead, but Peak is quick to point out that a four-person staff in no way limits grander corporate ambitions.

"We have run the company with four employees since we started, and I do not expect that to change anytime soon. Our size gives us advantages, and we can actually grow faster with only four people," he insists. "We have been called a 'virtual' company, but that misses the point. We may have taken the concept of outsourcing to its practical limit, but there is nothing virtual about us. Contango is real."

The "bare-bones" structure also provides a built-in buffer against business and price risk, he adds. "We have no need to enter into potentially expensive/risky hedge contracts because we are naturally hedged by keeping debt low and minimizing G&A costs by outsourcing everything–land, G&G, engineering, operations, legal, etc. You can make a lot of mistakes in business, but the one mistake you can never make–and expect to survive–is to run out of money. Most companies that get into financial difficulties have high debt and large G&A commitments, and we are allergic to both."

Money And Prospects

All of Contango's principals have professional backgrounds in finance. Peak previously worked as a financial consultant to the E&P industry, a commercial banker, an investment banker, and as treasurer and chief financial officer for energy companies. "I couldn't find oil in a service station," he quips. "But I think I know finance and good people when I see them."

One of the first tasks Peak undertook after the company's startup was building affiliations with like-minded partners who had histories of successful exploration, and then matching Contango's money with the prospects in its partner companies' inventories.

"The key to success is all based on what I call the "three Is:" integrity, intelligence and incentives," he reveals. "You have to work with people of the highest integrity, especially when you are a finance guy who writes checks based on their recommendations. Intelligence is easy to ferret out. Just look at the indi-

vidual's track record. If someone has been in business 20 years, he should have an established record of success of finding oil and gas."

What is in it for the partners?

"We add value by allocating capital to experienced oil and gas finders so they can get their prospects drilled, and by structuring the incentives so they get properly rewarded," he states. "All deals are structured so our partners do not make money before Contango makes money. The idea is to share risk, where our partners work on an incentive basis and get paid for the reserves they find. No one makes money on a dry hole, but everyone gets rewarded when a discovery is made."

In the deep Shelf play, the rewards can be substantial. "A handful of successful wells can make a company," Peak relates. "Where else can you go in the United States today besides the deep Shelf to get exposure to a relatively unexplored basin with huge potential reserves and high production rates with a ready infrastructure so you can bring discoveries on line within a couple months?"

The majority of wells budgeted under Contango's $10 million-$20 million capital program for fiscal year 2005 target conventional depths onshore the Gulf Coast. "We expect to drill 20-30 wells by the end of this summer, which is a huge increase in activity for us. Most of these wells are routine bread-and-butter prospects in South Texas that are intended to make a 15-25 percent rate of return and pay the bills," Peak reports.

A couple of its onshore wells, however, together with its deep Shelf prospects, are where Contango is seeking significant reserves. "Our deep Shelf wells are risky and expensive, with $10 million-$20 million in projected dry hole costs. There will certainly be dry holes, but the deep Shelf offers opportunities for discoveries that could dramatically impact our balance sheet," he avers.

Deep Shelf economics are enhanced by federal royalty relief on the first 15 billion-25 billion cubic feet of gas produced under a program administered by the U.S. Minerals Management Service on wells drilled to 15,000 feet or deeper. "These incentives greatly improve the play's economic profile," Peak allows. "That is key, especially for companies like Contango that sell their deep Shelf prospects to the industry and retain an overriding royalty interest and/or a back-in working interest as compensation."

Hinging On Technology

Whether exploring the depths underlying the shallow-water Gulf or helping chart a course to the energy future, Contango's business model coalesces around technology. For its deep Shelf exploration program, for example, the company has installed a 360-gigaflop clustered supercomputer with 10 terabytes of storage to process 3-D seismic data covering 4,000 blocks in the Gulf, where the deep drilling success hinges on accurate geophysical imaging of structures three miles or more below the seafloor.

"That is a lot of computational horsepower; enough to run even the most complex processing algorithms," Peak states. "The ability to access significant computing power at ever-lower price levels has revolutionized the exploration business, lowering barriers to entry, leveling the competitive playing field between large and small companies, and allowing really talented explorationists to freelance as never before."

The cluster is powered by commodity-priced, off-the-shelf Intel® chips running the Linux® operating system. With hardware continuing to obey Moore's Law, which holds that microprocessor power effectively doubles while cost halves every 18 months, Peak says scalable clusters are delivering unprecedented bang for the buck.

"Prices keep going down and performance keeps going up," he notes. "Periodically upgrading to the newest chips lets you grow computing capacity as you go without having to spend a lot of money. As a result, our computing capacity is on par with the systems found at much larger companies."

Contango, bidding through its affiliates, was one of the most active participants at last year's Central Gulf Lease Sale 190, submitting the high bid on 24 blocks. "You will continue to see us being active at federal lease sales, as well as working farm-out deals with companies that hold acreage we are interested in," Peak assures.

The company's licensed seismic library covers OCS lease blocks extending from offshore Galveston, Tx., eastward to New Orleans in water depths ranging to 300 feet. These 3-D data were initially acquired in 1990s-vintage commercial surveys. "This is the third iteration of this data set. Numerous discoveries were made from the first iteration drilling bright spots on structure. Then the data were reprocessed for prestack time migration to see prospects that were not imaged before," he details. "We are reprocessing the data yet again to focus on deep horizons that have never been interpreted or tested."

The ability to run all processing sequences internally provides decided advantages, according to Peak. "The geoscientists we work with are intimately involved in reprocessing from the first step on, and are able to provide immediate feedback and input at every phase," he elaborates. "It is a very interactive and iterative process, and we can run a reprocessing job as many times as it takes to get it right. Cycle times are also reduced, and we can work on our own schedule."

On a typical offshore deep Shelf deal, once Contango has acquired a lease sale block, it sells the exploration prospect to outside parties, retaining a back-in working interest and/or an overriding royalty, Peak says. However, he notes the proceeds from a pending $50 million sale of 16 Bcfe worth of South Texas oil and gas interests to Edge Petroleum Corp. will be used partially to give Contango the working capital to take a direct working interest position in its deep Shelf prospects.

"The larger the working interest we retain, the bigger the impact a successful discovery will have on the company," he explains. "But even a 5-10 percent working interest is a significant investment on a deep Shelf well, and I did not want to make that investment using debt under our bank credit line. With the South Texas sale, we will have the funds to take up to a 20 percent working interests in deep Shelf wells."

Peak stresses that one of his guiding philosophies is to carry as little debt as possible. "At present, we have no bank debt, and that is the position I prefer to be in. We have borrowed as much as $18 million at times in the past, and will undoubtedly borrow again if the right opportunities present themselves," he relates. "Our goal is to have the cash flow available to fund our exploration pro-

gram, as well as our LNG and alternative energy investments, without having to tap bank credit."

In Front With LNG

The risk and cost structure associated with deep Shelf development alone are enough to scare off many larger companies, so why would a small independent already taking on the challenge of deep Shelf exploration want to venture into the high-stakes LNG and alternative energy markets–the other main pieces of the puzzle for Contango?

"The deep Shelf is a capital-intensive play, and although our business model removes some of the capital requirements and risk, we are still making a big bet on deep Shelf exploration," Peak explains. "We think that bet will pay off, but in the longer term, we are convinced that LNG and fuel cells will also play a big role in the U.S. energy picture. Our LNG and alternative energy investments are partly hedges against future natural gas prices and exploration risks, but they also are excellent opportunities on their own merits, where we could see potentially big returns down the road from a relatively small capital outlay. I am constantly looking for ideas where a small amount of capital against a big risk can be levered into a significant capital return."

Contango is staking a leading position on the LNG front through its 10 percent limited partnership interest in Freeport LNG Development, the first new LNG receiving terminal in decades to be greenlighted for construction in the United States. The Federal Energy Regulatory Commission issued an order authorizing construction of the plant last June, and startup and commissioning is expected in 2008.

The company purchased its share in Freeport LNG Development from Cheniere Energy Inc. for $2.3 million in March 2003. "I previously served on Cheniere's board of directors, and Cheniere's Chairman, President and CEO Charif Souki had an LNG vision that I agreed with," Peak explains. "When the opportunity to invest in Freeport LNG arose a couple years ago, the rationale for LNG imports was not as obvious as it is today, but I took that risk and opportunity because I believed LNG was something that simply had to happen."

He predicts that the Freeport, Tx., plant will be the first of many new facilities built to land LNG imports. "By 2010, I think there will be 10 Bcf-15 Bcf a day of LNG coming into the U.S. market. "How that will ultimately impact natural gas prices is anyone's guess, but I will hazard that one thing is for certain: we will continue to see natural gas price volatility," Peak asserts. "Natural gas will remain a weather-sensitive commodity, and LNG will in no way repeal the laws of cyclicality."

Investing In Alternatives

Through its investment in Contango Capital Partnership Management LLC, the company is also getting ahead of the curve in alternative energy. Contango Capital Partnership was formed to invest in the energy venture capital market with a focus on environmentally preferred energy technologies, and to expose the company to leading-edge alternative energy technologies. Last July, the company became a limited partner in Trulite Inc., which is working to develop compact self-generating power sources for computers, portable military applications, communications devices, surveillance equipment, etc.

"There is an enormous need for lightweight, portable power generation. For example, a huge problem for U.S. troops in Iraq is 'muleing in' all the batteries they need to run their equipment in the field," Peak details. "We are investing in developing small hydrogen-generation technologies for fuel cell systems. As opposed to automotive fuel cells, these are niche technologies for smaller markets, but they are potentially very robust markets."

The hydrogen is generated from a lithium-aluminum hydride chemical reaction. While the chemistry behind hydrogen generation has been known for years, the challenge has been to develop a process that generated more energy than it consumed in creating the hydrogen, Peak relates. "You also have to control the chemical reaction and release the energy slowly and continuously," he notes. "We are not there yet, but the science behind hydrogen generation is getting better all the time, and I think real breakthroughs will be made over the next couple years."

Hydrogen appears to be the next logical step in a continuum toward more efficient and more environmentally benign energy sources, Peak goes on. "The world has progressed from wood, to coal, to oil, and now to natural gas as it marches to the drumbeat of less carbon, more hydrogen and cleaner energy sources. I think people always underestimate the ability of free markets to solve problems, and I am convinced that hydrogen-powered fuel cells will prove very cost competitive," he asserts.

Any returns Contango may receive on its investments in alternative energy technologies are doubtless years away, but then, a quick payout was never the idea. "In exploration, you do your homework, pick your prospects and then wait for the drill bit to prove them up. Here, the choices are much harder and it will be much longer before we can judge our success. The odds are for sure stacked against us, but I like our chances anyway," he remarks.

"I always bet the jockey, and in this case, I really like our jockey," Peak concludes. "The young man who runs this program is extremely smart, and I am betting he gets Contango into some of the right alternative energy investments. And just as it takes only a few good deep Shelf discoveries to make a huge impact on a company of Contango's size, hitting on only one or two alternative energy technologies could prove very significant at the end of the day." ❐