

## ***Twilight in the Desert\****

### **Summary**

The markets told the world last year that Saudi Arabia was bluffing about its capacity to supply more oil to the growing global economy. In his authoritative new book just published, Matt Simmons provides the painstaking detail to support that conclusion. The great resources of the world's leading oil producer are not only at the end of their primary recovery stage, but also near the end of their secondary recovery stage. In a startling negative sign, more water is being pumped into the ground than oil is coming out. As a result Saudi's ability to sustain production at a higher rate may be remote. Ironically, declining production may attract a higher price in Saudi Arabia and in some of the great old fields of the U.S. Representing ownership of increasingly valuable production, six trusts and a partnership offer average estimated distribution yield of 9.3% for the next twelve months and median unlevered cash flow multiple, EV/Ebitda, of 9.7 times.

### **Saudi Resource Capacity Little Changed in Thirty Years**

The production capacity of the Middle Eastern Kingdom was first tested in the 1970s as the rate increased dramatically to offset the sudden decline of U.S. oil supply. The all-time peak rate may have been reached in 1981 as Saudi Arabia offset supply lost from Iran. The peak was not tested again until 1990 when Saudi Arabia offset supply lost from Iraq and Kuwait. Finally the peak of light oil production was reached definitively last year when inexorably rising demand called on the country to deliver all of its spare capacity. Along the way oil was apparently overproduced at the time of each peak, thus compromising long-term recovery.

We were surprised to learn that Arabian American Oil Company (Aramco, now Saudi Aramco) has been injecting water to assist oil production for forty years already. Current rates of water production along with oil apparently are far higher than we had thought. Aramco has employed practically all the best practices and expensive equipment for exploration and production the world has ever known and producing capacity is no higher today than it was thirty years ago.

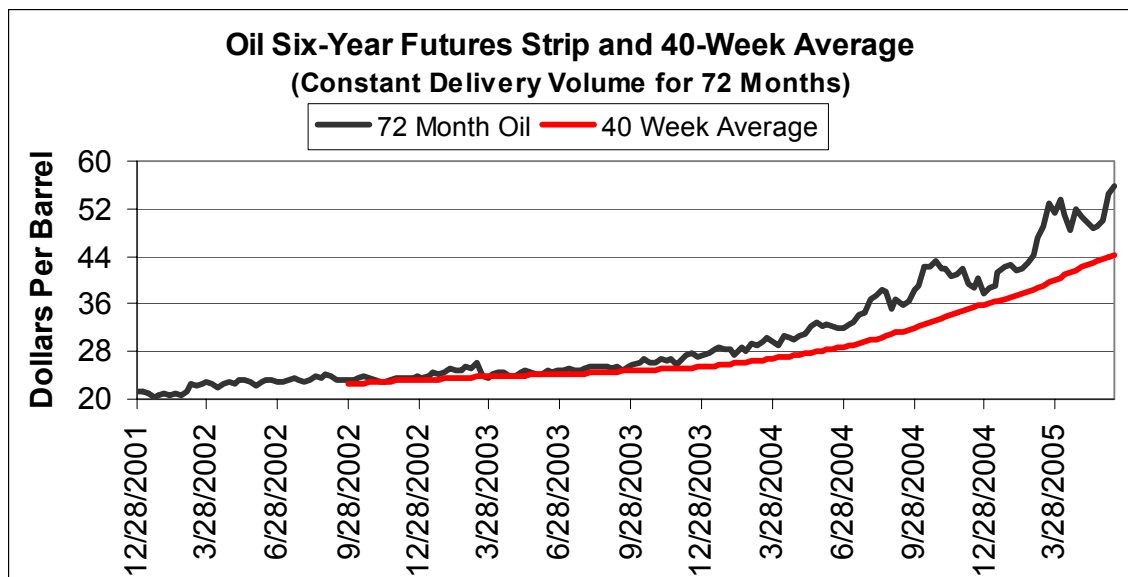
Some of what has happened in Saudi Arabia reminds us of how some companies have evolved. The country seems like the oil company that makes the big discovery, gets rich, and then spends much of its cash flow trying to reproduce the big discovery without

\* Simmons, Matthew R., *Twilight in the Desert*, John Wiley & Sons, Inc., New Jersey, June 2005.

success. The announcements of new capacity being brought on in the next few years also resemble experiences we have had with some companies over the years. The announcements conveniently seem to overlook the fact that the new capacity will likely merely replace the decline of existing capacity.

**Gradual Adjustment**

Mr. Simmons, our business school classmate, alludes to the negative consequences of a decline in oil production by Saudi Arabia. While we can worry about negative surprises, the futures market already seems to be pointing to a gradual adjustment. At a record \$55.80 a barrel, the price of six-year futures is rising in a well-defined trend that could continue for years (see chart Oil Six-Year Futures Strip and 40-Week Average).



The natural gas price outlook is stronger. The trend in six-year futures is likely to carry higher with natural gas price reaching the oil price divided by 5. On that basis, the current six-year natural gas quote ought to be \$11.16 a million btu rather than \$6.88.

One of Mr. Simmon’s surprising chapters concerns natural gas. Demand for natural gas for electrical generation and water desalinization is rising so rapidly along with the Saudi population that the Kingdom’s natural gas reserves will soon be stretched.

Oman, Iran, Russia, the former Soviet satellites and other countries have more natural gas reserves than Saudi Arabia. We think natural gas is part of the global solution to constraints on oil supply. The value of that gas is likely to be higher than the artificially low price Saudi Arabia puts on it for now.

Historical independent energy investment analysis by Kurt Wulff doing business as McDep Associates is posted at [www.mcdep.com](http://www.mcdep.com). Analyses are prepared from sources and data believed to be reliable, but no representation is made as to their accuracy or completeness. Mr. Wulff is not paid by covered companies. Neither he nor his spouse trade a subject stock within a week before or after a change in rating.

**A Valuable Gift**

*Twilight in the Desert* may be the most important readily available contribution to the understanding of the outlook for the world's largest oil producer. We read it in two days starting with the last chapter and ending with the first. Thanks, Matt!

Kurt H. Wulff, CFA

**U.S. Natural Gas and Oil Royalty Trusts**

**The Account**

	<i>Symbol</i>	<i>Price (\$/un) 9-Jun 2005</i>	<i>Units</i>	<i>Market Value (\$)</i>	<i>Next Twelve Months Distrib. (\$/un)</i>	<i>NTM Distrib. Yield (%/yr)</i>
Cross Timbers Royalty Trust	CRT	40.10	400	16,040	3.49	8.7
Sabine Royalty Trust	SBR	39.81	400	15,924	3.58	9.0
San Juan Basin Royalty Trust	SJT	38.06	500	19,030	3.42	9.0
Mesa RoyaltyTrust	MTR	63.25	200	12,650	5.80	9.2
Dorchester Minerals, L.P.	DMLP	21.76	700	15,232	2.10	9.6
Permian Basin Royalty Trust	PBT	13.24	1,200	15,888	1.31	9.9
Hugoton Royalty Trust	HGT	28.65	500	14,325	2.85	10.0
	<i>Total</i>			<i>109,089</i>		<i>9.3</i>
<b>Futures Strip</b>						
	12 Month - Oil (\$/bbl)	56.95				
	12 Month - Natural Gas (\$/mmbtu)	7.61				
	72 Month - Oil (\$/bbl)	55.80				
	72 Month - Natural Gas (\$/mmbtu)	6.88				

**Rank by McDep Ratio: Market Cap and Debt to Present Value**

	<i>Symbol</i>	<i>Price (\$/sh) 9-Jun 2005</i>	<i>Shares (mm)</i>	<i>Market Cap (\$mm)</i>	<i>Net Present Value (\$/sh)</i>	<i>EV/ Ebitda NTM</i>	<i>McDep Ratio</i>
Sabine Royalty Trust	SBR	39.81	14.6	580	33.00	11.1	1.21
San Juan Basin Royalty Trust	SJT	38.06	46.6	1,770	32.00	10.1	1.19
Cross Timbers Royalty Trust	CRT	40.10	6.0	240	36.00	11.4	1.12
Permian Basin RT (41%)	PBT	13.24	19.1	250	12.00	9.3	1.10
Hugoton RoyaltyTrust (46%)	HGT	28.65	18.4	530	27.00	8.3	1.06
Mesa RoyaltyTrust	MTR	63.25	1.9	120	60.00	9.7	1.06
Dorchester Minerals, L.P.	DMLP	21.76	28.2	620	21.00	9.5	1.04
	<i>Total or Median</i>			<i>4,100</i>		<i>9.7</i>	<i>1.10</i>

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### Rank by PV/Ebitda: Present Value to Earnings Before Interest, Tax, Deprec.

	<i>Symbol</i>	<i>Total Present Value (\$mm)</i>	<i>Unit Present Value (\$/mcf)</i>	<i>Reserves (bcf)</i>	<i>Natural Gas/Ebitda (%)</i>	<i>Adjusted Reserves/Production NTM</i>	<i>Revenue Royalty (%)</i>	<i>PV/Ebitda</i>
Cross Timbers Royalty Trust	CRT	216	3.10	70	73	20.0	85	10.2
Sabine Royalty Trust	SBR	481	3.70	130	58	11.9	100	9.2
Dorchester Minerals, L.P.	DMLP	593	3.79	157	79	13.4	54	9.1
Mesa RoyaltyTrust	MTR	112	2.58	43	74	20.0	-	9.1
San Juan Basin Royalty Trust	SJT	1,491	2.85	523	99	12.0	-	8.5
Permian Basin RT (41%)	PBT	229	2.30	100	39	16.4	30	8.4
Hugoton RoyaltyTrust (46%)	HGT	497	2.90	171	92	13.7	-	7.9
<i>Total or Median</i>		3,620		1,194	74	13.7		9.1

### Index of Recent U.S. Royalty Trust Research

#### Single Trust Analyses

<i>Date</i>	<i>Symbol</i>	<i>Stock</i>	<i>Theme</i>
13-May	DMLP	Dorchester Minerals, L.P.	Royalty Volume Increasing
28-Apr	* SJT	San Juan Basin Royalty Trust	Ten Bagger
24-Mar	* MTR	Mesa Royalty Trust	Long Reserve Life Reported
11-Feb	* HGT	Hugoton Royalty Trust	Improving Volume Trend

#### U.S. Natural Gas Royalty Trusts - A Weekly Analysis

9-Jun		Twilight in the Desert
3-Jun		Good Inflation
27-May	*	Understated Reserves
20-May	*	Institutional Longs
13-May	*	The Bottomless Well
6-May	*	Contango and Backwardation Mythology
29-Apr	*	No Debt, No Hedges
		* Archived on <a href="http://www.mcdep.com">www.mcdep.com</a>

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