

Growing through competitive advantages

Mark A. Hellerstein
St. Mary Land & Exploration Co.
Denver

Why are assets worth more to us than they are to others? Being able to answer that question is the key to creating economic value and opportunity at St. Mary Land & Exploration Co.

We believe the answer to this question begins at the core of St. Mary: our value systems; our risk/reward profile;

our incentive programs that help us attract, motivate, and retain top talent; and our reporting and feedback systems that help us understand our business better.

At the regional level, the answer may lie in better application of 3-D seismic and geologic knowledge; a large and strategic acreage position; the ability to apply new technologies; judgment to drill and stimulate wells more effectively and at a lower cost; the ability to

market our oil and gas at a premium over others; and our ability to operate at a lower cost or obtain financing at a lower cost.

It takes a combination of talent, creativity, focus, attention to detail, and proper application of technology to accomplish what we have accomplished. In each of our regions, we strive to establish clear competitive advantages. Once we establish a substantial competitive edge, opportuni-

Industry is awash in capital, but faces different set of challenges

John T. McNabb II
Growth Capital Partners LP
Houston

In this article, I will describe several macro-economic forces that are in play within the energy business as well as several economic trends worldwide. Finally, I will outline three challenges facing the industry.

Capital availability for the energy sector is not an issue. The oil and gas business is awash with capital and capital options. Traditional private capital sources continue to have an ample supply of available funds, and new players (i.e., hedge funds) have emerged.

Public markets have reopened to energy, with the one exception being that it is difficult and impractical for small oil and gas producers (market capitalizations below \$100 million) to be publicly listed these days. Additional costs, in terms of increased audit fees and additional manpower, are the result of Sarbanes-Oxley requirements, enacted in the post Enron compliance environment.

A year-to-year review of public filings reveals that audit costs have tripled in some instances as a result of Sarbanes-Oxley Section 404. Company size is not the issue; it is simply the additional cost of increased scrutiny.

So small public companies have an additional problem with compliance, and when added to the liquidity issues that large institutional investors have with investing in small-cap public companies, the feasibility of being small and public is less positive. But otherwise, the capital picture for the oil and gas business has, arguably, never been better.

In recalling an article I wrote for another publication at the beginning of the 1990s, my subject matter dealt with a very different set of macro-economic factors. The world has meaningfully changed since that time.

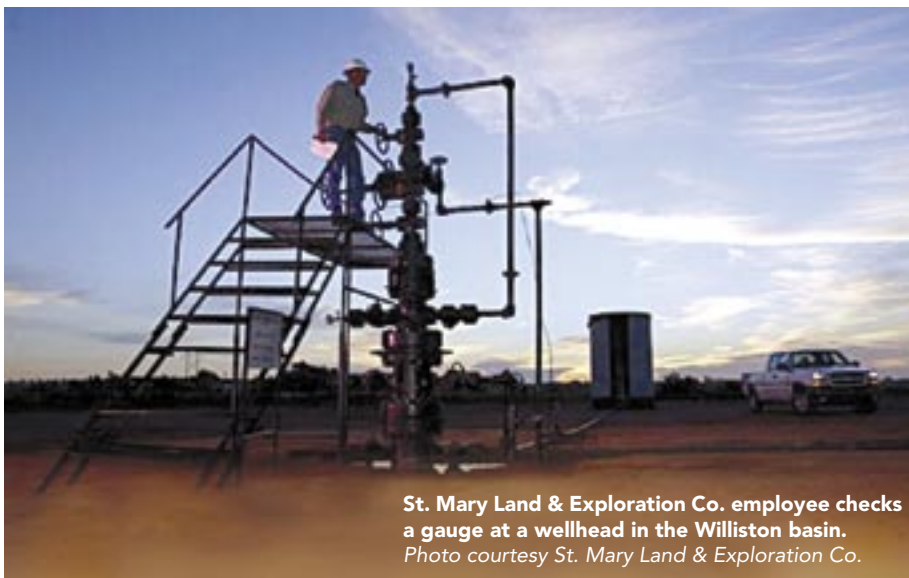
In the early 1990s, OPEC capacity utilization jumped to approximately 95 percent as a result of the first Persian Gulf War and has not dropped below the mid-80 percent range since. OPEC capacity utilization is once again hovering near 95 percent. To put this into

Capital Perspectives

ties follow.

At the core of our company are our employees. We have highly talented and motivated employees who embrace St. Mary's values. Our employees are motivated by unique incentive plans that match compensation with performance. We believe our incentive plans provide a competitive advantage that allows us to compete and grow in the current environment.

Our performance-based cash bonus and restricted stock plans are based on the growth of St. Mary's net asset value per share. Our net profit pool incentive plan rewards selected



St. Mary Land & Exploration Co. employee checks a gauge at a wellhead in the Williston basin.
Photo courtesy St. Mary Land & Exploration Co.

Capital Perspectives

perspective, OPEC's capacity utilization in the mid 1980s was just over 50 percent. And you will recall the single-digit oil price which resulted during that period.

In today's situation, we find that OPEC has little "dry powder." The cartel is currently producing flat out with only Saudi Arabia, Kuwait, and Nigeria having meaningful excess capacity. And Saudi Arabia accounts for approximately two-thirds of that cushion. Add to this picture, Russia, which is now in an apparent irreversible production decline due to inadequate infrastructure, spending issues, and reservoir concerns.

I believe we are experiencing a secular change in the energy business, a new paradigm if you please, that will alter the price deck for oil and natural gas for the foreseeable future.

Why has this occurred? The disappearance of OPEC's capacity cushion, increases in finding and development costs worldwide, and the increased infrastructure costs in the OPEC countries create a value proposition that has forced energy prices higher.

The other important piece to this scenario is the emergence of significant

economies outside the G-6 (US, Japan, UK, Germany, France, and Italy). In 2005 China, India, and the United States are the three most populous countries on the globe. On a GDP per capita basis, India's economy is about 70 times less than the US, and China's is about 30 times less than the US.

So the Indian and Chinese economies, on a per-capita basis, are currently dwarfed by the US economy. China, India, and the US will continue to be the most populous countries throughout the first half of the 21st century, but by 2025 these three should also constitute the world's three biggest economies both on a GDP and a GDP per capita basis.

The explosive growth of the Chinese and Indian economies may have caught many people off guard. This growth, coupled with the fact that both countries are net importers of energy, adds another important component to my view of oil and natural gas prices going forward.

So now please add to OPEC's reserve-to-production outlook, the projected explosive economic growth in the world's two most populous countries, both of which are net energy

importers, and the picture becomes a bit clearer.

Then add worldwide oil and gas production declines, higher OPEC infrastructure costs, and higher finding and development costs. Sprinkle in the very real threat of worldwide sovereign risk and the continued threat of terrorist activities aimed at destabilizing governments and damaging the world's energy infrastructure.

OPEC will account for even more of the world's energy production as non-OPEC sources decline faster and, given that OPEC has little current excess capacity, the global energy pricing picture is something I have not experienced in my career.

That is the current picture and most likely a look into the future. So what does this mean for the energy business?

I see at least three challenges facing the industry and will discuss each of them. The first challenge may be the least discussed but still is very real. The energy business has a talent shortage. The historical volatility of the energy business has driven talent away. Certainly, the mid- to late-1980s were difficult and our talent shortage can be traced back to this period, which

employees with a portion of cash flow from a pool of assets once St. Mary has recovered 100 percent of its costs. It is a unique plan that creates the proper tension between growth and economics. Over the years, we have been able to retain our employees and, at the same time, attract talented professionals to our company.

In each of our five core areas, we have developed competitive advantages that provide the edge we need to create value.

In the Williston basin, we have been able to map porosity as well as structure in the Red River formation

using 3-D seismic imaging, which has resulted in an 86 percent drilling success rate since 1991.

Other operators in the Williston basin that were not able to achieve a high success rate began leaving the basin. This allowed St. Mary to become a consolidator through a series of property acquisitions.

These acquisitions provided us with our next major competitive advantage: a large and strategic acreage position covering more than 1.3 million gross acres, 80 percent of which is undeveloped. This acreage provided an entrée into the Middle Bakken dolomite play,

the hottest oil play in the Rockies.

Our 80,000 net acres in the fairway of the Middle Bakken play have created significant value for St. Mary, as we recently completed our 21st well without a dry hole. We see this as a multi-year development project that has resulted from our competitive advantage of being able to map porosity and structure using 3-D seismic imaging.

The competitive advantage we have developed in our Hanging Woman basin coalbed natural gas play in the northern Powder River basin answers the question: "Why are these assets

saw widely fluctuating product prices accentuated in mid decade by single-digit oil prices. This period also saw a distinct lack of outside capital for the energy sector, which was not attractive for professionals to make their career bets.

So how does a company attract and retain talent? My view of this is simply by doing a better job of recruiting and identifying talent. Most independent producers do not do a good job in this area. It was always about finding oil and gas. Now it needs to be about finding yet another valuable resource – talented people.

Companies need to do much better jobs with their career development programs. Active career development should start earlier in a professional's career. The technical talent pool is shallow, and it is in a company's best interest to provide a roadmap for young professionals as to where they can go and how they can get there within a company.

And a final issue relative to talent is compensation. This, of course, is extremely important. A creative and competitive compensation program is a necessity in this environment. Do I think the industry does a good job in human capital management? My answer is "No." This focus should come from the board of directors to senior management in public and private companies. Human capital

Companies are flush with liquidity and are having difficulty making smart investments. Exxon Mobil gave money back to its shareholders in 2004, and BP is planning to do so in 2005. Many companies are finding it difficult to reinvest their cash flow.

management should start at the top of an organization.

The second challenge facing the industry today is technology. We have seen what the development of 3-D technology, improvements in horizontal drilling technology, the development of MWD/LWD, and tight formation fracturing techniques/technology have done for the energy business. The economic winners in the oil

and gas space are going to be able to attract and retain talent AND develop, understand, and utilize technology and science to their advantage.

The third challenge is the most important. The current high commodity price environment is creating ample liquidity for domestic producers. This, in turn, has generally caused a lowering of debt levels.

The major challenge, as I see it, is "where to spend your money?" Is it exploration? Domestic exploration programs have not worked well for most producers, and exploration

spending has declined by one-third since 1991.

"Trading Properties" or buying another company's reserves is becoming very expensive due to the overabundance of cash flow and outside investment capital. In a sense, we currently have the "best of times and worst of times."

Companies are flush with liquidity and are having difficulty making

Capital Perspectives

The User

worth more in our hands than in someone else's?"

Our mostly contiguous 154,000-net-acre lease position in the play allows us to drill on 160-acre spacing rather than on 80 acres, which would be necessary to protect our properties from drainage by other operators, if our properties were not contiguous. Since each well drains 160 acres, drilling on 160-acre spacing is the most economically efficient way to develop the property.

One of our employees has developed a packer tool that separates the water from each coal seam. This

enables us to complete multiple coal seams through the same wellbore. These two advantages will allow us to reduce the number of wells drilled per 640-acre section from 24 to eight, offering a dramatic reduction in capital costs as well as less environmental impact.

In a business where approximately 50 percent of the companies are routinely gone after five years, St. Mary has survived and thrived since our inception in 1908. Establishing competitive advantages is the key.

Growing through competitive advantages is a work in progress. The

battle never ends, but with each competitive advantage, we are building the tools that grow our company and create shareholder value. **OGFJ**

The author

Mark A. Hellerstein is chairman, CEO, and president of Denver-based St. Mary Land & Exploration Co. He has served as president and a director since 1992, as CEO since 1995, and was appointed chairman of the board in September 2002.



Capital Perspectives

The Provider

smart investments. Exxon Mobil gave money back to its shareholders in 2004, and BP is planning to do so in 2005. Many companies are finding it difficult to reinvest their cash flow.

So where does the industry go? One idea is identifying and producing non-conventional reserves. This is more than the newest "flavor of the month."

Fort Worth is now the "Natural Gas Capital of the United States." Who would have thought that 10 years ago? The Barnett shale has opened an active search for new basin-centered tight formation (non-conventional reserve) analogies to the Barnett shale. There will be other winners in other tight formation/shale plays domestically. And there will be some big winners.

In my opinion, exploitation has more promise domestically than exploration. So making property acquisitions can work if a company can exploit and otherwise improve a reserve base.

And this takes us right back to talent and technology – the two other

challenges discussed in this article. The future winners in the E&P sector will be companies that can manage talent, create and/or utilize technology, and create value by developing non-conventional reserves.

This is a most interesting time to be involved in the oil and gas business. I joined the E&P division of Mobil Oil in the late 1970s. My career has included managing the then largest private energy capital provider business in North America, working as a large-firm investment banker, and serving on domestic-based production company boards of directors listed on the New York Stock Exchange, American Stock Exchange, and NASDAQ. I have written a number of articles over this period.

The forward picture now is unique because the world has changed dramatically. An opportunity for historically high and stable product prices exists. The risks to this are omnipresent, such as a severe worldwide economic downturn and the ever-present geopolitical risks, of which we have grown accustomed. And the chal-

lenges to the industry are just as real in terms of talent, technology, and reserve replacement.

On balance, I like what I see as I move around the E&P and the service sectors. I believe the oil and gas business has entered a new era. It is a period of great opportunity but also one of continuing challenges. **OGFJ**

The author

John T. McNabb II is co-founder, chairman, and director of Houston-based Growth Capital Partners LP. He has held this position since 1992. He also serves on several additional boards of directors, including GCP Securities Inc., Vintage Petroleum, and Cust-O-Fab Services Inc. Previously, he was a managing director and board member of BT Southwest Inc., a subsidiary of Bankers Trust New York Corp. Prior to that, he was with The Prudential Insurance Co. and Mobil Oil. He holds BA and MBA degrees from Duke University.

