

Pioneer's Hugoton Deal

Summary and Recommendation

Natural gas producer, Pioneer Natural Resources (PXD), known to be looking at forming a royalty trust, instead sold for \$275 million a five year production payment interest in Kansas Hugoton reserves. Stressing the advantage of keeping the long-term upside potential, management indirectly affirmed some of the appeal in **Mesa Royalty Trust (MTR)**, a publicly traded security that participates in the same properties. The deal is the latest in a trail of transactions that dramatizes the greater investment efficiency of the royalty trust. We suggest that the McDep Energy Portfolio should have one total position made up of one or more of seven stocks (see table The Account).

The Volumetric Production Payment (VPP)

On January 27, Pioneer announced a transaction in which it would deliver about 58 billion cubic feet of natural gas over a five year period beginning February 1, 2005 in return for an immediate payment of about \$275 million. Apparently the buyer is entitled to about 80% of Pioneer's daily Hugoton natural gas production. The economics are illustrated in a discounted cash flow calculation though we do not know all the details (see table).

Present Value of Natural Gas Production

Volume Decline (%/yr):					9			
Discount Rate (%/yr):					7.0			
Regional Price Differential (%):					10.0			

Year	Volume (mcf)	Price			Revenue (\$mm)	Free CF (\$mm)	Disc Factor	Present Value (\$mm)
		Henry Hub (\$/mcf)	Differential (\$/mcf)	Hugoton (\$/mcf)				
Total 2005 through 2009; years ending on following January 31								
	58.0			5.48	318	318	0.86	275
2005	13.9	6.61	0.66	5.95	83	83	0.97	80
2006	12.6	6.39	0.64	5.75	73	73	0.90	66
2007	11.5	6.05	0.61	5.45	63	63	0.84	53
2008	10.5	5.70	0.57	5.13	54	54	0.79	42
2009	9.5	5.42	0.54	4.88	46	46	0.74	34

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The proceeds of the transaction seem to match a pattern of natural decline of production, futures prices, regional differential and discount rate. Pioneer has the obligation to meet all the costs of production and the buyer of the VPP gets the opportunity and bears the risk of commodity price.

The Price of Mesa Royalty Trust Not High Enough to Entice Pioneer

Practically half the value of MTR is in the Kansas Hugoton properties operated by Pioneer. There could not be a more obvious indicator of the proceeds Pioneer could raise by selling units of a nearly identical entity. By choosing the production payment instead of the royalty trust, management implied that it was unwilling to sell reserves at the market price of royalty trusts.

As it turns out a five-year VPP does not much resemble a royalty trust or an operating company. Pioneer retains the longer-term potential from further development or higher commodity price on remaining production just as do royalty trusts typically. Pioneer now has a greater proportionate interest in the residual value after the VPP is satisfied. Maybe that is good for the long term value of Mesa Royalty Trust which does depend on Pioneer to operate its Hugoton properties.

Case History of Royalty Trust Efficiency

The fascinating implication is how much debt, deals and fees can take out of the value of a prime property. At one time practically all of Pioneer's Kansas Hugoton properties were in Mesa Royalty Trust. Then about 90% of the trust units were retired while the remaining 10% still trades today. The 90% portion has gone through a trail of transactions of which the VPP is the most recent. The 10% portion makes regular income distributions.

The former trust property became the core of Mesa Limited Partnership. The partnership became part of Pioneer after the acquisition of Panhandle Hugoton properties. After a management change Pioneer went on to make more acquisitions. Now the Kansas Hugoton properties have been the subject of the latest transaction. An investor who tried to maintain ownership of the Kansas Hugoton through the subsequent transactions saw high distributions for awhile and then lost most of the principal through debt-driven deals. That hypothetical investor finally gives up five years of any further price appreciation on the assets covered by the latest transaction.

That leaves the question, "Did management add more value to the Kansas Hugoton properties than could be realized in the royalty trust?" A "No" answer helps explain why royalty trusts today have higher stock market value for the same properties than do operating companies.

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Hold an Investment Position

We suggest that the McDep Energy Portfolio should have one total position made up of one or more of the seven stocks (see table The Account). Most investors may want to concentrate first on the stocks with the most liquidity as indicated by Market Cap (see table Rank by McDep Ratio). We would also differentiate by McDep Ratio while recognizing that it is a challenge to measure relative value precisely. Finally, there is more analysis available (see Index of Recent Royalty Trust Research).

U.S. Natural Gas and Oil Royalty Trusts

The Account

	<i>Symbol</i>	<i>Price (\$/un) 3-Feb 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	40.46	400	16,184	3.00	7.4
Dorchester Minerals, L.P.	DMLP	24.10	700	16,870	2.01	8.4
Hugoton Royalty Trust	HGT	26.90	500	13,450	2.38	8.8
Mesa RoyaltyTrust	MTR	67.92	200	13,584	5.28	7.8
Permian Basin Royalty Trust	PBT	14.01	1,200	16,812	1.13	8.1
Sabine Royalty Trust	SBR	37.93	400	15,172	3.32	8.7
San Juan Basin Royalty Trust	SJT	31.49	500	15,745	2.76	8.8
	<i>Total</i>			<i>107,817</i>		<i>8.3</i>
Futures Strip						
	12 Month - Oil (\$/bbl)	46.46				
	12 Month - Natural Gas (\$/mmbtu)	6.54				
	72 Month - Oil (\$/bbl)	41.84				
	72 Month - Natural Gas (\$/mmbtu)	5.86				

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**U.S. Natural Gas and Oil Royalty Trusts
Rank by McDep Ratio: Market Cap and Debt to Present Value**

	<i>Symbol</i>	<i>Price (\$/sh) 3-Feb 2005</i>	<i>Shares (mm)</i>	<i>Market Cap (\$mm)</i>	<i>Net Present Value (\$/sh)</i>	<i>EV/ Ebitda</i>	<i>McDep Ratio</i>
Permian Basin RT (41%)	PBT	14.01	19.1	270	11.00	11.3	1.27
Sabine Royalty Trust	SBR	37.93	14.6	550	33.00	11.4	1.15
Dorchester Minerals, L.P.	DMLP	24.10	27.0	650	21.00	12.0	1.15
Mesa RoyaltyTrust	MTR	67.92	1.9	130	60.00	12.5	1.14
Cross Timbers Royalty Trust	CRT	40.46	6.0	240	36.00	13.3	1.13
Hugoton RoyaltyTrust (46%)	HGT	26.90	18.4	500	25.00	9.4	1.08
San Juan Basin Royalty Trust	SJT	31.49	46.6	1,470	30.00	10.1	1.05
	<i>Total or Median</i>			<i>3,800</i>		<i>11.4</i>	<i>1.14</i>

Buy/Sell rating after symbol: B1 - Buy full unlevered position, S2 - short quarter unlevered position
McDep Ratio = **M**arket cap and **D**ebt to **P**resent value of oil and gas and other businesses

Index of Recent U.S. Royalty Trust Research

Single Trust Analyses

<i>Date</i>	<i>Symbol</i>	<i>Stock</i>	<i>Theme</i>
3-Feb	SJT	San Juan Basin Royalty Trust	Real Value with Income
22-Nov	* MTR	Mesa Royalty Trust	Hugoton Predictability, San Juan Surprise
12-Nov	* CRT	Cross Timbers Royalty Trust	Low Risk, Long Life

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

28-Jan		Present Value at \$40 Oil
21-Jan	*	Overlooked Asset Class
13-Jan	*	Green on the Screen
7-Jan	*	All Barrels Are Not the Same
31-Dec	*	Charitable Gifts
24-Dec	*	Weather and Inventories

* Archived on www.mcdep.com

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