



May 1, 2005 • Issue 7

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Is Natural Gas Set to Spike?

US Natural Gas Rig Count*

While crude oil has gotten much of the investment community's attention over the last six months or so, natural gas has been maintaining its historically high price of approximately \$7.00 per thousand cubic feet (mcf). I believe there is a strong possibility natural gas will be the big story this summer with price spikes to well over \$10 per mcf. While my view might seem extreme given the ample amounts of gas currently in storage, I believe there is significant evidence to support my thesis. Below are several of the reasons why I believe natural gas prices are headed to much higher levels over the course of the next six months:

- 1) *North American natural gas production continues to decline despite record drilling and historically high prices.*

It is difficult to overstate the importance of declining production at a time of 100% rig utilization in the US and Canada. Over much of the past 25 years, North America has existed in a "natural gas bubble". Almost immediately after the regulation of natural gas market in 1978, the high natural gas prices of the era brought on an overwhelming supply response. Even after the deregulation of the US natural gas market in the late 1980's, any uptick in gas prices brought on a massive supply response. During the last several years of high gas prices and declining North American production, the industry has been able to fight the decline curve through increasing the number of rigs drilling for natural gas. Let me put some numbers behind this statement:

Date	Rigs
Dec 1998	483
Dec 1999	606
Dec 2000	874
Dec 2001	748
Dec 2002	722
Dec 2003	966
Dec 2004	1,058
Apr 2005	1,175

*Source: Baker Hughes

US Oil and Gas Rig Count**

Date	Rigs
Dec 1998	621
Dec 1999	771
Dec 2000	1,114
Dec 2001	887
Dec 2002	862
Dec 2003	1,126
Apr 2004	1,348

**Source: Baker Hughes

Since US rig utilization is now at 100%, I believe **"things are different this time"**. The market no longer has the possibility of a massive supply response should natural gas prices spike due to either a further fall-off in supply or increased demand. Without the ability to significantly increase the amount of rigs searching for natural gas irrespective of the how high prices go, there is virtually no chance of bringing the market back into balance without a sustained period of high natural gas prices. Demand would have to be destroyed to bring the natural gas market back into equilibrium.

2) Demand is becoming much more difficult to destroy.

Since the first natural gas spike of the new millennium which occurred during the summer of 2000, much of the easy demand has already been destroyed. We have seen aluminum smelters that were once based in the Pacific Northwest shut down operations and move to Australia. Many of the less efficient fertilizer plants in both the US and Canada have moved to Trinidad. The US Gulf Coast has seen a significant portion of its chemical industry move to locations with cheaper natural gas prices.

The most important reason natural gas demand is becoming increasingly difficult to destroy is that a higher percentage of US consumption is used as feedstock for natural gas-fired power plants. As can be seen from the table below, the amount of megawatts that have been generated by natural gas, coal and nuclear plants reached all-time highs last year. Since coal-fired and nuclear plants are now running at close to maximum capacity during the summer months, all incremental electricity demand will be met by natural gas-fired peaking plants. History tells us that at times of hot weather, demand destruction becomes extremely difficult. After two very mild cooling seasons in 2003 and 2004, this year could be the first year that many of the new natural-gas fired peaking plants that were built earlier in the decade are called into use.

Net Generation by Energy Source***
(thousand megawatt hours)

Year	Coal	Nat. Gas	Nuclear
1991	1,590,623	381,553	612,565
1992	1,621,206	404,074	618,776
1993	1,690,070	414,927	610,291
1994	1,690,694	460,219	640,440
1995	1,709,426	496,058	673,402
1996	1,795,196	455,056	674,729
1997	1,845,016	479,399	628,644
1998	1,873,516	531,257	673,702
1999	1,881,087	556,396	728,254
2000	1,966,265	601,038	753,893
2001	1,903,956	639,129	768,826
2002	1,933,130	691,006	780,064
2003	1,973,737	649,908	763,733
2004	1,976,333	699,610	788,556

***Source: US Department of Energy

3) The US gas market will remain tight due to limited import options.

With very limited spare capacity to increase imports of natural gas either from Canada or via liquefied natural gas (LNG), it is unlikely foreign sources of natural gas will play a major role in increasing supplies. After 16 years of growing Canadian production and exports to the US, natural gas production and exports to the US fell in 2003. While Canadian exports and production recovered modestly in 2004, this was only accomplished through drilling a record number of natural gas wells during the year. It should be noted that Canada supplies approximately 15% of the US natural gas market. Given the lack of major new fields that are coming online in 2005 and the high decline rate of many Canadian fields, I expect production and exports to the US to retreat once again.

While LNG has captured the attention of many in the media as the answer to North America's natural gas problems, increased imports of LNG will have little impact should natural gas prices spike. As can be seen from the table below, LNG imports still constitute a relatively minor amount, approximately 3%, of the US natural gas market. It should be noted that the US consumes approximately 60 billion cubic feet (bcf) of gas per day.

US LNG Imports (bcf)****

Year	Annual Import
1999	163.4
2000	226.0
2001	238.1
2002	228.7
2003	506.5
2004	652.0

****Source: US Department of Energy

While there is still capacity to import more LNG into currently existing receiving terminals, the lack of available cargoes will severely limit LNG imports into the US. With competition for spot cargoes continuing to grow from both Europe and Asia, the lack of aggressiveness by US receiving terminal operators in securing long term contracts for LNG cargoes has ensured that LNG will play

only a minor role in supplying the US market for the next several years.

4) A Spike in Crude Oil Prices Could Lead to a Spike in Natural Gas Prices

After reading several reports authored by prominent brokerage firms discussing the reasons crude prices could spike to triple digit levels, I quickly concluded that any large spike in crude prices would be incredibly bullish for natural gas prices. If crude prices were to spike to levels far about current prices, there would be an unprecedented incentive for industrial users of distillates to switch to natural gas where possible and for pipeline operators to strip liquids from the gas stream. While it is likely that natural gas would trade at a significant discount to oil on a BTU basis should oil prices spike, history tells us that a major run-up in the price of crude will drag the entire energy complex with it.

In conclusion, the price stability we witnessed in the natural gas market over the last six months is about to disappear. I believe astute investors should take advantage of recent market weakness and increase their exposure to unhedged North American natural gas producers who are growing production per share and reserves per share.

Model Portfolio

The last month has been nothing short of stomach churning for energy investors. The recent sell-off in crude and rampant profit taking has beaten down the stock price of many exploration and production (E&P) companies to very attractive levels. This has created an outstanding buying opportunity for investors looking to increase their exposure to the outstanding fundamentals of the energy sector. Given the strong earnings we have seen from the major integrated companies, it looks like Q1 2005 was a blockbuster across the board. The strong Q1 earnings I expect from nearly every member of the Model Portfolio should provide significant support for stock prices near current levels. In other words, I believe the bottom may be in for energy stocks.

While attending the Independent Petroleum Association of America (IPAA) Investment Symposium in New York in early April, I was very impressed with a number of the Model Portfolio companies in attendance. One company that particularly caught my attention was Carrizo Oil and Gas (NASDAQ:CRZO). CEO Chip Johnson clearly laid out the company's plans for its Barnett Shale drilling program this year as well as the company's other drilling plans along the Texas Gulf Coast. Mr. Johnson discussed CRZO's policy of taking a 100% working interest (WI) interest in wells where there is a strong likelihood of success, such as those in the Barnett Shale, and selling down the company's interest in higher risk exploration plays. This strategy has worked exceedingly well in building value for shareholders. I consider Carrizo Oil and Gas an outstanding investment candidate at this time.

Mike Watford, CEO of Ultra Petroleum (AMEX:UPL), who was also in attendance at IPAA, made his usual outstanding presentation. Ultra continues to pile up the reserves and increase its drilling locations while achieving the industry's best cost structure and highest margins. The company's Q1 2005 results, which were released in late April, provided further proof that despite a nearly 100-fold increase in the company's stock price over the last six years, there is still plenty of upside at Ultra. Earnings were \$37.3 million or \$0.46 per diluted share, an 89% increase from \$19.8 million or \$0.25 per diluted share for the same period in 2004. Cash flow for the period was \$69.4 million or \$0.86 per diluted share, a 91% increase from \$36.2 million or \$0.46 per diluted share for the same period in 2004. Production increased 61% to 15.6 billion cubic feet equivalent (bcfe) compared to 9.7 bcfe for the same quarter in 2004. Average natural gas prices were \$5.58 per mcf during the quarter, compared to \$4.95 per mcf for the same period in 2004. Also, Ultra recently announced shareholder approval for a two-for-one stock split. I consider UPL an outstanding investment candidate at this time.

PetroQuest Energy (NASDAQ:PQUE) was very active on the acquisition front in the month of April. In mid-April, the company announced it acquired a privately held exploration and production company with operations in the Gulf of

Mexico for approximately \$15.6 million. PQUE now has a Gulf of Mexico lease position of 184,000 gross and 111,000 net acres covering 46 offshore blocks. Also in April, PetroQuest announced it spent \$22 million in cash to acquire 8,900 net acres in close proximity to the company's current Arkoma Basin acreage and approximately 50 miles of pipeline and gathering infrastructure in the basin. This brings PQUE's total ownership to approximately 21,000 net acres and 108 miles of pipeline in the area. Given the company's history of consistent reserve and production growth and its very active 2005 drilling campaign, I consider PQUE an outstanding investment candidate at this time.

After urging caution with respect to the shares of Uranium Resources Inc. (OTCBB:URIX) in the April issue, I believe the recent sell-off in the company's stock has created a great opportunity for investors seeking exposure to today's bull market in uranium. After reading the company's recently filed 10K, I believe the company has overcome its earlier wellfield spacing issues that were causing the company to miss its production targets. It should be noted that the company is continuing to work with officials in the State of Texas in obtaining a permit for the re-commissioning of the company's Kingsville Dome project later this year or early next year. Based on the company's industry leading expertise in in-situ leach uranium mining and its rich portfolio of properties, I consider URIX an outstanding speculative investment at this time.

Petroleum Development Corporation (NASDAQ:PETD) currently presents a very unique investment opportunity. The company, which has legacy asset in the Appalachian Basin and the Antrim Shale of Michigan and several very prospective properties in the Rockies, recently entered the Bakken Shale play of North Dakota. The company announced that it picked up 35,000 acres of prospective Bakken Shale acreage in western North Dakota and plans to drill up to three horizontal wells into the play in Q3 of 2005. There have been over 125 successful horizontal wells drilled in Richland County, Montana and activity is moving across the border into western North Dakota. Currently there are 10 or more wells in various stages of progress targeting Bakken

reserves in the emerging North Dakota area of the play with more than a dozen operators competing for acreage in the area. Should PETD be successful in developing its newly acquired Bakken Shale play, the company will have a very large foothold in an exciting new resource play. I consider PETD an outstanding investment candidate at this time.

Once again, my good friend Dan Steffens has agreed to provide a company profile. This month Dan has done a fantastic profile on Arena Resources.

Arena Resources

By Guest Analyst Dan Steffens, CPA

Quick Facts

Symbol: ARD

Price: \$11.00 (April 29, 2005)

Market Cap: \$112.1M

Shares Outstanding: 10.2M

Q4 2004 Cash Flow per share: \$.13

Q4 2004 Earnings per share: \$.10

Q4 2004 Production: 810 boed

Reserves as of 12/31/2004: 21.2 million boe

Arena Resources (AMEX:ARD) is one of the small-cap E&P "Diamonds in the Ruff" that I stumble across from time-to-time. The shares are currently trading at about half the present value of the company's proved oil and gas reserves net of all liabilities. I believe that if the company carries out its 2005 low-risk development drilling program, the market will see the value and the share price could move well over \$20/share within 12-months.

Arena was formed in 2000 by Lloyd T. (Tim) Rochford and Stan McCabe who between them have over 55 years of exploration & production experience in the Mid-Continent area. Their business plan is to acquire older properties that have proven reserves, positive cash flow and significant development opportunities through in-fill drilling, increased density, field expansion and secondary recovery methods. Over the last four years, Arena has been successful in acquiring fourteen fields that fit their plan.

Based on an independent appraisal of Arena's oil and gas properties prepared by Lee Keeling &

Associates, Inc., Tulsa, Oklahoma (using year-end average prices of \$39.00 per barrel of oil and \$5.19 per mcf for natural gas) it is clear the company has acquired a strong inventory of development projects at a steep discount.

- PV10 value of future net cash flows before income taxes = \$302.4 million
- Net Asset Value per Share = \$29.65 (based on 10.2 million shares outstanding at 3/31/2005)
- Acquisition costs = \$25.5 million
- Proved Developed Reserves = 5,490,502 barrels of equivalent (boe)
- Proved Undeveloped Reserves = 15,726,752 boe
- Total Proved Reserves (P+P) = 21,217.254 boe

Also impressive is that the company has been profitable since 2001 even though it has been in acquisition mode until late in 2004. This tells me that the management team has maintained their focus.

The company has fourteen active projects but the primary focus will be on the Fuhrman – Mascho Field in Andrews County, Texas during 2005. The company holds all of the WI with a 75 percent net revenue interest. The Texas Railroad Commission has approved reduced spacing for the field, from 40 acres to 20 acres per well, which creates over 130 low risk development locations.

During the 2nd quarter of 2005, a drilling rig will be moving onto the Fuhrman – Mascho Field to begin a 27 well infield drilling program. All of the wells are being drill on Proved Undeveloped (PUD) locations identified and confirmed by Lee Keeling & Associates, Inc. In addition, a workover rig is on location to fracture 15 existing wells. The new wells and the workovers are each expected to generate over 40 barrels of additional production. Therefore the program is expected to increase Arena's net daily production by 1,260 barrels of equivalent per day (boepd). If successful with Phase One, the company plans to drill an additional 80 PUD locations in 2006 and 2007.

This year, the company is also drilling six additional new wells and a dozen workovers will be completed on other properties. Several water flood projects are being planned. The first and

largest water flood project is the East Hobbs San Andres Unit in Lea County, New Mexico, where first water injection is slated for the 4th quarter of 2005.

Layering the Fuhrman - Mascho development project and other planned projects on top of the company's base production has Arena's estimated daily production ramping up to over 8,000 boepd by 2011. It is the company's steady and predictable growth profile that offers investors an outstanding opportunity to profit from Arena's growth.

Adding to the upside is the fact that all of Arena's production is currently unhedged. If commodity prices hold near the current NYMEX strip, 2005 earnings should exceed my forecast of \$0.71 per share.

GMX Resources

Quick Facts

Symbol: GMXR

Price: \$11.00 (April 29, 2005)

Market Cap: \$90.2M

Shares Outstanding: 8.2M

Q4 2004 Cash Flow per share: \$.19

Q4 2004 Earnings per share: \$.12

Q4 2004 Production: 4.7 mmcfe/d

Reserves as of 12/31/2004: 64.3 bcfe

GMX Resources has been one of the truly great small capitalization oil and gas success stories over the last few years. The company, which is led by the very competent father and son management team of CEO Ken Kenworthy Jr. and CFO Ken Kenworthy Sr., was the epitome of consistent drilling results in 2004. The company had a 100% drilling success rate during its 2004 drilling campaign. It should be noted that the Kenworthy family's interests are very much aligned with those of outside shareholders given that management controls 32% of GMXR's outstanding shares. As the company continues to drill out its Cotton Valley prospects in the North Carthage Field of East Texas, the company's growth potential will become increasingly clear to the marketplace.

GMXR's main asset is its 21,000 gross (12,000 net) acres in the North Carthage Field that it is currently developing with joint-venture partner Penn-Virginia Corporation (NYSE:PVA). After spending much of 2001 and 2002 in a capital-draining dispute with a drilling contractor which the company eventually won, GMXR was in need of an industry partner to provide the capital to drill up its main asset. After consultations with a number of potential industry partners, the company decided to split its North Carthage acreage into three "Phases" or sections. Phase I and Phase II would be developed in conjunction with PVA. Phase III, which the company believes holds the field's most prospective acreage, would be developed solely by GMX Resources.

To say the company's plan has been a success would be an understatement. After drilling 15 gross (4 net) successful wells targeting the Cotton Valley Sand (CVS) on its North Carthage property in 2004, the company has a very active drilling program planned for 2005. With the addition of a second drilling rig in March 2005 that split its time between Phase I/II wells and 100% Phase III wells, the company plans to drill at least 23 gross (11.6 net) wells in 2005.

In addition to CVS wells having very low drilling risk, the economics of the formation are excellent. Each well takes between 14 and 18 days to drill and costs approximately \$1.6 million to drill and complete. Given the average well's modest drilling and completion costs and its average initial production rate of 2 million cubic feet per day (mmcf/d) and a gross recovery of 1 bcfe, payback can be achieved in a very short period of time. However the most exciting aspect of the firm's North Carthage property is the amount of potential drilling locations. Using the field's current spacing of one well per 80 to 160 acres, the North Carthage Field can support 205 gross (125 net) locations. While using 40 acres spacing, which is likely to be approved by the Texas Railroad Commission sometime in the next two years, the field can support 501 gross (297 net) locations.

Given the outstanding operational results of GMX Resources, its strong management team, its aggressive 2005 drilling program and its wealth of

prospects, I consider the company to be an outstanding investment candidate at this time.

Editor's Note:

Managed Account Service - For investors who are interested in receiving assistance in profiting from today's rising energy prices, I now offer a managed account service. For more information please give me a call at 773-271-7574. Thanks.

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Model Portfolio as of May 1, 2005

Prices Updated: April 29, 2005

Company Name	Date of Initial Price	Beginning Price US\$	Price US\$	% Change US\$	US Symbol	Comments
Arena Resources	2/15/2005	\$10.01	\$11.00	32%	ARD	Excellent portfolio of properties in N. Mexico and Texas and experienced management
ATP Oil and Gas	10/15/2004	13.14	\$20.47	56%	ATPG	Great properties in GOM and N. Sea, cheap valuation
Berry Petroleum	10/15/2005	\$37.35	\$46.72	25%	BRY	Cash cow heavy oil prop. in Calif and property in Utah
Bill Barrett Corp.	12/15/2004	\$31.85	\$26.64	-16%	BBG	Newly public Rockies producer run by a pioneer in Rockies E&P
Carrizo Oil and Gas	10/15/2004	\$9.80	\$16.53	69%	CRZO	Excellent exposure to the Barnett Shale
Denbury Resources	10/15/2004	\$25.43	\$31.74	25%	DNR	Focused on CO2-enhanced recovery on the Gulf Coast
Double Eagle Petroleum	10/15/2004	\$14.84	\$18.36	24%	DBLE	Developing prolific Atlantic Rim CBM play in WY
Encore Acquisition	10/15/2004	\$33.11	\$36.72	11%	EAC	Low cost producer with great growth
Energy Partners	10/15/2004	\$17.30	\$22.86	32%	EPL	Ramping production from GOM properties.
FX Energy	10/15/2004	\$8.55	\$10.60	24%	FXEN	High risk/high reward project in Poland
GMX Resources	10/15/2004	\$7.15	\$11.00	54%	GMXR	Rapidly growing production in Cotton Valley
Infinity Exploration	10/15/2004	\$5.06	\$8.65	71%	IFNY	Excellent diversity of high-impact exploration
Petrohawk Energy Co.	10/15/2004	\$9.19	\$8.67	-6%	HA WK	Early stage company with proven management
PetroQuest Energy	2/15/2005	\$6.07	\$6.15	1%	PQUE	Aggressive drilling in 2005 should boost shares
Plains Exploration	10/15/2004	\$25.67	\$32.18	25%	PXP	Investing alongside Hall of Famer Jim Flores
Petroleum Dev. Corp	10/15/2004	\$38.41	\$25.61	-33%	PETD	Properties in Antrim Shale in Michigan and Rockies
Questar Corporation	10/15/2004	\$45.90	\$58.40	27%	STR	Large operator on the Pinedale Anticline
Range Resources	10/15/2004	\$16.42	\$22.65	38%	RRC	Excellent exposure to Trenton Black River in NY State
Southwestern Energy	10/15/2004	\$43.30	\$58.75	36%	SWN	Excellent property in Arkoma Basin and East Texas
The Exploration Co.	10/15/2004	\$4.89	\$4.93	1%	TXCO	Production accelerating on Maverick play in Texas
Ultra Petroleum	10/15/2004	\$49.28	\$50.48	2%	UPL	Largest oper. on the Pinedale Anticline w/China exposure
Uranium Resources Inc.	11/15/2004	\$0.73	\$0.48	-34%	URIX	In-Situ uranium producer in Texas with outstanding potential for production increases
XTO Energy	10/15/2004	\$31.35	\$30.17	-4%	XTO	Excellent low cost exploiter of assets
Removed From Portfolio			Ending Price			Date Removed
Quest Resource Corp	10/15/2004	\$5.00	\$6.05	21%	QRCP	1/15/2005
CanArgo Energy Corp.	12/15/2004	\$1.22	\$1.79	47%	CNR	3/2/2005
Gasco Energy Inc.	10/15/2004	\$3.12	\$3.74	20%	GSX	3/2/2005