

BREITBURN ENERGY



Source: Google Inc.

About the Business

BreitBurn Energy Partners LP ("BreitBurn") is an independent oil and gas partnership that focuses on the acquisition, exploitation and development of oil and natural gas properties in the United States. BreitBurn's primary objective is to manage its oil and gas producing properties so that it can generate and distribute its excess cash flow.

What Drew Me to BreitBurn

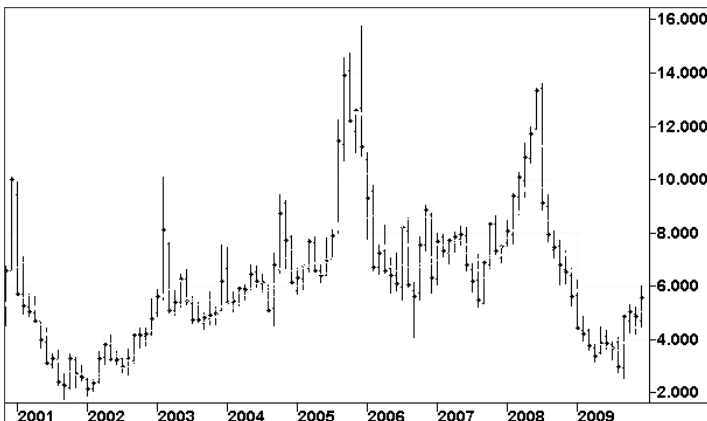
There are three things that immediately prompted me to investigate BreitBurn further:

1. Oil and gas prices had crashed, causing companies like BreitBurn a lot of headaches and losses,
2. Their properties are primarily inside the United States, which could be good if the dollar continues its fall, and
3. Their primary focus is to distribute their excess cash.

If oil and natural gas continued their freefall, it could spell disaster for a company like BreitBurn; however, if the commodity crash was merely a temporary correction (as I suspected and continue to believe), companies like BreitBurn could be sitting on an amazing array of assets (oil and gas properties) with higher cash flows on the horizon when their underlying commodities rebounded.

The Crash in Natural Gas

We all remember \$4.00 gasoline, but a crash in natural gas is not nearly as newsworthy or evident. Below is a monthly chart of natural gas prices so that you can see for yourself how hard the commodity crashed from its 2008 peak.



With natural gas at \$3 or \$4, most natural gas producers can't

possibly make any money. Though the commodity crashes, their costs for extracting, refining, etc. do not crash along with it.

More Panic Surrounding BreitBurn

In addition to a crashed commodity, BreitBurn eliminated its dividend and began reporting shrinking earnings which later turned into quarterly losses. For the three months ended June 30, 2009, the company reported *negative* revenues.

Mr. Market hated BreitBurn.

The Value in BreitBurn

Net Asset Value: When I began looking into the company, it was trading at a market cap of just \$500 million or so. At that price, the company could be broken up and the oil and gas reserves sold for more than the market value of the company; so, it looked cheap.

Furthermore, oil and gas prices were still depressed. Any rebound from \$3 natural gas or \$65 oil would only serve to make BreitBurn's properties (and hence, break-up value) even *more* valuable.

Future Cash Flows: BreitBurn was suffering severe accounting losses from the effects of the crashed commodities; however, those losses appeared to be temporary and multi-faceted:

1. the company was losing money operationally because of the depressed commodity prices, and
2. the company was booking massive accounting (*i.e.*, non-cash) losses due to futures and derivative positions.

I liked the latter. As these companies routinely do, BreitBurn hedged its natural gas and oil properties with futures contracts and price swaps. As the commodities prices moved, these contracts gained and lost value – gains and losses that were then booked to BreitBurn's earnings.

Things are now working in BreitBurn's favor, though I don't know if or when this will be reflected in the stock price. Those collars and price swaps have reversed their course, the commodities have rebounded further, and the company has reduced its debt by 17% over the last two quarters. Should things continue to revert back to "normal," BreitBurn should experience tremendous growth in its cash flows.

Intrinsic Value

BreitBurn appeared to be cheap whether looking at the



assets, future cash flows, or both. Because the company invested so much in capital expenditures in 2007 and 2008, it is in the enviable position of being able to maintain (or reduce, as needed) production levels *and* reduce debt without the need to sacrifice one or the other due to heavy capital spending requirements.

(Compare that to General Motors' difficult position of needing to outlay tons of cash on plants and equipment – capital spending – *and* pay down debt while juggling various production levels. Eventually, something had to give, and the company went into bankruptcy, wiping out shareholders in the process.)

Asset Value: After consummating its recent sale of the Lazy JL Field in West Texas, BreitBurn estimates that its remaining properties have about 102MMBoe of “proved reserves,” of which about 75% are natural gas and 25% of which are crude oil. 102MMBoe is the equivalent (in volume) as 102 million barrels of oil; so, BreitBurn estimates that it has about 25.5 million barrels of crude oil and about 443 million BTUs of natural gas. Based on various assumptions for oil and natural gas prices, and discounting certain other assets (to as little as zero), I estimate that the net liquidation value for BreitBurn at least twice its 12/31/2009 market price, and even more if the prices of oil and natural gas hold steady or rise over time.

Proved Reserves: The estimated quantities of crude oil, natural gas and natural gas liquids that geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions.

This definition of proved reserves is abbreviated from the applicable definitions contained in Rule 4-10(a)(2-4) of Regulation S-X.

If this proves to be the case, we may enjoy significant safety in the company's assets, should it be liquidated. (Note: I don't see any reason for the company to be liquidated.)

Ongoing Business: If today's commodities prices (~\$80 oil and ~\$5.50 natural gas) are more “normal” than the \$35 and \$3 panic prices we saw over the past year (respectively), then I would expect BreitBurn's operations to generate about \$130 million per year in excess cash flows, plus or minus the effect of cash gains or losses on their hedging and interest rate activities.

If this is the case, then BreitBurn's 12/31/2009 price is just three to five times future cash flows. That is...it's cheap.

What Can Upset the Apple Cart

Though BreitBurn (like other energy companies) tries to hedge against wild volatility in commodities prices, a prolonged crash in commodities could prove difficult for most energy companies, and BreitBurn is no exception. If I had reason to believe that oil would remain below \$50 or \$60 per barrel for a number of years and/or natural gas would remain below \$4 or \$5 for a number of years, I would likely avoid

BreitBurn as both my asset and future cash flow estimates would be way off base.

Commodities prices would fall for one of two main reasons:

- Demand dries up due to the rapid and massive introduction of alternative energies,
- Demand dries up due to another severe contraction in the economy, and/or
- The dollar strengthens dramatically.

I'm not terribly concerned about any of these. Natural gas is an alternative energy to oil, and both this and other alternatives are many years (or decades) away from replacing oil. The economy is still in turmoil; and, though we may see another downturn over the next year or two (not a prediction, but a consideration), I don't think that any such downturn would dramatically reduce oil and gas usage beyond their already Great Recession-reduced demand levels.

I don't see a dramatic advance in the dollar. Current fiscal policies and agendas, as well as massive government debt, printing and spending, virtually ensure a lower dollar many years in the future. Any reversal of spending, printing, or debt assumption is likely to be slow and done over time; so, a massive and quick strengthening of the dollar is not likely from a fundamental standpoint (though it can do anything from a trading/short-term standpoint).

BreitBurn has done a great job of reducing its long-term debt. Six months ago, the level of debt it carried compared to the provisions in its debt covenants was very high, thus causing the company to suspend its dividend payment/distributions. The banks have recently reaffirmed the company's \$732 million borrowing base; so, its \$585 million of debt (as of 9/30/2009) is well below that level. Should the banks modify BreitBurn's credit lines below \$585 million (or the 12/31/2009 debt level, which is not yet known but likely to be lower), BreitBurn could face covenant violations, penalties, and higher interest rates – the fate of *any* company that overdraws on its credit limits or experiences a reduction in credit limits below current debt levels.

A Value Catalyst?

If BreitBurn continues to pay down its debt (from \$736 million at its 12/2008 peak to \$585 million on 9/2009) and oil and natural gas prices remain firm or continue to rise, the company is likely to begin distributing its excess cash in the next three to six months. Any one of these situations could be a catalyst to unlock BreitBurn's value, and the combination of two or three of these events only increases that possibility.

I don't necessarily look for catalysts as I have found that, more times than not, “catalysts” do not play out well. Instead, my focus is on value, and I let time and the ordinary course of business and economics work for us. Still, BreitBurn may have a catalyst in any of the above, and that will help me decide whether or not to sell should the price advance or the dividend be reinstated.