

# Source Capital Group, Inc.

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**PETROL OIL and GAS, Inc. (OTCBB:POIG - \$1.90)**  
**Update –POIG transitions from Development to Operating Company- BUY**  
**12-Month Price Target = 6.00**

**For Research Disclosures – See Page 7**

## UPDATE:

Petrol Oil and Gas, Inc. (“Petrol” or the “Company”) has, in recent months, dramatically made the transition from a development company to an operating Company. Petrol is involved in the exploration, development and production of coal bed methane (“CBM”). The Company has purchased leasehold rights to approximately 10,000 acres and 71 production wells in Wilson and Neosho Counties in Southeast Kansas and previously purchased mineral lease rights on approximately 165,000 acres in Eastern Kansas and Western Missouri.

Key events that demonstrate the transition include:

Statistical Data	
Shares outstanding	24.4 million
Float	4.1 million
Market Capitalization	\$46.4 million
Avg. Daily Volume (10 days)	55,000
52-Week Range	\$1.00 - \$4.00
Acres under Lease (Approx)	175,000
2005 EPS Est. No income tax	\$0.08
2006 EPS Est. Fully taxed	\$0.14
P/E 2005 Est.	23.7x
P/E 2006 Est.	13.5x

**www.petroilandgas.com**

## HIGHLIGHTS - COMPANY

- Acquired a gas producing property in the Thayer gas field, which is located in the Cherokee Basin, with over 3 million cubic feet per day of gas production and estimated annual revenue in excess of \$9.0 million.
- Completed a \$6.6 million equity financing that will enable aggressive drilling and completion of wells in the Bourbon Arch leases held by Petrol.
- One of the CBM test wells drilled earlier in Woodson County, Kansas has been completed as an oil well and is now under production.
- Six wells that were pilot/exploration wells in Coffey County have been completed and are currently in the process of being dewatered. These wells should be under production in the first quarter of 2005.
- The Company has executed a multi-year sales agreement for CBM production with a marketing company.
- Petrol has acquired a 640 acre producing oil field that is close to its CBM fields. The field currently produces approximately 10,000 barrels per year. Management believes that current wells can be reworked to increase production and there is space to drill additional wells on the property.
- Petrol has recruited an experienced financial executive, John C. Garrison, as its Chief Financial Officer. Mr. Garrison was a Director and consultant to Quest Resource, a developer of CBM in the Cherokee Basin.

## HIGHLIGHTS – INDUSTRY - AREA

- **The Kansas Geological Society has updated its reserve outlook for the Bourbon Arch, the predominant area of leasehold rights for Petrol, and published estimates of 2.0 trillion scf of Original Gas in Place.**
- Oil prices surged to over \$50.00 per barrel since our April report and have now retraced some of that advance. Still, there remains a sense of urgency in the development of domestic oil and gas production.
- Natural gas prices have continued to hold close to the prices used in our April report. The Department of Energy reports average wellhead prices for August of 2004 at \$5.36 Mscf.
- Political stability in the world’s major oil nations continues to degrade. Besides the war in Iraq, tensions are accelerating between Iran and the world community about nuclear fuel processing. Iran supplies approximately 2.0 million barrels per day into world oil markets. If sanctions are imposed, or if military operations are instituted against Iran the world could be in a free for all for oil supplies.



The increase in natural gas prices has spurred several companies to begin exploring in the Bourbon Arch and into the Forest City Basin. Quest Resource and Burlington Resources are actively leasing and drilling test wells in the area. Heartland Oil & Gas has just purchased the lease holdings of Evergreen Resource in the Forest City Basin, leaving Heartland with over 1.0 million acres under lease. There are attempts at consolidating leasehold rights in the area so that companies can obtain efficiencies in drilling, production operations and gathering of gas produced.

Coffey County has previously been an active area for oil and gas development, providing excellent geological data on coal seams and depths. In previous exploration attempts the search was for oil, and small wells were found and developed. As the price of oil declined, the smaller reservoir searches were discontinued and Eastern Kansas was idle until the recent boom in coal bed methane. The Cherokee Basin, to the South, has been the concentration of activity because of larger coal seams and more mature coal. These characteristics produce more methane per acre of lease and are economic at lower prices of gas. Now, with higher gas prices, the Bourbon Arch area has become attractive and very economic. The terrain is flat and easily accessible resulting in lower drilling costs. Combine low cost drilling with ready access to major gas transmission lines and the economics of Coffey County become compelling.

*The properties under lease in Coffey County, Kansas and Western Missouri have spacing to drill and develop a potential 1,700 wells.* This total compares to a total of 170 wells possible in the Petrol-Neodesa property. Thus, our emphasis on the potential for the Bourbon Arch play.

### **PETROL TEST WELL RESULTS:**

Petrol's test wells in the Coffey County area have confirmed the more optimistic outlook expressed by the Kansas Geological Society. The test wells drilled earlier in the year are being converted to production wells. These wells have been perforated in some of the coal intervals that contain gas and were subsequently fractured using conventional hydraulic techniques in order to stimulate production. These wells are in the process of being de-watered and should be in production by the first part of 2005. Gathering lines are being laid and major gas transmission lines are within a short distance. Additional wells will be drilled in the fourth quarter of 2004 for probable production in the second quarter of 2005.

### **THE BUSINESS DRIVER – NATURAL GAS PRICES**

The factor driving cycles in domestic energy exploration and drilling has been prices for gas and oil. After the OPEC embargo in 1973 there was a sustained period of oil and gas exploration and drilling in the United States. Crude oil prices spiked to above \$40.00 per barrel during that period. When the political situation in the Middle East stabilized in the mid 1980's, and Russia entered world markets as a major oil producer, oil and gas prices drifted down, with crude oil dropping to as low as \$11.00 per barrel in the recession of 1998. The average price for natural gas at the wellhead for all of 1998 was \$1.98/mcf.

The next big spike in gas prices came in late 2000, with the electricity crisis in California. Concurrent with the increased demand in California, there was a gas line explosion in New Mexico that interrupted delivery of gas to California from Texas and Louisiana. In late 2000, spot prices for natural gas rose to over \$10.00/mcf. Prices again drifted lower in 2001 and 2002, reaching a low point of \$2.19/mcf in February of 2003. For all of 2002, wellhead prices averaged \$2.95/mcf.

A recent surge in building electrical generation facilities using natural gas has expanded the demand for this clean burning fuel, but there has been a limited increased supply. Now it appears that the U.S. is in another long term cycle of higher energy prices and increased exploration, drilling and domestic production. Average wellhead prices for gas for 2003 was an estimated \$4.97/mcf, an increase of 68% above the 2002 price. In January of 2004, wellhead prices were \$5.53/mcf. Analysts at the Energy Information Agency (EIA) have raised forecasts of prices for 2005. Although there may be some seasonal fluctuations, the expectations are that natural gas prices will remain at these high levels for the foreseeable future.

## PETROL PLAN OF OPERATION

With the completion of its equity raise in September, Petrol has initiated an aggressive drilling program in its Coffey County and Western Missouri properties. Additionally, the Company can continue to develop the Petrol-Neodesa property. With a diversity of opportunities, the Company can concentrate on the property with the largest payoff and ability to generate cash for additional drilling.

Our model has spread the drilling program over the four properties. However, should the focus be on completing out one property because of infrastructure or gas production advantages, the financial result should be the same or better than we currently estimate. The fluctuation in the number of wells is primarily because of weather and seasonal impacts for drilling.

### Petrol – Estimate of wells drilled per quarter

<u>Leasehold</u>	<u>4Q04</u>	<u>1Q05</u>	<u>2Q05</u>	<u>3Q05</u>	<u>4Q05</u>
Neodesa – Cherokee Basin	5	10	10	5	7
South East Coffey County	4	4	6	3	5
North East Coffey County	4	4	6	3	5
Western Missouri	<u>4</u>	<u>4</u>	<u>6</u>	<u>3</u>	<u>5</u>
Total wells per quarter	17	22	28	14	22

## FINANCIAL PROJECTIONS

When we initiated coverage on Petrol in April, our financial projections were predicated on obtaining equity financing at then estimated prices for common stock. Petrol has completed its first equity offering, with gross proceeds of \$6.6 million. As of September 30, 2004, the Company had \$6.1 million in cash with which to initiate drilling or to buy additional properties. A portion of that cash was used to purchase the Petrol-Neodesa property. The remainder of the \$10.0 million acquisition price of Neodesa was secured through a placement of convertible term notes in the amount of \$8.0 million, closed in early November. As of the date of this report, Petrol should have between \$2.5-\$3.0 million with which to drill in the Bourbon Arch. Cash flow from the Neodesa production will assist in the drilling program outlined above. The Company may have to secure a moderate amount of additional financing in 2005 and 2006 to accomplish the above program.

The following estimates are predicated upon the above drilling program, with full production coming on in the quarter after funds are spent. Each well is estimated to produce between 42 and 50 mscf per day, and has pricing in effect as of today. The Company has estimated that approximately 65% of its production will be hedged, with 35% available for market pricing.

## FUNDING FOR ACCELERATED DRILLING

Our current model can be accomplished without the substantial addition of new funds. Some borrowing may be necessary to bridge tight spots, but over the three years, the cash flow from operations and small borrowings should be able to accomplish these results. However, the potentials for expanded drilling in the Bourbon Arch could cause Company management to seek additional funding. There are currently options and warrants outstanding that could provide most of this additional funding. Our calculation is that existing options and warrants, if exercised, could provide an additional \$41.0 million, an amount sufficient to be as aggressive as necessary.

<b>Petrol Oil and Gas -</b>	(OTCBB:POIG)		Amounts in Thousands - except EPS								262 Year 2006	371 Year 2007
	88	110	138	152	152 Year 2005	174	207	240	262			
Fiscal Year, Dec 31,	1Q05	2Q05	3Q05	4Q05		1Q06	2Q06	3Q06	4Q06			
Total wells producing												
Net Revenue Gas & Oil	\$ 1,728	\$ 2,270	\$ 2,927	\$ 3,225	\$ 10,150	\$ 3,704	\$ 4,399	\$ 5,095	\$ 5,574	\$ 18,772	\$ 27,806	
Cost of Production	554	709	916	1,006	3,185	1,152	1,361	1,571	1,717	5,801	8,510	
Depletion	259	340	439	483	1,521	556	660	764	836	2,816	4,171	
Depreciation	184	229	287	317	1,017	362	431	500	546	1,839	2,731	
Total Cost of Production	997	1,278	1,642	1,806	5,723	2,070	2,452	2,835	3,099	10,456	15,412	
Gross Profit	731	992	1,285	1,419	4,427	1,634	1,947	2,260	2,475	8,316	12,394	
General & Administration	375	385	390	400	1,550	425	450	475	490	1,840	2,175	
Operating Profit	\$ 356	\$ 607	\$ 895	\$ 1,019	\$ 2,877	\$ 1,209	\$ 1,497	\$ 1,785	\$ 1,985	\$ 6,476	\$ 10,219	
Interest Expense - Net	170	165	160	150	645	130	120	115	105	470	230	
Minority Interest - Charge	28	36	48	51	163	55	59	63	67	244	284	
Income before Income Tax	\$ 158	\$ 406	\$ 687	\$ 818	\$ 2,069	\$ 1,024	\$ 1,318	\$ 1,607	\$ 1,813	\$ 5,762	\$ 9,705	
Income Taxes	-	-	-	-	-	399	514	627	707	2,247	3,785	
Net Income after Tax	\$ 158	\$ 406	\$ 687	\$ 818	\$ 2,069	\$ 625	\$ 804	\$ 980	\$ 1,106	\$ 3,515	\$ 5,920	
Earnings per Share Basic	0.01	0.02	0.03	0.03	0.08	0.03	0.03	0.04	0.05	0.14	0.24	
Shares O/S - Basic	24,404	24,404	24,404	24,404	24,404	24,404	24,404	24,404	24,404	24,404	24,404	
EBIDTA	\$ 799	\$ 1,176	\$ 1,621	\$ 1,819	\$ 5,415	\$ 2,127	\$ 2,588	\$ 3,049	\$ 3,367	\$ 11,131	\$ 17,121	
EBIDTA/share - Basic	0.03	0.05	0.07	0.07	0.22	0.09	0.11	0.12	0.14	0.46	0.70	
Cash Flow	\$ 601	\$ 975	\$ 1,413	\$ 1,618	\$ 4,607	\$ 1,543	\$ 1,895	\$ 2,244	\$ 2,488	\$ 8,170	\$ 12,822	
Capital Expenditures	2,200	2,800	1,400	2,200	8,600	3,300	3,300	2,200	2,200	11,000	8,900	

## VALUATION

**Reserve Valuation:** Petrol's production is too new to value on an operational basis. The true value lies in reserves contained in the leasehold rights. We are using the valuation basis established in our original report, modified to decrease the amount of recoverable original gas in place, but decreasing the discount rate in uncertainty from 85% to 60% due to results provided by Petrol's test wells and the 2004 report by the Kansas Geological Society which increases the probable gas content of low depth coals.

**Valuation of Gas in Place:** Based on geological studies of coal seam thickness in the Coffey County, Kansas area, we have used a cumulative depth of 10 feet of coal for seams down to 2,000 feet. (Geological data for Franklin and Anderson Counties, immediately east of Coffey County, suggest that there is the prospect of occasionally finding fairly large pockets of conventional gas.) With desorption rates of 175 scf/ton of coal, the leases held by Petrol have an estimated 400 bbscf of original gas in place. Since some thin seams may not be recoverable, we have used a recovery rate of 80%.

In December of 2003, Quest Resources purchased the operations of Devon Energy in the Cherokee Basin and proven reserves were allocated a price of \$0.89/mcf. Evergreen Resources sold its Forest City Basin leaseholds with a proven reserve value of approximately \$0.90 per mscf. To value unproven reserves, one must take into account the current price of gas, the cost of drilling, producing, gathering and transporting that gas, and then discount the result based on the probability of finding gas and its production economics. We know the prospects of finding gas in the Petrol leases are high and the drilling and collection costs are reasonably low. Using the estimate of original gas in place of 400 bbscf, a recovery rate of 80%, a proven gas reserve value of \$1.00/mcf and discounting the results by 60%, our calculation suggests a current value of Petrol shares of approximately \$5.35 per share. Any drilling in the area that better defines the reserves will bring the discount factor up. Our estimates of over 200 wells drilled would accomplish that reduction in uncertainty. The valuation of gas in place and a probable increase in the definition of reserves supports our 12-month price expectation of \$6.00 per share.

## INVESTMENT RISKS

**Gas Prices:** Prices for natural gas may not remain as high as currently being experienced. Should prices go into a cyclical decline, the wells to be drilled may not be as economic as indicated in our estimates.

**Area for Development:** Coal bed methane has been developed in areas that are south of the leases owned by the Company. There has not been large scale methane gas production in Coffey County in the past because of thinner coal seams and less mature coals. The current price of natural gas makes prospective development in this area economic. The Company may not be able to discover and develop commercial quantities of coal bed methane in the area that it is exploring.

**Management:** As a development Company, Petrol has secured most of its services from outside contractors. As the Company enters its operational phase, it may not be able to secure the services of competent management personnel to achieve the operational levels outlined in our estimates.

**Funding:** Although the Company has funds that appear to be sufficient to complete the drilling program in our estimates, cost overruns and delays could affect the results that are reflected in our model. The Company may not be able to raise the funds necessary to complete the production drilling and completions operations as envisioned in our estimates.

## RESEARCH DISCLOSURES FOR PETROL OIL & GAS, Inc (POIG)

**Prior Recommendations:** Source Capital Group, Inc. ("Source Capital") initiated coverage on Petrol Oil and Gas in April of 2004. At that time the price of the stock was \$3.10 and the twelve-month target price was \$6.00 per share.

The Analyst certifies that the views expressed in this report are his own, without undue influence by Source Capital, the subject Company or the future prospects of business between Source Capital and the Company.

The analyst owns stock in the subject Company. Source Capital acted as placement Agent for a portion of the Company's self directed initial public offering. The Analyst has not received any compensation, either directly or indirectly, from investment banking services provided to the Company by Source Capital and does not expect to receive any compensation from such services in the next three months. The Analyst has received direct compensation from the Company for the preparation of this report which is detailed below. To the degree that the analyst receives direct or indirect compensation, it may affect the views expressed in this report.

Source Capital and its brokers and investment advisors offer individual account management and 401(k) advisory services for which they solicit the Company, its management and its board of directors as clients. The Analyst may receive compensation in the form of commissions or investment advisor fees from his role as broker or investment advisor to the Company, its management or members of its board of directors. The amount and timing of any indirect compensation received by the Analyst in the form of commissions and/or investment advisory fees cannot be determined at this time.

The Analyst manages a fund for private investors that currently own shares of the subject-Company.

Source Capital is not a Market Maker in shares for the subject Company. Source Capital will solicit the subject Company for investment-banking services and may receive compensation for such services over the next 12-months.

### Meanings of Ratings:

The ratings used by Source Capital in its Research Reports have the following meaning:

**BUY:** The Analyst expects the stock price of the subject company to exceed the performance of the major market indices (Standard & Poor's 500 or Dow Jones Industrials) by 20% or more over the coming 12-18 months.

**NEUTRAL:** The Analyst expects the stock price of the subject company to perform at or near (plus 5% to minus 5%) of the major market averages over the coming 12-18 months.

**SELL:** The Analyst expects the stock of the subject company to decline or perform worse than the major market averages by 10% or more over the coming 12-18 months.

<b>Rating Distribution:</b>	<u>BUY</u>	<u>NEUTRAL</u>	<u>SELL</u>
Percentage of covered companies assigned this rating	75%	25%	
Percentage of covered companies for which Source Capital has Provided investment banking services during the past 12 months.	33%	(Two of six companies.)	

The Analyst has received direct compensation from the Company for the preparation of the report. Compensation was received before the report was written and the Agreement between the Company and the Analyst calls for the Analyst to maintain full discretion to report his own opinion about the investment prospects of the Company and its desirability for both individual and institutional investors. Compensation consisted of \$6,000.00 cash received before the report was prepared; 10,000 shares of restricted stock to be issued and options for 25,000 shares at \$2.50 per share and options for an additional 25,000 shares at \$4.00 per share.