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Natural Gas

Blowing Out the Blue Flame?
Obama Budget Proposal VERY Negative for Natural Gas

- The Obama Administration's 2010 budget proposal, unveiled last Thursday, not surprisingly seeks to tap many sources; after all, the federal government has been spending money like Wall Street used to since late last year and has to raise some revenue. With ExxonMobil and Chevron reporting 2008 profits that exceeded the gross domestic product of many nations, public sentiment at the moment probably resembles that of a plundering mob, so we're not surprised that the oil and gas industry is being targeted to foot some of the bill.
- At the same time, the Administration emphasizes renewable energy, conservation, and new technologies. We support these, but would emphasize we're not there yet--the vast majority of our energy is still sourced from fossil fuels--and an overnight transition is physically, logistically, and economically impossible, in our view.
- Specifically, the Obama budget proposes to levy a new 13% excise tax on Gulf of Mexico production, impose a "drill or lose" rule as well as a per acre fee on non-producing offshore leases, and eliminate tax deductions for percentage depletion and intangible drilling costs. **That last one could do some seious damage and actually undermine both energy independence and the renewable transition.**
- **Why?** Over the past 5 years, natural gas producers have applied a combination of advanced well drilling and completion technologies to reverse what had been accepted as an inexorable decline in U.S. productive capacity, allowing natural gas to emerge as an abundant, affordable, and clean domestic alternative to the heavy hydrocarbons--oil and coal. The massive R&D effort that made that possibly remains underway and is facilitated by the ability to deduct the huge up-front costs.
- **Natural gas is bridging the transition to renewables** and the more intelligent and efficient use of energy while making an immediate positive contribution to cutting emissions of everything from sulphur to carbon. But the industry is now reeling from falling prices and rising capital costs. We believe losing the IDC deduction could kill the nascent re-emergence of natural gas at a time that the country needs it most, costing American jobs, energy security, and state and federal tax revenues as well.
- **Most natural gas in the U.S. is developed and produced by independent** E&P companies, not the super-major oils. A body blow to the smaller guys would have some serious unintended consequences, including forced reliance on the major and foreign oil companies for imported liquefied natural gas (LNG), a shift in power generation economics to favor coal, and sharp increases in utility bills--three outcomes that we seriously doubt the Administration wants to see..
- **Keep an eye on this**. While the political motivation--go after them that's got it--is clear, this broad-brush approach could spell disaster for the domestic natural gas sector. Despite the current economic challenges, we've remained positive on gas given its unique ability to solve a myriad of energy, economic, and environmental challenges That thesis will be completely undermined if Washington goes hunting with a bazooka. **Gas sector investors should watch this process very closely.**

Utilities

Samuel Brothwell, Senior Analyst
(212) 214-5044 / samuel.brothwell@wachovia.com
Jonathan Lefebvre, Associate Analyst
(212) 214-8026 / jonathan.lefebvre@wachovia.com

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The Unintended Consequences of Law

Over the past five or so years, the outlook for natural gas has turned decidedly positive—as has our overall investment thesis. Rising concerns about environmental issues, national energy security, and higher and more volatile oil prices have all made a strong case for natural gas, which was only held back by concerns over long-term supply viability—five years ago, conventional wisdom held that the United States was bound to start importing gas in the twenty first century just as it had been forced to import oil in the twentieth.

But the inevitability of turning to LNG has been turned on its head over the past five years, thanks to a combination of higher prices, cheap capital, and the application of advanced technology that was developed off shore and brought to bear on terra firma to coax what had been unthinkable quantities of natural gas out of intractable geologic formations such as shales. Indeed, the achievements of the natural gas industry over the past five years are a robust example of a successful research and development effort and the application of advanced technology to a very productive outcome with clear economic, environmental, and societal benefits.

The costs associated with that effort are significant, with a typical gas well today running a couple of million dollars to drill and complete—a big up-front investment that typically pays back over a time horizon that can span a decade or more. A key part of the overall cost recovery scheme is the ability to offset some of those up-front costs as deductible expenses against income taxes as the well starts to produce and pay. The loss of the ability to deduct those costs would significantly lengthen the payback period and undermine returns on invested capital. Drilling activity has already slowed significantly due to lower commodity prices and higher capital costs—the market does work, but it doesn't work perfectly—but we fear that the imposition of another negative cash flow step change could potentially deal a knockout blow for some producers at a crucial time.

The U.S. Needs More Natural Gas, Not Less

This is significant, because the ability to sustain natural gas production depends on continued drilling to replace declining legacy production. This is especially true with the emerging unconventional gas resources such as shale plays, which tend toward hyperbolic rates of decline—they flow gas at prodigious rates initially and then quickly taper off to a much lower sustained level. In our view, a significant change in tax policy such as eliminating the IDC deduction—on top of sharply lower natural gas prices and higher capital costs--could significantly accelerate the decline in drilling activity currently being experienced. The ensuing and inevitable shift back to declining production would have many unintended consequences, not least being a a return to the inevitability of LNG reliance that has been mitigated over the past five years as gas has re-emerged as a decidedly domestic fuel. Given that the largest holders of gas reserves outside the U.S. include Russia and Iran, we doubt this is a scenario that U.S. energy policy should want to embrace.

It can and does get scarier. One of the world's largest producers of the darker and most political of fuels—Venezuela—is actually encouraging U.S. dependence on imports through an insidious ad campaign targeted at those less fortunate. The "Joe for oil" ads used to fly solely under the Citgo banner but now unabashedly posit "Veneuela's People" as a U.S. energy ally. In our view, the absurdity of this notion is clear, but so is its counter-argument: U.S. energy policy should encourage the development of domestic, secured, sustainable and clean energy resources. Natural gas fits that description.

Making Progress on Carbon

At current prices, we have previously noted that natural gas has become highly competitive with coal on a Btu parity basis, and is therefore increasingly advantaged as a power generation fuel, even before the cost of environmental remediation is taken into account. Another of the Administration's ambitious energy goals—the reduction of carbon emissions—is already making progress as utilities shift away from older, less efficient coal fired boilers to—yes, renewables--but also to advanced natural gas generation technology. That positive trend will likely be quickly undermined if growth of domestic gas production is arrested by tax policy.

We would add that gas has the ability to facilitate significant efficiency gains all along the value chain through its increased use in distributed cogeneration (the conversion of gas into both power and heat at the point of use) which has the further advantage of taking strain off the electrical transmission and distribution

grid. In the current energy debate, we hear the notion of distributed generation tossed around quite a bit. Natural gas is key to making that happen, especially given the variable nature of renewables such as wind and solar. We have also noted that natural gas is a clean alternative to gasoline and diesel fuel in transportation. Our views on these topics are spelled out in greater detail in our "Blue Flame" research notes published in February and September 2008.

Keep a Close Eye on This

Because we view natural gas as an integral solution to future energy challenges, we have maintained a decidedly positive long term thesis on natural gas and associated infrastructure, even as commodity prices have fallen in the current cycle,. However, the tax proposals contained in the Administration's current budget have the potential to seriously undermine that thesis as we doubt the industry could sustain such a major cash flow hit on top of the others it has already taken without losing both players and momentum that would be very difficult to replace. Importantly, the Administration's proposal is just that—a proposal. But for investors all along the natural gas value chain—not to mention consumers--it could have serious adverse consequences and therefore bears careful monitoring.

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