Oil Spill in the Gulf of Mexico / June 2010

GLOBAL FUNDAMENTALS FOR ENERGY SUPPLY AND DEMAND HAVE NOT CHANGED

Implications for U.S. Energy Sector

Conning expects the primary impact from the Deepwater Horizon rig explosion, the Macondo well rupture and subsequent oil spill, currently the worst such incident U.S. history and still growing, will be heightened safety standards and stricter regulatory approval requirements for deepwater (500+ feet) exploration and production projects in the U.S. Gulf of Mexico (GOM). These actions will increase the cost of deepwater drilling in the GOM and other U.S. coastal regions (to the extent allowed), but will not end the activity.

The U.S. Department of Interior (DOI) has imposed a six-month moratorium on new drilling and exploration activities in the GOM. The moratorium will allow the DOI time to implement new safety requirements for deepwater offshore drilling and President Obama's independent commission to complete its investigation of the Deepwater Horizon incident. The DOI stated that with the oil spill still growing and investigations and reviews still underway, a six-month pause in new drilling was both appropriate and prudent.

The DOI moratorium does not affect wells in production, and will not have a material impact on global crude oil prices or production levels in the GOM over the next six months. Daily GOM deepwater oil production averages 1.35 million barrels at present, 1.65% of global demand. Current estimates suggest the moratorium will reduce volumes over the next six months by 5-10% (75,000 to 150,000 barrels), an inconsequential amount relative to global demand. But the figure will rise if the moratorium is extended, as existing wells deplete and are not replaced. The implication would be increased imports of foreign oil and further worsening of the U.S. trade deficit. The U.S. need for domestic energy sources will ultimately outweigh the horror of this environmental disaster, although the phrase "drill, baby, drill" has apparently disappeared from political speech for the foreseeable future.

The prospect of more stringent safety standards and regulations for offshore drilling in the GOM prompted several negative credit rating actions against smaller oil and gas companies doing business in the region. The negative actions centered on concerns that there could be extensive delays for new projects due to new safety standards once the moratorium is lifted, impacting the cash flows of smaller energy companies. Additionally, existing deepwater drilling rig contracts could also become subject to force majeure provisions, which will be a negative for pricing initiatives and cash flows. Industry consolidation is possible, but will mostly be among shallow water players. Deepwater has always been the sole domain of major energy companies due to its high cost barriers to entry (a single well can cost upwards of $57 million). Over the 2003-2007 period, 520 deepwater sub sea wells were drilled and completed, requiring total capital expenditures of $29.8 billion.

The Players

The Macondo well was primarily owned (65%) and operated by BP, PLC “BP” who contracted with Transocean, Inc. “RIG” for its semi-submersible rig Deepwater Horizon to drill the location. Passive investment partners in the Macondo well were Anadarko Petroleum Corporation “APC” (25%) and Mitsui & Company “Mitsui” (10%). Oilfield services included cementing solution to provide a casing for the well hole from Halliburton Company “HAL” and a well blow-out preventor provided by Cameron International “CAM”. A player summary follows.

Symbol	Player	Role
BP	BP, PLC	65% owner operator of Macondo well
APC	Anadarko Petroleum Corporation	25% owner non-operator
Mitsui	Mitsui & Co.	10% owner non-operator
RIG	Transocean, Inc.	Deepwater Horizon - rig owner
HAL	Halliburton Company	Cement provider
CAM	Cameron International	Blow-out preventor

Responsibility

BP has been deemed the responsible party by the U.S. government in accordance with the Oil Pollution Act of 1990 (OPA). BP has also publicly assumed full responsibility for the clean up efforts and stated that they will pay all legitimate third-party claims. We believe the company will eventually make cash calls on their partners in the Macondo well (APC and Mitsui) in the near term. However, Conning believes BP may also pursue RIG as additional details become available once the company has successfully plugged the well and examined the blowout preventor. Indications are there was some miscommunication between employees of BP and RIG regarding the drilling operations at the Macondo well before the explosion.

Currently, HAL and CAM appear to be excluded from assuming any liability related to the oil spill given the indemnification language in the services contracts signed with BP. The spirit of the indemnification language in the contracts reflects the fact that BP would have reaped the upside of the Macondo well and, as a result, assumes most of the risk. CAM’s responsibility was limited to providing spare parts after installing the blowout preventor, which was only designed to shear the drill pipe. In addition, HAL did the cement job to provide a casing for the Macondo well and BP signed off on its integrity.

Oil Spill Cost Update

Updates on the oil spill have revised the rate of oil flowing out of the well consistently upwards, and latest estimates are up to 10 times the initial figures. It will probably take a year or more to clean up the oil once the well is capped and will cost $15-23 billion. This includes expenses related to skimming oil, laying boom, employing vessels, and hiring personnel. Third-party liability cost estimates vary and remain uncertain. However, the latest estimate is $14 billion, which takes into account economic damages related to tourism and the fishing industry in the gulf region. This equates to a total cost of clean-up and third-party liability claims at the high end of $37 billion. So far, BP has spent nearly $1 billion (including claims and grants to affected states), with another $500 million pledged for research into the impact of the spill. BP has vowed it will remain in the region with its CEO, Tony Hayward, stating that the company will clean up every last drop of oil.

Risks to current cost estimates do exist. The most obvious are if the estimated spill rate is confirmed on the high end of the range and if the relief wells being drilled currently (now the most likely approach to successfully plugging the well) are delayed. Scheduled completion is early August. Hurricanes could delay and disrupt operations, and also could spread the spilt oil over a wider geographic area, resulting in greater clean-up costs.

Ability to Pay

BP's CFO, Byron Gote, noted during a conference call on June 4, 2010, that the company was generating cash from operations, has a low leverage ratio (19% at Q1'10), and has access to $5 billion in cash, $5 billion of standby facilities and another $5 billion of undrawn debt facilities. The company also affirmed its intention to remain an AA rated company. The CEO also reiterated that the company will not draw upon the Oil Spill Liability Trust Fund, established in 1986 with tax dollars from the petroleum industry to respond to oil spills.

BP, PLC

Projections *$ in millions*		**2010E**	**2011E**	**2012E**	**2013E**	**2014E**	**2015E**	**5 Year Total (*)**
Operating Cash Flow (1)		**$ 34,123**	**$ 35,243**	**$ 36,637**	**$ 39,375**	**$ 39,287**	**$ 39,781**	**$ 224,446**
Exploration		$ (540)	$ (900)	$ (900)	$ (900)	$ (900)	$ (900)	**$ (5,040)**
Capital Expenditures		$ (20,960)	$ (20,853)	$ (21,100)	$ (21,300)	$ (21,600)	$ (21,850)	**$ (127,663)**
Dividends paid		*$ (10,490)*	*$ (10,486)*	*$ (10,486)*	*$ (10,486)*	*$ (10,722)*	*$ (11,043)*	**$ (63,713)**
Free Cash Flow		**$ 2,133**	**$ 3,004**	**$ 4,151**	**$ 6,689**	**$ 6,065**	**$ 5,988**	**$ 28,030**
Free Cash Flow ex. Dividend		**$ 12,623**	**$ 13,490**	**$ 14,637**	**$ 17,175**	**$ 16,787**	**$ 17,031**	**$ 91,743**
Net Depreciating Assets		**$ 141,138**	**$ 146,545**	**$ 151,604**	**$ 156,268**	**$ 160,635**	**$ 164,657**	
Current Cost Estimates: (2)								**65%**
Clean Up Costs - high end	**$ 23,000**							**$ 14,950**
Third Party Liability Claims	**$ 14,000**							**$ 9,100**
Total Oil Spill Costs	**$ 37,000**							**$ 24,050**

Source: Credit Suisse, BP

(1) Assumes $80/bbl oil price, and $7.00/mcf natural gas price. The company noted that it continues to generate cash in this environment and has the capacity to absord costs related to the oil spill. Cash flow projections clearly illustrate the company's financial capacity against the largest costs estimates, which does not incorporate cash calls on APC (25%) and Mitsui (10%). (2) Latest cost estimates (6/2/10) provided by Credit Suisse, 65% represents BP's ownership interest in Macondo well. Company is being pressured to suspend its dividend until Oil Spill in gulf is cleaned up. (*) 5 year period clearly indicate the company will have the capacity to absord the oil spill event with cash from operations, including dividend payments.

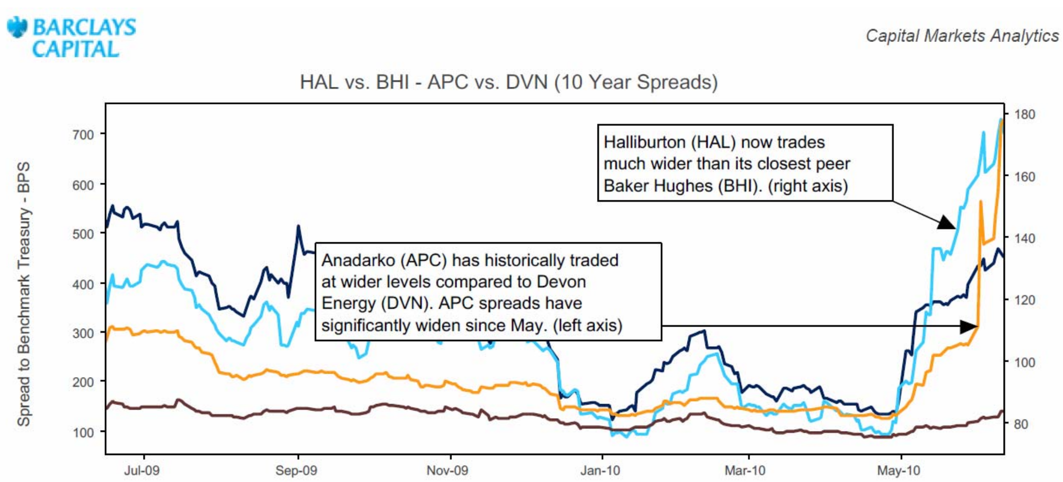
BP's other sources of capital that could be utilized to help pay for spill-related costs include reducing/cutting its annual $10.5 billion dividend, selling fixed assets ($108 billion book value at 3/31/10) and possibly delaying growth-related projects included in its annual $20+ billion capital investment budget. BP's projected operating cash flow is robust, expected to average $36 billion annually over the next 4 years based on $80/barrel oil (Credit Suisse). Using current oil spill cost estimates, including third-party liability claims that will more than likely take years to settle, the company has sufficient capital resources to absorb this event. BP is currently facing substantial political pressure from U.S. government officials to suspend its dividend payment until the oil spill is completely cleaned up and all claims are paid.

Energy Sector Relative Value

Despite the explosion and subsequent oil spill, Conning continues to maintain a stable fundamental outlook for the Energy sector as hydrocarbons continue to be vital to global economic growth. We believe there is now a major disconnect between industry / company fundamentals for the players involved in the disaster and investor sentiment. Factors driving this disconnect include provocative media headlines, self-interested politicians / trial lawyers and misleading cost estimates, creating an unwarranted panic. In our view, the situation presents opportunities for investors with moderate risk tolerance and a long-term investment horizon.

However, we remain cognizant of escalating clean-up costs and third-party liability claims; it could take decades before all claims are completely settled. There is growing negative sentiment from local residents, business owners and public officials who are feeling the direct impact of the oil spill. This includes soiled beaches and damaged property, lost business from limited tourism and a subsequent decline in state revenues. Conning believes the burden of responsibility will be concentrated on a few names. BP remains the central focus of the oil spill – recent articles indicate that the company may have cut corners in the drilling process, which ultimately could have caused the explosion.

Conning continues to believe that the market value declines of BP, APC, RIG, and HAL is an overreaction, reflecting investor flight rather than solid company and industry fundamentals. However, we remain cautious on increasing positions in BP and RIG until a forensic investigation into the cause of the rig explosion is completed, which is not scheduled to begin until some time in August when the relief wells have met critical depths and the Macondo well is successfully capped. In our opinion, the companies that appear to have limited involvement in the disaster that offer good value at current trading levels are HAL and APC.



Key	Axis	Name	Last	Minimum		Maximum		Mean	SD	SD Change
	Right	BHI 10Yr/40% Fitted Benchmark Par Spread	133.607	80.866	01/05/2010	150.317	06/18/2009	112.110	19.337	2.852
	Right	HAL 10Yr/40% Fitted Benchmark Par Spread	173.697	75.088	01/11/2010	178.525	06/10/2010	105.441	21.175	3.154
	Left	APC 10Yr/40% Fitted Benchmark Par Spread	731.24	126.93	04/23/2010	731.24	06/11/2010	206.50	85.95	20.26
	Left	DVN 10Yr/40% Fitted Benchmark Par Spread	140.63	86.90	04/22/2010	164.67	07/14/2009	124.92	19.54	3.46

Oil Spill Names Relative to Peer Companies

The chart below contains financial data (unweighted 3-year historical average) of a select peer group for the oil spill-related companies, grouped by sub-sectors. The oil spill-related names demonstrate strong earnings capacity and financial metrics relative to our select peer group, which validates our belief that in spite of the current situation, the oil-spill companies measure up well against their industry peers.

Symbol	Peer Company
PXD	Pioneer Natural Resources
DVN	Devon Energy Corporation
BHI	Baker Hughes, Inc.
WFT	Weatherford International
COP	ConocoPhillips
DO	Diamond Offshore
NBR	Nabors Industries

Industry Comps - Oil Spill Names vs. Closest Peers

	Independents			Oilfield Services					Integrated			Contract Drillers		
	APC	**PXD**	**DVN**	**HAL**	**BHI**	**SLB**	**CAM**	**WFT**	**BP**	**COP**	**SHELL**	**RIG**	**DO**	**NBR**
Moody's/S&P	Baa3(n)/BBB-	Ba1/BB+	Baa1/BBB+	A2(s)/A(s)	A2/A	A1/A+	Baa1(s)/BBB+(s)	Baa1(n)/BBB	Aa2(*-)/AA-(*-)	A1/A	Aa1/AA	Baa2(s)/BBB+(*-)	Baa1/A-	Baa1/BBB+(n)
Conning	Low BBB(d)	High BB(s)	High BBB(i)	Mid A(s)	Mid A(s)	High A(s)	High BBB(s)	High BBB(d)	Mid AA(d)	Mid A(s)	Mid AA(s)	Mid BBB(d)	High BBB(s)	High BBB(d)
Unweighted 3 Year Average														
(Units reported in: Millions)														
Revenues	$ 11,470	$ 1,843	$ 10,584	$ 16,073	$ 10,652	$ 24,380	$ 5,246	$ 8,004	$ 295,687	$ 177,647	$ 364,110	$ 10,202	$ 3,248	$ 4,714
Operating income (bef. D&A)	6,181	1,008	6,798	4,112	2,601	8,517	991	2,356	41,769	29,510	47,186	5,686	1,969	1,656
EBITDA	**7,408**	**1,228**	**6,924**	**4,066**	**2,579**	**8,477**	**1,008**	**2,375**	**40,241**	**30,261**	**46,493**	**5,725**	**1,972**	**1,703**
EBIT	**2,897**	**483**	**4,114**	**3,263**	**1,910**	**6,267**	**864**	**1,669**	**31,465**	**24,760**	**39,623**	**4,658**	**1,700**	**882**
Cash flow from operations	**4,400**	**718**	**5,922**	**2,751**	**1,544**	**6,427**	**708**	**1,082**	**33,582**	**20,111**	**37,297**	**4,457**	**1,439**	**1,479**
Capital expenditures	4,417	1,379	6,485	1,838	1,290	3,212	290	1,796	22,517	14,142	31,054	2,117	883	1,529
Free operating cash flow	(17)	(661)	(563)	913	254	3,215	418	(714)	11,065	5,969	6,243	2,339	557	(50)
Cash and short-term investments	2,386	29	859	2,234	1,535	3,826	1,407	178	1,500	918	2,000	1,235	718	814
Debt	$ 15,360	$ 3,513	$ 8,769	$ 4,067	$ 2,205	$ 7,249	$ 1,265	$ 4,317	$ 52,911	$ 36,937	$ 42,137	$ 14,647	$ 865	$ 4,112
Net pension & postretirement deficit (after tax)	515	6	297	188	101	1,020	27	93	4,538	2,072	5,054	270	-	3
Total liabilities	31,248	5,895	16,026	7,315	4,472	14,283	3,426	6,169	137,227	88,478	149,419	18,524	1,913	5,671
Equity	18,645	3,459	18,212	7,827	6,799	17,034	2,828	7,316	97,089	72,914	127,951	16,766	3,285	4,796
Debt and equity	34,005	6,972	26,981	11,894	9,004	24,283	4,094	11,633	150,000	109,852	170,088	31,412	4,150	8,908
EBIT interest coverage (x)	**2.64**	**2.31**	**6.95**	**14.39**	**18.83**	**21.02**	**12.41**	**9.21**	**12.54**	**10.84**	**14.84**	**9.05**	**47.47**	**10.05**
EBITDA interest coverage (x)	**6.94**	**5.81**	**11.68**	**17.57**	**24.72**	**28.46**	**14.37**	**13.07**	**16.10**	**13.21**	**17.44**	**10.72**	**54.91**	**16.98**
Cash flow from oper. interest coverage (x)	**5.05**	**4.15**	**10.72**	**11.91**	**14.66**	**21.94**	**10.22**	**6.93**	**13.15**	**9.21**	**13.23**	**9.63**	**41.41**	**14.14**
Cash flow from operations/debt (%)	**29.25**	**20.27**	**69.75**	**70.30**	**76.35**	**88.76**	**55.42**	**28.63**	**63.59**	**56.24**	**94.52**	**32.09**	**210.17**	**35.96**
Free operating cash flow/debt (%)	**0.31**	**(18.53)**	**(6.53)**	**23.77**	**13.45**	**44.55**	**31.25**	**(13.24)**	**20.88**	**17.78**	**16.86**	**16.66**	**99.03**	**(1.32)**
Debt/EBITDA (x)	**2.25**	**2.92**	**1.38**	**1.06**	**0.92**	**0.87**	**1.24**	**1.76**	**1.37**	**1.33**	**1.02**	**2.94**	**0.43**	**2.47**
Debt/debt and equity (%)	**45.25**	**50.46**	**32.73**	**33.97**	**24.06**	**29.95**	**31.39**	**35.98**	**35.22**	**34.35**	**24.64**	**46.93**	**19.59**	**46.21**

Source: S&P, Conning, Bloomberg

Looking Forward

President Obama's address to the nation on June 15 emphasized BP's responsibility to cover all clean-up costs and restitution for damages, a responsibility the company had previously acknowledged. As of this writing, an escrow account funded over time by BP, combined with an equity dividend suspension, are likely.

We will continue to closely monitor the oil spill and its resulting implications for the local and national economy, politics and public policy, the environment and the energy sector, as well as the outlook for specific names. This far-reaching event will likely cause "spills" in many areas as its impact becomes fully felt. ◆

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