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THE IMPACT OF THE GULF OIL DISASTER ON THE ENERGY SECTOR



Nancy Prue, Executive Vice President of Petroleum & Resources, sat down with us recently to share her thoughts on the short and longer term impact of the events in the Gulf of Mexico.

Over the last few years, the Gulf of Mexico has been the largest domestic source of oil and gas production and reserves. Our nation derives about 33% of its domestically-produced oil and 10% of its natural gas from the region. In addition, production in the Gulf represents the entire net growth in U.S. oil supply and 4% of global oil supply growth. Deepwater drilling (from depths of 1,000 feet and greater) has been especially important in the Gulf, and ultra deepwater drilling (depths greater than 5,000 feet) has played a key role in that production. In fact, 9% of the oil and 3% of the gas produced from the Gulf is from ultra-deep locations.

Recent events have shown that this successful exploration and development is not without risk. On April 20, 2010, an explosion and fire occurred on the offshore drilling rig *Deepwater Horizon*, which had been drilling an exploratory

well on the Macondo prospect in approximately 5,000 feet of water, causing the rig to sink and taking the lives of 11 crewmembers. In addition to the human loss, the damaged well began leaking oil into the Gulf, damaging the environment and the economies of several coastal states.

All attention and current activities are now appropriately focused on efforts to contain the leak and to mitigate the resulting environmental damage. Subsea collection and skimming operations are capturing significant volumes of oil as the relief wells move closer to a kill of the leak. As the causes and blame for the accident are assessed, there is a wide range of potential outcomes from the spill. The coastal impact, harm to wildlife, or damage to the local economies will not be quantified for many years. Through the end of June, BP has spent \$3.2 billion on the spill

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and established a \$20 billion claims liability fund. For perspective, the Exxon Valdez went aground March 24, 1989, spilling 257,000 barrels of oil. Clean-up and penalty costs totaled \$4.54 billion, approximately \$17,000 per barrel spilled. The punitive damage award was heard by the U. S. Supreme Court and was finally settled in June 2008 – 14 years after the first jury award. The Gulf of Mexico is a very different environment and a large amount of the spill will evaporate. However, costs, litigation expenses, civil fines, and economic restitution will be enormous, and the impact on the Gulf of Mexico and local residents is vast.

The government's response is broad-based. The Minerals Management Service, responsible for issuing permits, was reorganized and renamed. A six-month halt in the issuance of new drilling permits was declared, and bills to raise taxes oil companies pay for producing oil, as well as raise the cap on damages the government can collect to \$10 billion from \$75 million, have been introduced. The first drilling permit ban has been lifted by court order, but drilling is unlikely to resume quickly.

Actual energy production and shipments have not been significantly impacted by the oil leak to date. Currently, only a fraction of 1 percent of offshore production has been shut down. However, the impact of the moratorium and the changes in the regulatory framework for operating in the Gulf will permanently alter production from the region. Higher insurance costs, permitting delays, greater risk premiums, and significantly higher potential liability will redefine the drilling economics in the region and potentially increase development costs by 25-50%. Small independent producers will not be able to afford to drill, and volumes for this prolific area will be impaired. As deepwater drilling declines and fewer producing wells come on stream, supplies from the Gulf will rapidly drop. Current OPEC spare capacity and economic weakness may mitigate that fall-off in the near term. But if sustained demand growth in China, India and the Middle East coincides with economic

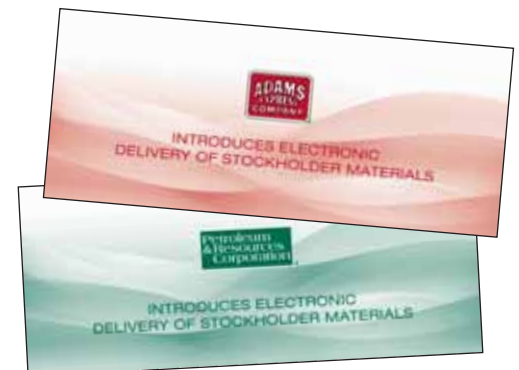
recovery in the United States and other developed countries, higher prices will be inevitable. Longer term, higher costs and stricter regulations will likely slow down production growth with a significant impact seen by 2014-15.

The Gulf oil spill may enhance the attractiveness of natural gas relative to oil. As the U.S. looks to reduce its dependence on foreign oil while easing the burden on the inherently higher risk deepwater Gulf of Mexico, domestic shale gas should emerge as a key solution to bolster energy security. Natural gas also offers a cleaner, lower-risk solution to bridge the gap to a broader alternative energy platform. Natural gas production is impacted by the accident but to a much lesser extent. Most of the incremental gas supply in the United States is coming from prolific onshore shale, or rock formations. Costs to produce shale gas have declined 20-30% and companies continue to spend. Weak demand growth and large reserve additions of gas have created an oversupplied market. In contrast to oil, gas offers abundant supply and lower prices.

The market impact from the spill on companies operating in the deepwater has been severe. BP, as the operator and with the greatest exposure to the well, has seen its stock decline by over 50% and has suspended its dividend. Other companies with direct exposure to the spill include Anadarko, a 25% participant in the well; Transocean, the owner of the drilling rig; and several other companies that provided goods and services. Some losses are based on misinformation, fear and headline risk. We anticipate the leak will be killed within the month allowing investors to have a clearer understanding of individual company exposure and risks. Litigation and appeals as to financial responsibility will go on for years, but investors will be able to evaluate companies based on fundamental growth unencumbered by the speculative news flow currently surrounding the spill.

Electronic Delivery of Stockholder Materials

We are pleased to offer our Stockholders the benefits and convenience of viewing financial reports and other materials online and encourage your participation which will reduce paper mailed to your home and lower the Funds' printing and mailing costs. Included with this mailing are easy-to-follow instructions to opt-in for electronic delivery via email.



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