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Rating: Hold

Dominion Resources

(D-NYSE-\$77)

E&P

Spin – Sale – Combination

Price	9/25						
	77						
52-week range	87-69				Relative	Price	Y-t-d
Book Value (12/31/05)	29.96	258%	P/b		Performance	9/25	%
							12 Mos.
Earnings - Ongoing					Dominion	77	0
2003	4.55	17.0	P/e		Phil. Electric Index	458	8
2004	4.61	16.8			Dow Industrials	11,576	8
2005	4.53	17.0			Coverage		
2006 Consensus	5.09	15.2			Analyst Total	18	
2007 Consensus	6.05	12.8			Buys	7	
2008 Estimate	8.55	9.0			Shares (millions)	347	
Dividend Per Share	2.76	3.6%	Yield		Market Value (\$Bil.)	27	

Overview

Tom Farrell, Chief Executive Officer, has been up front with the investment community concerning his strategy to review all businesses for the purpose of selling or spinning off segments that either fall short of long-term profit goals (gas distribution) and/or create risks that conflict with the conservative profile of its shareholder base. Farrell repeated his strategy at a Lehman conference on September 5, 2006 and again at a B of A conference on September 18, 2006 and indicated that the highly profitable Exploration & Production (E&P) business is being evaluated for possible sale or spin-off. Its fate will be decided by the end of the first quarter of 2007.

E&P earned \$1.64 a share (\$565 million) in 2005 or 36% of consolidated \$4.53 a share. Earnings growth had been expected to accelerate sharply as production increased and margins expanded via the roll-off of hedges priced below market. We had forecasted that E&P profits would rise to \$1.81 a share (\$636 million, 35% of consolidated) in 2006 and exceed \$4.00 a share (\$1,428 million, 47% of consolidated) in 2008. Although our estimates will be pared if energy prices remain at current levels, the E&P's 2008 profit contribution should account for about 40% of consolidated results.

Why would management elect to shrink Dominion by divesting its most profitable business? One aim is to unlock shareholder value and at the same time give shareholders the opportunity to sell the riskier paper. Other reasons include the industry's capital intensity, cyclical, competitiveness, and concern over whether Dominion possesses the expertise to compete longer term.

This exercise takes three "best guess" approaches: 1) spin-off, 2) sale and 3) partial spin-off and sale. We assume E&P meets our estimates and management guidance proves accurate: \$5.00-\$ 5.25 a share-2006, \$6.05-\$6.25 a share-2007, \$8.30-\$8.80 a share-2008, \$8.80-\$9.90 a share-2009. The year for spin-off is 2008 and cash sales are net of income taxes.

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See page 8 of report for Analyst's Certification, pages 8-9 for Important Disclosures and page 9 for Other Disclosures and Disclaimers

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Under scenario 1 spin-off, divestiture of the lower P/E business exposes the stand-alone Dominion Resources to P/E devaluation. Under scenario 2, cash sales, even ignoring tax considerations, pose the challenge of reinvesting proceeds at returns comparable to E&P. We believe economics favor retention or partial spin-off via a stock dividend, but with several caveats, not the least of which involve Investment Bankers. Bankers get paid to do deals, and cash proceeds in the billions (\$13-\$22 billion) represent a financial base that could be leveraged to acquire businesses perceived as less risky and, coincidentally, generate additional Banking fees.

Spin

(Spin-off of lower P/E business that generates significant earnings growth creates P/E risk)

Dominion Resources' price/earnings ratio (P/E) is 15, based on a price of \$77 a share and midpoint 2006 guidance of \$5.12 a share. The \$2.76 a share dividend provides a 3.6% yield and accounts for 54% of earnings. For comparison, the average electric company, according to the 49 companies we monitor, trades at 16 times earnings and yields 3.5% with a 56% payout.

According to the 8 companies management regards as peers, E&P as a separate entity would trade at \$16 a share, or approximately 9 times estimated 2006 earnings (Table 6), with a dividend of \$0.11 a share and a yield 0.7%. Dominion's stand-alone imputed price of \$61 a share (\$77 less \$16 for E&P) represents an 18.3 P/E, a 12% premium to the average. If Dominion stand-alone traded at the industry average, its price would drop 12% to \$53 a share, reducing the package value by 10% from \$77 to \$69 a share.

**Table 1
Market Value Comparisons
2006 & 2008**

	2006			2008		
	(1) Consolidated	(2) E&P	(3) Dominion	(4) Consolidated	(5) E&P	(6) Dominion
Price	77	16	61	128	36	92
Earnings Per Share	5.13	1.81	3.32	8.55	4.00	4.55
Price Earnings	15.0	9.0	18.3	15.0	9.0	20.2
Dividend Per Share	2.76	0.11	2.65	2.84	0.23	2.73
Payout %	54	6	80	33	6	60
Yield %	3.6	0.7	4.4	2.2	0.3	3.0

For the 2008 profile, we assumed 1) consolidated Dominion Resources continues to trade at 15 times earnings, 2) earnings meet management mid-point guidance of \$8.55 a share, and 3) E&P profits reach \$4.00 a share. (We also assumed a modest increase in the dividend to \$2.84 a share.) Dominion's consolidated price rises 67% to \$128 a share. Traded separately, however, the E&P price of \$36 a share leaves \$92 a share for Dominion stand-alone. Dominion's imputed P/E of 20.2 represents a premium of 26% to the industry and 10% from its current stand-alone value. P/Es of 18 and 16 lower Dominion's stand-alone values to \$82 and \$73 a share, respectively, reducing the combined package from \$128 a share to the \$118 a share (-8%) to \$109 a share (-15%) range.

Sale for Cash

(Cash may be king but reinvesting at comparable returns is challenging)

Our assumptions for cash proceeds are net of income taxes so actual sales prices would have to exceed our forecasts perhaps by 25%. This exercise takes two approaches: cash proceeds based on 1) theoretical prices, and 2) reserve valuations. Proceeds are applied to debt reduction and common stock buybacks on a 50/50 basis.

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Market Price: Market value of a separate E&P company based on peer comparisons would approximate \$12.8 billion (\$36 a share price multiplied by 357 million shares outstanding). The reduction of \$6.4 billion of debt at 5% generates after-tax savings of \$192 million. Share buyback at the consolidated price of \$128 reduces shares outstanding by 50 million, lowering the outstanding total to 307 million.

Table 2
Sale at Market
Application of Proceeds

	2008
Net Proceeds @ Market	12,808
Debt 50%	6,404
Equity 50%	6,404
Total	12,808
Interest Savings @ 5%	
Pre tax-\$-m.	320
After Tax 40% rate-\$mil.	192
Share Buy Back	
Price	128
Shares-mil.	50
Adjusted Shares Out-mil.	307

Interest reductions and stock repurchases nowhere near offset the loss of E&P earnings. Table 3 estimates the earnings impact at high, low and mid-point guidance for 2008. Earnings versus guidance decline about 30% to the \$6.21 to \$5.92 a share range. If Dominion-alone were to retain the P/E premium (18 times) implied by the current share price, its imputed value would drop from \$128 a share to the \$113 to \$108 range, approximately 12% to 16%. However, should Dominion's 2008 P/E decline to the average P/E of 16, the imputed value declines 25% to \$99-\$95 a share.

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Table 3
Dominion Resources
Pro Forma Earnings
Sale at Market
\$12.8 Billion

	High	Low	Average
Earnings Guidance	8.80	8.30	8.55
Earnings \$-millions	3,142	2,963	3,052
Less Loss of E&P Profits \$-mil.	1,428	1,428	1,428
Plus Interest Savings-\$-mil.	192	315	192
Pro Forma Net-\$mil.	1,906	1,850	1,816
Shares Outstanding	307	307	307
Earnings Per Share	6.21	6.03	5.92
Dilution From Guidance	29	27	31
Prices			
Before Sale			
P/E	15	15	15
Price	132	125	128
After Sale			
Dominion			
P/E - current imputed	18	18	18
Price	113	110	108
% Change from Consolidated	(14)	(12)	(16)
P/E Industry Avg.	16	16	16
Price	99	96	95
% Change from Consolidated	(25)	(23)	(26)

Sale of Reserves: Another “back of the envelope” approach is to value assets based on reserves. We’re not sure we support that approach, but it is simple and leads to values in excess of market prices. (Why not buy the company instead?) Table 4 contains estimates based on responses from energy analysts and a DTE Energy (DTE-NYSE-Hold) presentation earlier this year that valued reserves at the Barnett field in Texas. Back in March, however, natural gas futures were in the \$10.00-\$11.00 per mcf range versus \$4.50 currently, and oil traded at \$70-\$75 a barrel compared to \$61 currently. We assume the more realistic best guesses are in the average to low ranges in Table 4.

As per the 2005 10K, E&P reserves totaled 11.5 trillion cubic feet (Tcf): 6.3 proved, 2.0 probable, 3.2 possible. We’ve assigned market values per mcf of \$3.00-\$2.50 for proved, \$1.00-\$0.50 probable, and \$0.50-\$0.25 possible. Total market values range from \$22,420 million to \$17,478 million with an average of \$19,949 million. Proceeds again assume no income tax consequences so the actual bid price would have to be significantly higher. Proceeds are again allocated to debt reduction and buybacks on a 50/50 basis. Our common buyback price is \$128 (Table 1, column 4).

Earnings versus guidance decline by 14%-25% to a \$7.60 a share to \$6.22 a share range with a midpoint of \$6.89 a share. If stand-alone Dominion continued to command an 18 P/E, the high value assumptions could produce a price of \$138 a share, a 5% increase versus a price based on no divestiture and a 15 P/E applied to the guidance range. At an average P/E of 16, however, the high end assumptions produce a pro forma 8% decline in price.

At the low-end reserve valuation, Dominion’s price declines to \$113 a share (-9%) to \$100 (-20%) versus pro forma consolidated depending on whether it maintains a P/E premium (18 times) or average (16 times). At average valuations the price drops to \$125 a share (-2%) at an 18 P/E and to \$110 a share (-14%) at a 16 P/E.

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Table 4
Dominion Resources
Pro Forma Earnings
Sale Valued on Reserves

Reserves Value mcf	High	Low	Average
Proved	3.00	2.50	2.75
Probable	1.00	0.50	0.75
Possible	0.50	0.25	0.38
Proceeds (\$-Million)			
Proved	18,804	15,670	17,237
Probable	2,000	1,000	1,500
Possible	1,616	808	1,212
Total	22,420	17,478	19,949
Application \$-Millions			
Debt 50%	11,210	8,739	9,975
Equity 50%	11,210	8,739	9,975
Total	22,420	17,478	19,949
Earnings Guidance 2008	8.80	8.30	8.55
Balance to Common \$-millions	3,142	2,963	3,052
Shares Outstanding – Millions	357	357	357
Adjustments to Earnings \$-Mil			
Less E&P Profits \$-millions	1,428	1,428	1,428
Profits Excluding E&P \$-millions	1,714	1,535	1,624
Interest savings @ 5%	561	437	499
Net of Tax 40% rate	336	262	299
Pro Forma Net Income \$-millions	2,050	1,797	1,924
Share buyback			
Price	128	128	128
Shares Bought	87	68	78
Adjusted Shares Out- Mil	270	289	279
Pro Forma Earnings Per Share	7.60	6.22	6.89
Dilution vs. Guidance %	14	25	19
Price Before Sale	132	125	128
P/E	15	15	15
Dominion Stand-alone			
P/E Current Implied	18.2	18.2	18.2
Price	138	113	125
% From Guidance	5	(9)	(2)
P/E Industry Avg.	16	16	16
Price	122	100	110
% From Guidance	(8)	(20)	(14)

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Sale or Spin 49%

(Probably the more logical option)

Table 5 assumes 49% of E&P is spun 1) via a stock dividend (column 1), 2) for cash (net of tax) based on theoretical market value (column 2), and 3) average reserves values net of taxes (column 3). The larger the percentage of E&P earnings retained and capitalized above the 9 P/E of the E&P group, the more favorable the price performance versus full divestiture. Spin-off of 49% via a stock dividend to shareholders 1) reduces exposure to risky E&P, 2) maintains and perhaps increases shareholder value, 3) avoids income tax complications, and 4) offers investors the opportunity to limit risk by selling separately traded shares.

Table 5
Dominion Resources
Pro Forma Earnings
49% Divestiture Market & Average Reserves

Column	(1)	(2)	(3)
	2008		
	Stock Spin Share Spin @ Market	Cash Sale \$ Market	Cash Sale Avg. Res.
\$-Millions			
Cash Value	0	12,556	19,949
Proceeds @ 49%	0	6,153	9,775
Debt Retirement	0	3,076	4,888
Share Buy Back \$ Millions		3,076	4,888
Earnings before Spin	3,052	3,052	3,052
Loss of E&P Earnings @49%	700	700	700
After Tax Interest Savings	0	92	147
Pro Forma Earnings	2,353	2,445	2,499
Share Buy Back Price		128	128
Shares Bought		24	38
Pro forma Shares – millions	357	333	319
Per Share	6.59	7.34	7.84
P/E current	18.4	18.4	18.4
Pro Forma Price	121	135	144
P/E average	16	16	16
Pro Forma Price	105	117	125
E&P Earnings Per Share	1.96		
P/E	9		
Price Package	18		
P/E @ 18.4	139	135	144
P/E @ 16	123	117	125

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E&P Peers

Table 6
E&P Peer Companies

Peer Names		Price 9/24	Ytd %	12- mos. %	EPS 2006	EPS 2007	P/E 2006	P/E 2007	Div. \$PS	Yield %
Apache Corp	apa	61	(11)	(18)	8.21	9.00	7.4	6.7	0.60	1.0
Anadarko Pete	apc	42	(12)	(11)	5.76	6.68	7.3	6.3	0.36	0.9
Chesapeake Eng.	chk	29	(9)	(18)	3.43	3.48	8.4	8.3	0.24	0.8
Devon Energy	dvn	61	(3)	(6)	6.77	8.09	9.0	7.5	0.45	0.7
EOG Resources	eog	62	(15)	(14)	5.10	5.67	12.2	11.0	0.24	0.4
Nobel Energy	nbl	43	7	(6)	5.06	5.79	8.5	7.4	0.30	0.7
Newfield Expl.	nfx	37	(26)	(23)	4.08	5.45	9.1	6.8	0.00	0.0
XTO Energy	xto	39	(7)	(4)	4.12	4.65	9.6	8.5	0.30	0.8
Average		47	(10)	(13)	5.31	6.10	8.8	7.7	0.31	0.7

Source: Bloomberg Financial Service

Analyst's Certification

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Important Disclosures

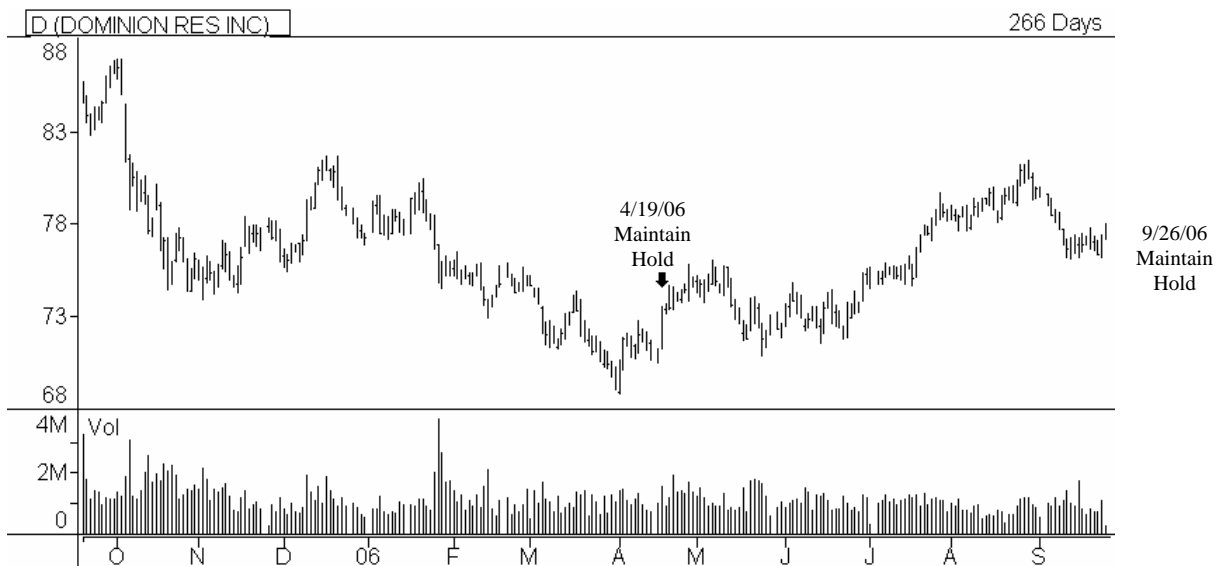
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Range of Formal Recommendations 17 total 1-buy-15-holds-1 sell



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