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Follow-up to September 26, 2006 Report (D-\$77)

Rating: Upgrade from Hold to Buy

### Dominion Resources (D-NYSE)

Price	11/16						
	80						
52-week range	84-69						
Book Value (9/30/06)	39.04	206%	P/b	Relative	Price	Y-t-d	12 Mos.
Earnings - Ongoing				Performance	11/16	%	%
2003	4.55	17.7	P/e	Dominion	81	4	8
2004	4.61	17.4		Phil. Electric Index	480	13	17
2005	4.53	17.7		Dow Industrials	12,252	14	15
2006 Estimate	5.10	15.8		Coverage			
2007 Consensus	5.83	13.8		Analyst Total	18		
2008 Estimate	6.70	12.0		Buys	8		
Dividend Per Share	2.76	3.4%	Yield	Shares (millions)	347		
				Market Value (\$Bil)	28		

#### Recommendation

On November 1<sup>st</sup> management officially announced that it had opted to exit the E&P business (except for the Appalachian Basin) and that the most likely vehicle is via a cash sale. The announcement received mixed reactions from the investment community including downgrades by at least two firms.

Investors expressed concern that the transaction would be dilutive and that the income tax liability would be substantial. Both statements are correct. The decision to go cash reflects the disconnect between stock prices and asset values of peer E&P companies. Recent cash transactions in the \$3.00 plus per mcf area generate more value net of taxes than a stand-alone E&P company selling at 10 times earnings.

As to earnings dilution, the "back of the envelope" approach in this report indicates reductions in a stand-alone Dominion Resources of 6% to 17%. Offsetting the earnings decline are stronger financial statements, a less risky business profile and the prospect of dividend payout policy more reflective of reduced risk. The current \$2.76 a share indicated dividend represents 2008 payouts of diluted earnings of 40% to 47%, versus the 50% to 70% for traditional, electric-mostly regulated electric companies. A payout of 55%, prospects of 4% to 6% annual growth and no change in the 3.4% yield would raise Dominion share price by 16% (\$94) to 39% (\$112) depending on proceeds from the E&P sale. Our 12-month price objective is \$100. We are raising our rating from hold to buy.

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See page 6 of report for Analyst's Certification, pages 6-7 for Important Disclosures and page 7 for Other Disclosures and Disclaimers

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We regard the most significant risk to achieving our price targets (besides general market trends and possible changes in the regulatory environment) is the direction of energy prices, particularly natural gas. Those prices obviously impact the earnings expectation and potential proceeds from an E&P sale.

### Management Opts for Cash Sale

Consolidated guidance of \$8.80 to \$8.30 a share for 2008 issued by management on May 22<sup>nd</sup> was based on NYMEX futures gas prices as of April 28<sup>th</sup> of \$9.72 per mcf. By November 14<sup>th</sup>, futures declined by \$1.37 per mcf to \$8.35 and guidance was lowered to \$7.43-\$6.93 a share. (According to management each \$1.00 per mcf change represents \$0.55 a share in earnings.)

E&P earnings were estimated at 40% of consolidated results including the Appalachian Basin properties that are to be retained. The earnings break-down in Table 1 estimates E&P profits at 40% of the guidelines less 3% for Appalachia.

Table 1  
2008 Earnings Profile

	2008		
	High	Low	Average
Original Guidance (5/22/06)	8.80	8.30	8.55
Lower NYMEX Gas Quotes	1.37	1.37	1.37
Adjusted Guidance	7.43	6.93	7.18
E&P Profits	2.88	2.69	2.79
Dominion stand-alone	4.55	4.24	4.39

Management elected to sell E&P for cash despite incurring a tax liability. Spin-off was nixed as E&P companies trade at only 10 times earnings, significantly less than the after-tax value of assets in the ground. If spun, E&P trading on its own, for example, would create market value of \$10 billion (\$28 a share multiplied by 357 million shares).

Table 2 assumes cash proceeds at \$3.75 per mcf (column 1) and \$3.00 per mcf (column 2) per proved 5.5 tcf reserves. The estimates are roughly comparable with recent transactions by Anadarko Petroleum (APC-NYSE-\$41) and El Paso Corp (EP-NYSE-\$14). Dominion Resources tax base for E&P properties is \$3,800 million and book cost \$10,500 million. Since the transaction will reflect a combination of operating and capital gains, we assumed a composite tax rate of 33%.

Our scenarios produce net of tax proceeds of \$15,073 million at \$3.75 per mcf and \$12,309 million at \$3.00 per mcf. Book gains, as measured by estimated net of tax proceeds less investment per book are \$4,573 million at \$3.75 per mcf and \$1,809 million at \$3.00.

Table 2  
Cash Sale Proceeds

Column	(1)	(2)
Cash Sales Price per mcf	3.75	3.00
Reserves proven- tcf	5.5	5.5
Sales Price \$millions	20,625	16,500
Less Tax Basis \$millions	3,800	3,800
Taxable Gain \$millions	16,825	12,700
Tax rate	33%	33%
Tax Bill \$millions	5,552	4,191
After Tax Proceeds \$millions	15,073	12,309
Book Value \$millions	10,500	10,500
Book Gain \$millions	4,573	1,809

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### Pro Forma Capitalization @ \$3.75

Table 3 records the transaction in two steps. First, common equity is increased by the after-tax profit of \$4,573 million, raising book value to \$57.72 a share. Second, allocation of the after-tax proceeds of \$15,073 million assumes common equity remains at 50% of capitalization. Share repurchases and debt retirement are allocated approximately 50/50. Shares outstanding, assuming an \$85 price, decline by 25% to 267 million and book value ends up at \$48.56 a share.

Table 3  
Capitalization - 2008 Profile

Column	(1) 2008 \$-Mil.	(2) Profit \$-Mil.	(3) Pro Forma \$-Mil.	(4) Sale Proceeds \$-Mil.	(5) Pro Forma \$-Mil.
Capitalization					
Debt	20,153		20,153	(7,441)	12,712
Preferred	255		255		255
Common	16,035	4,573	20,607	(7,632)	12,976
Total	36,443		41,015	(15,073)	25,943
Capital Structure	%		%		%
Debt	55.3%		49.1%		49.0%
Preferred	0.7%		0.6%		1.0%
Common	44.0%		50.2%		50.0%
Total	100.0%		100.0%		100.0%
Book Value	44.92		57.72		48.56
Shares	357		357		267

### Pro Forma Capitalization @ \$3.00

At \$3.00 per mcf (Table 4), net proceeds total \$12,309 million and the book gain is \$1,809 million. Allocation of proceeds works out to 40% share repurchase (\$4,868 million) and 60% debt retirement (\$7,444 million). Share repurchases at \$85 reduce outstanding shares by 16% to 300 million. Pro forma book value is \$43.29 a share.

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Table 4  
Capitalization - 2008 Profile

Column	(1) 2008 \$-Mil.	(2) Profit \$-Mil.	(3) Pro Forma \$-Mil.	(4) Sale Proceeds \$-Mil.	(5) Pro Forma \$-Mil.
Capitalization					
Debt	20,153		20,153	(7,441)	12,712
Preferred	255		255		255
Common	16,035	1,809	17,844	(4,868)	12,976
Total	36,443		38,252	(12,309)	25,943
Capital Structure	%		%		%
Debt	55.3%		52.7%		49.0%
Preferred	0.7%		0.7%		1.0%
Common	44.0%		46.6%		50.0%
Total	100.0%		100.0%		100.0%
Book Value	44.92		49.98		43.29
Shares	357		357		300

#### Pro Forma Earnings Dilution

Under either scenario, the transaction is dilutive versus guidance. At \$3.75 per mcfe, earnings decline about 6% from the \$7.43-\$6.93 a share range to \$6.95-\$6.54 a share. At \$3.00 per mcfe, dilution rises to 16% with earnings in the \$6.20-\$5.83 a share range.

Table 5  
Pro Forma Earnings

	\$3.75			\$3.00		
	PS	2008	PS	PS	2008	PS
	High	Low	Average	High	Low	Average
Adjusted Guidance	7.43	6.93	7.18	7.43	6.93	7.18
E&P Estimates	2.88	2.69	2.79	2.88	2.69	2.79
Stand-Alone	4.55	4.24	4.39	4.55	4.24	4.39
Stand-Alone \$-mil.	1,623	1,514	1,569	1,623	1,514	1,569
Interest savings 3.2%	234	234	234	234	234	234
Balance to Common	1,858	1,748	1,803	1,858	1,748	1,803
Shares Outstanding	267	267	267	300	300	300
Consolidated Earnings	6.95	6.54	6.75	6.20	5.83	6.02
Dilution	(6)	(6)	(6)	(17)	(16)	(16)

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### Appreciation via Dividend Growth

Tom Farrell, Dominion Resources' new Chief Executive Officer, wouldn't implement structural change if the outcome was to reduce shareholder value. It's obvious that the transaction creates stronger financials and a less risky business profile, more suitable for its conservative ownership base. It should also enable the Board to adopt a less restrictive dividend policy.

Even with dilution, the dividend payout percentage of 40% to 47% is modest versus the 50% to 70% range of many traditional, and mostly regulated, electric companies. Should the Board adopt a 55% payout, the dividend would rise from \$2.76 a share currently to a range of \$3.21 to \$3.82 a share and provide 4%-6% annual growth longer-term. Assuming the current 3.4% yield remains unchanged, price appreciation would range from a low of 16% (\$94 a share) to a high of 39% (\$112 a share).

Table 6  
Valuation  
Appreciation via Dividends

	\$3.75			\$3.00		
	PS	2008	PS	PS	2008	PS
	High	Low	Average	High	Low	Average
Earnings	6.95	6.54	6.75	6.20	5.83	6.02
Dividend	2.76	2.76	2.76	2.76	2.76	2.76
Payout %	40%	42%	41%	45%	47%	46%
Price (11/15/06)	81	81	81	81	81	81
Yield	3.4%	3.4%	3.4%	3.4%	3.4%	3.4%
Estimated Payout	55%	55%	55%	55%	55%	55%
Pro Forma Dividend	3.82	3.60	3.71	3.41	3.21	3.31
Price @ 3.4% yield	112	106	109	100	94	97
% Price Change	39%	30%	34%	24%	16%	20%

## Analyst's Certification

I Raymond E. Moore certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report. Other Dominion Resources reports issued by me are: 9/26/06 (\$77) – Hold; 4/19/06 (\$73) – Hold; 3/12/04 (\$63) – Upgrade to Hold; 1/23/04 (\$62) – Under Perform; 12/27/02 (\$54) – Under Perform.

## Important Disclosures

### Guide to Investment Ratings:

**Buy** Total return is expected to exceed significantly the average total return of the analyst's industry coverage universe over the next 12 months.

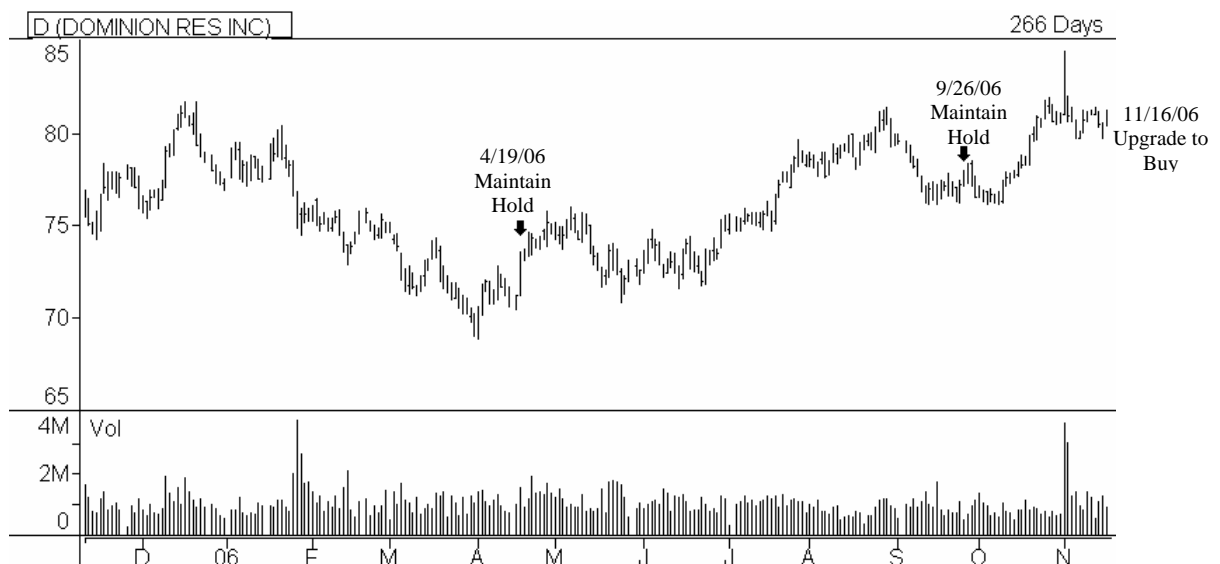
**Market Perform & Hold** Total return is expected to equal the average total return of the analyst's industry coverage universe over the next 12 months.

**Sell** Total return is expected to significantly under perform (15% plus) the total return of the industry coverage universe over the next 12 months.

### Analyst's Ratings Distribution

		% Investment Banking
Buy	12%	0%
Hold	82%	0%
Sell	6%	0%

The principal risks to the achievement of our price targets include general market trends, disappointing earnings and lower energy prices and adverse regulatory developments



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