DAVE FREUDENTHAL
GOVERNOR

THE STATE OF WYOMING

STATE CAPITOL
CHEYENNE, WY 82002

Office of the Governor

August 21, 2008

Senator Grant Larson, Chairman
Joint Minerals Business and Economic
Development Committee
P O Box 3490
Jackson, WY 83001

Representative Tom Lockhart, Chairman
Joint Minerals Business and Economic
Development Committee
770 East 12th Street
Casper, WY 82601

Gentlemen,

I am in receipt of your August 5, 2008 letter which offers several questions, all of which we have discussed in some detail over the last several years. I am glad to respond in writing since that appears to be your desire. Before addressing your thoughtful and open-ended inquiries, I might share some information we gathered from the Wyoming Pipeline Authority (WPA). According to the WPA, the following pipeline capacity has been added since 2002.

May 02	Trailblazer	+325 mmcf/d	(Cheyenne to MidContinent)
May 03	Kern	+900 mmcf/d	(Opal to NV/CA)
Nov 03	WBI	+80 mmcf/d	(PRB indirect to MidContinent)
Jan 05	Cheyenne Plains	+560 mmcf/d	(Cheyenne to MidContinent)
Jan 06	Cheyenne Plains	+170 mmcf/d	(Cheyenne to MidContinent)
Jan 08	REX	+1400 mmcf/d	(Cheyenne to MidContinent)
Jan 08	Cheyenne Plains	+70 mmcf/d	(Cheyenne to MidContinent)
Total		+3505 mmcf/d	

This added 3.5 B of capacity has been helpful but remains insufficient. While much of the added capacity is the result of the marketplace at work, I am convinced that the WPA has played a significant role in moving the marketplace forward.

I have also attached a chart provided by WPA providing information on nine projects under discussion in Wyoming. As your letter correctly observes, the timing of these projects is 2010 at the earliest. Again, the WPA has been an active part of the discussion surrounding these proposals. While everyone remains frustrated with the pace of the private sector marketplace decisions to develop pipelines, I believe we should continue to support the WPA role in moving those decisions forward.

I will attempt to provide some insight as to the questions you have presented. I doubt that I am providing you with any new information since we have all wrestled with these questions for

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many years. Early on in my first term, we activated and re-defined the Wyoming Pipeline Authority to work on these issues. I continue to look to them as the experts in the area.

Question 1: From your perspective, can you tell us what you believe are the consequences for Wyoming producers as the result of the lack of adequate pipeline capacity?

The most accurate answer to the question would come from the producers. The impact for producers is generally negative. However, it varies depending on the size of the producer. Large producers with contracted production who have pledged some portion of their balance sheet to "own" firm capacity suffer fewer negative consequences. Smaller producers who are either unable or unwilling to contract for long term firm pipeline capacity are most negatively impacted. And this impact can be severe. This is a very real problem for CBM producers who cannot shut-in production.

Question 2: Will you provide us with an estimate of the loss of revenue to the state as a result of the lack of pipeline capacity?

Clearly there is a serious negative revenue impact. Determining the amount is a forecaster's dream. Like most economic forecasts or calculations, it is entirely dependent on the assumptions employed in the projection. I have attached a paper from the WPA explaining their $500 million calculation and the assumptions they employed.

The difficulty I have in accepting the assumptions and the $500 million state revenue loss is what it means in terms of the private sector loss. The total of state severance tax rates, federal mineral royalties and local property taxes equals around 18 percent of value. For the state to be foregoing $500 million, the private sector would be foregoing approximately $2 billion of revenue net of royalties and state and local taxes. I have two observations. First this seems like a sufficiently large sum to motivate expedited producer attention to adding pipeline capacity. Secondly, these same producers continued to sell gas into this market at the prevailing prices. Assuming they are economically rational, it is hard to accept that they would voluntarily forego $2 billion in income.

There are questions about the interaction of markets and whether it is ever reasonable to expect a sustained one-to-one correlation between Henry Hub and Opal. The market is further complicated by individual producer decisions to shut-in production, enter long-term contracts or use their pipeline capacity for production from other states, notably Utah or Colorado. As the attached chart prepared by A&I demonstrates, the emergence of new capacity may have a short-term impact on the differential. But even this conclusion does not negate the fact that more pipeline capacity is better than less. The point being that no one, including the WPA, has formulated a strategy which allows us to draw a direct line between a particular state action and capturing hypothetical estimates of lost revenue.

Question 3 and 4: What initiatives are you aware of that may be effective in resolving this issue? Which of these initiatives would you support?

First, I think it is important to recognize the complexity of the gas market, the numerous players involved, the multi-state nature of this issue, the financial commitment required of commercial consumers, producers and pipeline companies to underwrite pipeline construction, the significant costs of construction and the lead time required to place capacity into service.

I continue to support those activities by this office, the legislature and the WPA which facilitate the operation of a free market economy. This includes actions such as encouraging certainty in resource availability, dissemination of market-clearing information and asking producers and commercial consumers to contract for pipeline capacity.

I remain skeptical both as a philosophical matter and in deference to the limitations imposed by the Wyoming Constitution about suggestions that Wyoming become directly engaged in the interstate natural gas pipeline business. The Wyoming Constitution established clear boundaries between governmental and private sector activities. The government should not try to compete in the private economy.

I have yet to meet with a pipeline company or a significant producer who advocates direct state involvement in the natural gas pipeline business. Even when the discussion arose about giving producers a severance tax credit for signing up for long-term pipeline capacity, the general response was they would be delighted to receive a tax break, but it would not actually change the decision horizon for a long-term commitment to pipeline capacity. The larger issue seemed to be assured access to the resource.

<u>Question 5: What support can we provide to assist in resolving these issues?</u>

Most of this is addressed in the prior discussion. I would add a couple of observations. First, I understand this is a frustrating issue for all of us in public life and for the producers. I am open to suggestions about added steps beyond the WPA's current activities. But most of these discussions reflect our frustration that the marketplace works slowly and at its own pace. Everyone agrees that more pipeline capacity is desirable. However, I do not support changing the Constitution and placing the State in the pipeline business either as owner of equity in the line or as guarantor/owner of long-term capacity in a line. Having stated my position, I also recognize that I may be wrong. I remain open to persuasion and to other proposals.

Best regards,

Dave Freudenthal

Dave Freudenthal
Governor

DF:pjb

Enclosures

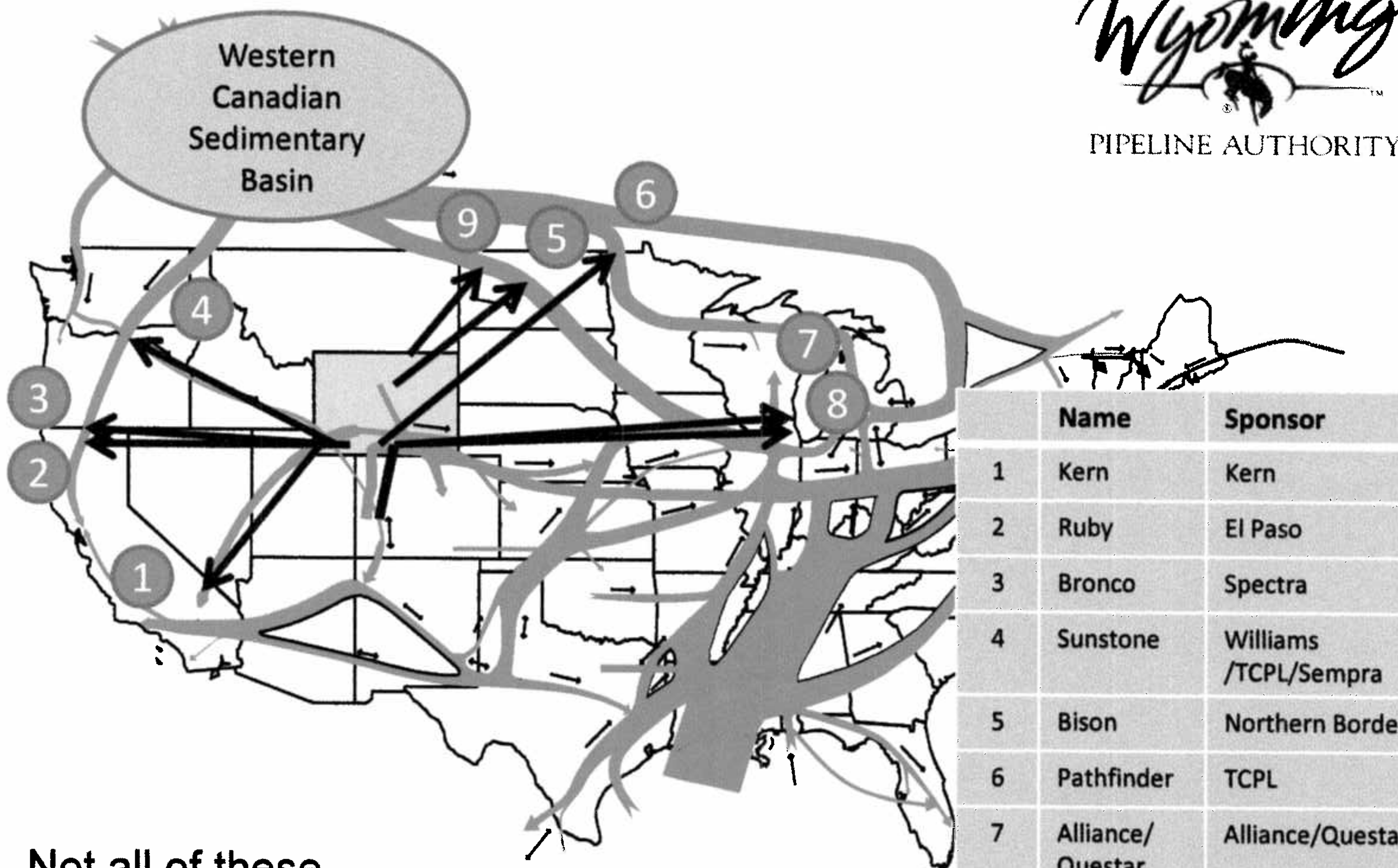
c: Senate Leadership: President John Schiffer, Senator John Hines, Senator Jim Anderson, Senator Ken Decaria, Senator Kathryn Sessions, Senator Mike Massie
House Leadership: Speaker Roy Cohee, Rep. Colin Simpson, Rep. Tom Lubnau, Rep. Ed Buchanan, Rep. Marty Martin, Rep. Debbie Hammons, Rep. Ross Diercks

Joint Minerals Business and Economic Development Committee: Senator Eli Bebout, Senator Stan Cooper, Senator Bob Fecht, Senator Bill Vasey, Rep. Bob Brechtel, Rep. Amy Edmonds, Rep. Floyd Esquibel, Rep. Elaine Harvey, Rep. Saundra Meyer, Rep. Lorraine Quarberg, Rep. Jeb Steward

Legislative Service Office

Proposed Additions to Capacity out of Wyoming

Wyoming PIPELINE AUTHORITY



Not all of these projects will be built

	Name	Sponsor	Capacity
1	Kern	Kern	145
2	Ruby	El Paso	1300+
3	Bronco	Spectra	1000
4	Sunstone	Williams /TCPL/Sempra	1200
5	Bison	Northern Border	405
6	Pathfinder	TCPL	1200
7	Alliance/ Questar	Alliance/Questar	1300
8	Chicago Express	Kinder Morgan	1200
9	Grasslands	Williston Basin PL	40

Current status of proposed pipelines that would increase export capacity from Wyoming. It is not likely that all of these projects will mature.

Map Key	Project Name	Project Sponsor	Origin	Destination	Size	Capacity (MMcf/d)	Target Date	Status
1	Kern Expansion	Mid America Holdings - Kern River Transmission	Opal	CA/NV	No pipe - compression expansion and pipe uprating only	145	Nov-10	Has been announced as a "go" project
2	Ruby	El Paso Corp	Opal	Malin at CA/OR Border	42	1300+	Mar-11	Has been announced as "moving forward". Pipe has been ordered, environmental work for FERC is ongoing, California PUC ruling on PG&E's request to be a shipper scheduled for October 2008
3	Bronco	Spectra Corp	Opal	Malin at CA/OR Border	42	1000	NA	Not being actively pursued
4	Sunstone	Williams/TransCanada/ Sempra	Opal	Stanfield, OR	42	1200	Nov-11	Reviewing results of recently completed open season. Sempra addition as a potential 25% equity partner and shipper for "significant" capacity is a recent development
5	Bison	Northern Border PL (TransCanada)	Near Gillette	Northern Border Pipline In ND	24	405	Nov-10	"In the final stages of negotiating shipper agreements." Hope to make announcement on project by end of third quarter 2008. Announced Anadarko as a foundation shipper for 250 MM/d
6	Pathfinder	TransCanada	Wamsutter	Emerson, Manitoba	42	1200	Late 2010 for first phase to Northern Border PL in ND, 4Q-2011 for second phase to Emerson	Reviewing results of recently completed open season where responses included conditions that must be evaluated. Recently announced that Enterprise (the operator of substantial gas processing plants in Wyoming and Colorado) is a 50% equity partner who wishes to take 500 MM/d of space
7	Alliance/ Questar	Alliance/ Questar	Wamsutter	Joliet, IL	42	1300	Late 2010	Continuing to market project and to expand upon responses received in recently completed open season. Continuing to spend development dollars to stay on track for a late 2010 start
8	Chicago Express	Kinder Morgan	Meeker, CO and Wamsutter, WY	Joliet, IL	42	1200	Oct-11	Continuing to market project and evaluate support
9	Grasslands Expansion	Williston Basin PL	Northern PRB	Northern Border Pipline In ND	No pipe - compression addition only	40	Aug-09	Open season completed in late July, no recent announcements

<u>Where did the $500 MM dollar amount that the Wyoming Pipeline Authority represents as revenue deprived to the State of Wyoming in 2007 come from?</u>

The WPA calculated the number in the following manner:

Total marketed production for Wyoming in 2007 was assumed to be an average of 5.4 Bcf per day. Marketed production is the amount of gas that is available for sale after field handling of the natural gas. Marketed production was taken as 90% of gross production of 6 Bcf per day.

The 5.4 Bcf per day of marketed production was apportioned as production from federal leases, state leases and fee leases. Those apportionments were 67%, 7% and 26%, respectively.

The actual basis differential for calendar 2007 was determined using the difference between the *Inside FERC Gas Markets Report Northwest Pipeline Index* and the corresponding NYMEX settlement price for each of the calendar months of 2007. Previous work using severance tax data shows a very strong correlation between changes in this reference price and changes in monthly severance tax data. This reference price is also routinely used in gas purchase and sale agreements in Wyoming.

The Rockies Express Pipeline ("REX") downstream of Cheyenne entered service in January of 2008. In order to compare the pre-REX environment of 2007 to the post-REX environment of 2008, we used the Northwest Pipeline Index basis differential for calendar 2008 that was trading in December 2007. The difference between the actual basis differential of 2007 and the post Rockies Express Pipeline differential for 2008 in the forward market was an improvement (decrease) in basis of $1.55. This improvement was attributed to the widely publicized status on the availability of the REX expansion.

The <u>combined state and county</u> revenues from ad valorem taxes, state royalties, the state share of federal royalties, and severance taxes were calculated at two annual average gas prices. The difference in the two annual prices was set at $1.55 per Mcf. The resulting calculations differ by $506 MM. That number has been referred to as "approximately $500 MM". A spread sheet with those calculations is available. The reference to county revenue is to recognize that the ad valorem tax collections in the calculations include that portion of ad valorem tax that is collected by the state on behalf of the counties in which production occurs.

The WPA uses the $500 MM figure to illustrate the affect of pipeline expansion on basis differential and consequently on state and county revenue. In this example, the statement is routinely made that "If we could magically turn back time and cause the Rockies Express Pipeline downstream of Cheyenne to have occurred at the start of 2007 rather than the start of 2008, then the State of Wyoming and its counties would have been collectively better of by $500 MM in 2007." This calculation is highly influenced by the change in the price differential that is attributed to a change in pipeline capacity.

Calculation of the change in combined state royalty, state share of federal royalty, ad valorem (including county share) and severance tax when price of gas is changed

Revenue Calculation using Original Annual Gas Price

Daily Marketed Production	5,400,000
Annual Production	1,971,000,000
Percentage Production from Federal Leases	67%
Percentage Production from State Leases	7%
Percentage Production from Fee Acreage	26%
Annual Price of Gas	$ 4.00
Severance Tax Rate	6.0%
Ad Valorem Tax Rate	6.6%
Federal Royalty	12.5%
State Share of Federal Royalty	48.0%
State Royalty	16.7%

		Wyoming share of Federal Royalty	Wyoming Royalty	Wyoming Severance Tax	Wyoming Ad Valorem Tax	
Production from Federal Acreage	1,320,570,000	$ 316,936,800	NA	$ 277,319,700	$ 305,051,670	
Production from State Acreage	137,970,000	NA	$ 92,163,960	$ 27,582,962	$ 30,341,259	
Production from Fee Acreage	512,460,000	NA	NA	$ 122,990,400	$ 135,289,440	
		$ 316,936,800	$ 92,163,960	$ 427,893,062	$ 470,682,369	$ 1,307,676,191

Revenue Calculation using revised Annual Gas Price

Daily Marketed Production	5,400,000
Annual Production	1,971,000,000
Percentage Production from Federal Leases	67%
Percentage Production from State Leases	7%
Percentage Production from Fee Acreage	26%
Revised Annual Price of Gas	$ 5.55
Severance Tax Rate	6.0%
Ad Valorem Tax Rate	6.6%
Federal Royalty	12.5%
State Share of Federal Royalty	48.0%
State Royalty	16.7%

		Wyoming share of Federal Royalty	Wyoming Royalty	Wyoming Severance Tax	Wyoming Ad Valorem Tax	
Production from Federal Acreage	1,320,570,000	$ 439,749,810	NA	$ 384,781,084	$ 423,259,192	
Production from State Acreage	137,970,000	NA	$ 127,877,495	$ 38,271,360	$ 42,098,496	
Production from Fee Acreage	512,460,000	NA	NA	$ 170,649,180	$ 187,714,098	
		$ 439,749,810	$ 127,877,495	$ 593,701,624	$ 653,071,786	$ 1,814,400,715

Total change in revenue attributable to change in annual price of natural gas ***$ 506,724,524***

Natural Gas Prices - Monthly Averages

($ per MCF)