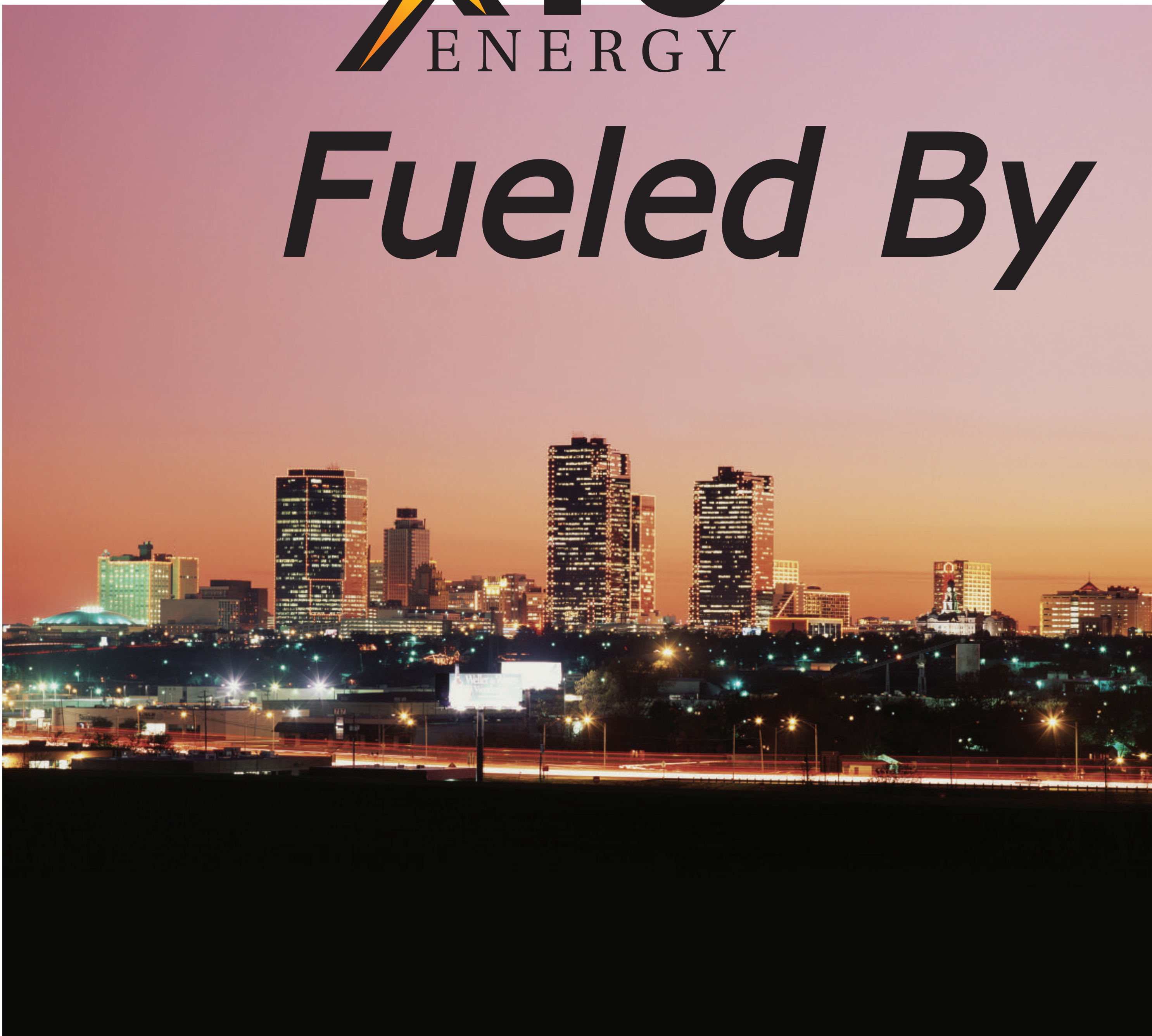
XTO ENERGY

Fueled By



Acquisitions,

XTO Energy Turns Corner To Organic Growth Strategy

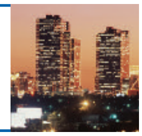
By Gregory DL Morris
Special Correspondent

FORT WORTH–On his first day as chief executive officer of XTO Energy Inc., Keith A. Hutton strode the halls of the firm's headquarters in downtown Fort Worth wearing an open-collared golf shirt, bright eyes, and a big smile.

It was early December and commodity prices were tumbling on the heels of yet more grim news on the global and national economic fronts. But Hutton was smiling in spite of it all, even on his very first day taking over chief executive duties from the only other CEO in XTO's history, company founder Bob R. Simpson (who continues to serve as chairman of the board), and surveying first-hand the inherent challenges of running one of the largest U.S. independent oil and gas companies.

He was able to smile, because as Hutton says, after growing largely through acquisitions since its inception in 1986 to become a "brand name" independent producer, XTO is now ideally positioned to flourish–even amid the up-and-down volatility that has come to define oil and gas markets in recent years.

"In these challenging times, the strength of our property base allows XTO to continue to create shareholder value through volume growth and strong economic margins," Hutton states. "With this managed growth strategy, the company expects to average utilizing 90 drilling rigs in 2009. Activities will include drilling 1,250 new wells and conducting 800 workovers."



And coming off a year in 2008 in which the company closed on more than $10.5 billion in acquired properties–the most it ever has spent on acquisitions in a calendar year–XTO Energy is following its buying frenzy with an aggressive hedging program designed to complement its new drill bit-focused growth strategy, according to Hutton.

"We use hedging to ensure a good return rate. For 2009, we have 77 percent of our projected production hedged at an average price of $10.77 an Mcf equivalent," he reports. "We also already have a significant amount of 2010 projected production hedged, and we will continue to look for opportunities to increase our hedge position going forward."

Major Growth Basins

XTO holds sizable positions in plays ranging from the Bakken horizontal oil trend in the Williston Basin (where the latest discovery on its 450,000-acre leasehold, the DeAngelis No. 41X-21 well, produced an initial daily rate of 1,750 barrels of oil equivalent at 2,200 pounds of flowing tubing pressure) to coalbed methane and multipay gas targets in the San Juan, Raton and Uinta basins (where it has identified more than 1,500 potential drilling locations). However, Hutton explains that the crown jewels in the company's inventory are six "major growth basins." Two of these plays are in full production, two are being accelerated, and two are waiting in the wings.

"There are other companies with one or two very good lease positions, but to have six going is unique," he says. "And these are right up our alley, where we have to find out how to fracture the rock better, drill wells faster, drill longer horizontals, and keep costs in check."

XTO continues to ramp up production in the Barnett Shale, a play the company entered in 2004 through a relatively small acquisition and has since become a leading producer. Hutton says XTO now controls 280,000 net acres and is running 20 rigs in the Fort Worth Basin. "The Barnett Shale accounts for 490 million cubic feet a day equivalent, or nearly 20 percent of our total production," he relates.

"The budget will let us keep our activity levels on par with 2008 levels. Combined with our hedging program and anticipated 18 percent growth in year-over-year production, we are actually forecasting record cash flow for 2009."

KEITH A. HUTTON
Chief Executive Officer, XTO Energy Inc.

To the east, the Freestone play in East Texas and northern Louisiana–targeting commingled production from the Cotton Valley Lime, Bossier, Cotton Valley sands and Travis Peak–is one of XTO's biggest success stories, according to Hutton. "We entered the region in 1998 through a $250 million acquisition, and now have more than 1 million net acres under lease and are running 40 rigs," he says, noting that the region is producing nearly 750 MMcfe/d and is expected to reach 1 Bcfe/d within the next few years.

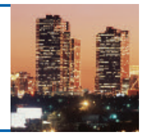
The two basins that XTO is counting on to carry the ball next are the Woodford Shale in Southeast Oklahoma and the Fayetteville Shale in Arkansas. On the bench, Hutton says, XTO has the Marcellus Shale in the Northeast and the Haynesville Shale in Louisiana, where it has begun drilling initial exploration tests.

Turning A Corner

For more than two decades, the art of the acquisition has been a hallmark of XTO Energy's growth plan. In the past five years alone, Hutton reports, the company has invested nearly $19 billion in acquisitions. It spent $624 million on acquisitions in 2003, $1.9 billion in 2004, $1.7 billion in 2005, $561 million in 2006, $3.2 billion in 2007, and a whopping $10.6 billion last year, including $4.2 billion to acquire Hunt Petroleum Corporation and $1.8 billion to buy 352,000 net acres in the Bakken Shale from Headington Oil, in addition to numerous smaller deals in core areas in the San Juan Basin and Marcellus, Woodford, Fayetteville Barnett, and Haynesville shales.

With those deals consummated, Hutton says the company has turned a corner in its corporate strategy. Where it once relied on internal expertise to acquire the best reservoir rock to grow reserves and returns, it now is applying its expertise to achieve strong organic growth from an asset base strategically positioned in high-return, unconventional resource plays characterized by long reserve lives and predictable production profiles, he notes.

"We expect to have 29 percent production growth in 2008," Hutton declares. "And that will come on the back of 19 percent production growth in 2007."



Throughout its history, acquisitions have been a hallmark of XTO Energy's growth plan. In the past five years alone, the company has invested nearly $19 billion in acquisitions. With those deals consummated, however, XTO is shifting its corporate strategy to leverage the drill bit to generate double-digit annual production growth from a large asset base characterized by unconventional resource plays with long-lived reserves and predictable production profiles.

That production growth taps total reserves of 11.29 trillion cubic feet equivalent at year's end, with 84 percent of those reserves gas and 16 percent natural gas liquids and oil. More importantly, Hutton says, the reserves are accessible: 66 percent are proven developed and producing (PDP), and 34 percent are proven but undeveloped (PUD). "That two-to-one ratio is a target for us between PDP and PUD, and we have maintained that ratio over the past several years," Hutton remarks.

Readily accessible reserves help keep development costs low, Hutton goes on. XTO's five-year running average for drilling and development costs are $1.34/Mcfe, he reports, while the five-year all-in (drilling plus acquisition) costs come in at $1.59/Mcfe. Third-quarter 2008 actual production was 2 Bcf/d of gas, 58,000 bbl/d of oil, and 16,000 bbl/d of NGLs.

From 1986 through 2007, XTO acquired 7.1 Bcfe of reserves and then added another 8.7 Bcfe in organic growth. And that, Hutton says, is XTO's key to success: savvy buying of reserves with the seeming contradiction of a proven production history but high value-adding potential. That usually means complex formations, but the payoff is a net for two decades of work that comes to 1.23 Bcfe of reserves added through the drill bit for every 1.0 Bcfe of reserves acquired.

Best Is Yet To Come

But the best may be yet to come, Hutton maintains, noting that XTO has identified 11.3 Bcfe of potential reserves that could be added over the next three to five years. If all those reserves come in as planned, it will translate to 2.82 Bcfe gained through the drill bit for every 1.0 Bcfe acquired.

"One of the traps we got ourselves into earlier in our history was buying properties that had good production, but were hard for us to grow from because they lacked a lot of upside. We did not want to be primarily an acquisitions company with development coming secondary," Hutton explains.

"What we have been able to do this time is layer old-line acquisitions such as Hunt Petroleum and the Headington Oil Bakken Shale properties with our existing leaseholdings," he continues. "The result is large acreage positions that are easy to grow from. It also means we no longer have to rely on acquisitions to add reserves, nor do we have to lean so hard on the Barnett and Freestone plays to fuel growth."

While market conditions make it unlikely that the company will be doing much shopping in the first half of 2009, the change in strategy does not necessarily mean XTO Energy is no longer a player in the acquisitions market should the right deal happen along, Hutton stresses.

"With the price of oil declining so quickly since the record highs last summer, there is a distinct reality gap between buyers and sellers," he says. "Those deals where both sides could agree easily have been made, but there are still a lot of questions about where prices are going and what constitutes a fair price for acquired reserves."

Hutton estimates that it will take at least six months for the downturn in the nation's economy and lower commodity prices to wash completely through the industry. "Buyers and sellers do not see eye to eye right now. A lot of potential sellers think prices are sure to rebound, so they are not going to sell reserves for $6.50/Mcf. They want $9.00/Mcf. And buyers are not going to pay that because they do not have any guarantees that prices are going to return to those levels anytime soon," he comments.

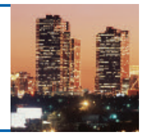
One factor that is not at issue is the nation's ongoing liquidity crisis. XTO has a standing policy of bankrolling its acquisitions strictly out of cash flow, so the freezing of credit markets is not an issue. Indeed, all the acquisitions the company made between 1986 and 2007 consumed only 74 percent of cash flow. "As long as we fund acquisitions with cash flow, there is really no difference between growing through acquisitions and growing through the drill bit," Hutton says.

Great Hand To Play

His first day on the job as CEO was admittedly a big moment for Hutton, but he insists that it was just another day for his company. "This is not a big change for XTO Energy," he assures. "We have been working under a team concept for many years, and I have worked with Bob Simpson since I came on at XTO as a young engineer of 28 or 29 years of age."

What is new to almost everyone associated with XTO, however, is the concept of adding reserves and ramping production without bringing in a new crop of acquired properties. "We really have been on a buying spree for the past two or three years," says Hutton. "We have grown from just one basin–the Freestone trend–to two when we went into the Barnett in 2004, and now we are in all the big shale gas plays. I have been given a great hand to play in my position as CEO."

To make that portfolio pay out, Hutton and his team have finalized a 2009 capital budget that mirrors 2008 spending, despite the fact that hydrocarbon prices have fallen sharply in recent months. Some $3.3 billion will be spent on development



and exploration, plus another $500 million on pipelines, compression and processing facilities (ownership of midstream gathering and processing assets in its core areas, as well as marketing its own production, are other key elements of XTO's operating strategy).

Those numbers are in the same ballpark as the 2008 budget of $3.5 billion for development and exploration, plus $600 million for pipelines, compression and processing. By area, the 2009 budget allocates $1 billion to the Eastern region, $800 million to the Barnett Shale, $500 million to the Arkoma Basin and Mid-Continent, $350 million to the Bakken and onshore/offshore Gulf Coast, $300 million to the Permian Basin, and $250 million to the San Juan, Raton, Uinta and Piceance basins. Hutton says another $100 million is earmarked for exploration projects in those regions.

At a time when many upstream companies are scaling back spending, XTO's ability to maintain a budget in line with last year's capital commitment is noteworthy, but not as surprising as estimated cash flows that XTO projects to be in the neighborhood of $2 billion this year, according to Hutton.

"The budget will let us keep our activity levels on par with 2008 levels, while allowing us to take advantage of organizational efficiencies and falling costs," he details. "Combined with our hedging program and anticipated 18 percent growth in year-over-year production, we actually are forecasting record cash flow for 2009."

Financial Flexibility

With that kind of cash flowing back into the company's coffers, it sets XTO Energy up for what could be another round of acquisitions somewhere down the line, Hutton maintains. "Trying to grow real hard into what for the moment looks like a lower-commodity price environment is not real smart. So we want to give ourselves as much financial flexibility as possible.

After achieving 19 percent year-over-year production growth in 2007, XTO Energy is expecting a 29 percent increase in production for 2008. And with a 2009 capital budget of $3.3 billion, which is in line with last year's budget, the company is targeting continued production growth this year, with plans to keep 90 drilling rigs running on average to drill 1,250 new wells, and to conduct 800 workovers.

Of the $2.0 billion in free cash we expect to generate from the $3.3 billion capital investment, about $1.25 billion will go toward debt reduction," he says. "The rest probably will be used to make acquisitions to give ourselves as much flexibility as possible."

At a time when the West Texas Intermediate price is in the $45 range and natural gas prices hover between $5 and $6 an Mcf on the New York Mercantile Exchange, having three quarters of its 2009 aggregate production locked in at $10.77 an Mcfe is a huge advantage that brings stability to XTO's capital program, despite a topsy-turvy market, Hutton notes.

In detail, Hutton says the actual numbers of the hedging program break out to 85-90 percent of oil production locked in at $118/bbl and 70 percent of gas production locked in at $8.83/Mcf. It is also worth noting that XTO has more than two dozen counterparties in the hedges. "In terms of counterparty risks, that is about as good a you can get," Hutton states.

But if it seems like all the heavy lifting has been done and the table is now set, Hutton says running dozens of rigs in multiple basins is going to make for a lot of very busy days. In fact, if anything, he suggests that the change from reserves acquirer to reserves developer will require XTO's management team to work even harder.

"Development was secondary while we were on this acquisition and leasing spree," says Hutton. "But now we are going to have to work harder to grow. We have a full boat. I do not think we are going to make any acquisitions for at least six months, largely because we have everything we can handle for the time being."

It is not the first time XTO has ventured down this path. "From 1997 to 1999, we bought a bunch of assets and then concentrated on development for a couple years, making only a few 'bolt-on' acquisitions in our core areas from 2000 to 2002," Hutton explains. "We are now repeating that pattern and returning to a development phase focused on attaining double-digit growth rates through the drill bit."

Good Economics

Looking to the future and its major growth basins, Hutton says XTO divides its six operating regions into three groups. The Freestone and Barnett Shale are fully developed, but still offer incremental growth, while the Woodford and Fayetteville are the focus of current development, and the Haynesville and Marcellus plays are targeted for long-term development. "All these plays have good economics," Hutton insists.

Spanning East Texas and northwestern Louisiana, the Freestone is XTO's largest producer, but still has a significant untapped upside, says Hutton. "We were resource before resource was cool," he quips. "In 2001, we produced 50 MMcf/d from the Freestone trend, and today we are making 750 MMcf/d. We should take that to 1 Bcf/d within two or three years. We have extracted about 4 Tcf from of this formation, but we estimate it has the potential for 10 Tcf, so we are still not even half way there."

One of the newest Freestone completions is the Beddingfield No. 6H, a horizontal Cotton Valley Lime well drilled in the Farrar/Bear Grass Field that is producing 8.0 MMcf/d. According to Hutton, the Beddingfield 6H offsets 5,500 acres of producing leases acquired in the Hunt Petroleum transaction where drilling activity will commence this quarter.

The Freestone also provides a prime example of another XTO differentiator: commingled production from multizone completions. "Conventional petroleum engineering theory tells you that to get every drop of production, you complete the deepest zone, produce that to depletion, then move up to the next zone, backing out of the hole," says Hutton. "The trouble is that wells are only semi-economic if you do that. By completing multiple zones, you essentially force all the production forward in time.

"We have found that the potential for losing reserves is overbaked," he adds. "Of course, it does not work everywhere. You need to be in the right zone. We are good at figuring out where to complete multiple zones and commingle the production."

XTO's 380,000 net-acre Fayetteville leasehold is producing 50 MMcf/d with seven to eight rigs working, says Hutton. "We plan to end next year producing 150 MMcf/d and have already signed agreements for firm transport of 450 MMcf/d," says Hutton, who points out that XTO has drilled and completed five Fayetteville horizontal wells with 4,000-foot lateral sections that are each producing average daily rates of 2.5 MMcf.

Current production in the Woodford is 40 MMcf/d, with five rigs working through 2009 on 160,000 net acres. The newest Woodford Shale well, the Churchill No. 1-26, has been completed and is producing 4.3 MMcf/day, according to Hutton.

Repeating Success

Hutton notes that XTO expects to repeat the same success in its Woodford and Fayetteville leaseholds that it has experienced in the Freestone trend and Barnett Shale. "Today, the Woodford and the Fayetteville regions produce 70 MMcf/d combined, and we hope to increase production to more than 1 Bcf/d over the next three or four years," he remarks. "If we can get each one to produce 500 MMcf/d, we will have created another Barnett or Freestone, and we hope to do even better than that."

In its Mid-Continent region, XTO is running five rigs on 450,000 net acres in the Bakken play, a level that Hutton says is sufficient to maintain current production levels. The focus of horizontal drilling is in the middle Bakken Dolomite, with work going on in the DeAngelis, Three Forks, and Sanish field areas. Hutton says XTO plans to bring a sixth or even seventh rig into the basin starting in 2010.

A legacy leasehold in Louisiana, combined with leases added through the Hunt Petroleum acquisition last year, give the firm 100,000 net acres of running room in the emerging Haynesville Shale. Although Hutton says activity is restricted by a lack of pipeline take-away capacity in XTO's lease area, the company has spudded its first horizontal Haynesville wells.

In Pennsylvania, meanwhile, drilling was proceeding on one vertical Marcellus Shale well in December with plans on board for a horizontal well in 2009. Hutton says XTO is planning its initial drilling locations in close proximity to pipelines to ensure ready access to market. "This is not just a science project," he ensures. "We are drilling these wells to be producers."

With crude oil trading in the $40/bbl range and natural gas under $6/Mcf heading into the new year, having three quarters of its 2009 aggregate production hedged at $10.77/Mcfe brings stability to XTO's capital program despite market uncertainties. The company has 85-90 percent of its oil production hedged at $118/bbl and 70 percent of its gas production hedged at $8.83/Mcf through an aggressive program that involves more than two dozen counterparties.

As with every other operator active in the Marcellus, Hutton says XTO is challenged by how to acquire sufficient water to stimulate the pay zone with massive hydraulic fractures, and then what to do with the water once it has been recovered from the well bore. "We are working hard to try to minimize the amount of water used in oil and gas operations," he states. "We are trying all kinds of things, including recycling the water to use in the next frac job. Disposal is likely to be by very deep injection wells."

Hutton also notes that Marcellus wells do not produce much water once they are completed, so it may be possible to set up a sort of daisy chain where the water from one well is used to frac the next well being drilled. "I see the Marcellus as a formation that will start to come in around the 2010-13 time frame," he holds. "We have signed five-year leases with five-year kickers, so we have plenty of time to develop our lease position."

Conventional Production

Aside from its position in unconventional resource plays, XTO maintains conventional oil and gas production operations from the shallow-water Gulf of Mexico to West Texas, and even to Alaska. "We bought the Alaska field from a major operator in 1998. It consists of two platforms that were built in 1964 to produce a tight oil formation with a shallow decline curve," says Hutton. "I think we paid $45 million for the property. At $100/bbl oil, it produced almost $100 million cash flow for us. In fact, it has paid for itself many times over, and it still is producing about what it was when we bought it 10 years ago."

XTO's San Juan Basin region is a large geographic area that includes both conventional and unconventional gas formations as well as coalbed methane in the San Juan, Uinta, Raton and Piceance basins in Colorado, Utah and New Mexico. "These are areas where we tend to have multiple productive horizons and stacked pay intervals," says Hutton. "As with the Freestone trend and some of the plays in our Mid-Continent region, it is not economical to produce one zone at a time in these wells. A good example is the Uinta Basin, where we are getting excellent wells commingling different zones in the Wasatch and Mesa Verde groups."

Although it is staking its future largely on gas shales, Hutton points out that XTO has an established history developing CBM projects in the Rockies. And as with low-permeability shales, hydraulic fracturing is vital to success in many CBM reservoirs.

"We cut our teeth on coalbed methane in the San Juan Basin after acquiring acreage from Williams Cos. in 2002. Before that it was owned by five other companies. The first company had used very large sand fracs, and each successor company used various lighter frac designs to try to optimize production," Hutton recalls. "We went back to the big sand fracs and refined the process to where we were able to take production from 20 Mcf/d-25 Mcf/d to 80 Mcf/d-100 Mcf/d."

The story was the opposite in the Freestone trend. "The first companies targeting the Freestone rendered production uneconomical by using huge frac jobs that pumped 2 million-3 million pounds of sand. Realizing that it was a tight formation, we knew we did not need highly conductive fracs, but fracture lengths to make economic wells," Hutton remembers. "So we came in with low-cost water frac technology and spent $100,000 to get good fracture lengths instead of paying three or four times that amount for an ineffective sand frac job."

Acquisitions Philosophy

Through the years, few staff members at any level of the corporate structure have been more integral to XTO's success than the personnel who find and evaluate acquisition opportunities. Tim Petrus, executive vice president for acquisitions, heads the division charged with that responsibility. He says the company follows a simple, yet selective approach.

"We tend not to buy scattered assets. We stay focused in our acquisitions by concentrating on assets that complement our existing operations while adding measurable upside to maintain a clean, high-value portfolio," he details.

That philosophy relies heavily on having the discriminative expertise to be able to quickly analyze all the geologic and economic factors that make a property a good buy for XTO, Petrus explains, and not simply taking whatever comes across the table to cherry pick a few select assets.

"We will occasionally sell some low-end assets that come with an acquired property package, but we would prefer not to buy low-end assets in the first place and only acquire properties where we have a high degree of confidence in being able to develop the upside," says Petrus.

One rule of thumb is to concentrate on areas with more complex geology, where previous operators may have missed entire play concepts, he adds. "We look at geology in great detail. For example, the overthrust belt in Oklahoma and Arkansas represents a great opportunity for us. But it also means a lot of work to properly analyze prospects because of all the geologic complexity," Petrus notes.

XTO invested $10.6 billion in acquisitions in 2008, including a $1.8 billion deal with Headington Oil to buy 352,000 net acres in the Bakken Shale in Montana and North Dakota–the largest oil resource play in the country. XTO estimates that the Bakken Shale properties held 68 million barrels of oil equivalent proved reserves at the time of the acquisition, and the company expects to more than double that figure through horizontal drilling, improved stimulation techniques and enhanced recovery.

Another rule is to stay ahead of the pack so as to be able to move early and aggressively to get deals done. "We always want to look way ahead to allow us more time to do the 'spade work' on acquisitions," Petrus relates. "Timing really is everything."

And right now, the timing is generally not good across the industry, he observes. "We expect 2009 to be pretty slow in terms of acquisitions, except for small bolt-on deals. There is a time lag in the market between valuations, and that uncertainty kills deals. We need a period of relative stability," Petrus states. "Producers are still putting together packages, but no transactions are going through."

That situation is likely to change sooner rather than later, he predicts, even if the broader economy does not start showing signs of recovery. "A lot depends on the status of the credit markets, but many producers will soon begin running up against lease expirations. So even if the economy remains depressed, I bet that by the second half of this year operators are going to start needing to raise drilling capital or risk loosing leases," Petrus says. "One way to access capital, even in a tight credit market, is to sell noncore assets."

And when the time comes, Hutton assures that XTO Energy will be ready to do deals if the right assets become available, although at least for now, the view from the sideline suits him just fine as the company sets its sights on organic production growth in 2009.

"We have always been an acquisitions company. It was through acquisitions that we went from essentially one growth basin in the Freestone trend, and then into the Barnett Shale, and now to all these other high-growth shale plays," Hutton concludes. "But we now have reached the point where acquisitions are no longer fundamental to growth. We have the biggest asset base in XTO's history, and our portfolio contains a lot of exciting resource plays that provide tremendous potential for growth through the drill bit." ❐