

CAPITAL COMMITTED IN SELECTED KEY DEALS

19 February 2009

Key Upstream Business Development Initiatives in 2008

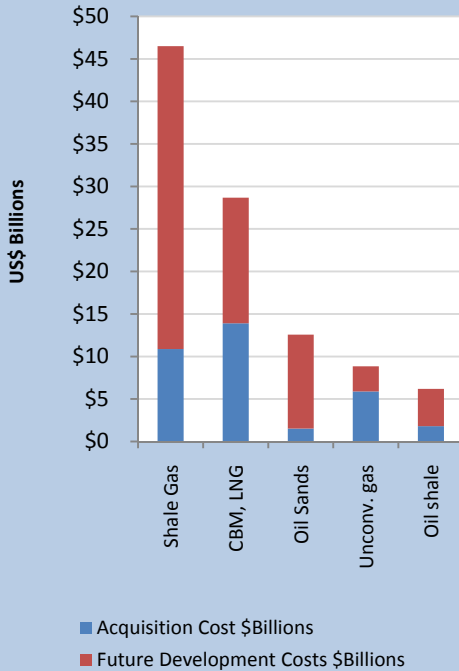
Summary of 2008 Trends

- A resource-based focus has emerged as a key element of a number of business development programs. This reflects the combined impact of several important drivers and business conditions on company strategies. The target in these programs is land positions which primarily offer access to not fully proven or producing resources.
- The distinction is important. Conventional mergers and corporate deals focus heavily on reserves and production. The success of such deals often hinges on cost management after the deal and future market conditions (oil and natural gas prices) that are beyond the buyer's control. For example, the success of ConocoPhillips' acquisition of the ARCO Alaskan assets is rooted in the fact that oil prices have been much higher than anyone expected at the time of the deal. In the same way, the post Burlington write downs reflect the opposite circumstances.
- Many of the apparently more traditional A&D deals in 2008 involved larger companies in transactions with relatively focused small and mid-cap companies. In these cases the driving force behind the deal is still the access to specific resources that the small or mid-cap target offers.
- At the same time many of the key recent deals have reflected a heavy parallel focus on farm-in activity to unproved acreage plus grass roots land acquisition through bidding rounds
- The Gulf of Mexico continues to be an area of intense interest and entry for non-US based companies. Farm-in strategies have resulted in significant moves by companies such as Ecopetrol and Maersk. Other companies such as KNOC have participated in lease sales
- Traditional economic drivers of mega-mergers between equals or near equals have diminished in importance. These traditional drivers include cost savings from combining redundant operations, exploitation of market valuation discounts and

A key deal is:

- *Indicative of a broader, market-wide trend that is likely to alter the game for competitors*
- *Signals a fundamental change in buyer or seller strategy with respect to capital allocation and strategy or meets an underlying critical need*
- *Reflects a fundamental shift in valuations or differences in valuation*

By Type of Asset



Some Key Conclusions

- Several of the global peer group of competitors have shifted and will likely continue to shift capital resources to unconventional resource plays in North America, Australia, and elsewhere.
- Recent events closed a number of doors. However, these events have also created an environment rich in critically important investment opportunities.
- However, these opportunities are best exploited through a more balanced business development program rather than mega-mergers.
- The widely held consensus favoring a project-focused business development approach has distorted strategy. A long overdue re-balancing is underway.

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acquisition of growth assets not otherwise available to the buyer

- A growing pool of potential buyers has developed. These buyers are searching for assets in targeted areas of operations. The deals are being undertaken in an environment of limited access in key parts of the world and increased competition.
- This pool has also been increased by significant moves on the part of national oil companies towards international E&P

Following a three-year period of heavy land accumulation, a large pool of likely sellers has emerged. These companies require large amounts of capital to exploit these land positions before they expire. In the current financial and industry environment, accessing this capital on a sole risk basis is often not a viable option for the land rich companies.

Reflecting all of the trends we have described here, the allocation of business development capital to traditional acquisition costs has fallen while potential future exploration and development capital costs have risen in importance. This reflects the more options-focused programs that buyers are pursuing and not, as some have suggested, a weak market for deals.

For a number of reasons we expect these trends to continue into 2009 and beyond.

This special supplement to On Point examines these trends and some of their implications for your company. We will use selected examples of what we believe are key deals to illustrate the process of change now underway in the business.

Focal Points of 2008 Key Deals

Figure 1 shows, for selected key deals in 2008, the capital committed to the initial acquisition and compares this to the estimated future costs associated with the exploitation of resources acquired in the deals.

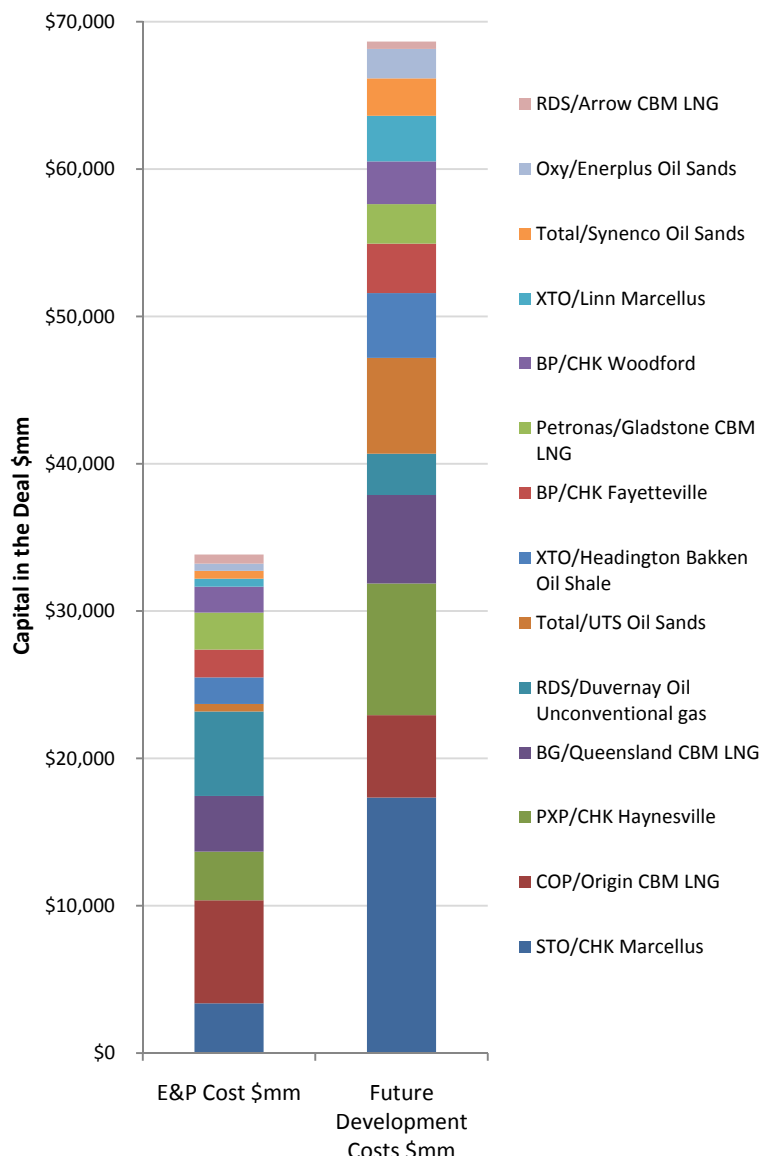
Due to data limitations, not all key deals can be shown. For example, future costs associated with ExxonMobil’s farm-in to the Mako Trough gas play or Black Sea

deepwater are not available. Nevertheless, the results are sufficient to demonstrate the key points we made in the introductory comments.

Capital Allocation

In reviewing industry business development efforts in 2008, several key questions should be considered. The obvious question is how much capital has been allocated to key deals? Beyond this, are there any clear patterns in terms of the types of new business

Figure 1: Capital Committed in Selected Key 2008 Deals



development assets being sought by buyers?

Are the transactions primarily being undertaken at the corporate or the asset level? Is there evidence of a geographic or regional focus on the part of the buyers? And, finally, are the transactions being dominated by any specific companies or peer groups?

How Much?

Fourteen transactions are evaluated in this study as examples of key deals and are representative of major classes of deals. Figure 1 compares direct acquisition costs with future spending commitments for the fourteen deals. Direct acquisition spending was US\$33.8 billion. Slightly more than two-thirds of direct acquisition costs are associated with five large deals.

When compared to the cost of conventional large scale mergers this is a relatively small amount. For example, the value of ConocoPhillips' December 2005 acquisition of Burlington Resources was announced at an estimated total cost of US\$35.6 billion.

However, the character of the deals in Figure 1 is fundamentally different. Only a few 2008 deals are corporate and none of these involve large, established legacy production portfolios. Instead, the deals in 2008 were more targeted at future investment opportunities. As a result, the estimated potential future capital spending associated with exploitation of the acquired assets is much greater than direct acquisition costs. Future development costs require another US\$68.7 billion in spending (67% of the all in costs of the transactions).

What?

The key deals of 2008 demonstrate an unambiguous weighting towards unconventional oil and gas resource plays and are part of a continuing trend over what is now a three-year period:

- Accumulation of oil sands assets by the large global competitors such as Total has spread to the next tier of companies. This includes Marathon's acquisition of Western Oil Sands in

July 2007 and, more recently, Occidental's acquisition of Enerplus Resources interest in the Joslyn Oil Sands project in June of 2008.

- Among the large global companies this resource play focus has extended to unconventional natural gas including coal bed methane, shale gas, and tight gas.

This resource play focus results in an important shift in potential acquisition capital resources away from the high up-front direct costs associated with traditional mergers and corporate deals. Instead a substantial portion of the capital that might have been spent on direct acquisition costs has been implicitly allocated to likely future costs of developing and exploiting the resource play acquired in the deal.

Where?

Reflecting the more limited access to new business development opportunities globally, a very large portion of the key deals in 2008 were in North America, Australia and Europe.

Deepwater operations have recently been an area of interest for a wide range of companies seeking to build their global operations. Anadarko's Gulf of Mexico portfolio rationalization program following the Kerr-McGee acquisition was a critically important source of asset deals (Statoil, Repsol YPF and BHP Billiton being major buyers) in 2007.

At the same time, companies have built significant land positions offshore Australia (Hess, Total and Inpex stand out) both through farm-ins and license round awards.

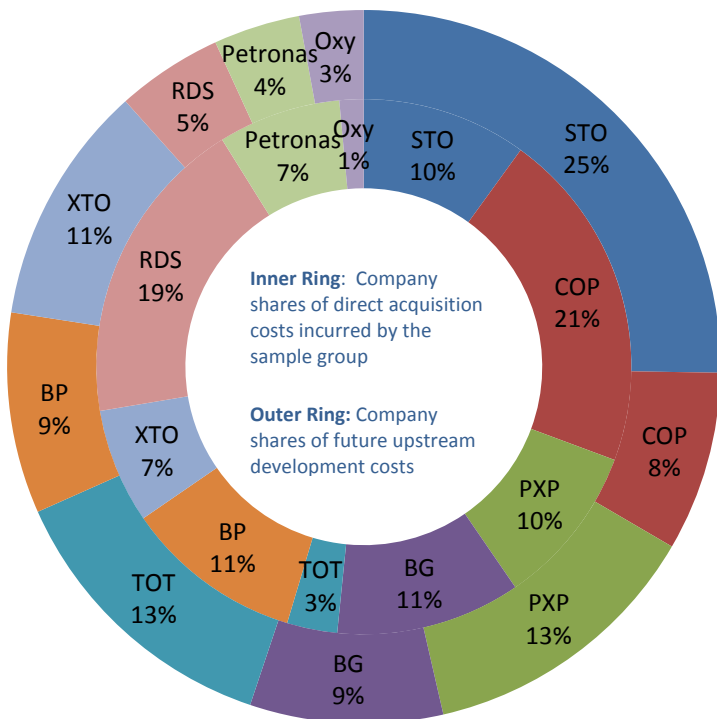
While the OECD has been an area of heavy activity, there have also been several key cases of interest in unconventional gas plays outside the OECD countries: BP in Oman, ConocoPhillips in the UAE, and EOG in China.

Who?

Figure 2 shows, for our sample, the relative shares of each company in capital expended on the initial acquisition (the inner ring) and future capital spending to exploit the acquired resource (the outer ring).

With the exception of Chevron and ENI, the large global peer group has been a driving force behind key 2008

Figure 2: Company Shares in Capital Committed to Key 2008 Acquisitions



deals. If we expanded the sample to include key 2007 deals ENI emerges as a major buyer (Dominion Resources Gulf of Mexico assets and the Congo assets of Maurel & Prom and Burren Energy).

The national oil companies and oil companies based in selected key consuming countries including Japan and Korea have also been active drivers of deals worldwide. As previously noted, sellers are overwhelmingly the small to mid-cap companies.

Selected Grass Roots & Farm-In Programs in 2008

For a more complete picture of the nature of business development programs in 2008 and the level of capital committed to these programs we must also consider the role of grass roots land acquisition programs plus the other secondary market mechanism: farm-Ins.

The data are more limited in a number of ways:

- A substantial portion of land acquisition costs are not reported on a comparable basis to conventional acquisitions. The best sources of at least roughly comparable data are competitive rounds involving a heavy weighting on cash signature bonus payments.
- The role of land agents often masks the amounts paid by the oil and gas companies.
- It is very difficult to attribute future spending obligations incurred as these are either not reported or they are not binding.

The timeline and graphic shown in Figure 3 identifies selected competitive leasing rounds and the total capital exposed in winning bids for selected rounds.

Over the period from October 2007 through end of year 2008 the industry committed US\$14 billion in bonuses in Brazil, the Chukchi Sea, the Gulf of Mexico and British Columbia. Of this capital budgeted to grass roots land programs, US\$11.7 billion was committed over the period from October 2007 through the end of March, 2008. That is, most of the funds were expended before the global economic recession and its impact on capital availability was fully evident.

The role of farm-ins is typically not accounted for in most analyses of the acquisition market.

Figure 4 incorporates grass roots land acquisition in selected competitive lease rounds and important farm in deals. The goal in Figure 4 is to highlight some important differences in the relative roles of acquisitions, farm-ins and grass roots programs in the capital allocation decisions of some leading competitors.

Figure 3: Capital Spent in Major Competitive Licensing Rounds

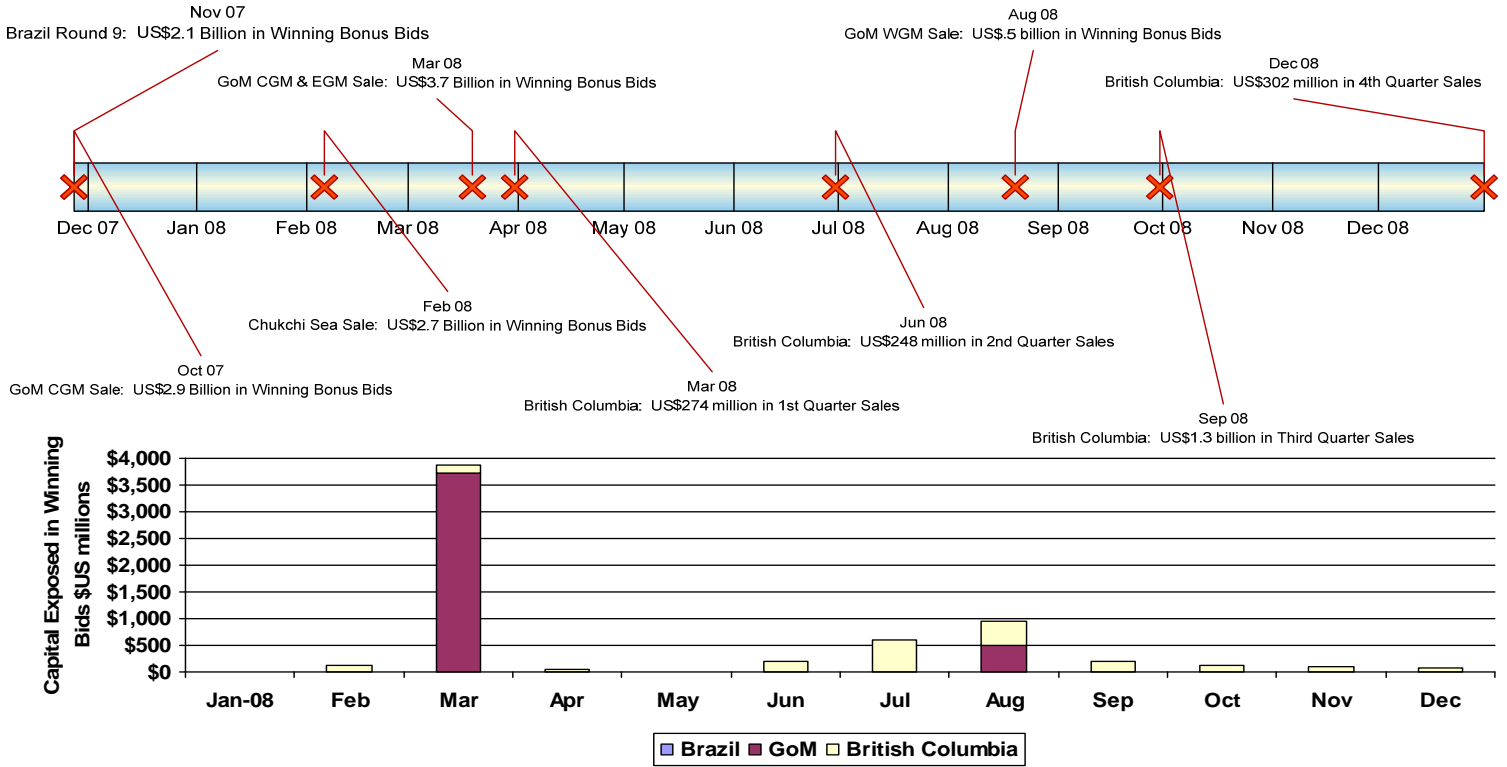
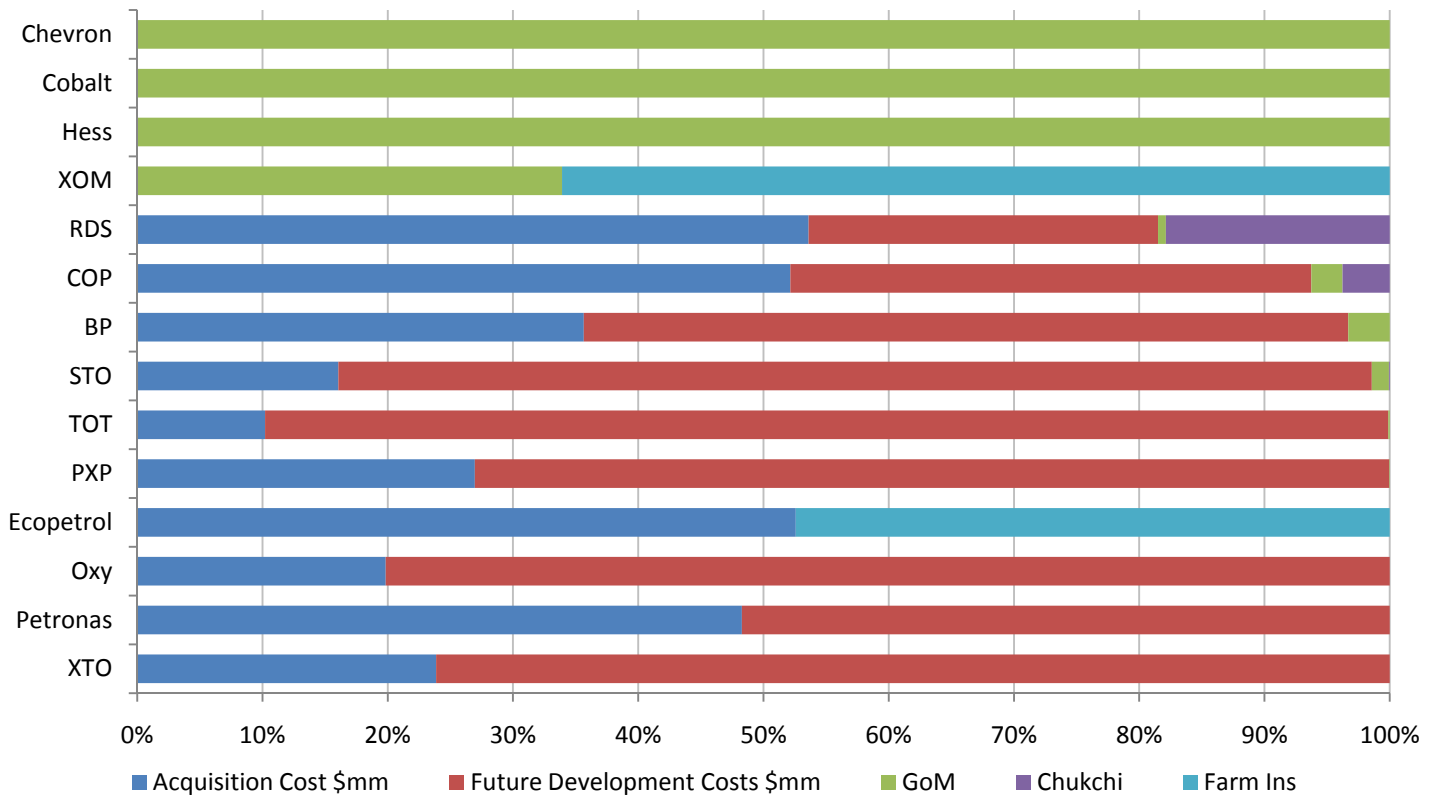


Figure 4: Comparative Budget Allocations by Method of Access in 2008



Note: Gulf of Mexico and Chukchi Sea costs are winning bids to acquire acreage in 2008 competitive rounds

The results tend to reinforce our earlier comments about the nature of the deal environment in the current stage of the industry business cycle.

With the exception of Chevron, Cobalt and Hess, Figure 4 shows that grass roots land acquisition in 2008 captured a relatively small portion of the total capital budgets among the leading competitors.

The very large role of future development costs is clear for those companies focused on targeted resource plays.

The internationalization of competition for growth assets in the Gulf of Mexico has been an ongoing, secular trend in business development strategies

- Key players that have driven this trend have been Statoil, Norsk Hydro, Repsol YPF, Petrobras and the Japanese
- More recent examples are Ecopetrol, Maersk, KNOC, and in February 2008, the GDF Suez farm in to ENI GoM acreage
- A common tactical pattern has been a blend of conventional acquisitions, farm ins (usually in the form of multi-block JVs), and in some cases participation in lease sales

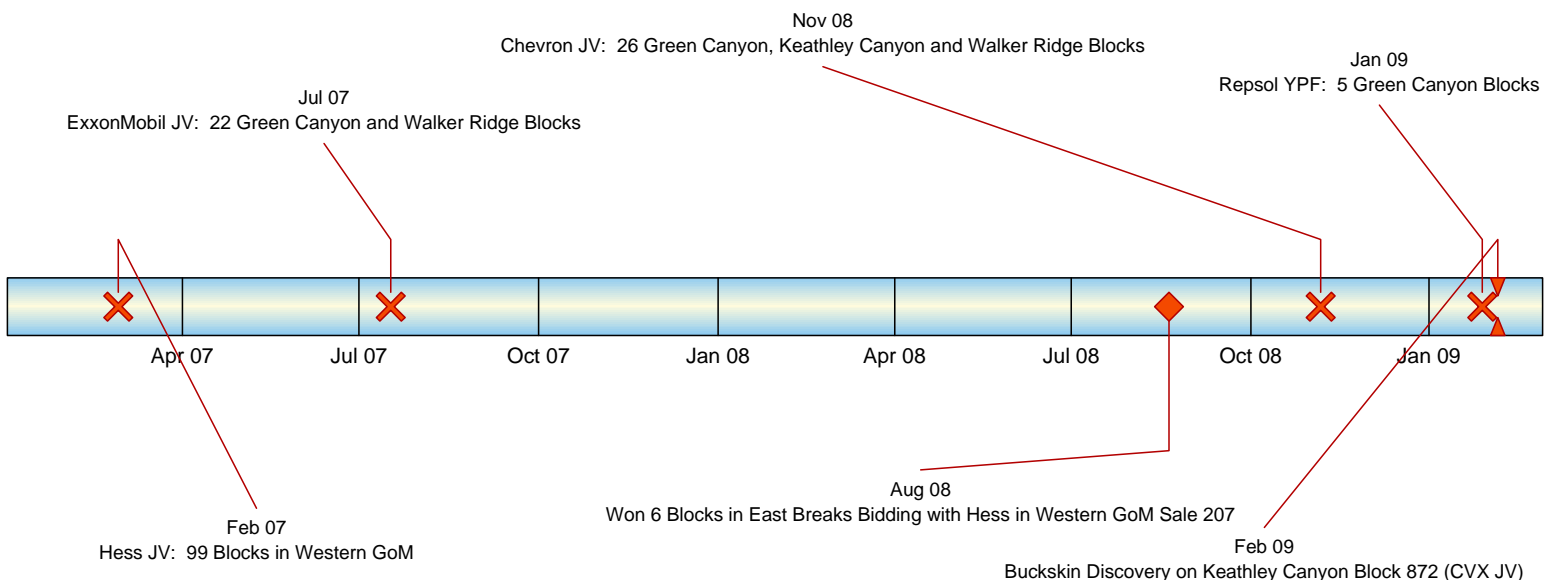
The Maersk program has not captured many headlines but merits specific attention here.

Figure 5 is a timeline of major moves and events in the Maersk program which dates back to early 2007. The pattern is very similar to that pursued by Statoil in its early program. Maersk's operations in the GoM have included four major farm-in initiatives with Hess, ExxonMobil, Chevron and Repsol YPF, in chronological order.

- The Hess JV is the largest and was supplemented late last year in a bidding JV that won six East Breaks blocks.
- The Chevron agreement included a number of blocks in Walker Ridge that supplemented positions acquired in the ExxonMobil deal. As a result of the Chevron agreement, Maersk also gained entry to nine Keathley Canyon blocks, including Block 872, the site of the just announced Buckskin oil discovery in the Lower Tertiary play.
- In addition, the Repsol YPF farm in increased Maersk interest in five Walker Ridge blocks previously entered through the Chevron deal.

Unlike many prior non-US-based entrants to the Gulf of Mexico, Maersk has not yet (1) made a conventional

Figure 5: A Timeline of Maersk's Program in the Gulf of Mexico



Note: X denotes farm-in joint ventures or acquisitions; the diamond is grass roots bidding in lease sale; the double arrow indicates exploration results

acquisition of producing assets or development projects or (2) made the transition to significant grass roots bidding in lease sales. The company's experience thus far reaffirms the long lead times confronting new entrants in the GoM and the necessity for multiple deals.

Ecopetrol has also entered the GoM through recent farm in agreements with Shell and Chevron. This is part of a broader program of international expansion by the company that has included bidding in Brazil and acquisitions in Ecuador.

The most recent example of the trend described here is provided by the GDF Suez farm-in to twelve ENI blocks. This deal is heavily weighted towards shallow water (only two blocks in water depths greater than 300 feet). GDF's strategy is still unclear.

Based on past experience of companies entering the GoM two outstanding issues should be noted. First, the recent entrants have not yet used conventional acquisitions as part of the building process. This is likely to change. Second, achieving a balanced GoM strategic position is difficult for the new entrants unless they are prepared to do acquisitions as well as farm-ins and grass roots bidding in lease sales.

The issue of balance is an important one and has been the rock on which many past programs have crashed. There have been many leading competitors in the deepwater GoM over the past two decades but few have sustained a leading position for long.

By balance we mean a spectrum of assets across multiple time horizons, avoidance of an over-dependence on only one play concept or assets at only one stage of development, and in terms of the capacity to profitably sustain initial gains through more near to medium-term exploration and exploitation as well as higher-risk, longer lead-time prospects.

Combined Results

Figure 6 compares leading competitors in terms of their relative share of business development spending in

three different categories as well as the combined total.

A broad cross-section of companies in the global peer group (StatoilHydro, ConocoPhillips, BP, Total, and Shell) were key drivers of competition. In most cases the large role played by these companies extended over all of the major activity areas considered in this report. We believe that ExxonMobil's role is considerably understated in Figure 5 due to insufficient data. The results shown do not include capital associated with its recent farm ins to deepwater Black Sea acreage. They also do not include estimates of potential future development costs associated with exploitation of the Mako Trough acreage (assuming the resource is proven viable).

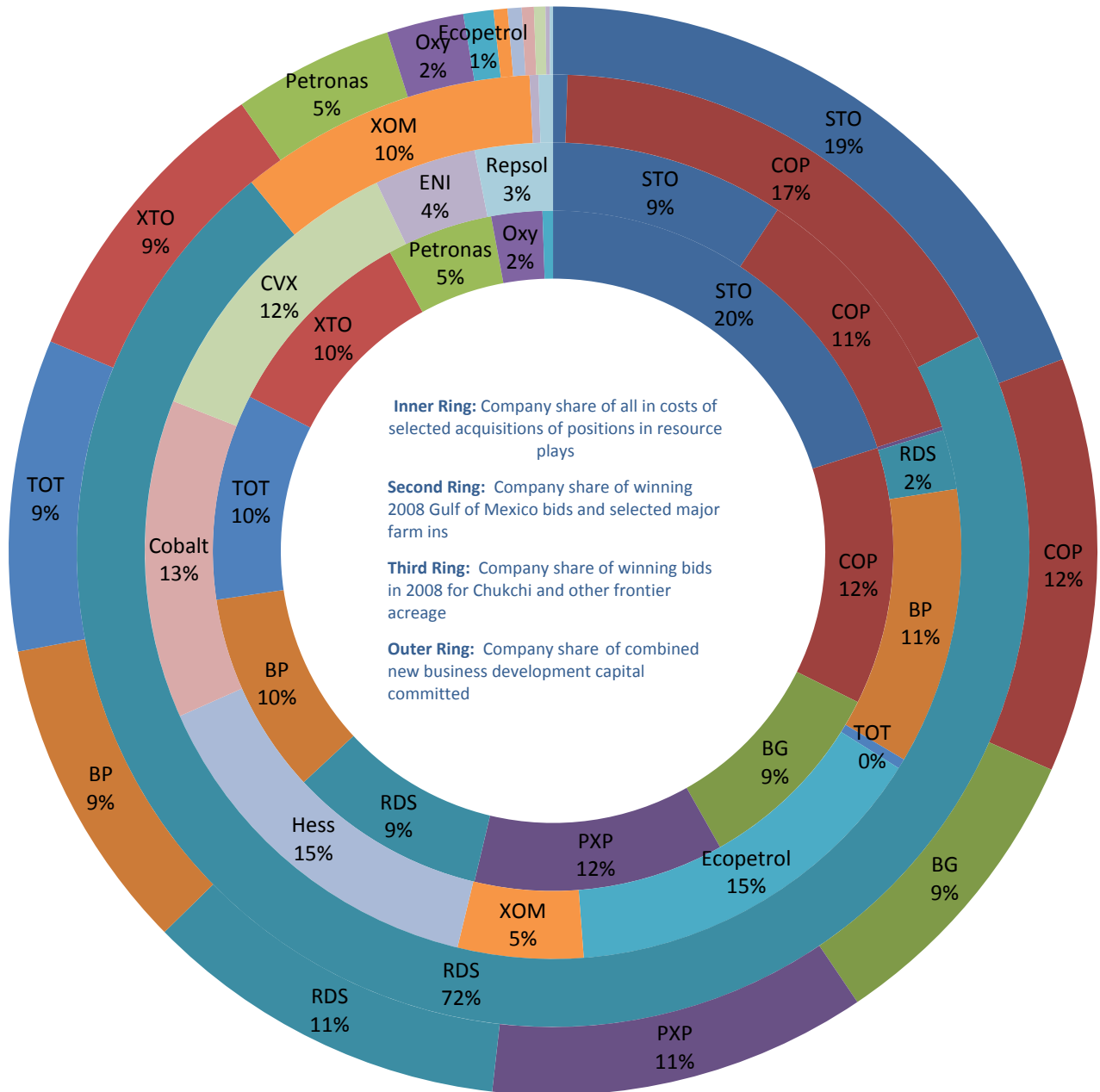
Plains Exploration and Production and XTO are worth noting since they are the only independents that figure prominently. This is, of course, a significant change from the pre-2008 period when many independents were prepared to commit very large amounts of capital to both acquisitions and land accumulation in major resource plays.

Note also, Cobalt's very large role in GoM bidding. This privately held company is funded from external equity sources. Private equity was a major new source of capital driving up bidding competition in the period leading up to the financial meltdown. Cobalt is only one example of companies that may be facing significantly reduced access to capital for future lease sales. Finally, National Oil Companies (or quasi-NOCs) also are significant. These include RepsolYPF, Ecopetrol and Petronas. Petrobras has receded somewhat into the background in 2008.

Outlook for 2009 & Beyond

In our view, the commonly cited reasons for the relative scarcity of mega mergers in 2008 miss the key point. At this point in time corporate cannibalism is not necessary to gain access to quality resource opportunities. Moreover, the traditional corporate deal is not the best means (in some cases it is not even a viable means) to the end.

Figure 6: Comparative Company Role in Defining Competition for 2008 Key New Business Development Areas



Why Corporate Mergers and Deals Have Played a Smaller Role

Throughout 2008 and still, as we enter 2009, the owners of unexploited resource acreage need capital if they are to realize the value of the land inventory. This need for capital is great at this point for two reasons:

- The land rich companies often cannot wait for better times to exploit the latent resources in their inventory

- Their invested capital in prior years' land acquisition costs is too great to lie unused and
- Growth requires exploitation

- Substantial portions of the acreage inventories of the land rich companies are not held by production and, therefore, are vulnerable to license expirations

Why Corporate Mergers and Deals are not Always the Best Way

The BP and StatoilHydro deals with Chesapeake highlight an important reason why we believe that corporate acquisitions are not the best tool for large global companies (or for that matter NOCs). BP or any of a number of large global companies could easily purchase Chesapeake in a corporate merger. This is especially true in the current economic environment. However, in the aftermath of any such acquisition it is a pretty safe bet that the human resources and skills currently working for Chesapeake will melt away, flowing to other independent producers. In other words a conventional merger will destroy a significant part of the capabilities the acquirer is seeking.

Another important thread running through 2008 strategies and deals should be noted. There is a very heavy emphasis on the OECD country resource plays and this emphasis is likely to continue as a major driver.

In part the OECD emphasis is traceable to the closure of new business development opportunities in many developing countries.

Resource nationalism has clearly been a factor and it is to be expected that the residue of recent resource nationalism persist well into the current economic downturn. However, there is more to it than that. The resource potential in the developing world is clear but the economics are problematic at best. Three key reasons are worth noting. First, fiscal systems in the developing countries are often poorly adapted to the realities of unconventional resource development. Second, there is a persistent and substantial policy preference towards discounting the value of natural gas in the domestic market. Third, export market access typically requires very heavy additional costs associated with gas liquefaction and, as a result, significant discounts in realized wellhead prices.

If limits on access to new opportunities are the only reason for the shift of capital into the OECD then this pattern of behavior may not last. Sustained low oil and natural gas prices will erode the capacity for governments in key countries (Russia and Venezuela

stand out) to sustain the effects of the latest round of resource nationalism.

However, in our opinion, limited investment opportunities in the developing world are not the only reason for the OECD emphasis.

- Unconventional resources (tight gas, shale oil and gas, oil sands, and coal bed methane) in the United States, Canada, Australia and possibly Europe offer world class resource potential due in large part to improved technology. Fully exploiting this potential will take many years.
- Also we believe that the OECD emphasis reflects an internal re-thinking of two long-held strategic misconceptions within the large global companies.
 - The first misconception is the long-standing strategic consensus among the large global companies that the upstream sector in North America is too mature and too competitive to be material to a large global company
 - As a result, in this strategic view of the world, the role of North America, Australia and Europe is primarily that of a consumer.
 - The corollary to this belief has been an often one-dimensional focus on the developing world for the future of the upstream segment.
- The second strategic misconception among the large global competitors has been a gradual but critically important distortion of the meaning of core areas, how they are built and their role in long-term success. The result has been an unambiguous shift in mind-set from core area building to an engineering and corporate finance-driven focus on mega-projects.

The essence of a core area and of the industry's collective experience since Drake's first well is two-fold: (1) an area of interest can be of core value if it offers repeatability of profitable investments over the industry cycle and (2) control of sufficient high quality land (resources, source rock, etc) is essential if the

benefits of economies of scale are to be captured.

A project-focused strategy with volumetric growth as a key metric of success, combined with the search for materiality, has caused an over-emphasis on projects. Despite companies' best efforts these projects are often one-off in nature so that the project focus is at the expense of building repeatability.

Total, in the 1990's, was the pioneer of this project-focused approach and of the strategy by which to gain access to projects. Driven by a desire to achieve parity with the global peer companies of that era, Total adopted volumetric growth as a central strategic goal of new business development. The tool for achieving this growth was negotiated agreements with governments in the developing world to develop existing world class reserves.

Total was extraordinarily successful in its strategy -- for a while. Mobil was an early convert to the approach and, ultimately, ExxonMobil's success in Qatar is traceable to Mobil's early positioning on top of the North Field resources. However, a wide range and growing number of the very large oil and gas companies have emulated Total over the last two decades.

Not surprisingly, Total's initial success was ultimately eroded away by the competition that success attracted. Indeed, we believe that this was recognized within Total and, in response, the company acquired PetroFina and Elf to build land positions in West Africa with more sustainable growth and re-investment opportunities than one-off projects could offer.

However, inside the major oil companies the project-focused approach as a surrogate for core area building has been dominant for far too long (and despite growing evidence of its inadequacies). For very good reasons the strategic misconceptions of the last decade or more are crumbling. The resource plays of the OECD countries are ripe for core area building.

Insofar as this is true, look for large competitors to

commit more capital to building in the OECD unconventional resource plays and for additional companies to join this strategic shift.