

ON POINT

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GORDON ENERGY SOLUTIONS

Candid, Forward-Looking Analysis of the Oil & Gas Industry

IN THE NEWS

Devon Sells Egyptian Assets – Devon is progressing its plans to substantially withdraw from international E&P operations. The company recently announced that it has sold its Egyptian operations to Dana Petroleum for US\$375 million. The company also announced plans to open data rooms for its West African assets this month. While Devon will continue to have operations in Brazil and China, these will be a relatively minor part of the now North American focused program.

China Balks at Iranian LNG Price – Sinopec announced that it will not continue negotiations to buy Iranian LNG due to the high cost of the project and the resulting price of gas.

Sinopec's position on pricing is reinforced by its recent announcement that the recoverable reserves at Puguang gas field in Sichuan province reserves are 12.6 Tcf with the company claiming the potential for that to double. The field is scheduled to begin operations by mid-2008.

The company anticipates spending US\$8.2 billion to develop the field and build a 1,700 km pipeline to carry up to 1.5 bcf/d. If Sinopec can meet its capital budget on the project, the roughly US\$0.65/mcf capital cost will be hard to beat with LNG. Based on the company's estimate of annual sales revenues, it anticipates generating roughly US\$6.12/mcf at the point of delivery.

Sakhalin 2 – As part of the deal allowing Gazprom to acquire a controlling interest in Sakhalin 2, the Russian government was issued a single nonvoting share that entitles the government to a profit share. If reports are true, the effect may be to circumvent the PSC terms by allowing the government access to a share of revenues earlier than previously agreed. This provision works to at least reduce the government's objections to the PSC's cost recovery provisions.

Pacific LNG – In Papua New Guinea, InterOil is evaluating a potentially world scale gas and condensate discovery at its Elk prospect. The company has speculated that reserves may range from 3 to 15 Tcf and could serve as the basis for a revived LNG export project.

Statoil Acquires Canadian SAGD Position

In a continuation of its program of aggressive growth and asset diversification Statoil announced that it will acquire 100% of North American Oil Sands Corporation (NAOSC) in a US\$2 billion all-cash deal.

NAOSC holds 275,000 net oil sands acres, operates 257,000 of those acres, and is planning an extended, phased program of Steam Assisted Gravity Drainage (SAGD) and two bitumen upgraders over the next ten years. Planned bitumen output is to rise from a 10 Mb/d pilot project in 2010 to a plateau of 200 Mb/d from multiple SAGD projects by 2016. NAOSC has a 100% interest in 97% of the acreage and

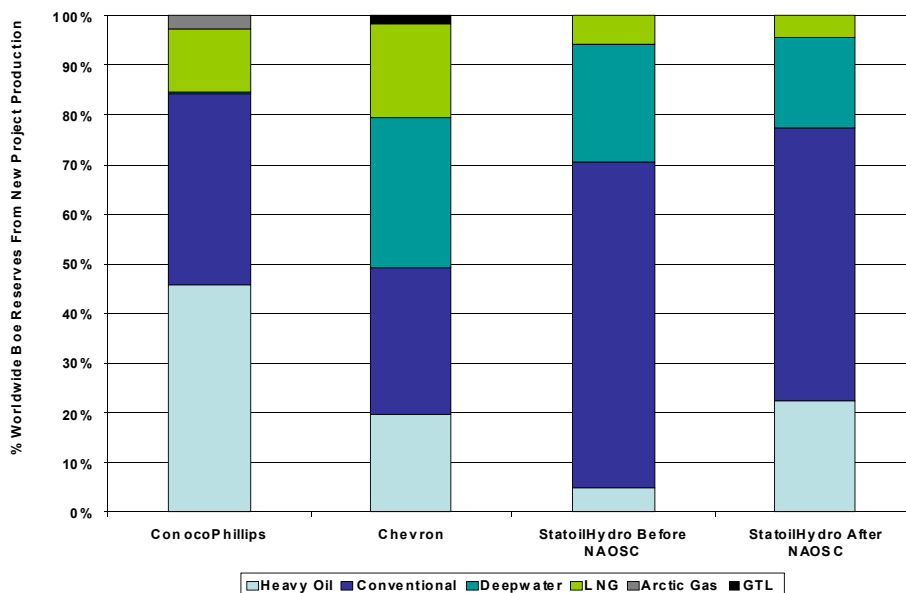
operates all but a negligible portion of the acreage.

Statoil estimates that the acreage has roughly 2.2 billion barrels of recoverable reserves. At less than US\$1 per barrel, the acquisition cost is quite low.

The NAOSC acquisition is significant for a number of key reasons:

- As shown in Figure 1, the deal balances the new project portfolio by significantly increasing the role of heavy oil in future production. In the process, the composition of StatoilHydro's new source production will be much more consistent with its peers.

Figure 1: Comparative Sources of New Project Output, 2007-2030 Impact of the NAOSC Acquisition on StatoilHydro



Note: Production forecast is based on the combined new project portfolio's of Statoil and Norsk Hydro.

Source: GES Peer Analysis Service, New Project Economics Reports

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Continued on p. 3

CONTACTS



Gordon Energy Solutions is an energy consulting firm specializing in competitor analysis, strategic decisions, political risk analysis, and global issues concerning the international, integrated oil & gas industry. We anticipate future opportunities and challenges confronting our clients and assist in exploiting those opportunities.

By integrating the corporate and financial dimensions of strategy and performance with detailed project level analytics, we maintain a unique approach to your business. GES provides value to our clients through our forward-looking, critical analysis and unique perspective.

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- In addition, the role of North American assets in future StatoilHydro output is substantially increased. The result is a more stable commercial base and a very considerable long-term upside potential.
- The oil sands assets also complement the company's deepwater position in the Gulf of Mexico.
- The phased nature of the program developed by NAOSC offers StatoilHydro a very substantial benefit. Specifically, the program (the scale of the project, timing and StatoilHydro's capital commitment) can be "managed" in response to volatile shifts in costs and markets.

Based on estimates provided by NAOSC, the cost of completing the planned investment program (including the construction of upgraders) will be roughly US\$10 billion in real 2007 dollars. This cost is split roughly equally between the SAGD and upgrader components of the plan.

An important outstanding issue should be noted. Like all oil sands projects, the StatoilHydro project will be an energy as well as a capital intensive venture.

More detailed analysis of StatoilHydro's assets and comparative evaluation with respect to its new peers is available through our Peer Analysis Service.

On the Cost Front

Last month we commented on the fact that key frontier sources of supply to the North American natural gas market are stalling out. As noted then, the problem is rooted in the combined effects of two different forces: (1) environmental and political opposition to new LNG terminals and (2) rising costs of key frontier projects such as Mackenzie Gas.

The impact of cost inflation extends throughout the worldwide industry. Recent news highlights the many impacts of cost inflation. Some examples are noted below.

LNG: Total's CEO announced that the Pars LNG project in Iran may be in jeopardy due to rising costs. The most

recent cost estimate is US\$10 billion. Meanwhile, China's Sinopec seems to have affirmed the project's problems when it announced that it will not purchase proposed Iranian LNG supplies because they are too expensive. The difficulties Iran is having in getting its gas export programs off the ground compound an energy sector problem that is rooted in the internal fuel subsidies.

Repsol also has announced project difficulties in Algeria. Specifically, it was announced that Repsol will absorb the costs of a two-year delay in start-up of the Gassi Touil LNG project in Algeria. Repsol reportedly attributed the delays to technical difficulties while Algeria's oil minister attributed it to disagreements over costs and a lack of subcontractors.

GTL: Following on the heels of Qatar's decision to shelve the ExxonMobil GTL project, Algeria was reported to be on the verge of dropping its previous plans for a 36 Mb/d GTL plant at Tinrhert. The problem was attributed to "soaring" costs as one of three bidders dropped out.

Frontier Gas: The Mackenzie Gas and the Alaskan Gas projects are not the only frontier gas projects facing cost problems. In the UK, potential development of gas reserves in the West of Shetlands area is looking doubtful.

The issue is being studied by an industry group that includes BP, Chevron, DONG, ExxonMobil and Total. A preliminary presentation by the companies suggested that development of the area's 2 to 4 Tcf of gas resources in multiple fields will cost upwards of US\$8 billion or US\$2 to \$4 per mcf. The project economics are considerably undermined by two factors. First, the reserves are scattered across multiple fields rather than in a single large field. Second, because the resources are scattered, significant infrastructure investments are required.

Recent declines in UK natural gas prices combined with cost inflation make it difficult to justify moving forward at this time.

The cumulative significance of recent cost inflation pressures is far larger than the impact on a particular project's economic performance. As multiple

world class projects are delayed or cancelled, the impact on future supplies of oil and natural gas takes on a macro-economic importance. This macro-economic effect has a tendency to get lost in the noise.

Put bluntly, as cost inflation chokes off supply (and as political and environmental opposition also limits entry of new supply) is it not increasingly likely that we have not yet seen the end of the recent price cycle expansion?

ENI Buys Dominion's Gulf of Mexico Assets

ENI announced on 30 April that it reached an agreement to buy Dominion's Gulf of Mexico assets for \$4.757 Billion (including \$680 million allocated for Dominion's exploration assets). The acquisition is costly both in absolute terms and relative to other deals. Based on data released by ENI, the estimated per boe cost of the reserves acquired in the deal is US\$18.75. This estimate is after eliminating the estimated US\$680 million paid for Dominion's exploration assets.

ENI has been active in the deepwater GoM for some time. Its efforts have included two major acquisitions: (1) a purchase of the Macaroni and Europa development assets from Shell in late 1999 and (2) the acquisition of British Borneo in early 2000. In addition, the company participated in a very large farm in agreement with ExxonMobil.

Despite substantial investments what ENI has not yet been able to do is to establish a sustainable GoM business that materially contributes to its global strategy.

Dominion has been an active and generally successful competitor. What does ENI get in the deal? Can ENI build from this deal to achieve a sustained growth position in the deepwater GoM?

Figure 2 shows the GES forecasts of ENI and Dominion deepwater production. The positive near-term impact of the deal on ENI output is clear with Dominion output in 2007 expected to be more than triple ENI's output.

Key new projects acquired by ENI include Independence Hub and Thunder Hawk which are under construction as well as the future developments of Thunder Bird, Thunder Ridge, and Claymore which are in the Concept phase.

However, a substantial portion of the assets purchased are legacy positions and within the next few years will begin their decline. As these steep declines inherent to the

deepwater Gulf of Mexico begin, ENI will be faced with the challenge of replacing that production. In short, Dominion's projects only give ENI limited breathing room before the production replacement problem re-emerges but, this time, at a higher level.

Figure 3 looks at the impact of this acquisition on ENI's acreage position. As shown here, in excess of 50% of ENI's existing deepwater acreage portfolio is scheduled to expire this year with other major losses looming in a few years.

Dominion clearly brings significant additional acreage to ENI, especially acreage that is not scheduled to expire soon.

Figure 2: Gulf of Mexico Deepwater Production

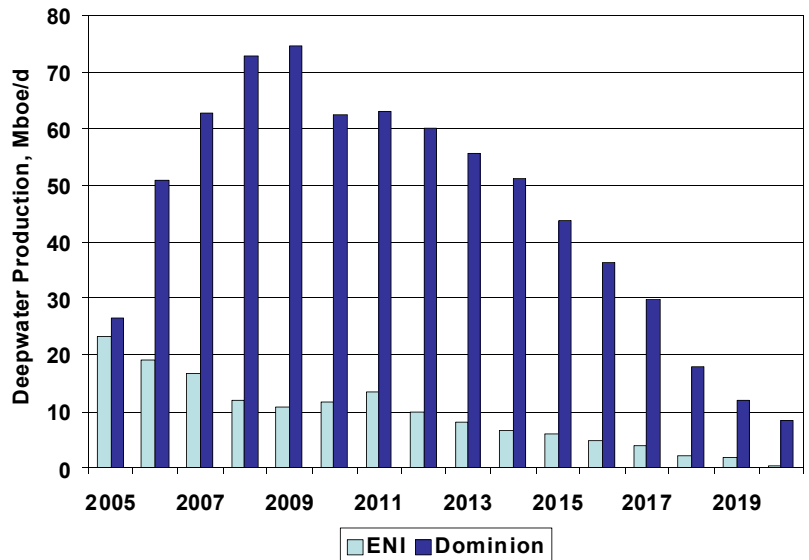
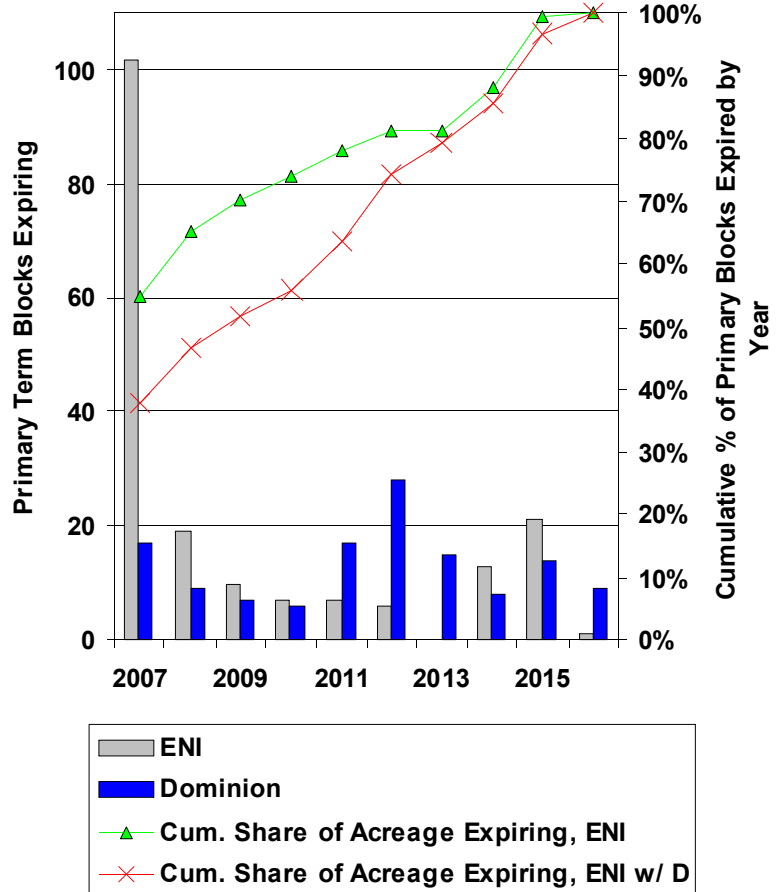


Figure 3: Deepwater Primary Term Blocks Expiring by Year And Cumulative Percent of Current Inventory Expiring



Source: MMS, GES Gulf of Mexico Lease Database

OPERATING COST UPDATE



2005 vs. 2006

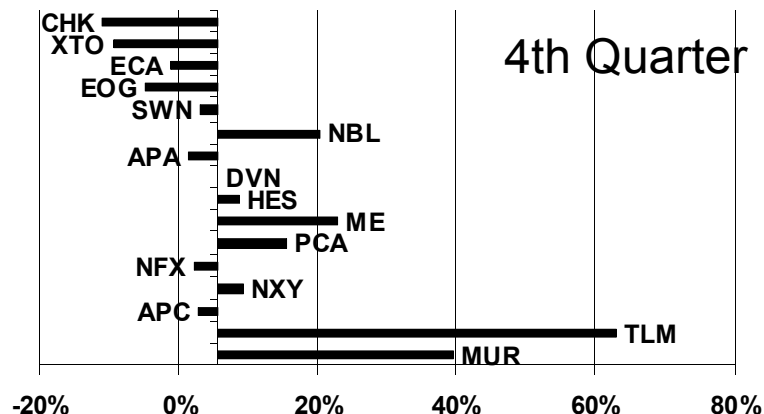
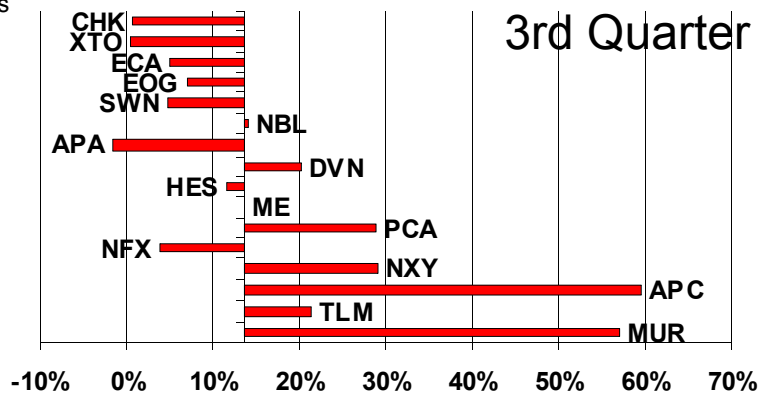
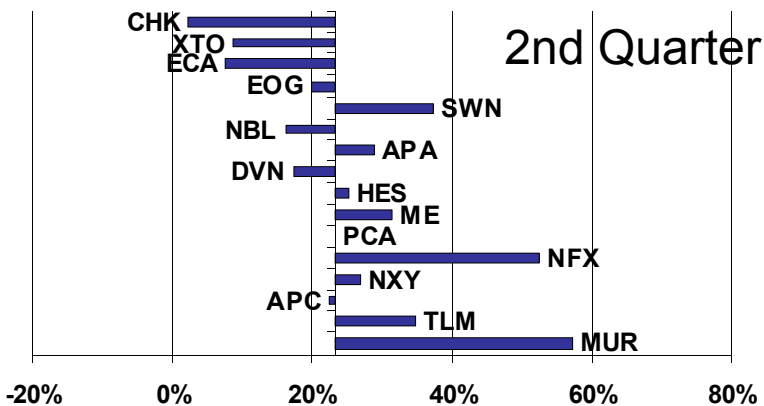
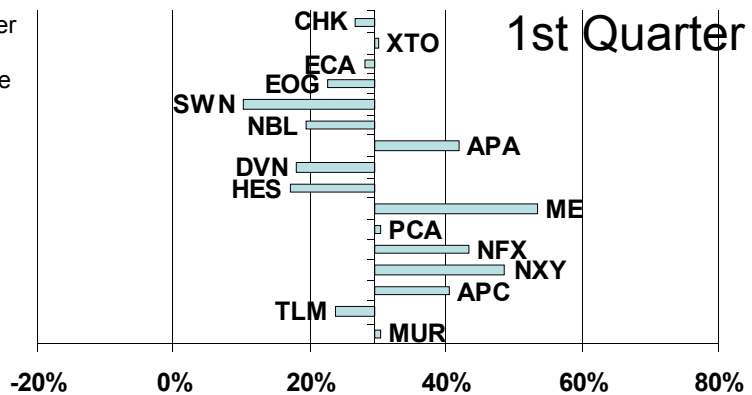
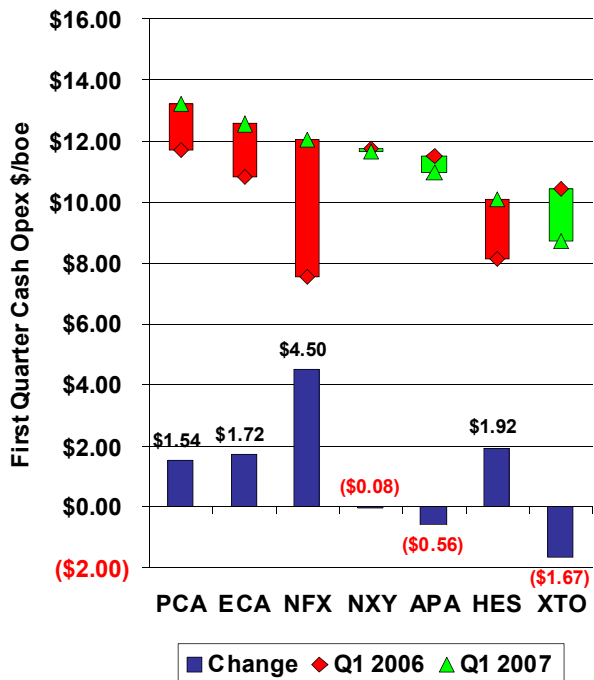
The graphics along the right hand side of this page show, by quarter, estimates of the rate of inflation of cash operating costs per boe produced for a group of companies in 2006. In each graph 2006 cash costs for that quarter are compared to costs in the same quarter in 2007. In each graph the axes intersect at the median inflation rate for that quarter.

Several important facts emerge from the results.

- Very strong inflationary pressures existed over most of 2006
- These pressures were not uniform for all companies and the timing of cost increases tended to vary somewhat as well
- While strong, cost inflation measured by the median for the group of companies tended to become less severe as the year progressed and, by the last quarter, a few companies actually posted some relatively modest cost deflation. This is consistent with the results shown in the producer price index data that we regularly follow.
- The median inflation rate for the total sample of companies in 2006 was 15.7%

Companies with very large North American natural gas positions tended to report less cost inflation and also tended to be among those companies with falling costs in the last quarter. One likely reason for this is that a substantial portion of cash costs consist of non-income based taxes that tend to be positively correlated with prices. Hence, as North American natural gas prices fell, the cost pressures tended to be reduced.

Preliminary first quarter 2007 data are becoming available and will be published next month. Some initial results for seven companies are shown below. Some companies are posting cost reductions (Nexen, Apache, and XTO). However, it is somewhat surprising that other companies are demonstrating continuing and significant cost inflation pressures.



COST WATCH



First quarter 2007 results point towards continuing high, but stable, tubular steel prices. Both US Steel and Ipsco reports show the same result.

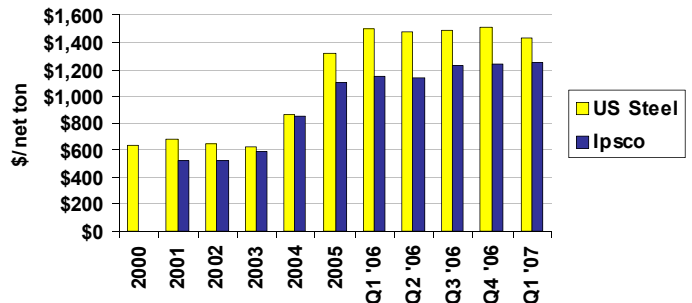
While the current stabilization of steel is a positive factor, the continuing high price level suggests that steel costs are unlikely to do much to cut industry project costs any time soon.

March Producer Price Indices

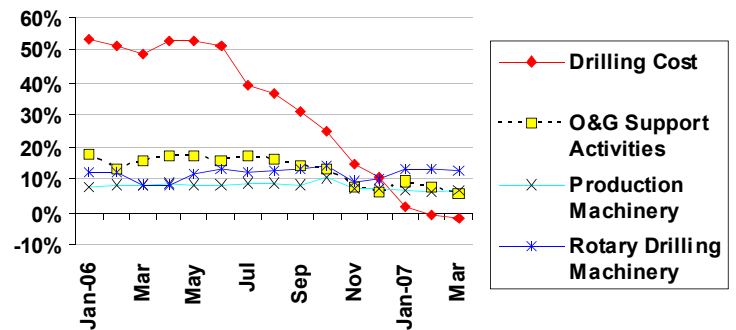
Drilling cost inflation rates have declined steadily through the last six months and has actually fallen compared to 2005 in both February and March of 2007.

The rate of inflation of oil and gas support services has also declined substantially in recent months: down from a nearly 20% rate through July or August 2006 to less than 10% in the first three months of 2007.

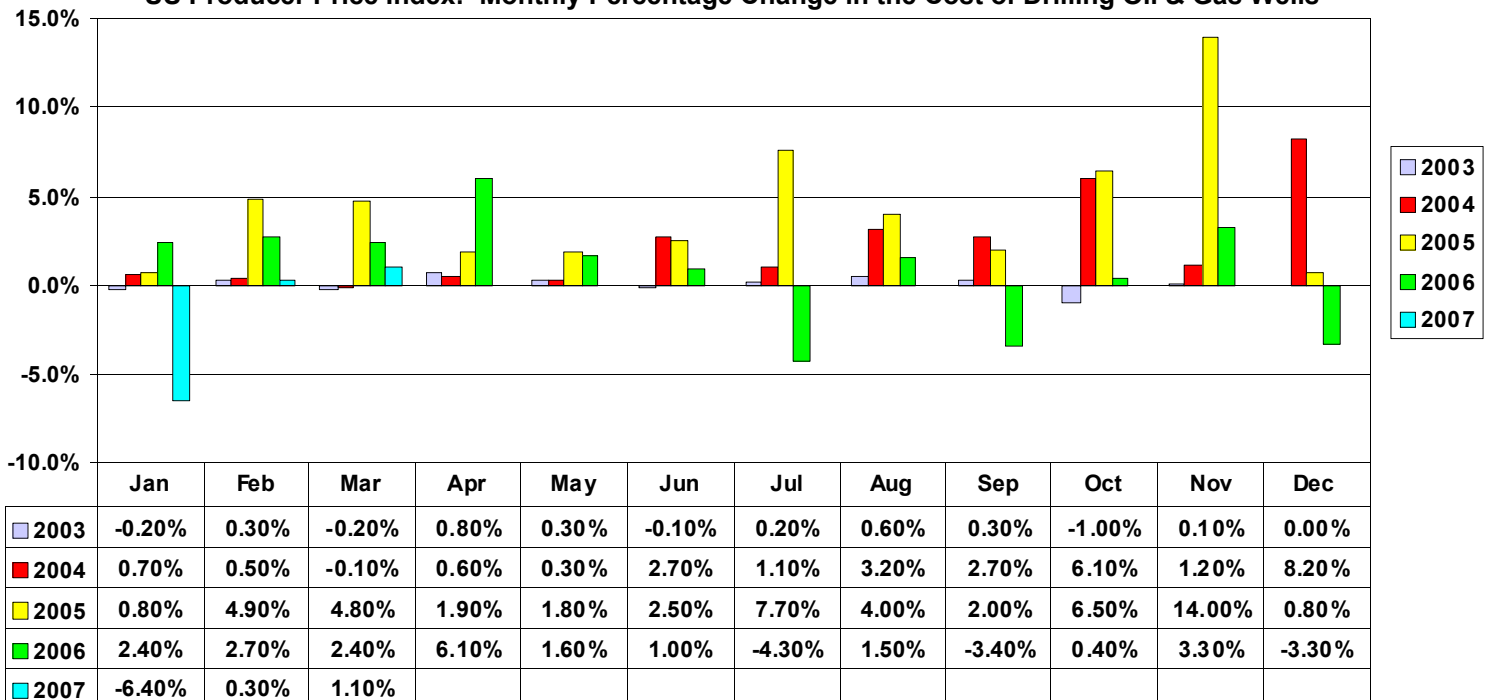
Tubular Steel Products Price



Annual Inflation of Selected Industry Costs



US Producer Price Index: Monthly Percentage Change in the Cost of Drilling Oil & Gas Wells



Year over Year Percentage Change

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2005	27.2%	31.7%	36.5%	37.8%	39.4%	39.2%	45.8%	46.6%	45.9%	46.3%	59.1%	51.7%	43.2%
2006	53.3%	51.1%	48.7%	53.0%	52.7%	51.3%	39.2%	36.7%	31.3%	25.2%	14.5%	10.4%	37.7%
2007	1.6%	-0.8%	-2.0%										