

Key Conclusions

- Note: Throughout our discussion, deepwater includes blocks with minimum water depths greater than 1,500 feet
- Bid low and bid often.
- In the current economic environment it is likely that (1) the number of competitors for deepwater Gulf of Mexico (DW GoM) acreage in Sale 208 will be down from last year and (2) bid budgets of those companies staying in the game will be cut. There was already evidence in 2008 of companies being “priced out” of the competition.
- Look for many of your competitors to reallocate much of what is left of the bid budget towards a small number of the top valued blocks.
- An important likely result is that winning bids will be significantly lower than last year. The bid distribution is likely to be considerably lower. But the reductions could be most heavily felt blocks in the mid-value range rather than at the top of the distribution.
- A low risk bidding strategy has been pursued for some time by selected competitors in the DW GoM. This strategy, which we call swath block bidding, focuses less on the top valued blocks available and more on the next tier (roughly 50th to 90th percentile blocks).
- Such a strategy, applied in Sale 208, is likely to yield considerable success.

16 March 2009

Competitive Outlook in the Deepwater Gulf of Mexico Central Sale 208

Central Sale 208 will be an important test of how company expectations and strategy are responding to the current economic situation.

There is good reason to believe that many companies will significantly scale back their bid budgets in this sale

- Capital and exploratory budgets are being cut at most of the companies that have historically driven competition for deepwater acreage in the Gulf of Mexico.
- A broad cross-section of competitors has increased acreage holdings significantly and, in so doing, have alleviated demand side pressures due to expiring acreage from prior years
- In 2008 a number of companies

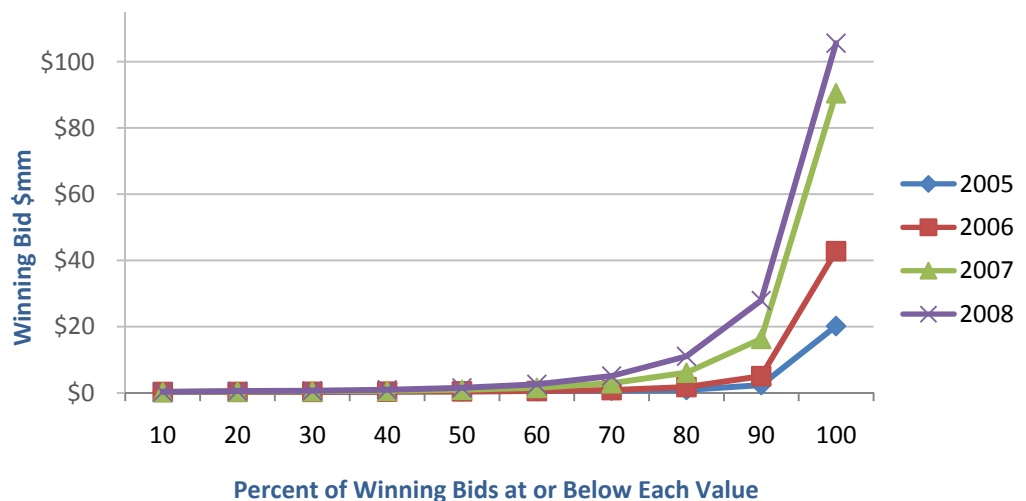
showed clear signs of balking at the run-up of acreage costs in prior sales

Sale 208 offers a low risk opportunity to pick up substantial acreage at a low cost. Our recommended bidding strategy for Sale 208 is simple: Bid low and bid often. More on this later.

Where We Are

Over the past four years there has been very significant inflation in the cost of winning acreage in MMS Central Gulf of Mexico (CGM) lease sales. This is illustrated in Figure 1 which shows the percentile distribution of winning bids by year. The winning bid on the highest valued block doubled between 2005 and

Figure 1: Percentile Distribution of Winning Bids in the Central Gulf of Mexico Sales, 2005-2008



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Richard Gordon, Ph.D
President & CEO
(913) 451-9539

Steve Gordon
Vice President
(913) 451-9539

2006 and then doubled again between 2006 and 2007.

It is significant that these cost inflation pressures spread to lower percentiles over the past three years as well. In fact, percentage increases in winning bids were much greater in the 50th to 90th percentile ranges in 2007 and 2008. This can be seen from the thickening of the left hand tail after 2005.

In effect, competitors have been raising the bets required to “stay in the game” for a very broad spectrum of blocks, not just the top targets. One reason for this is shown in Figure 2 where we compare the number of bidders in each year to the number of bidders that increased their bid budgets compared to the prior year. The number of companies competing for deepwater acreage rose significantly from 36 companies in 2005 to 47 in 2006 but then dropped to 41 and 43 companies in 2007 and 2008, respectively.

New entrants like Cobalt International, Maersk, and KNOC were partially offset by exits from the competition due to mergers and acquisitions (Kerr-McGee, Dominion Resources, Spinnaker, and Norsk Hydro) or due to strategic decisions to withdraw (Pioneer Natural Resources).

Much like the percentage changes in the bid curves shown in Figure 1, the percentage of competitors that increase their bid budgets in each year is an indicator of

competitive momentum in the lease sales. In other words, as the bid curves in Figure 1 move upward companies must (1) increase their budgets if they are to achieve the same success rate as in prior sales or (2) must focus more of the budget on fewer blocks of particular interest.

Another group emerged as a major factor in defining the competition. This included a group of companies (ConocoPhillips or Marathon are two good examples) that have been DW players in the past but have been relatively minor competitors for acreage for some time. These companies implemented major increases in their bid budgets after 2005. These companies plus a large number of regular bidders in the MMS sales were an important factor in 2006 and 2007 as they increased their bid budgets compared to the prior year level.

The percent of DW bidders increasing their budgets on a year to year basis was 79% and 93% in 2006 and 2007, respectively. However, by 2008 this support under acreage values fell to 56% of the competing companies. When this sort of a drop occurs it suggests that a growing number of companies are not prepared to pay the prices being commanded. We believe that it is very likely that another drop in this indicator will occur.

Table 1 identifies the years in which companies increased their DW bid budgets. Three groups are identified based on the number of years they increased their budgets.

Figure 2: Shifts in the Pool of Companies Competing for Deepwater Gulf of Mexico Acreage

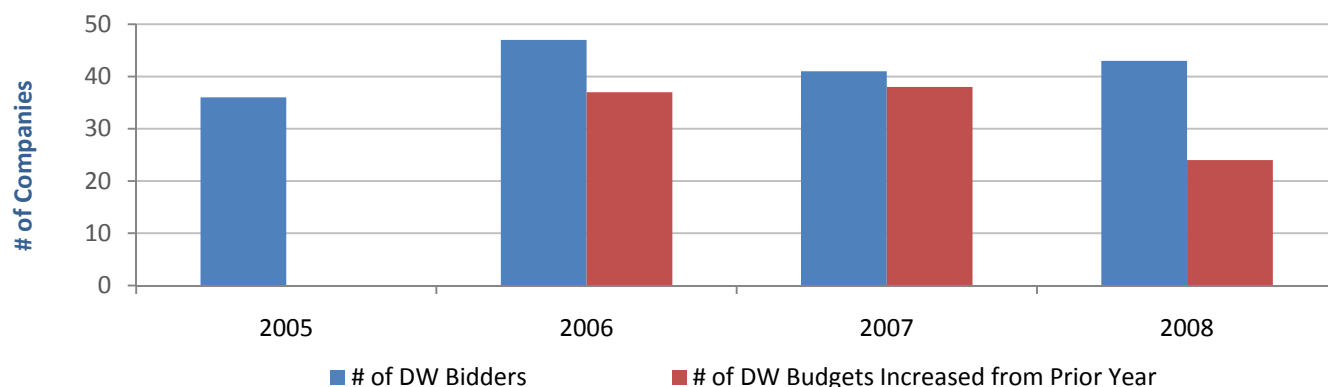


Table 1: Companies that Increased their Deepwater Bid Budgets in One or More of the Last Three Years

Company Name	2006	2007	2008	Years of Increased Bid Budgets
Hess	704%	192%	117%	3
BP	460%	105%	107%	3
Samson Off	Nm	201%	79%	3
ENI	Nm	830%	69%	3
StatoilHydro	Nm	86982%	54%	3
Noble Energy	217%	417%	53%	3
Repsol	Nm	301%	53%	3
Chevron	278%	513%	50%	3
Woodside	7612%	69%	49%	3
Anadarko	53%	120%	45%	3
Total	Nm	76%	45%	3
Cobalt Int'l	Nm	902%	26%	3
Stone Energy	29%	433%	22%	3
Devon	447%	252%	7%	3
Maersk	Nm	Nm	996%	2
ExxonMobil	-78%	1505%	873%	2
ConocoPhillips	-37%	4758%	106%	2
Petrobras	157%	276%	-2%	2
Newfield	64%	116%	-4%	2
Marathon	2755%	3344%	-25%	2
Plains E&P	7790%	125%	-26%	2
BHP Billiton	695%	737%	-28%	2
Shell	102%	1368%	-57%	2
Energy Partners, Ltd.	Nm	1264%	-72%	2
Deep Gulf Energy LP	Nm	4589%	-73%	2
Nexen	1138%	487%	-77%	2
Bois d'Arc	Nm	192%	-77%	2
Davis Offshore, L.P.	214%	1480%	-87%	2
Stephens Production	Nm	283%	-94%	2
Norsk Hydro	105%	152%	-100%	2
Callon	1%	-100%	Nm	2
Houston Energy, L.P.	115%	-100%	Nm	2
Red Willow Offshore	110%	-100%	Nm	2
Focus Exploration	-32%	-18%	460%	1
Hunt Oil	5218%	-29%	-12%	1
LLOG	-49%	1057%	-16%	1
Mariner	-34%	1357%	-29%	1
ATP	277%	-76%	-31%	1
Deep Gulf Energy II	Nm	Nm	-42%	1
Murphy	-31%	782%	-77%	1

Drivers of Bid Inflation

The competitive outlook prior to any lease sale or round will clearly hinge on industry expectations concerning the underlying value of available acreage. Oil prices have been a key driver of bid budgets as shown in Figure 3.

While it seems likely that long-term oil price expectations are probably more stable than current oil prices, the strong correlation in Figure 3 suggests, if nothing else, that higher current prices and the cash

surpluses they generate fund increased bid budgets.

Another logical driver of capital allocated to deepwater bidding is a contractual or institutional factor: the 10-year cycle of expiring primary terms associated with deepwater blocks in the Gulf of Mexico. This process of expirations has created a large flow of acreage back into the pool available for leasing since 2005.

Figure 3: The Link between Oil and Gas Prices and Deepwater Bid Budgets

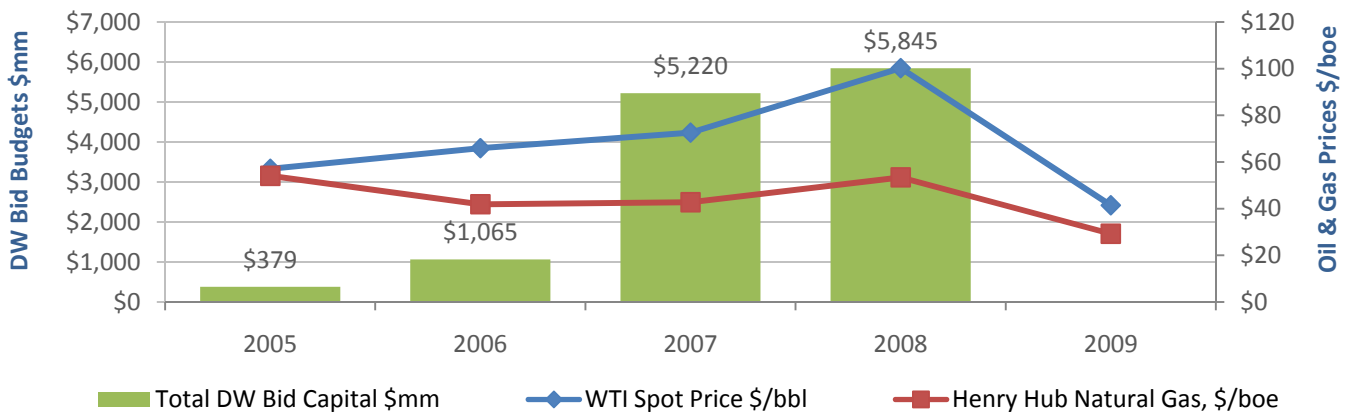
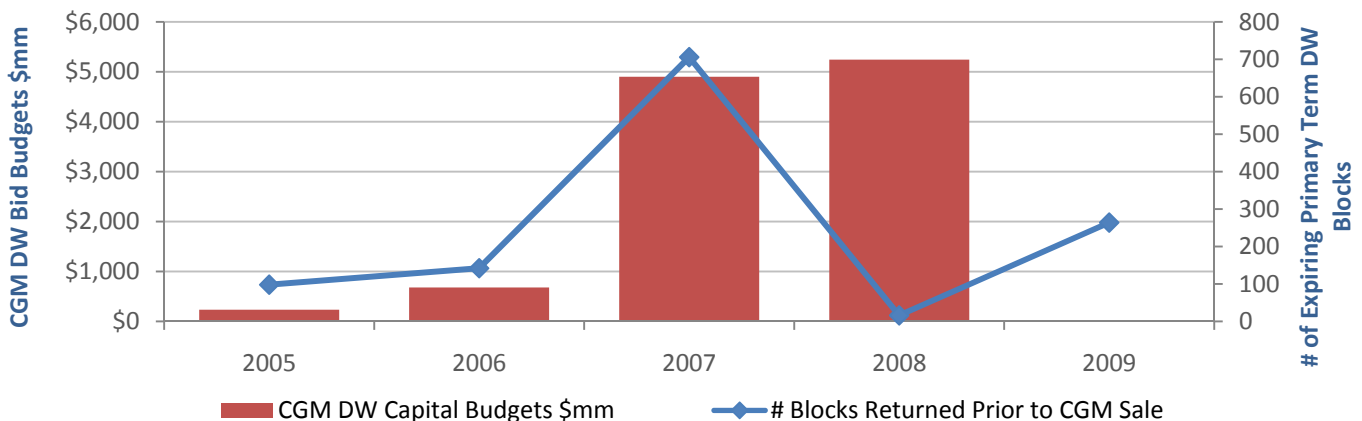
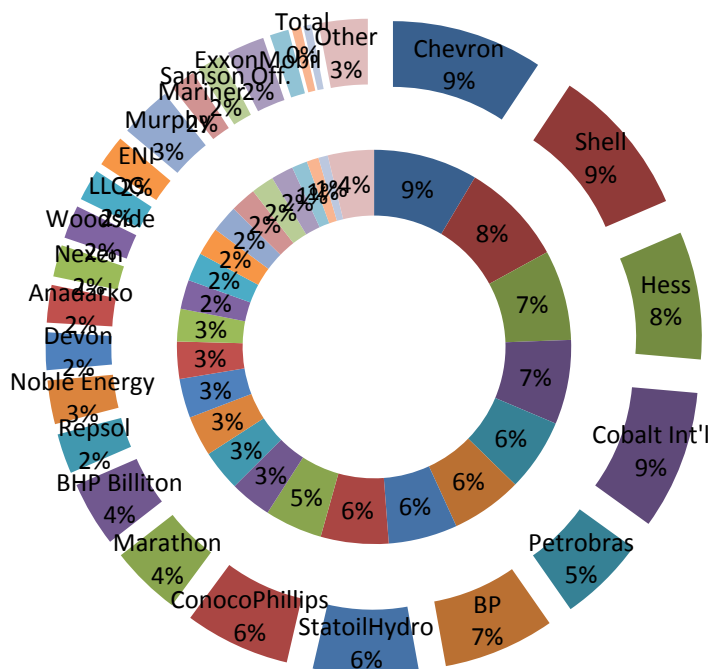


Figure 3: Central Gulf of Mexico Bid Budgets and the Flow of Acreage Back into the Pool of Available Blocks



Note: Central Sale 205, held in 2007, included an expanded area that included significant parts of Keathley Canyon and Garden Banks. Moreover, the sale was delayed from its usual March date to October

Figure 4: Drivers of Deepwater Gulf of Mexico Competition: Leading Competitors



Inner Ring: Share of Industry Deepwater Bid Budgets, 2005-2008
Outer Ring: Share of Industry Deepwater Winning Bids, 2005-2008

We have reproduced Figure 1 below to illustrate a likely competitive scenario for Sale 208. It is always true that the best bidding strategy will depend on what your competitors are likely to do. We suspect that in Sale 208:

- The number of competitors will drop,
- It is also likely that the majority of companies participating in DW bids will significantly reduce their bid budgets in Sale 208
- The effect will be to shift the 2008 bid curve shown below downward.
- In our opinion the greatest percentage shifts will come in the 50th to 90th percentiles of the bid distribution. In other words, it should not be surprising if the winning bids on the most highly valued blocks (in the top 10 percent, for example) remain relatively high.

What this implies is that (1) companies will cut the aggregate size of their bid budgets and (2) shift the allocation of the remaining budget to a heavier weighting on targeted prospect bids. It is beyond the scope of this newsletter to discuss bidding strategies in detail. We will welcome a chance to discuss our analysis of bidding strategies in separate

on-line web meetings or teleconference calls.

However, the scenario we anticipate on 19 March presents an outstanding opportunity to pursue what we call a swath block bidding strategy. The goal is to build substantial acreage positions now when the cost is likely to be lower. This involves focusing on the 50th to 90th percentiles of the bid distribution and bidding lower than the 2008 bid distribution would suggest for those blocks. In other words, move in the opposite direction we expect your competitors to go.

Table 2 compares companies that have been drivers of the competition in prior lease sales.

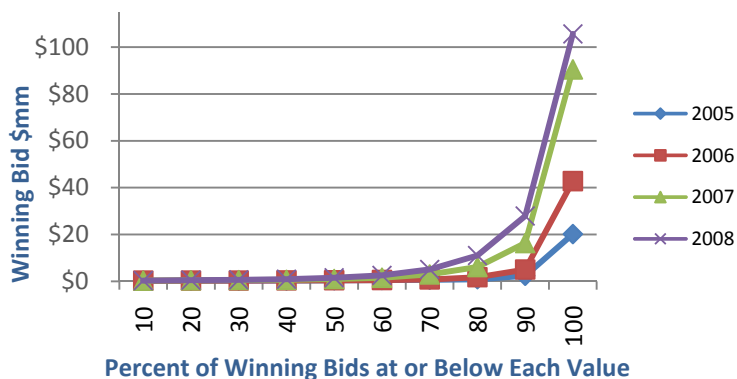


Table 2: Summary of Recent Bidding

Company Name	2008 DW Budget \$mm	Rank 2008	Cum. (2005-08) DW Bid Budget \$mm	Rank '05-08	Percent of budget in 2008	Years of Rising Bid Budgets	
Chevron	\$576.2	1	\$1,038.9	1	55.5%	3	2009 Spending Flat; spent a lot on acreage the last two years; conservative management likely to slow things down
Hess	\$548.4	2	\$899.2	3	61.0%	3	33% Cut in 2009 Budget (61% cut in US Budget). 2008 budget seems to have been reactive in nature and is not likely to be sustained this time around
Cobalt Int'l	\$449.1	3	\$841.8	4	53.3%	3	Private Equity funded. Not producing, likely capital constraint? Heavy bidder in last two years but probably in a deal and drilling mode now
StatoilHydro	\$417.1	5	\$687.8	7	60.6%	3	15% cut in 2009 capital and exploratory budget; 13% cut in exploration. Has accumulated a lot of acreage in sales and is now dealing actively in the secondary market (farm ins and farm outs)
BP	\$404.7	6	\$711.8	6	56.8%	3	Capital budget flat. Has pursued a bidding strategy that is very similar to our recommendation. Rationalization of acreage portfolio is ongoing.
Repsol	\$224.0	10	\$407.4	11	55.0%	3	
Noble Energy	\$220.8	11	\$402.3	12	54.9%	3	20% Cut in Capital Budget for 2009.
Devon	\$173.5	13	\$391.1	13	44.4%	3	Major bidder but strategic approach to GoM generally weighted towards deals: farm ins
ENI	\$168.6	14	\$279.3	18	60.4%	3	3.6% cut in 2009 budget
Anadarko	\$167.9	15	\$370.2	14	45.3%	3	Has been busy digesting Kerr-McGee and rationalizing asset portfolio. Budget has risen steadily but slowly since 1005
Woodside	\$139.7	17	\$290.0	16	48.2%	3	
Samson Offsh.	\$130.7	18	\$227.9	21	57.3%	3	
Stone Energy	\$56.7	21	\$118.9	25	47.7%	3	
Total	\$45.8	25	\$95.2	26	48.1%	3	6% increase in 2009 budget worldwide. Inconsistent commitment to US upstream operations.
ConocoPhillips	\$446.9	4	\$675.2	8	66.2%	2	12.8% Cut in 2009 Capital & Exploratory Budget. Big shift towards DW GoM has resulted in very large bid budgets despite a negative management attitude towards exploration risk. Probably done for now
Petrobras	\$300.9	7	\$721.4	5	41.7%	2	Other priorities back home
Shell	\$288.8	8	\$1,030.8	2	28.0%	2	Cut back sharply in 2008 compared to 2007
Marathon	\$242.3	9	\$574.6	9	42.2%	2	Planned 26% cut in US upstream capex & exploratory. Like ConocoPhillips has made major move in DW GoM acreage accumulation but likely to pull back
ExxonMobil	\$196.3	12	\$223.4	22	87.9%	2	Sharp uptick in bid budget in 2008 but don't expect too much since commitment has been lacking for some time. The expanded bidding primarily just renewed some positions that were expiring

BHP Billiton	\$161.4	16	\$415.8	10	38.8%	2	
Maersk	\$54.8	22	\$59.8	29	91.6%	2	New entrant. Limited bidding; focus thus far on farm ins
Newfield	\$54.2	23	\$153.1	24	35.4%	2	
Nexen	\$52.4	24	\$324.2	15	16.2%	2	Has tended to be outbid in last three years. Cut bid budget deeply in 2008. The 2009 sales could be an opportunity to pursue swath block and win
Plains E&P	\$24.8	27	\$73.2	28	33.9%	2	
LLOG	\$113.8	19	\$284.3	17	40.0%	1	
Mariner	\$96.9	20	\$256.2	20	37.8%	1	
Murphy	\$41.2	26	\$272.6	19	15.1%	1	
Hunt Oil	\$10.3	28	\$38.9	33	26.5%	1	Has pursued a swath block strategy in recent sales but without too much luck. Might be back
ATP	\$0.7	40	\$7.3	45	9.9%	1	
Remington	\$0.2	43	\$12.3	39	2.0%	1	

Cost Watch

On an annualized basis, 2008 costs are up from 2007 levels. However, the more substantial cost side pressures have been felt in the machinery sector.

Drilling costs are estimated to have fallen in each of the last two months (December 2008 and January 2009). Data from October 2008 are still subject to revision and, at this time, it is likely that initial estimates of drilling costs will be revised downward in the last quarter of 2008.

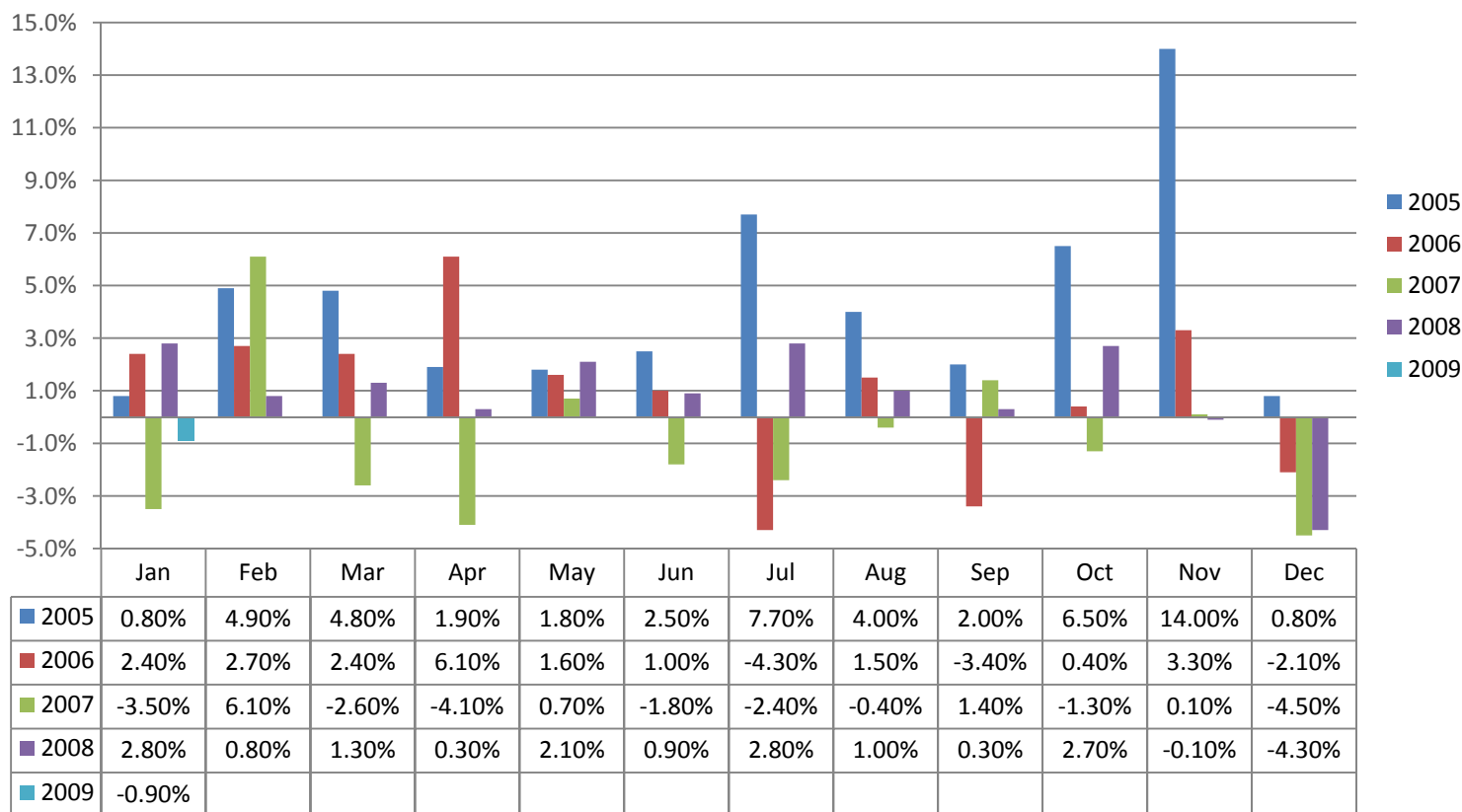
Annualized Cost Inflation Rates

Cost Component	2006/2005	2007/2006	2008/2007
Drilling Cost	37.8%	-4.6%	1.9%
O&G Support Activities	13.1%	3.6%	1.3%
Oil Field Machinery	8.7%	7.0%	7.8%
Rotary Drilling Machinery	11.5%	8.9%	5.0%

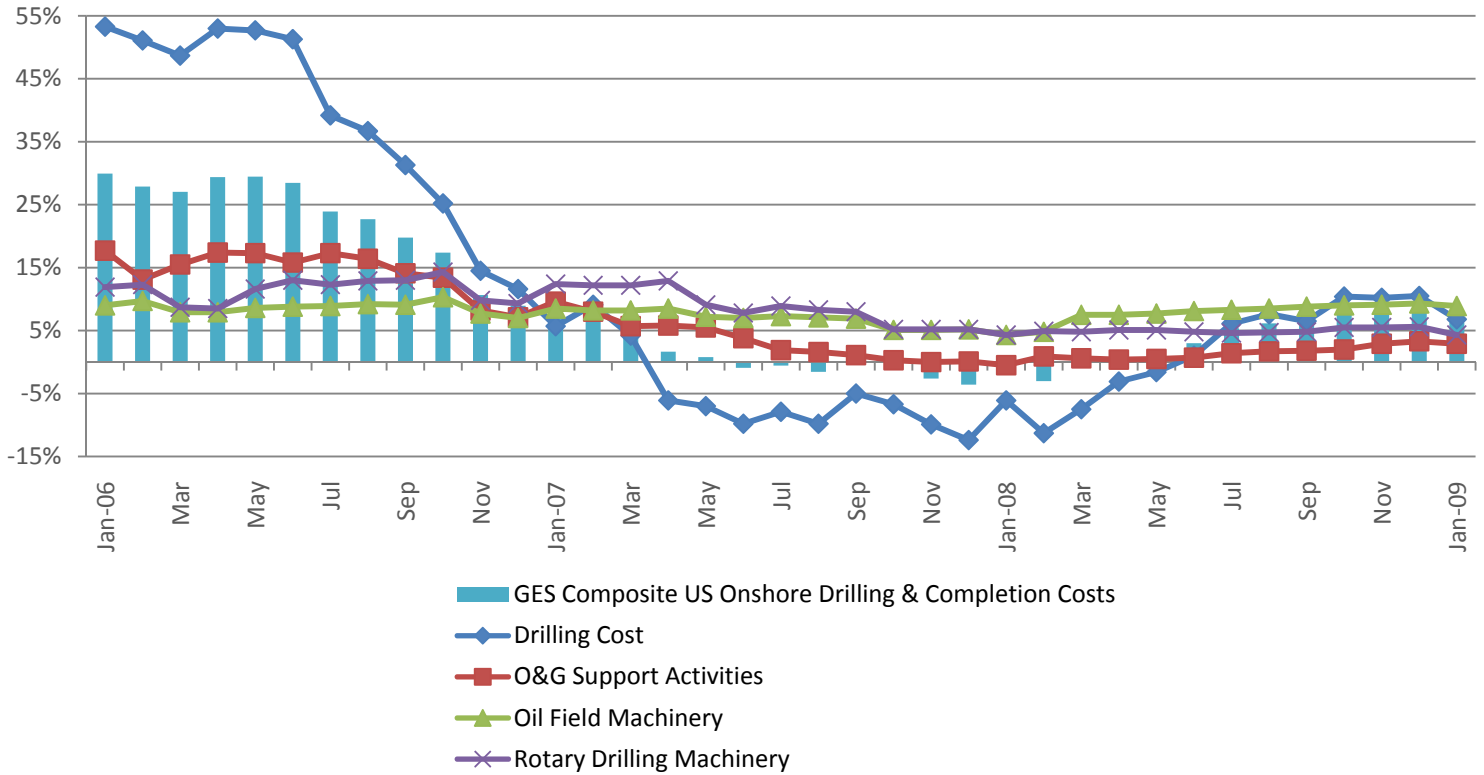
Note: 2008 inflation estimates subject to revision

Our estimate of the rate of inflation of composite costs of drilling and equipping onshore wells moved down again in January 2009, reflecting falling drilling costs and some movement in support activities and machinery costs.

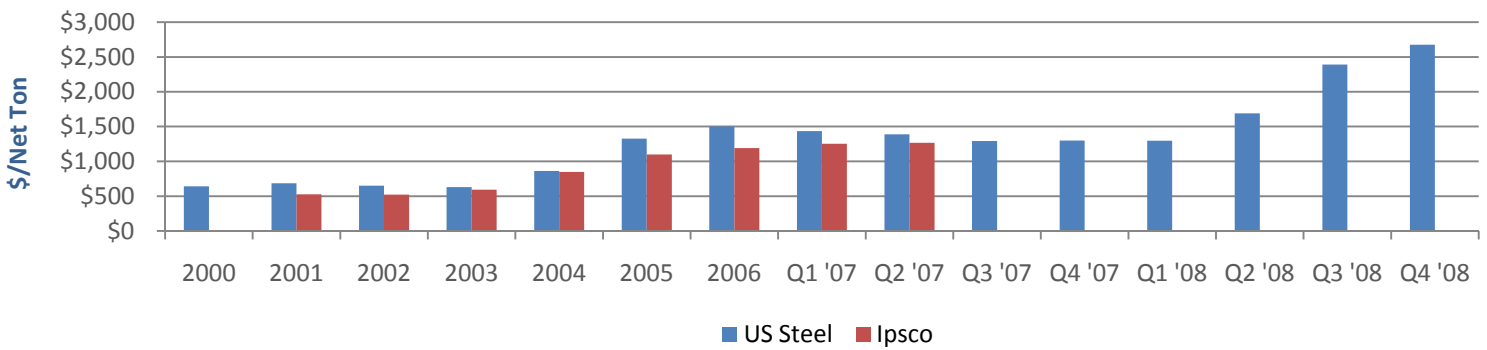
US Producer Price Index: Monthly Percentage Change in the Cost of Drilling Oil & Gas Wells



Monthly Year over Year Inflation of Selected Industry Costs



Tubular Steel Products Price



As of end of year 2008 tubular steel prices had not yet begun to respond to falling industry spending budgets and drilling plans.