

## Key Conclusions

- Statoil's participation in the deal is significant because up to this point the company has tended to participate in lease sales as a targeted prospect bidder. As such, the deal with BHP suggests that Statoil is moving to what we believe is a more three-dimensional strategy.
- By its participation in this alliance, Total has likely committed very large amounts of capital in compensation to Cobalt, a move that is a dramatic shift from its own long-standing prior bidding strategy that has shown a relatively limited commitment to building a deepwater GoM business.
- These deals provide a further illustration of the strategic opportunities we described in our recent On Point Supplement: Key Upstream Business Development Initiatives in 2008.

23 April 2009

## Recent Deals in the Deepwater Gulf of Mexico

There have recently been two very important transactions in the deepwater Gulf of Mexico (GoM) play. In the first deal, Statoil has farmed into a 40% working interest in 50 De Soto Canyon blocks with BHP Billiton. In the second deal, Total and Cobalt International have entered a joint venture alliance pooling their respective deepwater acreage positions.

The significance of these transactions is at least two-fold:

- In both cases the European parties have used the secondary market for leases to materially increase their deepwater GoM positions. These moves have come in spite of the current industry conditions and despite the consensus-based cutbacks in land acquisition by their competitors and peers (as evidenced by the heavy cutbacks in bidding in the last Central GoM lease sale).
- While the most obvious effects of the two deals are, in many ways, similar (building land positions in a highly competitive play), the two examples are case studies in opposing strategies for accumulating land positions.
  - The Total/Cobalt deal involves acreage that was generally acquired by Cobalt as part of a targeted prospect bidding strategy. This bidding strategy (1) tends to focus on specific blocks that are in areas of broad-based interest, (2) almost always involves payment of very substantial premiums to win the blocks funded by very large bid budgets and (3) typically results in large amounts of money left on the table by the winning bidder. By its participation in this alliance, Total has likely committed very large amounts of capital in compensation to Cobalt, a move that is a dramatic shift from its own long-standing prior bidding strategy that has shown a relatively limited commitment to building a deepwater GoM business.
  - The Statoil/BHP deal involves acreage acquired by BHP as part of a swath block bidding strategy. This approach (1) focuses on building acreage over a broader area of often relatively limited interest (hence the swath bidding terminology), (2) is characterized by relatively low winning bids and (3) much more limited amounts of money left on the table by the winning bidder. Statoil's participation in the deal is significant because up to this point the company has tended to participate in lease sales as a targeted prospect bidder. As such, the deal with BHP suggests that Statoil is moving to what we believe is a more three-dimensional strategy. *Continued on p.4*

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.

The cornerstone of our firm is supplying Research Services on Demand, enabling GES to deliver the analysis you want, when it's needed. Our services are uniquely tailored to fit your company's needs and reflects our role as a source of independent research and analysis.

Please feel free to distribute this to your colleagues. If you received this issue as a forward, and wish to receive it directly, please send an e-mail to [subscribe@gordonenergysolutions.com](mailto:subscribe@gordonenergysolutions.com). If you no longer wish to receive this newsletter and would like to have your e-mail address removed from our list, please send an e-mail to [unsubscribe@gordonenergysolutions.com](mailto:unsubscribe@gordonenergysolutions.com). Please let us know how we may improve this service.

For additional information concerning our most recent work or to find out more about our company, please visit <http://www.gordonenergysolutions.com>.

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

Steve Gordon  
Vice President  
(913) 451-9539

## Cost Inflation: Comparative Performance and Strategic Implications

A new study has been completed evaluating production costs inflation. We quantify inflation rates since 2005, compare company results, and analyze the causes and potential longer-term significance.

- Companies included in the study are Anadarko, BHP Billiton, BP, Chevron, ConocoPhillips, ExxonMobil, Hess, Marathon, Occidental, Shell, Statoil, Talisman and Total.
- Regional coverage includes the United States, Canada, Europe, Asia-Pacific and Africa.

### Key Findings

On a worldwide basis, three groups are identified on the basis of substantially different rates of inflation of per boe production costs since 2005. Relative performance also varies significantly across regions.

The consensus industry view is that recent cost inflation pressures are cyclically driven. Working from this belief, companies are pursuing an essentially tactical response while basic strategies are left unchanged. Major projects are being delayed and budgets to maintain base production are being cut. The primary goal is to reduce capital costs for new projects. However, it is also widely believed that operating costs will return to previous levels.

### Strategic Implications

Current, tactical deferrals of large projects and reduced investments to manage base asset declines assume that cost inflation has been purely cyclical. Our analysis shows that this conclusion is too simplistic. Other longer-term or structural factors have been at work and some are likely to intensify in importance as a result of budget cuts. Reductions in production costs are likely to be less than expected and may be more temporary than many believe.

Two structural factors are evaluated: (1) increased non-income based taxes and (2) the role of declining production rates in multiple companies' historic core producing areas. It is shown that these structural drivers explain a substantial part of inter-company differences in cost inflation rates since 2005. The desired benefits of cost deflation in the current period of lower activity will not be realized equally by all companies or in all regions.

The current tactical response risks exposure to two externally driven risks that are not receiving the attention they deserve. First, as governments pursue economic stimulus policies they are rapidly inflating the money supply and setting the stage for a potential macro-economic inflation. Oil and gas industry costs will not be immune. Second, more restrictive carbon emissions policies will (1) ultimately severely limit the ability to resume a number of major investment programs and/or (2) increase the cost of these investments very substantially.

Beware of deferring major programs for too long or cutting back too much.

### For more information please contact:

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

There are obviously many shades of gray between these two extremes of targeted prospect and swath block strategies and many companies tend to plan their bidding programs in these gray areas. Nevertheless, the extreme cases are useful in understanding company programs and anticipating their behavior.

Our studies of lease sale bidding programs over an extended period of time strongly suggest that the payoff from a targeted prospect bid strategy relative to the costs and risks involved is much lower than is widely believed.

**The Statoil/BHP Deal**

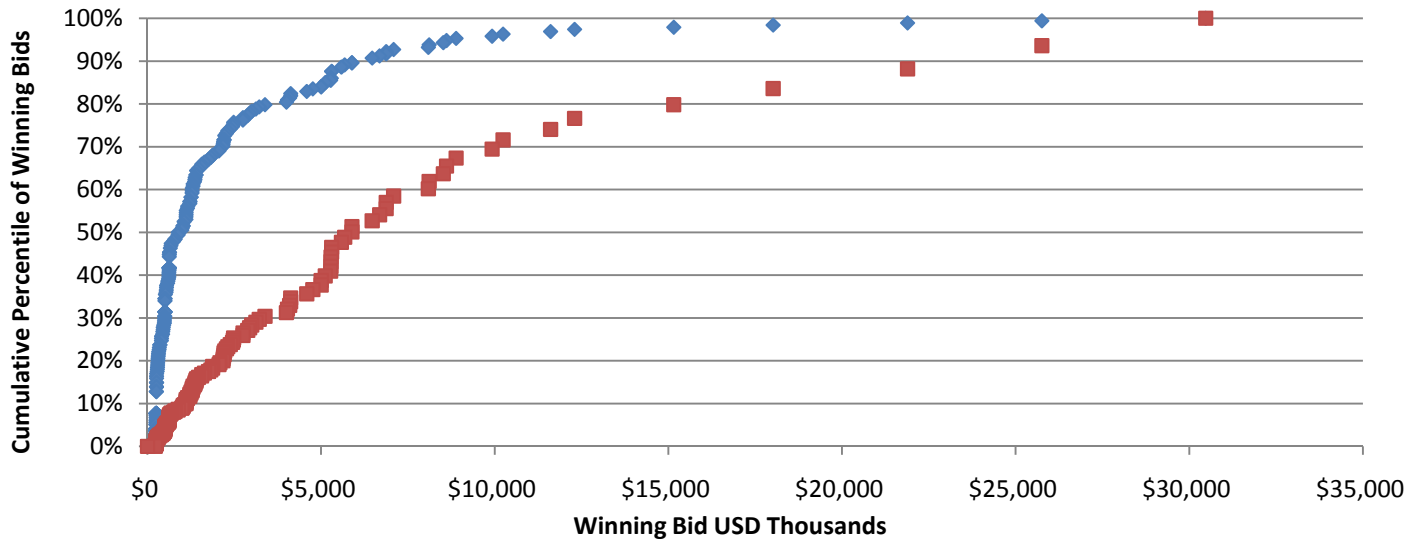
This deal involves 50 blocks exclusively in De Soto Canyon that were acquired by BHP in lease sales 206 and 224 held in March 2008. BHP won all of these blocks with a working interest of 100%.

The percentile distribution of BHP's winning bids for these blocks is shown in Figure 1. For purposes of comparison, Figure 2 shows the percentile distribution of all winning bids in De Soto Canyon over the period from 2001 through 2008.

**Figure 1: Cumulative Percentile Distribution of BHP Winning Bids for De Soto Canyon Blocks**



**Figure 2: Cumulative Percentile Distribution of all De Soto Canyon Winning Bids in Lease Sales Held from 2001 through 2008**



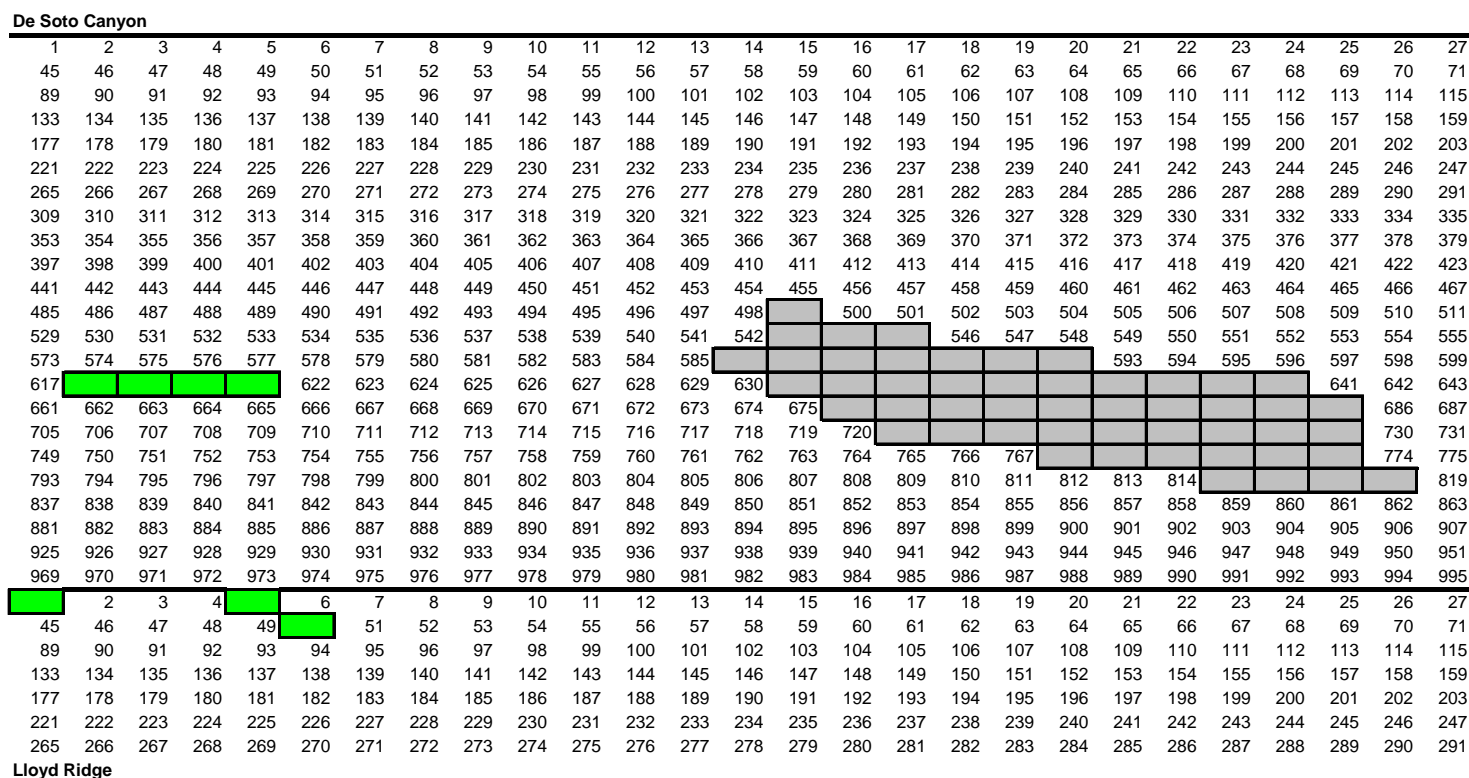
Seventy five percent of all of the blocks acquired by BHP in the two lease sales were won with bids of US\$1.8 million or less and the highest winning BHP bid was US\$5.6 million. Half of the total capital committed by BHP in winning bids was for blocks valued at US\$2.2 million or less. By contrast, for all sales beginning in 2001 the 75<sup>th</sup> percentile value is US\$2.5 million and the highest winning bid was US\$30.5 million. Half of the total capital committed by winning bidders over the period beginning in 2001 was for blocks valued at US\$5.9 million or less. The two distributions highlight the difference in the two extreme bid strategies we

have described: BHP's program was concentrated in the lower end of the bid distribution. A targeted prospect bid program will be more concentrated in the upper end of the bid distribution.

Figure 3 shows a map of the area involved in the Statoil/BHP deal. The gray shaded area highlights the blocks involved in the transaction. Green shaded blocks show fields that have been developed as part of the Independence Hub project or discoveries.

The swath-like character of acreage accumulated by BHP in lease sales is clear.

Figure 3



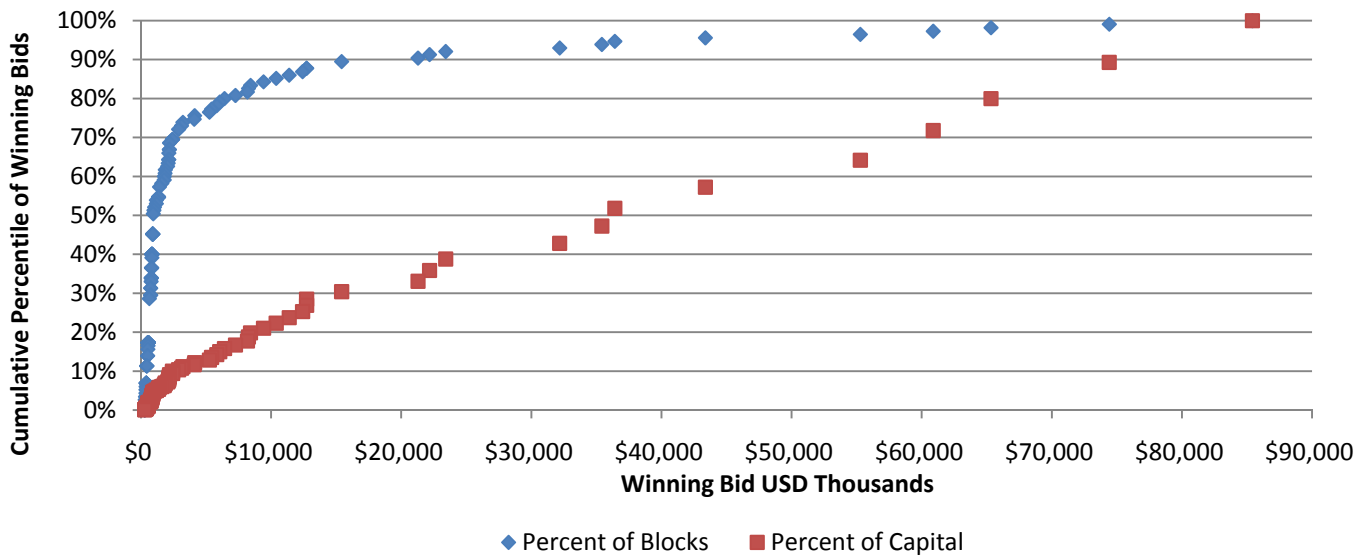
**The Total/Cobalt Deal**

The transaction combines interests in 122 deepwater GoM blocks leased by Cobalt, 80 blocks leased by Total. And 12 blocks that are already jointly owned. Partner shares will on the combined portfolio will generally be 60% for Cobalt which will operate and 40% for Total. In addition, the companies have signed an agreement concerning a Joint Participation Area in which the two companies will cooperate for future opportunities.

Drilling is expected to begin by mid-year 2009 using a Total rig.

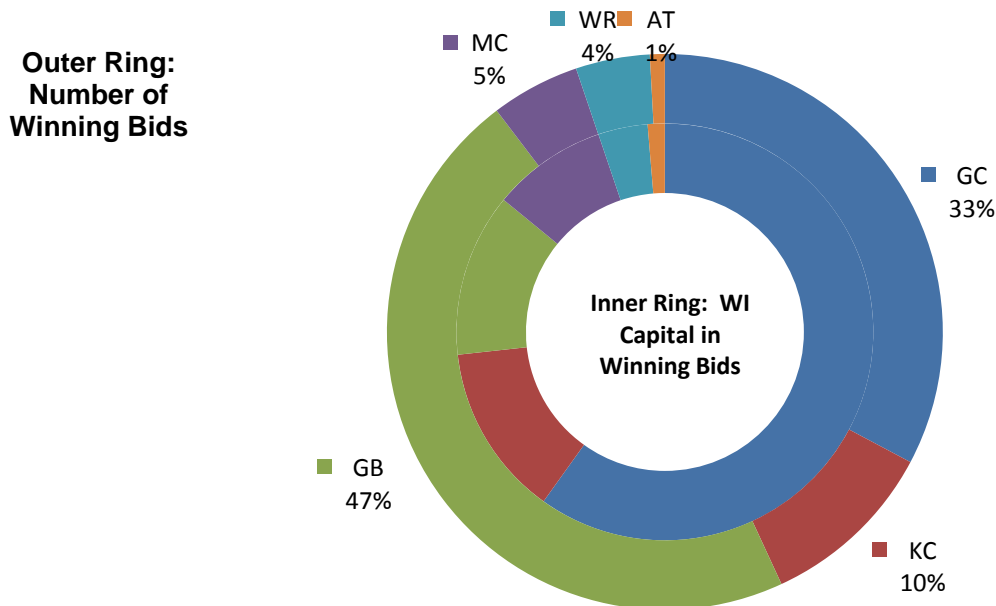
Figure 4 shows the cumulative percentile bid distribution for blocks won by Cobalt in lease sales held from 2006 through 2008. The contrast with BHP's De Soto Canyon bid strategy is clear, especially based on the percent of capital distribution. More than 50% of total capital in winning bids was associated with just seven blocks valued at US\$36.4 million or more each.

**Figure 4: Cumulative Percentile Distribution of Cobalt Winning Bids, 2006-08**



**Figure 5 Note:** Some Cobalt bids were placed in partnerships. The Percent of Capital calculation is made as if Cobalt bid on a 100% basis for all blocks to illustrate the relative block valuations.

**Figure 6: Distribution of Winning Bids by Area**



The targeted prospect character of Cobalt's bidding program is also illustrated by the results in Figure 5 which show the distribution of winning bids in terms of working interest capital expended (inner ring) and the number of blocks acquired (outer ring). Sixty percent of the company's capital expended on winning bids was concentrated in Green Canyon.

Reflecting the widely shared interest in acreage sought by Cobalt, 47% of Cobalt's winning bids were on contested blocks. Of these contested blocks 48% of Cobalt's share of capital committed to winning bids was money left on the table. We cite these statistics not as a criticism of the company's bidding program but because they illustrate the company's focus on targeted prospects and, therefore, the distinction between the two transactions being discussed here.

#### **The Broader Meaning of the Total/Cobalt Deal**

This transaction is a significant indicator of a basic change in Total's strategic attitudes towards the deepwater GoM play. Total has been present in this play for some time (due in no small part to the Elf acquisition). However, the company's efforts to build the position to the status of a material source of production have been limited in size and there has

been a clear lack of consistent commitment to the program over a long period of time. The deal with Cobalt marks for the first time, a fundamental move to address these deficiencies.

The deal also provides a further illustration of the strategic opportunities we described in our recent On Point Supplement: Key Upstream Business Development Initiatives in 2008. There we argued that:

- 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 but, in the current environment, accessing this capital on a sole risk basis is often not a viable option.
- A growing pool of potential buyers has developed (including a number of very large global competitors). These buyers are searching for assets in targeted areas of operations which primarily offer access to not fully proven or producing resources.

Total's alliance with Cobalt in the deepwater GoM is an unambiguous example of the process we described in the supplement.

## Cost Watch

After falling in each month from December 2008 through February 2009 preliminary March estimates show a small increase in drilling costs. We suspect that estimate will be revised downward in coming months. A downward revision of the November 2008 cost index resulted in a negligible increase.

On a year to year basis, March drilling costs were down again by 2%. This was offset slightly by continued inflation of machinery costs. However, the cost of Oil and Gas Support activities is tentatively estimated to have fallen

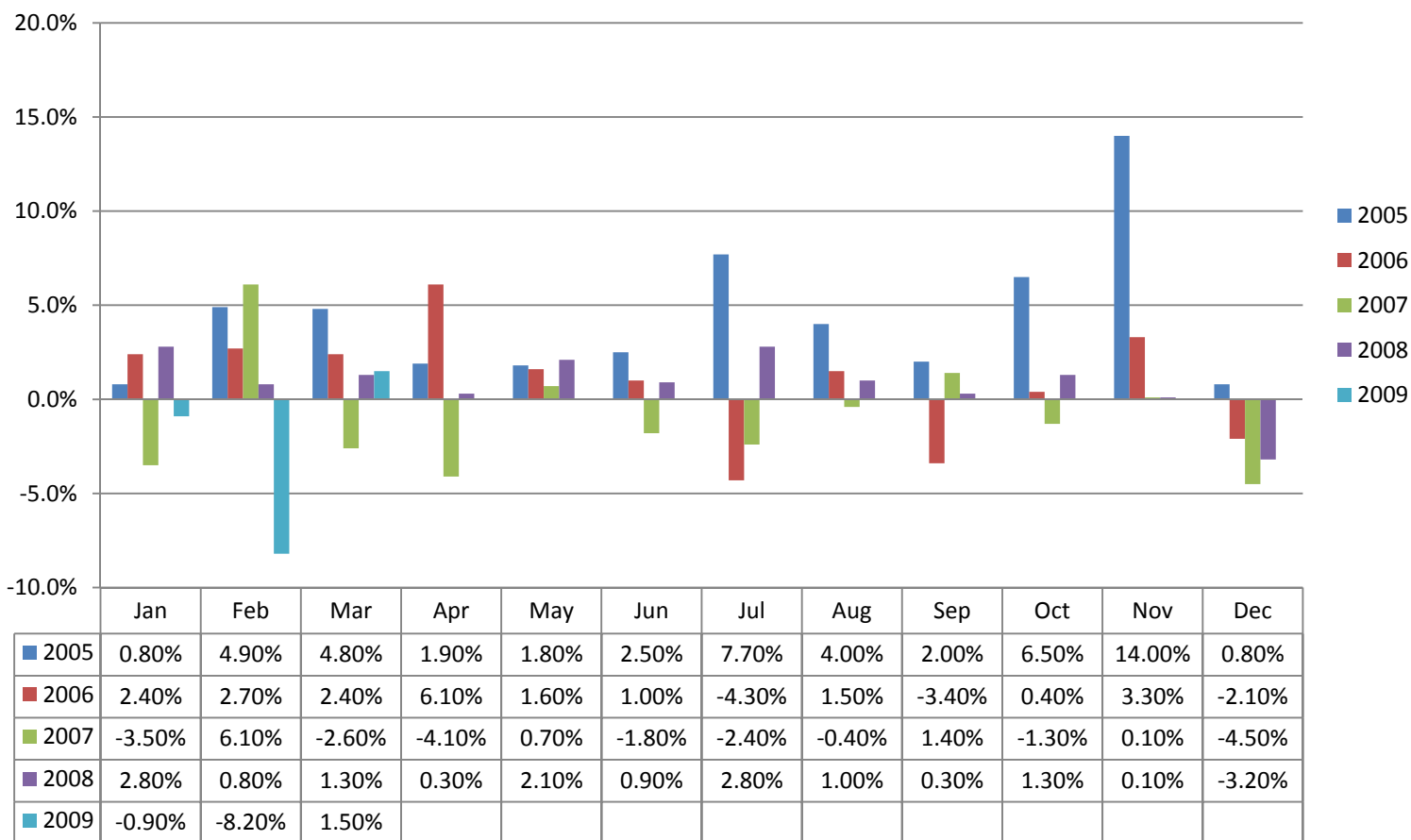
**Annualized Cost Inflation Rates**

Cost Component	2006/2005	2007/2006	2008/2007
<b>Drilling Cost</b>	37.8%	-4.6%	1.7%
<b>O&amp;G Support Activities</b>	13.1%	3.6%	1.4%
<b>Oil Field Machinery</b>	8.7%	7.0%	7.8%
<b>Rotary Drilling Machinery</b>	11.5%	8.9%	5.0%

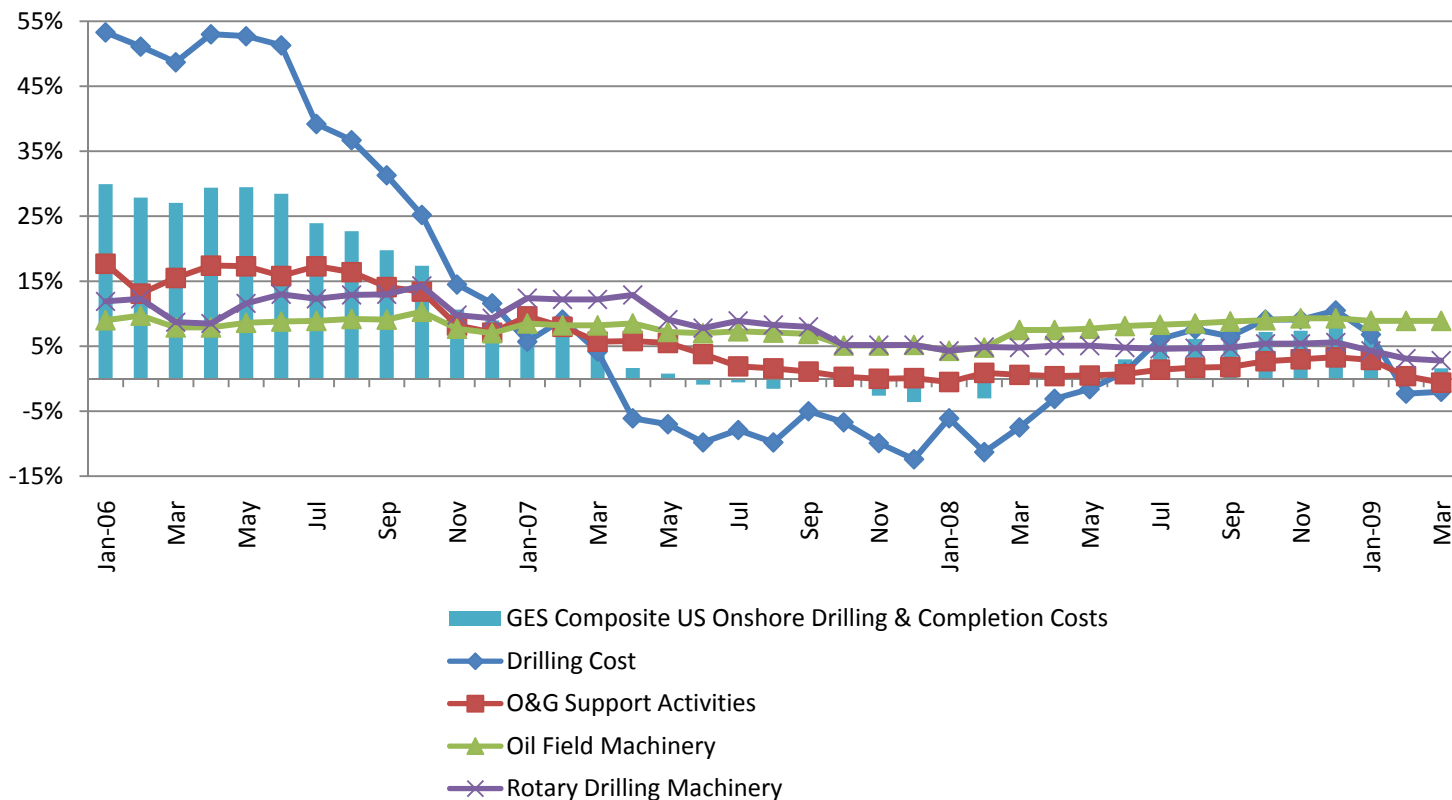
**Note: 2008 inflation estimates subject to revision**

in March by six tenths of a percent. Our estimate of the rate of inflation of composite costs of drilling and equipping onshore wells on a year to year basis dropped again in March 2009 although it remains positive.

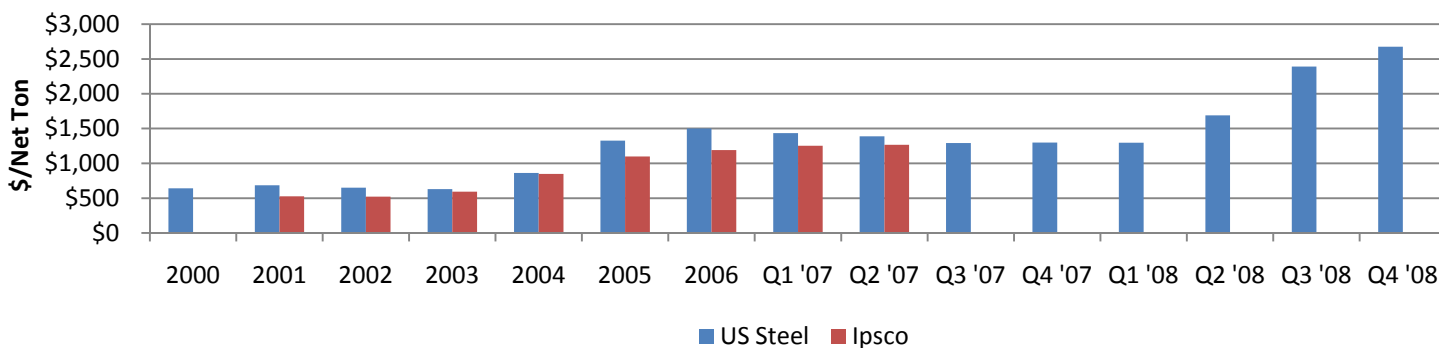
**US Producer Price Index: Monthly Percentage Change in the Cost of Drilling Oil & Gas Wells**



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.

Reflecting the severity of the macro-economic recession, the primary metals manufacturing cost index was down almost 18% in March compared to the same month in 2008 and is now only marginally above its level in March 2006.