Introduction
Welcome to the premiere issue of the Energy Transaction Trends newsletter. M&A is a constantly evolving area and our aim is to keep you apprised of issues and our views on those as they occur. This semi-annual compilation of articles is designed to give a brief overview of M&A issues currently affecting the oil and gas industry. Our experts are involved in numerous transactions on a daily basis and aim to share their insights and experiences to assist others who are facing similar issues.

The first article assesses the impact of percentage-of-completion accounting on M&A transactions. The second article discusses Master Limited Partnerships (MLPs) with a particular focus on the issues surrounding the valuation of the General Partner (GP). The last article is a summary analysis to the 2007 Oil & Gas Deals annual review, which provides a deeper discussion on the potential affect of the credit crunch on energy M&A. Additionally, we’ve provided a summary look at the major energy deals of 2007.

If you know someone who would like to regularly receive this newsletter or would like a soft copy version of this, please contact us at USEnergyMarketing@us.pwc.com.

–Rick Roberge, US Energy Transaction Services Leader

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The oilfield service industry has a number of players in the manufacturing and maintenance space, that are impacted by the use of percentage-of-completion (POC) accounting by the target. There are a number of unique considerations that apply specifically to transactions where the target uses contract accounting.

Generally, EBITDA is used for deal valuation as a proxy for cash flow. However, in POC accounting, there are a number of disconnects between reported EBITDA and cash flow:

1. Management estimates of costs drive gross margin and EBITDA.
2. Change orders can shift cash flow between periods, but should not necessarily shift EBITDA.
3. Loss contracts are recognized in advance and shift EBITDA to the beginning of the contract life, while cash outflows exist over the entire contract life.
4. Quality of Earnings adjustments can be muted by the recognition of revenue on the resulting adjustment.

These issues are discussed more fully below.

Impact of percentage-of-completion accounting on M&A transactions

If specific circumstances exist on a contract that causes the contractor to be unable to apply the POC method of accounting, they should use the completed contract method, and disclose the reasons for doing so.

Application of POC accounting

There are a variety of methods used to determine percent-complete, broadly grouped into two categories, input methods, and output methods. The most commonly used input method is the cost-to-cost method. The most commonly used output method is the milestone method. For purposes of this article, only the cost-to-cost method will be discussed as it is the most commonly applied method of POC accounting.

Under the cost-to-cost method, percent-complete is measured based on costs incurred to date compared to total estimated costs over the contract life. For instance, a contract with costs incurred of $90 to date, and total estimated costs of $100, would be 90% complete. A company would then recognize revenue of 90% of the total contract value. If billings are less than revenue recognized, an asset is recorded entitled “Costs and Estimated Earnings in Excess of Billings on Uncompleted Contracts” (CNXS). If billings are greater than revenue recognized, a liability is recorded entitled “Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts” (BNXS).

Impact on EBITDA

The cost-to-cost method can have a significant impact on EBITDA because at the outset of each contract, the total costs on the contract are estimated by management. On significant long-term contracts, the final total costs, and the estimated total costs can vary significantly. Revenue recognized is a function of total costs incurred to date, and the total contract revenue. If the estimated contract costs and the actual contract costs differ, gross margin percentage recognized from period to period on an identical contract differ significantly. Consider the following extreme example. A contract is entered into with $200 in total revenue, and estimated total costs of $100, for a gross margin percentage of 50%. In year 1, $90 in costs are incurred for a contract that is 90% complete, and $180 in revenues are recognized. In year 2 an additional $110 in costs are incurred, making the contract breakeven. Thus the same contract in year 1 had revenues of $180 and gross
margin of $90 and in year 2 had revenues of $20 and -$90 gross margin. While not all cases will be as extreme as the above example, the overall impact on EBITDA from one year to the next can be significantly impacted by management estimates.

In order to normalize EBITDA of a target company in each year of analysis, a "hindsight" analysis should be performed. The purpose of a hindsight analysis is to adjust revenue (and therefore gross margin) in each period of a contract's life to recognize earnings at the gross margin rate after the contract was fully complete. For example, in the above analysis, a Quality of Earnings (QoE) adjustment would be recorded to reduce revenue in year 1 to $90, and increase revenue in year 2, to $110. The adjustment effectively reduces gross margin and EBITDA in each year to the rate recognized over the entire contract life 0%. The adjustments would be opposite if a contract finished at a higher profit margin than was originally estimated. The entire purpose of the analysis is to smooth profit margin in all periods to agree with the final result of the contract.

This analysis should be performed for all contracts in progress in each year that is included in the QoE analysis. The final profit margin for completed contracts should be used for each year of the contract life. When projects are not complete, the most recent estimate of total contract costs should be used for all periods of the contract life.

In addition to the impact that management estimates have on EBITDA, there are a number of additional considerations that are specific to the contracting industry.

Retainage
It is common in the construction industry for retainage to be withheld by customers on contracts. Retainage is a percentage withheld by customers on payments until a contract is completed, generally 5%-10% of the invoiced amount. When the contract is completed to the customer's satisfaction, the amount withheld as retainage is paid. Sometimes, small contracting operations with unsophisticated accounting, will not bill retainage until it is collectible, and will thus understate revenue for all periods retainage is not billed, and will overstate revenues in periods it is billed.

Change Orders
Another common occurrence in contracting is change orders. Change orders are issued to customers when something arises in the performance of a contract that was not contemplated in the initial bid. For instance, a customer may request that 1,000 barrel tank be expanded to 12,000. The additional costs and revenues associated with the additional capacity would be negotiated and submitted to the customer as a change order to the original contract. Revenues from a GAAP perspective should not be recognized on change orders until they are approved by the customer. Some contracting businesses recognize revenues related to change orders that may not be collectible. Diligence should be performed on all unapproved change orders in order to determine if collection appears likely.
Additionally, it is common for a business to recognize the revenue related to change orders at the end of the contract life. To the extent the change orders are approved, or likely to be approved, the revenue associated with them should be recognized rateably over the entire contract life, consistent with the hindsight analysis.

**Loss Contracts**
If a contract is estimated by management to finish as a loss contract, the entire amount of the estimated loss on the contract should be accrued at the time this determination is made. An expense and corresponding liability would be recorded equal to the amount of the estimated loss. The liability would be reduced in order to ensure a zero profit margin over the remaining contract life. A QoE adjustment should be made in all periods to remove the impact of this accrual and to recognize the life rateably over the contract life, as the QoE analysis is meant to approximate cash flow. Additionally, the future loss contract should be considered a debt-like item.

**Backlog**
A final additional consideration in contracting business is backlog. Backlog is a schedule prepared by management that shows upcoming projects that have not started. The analysis will sometimes also contain the uncompleted portions of contracts in progress. This is usually considered by buyers to be part of the value they are receiving when they purchase the target. The backlog analysis should be discussed with management in order to determine the criteria used to include a contract on the schedule. Sometimes, the schedule will only include contracts that they know they will perform. Other times, the contract will also include contracts where they believe they have bid to perform the work, but have not yet actually received notification they were the winning bidder. It is important to disclose to the buyer what criteria the target is using. Additionally, the estimated margins on backlog should be analyzed to determine if the seller has underbid future projects in order to display a strong backlog to the Buyer in terms of revenue at the expense of future profitability.

There are a number of considerations when the target uses contract accounting. This article was meant to highlight the primary considerations when performing due diligence on an entity that uses contract accounting. While the above list may not contain every issue that arises on a particular transaction, we have found that they are the likely material issues to arise on any contract accounting project.

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**Calendar year 2007 weekly values**

The graph below captures several key benchmarks and their relationship to one another.

- The oil & gas prices/indices in the accompanying chart have been normalized for presentation on a comparable basis with the end of 2006 equal to 100.
- BUSOILP: This is the Bloomberg US Oil and Gas Producers Index (replaces the S&P 500 S&P Oil and Gas Exploration and Production Index used in prior issues of Houston Deal.)
- BUSOILS: This is the Bloomberg US Oil and Gas Services Index (replaces the S&P 500 Oilfield Services Index used in prior issues of Houston Deal.)
- WTI: West Texas Intermediate crude oil prices at Cushing.
- HH: Henry Hub natural gas prices.

![Calendar year 2007 weekly values graph](image-url)
MLP: The value proposition of the GP

Master Limited Partnerships (MLP) are a unique structure, where the governance is administered by a General partner (GP). The GP is, in most cases, composed of the parent company’s executive management team or financial buyers (e.g. private equity) serving as MLP management.

MLPs equity structure consists of two distinct units: limited partners (LP) and general partners. The GP makes the operational and investment decisions for the MLP. Of the two MLP components, LPs and GPs, GPs possess a number of unique attributes that must be considered when analyzing its value. In our examination of the value proposition to the GP, we will explore the GP’s relationship to the underlying MLP, the aforementioned key attributes that are the drivers of the GP’s value and offer some evidence of the publicly-traded GP’s higher risk/higher return relationship compared to publicly traded MLPs and other public companies.

MLP Basics
Publicly traded MLPs are limited liability companies or partnerships whose units trade on public exchanges. In the Revenue Act of 1987, Congress determined that an MLP must generate 90% of its gross income from “qualified sources” including real estate or natural resource activities. The natural resources activities were defined as exploration, production, development, mining, processing, refining, storage, marketing and transportation of oil and gas, minerals, geothermal energy, or timber. There are currently more than 50 MLPs in the marketplace, most of which are related to the energy, natural resources and real estate industries.

MLPs hold a considerable tax advantage over their corporate peers. MLPs operate in a similar manner to corporations, but are able to pay out a greater portion of their “net income”, or distributable cash flow, in the form of distributions to unitholders because net income is taxed at the shareholder level instead of at the corporate level. For unitholders, the tax advantage of these entities over corporations is that they avoid double taxation under these structures because they operate as “pass through” entities. Therefore the unitholders, like stockholders in a corporation, are taxed on income distributed to them.

Key attributes for valuing the GP
There are a number of key attributes that drive the value of the GP. Each of the attributes listed below must be taken into account when valuing the GP:

- Incentive Distribution Rights
- Organic Growth and Accretive Acquisitions
- Risk and Reward

Each of these attributes is discussed in more detail below:
Incentive Distribution Rights (IDRs)
Owning units within the MLP entitles the unitholders, LPs and GPs, to cash distributions. The cash distributions are organized according to the Partnership Agreement established between GPs and LPs. The GPs' cash distributions are a function of the incentive distribution rights. Management is incentivized by taking ownership positions in the MLP via the IDRs. IDRs are meant to insure that the GP focuses on growing the cash distributions of the company. As the company's distributable cash flow increases, so does the GP's share of that cash flow. The GP's IDRs are structured to grow proportionally with the incremental increases in cash distributions to LP unitholders, as shown in the table below:

The above table illustrates a sample structure (very typical in reality) detailing how the GP's cash distributions grow with incremental increases in distributable cash flow. These IDRs provide the GP with the incentive to actively drive the growth of the underlying MLP and ultimately its distributable cash flows.

Organic Growth and Accretive Acquisitions
The ability of an MLP to preserve and, at some point, increase its distributions is integral to it achieving long-term success. Organic growth rates and a history of accretive acquisitions are important, as they are indicative of management's ability to increase earnings and distributions. Management can employ a number of tools to increase growth including execution of accretive acquisitions, internal expansion projects and sound management of operating costs. The ability of management to execute a sound acquisition strategy that maximizes synergies and reduces costs is tantamount to the GP's success as well as the success of the underlying MLP. GPs holding assets they can be “dropped down” into the MLP increases the intrinsic value of the GPs. At the same time, dilutive acquisitions can lead to a decline in per unit cash flows which reduces the GPs' ability to move higher in the splits.

Risk and Return
When analyzing the value proposition of the GP, it is important to determine the cost of capital and corresponding expected return. The drivers of risk and return can shape assumptions driving the analysis. Several points must be considered when establishing the cost of capital for the GP. The GP interest is subordinate to the debt and LP interest in the underlying MLP. As such, in the event of liquidation, investors in a GP would be paid after the debt holders and investors in the LP interest. Therefore, the leverage inherent in the GP increases its risk and ultimately increases the return a prudent investor would require.

Although liquidation is an extreme case, the same relationship holds true with respect to cash distributions. The GP units, as previously discussed, are subordinate to the LP interest, common units. By definition, holders of subordinated units are paid distributions after units with a superior liquidation preference. In a scenario in which the MLP must reduce distributions, the GPs reduction in distributions decrease at an increasing rate compared to the LP's cash distribution. It is also important to note that the GP can establish a cash reserve to insure that cash distributions are paid, which makes the reduction in distributions a rare occurrence.

In assessing risk, it is also important to consider the percentage of fixed versus floating rate debt. The adoption of fixed rate debt reduces the volatility embedded in floating rate debt instruments, thereby reducing risk and the impact of the debt on the cost of capital. Therefore, the lower the percentage of floating rate debt, the lower the risk inuring to the GP.

Another key metric for establishing the GPs risk exposure and expected return is the cash distribution coverage ratio. The higher the coverage ratio, the lower the risk is and the less likelihood of a scenario resulting in the reduction or suspension of distributions.

The GP typically has a lower yield, but ultimately produces a much higher return depending on the success of the underlying MLP's growth strategy. Although leverage increases risk for the GP, it also drives DCF growth which increases at an increasing rate for the GP. The leverage is driven by acquisitions and organic projects in the underlying MLP. Management teams have been fairly successful as evidenced by their returns. Their success has been driven by their familiarity with the assets being acquired, as well as the contiguous nature of those assets with respect to their existing portfolio of assets.

Although there may be other unique points to consider, we have highlighted some of the attributes that drive value for the GP as well as some of the variables that expose the risk inherent in the MLP structure.
Oil and gas M&A undeterred by the credit crunch

M&A levels in the oil and gas industry held up throughout 2007 despite the impact of the credit crunch. The latest edition of annual analysis of M&A activity in the sector by PricewaterhouseCoopers, 'O&G Deals', shows deal totals edging up slightly, from US$291.1bn to US$292.2bn year on year.

There was no clear evidence of a decline in oil and gas deal activity in the second half of the year as the credit crunch broke. Indeed, the number of final quarter deals in 2007 was 7% up on the final quarter of 2006. What is clear, though, is the changing dynamics of M&A activity within the sector. Oilfield service deals continue to boom reflecting growth in demand and utilisation rates for rigs as well as the need for service companies to scale-up globally in a consolidating market.

The total value of deals in the oil field services sector jumped 165% from US$25.4bn to US$67.3bn in 2007. The oil services sector is now a key motor of M&A activity in the wider oil and gas industry, accounting for nearly a quarter (23%) of the value of all deals compared to just 4% in 2005. The trend of consolidation in the sector looks set to continue in 2008.

The majors continue to be relative M&A absentees with the dominance of the national oil companies (NOCs) constraining the use of M&A as a reserve replacement strategy. There was a lull in activity that in previous years had seen Russian, Chinese and Indian NOCs becoming major competitors for assets outside their home territory.

Instead, it was oilfield services and the downstream sectors that fuelled M&A activity. Aggregate deal value in both sectors more than doubled, in downstream from US$28bn in 2006 to US$61.7bn in 2007 and, even more strongly, from US$25.4bn to US$67.3bn in the services sector. Much of the US$33.6bn increase in downstream deal value was accounted for by the largest O&G deal of 2007—Dutch chemicals group Basell's leveraged US$20bn buy-out of Lyondell.

'O&G Deals' anticipates that highly leveraged deals will become more difficult in the sector as the credit crunch takes effect. However, while the wider financial and economic environment will be less predictable, the report points to a range of factors that will continue to drive deal activity:

- Corporate players will be mindful of the pressure to replace reserves and the structural rationale for consolidation.
- National oil companies will continue to use their strength to look for international investment opportunities.
- Middle Eastern investors will remain active deal makers.
- Supply constraints, geopolitical considerations and climate change concerns will necessitate continual re-evaluation of asset portfolios.
Michael Hurley, UK oil and gas advisory leader, PricewaterhouseCoopers LLP, said:

“M&A activity will continue to be fuelled by the search for globalisation, scale and profitability. European oil field service activity is likely to consolidate and internationalise away from mature markets. Junior oil companies will continue to be the targets for majors who are opportunity constrained while integrated oil companies will continue to look at downstream divestments. All this adds up to continued strong activity over the next year across the board.”

Russia and the Commonwealth of Independent States—oil and gas M&A activity was driven by the continuing restructuring of the Russian energy industry. Total deal value was up 19%, from US$30.1bn in 2006 to US$35.7bn in 2007, in the Russian Federation and neighboring CIS states.

The number of deals was relatively unchanged, 41 deals in 2007 compared to 42 the previous year. This pushed average individual deal value up 21% and the US$870 million deal size was three to four times the average US$236 million recorded in other geographic regions. Not surprisingly, the vast majority, 83%, of the region’s O&G deal value was in the upstream sector. This was more than double the 40% upstream share worldwide outside the region.

Rick Roberge, US energy transaction services leader, PricewaterhouseCoopers said:

“This phase of service sector consolidation and oilfield service companies’ reach for global scale has a long way to run. Ultimately, logic points to a small number of large global oilfield services players that will be akin to the majors in the integrated sector. The sector is complex with many speciality services and consolidation will not necessarily make sense across the board, but the scope for deal-making will be high on the agenda of many companies as well as investors.”

The report also includes a focus on international deals and on each of the key regional markets:

International—International deals, involving either international groups of investors or assets that are spread across territories, were up across the board in 2007, with the exception of the upstream. Total value rose 269% from US$20.5bn in 2006 to US$75.8bn in 2007. Deal numbers were up 42% from 50 to 71 and average deal value was up 160% from US$400 million to US$1.1bn.

International deals took four of the top ten deals in 2007, with bids for Lyondell, GlobalSantaFe, Huntsman and IPSCO totalling US$54.4bn. In the 2006 top ten, in contrast, there was just one international deal, worth US$5.3bn.

North America—O&G deal volume in North America was down 21%, from US$164.7bn in 2006 to US$129.7bn in 2007. Much of the difference was accounted for by the presence of the US$32.4bn Kinder Morgan buyout in the 2006 total. Setting this aside, deal numbers and value were broadly level year-on-year. There were 31 deals in 2007 worth US$1bn or above, for example, compared to 32 in 2006. Moves by foreign buyers for North American assets were a common theme in 2007 including noteworthy moves by a number of European buyers.

Europe—Total O&G deal value in Europe could not rival that of 2006 when the overall total was boosted by the StatoilHydro US$32.2bn upstream merger. Setting this single deal aside, remaining upstream deal value was slightly up and the value of downstream deals more than doubled, from US$3.7bn in 2006 to US$8.4bn in 2007, to account for the biggest share of total European O&G deal value.

Asia Pacific—Total 2007 deal value in the Asia Pacific region maintained its 2006 level with a total US$16.2bn of deal activity. The total continues to fall short of the US$19.6bn transacted in 2005. Deal numbers fell 28% from 105 to 76 but this pushed average size up 38% to US$213 million.

Australia provided the focus for the largest number of deals within the region but South Korea was the location for the biggest share of total transaction value with a string of deals for downstream refining, petrochemical and retailing assets. The period ahead will see a major burst of deal activity in Australia, as the state government of South Australia removes an ownership cap on Santos, Australia’s third-largest oil and gas group. With substantial reserves and a strong international presence, the company sees this as a growth opportunity, allowing them to offer scrip for acquisitions. It has also been speculated that the move will lead to a multibillion dollar auction.
We have summarized recent deal activity of select companies in the Oil & Gas industry for the calendar year 2007. As the information was obtained from publicly available news sources, PricewaterhouseCoopers has not independently verified its accuracy.

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<th>Buyer</th>
<th>Seller</th>
<th>Announce Date</th>
<th>Transaction Value USD$MM</th>
<th>Implied Reserve Value ($/BOE)</th>
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<tr>
<td>First Reserve Corp</td>
<td>Abbot Group plc</td>
<td>12/19/07</td>
<td>$2,889</td>
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<tr>
<td>OSS Capital Management LP; et al</td>
<td>CCS Income Trust</td>
<td>06/29/07</td>
<td>$2,625</td>
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<tr>
<td>Hercules Offshore Inc</td>
<td>TODCO; Shareholders</td>
<td>03/19/07</td>
<td>$2,233</td>
<td></td>
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<tr>
<td>Tenaris SA</td>
<td>Hydril Co</td>
<td>02/12/07</td>
<td>$2,046</td>
<td></td>
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<tr>
<td>General Electric</td>
<td>3i Group; et al</td>
<td>01/08/07</td>
<td>$1,900</td>
<td></td>
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<tr>
<td>United States Steel Corporation</td>
<td>Lone Star Technologies</td>
<td>03/29/07</td>
<td>$1,673</td>
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</table>
About the authors

Rick Roberge is the leader of the Energy Transaction Services practice based in Houston. Rick has over 12 years experience advising clients, domestic and international, in all sectors of the energy industry on mergers and acquisitions, including detailed financial modeling, structuring, capital market analysis, purchase price determination, and negotiation strategy.

Michael Hoyt is a Houston-based manager in our Energy Transaction Services area, who has 4 years experience working closely with energy clients and who specializes in Oil and Gas and Utilities.

David Joyce is a Houston-based manager in the Energy Transaction Service FDD practice. David has been with the Firm for 8 years, and has spent the last 4 years in the Houston Transaction Services practice working primarily on transactions in the oil and gas/energy sector.

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