Finance review

During 2007, Tullow focused on allocating resources to assets which will drive future growth. Our financial strategy supports our long-term business objectives.

During 2007, Tullow's business reached a new level of scale in terms of production, operating cashflow, market value and future growth potential. Total shareholder return in 2007 was 66% (2006: 49%), placing Tullow in the top quartile of its peer group. Over the three-year period from 2005 to 2007, Tullow's total shareholder return has been in excess of 440%.

Overall, results for the year were solid. However, a 19% decline in realised gas price, which represents 40% of revenue, impacted our performance and this, combined with increased depreciation and interest charges and exploration write-offs, meant that basic earnings per share declined 71% to 7.1 pence per share.

Our financial strategy is to maintain financial flexibility to support the Group's significant appraisal and development programmes in Ghana and Uganda and effectively allocate capital across the remainder of our business.

Strong production and pricing

Working interest production averaged 73,100 boepd, 13% ahead of 2006. Sales volumes averaged 62,600 boepd, representing an increase of 9%. As a result of increased sales volumes and higher oil price, offset by the weaker UK gas price, 2007 revenue increased by 10% to £639.2 million (2006: £578.8 million).

The bulk of production growth came from our African oil portfolio, which represented 55% of total output and 58% of Group revenue. This was driven by an exceptional performance from the Okume development and the Ceiba field in Equatorial Guinea and a first year of production for Tullow from the Chinguetti field following the completion of the Hardman acquisition.

Key financial metrics

	2007	2006	Change
Production (boepd, working interest basis)	73,100	64,720	+13% ↑
Sales volume (boepd)	62,600	57,300	+9% ↑
Realised oil price per bbl (US$)	62.7	52.2	+20% ↑
Realised gas price (pence per therm)	37.3	46.2	-19% ↓
Cash operating costs per boe (£)[1]	5.05	4.74	+7% ↑
Operating cashflow before working capital per boe (£)	17.77	18.76	-5% ↓
Net debt (£m)	479.5	122.1	+293% ↑
Interest cover (times)	10.4	24.0	-13.6 ↓
Gearing (%)[2]	67	16	+51% ↑
TSR (%)	66	49	+17% ↑

1. Cash operating costs are cost of sales excluding depletion, depreciation and amortisation and under/over lift movements.
2. Gearing is net debt divided by net assets.

Gas production from South Asia also rose significantly, due to new production from the Chachar field in Pakistan in August and continuing strong performance from the Bangora field in Bangladesh. Gas production from Europe of 171 mmscfd (28,500 boepd) showed a modest decline from 2006 levels.

Oil prices continued to be strong throughout the year and Tullow's realised oil price after hedging was US$62.7/bbl (2006: US$52.2/bbl), an increase of 20%. Tullow's oil production sold at an average discount of 3% to Brent during the year (2006: 5% discount).

Whilst oil pricing was positive, UK gas price realisations fell by 19% to 37.3p/therm (2006: 46.2p/therm). Following a period of exceptional pricing, particularly in early 2006, new sources of supply and a mild winter combined to significantly reduce gas price in the first half of 2007 and despite strengthening prices in the second half, the average UK day ahead gas spot price for 2007 was 29.7p/therm. Tullow's UK gas hedge programme proved highly effective during 2007, contributing approximately 7.6p/therm to the Group's realised price, amounting to an additional £39 million to Group revenue. The Group also recorded tariff income of £17.5 million (2006: £16.6 million) from its UK infrastructure interests.

Disciplined cost management offset by higher depreciation

Underlying cash operating costs, which exclude depletion and amortisation and movements on under/overlift, amounted to £134.7 million (£5.05/boe). These costs were 7% above 2006 levels, principally due to upward cost pressures in oil and gas services and in our UK business.

Depreciation, depletion and amortisation before impairment charges for the year amounted to £203.0 million (£7.61/boe). This represents a 19% increase over 2006, principally as a result of a higher depreciation charge on UK assets, and the addition to Tullow's portfolio in early 2007 of the Chinguetti field where performance was significantly below expectations, leading to a 25% increase in depreciation rates above initial estimates. In addition we have recognised an impairment charge of £13.8 million (£0.48/boe) on Chinguetti, which is due to the ultimate recoverable commercial reserves being downgraded by 50%.

Tullow continued to invest in people during 2007 increasing average staff numbers by 33% to 277 people, due to the significant increase in investments being made during the year and also the need to establish an appropriate resource pool to fulfil our long-term growth objectives. As a result, underlying general and administrative costs have increased by 43% to £26.2 million (2006: £18.3 million). The total general and administrative costs charge of £31.6 million also includes a charge of £5.4 million in respect of the Group's share-based incentive schemes (2006: £4.2 million).

Total dividend distribution

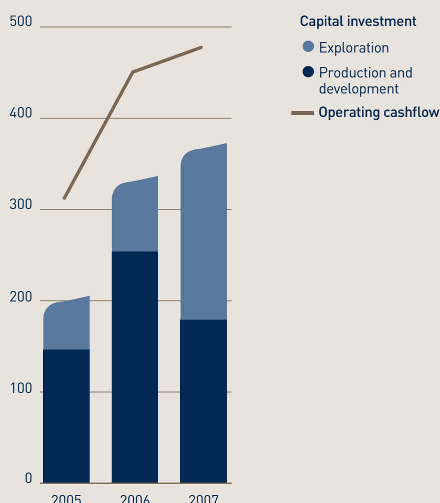
£97 million

Since 2003 Tullow has returned £97 million to shareholders in the form of dividends. Over the same period the Group has shown a total shareholder return of over 700%.

Exploration write-off

Exploration costs written off were £64.2 million (2006: £32.5 million), in accordance with the Group's 'successful efforts' accounting policy, which requires that all costs associated with unsuccessful exploration are written off to the Income Statement. Of this write-off £51.1 million

Operating cashflow and capital investment (£million)



£474 million +6%

Operating cashflow

Tullow demonstrated strong cashflow growth in 2007 which enabled us to continue our aggressive growth in capital investment. During 2007, approximately 48% of our investment was allocated to production and development assets, with the balance invested in our exploration portfolio.

The success of our 2007 exploration programme has led to major appraisal and development programmes in 2008. Our assets in Ghana and Uganda will together account for over 50% of expenditure during the year.

is principally associated with unsuccessful exploration activities in the UK, Gabon, Ghana, Namibia and new ventures/pre-licence costs and a recent decision to relinquish Blocks 107 and 108 in Côte d'Ivoire. The remaining £13.1 million is in relation to a downgrade of Chinguetti contingent resources as at 31 December 2007. In addition to the impairment charge set out above, this brings the total charge associated with Chinguetti to £26.9 million.

Operating profit

Operating profit before exploration activities amounted to £253.3 million (2006: £295.1 million), a decrease of 14%, due to the increased depreciation charges, partly offset by production growth and strong oil prices.

Derivative instruments

Tullow continues to undertake hedging activities as part of the ongoing management of its business risk and to protect the availability of cashflow for reinvestment in capital programmes which are driving business growth. Hedges undertaken in respect of 2008 combined with portfolio management provide downside protection on revenue of over £300 million, representing approximately 70% of planned 2008 capital investment.

At 31 December 2007, the Group's derivative instruments had a negative mark to market value of £158.0 million (2006: £21.0 million). Of this, £136.9 million relates to a negative mark-to-market on oil contracts, the majority relating to hedges acquired as part of the acquisition of Energy Africa in 2004 and £21.1 million relating to a negative mark-to-market on gas contracts.

While all of the Group's commodity derivative instruments currently qualify for hedge accounting, a charge of £29.3 million (2006: credit of £15.7 million) has been recognised in the income statement for 2007. Of this charge £23.4 million relates to oil and gas hedges while the balance of the charge comprises £5.9 million relating to the Group's foreign exchange derivatives associated with the acquisition of Hardman Resources.

The Group's hedge position as at 5 March 2008 can be summarised as follows:

Hedge position

	2008	2009	2010
Oil			
Volume – bopd	19,293	11,000	2,000
Current Price Hedge - US$/bbl	70.9	63.4	89.4
Gas			
Volume – mmscfd	81.0	38.7	12.3
Current Price Hedge - p/therm	50.1	50.4	54.1

Gearing, financing costs and interest cover

The net interest charge for the year was £45.6 million (2006: £15.0 million) and reflects the significantly increased levels of net debt during 2007 following the completion of the Hardman Resources acquisition in January. In addition the amortisation of finance costs associated with the US$1 billion Bridge Facility negotiated to effect this transaction and a reduced level of interest capitalisation in relation to development assets has also contributed to this increase.

At 31 December 2007, Tullow had net debt of £479.5 million (2006: £122.1 million), which was approximately one times the Group's operating cashflow before working capital movements for the year. Interest cover has reduced to 10.4 times (2006: 24.0 times) however both overall debt levels and interest costs remain very comfortable in the context of the Group's overall production profile, recent portfolio management transactions and future growth opportunities.

Taxation

The tax charge of £61.6 million (2006: £105.9 million) relates to the Group's North Sea, Gabonese, Equatorial Guinea and Mauritanian activities and represents 54% of the Group's profit before tax (2006: 40%). After adjusting for exploration costs and movements associated with overlift balances, the Group's underlying effective tax rate is 34% (2006: 35%).

Dividend

The Board has a high level of confidence in the Group's business and future profit potential, as well as a strategy of maintaining capital discipline through periods of strong oil and gas pricing. Consequently the Board has proposed a final dividend of 4.0 pence per share (2006: 3.5 pence per share). This brings the total payout in respect of 2007 to 6.0 pence per share (2006: 5.5 pence per share). The dividend will be paid on 21 May 2008 to shareholders on the register on 18 April 2008.

Strong cashflow and capital investment

Increased production and the strong oil price environment led to record operating cashflow before working capital movements of £473.8 million (2006: £446.7 million), 6% ahead of 2006. This cashflow facilitated investment of approximately £370 million in exploration and development activities, payment of an increased final 2006 dividend and servicing of the increased debt facilities.

Tullow currently plans a total 2008 capital investment of approximately £440 million, with Tullow's Africa activities accounting for approximately 75% of this anticipated investment. In addition to our 2008 commitments we are planning for the future, as evidenced by the US$700 million (£350 million) contract on behalf of the Jubilee field partners for the Eirik Raude rig as part of the Ghana development programme, which is targeting first oil in 2010.

Effective portfolio management

The exploration and appraisal investments planned for 2008 will drive future growth and as we seek to prioritise our allocation of capital, we have identified a number of interests which are not central to our longer-term strategy. As at 31 December 2007, our interest of 40% in the Ngosso permit in Cameroon and our interest of 11% in the M'Boundi field in Congo (Brazzaville) have been classified as 'assets held for sale' in accordance with IFRS 5 – Non-Current Assets Held for Sale and Discontinued Operations. Both

transactions are expected to complete in 2008 for a total consideration of US$480 million (£240 million) with the M'Boundi sale still being subject to partner pre-emption. The disposals are also subject to government approvals. The Group expects to recognise a very substantial profit on these disposals in the 2008 financial statements.

The successful completion of portfolio management efforts announced year to date will halve Tullow's net debt at 31 December 2007 and provide substantial additional cash resources for investment in key assets. These transactions also indicate the inherent value of Tullow's asset portfolio at a time where many players in our industry are becoming increasingly opportunity constrained.

The Board will continue to actively monitor the Group's portfolio and consider asset divestments or acquisitions as appropriate to ensure shareholder value is maximised and resources allocated in the most effective manner.

Hardman Resources acquisition completion

The Hardman acquisition was completed on 10 January 2007 with the payment of £334.9 million and the issue of 65 million shares to Hardman shareholders. A final review of the fair value allocation to the acquired assets and liabilities was undertaken in accordance with the provisions of IFRS 3 – Business Combinations. The final total fair value attributed to the transaction amounts to £759.4 million, comprising £595.2 million of consideration and associated costs and an additional £164.2 million of deferred tax uplift in accordance with IAS 12 – Income Taxes.

Accounting policies

UK listed companies are required to comply with the European regulation to report consolidated statements that conform to International Financial Reporting Standards (IFRS). The Group's significant accounting policies and details of the significant accounting judgements and critical accounting estimates are disclosed within the notes to the financial statements where appropriate on pages 73 to 76. Other than the mandatory adoption of IFRS 7 – Financial Instruments: Disclosures, which increased the disclosure requirements in respect of financial instruments, the Group has not made any material changes to its accounting policies in the year ended 31 December 2007.

Financial strategy and outlook

During 2007 the value of Tullow's business was transformed by successful exploration activity in Ghana and the ongoing programmes in the Albertine Rift basin in Uganda. With focused investment in appraisal and development over the coming years, reserves and production have the potential to reach multiples of current levels.

A successful phased development in Ghana and the achievement of commercial volumes for pipeline export in Uganda will materially extend the Group's reserve life and financial profile. In anticipation of this we are evaluating long-term financing options with the support of our bank syndicate.

While the global credit environment has been challenging in recent months, operating fundamentals in the oil and gas industry remain strong and there continues to be encouraging bank support for transactions involving exploration and production companies.

Our financial strategy must support these plans by ensuring sufficient funds are allocated to our growth assets, by maintaining an appropriate level of gearing and financial risk and by constantly analysing our portfolio to ensure our asset mix is aligned with our long-term business strategy.

Investor Relations

2007 was an active year for Tullow's Investor Relations, with significant positive newsflow and the Group's entrance into the FTSE100 leading to increased investor interest. During the year Senior Management participated in over 250 investor meetings in 11 countries, presented at over 20 conferences and hosted an investor trip to Uganda for sell-side analysts. Tullow is now covered by 22 sell-side analysts and has a broad shareholder base across the UK, Europe and North America.

We always welcome shareholder queries so please feel free to contact Chris Perry, the Head of Investor Relations by email on chris.perry@tullowoil.com.

Shareholder analysis

March 2008 by segment

March 2008 by geography