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Palliser Report- Good Oil Conference September 2007

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The annual Good Oil Conference in Fremantle continues to grow in importance as a venue for providing a window on the industry for small to mid cap companies and what is driving their exploitation successes and profitability. The importance of the 2-day “beauty-parade” event is demonstrated by the significant industry participation (about 50% investors and 50% companies) with 45 companies detailing their strategies and financial position, economic forecasts and contribution to the hydrocarbon industry. However, with a few exceptions, the calibre of presentations was poor this year compared to previous years.

The following observations are made with reference to the **Disclaimer** below

1. Industry direction- why the move overseas!

- a. There is plenty of cash chasing limited opportunities in Australia with significant exploration that can be “company makers”. Mid-cap companies are moving to tougher financial jurisdictions but with substantially higher exploration potential in Asia, such as Indonesia, Malaysia, Philippines and China, because they provide the upside and markets for hydrocarbon commercialisation and can be managed in the same Australian time zones with easier access which improves business efficiency.
- b. The head-long rush by Australian small and mid-cap companies to the USA is now muted as those companies who moved there in 2005 and 2006, with few exceptions and despite rapid cashflow from discoveries, are still not well understood by the Australian equity market (many comparative studies show why many of these companies are trading below net asset backing and should have higher prices!). In addition, the reserve size of the discoveries from the known hydrocarbon fairways onshore and in the Gulf State waters in southern USA are unlikely to provide the reserve base that will be a “company maker”. Exploitation in these areas requires constant re-investment of production dollars to maintain a company’s reserve and asset position. Hence the need to look in other basins in other jurisdiction to fuel significant growth.
- c. In reviewing the presentations over the last 3 years, this year there was a distinct dearth of new ideas and strategies, particularly from those positioned in the USA. There was a tendency for some of the companies to rehash the stories of the previous years with little insight on how they would make the next “great leap” forward. One may be forgiven for thinking they were at a super market buying groceries as there was a lot of “Fig Jam” for sale. For small-caps to be taken seriously, they need to show the strategies and the results - not stress how good they are!

2. Pricing and Industry Optimism. There was an acceptance that

- a. Oil prices will remain at or near US\$70/bbl in the foreseeable future given the continued deterioration of the global supply / demand imbalance for liquids production; this being aggravated by increasing global liquids demand underpinned by rising living standards in Asia, particularly in China.
- b. The forward price curve for 12-month NYMEX crude contracts shows prices to remain in excess of US\$75/bbl. This 12-month forward curve price has been increasing over the last 4 years in response to substantial changes in petroleum demand, particularly in Asia, and is not indicating a price plateau or “bubble burst” in the oil price. This pricing signal is a key determinant in using cashflow to generate new and alternate exploitation options.

- 3. Global markets.** The macro demand issues driving the market are -
- a. Global GDP growth will be 5.25% p.a. and 4.75% p.a. in 2007 & 2008 respectively with a split 75% for underdeveloped countries and 25% from developed countries.
 - b. Global demand for oil and gas to 2030 is estimated to grow at 3.6% p.a. and 4.35% p.a. respectively; for liquids, demand rising from over 80 MMBOPD now to 140 MMBOPD in 2030. Of these growth factors, 1/3 of the global increase in oil demand is from China. China is “in transition” with strong GDP growth over the last 5 years greater than 10% p.a. This high level of GDP growth is forecast to continue for a least the next 2 to 3 years, which will underpin a burgeoning domestic economy with discretionary expenditure estimated to grow from circa \$US 2,000 to US\$ 5,000 per capita by 2016. Empirical correlations in other country economies with past rising discretionary incomes show this rising standard of living will lead to higher automotive growth and petroleum demand (as forecasted above from 80 MMBOPD to 140 MMBOPD by 2030) with 60% of the demand related to transport - primarily automotive use. Car sales are forecast to reach 1660 million in 2030 from 939 million in 2010. China’s market share of the increase will be from 11% to 23% of total cars global sales (380 million) over this period. In the absence of major and sustained exploration success, these facts point to continued upwards pressure on the oil price.
 - c. In the absence of major and sustained exploration success, these facts point to continued pressure on liquids pricing as the market adjusts to the forecast demand scenarios as noted in point 2.
 - d. The Australian exchange rate is expected to be valued at around AUS\$0.85: US\$ for 2008. This appreciation in the exchange rate will ameliorate the rises in crude prices to the Australian consumer and a level of AUD\$0.75: US\$ would push the bowser price over \$1.50 to 1.60 per litre!
(Data source: Westpac and Paterson Securities)

4. CSG provides the excitement to the gas market!

The market can best be summarized as follows:-

- a. In Queensland, companies have contracted large acreage positions with significant hydrocarbon potential. Increased certified 2P reserves are being achieved for commitments to sales contracts for retail and power generation. Assets are being commercialised. The industry is addressing technology issues, such as non- potable water production, that improves profitability of operations. 60% of QLD gas production is CSG and its market share will likely increase with increased reserve certification.
- b. There are extensive exploration and work programmes addressing stratospheric claims of potential reserves of about 6 to 10TCF as companies are committing substantial budgets and resources to “prove-up” and commercialise this important resource.
- c. The industry is being innovative in seeking “value-add” processes to generate trading margin as there will be limited opportunity for substantial price improvement because there is no external pricing source to the Queensland gas market given the potential reserve supply. Improved pricing will come from processing “value adds” – LNG, power generation, CTL etc. This will also diversify pricing risks based on well head values only. Generation of carbon credits will enhance project economics.
- d. There are 2 LNG projects planned for Gladstone based on CSG, subject to reserve commercialisation, by Arrow Energy NL and Santos Limited. Both are intending to service the export markets of Asia from 2010 to 2015. These are new and critical developments for the commercialisation of CSG.
- e. There are tentative plans to increase the pipeline infrastructure that will enhance CSG projects and the commercialisation to markets serving the Gladstone area and mid-NSW. If the CSG fields are developed, “pipeline geology” will ensure additional reserves.

- 5. Cooper Basin consolidation-** The time is rapidly approaching when there will be significant consolidation of Cooper Basin producers- rationalization of the administrations of companies chasing fewer sizable deals. The companies operating in the Cooper Basin generally have low reserve indexes (less than 3 years), but high short term cashflow which needs to be re-invested

in reserve replacement exploitation that will not come from the Cooper Basin. Hence, companies are now changing strategies to use the high short-term cashflow (mainly derived from price) to obtain exploration positions overseas in “unexplored basins” as they strategically position themselves in Asia, Africa and Middle East hoping to build sizable reserves & production.

Shareholders with few exceptions are not rewarded through dividend flows and so value will only be derived from market plays on the stock market or from consolidation. This will be a different risk position for investors and their collective reaction to these new exploration areas will be interesting to monitor!

6. **LNG options for PNG** are gathering pace with a possible ExxonMobil-led consortium continuing commercialisation studies for a plant complex to be located on the Papua Gulf leveraging off the existing oil export infrastructure, at an estimated cost of US\$ 9 to 10 billion with production targeted for 2012- 2014 at a rate of 6- 7 MTPA. This is underpinned by substantial reserve certification and high liquids content to justify the economics of the project. The commercial viability is being evaluated against a strong demand for LNG - with recent contracts priced at US\$ 8.00/GJ (US\$60/BBBL) - and Asian market opportunities post 2010. All signs point to FEED decision by year end 2007 and regulatory approvals are well advanced. It adds a strong dimension to PNG gas exploitation and there is increased interest and activity in exploration of new permits and tentative plans for the development of “stranded assets”, but based on the ExxonMobil consortium decision.
7. **Company valuations** Industry data suggested that valuations have risen significantly based on the strength of the oil price.
 - a. Purchase price for hydrocarbon reserves has increased 30% since 2004 to US \$ 9.70/BOE
 - b. ASX listed resource companies are likely to have P/E ratios on earnings of June 08- X14.7 and X13.5 for June 09 against a long term average of X18.6 (Patersons) These parameters indicate likely softening in values for the oil and gas sector.
8. **Companies that are positioned in the growth areas**

Over the last 5 years it is interesting to see how the industry has been transformed from an exploration focus with limited cashflow to a position where companies with significant cashflow and reserves can sustain aggressive exploitation programs to build shareholder wealth. For example:

 - (1) AWE with long-life reserves and burgeoning cashflow with Tui field commencing production;
 - (2) ROC with a strong reserve position and production of 10,000 bopd in 2007 plus strong cashflow and Angola and China exploration upside;
 - (3) Nexus Energy NL with projects, financial resources and cashflow generated from 40,000 boepd from 2012;
 - (4) Arrow Energy with its substantial CSG resources to evaluate the feasibility of LNG to Asia markets around 2015;
 - (5) Horizon Oil NL with net production at 6000 bopd by 2010- proven reserves underpin share price, but substantial exploration upside in Offshore China, Thailand and PNG;
 - (6) First Australian Resources Ltd (FAR) with exploration exposure in Senegal- 7 leads with potential 1 billion barrels with about 50% working interest.

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Disclaimer

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