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Palliser Report

RIU Good Oil Conference September 2005- Observations on Activities of Oil & Gas Explorers and Producers

The 2005 Good Oil Conference was held on the 7 & 8th September in Fremantle W.A. A strong field of 36 companies ranging from junior to medium sized explorers & producers presented their strategies, corporate structures, achievements over the last 12 months and their plans for 2006 and beyond.

1. **General Observations**

- a. **Industry Optimism;** The sentiment of the 2-day “talk- fest” was very positive with a focus on achievements, cashflow and opportunities to advance their respective businesses with strong commitments to rapid commercialisation of reserves and extensive forward exploration programs.
The current commercial environment of high commodity prices is a **generational opportunity for these companies to repair their balance sheets and generate cash for expansion of their businesses through exploration.** There are an exciting array of projects including offshore developments eg CliffHead and potential developments of past uneconomic discoveries eg BMG in Bass Strait, plus expansion of onshore production through the Perth and Cooper Basins, as well as CSG and **a renewed focus on USA with high gas prices about 4 times higher than here in Australia.** As in all commodity markets, rationalisation will occur in time but most likely based on *strategic positioning* to leverage the businesses to a quantum change in opportunity & value, not cash shortages eg ARC/Voyager deal!
- b. **Production & Cashflow;** Of the 34 companies that presented at RIU about **25** of them intend to use **production and cashflow** to fund aggressive exploration programs in the next 2 years. This represents a major structural change over the last 3 to 4 years in the small cap end of the market where **company values will be underpinned by operating cashflow plus the excitement & risked value of exploration success!**
- c. **Companies Focus- Speed to Market and husbanding their Corporate Resources;** Strategies focused on diversified portfolios of gas/oil, being close to infrastructure and markets with strong commodity pricing eg USA Gas, as well as the use of advanced technology to reduce exploration risk and when remapping and interpretation of old and existing non commercial discoveries. There is a strong focus on **corporate resources** needed to drive the businesses forward- trained staff, technology and businesses processes to re-invigorate the management of the businesses from the operations to the Board and hence maintain tight cost control.

Companies are focusing on speed to market in commercialising reserves and **equity participation levels in JVs that have a material impact on the growth or a “company maker”** of the business at the expense of taking some greater risk.
- d. **Commodity Pricing** There is a range of views on the commodity prices with as many experts as there are forecasts! Nobody will get it right! The broad consensus on the direction of the prices is that they may have reached a short term plateau and that the

oil price will oscillate around levels of \$US 65/barrel, although there is the probability of a short term price adjustment downwards to a range of US\$ 50 to \$55/barrel. This adjustment of between US\$ 7 to \$15 /barrel imputed in the crude price would be a result of some global market acceptance of negative market sentiment (political, disasters) not related to supply and demand fundamentals. Major additions to supply and capacity will take time to materialise and hence, over the next 2 years, downward price movements are likely to be transitory (See point f).

- e. **Forward Oil Prices and Values** The trajectory of the forward price curves for crude sold in 12 month's time, suggests that prices are settling around US\$ 65/barrel. The **capital markets assess the long term value of oil & gas assets in the range of US\$ 55 to \$60/barrel**, ie a "C" change in the pricing of oil through different demand profiles. This will drive valuations, producing asset trades, exploration decisions and risk assessments. Companies will probably use a "low price case" in the mid \$US40s/ barrel to provide sensitivities to pricing assumptions.

- f. **Oil Demand Growth** Global demand is escalating at around 3.0 to 3.5 % (China accounts for about 1% of the growth) and is likely to outstrip supply in the medium-term. No new "mega" fields are being exploited and therefore production is not being replaced. This will **underpin prices at current levels over the next 2 to 3 years, notwithstanding there are likely to be temporary adjustments**. New infrastructure and resources will take time to develop! However, sustained higher prices over several years will reduce global growth, encourage energy substitution and make inroads into changing consumption patterns. These factors will put downward pressure on prices. It is a dynamic market and the exact timing & impact of these factors are difficult to predict so operational flexibility and awareness of emerging trends are important in assessing future commitments! Explorers & producers will, at their own peril, ignore the history of the cyclical pattern of commodity markets and pricing. Material price rises are followed by falls. This is critical as companies have committed to significant exploration expenditure on the basis that the "good-times" keep rolling on! They should have "Plan B" based on materially different prices in their corporate memory and ensure tight cost control of expenditure as well as ruthless assessment of capital project viability & ranking as they commit to aggressive forward exploitation programs.

- g. **USA Gas Market** The importance of gas to the energy market particularly in the USA, with well head prices exceeding \$US 9 to 10/MCF and the forward NYMEX price curves showing US\$ 7/MCF in 4 years, underpins a major theme at the conference. The "Juniors" are charging to the USA market driven by well-head prices (well in excess of Australian prices) which, when coupled with lower exploitation costs, very close proximity to market infrastructure, a strong energy market demand and ample deals, gives the new rush to USA momentum to generate free cashflow for expansion elsewhere! The secret is to have a local presence (staff & image) & alliances- in effect to have the "skin" as an American company, as this gives the "Juniors" access to deal flow.

2. **Company Observations**

The following Companies are a sample of those with exploitation success, reserves, cash and aggressive exploration programs that will be likely to drive the value of their businesses by providing excellent investor returns and leverage for the share price over the next 1-2 years given their strategies, production growth and exploration focus. The following is not a detailed listing of corporate data, but rather a summary of the factors and strategies that provide the basis for continued strong performance

- a. **International Exposure**
 - i. **Oil Search** with enhanced PNG oil production and extended oilfield life through judicious stewardship of PNG assets, strong profitability, PNG gas project that continues its drive to commercialisation and the diversity of successful exploitation of discoveries in Yemen. Very solid performance.

- ii. **Roc Oil** within 18 months, will have 4 major projects commence production, it is well cashed up with approximately \$145 million to fund an aggressive exploration & development program in West Africa, Angola, UK, China and offshore W.A. Roc's onshore Angola position (with the first seismic in 30 years underway) provides tantalising prospect of onshore structures similar to the prolific offshore fields.

b. **Australian Exposure**

Production

- i. **AWE** is an excellent production growth play with significant production increases in the next 12 months coming from Gippsland and Otway Basins (Oil & Gas), New Zealand (oil), offshore W.A.(oil). It has an extensive inventory of prospects & discoveries which provides substantial leverage and long-term production to the Victorian gas market and national gas grid. It has focussed Board and management. Well run outfit! Market analysts value company at around \$2/share. Recent capital raising of \$120 million at \$2/share to fund developments and an accelerated exploration program in its interest areas. Forecasts presented at RIU, suggest substantial leverage to Operating Cashflow in 2006/2007 from \$100 million (low oil price US \$25) to \$250 million (US\$ 70).
- ii. **Stuart Petroleum** has strong cashflow growth from Cooper Basin reserve base (~3 yrs reserve life index) and an extensive portfolio of exploration prospects. Focus on working the Cooper assets to grow the business. International alliances for farmins to its Cooper Basin position will provide an axis to expand to other basins in due course. Focus on shareholder returns especially paying dividends!
- iii. **Beach Petroleum** has strong cashflow growth and resources from the Cooper and Otway Basins and with a diversified portfolio in oil & gas reserves there and in Bass Strait (BMG production in 2006) underpins future production and cashflow growth(~12 yrs reserve life index).
Also its recent purchase of 40% of Arrow Energy's Tipton CSG project plus adjacent projects for \$35 million for 49.6 PJ of 2P plus under developed gas will give exposure to the Queensland gas market and production in 2006.
- iv. **Arc Energy** there is not much that has not been said about Arc- its success, focus and the leadership of Eric Streitberg and his team! Over the last 12 months strong price growth from production and exposure to oil price. The focus is on re-investment of cashflow in an aggressive exploration program into 2006, so don't hold your breath on shareholders getting access in the short term to the big D! Strong focus on leverage of corporate resources- staff, Board and management processes to underpin growth objectives. Arc could be a major catalyst for strategic rationalisation in the industry in time.

Exploration/Appraisal

- v. **Nexus Energy** (1) Nexus was made Explorer of the Year at the RIU Conference! It has excellent appraisal and exploration exposure to the Eastern SeaBoard Gas Market through its interests in the Gippsland Basin in 2005/2006 through a 5 well farm out to Korean National Oil Corporation and Seoul City Gas Company. Appraisal on LongTom gas discovery in 2006. The recent Crux gas condensate acquisition in the Timor Sea substantially advances Nexus's ambition to join the producer ranks. Management focussed on technical excellence through staff and decisions based on measured risk!

- vi. **Bow Energy Limited** has just been floated. Management has proven technical skills to find hydrocarbon! Strategy is to maintain a tight focus- low risk in producing fairways, disciplined use of technology and close to infrastructure. It will be interesting to watch its progress over the coming RIU Conferences.

- c. **Coal Seam Gas**
Arrow Energy has resources, acreage and projects to produce between 35 to 45 PJ by 2010 from CSG. Commercial reserves in long term contracts at Kogan and Tipton with significant production to commence 2005/2006. Focused on low cost operations, speed to market with close proximity and substantial exploration acreage in Bowen, Styx and Clarence/Morton basins. Certified reserves of 2P 143 PJ & 3P 2,028 PJ plus aggressive exploration program 2005/2006 provides the basis to procure additional gas contracts in power generation, etc.
Arrow's recent sale of 40% of Tipton CSG project to Beach for \$35 million for Stage 1 Development and an option for additional 40% based on exploration spend in adjacent permits for \$7 million. This represents a significant profit & effective cash injection to Arrow for its project developments and vote of confidence in the resource and its importance to the Queensland gas market.

- d. **USA**
Antares Energy has a cash "war-chest" resulting of \$US 40.4 million sale (plus exploration upside of \$US 4.4 million) of its Turkish properties. This cash is being re-focused in the USA gas exploitation. It has a track record of successful commercialisation of gas assets to market. Market price may have factored in some anticipated success already! It has an operational base in Dallas- effectively a USA "skin" with USA President and staff with access to deal flow through prior relationships. Focus on gas plays in Texas with high deliverability (Wilcox Formation)- with high gas prices and close to infrastructure means rapid commercialisation and funds for exploration expansion. For success in the USA, it is critical to have local knowledge and presence through US staff in the main deal areas and they have it!

Overall, an excellent forum to promote the strategies and achievements of Australian oil and gas explorers and producers and a basis to measure achievements of the companies over time at future RIU Conferences.

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Note (1). Palliser has been a consultant with Nexus Australia Ltd.

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