Australia oils conferences

Much food for investor thought Down Under

DUG Australia and Good Oil conference wraps

Oil & gas

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On the coattails of our *Onshore down under* report, we recently attended two major Australian E&P sector conferences. The first event, DUG Australia, delivered a dose of cautionary top-down reality from those from North America who have done it all before. The second event, Good Oil, provided a strong offset by reminding of the sheer scale of the opportunity set on offer to investors in Australia. The two events served strong support for the overarching conclusion we reached in *Onshore down under*: careful E&P stock selection in Australia is critical.

DUG 2013: Bearish top-down North Americans

Following the tabling of our Onshore down under sector report in early August we attended two E&P forums to further gauge sector sentiment and direction. The first event, DUG Australia, brought to Brisbane a number of North American E&P specialists deeply versed in developing unconventional oil and gas to offer their experience and learnings to budding Australian E&P companies looking to do the same down under. The forum was valuable as a reality check to an Australian sector that regularly holds out North American physical and valuation analogues, but less regularly offsets this against the immense amount of time and capital investment that will be required to validate early-stage local plays. The two days served as a frank reminder of the long and winding journey that many investors will face while Australian players work through the expansive work programmes necessary to prove up their acreage.

Good Oil 2013: Bullish bottom-up Australians

In the week that followed the DUG Australia event we attended Good Oil, the annual investor showcase for ASX-listed E&P companies. Again it was well attended, and we thought sentiment at the event was at least as positive as last year. Company outlooks and work programmes remain strong and seemingly little affected by the pain being felt elsewhere in the Australian resources sector. Continuing oil price strength and growing supply-side optimism towards the extent of demand-side overhang emerging in East Coast gas markets are supporting sector mood and spend. A broad theme of balance sheet strength across the sector is also supportive of capital programmes. Although the then-imminent Australian general election did not attract much airtime at the forum, the subsequent sweep to power of the right-leaning Liberal-National coalition will serve to further reinforce confidence, particularly if and when the new regime delivers on campaign promises it made to repeal the existing carbon tax regime, repeal the Minerals Resources Rent Tax (and, possibly, the onshore extension to the existing Petroleum Resources Rent Tax) and streamline the environmental consenting processes.

Companies in this report

3D Oil (TDO)
Aleator Energy (AWD)
Antares Energy (AZZ)
Aurora Oil & Gas (AUT)
AWE (AWE)
Buru Energy (BRU)
Central Petroleum (CTP)
Comet Ridge (COI)
Cooper Energy (COE)
Cue Energy (CUE)
Drillsearch (DLS)
Empire Oil & Gas (EGO)
FAR (FAR)
Incremental Oil & Gas (IOG)
IPB Petroleum (IPB)
Jacka Resources (JKA)
Linc Energy (LNC)
Lonestar Resources (LNR)
MEO Australia (MEO)
Neon Energy (NEN)
New Standard Energy (NSE)
Oilsearch (OSH)
Pan Pacific Petroleum (PPP)
Petrel Energy (PRL)
Pura Vida (PVD)
Range Resources (RRS)*
ROC Oil (ROC)
Santos (STO)
Strata-X Energy (SXA)
Strike Energy (STX)
Sun Resources (SUR)
Sunbird Energy (SNY)
Tangiers Petroleum (TPT)
Tap Oil (TAP)
Target Energy (TEX)

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DUG Australia 2013

Bringing North American unconventionals down under

Recently we attended the DUG ('Developing Unconventional Gas', more recently broadened to 'Developing Unconventionals') event in Brisbane. The DUG conference series has since 2006 become established in North America as an effective and popular industry forum for discussing local, regional and international unconventional-specific issues. The series now includes seven separate annual DUG forums including events specific to each of the Eagle Ford, Marcellus, Permian and Bakken basins. The event in Brisbane, which was well attended, was the inaugural Australian event, and in our view is a valuable addition to the local circuit.

What made the forum a success was the presence of a number of North American sector veterans and specialists who shared their experiences and insights to the room and offered their views on the Australian space. There were also presentations from a number of local players with significant unconventional work programmes. ASX companies presenting included Aurora Oil & Gas (AUT), AWE (AWE) Drillsearch (DLS), Linc Energy (LNC), New Standard Energy (NSE), Santos (STO) and Strike Energy (STX). The unconventional work programmes of most of these players were covered in our Onshore down under sector report.

We focus on the key themes from discussions at the event based on perspectives offered by North American speakers.

Operational themes we noted include:

- In North America, the business of unconventional oil and gas production is increasingly a manufacturing model. In maturing plays, the emphasis is on margin capture. With pricing (particularly gas) continuing to remain soft, netback margin focus centres for now on the cost side of the business.
- Operating efficiencies that have been advanced in recent years have delivered very substantial benefits. Skid-based drilling, longer laterals, intermediate casing and zipper fracking have all delivered major cost and operating efficiencies. In North America 18-stage fracks are now increasingly the norm along laterals of c 5,000 ft (c 1,500m). Frack stages are down to as little as 200ft apart. Service sector technology advances continue to improve economics, with the arrival to market of self-erecting 'walking' land rigs that drastically reduce mob and demob turnarounds a recent example.
- Well spacings are continuing to fall as efficiencies rise. Whereas just a couple of years ago 320 acre density was the norm, now operators are spacing wells as little as 40 acres in spread, meaning wells are now being spaced as little as 100m apart.
- Even in plays where data is abundant and subsurface understanding strong, well streams and hydrocarbon compositions can vary significantly across spacings of even less than 1,000 ft.

In respect of **commercial** and **transactional** themes, we noted:

- Having been through the shale-fed M&A land grab boon in the mid/late 2000s, the North American sector has moved on so that its focus is now largely on extracting portfolio efficiencies and economies of scale. Portfolios are being optimised and divestments made so that focus is sharpened to that acreage that is core and provides the strongest returns.
- Increasingly operators are advancing strategies to upgrade the value of gas to improve supply chain economics. Gas-to-liquids (GTL) work programmes are finding increasing favour with a particular emphasis on LNG, petrochemicals and transport fuel.

- LNG export is an increasing focus. However, it is Canada rather than the Gulf of Mexico where interest is growing the fastest, due to the shipping proximity of the West Coast to Asian markets.

Notable **observations** from North American speakers on the Australian sector include:

- Australian cost curves make it very unlikely that further land-sited greenfield LNG liquefaction plants will be built in Australia. While the weakening Australian dollar is lifting competitiveness, projects in North America of similar scale to comparable Australian projects present capex profiles at least 20% and up to 50% lower.
- Doing business in Australia compared to North America is vastly more expensive, at both a capital and operating cost level. Distances, remoteness and access to infrastructure are very substantial disadvantages. Mob and demob costs of A$2-3m/well would destroy North American well economics.
- Leasehold footprints in Australia are far too large, with the result that too much acreage is placed in the hands of single operators. This eliminates the space for small independents to enter and removes room for competitive tension to meaningfully advance work programmes.
- Apart from a small number of regions where activity is relatively strong (principally the Bowen, Surat and Cooper basins), operator work programmes are individually and collectively far too shallow to produce meaningful results. A North American rule of thumb offered opined that success and efficiencies will see a company's first 100 wells be unprofitable, the next 50 wells will break even and thereafter wells will make money. The message was that companies that *play* in unconventionals will not succeed – a *programme* is required. In Australia where wells might cost up to A$10m apiece to drill, the capital intensity of an expansive programme is often prohibitive. A clear partnering and/or sell-down/exit strategy is fundamental from the outset.
- Formal collaboration between operators and service companies will be critical to overcome the many logistical and commercial challenges involved with doing business in Australia.

Good Oil 2013

Sentiment still strong

Good Oil is the leading investor event on the Australian E&P calendar. Held each year in Fremantle, it attracts companies from along the full length of the ASX small- to mid-cap spectrum. The two-day event is dominated by nearly 40 company pitches of strictly 20 minutes each, with a small number of presentations from corporates and sponsors. The event was again well attended this year, although perhaps slightly down on the c 900 that attended in 2012.

ASX companies that presented this year were 3D Oil (TDO), Aleator Energy (AWD), Antares Energy (AZZ), AWE (AWE), Buru Energy (BRU), Central Petroleum (CTP), Comet Ridge (COI), Cooper Energy (COE), Cue Energy (CUE), Drillsearch (DLS), Empire Oil & Gas (EGO), FAR (FAR), Incremental Oil & Gas (IOG), IPB Petroleum (IPB), Jacka Resources (JKA), Linc Energy (LNC), Lonestar Resources (LNR), MEO Australia (MEO), Neon Energy (NEN), New Standard Energy (NSE), Oilsearch (OSH), Pan Pacific Petroleum (PPP), Petrel Energy (PRL), Pura Vida (PVD), Range Resources (RRS), ROC Oil (ROC), Strata-X Energy (SXA), Strike Energy (STX), Sun Resources (SUR), Sunbird Energy (SNY), Tangiers Petroleum (TPT), Tap Oil (TAP), Target Energy (TEX), WHL Energy (WHN) and Xstate Resources (XST).

We met with 25 companies in and around the conference from across the scale spectrum, which provided a solid gauge of player sentiment and outlook. To a very significant extent, our *Onshore down under* report reflects the key themes that emerged from those discussions. We would also recommend a fresh read of our APPEA 2013 conference wrap, which gives additional analysis on a number of further pan-sector issues.

Beyond the key messages already teased out in *Onshore down under* and our APPEA report, our read of key threads and themes from company presentations we attended and meetings we had is as follows:

- **Work programmes still full**: Despite otherwise soft market conditions, player activity levels remain high and work programmes full. Most players can point to catalyst-rich outlooks over the next six months. Locally, focus continues to fall on the pending demand overhang in East Coast gas markets, particularly among Cooper Basin players.
- **Balance sheet health**: Supporting the strength in sector work programmes, the sector presents a generally positive aggregate picture of balance sheet health, led particularly by those with established producing assets and funding buffers. Juniors appear to have become more appreciative of the advantages of balance sheet strength in a market that continues to remain soft. The closing of an increasing number of trade deals with E&P majors and/or gas users are also serving juniors well towards managing capital and risk.
- **Frustration at lack of market recognition**: A common thread among most companies was frustration at not being rewarded by the market for progress made with work programmes and deal closures. Multiple cases are evident where substantial upgrades to 2P reserves have gone unrecognised. Similarly, as we highlighted in *Onshore down under*, markets continue to severely discount inferred deal-backed asset values, by (we calculate) an average of 85%. There is also little evidence of catalyst-rich near-term outlooks for a number of players being recognised with risk-adjusted exploration upside.
- **Capital market awareness**: Players are deeply aware of the challenges posed by current capital market conditions and the constraints likely to be faced by those needing to approach the markets for development and working capital. On the back of this understanding examples of innovative funding arrangements are coming forward, such as Strike Energy's deal with Orica, which we profiled in *Onshore down under*.
- **Overhead cost control**: Players are conscious of the pain being felt in the mining sector and are keeping tight control on cost and overhead bases. A number of companies we met with had completed restructure programmes to address headcount and reduce operating bases.
- **Indifference to change of government**: Given the proximity to the Australian general election and the differences in policy agendas between the two sides (see our APPEA note for more), we were surprised at the lack of attention the election attracted. We read this as a (correct) sense of inevitability of the outcome and an acceptance of change.

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