Australia's Unconventional Fairytale Continues

BY ANDREW HOBBS

THE coming year is likely to see an uplift in activity for the oil and gas sector, driven by unconventionals – assuming the absence of ongoing economic turmoil in Europe.

Patersons Securities oil and gas analyst Alexis Clark told the Good Oil Conference in September that companies with unconventional oil and gas projects had been a "key theme" among the top performing oil and gas companies in 2012.

"The last 12 months in the Australian sector have seen a flurry of activity by big oil in this space, continuing a record pace we do not expect to slow, driven by the excellent financial returns of the unconventional plays," he said.

Mr Clark said Statoil's decision to farm-in to PetroFrontier's acreage for $210 million was "probably the most significant transaction in this region," for the year, with transactions from BG, ConocoPhillips and Mitsubishi also ranking highly.

"Australia is now at the forefront of this revolution," he said. "Company interest has picked up significantly in Australian shale assets in the last 12 months."

The bigger exploration and production companies had paid a premium to enter the US unconventional plays after they had been derisked by smaller players, Mr Clark said.

"They could be trying to avoid this in the Australian market," he said, adding that the companies had structured their farm-ins conservatively, with staged investment the preferred approach.

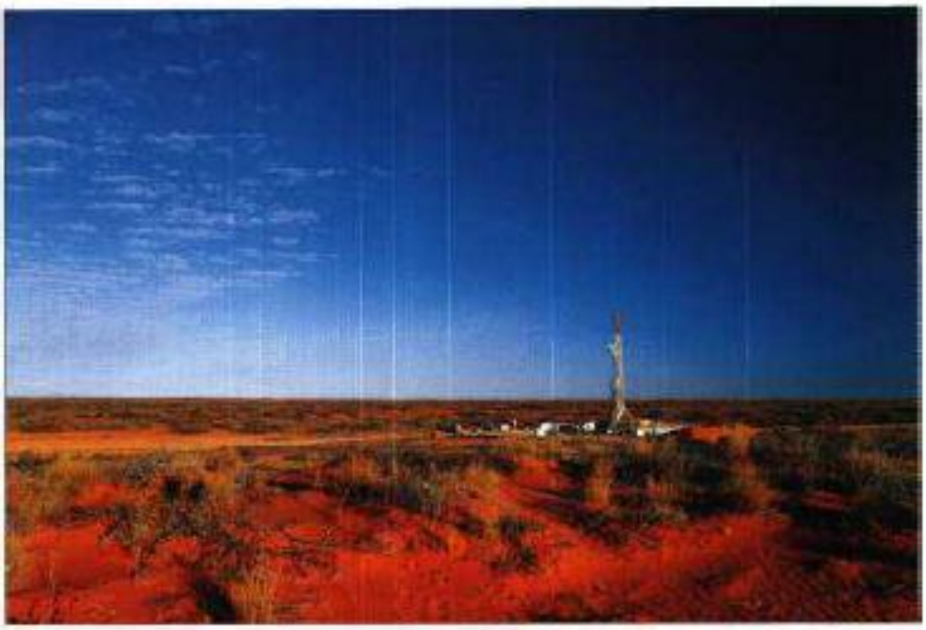
China, with one of the largest shale resources in the world, was looking to be the next entrant – working over its domestic gas prices and putting in place incentives to develop its shale resources, with Mr Clark saying early results had been promising.

This trend was occurring as costs of developing Australian shale assets increased – with companies operating locally pushing to consolidate their development projects.

Technical and geological risks to local development were high and, with large capital requirements needed to drill up the acreage, funding was also a concern – made all the more difficult by low gas prices.

"Lack of infrastructure is still a key issue – we are dealing with remote locations, with a lack of pipeline and drilling infrastructure," he added, also mentioning that environmental issues around frack completions also needed to be monitored. "Clearly this represents a significant threat to the development of Australia's unconventional gas resources from realising its true potential."

Unconventional oil and gas projects have been the fairytale of the past 12 months. Images courtesy of Beach Energy



Coupled with this was the threat of developing gas fields in Africa, with large finds recently reported in Mozambique and Tanzania, while Puntland, Somalia, and offshore Madagascar were regions to watch.

"Recent discoveries onshore East Africa by Tullow in the East African Rift Region are exciting and have the potential to exceed the output of the Ghanaian discoveries, where Tullow had its earlier success," Mr Clark said. That said, while African demand for LNG was high, the region was still subject to significant challenges and risk.

"Political risks aside, infrastructure challenges are significant – the lack of a services industry, fiscal terms and offshore drilling costs are also a key issue, which would make any East African LNG plant a higher risk adjusted break-even return, versus a developed well management plant," he said. Mr Clark suggested companies with interests in the region to watch were Pancontinental Oil & Gas, Jacka Resources, Rialto Energy and FAR Ltd, saying Patersons liked companies in the region which had higher retained interests in their projects and the ability to farm-down.

"While we continue to experience an extended period of volatility, the past 12 months have proved to be full of opportunity and success for the small to mid-cap players as they develop their prospects," he said.

"Those companies most able to adapt to the challenging environment and capitalise on their opportunities will be the ones most able to generate the value to return to their shareholders."

That challenging environment was due in no small part to the European sovereign debt crisis, Mr Clark said, adding International Monetary Fund predictions of a 3.5% growth rate in the global economy, picking up to 3.9% in 2013, was predicated on a stabilisation in the Eurozone.

European uncertainty had also taken its toll on the oil price, with increasing geopolitical instability coming out of Iran also likely to have an impact.

That said, the most significant trend of the past two months was gas prices, Mr Clark said. "US gas prices fell to below $2/mmBtu, due to the oversupply of shale gas which obviously everybody has been following closely," he said.

"It's been tracking back recently, close to $3, but the resulting falls have resulted in significant writedowns of shale gas assets by US majors as they have shifted their focus to liquids."

"The introduction of shale gas production has transformed US markets for self sufficiency, and according to the IEA total gas production is forecast to grow by 55% by 2035, with unconventional accounting for 66% of this growth," he said.

While there was no immediate threat of an oversupply of liquefied natural gas from the US, development of an export hub at the Kikimat region in British Colombia and separate projects approved by Shell and Apache in Canada could see a shake-up in North American markets.

In Australia, East Coast gas prices were currently low, at $4 an MCF compared to between $7 and $9 on the west coast, though the east coast trend was "significantly upwards post 2015," he said, adding that a local gas price convergence was some way off.

Despite this, Australian markets remained supportive of unconventional players in the energy sector, Mr Clark said, with placements successfully carried out by Australian companies Buru Energy, Red Fork Energy and New Standard Energy. Small cap energy players preferred placements and rights issues, as they helped them realise the true value of the acreage in a more lacklustre market.

"The IPO side of the market has been quite depressed, only four IPOs of significance have occurred in the last 12 months, and they have only occurred in the smaller end of the market," Mr Clark said.

While investors were cautious on small capes, Mr Clark said a chart of the performance of the small caps versus the large caps in the ASX 200 over the past five years showed that small caps had outperformed on the upside and underperformed on the downside.

"While we continue to experience an extended period of volatility, the past 12 months have proved to be full of opportunity and success for the small to mid-cap players as they develop their prospects," he said.

"With the Mid-Cap E&Ps becoming increasingly interested, Australia is well positioned to exploit its vast resource potential. The question is; will this happen at the asset level or at the corporate level if share prices do not reflect the true underlying value?" he said. ●