

Eastern Star Gas (ESG)

Power to the people

Independently certified 2P reserves of 185PJ of gas in a small part of PEL 238 indicate that ESG will turn MOUs with major power generators into Gas Sales Agreements, and could realise our intermediate price target of A\$0.57 per ESG share.

Key forecasts

	FY06A	FY07A	FY08F	FY09F	FY10F
EBITDA (A\$m)	-4.66	-6.59	3.13	7.22	17.9
Reported net profit (A\$m)	-12.6	-13.5	0.16	3.03	4.87
Normalised net profit (A\$m) ¹	-12.6	-13.5	0.16	3.03	4.87
Normalised EPS (c) ¹	-2.00	-2.15	0.02	0.44	0.71
Normalised EPS growth (%)	43.6	7.65	-99.2	1740.4	60.9
Dividend per share (c)	0.00	0.00	0.00	0.00	0.00
Dividend yield (%)	0.00	0.00	0.00	0.00	0.00
Normalised PE (x)	n/m	n/m	1553.6	84.4	52.5
EV/EBITDA (x)	n/m	n/m	80.0	33.9	12.8
Price/net oper. CF (x)	-50.1	-19.9	85.5	43.7	16.3
ROIC (%)	0.00	-36.3	0.46	6.95	11.9

*1. Pre non-recurring items and post preference dividends
Accounting Standard: Australian GAAP
Source: Company data, ABN AMRO Morgans forecasts*

year to Jun, fully diluted

Local markets for gas - monetisation of early gas

The Bohena and Bibblewindi pilot areas south of Narrabri, NSW, within the 265sqkm PAL 2 that is excised from the 9,100sqkm PEL 238 (ESG 65%), have enabled ESG to obtain 2P reserve certification of 1,85PJ of coal seam gas. This is from a minor portion of its prospective acreage. We estimate these reserves are more than adequate to support the potential demand for 3-4PJ pa from the proposed expansion of ESG's 100%-owned gas-fired Wilga Park Power Station to 40MW, via a proposed 32km pipeline. It would also support sales into the Gunnedah and Tamworth markets, which may offer a potential market for 5-8PJ pa of gas. These production levels will monetise the gas reserves by demonstrating commerciality and justify the pipeline infrastructure required to access larger metropolitan markets.

The main game - 2P reserves target above 1,000PJ

ESG and JV partner Gastar Exploration have entered into an MoU for supply of up to 40PJ pa of gas for a proposed power station to be built by Babcock & Brown. Under a separate MOU it is also investigating supply of up to 500PJ of gas (in total) to the NSW government-owned electricity generator Macquarie Generation for the expansion of its Bayswater Power Station. The gas pipeline linking ESG's Narrabri gas project to Bayswater could bring gas within 100km of Newcastle and provide potential for additional gas sales into the high-priced Hunter Valley market, the broader Sydney region market and south-east Australian markets.

Conventional gas upside potential through Orion (OIP.AX)

ESG has 35.75m shares (23.1% interest) in Orion Petroleum, which listed on the ASX on 12 December 2007 (OIP.AX). It reported it is earning a 75% interest in PEL 427 and a 60% interest in PEL 428 in the Gunnedah Basin, NSW. It has a 97.5% interest in PEL 6 and a 100% interest in PEL 455, which cover the southern extensions of the Surat and Bowen basins into NSW, and holds a 100% interest in PELs 8, 422 and 424 as well as PEL Application 73 in the Darling Basin, NSW. OIP reported net cash of A\$21.3m at 31 December 2007.

Important disclosures regarding companies that are the subject of this report and an explanation of recommendations and volatility can be found at the end of this document.

Priced at close of business 17 April 2008.

ABN AMRO Morgans Limited (A.B.N. 49 010 669 726) AFSL235410 A Participant of ASX Group

Buy

Important: The above recommendation has been made on a 12 month view and may not suit your investment needs or timeframe. The basis it is prepared on is summarised on the last page of this report. **PLEASE CONTACT YOUR ADVISOR TO DISCUSS THIS GENERAL RECOMMENDATION BEFORE ACTING ON IT.**

Absolute performance

n/a

Short term (0-60 days)

Energy

Australia

Price

A\$0.37

Target price

A\$0.57

Market capitalisation

A\$255.60m (US\$239.65m)

Avg (12mth) daily turnover

A\$0.57m (US\$0.48m)

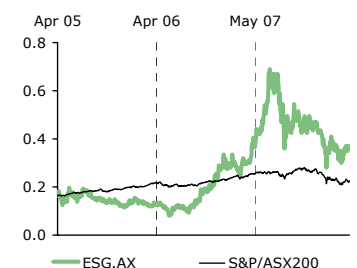
Reuters

ESG.AX

ESG80417

Price performance (1M) (3M) (12M)

Price (A\$)	0.3	0.4	0.3
Absolute %	23.3	4.2	12.1
Rel market %	17.4	10.7	27.0
Rel sector %	24.4	31.7	-18.4



Stock borrowing: **Hard onshore, Impossible offshore**

Volatility (30-day): 75.89%

Volatility (6-month trend): ↑

52-week range: 0.79-0.25

S&P/ASX200: 5470.30

BBG AP Oil & Gas: 648.24

Source: ABN AMRO, Bloomberg

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Company overview

The Bohena project (ESG - 65%) centred 30km south of Narrabri, NSW, is covered by the 265sqkm Petroleum Assessment Licence (PAL) 2, within the 9,100sqkm Petroleum Exploration Licence (PEL) 238 (ESG 65%). Independently certified reserves for the two pilot areas currently on-pump in PAL 3 are 21PJ of P1 (Proven) and 185PJ of 2P (Proven+Probable) reserves, from less than 10% of the area of PAL 3, and less than 1% of the broader PEL 238. The 3P (Proven+Probable+Possible) reserves for PAL 3 are 1,300PJ at this stage. Under the Society of Professional Evaluation Engineers reserve guidelines for the Petroleum Resources Management System (SPE-PRMS), these 3P reserves are limited by a Memorandum of Understanding (MOU) to commercialise them, rather than by the physical size of the resource.

The 100%-owned Wilga Park Power Station, 10km south-west of Narrabri, is currently configured with four gas-fired generators each of 1MW capacity. The gas supply is from ESG's conventional Coonarah gas field, and the electricity and associated NSW Gas Abatement Certificates are sold under a Power Purchase Agreement (PPA) to the NSW government-owned Country Energy. The Coonarah field is substantially depleted, and ESG has proposed a 32km pipeline from the Bohena project to fuel the power station. It has proposed expanding capacity to 40MW, which could be expected to consume 3-4PJ pa of gas. This would enable ESG to monetise its existing 2P reserves and establish the commercial parameters for production at higher rates.

ESG and its JV partner Gastar Exploration (AMEX: GST & TSX: YGA 35%) have entered into an MOU for gas supply for a proposed power station to be built by Babcock & Brown, and to the NSW government-owned electricity generator Macquarie Generation for the expansion of its Bayswater Power Station. The gas pipeline to Bayswater would bring gas within 100 km of Newcastle and provide potential to access the major metropolitan markets in southeast Australia.

During 2007 ESG raised A\$58m, with the most recent placement and SPP in late 2007 raising A\$48m at 42.5cps. ESG reported cash of A\$43.8m at 31 December 2007. ESG also has a 23.1% interest in Orion Petroleum, which listed on the ASX on 12 December 2007 (OIP.AX). It reported net cash of A\$21.3m at 31 December 2007. Orion is earning a 75% interest in PEL 427 (currently 30%) and a 60% interest in PEL 428 (currently 20%), both in the Gunnedah Basin, NSW, and has a 97.5% interest in PEL 6, and a 100% interest in PEL 455 which cover the southern extensions of the Surat and Bowen basins into NSW. It holds a 100% interest in PELs 8, 422 and 424 as well as PEL Application 73 in the Darling Basin, NSW.

Background

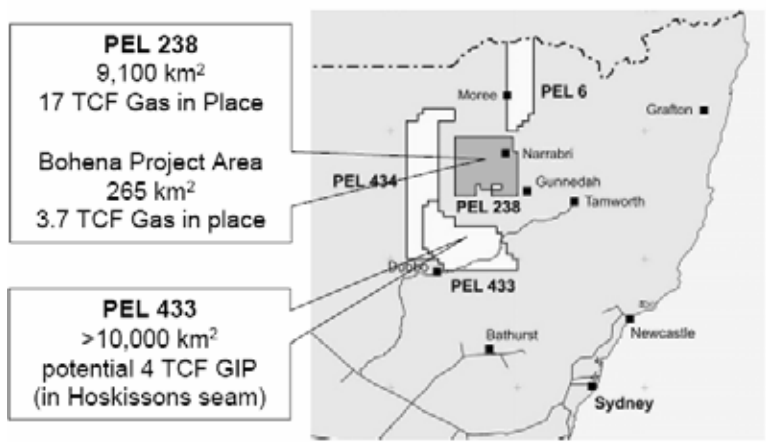
Eastern Star Gas listed on the ASX in early 2001 with interests of not less than 97.5% in exploration tenements prospective for both conventional gas and coal seam gas in the Gunnedah and Darling Basins in NSW, and the interpreted extensions of the Bowen and Surat basins into NSW. It also held rights to explore and develop possible coal seam gas deposits in shallow brown coals on the western outskirts of Melbourne.

Appraisal drilling of the Coonarah structure (ESG 100%), now held under PPL 3 in the Gunnedah Basin, successfully established the first commercial conventional gas field in NSW, with proved and probable reserves of 11.3PJ. The Wilga Park Power Station (100% owned), with an initial installed capacity of 10MW, was commissioned in July

2004 and operated as a base-load embedded electricity generator, with sales of electricity and the associated NSW Greenhouse Abatement Certificates under the terms of a 10-year Power Purchasing Agreement (PPA) with the NSW government owned retailer Country Energy. The Wilga Park Power Station operated reliably, but at less than available capacity due to the continued shortfall in gas production from the conventional Coonarah Gas Field. After a commercial dispute over the terms of the lease-purchase agreement for the 12 gas-fired 1MW generators the plant was shut down in July 2007. It re-opened in September after the dispute was resolved, with four of the 12 generators in operation.

The failure of Coonarah to meet production projections stimulated ESG to prioritise evaluation of the CSG potential of its tenements. It resolved a complex ownership and royalty structure, and focused its efforts on establishing completion techniques and reserves at its Narrabri CSG Project.

Figure 1 : ESG's tenement position



Source: Eastern Star Gas Limited

Gunnedah Basin – PEL 238 (ESG 65%)

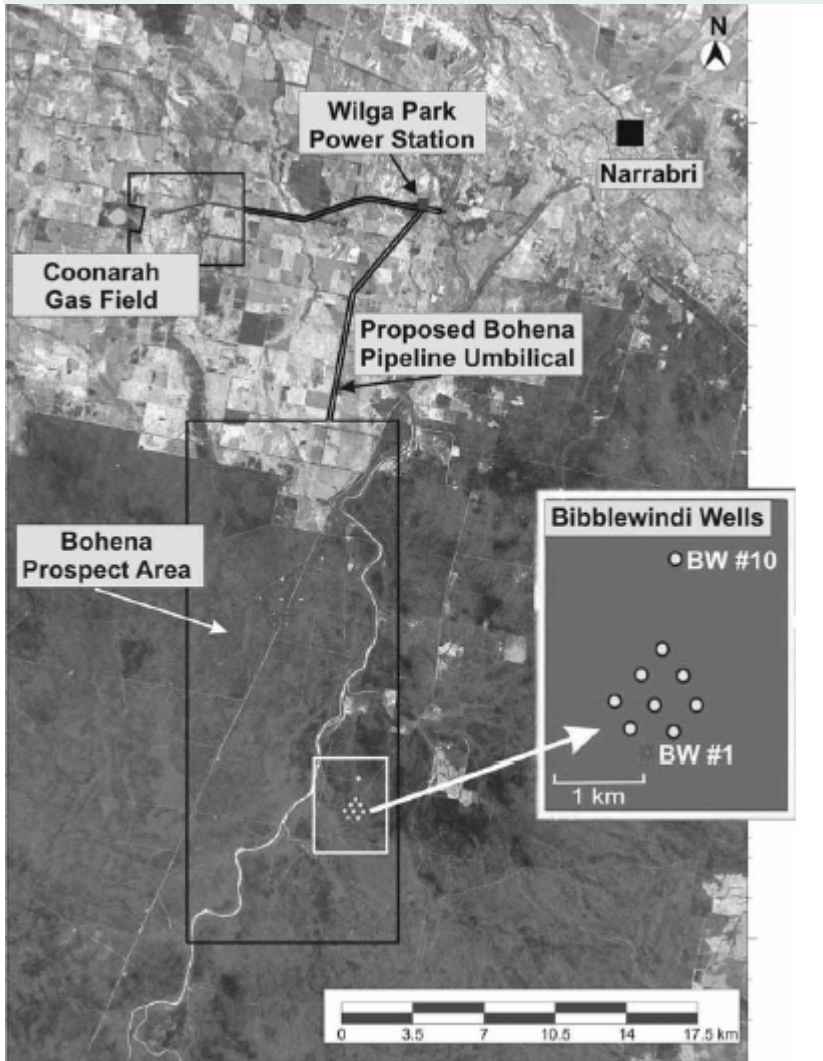
The Narrabri CSG Project

Gas reserves 2P – 185PJ

Eastern Star has a 65% interest in the Narrabri Coal Seam Gas Project and with the JV has entered into a Memorandum of Understanding for supply of up to 40PJ pa of gas for a proposed power station to be built by Babcock & Brown. Under a separate MOU it is also investigating supply of up to 500PJ of gas (in total) to the NSW government-owned electricity generator Macquarie Generation for the expansion of its Bayswater Power Station. The gas pipeline linking ESG's Narrabri gas project to Bayswater could bring gas within 100km of Newcastle and provide potential for additional gas sales into the high-priced Hunter Valley market, the broader Sydney region market and south-east Australian markets.

Although it first commenced pumping from the Bohena CSG Project in 1999, it wasn't until 2004 that Eastern Star changed its primary focus from conventional oil and gas exploration and production to CSG evaluation. In early 2005, four vertical wells at the Bohena Project that had been fraced during 2004 were put on pump to evaluate water and gas flow rates. The current campaign involves pumping from three wells – Bohena #3, #7 and #9 – with monitoring of other wells in the pilot area.

Drilling of the Biblewindi Pilot Cell wells commenced in early 2006, and nine wells were fraced and completed for production testing in late 2006 early 2007. Dewatering commenced late 2006, and all production wells were on pump by April 2007.

Figure 2 : Narrabri CSG Project – Bohena & Bibblewindi pilots

Source: Eastern Star Gas Limited

Netherland Sewell & Associates Inc – an internationally accredited consultant with experience in the full range of reservoir engineering services including reserve determinations – has now certified proven (1P) reserves of 21PJ, and 2P reserves of 185PJ. They have also certified 3P reserves of 1,300PJ in the Bohena Project area. These reserves are in the Early Permian Maules Creek Formation coal measures.

Macquarie Generation and Babcock & Brown – 60PJ-plus pa?

The JV has entered into a Memorandum of Understanding with Babcock & Brown Australia Infrastructure Pty Ltd (a subsidiary of Babcock & Brown) for supply of gas electricity generation, and envisages supply of up to 40PJ pa of gas to a proposed power station to be built by Babcock & Brown.

It is also investigating supply of up to 500PJ of gas to the NSW government-owned electricity generator Macquarie Generation for the expansion of its Bayswater Power Station. The gas pipeline linking the gas project to the Bayswater Power Station, about 300km in length, could bring gas within 100km of Newcastle and provide for potential additional gas sales into the greater Newcastle-Sydney-Wollongong area.

Wilga Park Power Station – 3PJ pa potential

Gas deliverability from the conventional Coonarah gas field to supply the Wilga Park Power Station has been below budget, with recent testing indicating the field is now substantially depleted. Wilga Park is now configured with four reciprocating gas-engine driven generators each of 1MW capacity, and is expected to continue to operate below available capacity in the short term because of gas supply limitations.

Gas from the Bohena CSG Project (PAL 2) is to be used to supply Wilga Park, with deliveries anticipated by ESG from late 2008. With the confirmation of deliverability, Bohena is expected to support expansion of the power station to 40MW, with sales of electricity and the NSW Greenhouse Gas Abatement Certificates to Country Energy. This level of generation would require supply of 3PJ pa.

Other exploration tenements

Gunnedah Basin, NSW – PEL 433 & 434 (ESG reducing to 65%)

The Hoskissons coal seam in the Late Permian Black Jack Group is well developed in PEL 433, although it has not been subject to systematic evaluation for coal seam gas potential. Two core holes funded by Gastar Exploration – and designed to align equity interests with those in PEL 238 – were drilled in 2007 and show excellent coal quality with good permeability.

Arckaringa Basin, SA – PEL 117, 121 & 122 (ESG earning up to 50%)

ESG has a two-stage farm-in agreement with SAPEX (SXP.AX) to evaluate the CSG potential of the three petroleum exploration licences 117, 121 and 122. These tenements cover 27,000sqkm of the Arckaringa Basin, in the region of Coober Pedy, South Australia. The Early Permian Mt Toondina Formation typically consists of between five and nine coal seams, with an aggregate thickness of 25-30m.

Under the first stage of the agreement, ESG will drill three core holes, one in each licence to evaluate coal quality, and will earn a 25% interest. The second stage will involve drilling and testing a five-well pilot cell, to earn a further 25% interest.

Valuation and risks

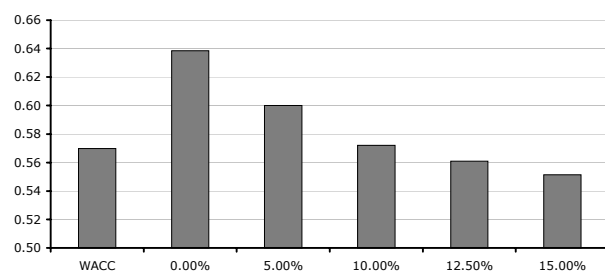
We re-initiate coverage of Eastern Star Gas with a Buy recommendation and a target price of A\$0.57 per share derived using a DCF-based sum-of-the parts valuation. The bulk of the value – A\$0.32 per share – is derived from assigning a value of A\$1.00/GJ to the anticipated 500PJ of gas to be identified in PEL 238, and risking this to 50%. We have also assigned value to Wilga Park Power Station and assumed an expansion of capacity to 40MW with ESG's attributable 2P gas reserves of 120PJ in the Bohena Project area. Successful delineation of gas reserves and the conversion of the MOUs to Gas Sales Agreements would add significantly to our valuation of ESG.

The key downside risk to our target price is failure to increase the 2P reserve base. Upside risk could come from an increased focus on and corporate activity in the oil and gas sector, or gas reserves increased above our expectations.

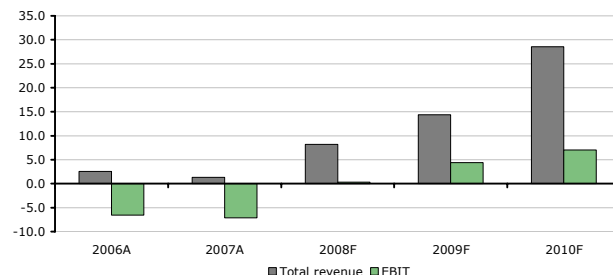
ESG – financial summary

Year to 30 Jun (A\$m)	AIFRS 2006A	AIFRS 2007A	AIFRS 2008F	AIFRS 2009F	AIFRS 2010F	
Income statement						
Divisional sales	2.0	0.7	6.9	13.1	27.3	
Total revenue	2.6	1.3	8.2	14.4	28.6	
EBITDA	-4.7	-6.6	3.1	7.2	17.9	
Depreciation & amortisation	-1.9	-0.5	-2.8	-2.8	-10.8	
EBIT	-6.6	-7.1	0.3	4.4	7.0	
Net interest expense	-0.4	-0.1	-0.1	-0.1	-0.1	
Pre-tax profit	-6.9	-7.2	0.2	4.3	7.0	
Income tax expense	0.0	0.0	-0.1	-1.3	-2.1	
After-tax profit	-6.9	-7.2	0.2	3.0	4.9	
Minority interests	0.0	0.0	0.0	0.0	0.0	
NPAT	-6.9	-7.2	0.2	3.0	4.9	
Significant items	0.0	0.0	0.0	0.0	0.0	
NPAT post abnormals	-12.6	-13.5	0.2	3.0	4.9	
Growth ratios	2006A	2007A	2008F	2009F	2010F	
Sales growth	34%	-63%	832%	90%	109%	
Operating cost growth	#VALUE!	10%	-49%	56%	61%	
Cash flow statement	2006A	2007A	2008F	2009F	2010F	
EBITDA	-4.7	-6.6	3.1	7.2	17.9	
Cash flow from ops (1)	-4.6	-11.7	3.0	5.9	15.7	
Capex (2)	-0.3	-2.8	0.0	0.0	0.0	
Disposals/(acquisitions)	0.0	0.9	0.0	0.0	0.0	
Cash flow from invest (3)	-0.3	-1.7	0.0	0.0	0.0	
Incr/(decr) in equity	14.3	10.5	0.0	0.0	0.0	
Incr/(decr) in debt	-2.1	0.0	0.0	0.0	0.0	
Ordinary dividend paid	0.0	0.0	0.0	0.0	0.0	
Other financing cash flow	-0.8	-0.5	0.0	0.0	0.0	
Cash flow from fin (5)	11.5	10.0	0.0	0.0	0.0	
Forex and disc ops (6)	0.0	0.0	0.0	0.0	0.0	
Inc/(decr) cash (1+3+5+6)	6.6	-3.4	3.0	5.9	15.7	
Equity FCF (1+2)	-4.9	-14.4	3.0	5.9	15.7	
Balance sheet	2006A	2007A	2008F	2009F	2010F	
Cash & deposits	8.1	2.1	5.0	10.9	26.6	
Trade debtors	0.0	0.0	0.0	0.0	0.0	
Inventory	0.5	0.3	0.3	0.3	0.3	
Investments	0.0	0.0	0.0	0.0	0.0	
Other intangible assets	0.0	0.0	0.0	0.0	0.0	
Fixed assets	4.9	4.6	1.8	-1.0	-11.8	
Other assets	10.1	44.0	44.0	44.0	44.0	
Total assets	23.6	51.0	51.1	54.2	59.0	
Interest bearing debt	1.9	0.1	0.1	0.1	0.1	
Trade payables	0.0	0.0	0.0	0.0	0.0	
Long-term borrowings	0.0	0.0	0.0	0.0	0.0	
Provisions	0.2	0.6	0.6	0.6	0.6	
Other liabilities	1.8	1.8	1.8	1.8	1.8	
Total liabilities	3.9	2.5	2.5	2.5	2.5	
Share capital	0.0	0.0	0.0	0.0	0.0	
Other reserves	0.4	3.3	3.3	3.3	3.3	
Retained earnings	-26.4	-39.9	-39.8	-36.8	-31.9	
Total equity	19.7	48.5	48.7	51.7	56.6	
Minority interest	0.0	0.0	0.0	0.0	0.0	
Total shareholders' equity	19.7	48.5	48.7	51.7	56.6	
Total liabilities & SE	23.6	51.0	51.1	54.2	59.0	
Closing price (A\$)	0.37				Price target (A\$)	0.57
Valuation methodology	DCF				Val'n (A\$)	\$ 0.57
Valuation summary	A\$m	A\$ps	DCF valuation inputs			
Wilga Park Power Station	25.0	0.04	RF	6.25%		
PEL 238	42.7	0.06	Rm-Rf	4.50%		
MacGen CSG MOU (500PJ)	162.5	0.24	Beta	1.46		
B&B CSG MOU (500PJ)	162.5	0.24	CAPM (Rf+Br)	12.8%		
Exploration	0.0	0.00	Tax rate (t)	30.0%		
Net Cash	21.0	0.03	WACC	10.35%		
Corporate & Other	-20.0	-0.03	Shares	690.8		
Total	393.7	0.57				
Production (Mt)	2007A	2008F	2009F	2010F		
Gas PJ	0.60	1.00	1.06	2.40		
Key assumptions	2007A	2008F	2009F	2010F		
A\$/US\$	0.79	0.89	0.90	0.86		
Oil Price (US\$/bbl)	63.50	79.79	75.25	57.00		
Gas Price (US\$/Gj)	4.70	6.87	5.69	5.56		
Per share data	2007A	2008F	2009F	2010F		
No. shares	627.8	690.8	690.8	690.8		
EPS (cps)	-2.2	0.0	0.4	0.7		
EPS (normalised) (c)	-2.2	0.0	0.4	0.7		
Dividend per share (c)	0.0	0.0	0.0	0.0		
Dividend payout ratio (%)	0.0	0.0	0.0	0.0		
Dividend yield (%)	0.0	0.0	0.0	0.0		
Operating performance	2007A	2008F	2009F	2010F		
EBIT growth	8%	-99%	1332%	60%		
NPAT growth	4%	-102%	1740%	61%		
Normalised EPS growth	8%	-99%	1740%	61%		
Asset turnover (%)	0.5	3.4	6.2	12.0		
EBITDA margin (%)	-233.2	-893.8	45.6	55.3		
EBIT margin (%)	-329.3	-965.9	4.5	33.7		
Net profit margin (%)	-347.1	-975.7	2.4	23.2		
Return on net assets (%)	-14.7	0.6	8.5	12.4		
Net debt (A\$m)	-2.0	-5.0	-10.8	-26.5		
Net debt/equity (%)	-4.1	-10.2	-20.9	-46.9		
Net interest/EBIT cover (x)	-98.9	4.3	61.1	97.7		
ROIC (%)	-36.3	0.5	7.0	11.9		
Comparable multiples (x)		2008F	2009F	2010F		
Eastern Star Gas	EV/EBITDA	18.8	7.8	7.3		
Year to 30 Jun	PE	-30356.2	15.8	15.2		
Queensland Gas Company	EV/EBITDA	91.7	56.2	34.9		
Year to 30 Jun	PE	95.0	82.5	83.9		
Arrow Energy	EV/EBITDA	24.7	20.6	19.9		
Year to 30 Jun	PE	46.2	29.4	40.6		
Earnings Sensitivity		2008F	2009F	2010F		
Gas sensitivity (+10%)		0.38	-36.75	-31.88		
Gas sensitivity (+ 10c Gj)		-39.78	-36.75	-31.88		

Valuation sensitivity to discount rate (A\$/share)



Total revenues and EBIT (A\$m)



Source: ABN AMRO Morgans forecasts, company data

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CHRIS BROWN	-	Senior Analyst	SCOTT POWER	-	Senior Analyst
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NICK HARRIS	-	Analyst	TAMARA STRETCH	-	Analyst
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JAMES LAWRENCE	-	Fixed Interest Analyst	REBECCA SULLIVAN	-	Retail Strategy
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