

Eastern Star Gas Limited

ESG

Wednesday 4 November 2009

Drilling activity focused on achieving 2P reserves of 1,300 PJ

Recommendation: BUY

Investment Rational

ESG is a coal seam gas (CSG) explorer and producer with interests in a number of permits covering a total of 70,600 km² in the Gunnedah, Bowen and Surat Basins in NSW and the Arkaringa Basin in SA. ESG's main focus is the evaluation of the CSG production potential of PEL 238 and PAL 2, in the Gunnedah Basin. In 2000, Nederland, Sewell & Associates, estimated the gas in place within this permit alone at 17 TCF in the extensive Hoskissons and Bohena coal seams. ESG has drilled a large number of core holes to test the extent and thickness of the coal and has established four production pilot projects within PAL 2. Gas produced from the pilot projects as well as the conventional Coonarah gas field is utilised in the Wilga Park power station.

Overview

The September quarter was an extremely busy period for ESG and the pace of drilling and completion activity has not subsided in the first month of the December quarter. Initial production results from the previously completed Bibblewindi multi-lateral pilot project established a significant increase in production of water when compared to production from vertical wells alone. However, the continued build up of gas production was hampered by the failure of pump drive rods as a result of a manufacturing fault. ESG has now replaced all the defective pump rods and the multi-lateral pilot has returned to full-scale production.

The amount of water recovered from the multi-lateral wells indicated that a much larger area of coal was being dewatered than originally planned. To better simulate gas production from the multi-lateral wells, ESG drilled two single lateral shield wells, one either side of the multi-lateral wells. The shield wells were designed to produce water from the larger than anticipated reservoir and allowing the multi-lateral wells to draw down reservoir pressure within the coals in the immediate vicinity of the wells in a timelier manner.

During the quarter, ESG also completed the drilling of the Bibblewindi West tri lateral production pilot. Unlike the three previous production pilots that tested the Bohena coal seam, the Bibblewindi West pilot will test the overlying Namoi coal seam. This coal seam is prevalent across a large area of PEL 238, but has not previously been tested and is not included in the determination of reserves. The Bibblewindi West pilot will commence production once gas and water pipelines to the wells are completed.

In the Dewhurst area, ESG has commenced the drilling of three single lateral wells as part of the Dewhurst production pilot. As an isolated pilot, it is intended that production will occur over a period, sufficient to demonstrate water and gas production only and will not be completed as a full scale development.

Gas from the Bibblewindi and Bohena pilots started flowing down the gas pipeline completed towards the end of the June quarter. Gas delivered via the 250 mm diameter pipeline now provides the majority of gas supplied to the Wilga Park power station which now comprises a 1 MW and 3 MW gas turbine generators. ESG now expects to operate the power station on a continuous basis utilising pilot production gas. As gas flow increases, the capacity of the power station will be gradually expanded to a planned capacity of 40 MW.

Water produced from the production pilots is processed through a reverse osmosis water treatment plant with treated water initially satisfying ESG's operational needs..

During the quarter, ESG announced that Netherland Sewell and Associates had increased gas reserves within PEL 238 (ESG share 65%).

Reserves Category	Reserves at 30 September 09	Reserves at 30 June 09	Increase
1P	21 PJ	33 PJ	57%
2P	336 PJ	602 PJ	79%
3P	1,300 PJ	1,959 PJ	51%

In addition to its production activities, ESG has been active in drilling a number of CSG exploration core holes and conducting seismic surveys in PEL 238 as well as its farm in blocks PELs 6, 427 and 428.

Snapshot

Last Price	\$0.86
Market Cap.	\$723.16 million
52 Week High	\$1.16
52 Week Low	\$0.30
Sector	Energy

Investment Fundamentals

Cash on hand (Oct 08)	\$48.98 million
Shares on issue	840.88 million
Employee shares	37.28 million (unlisted)

Directors

The Hon. John Anderson	Chairman
David Casey	Managing Director
Dr. David King	Non-executive
Chris Sadler	Non-executive
Alexander Sundich	Non-executive
Peter Lansom	Executive Director

Major shareholders

Santos Ltd	19.9%
TRU Energy	5.2%

Price Chart



Valuation target

ESG is on track to achieve its objective of booking 1,300 PJ of 2P reserves by the end of 2009. Four production pilots have been drilled and the fifth is currently being drilled.

ESG's current share price of \$0.86 is at the low end of its estimated value based on its CSG reserves at 30 June 2009 and on the average value of CSG transactions announced in the last 18 months of between \$0.83 and \$1.13 per share. However, the scale of its drilling activities in PEL 238 focused on increasing 2P reserves by more than 2 times by the end of the year as well as its drive to expand its market for CSG beyond the 2 power generation commitments, means that a significant increase in share price can be expected in the first half of 2010.

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