

PNG LNG – the making of Oil Search

In November 2010 Michael Bentley, Northward Capital's Sector PM for Metals & Mining, Energy, Utilities and Chemicals sectors, undertook a research field trip to the PNG operations of Oil Search Limited (OSH). This trip was a follow up to the one Michael completed a year ago. The visit had a number of objectives which included:

- reviewing the physical progress of the project,
- ascertaining if the main stakeholders (Oil Search themselves, Exxon, the PNG Government, the landholders and the broader PNG populous) have had any major shifts in attitude or objectives,
- assessing if there had been any significant change to the project's risk profile (in either a positive or negative way), and ,
- providing an opportunity to liaise with fellow Oil Search shareholders, including several major international investors and understand their major issues with the project and the company.

The 3 day visit to PNG comprised presentations by senior OSH staff, the PNG Treasurer and the PNG Minister for Enterprise, as well as, visiting the site for the PNG LNG processing plant and wharf, the Port Moresby Training College, the existing Hides gas facilities and expansion project as well as the Central Processing Facility. Michael also completed a flyover of all existing OSH facilities and PNG LNG project gas pipeline route and the new airport being constructed at Komo. During the trip there were also opportunities to meet with local landholders and have significant exposure to senior OSH executives including the CEO.

To recap, the total budget for the project is \$US15 billion. The project partners are ExxonMobil operator 33.2%, Oil Search 29.0%, PNG Government 16.6%, Santos 13.5%, Nippon Oil Exploration 4.7%, PNG landowners 2.8% and Petromin PNG Holdings 0.2%. The first LNG train is due to deliver LNG in 2014, and will produce 6.6 million tonnes annually which is fully contracted to customers in Japan, Taiwan and China. According to OSH, this project will double PNG's gross domestic product – which currently averages just \$US2,300 per person per year – while trebling exports.

Given the scale of the project, OSH's PNG LNG (Liquefied Natural Gas) project is of crucial importance to the PNG Economy, Government and the people as well as being considered a "company maker" for OSH.

One Year On

Our trip last year provided invaluable insight, and this year was no different. At the time of visiting last year the project had not reached Final Investment Decision (FID), and was not fully contracted. Those two significant milestones have been achieved and the project is now well and truly under way. Essential infrastructure and logistics are the main focus at the moment. The airport development at Komo in the Highlands is currently considered to be the most critical task. This airstrip will provide the key point for equipment and people movement in the highlands. The airstrip itself is some 3.2km long and will be capable of landing almost any description of aircraft, including the Russian Antonov 124 cargo plane, with some 80 cargoes from this type of plane alone being delivered. In addition, upgrades to highways and logistics routes are also a high priority at the moment. The LNG plant site has begun its construction with major civil works being well under way. The permanent training college at Port Moresby has been constructed and already several groups of trainees have completed initial courses. The Hides gas project expansion has also begun.

Still much to do

Although a significant amount of work has been started, the majority of the work remains to be done. The operator, Exxon has a global reputation of delivering projects on time and on budget and has established procedures developed over a long period of time and thousands of projects. There are 38 months left in the timeline and confidence is high that deadlines will be met. The construction work peak will occur next year and at the LNG plant alone there will be some 8,000 workers.

Support

Our presentation from two senior members of the PNG parliament reinforced the importance of this project to the country and the government is overwhelmingly supportive of the project. They also recognise where there are shortcomings within various departments and the need for additional resources in order to cope with such issues as approvals, issuing permits, customs and quarantine. As we noted last year the general population is behind the project, but there are without doubt risks associated with such a massive change happening to a 3rd world country in such a short period of time and managing expectations remains an important element of successfully delivering the project.

Practical implications

As we noted last year, a project of this size, in its geographical location requires exceptional planning and operating management. The logistics of getting the right materials in the right quantities at the right time is not without issue in such demanding mountainous terrain. Further, local civil unrest and tribal conflict is not uncommon. As mentioned previously Exxon brings unmatched project building ability, but are quite “naïve” when it comes to the management of the locals’ expectations and requirements. This is where Oil search provides the expertise. On this trip there was a notable level of

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frustration from Oil Search executives in regards to Exxon being very dogmatic in their approach and still needing to learn the value and skill that the local PNG “nationals” could bring. OSH employees are evidently working hard to rapidly educate Exxon in the ways of PNG. We remain confident in OSH’s ability to manage this issue, and the faster this happens, the better for the project.

Risks

One year on and we see that the risks of the project have not changed significantly. We are more confident the project will be completed on time and budget. The project has a strong ability to attract the required skill base from such regions as the Philippines, Taiwan, China, Malaysia and the Middle East and will not see the enormous cost pressure that Australian projects will bear. Equipment cost pressure is evident, however, many long lead items have been ordered and Exxon is able to apply significant buying power. We see the major risks being the “soft” issues. Dealing with the landholders, equitable distribution of wealth, corruption, government bottlenecks and stretched public infrastructure are the key risks. Dealing with those who have “missed out” remains an important issue. OSH recognises that part of its responsibility is to take on a “quasi government” role. Consequently, they have started the process of providing educational and health facilities to areas outside the bounds of the project itself.

Protection of a pristine environment is very high on the list for the project. Every effort is being made to keep the project’s footprint in the highlands to a minimum. Such things as burying pipeline, re-injecting water and avoiding critical wildlife habitats are just a few of the critical environmental issues that need to be dealt with.

Government support remains strong and we are comforted to see that the country is in the process of setting up sovereign wealth funds, an infrastructure fund and a future fund. The Australian government is assisting with the structure and set up of these funds and is also providing skilled staff in the areas of customs and immigration.

PNG is currently ruled by a 13 party coalition something that helps to maintain PNG’s politics “interesting” status. Subsequent to our visit the PNG Prime Minister has stepped down from office as he is investigated regarding some financial irregularities. Nevertheless, we believe that the support for the project is across all parties and thus the risk to the project associated with a change of government or senior ministers is quite low.

As with any project there is risk of the project becoming uneconomic. The PNG LNG project however has strong returns at oil prices as low as \$35 a barrel.

Future development

Over the last year the market has become more focused on the future expansion of the project. A third LNG train will provide much higher returns as much of the infrastructure required for that train will

already have been built as part of the initial project. The gas required for the third train has not been proven to a sufficient level of certainty yet. As a result further drilling will be required around the Hides gas project to obtain the necessary reserves. Current planning has this drilling commencing in 2012. However, Oil Search are currently pushing the joint venture to accelerate this drilling to early 2011 in order to be able to market the gas to potential buyers earlier and to ensure they roll over relevant skilled teams straight away into the third train build. OSH is confident they can achieve this acceleration and are extremely confident of successful reserves drilling. The current hurdle to the accelerated drilling is obtaining the approval of Exxon.

Why does this represent a 'company maker' for OSH?

The project's scale in terms of the investment, time and potential revenues all combine to make this a company maker for OSH. OSH's annual production will almost triple from 2014 onwards with the delivery of trains 1 and 2. The project has an estimated life of at least 30 years. The third train represents a significant increase in returns for the project as well as life extension.

Conclusions

Our visit this year has increased our confidence in the delivery of the PNG LNG project. Notwithstanding significant progress has been made, there remains a long way to go. Exxon are focused on project execution and Oil Search remains the key player in dealing with the local issues. While the key risks remain, we believe that as Exxon becomes more sensitive to PNG local issues those risks reduce. The government also appears to be growing to the task although they still have some major improvements to make. However, their intent to resolve their current issues is clear and, while they may not be perfect, if the current focus remains we believe these are unlikely to prove a major issue to the project's value. We see the major positive catalysts over the next 12 months being significant project progress and the potential drilling of further reserves.

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The Central Processing Facility and one of the drill pads in the Highlands.



The training facilities at Port Moresby



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The Antonov 124 - which will be delivering some 80 Cargoes to the Komo Airport

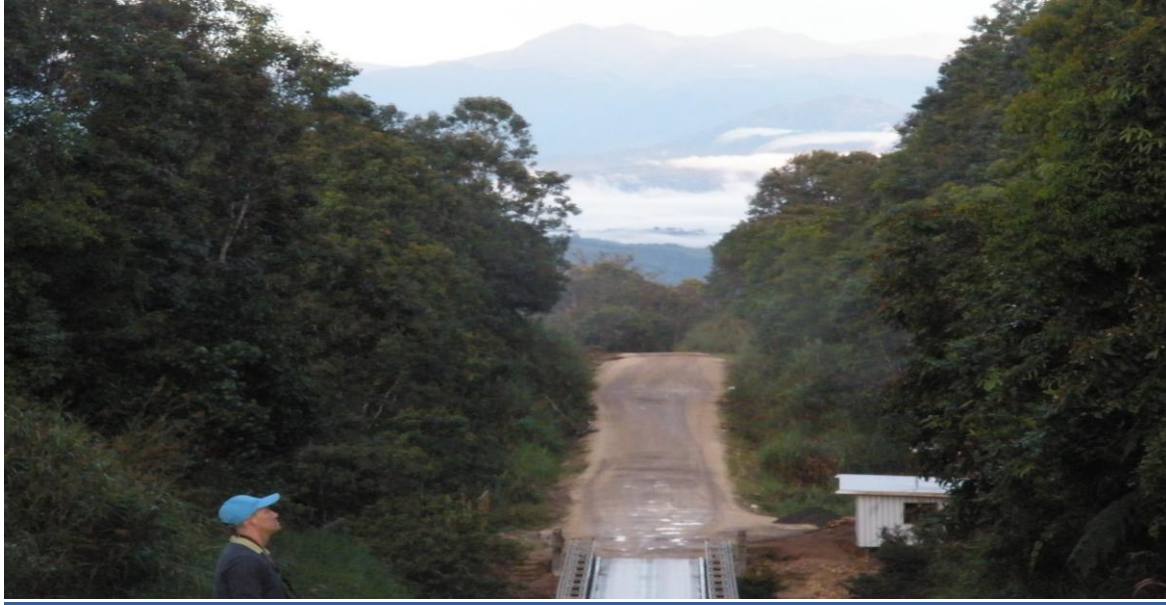


Development of Komo Airport



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The Highlands Highway where the project is making significant improvements (such as the new bridge pictured) to enable more efficient movement of goods and people.



The “Chief” of Oil Search, Peter Botten is greeted by 2 Huli Chiefs at the Hides Gas Project.

