



## Chairman and CEO's Letter to Shareholders

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### Year in Review

The big news is that everyone now understands that Eastern Australia needs more gas, and Blue Energy has nearly 4,000 PJ of un-contracted gas resource to sell.

In the twelve-month period since our last AGM letter to you, there has been a slight recovery in the international oil price. However, the reality is that this period has also seen the low point in the price cycle (US\$26.05/bbl on 11th February 2016) and the industry is still responding to the prolonged downturn by continuing to cut costs. Globally, companies are still shedding staff, and not undertaking discretionary expenditure on exploration activities. However, the "shrink to grow" strategy seldom works. Most companies are also not taking the opportunity to install new systems and technology to improve efficiency and productivity. Domestically, there have been large tracts of acreage surrendered by companies to reduce exposure, which in turn delays the exploration process as governments then need to turn over the acreage and re-gazette the acreage, resulting in more delays in discoveries. With the oil and gas Service Company sector in Australia largely decimated, Government red and green tape, approval delays and access to land further adding to the time it takes to get on with even the most basic of exploration, the time from gazettal to production continues to balloon. That is, don't expect to be able to find new gas resources and produce molecules when they are needed.

A further irony in a gas short market is that domestic gas prices continue to increase, as the Curtis Island LNG plants take more gas from outside their Joint Venture tenements (known as "third party gas"), yet Capital Markets are seemingly still substantially closed to explorers who need to fund activity for the discovery and development of new gas resources to bring to a higher priced market. The volatility and uncertainty of the global oil market has impacted on investors supporting the domestic gas explorers and future producers in what has become a very attractive price environment for upstream Operators.

Blue has continued throughout the year to closely monitor its costs and steward its cash reserves. The Company continues to be mindful of managing non-discretionary exploration program and expenditure. The changing political landscape, where some State governments think that it's appropriate to limit gas exploration at a time of real gas shortage and state wide power blackouts, shows the growing disconnect between those who would seek to access and deploy risk capital to discover and develop new gas sources (the explorers) and those who rely on those resources to keep the State's lights on and their manufacturing sector strong and profitable (the politicians, who have empowered the fossil fuel opponents).

### East Coast Gas

The intrigue surrounding the east coast gas market continues to deepen as all six LNG trains on Curtis Island have now commenced operation (although two of the six are not yet operating at nameplate capacity). Total gas demand on the East coast is approximately 4,800 – 5,000 TJ/day (or 1,700-1,800 PJ/annum) at the time of writing. Of this demand, some 68% comes from the Curtis Island export LNG plants. Rising levels of third party gas is being required to supply these LNG plants to maintain throughput and returns on investments, and all at a time of oversupply and subsequent low spot pricing in the global LNG market.

As the two main domestic gas contracts from the traditional Cooper Basin and Bass Strait supply sources will end in the next 12 months, more of that gas will be taken by the Curtis Island exporters and Sydney's gas will be coming more from the Gippsland Basin than anywhere else. The critical issue of gas supply at times of peak demand becomes the litmus test of a broader security of energy supply issue for the east coast, which is now being hotly debated on the national stage. The underlying issue here is that there isn't sufficient gas available now to fulfil the 20 year LNG contracts and the domestic/industrial user demand, and some governments are irresponsibly restricting the search for new gas supply. Just in time gas supply is not a concept that works in the exploration and production industry anymore given the lead time is years.

Given recent events in South Australia, Sydney and Melbourne, where the electricity grid in SA failed in late September, and a gas shortage during a cold snap saw spot gas prices in Sydney and Melbourne escalate to \$30-40/Gj which saw all gas storage capacity being drawn down to cope with demand, it is apparent that there is an imminent problem that policy makers and regulators need to address. Without gas, it is obvious that renewable energy alone cannot heat homes, allow domestic cooking or fire manufacturing in the depths of a southern winter.

With no exploration for gas allowed in onshore Victoria, the sovereign risk associated with exploration in NSW too high for new entrants and a fracture stimulation moratorium (pending a gas industry enquiry) in the Northern Territory, it seems that it will fall on South Australia and Queensland to continue the search for new gas resources. (there is no uncontracted gas in SA and exploration is shut down due to the cost of production in Central Australia).

It should be remembered that 85 % of current 2P gas reserves in Eastern Australia are held by LNG export proponents, and therefore the bulk of these reserves are committed to export. The remaining 2P reserves that might be available to the domestic market are not yet developed, but will require capital expenditure (ie, drilling completion and connection) to produce deliverable molecules. New gas fields could take up to 12 years to discover, appraise, develop and bring to market (largely due to regulatory process, land access and social licence issues). Therefore, already discovered but undeveloped molecules (like Blue Energy's 2P and 3P reserves in the Bowen Basin) are all the more valuable as demand rises and supply is constrained. Blue Energy continues to progress several opportunities to monetise its gas reserves and resources.

It is our view that the solution to the East Coast Gas shortage lies in connecting "the Bowen Basin Gas Province" reserves and resources to the southern market via Blue Energy's proposed Central Queensland Gas Pipeline linking Moranbah to Rolleston and Wallumbilla. This would unlock 10,000 PJ of reserves and resources alone. Couple this with the good recent news from Galilee Energy with their production testing of the Betts Creek Coal Measures in their Glenaris Pilot, and an additional 5,000 PJ of Contingent Resources could be added to the pool to bring south to market (Blue Energy has acreage adjacent to this activity).



## **Electricity**

It needs to be better understood that there is a symbiotic relationship between gas and renewable energy. Renewables (wind and solar) are by their very nature asynchronous, intermittent and unreliable. Electricity generation using gas is reliable, instantaneous and synchronous. Gas fired power generation stabilises the electricity grid, which is made unstable by the increasing amount of renewables being introduced to the grid. So it should be self-evident that with increasing renewables, there needs to be increased gas fired generating capacity to stabilise the grid and to provide back up during periods of low generation from the renewables.

The dramatic events in South Australia in late September which saw the electricity grid fail and the entire State plunged into darkness, has belatedly woken policy makers and politicians from their slumber to ask the question, does such a high reliance on wind energy have any impact on the stability of the electricity network? Whilst the investigation into the SA fiasco is still underway, it may be premature to assign fault, but what is clear is that if it were not for gas fired generation, South Australia would have remained in the dark for a lot longer. It displays the folly of being reliant on only one or two primary sources of baseload power and limited reliable peaking capacity, and is almost a carbon copy of the Tasmanian situation of 2015/16. Is this the future of power supply that industry needs to plan for?

## **Global Oil**

The big news in global oil is Russia, for the first time, is attempting to join in with OPEC to broker a production ceiling. Russia is the world's leading oil producer, with Saudi Arabia number two. OPEC has recorded record oil production last month, averaging 33 million barrels per day with Russia and Saudi Arabia combined accounting for about 23 million barrels per day. What does this proposed alliance mean strategically, and how does it sit with Russia's traditional ally Iran?

The global oil price has not really changed significantly in the last 12 months, other than to recover significantly from a dead low on 11 February 2016 (US\$26/barrel). The sporadic price rallies (then falls) are largely driven by the speculators hanging off every piece of information/misinformation from OPEC or Russia or Venezuela about freezing production levels (at record highs), and by traders' short or long positions in the commodity. Information on US oil inventory levels is also used by paper traders to move the price.

Ultimately the Saudis are producing at maximum output, and Russia is also keen to maximise US dollar income, whilst Venezuela is minutes from economic implosion and needs oil revenue maximised and will talk up the price at will. In reality the only real player with any ability to significantly increase production is Libya, but it is in a state of civil war.

What is clear is that global oil demand is increasing annually (by 2.5% pa) whilst expenditure to find more oil has fallen off a cliff. There is only one outcome from this – a probable price spike will occur once the small oversupply one-two million barrels per day out of 94 million barrels/day of production) disappears. China's domestic consumption plays a key role in the speed at which the current oversupply can be absorbed.

## **Global Gas and LNG**

As we have discussed previously, the ramping up of the six LNG liquefaction trains on Curtis Island (after an unprecedented build out of capacity in Australia) has unfortunately coincided with the slump in global oil price and consequent slump in LNG spot price (given the common linkage between oil price and LNG). These headwinds present significant challenges for LNG producers on Curtis Island as well as buyers with long term contracts, which may or may not have floor prices embedded in the price formula. Accordingly, buyers are seeking to on-sell cargos as either they have over committed to buy more than required or take advantage of the favourable spot price compared to their contracted price. Contract re-negotiation is subsequently an active pursuit from many Asian buyers who have highly priced long term contracts. Additionally, it would appear that Qatar, the world's largest LNG producer, is actively seeking to restore market share against its newer rivals by offering to renegotiate contracts with more beneficial terms for buyers. Interestingly Saudi Arabia attempted this in the oil market, but it didn't work, so why would the Qataris expect a different result in LNG?

Once again, the role of China will be pivotal in the global demand growth for LNG over coming years, as the central Governments mandated move toward greater use of gas over coal gathers pace and China moves from around 75% of its fuel mix being gas to 10% gas of the mix by 2020. This figure still lags well behind OECD countries which average 23% gas usage in the energy mix.

## **Australia's Energy Security and Vision**

As we have described earlier, the east coast of Australia has a tenuous grip on the secure supply of energy to the population and industry. The warning signs of the unreliability of that energy supply could not be any clearer, be it from the prolonged energy shortage in Tasmania, the catastrophic grid failure in South Australia, or the skyrocketing gas prices experienced in July in NSW, Victoria and South Australia. Whilst these events are not directly linked to each other they are the canary in the coal mine for problems ahead if the politicians continue to ignore the engineering realities of high levels of renewable energy inputs and the parlous state of exploration for new gas sources in onshore Australia. If we cast our eyes beyond our shores for a minute, we observe that countries that do not have indigenous energy sources (Japan, Korea, Taiwan), understand the need for energy security and they are committed to long term gas supplies (from multiple sources) and to the sanctity of the contract. These countries mitigate the risk of commodity cyclicity by ensuring stability of supply.

## **Summary**

The evolving gas supply situation and corresponding domestic price escalation, together with the general energy security issues playing out on the East Coast mean that Blue Energy's uncontracted gas reserves and resources are more valuable now than they were 12 months ago. We are focussing on marketing our gas to potential buyers both in the North Queensland area, and in the southern states with our proposal for interested parties to construct a gas pipeline connecting Moranbah to Rolleston in the Northern Denison Trough and hence connecting into the Wallumbilla Trading hub. Bringing the sizeable Bowen Basin (and potentially Galilee Basin) reserves and resources to market will provide a timely solution to looming gas shortages in the main gas demand centres. Your Company is well positioned to benefit from this tightening gas supply and growing demand, as there is a dawning realisation of the need for gas fired generation to partner the burgeoning growth in renewable energy,



so that the stability of the electricity grid is maintained. More gas to market will put downward pressure on price and provide a cleaner electricity source – just look at the United States for the proof.

## **Shareholder Communication and AGM**

We look forward to meeting with those able to attend this year's Annual General Meeting on 22 November to review in more detail the events of this year. It is a relatively large meeting agenda to work through this year, and we wanted to take some time to explain some of the Resolutions being put forward for your approval. Some of these matters are as follows:

### **Electronic Shareholder Connectivity – Cost Reduction Strategy**

To further complement our cost reduction efforts we would like to request email details from all shareholders so that our communications to our shareholder base can be cost efficiently undertaken and limiting the amount of printed material and postage where possible.

### **Explanation of Rights Issues to the Managing Director and Directors**

Shareholders will notice in the Resolutions to be voted on at the AGM, that the Board has sought approval from shareholders for the issue of Rights to the Managing Director. The Board has formed the view that in response to;

1. market conditions;
2. the lack of any salary adjustment for the Managing Director since 2010;
3. the significant cost savings achieved by the Managing Director; and
4. the salary voluntarily forgone by the Managing Director (totalling some \$100,000 forgone over the previous 15 months);

and in recognition in part for this, the issue of Rights to the Managing Director should be confirmed. It is important to remember that Rights are “at risk” remuneration (ie, they are not cash or shares per se), and for these Rights to convert to ordinary shares, several hurdles need to be achieved; namely, the share price needs to materially improve before these Rights vest (there needs to be a 50 % increase in Total Shareholder Return before the total amount of Rights can become shares).

The Managing Director is to be commended for proactively and voluntarily forgoing 20% of his salary during a period of sustained commodity price instability. Blue Energy was the first oil and gas explorer in Australia to set this standard.

The Board considers that is appropriate to recognise the Executive Chairman with similar “at risk” Rights and extended Options for his considerable efforts continuously directing the Company's alignment with shareholder value. The Board is also of the opinion that the Non-Executive Directors, who have forgone their committee fees, should also be recognised for this and incentivised by the grant of “at risk” Rights

Finally, your Board considers that having the ability of the Employee Incentive Rights Plan to cover issuance of Rights to both employees and Directors, gives greater transparency and efficiency in having a single Plan covering both Directors and employees with common terms applying to both, and also gives the Company flexibility to adjust Director fees and save money,

but compensate those Directors using “at risk” Rights, thus creating better alignment with that of the broader shareholder base.

### **Unmarketable Parcel Buy Back**

In an effort to reduce costs, the Company is seeking to aggregate unmarketable parcels of Blue Energy shares (any shareholder with less than 500 shares) and to reduce the costs of communicating with those shareholders who no longer take an active interest in the Company’s activities and in its dealings with shareholders. There are approximately 2,000 shareholders with holdings of 500 shares or less. The Company intends to acquire the holdings of these shareholders at market prices.

Yours sincerely



John Ellice-Flint  
Executive Chairman  
Blue Energy Ltd



John Phillips  
Chief Executive Officer & Managing Director  
Blue Energy Ltd