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Lodgement of 'Company Interview'



'COMPANY INTERVIEW'-MARKET PROFESSIONALS

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**Challenger Energy Ltd**

**Date of lodgement: 7/7/2014**

**TITLE: "Company Interview. Significant Role in Shale Gas in South Africa"**

**Highlights:**

- Pending award of Exploration Right for substantial position (~1 million acres) of prime area of emerging Karoo Basin.
- Gas flowed to surface previously on this acreage from unstimulated vertical well.
- Severe energy shortage in South Africa with Government supportive of emerging shale gas industry. Potential to provide substantial boost to GDP, significant job creation and energy security.
- Positive developments as Government revisits proposed amendments to key legislation. Publication of new regulations and award of Exploration Rights keenly anticipated.
- Challenger is only junior in the play with major companies like Shell, Falcon & Chevron.
- Challenger's profile growing in South African media (e.g CNBC).
- Challenger looking for strategic partner – negotiations advanced.
- Very strong, experienced and respected Board.
- Outlines growth strategy and investor proposition – potential company maker!

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**Introduction**

*Challenger Energy Limited (ASX: CEL, CELO) is currently focused on the emerging world-class shale gas play in the South Africa's Karoo Basin. Challenger's strategy is to leverage its high-value position in this future legacy asset to build a long-term sustainable company with an unconventional quality portfolio. Challenger will seek to identify and add high-potential assets that will be value-accretive to the Company whilst maintaining a balanced risk profile.*

## **RECORD OF INTERVIEW:**

### **Company Interview question:**

Challenger Energy Limited has applied for a shale gas exploration right in the Karoo Basin in South Africa. Can you give a brief outline of what the prospects are? How do these compare with others elsewhere?

### **Managing Director, Robert Willes**

Challenger has applied for a shale gas exploration right covering about one million acres in the Karoo Basin. Via its subsidiary Bundu (Bundu Gas & Oil Exploration (Pty) Ltd), Challenger was the first to do so, and was soon followed by Shell and Falcon. The US Energy Information Administration performed a global ranking of shale gas basins and ranks the Karoo at number 8 globally, with an estimated technically recoverable gas resource of 370 tcf, which is a huge number. By way of comparison, Australia's North West Shelf and Gorgon LNG projects would be based on tens of tcfs. So, the Karoo's economically recoverable number could be significantly smaller than the technically recoverable estimate and still remain highly compelling.

Moves by Shell and Falcon (which has subsequently announced a deal with Chevron) to apply for much of the rest of the prospective acreage underscore the attractiveness of this emerging world-class shale province.

Exploration was carried out in the region in the late 1960s by Soekor (then the State-run oil and gas exploration company). Soekor shot seismic and drilled a small number of wells which had gas shows in the shales. Importantly, the well drilled within our application area took a gas kick (they had to activate the blow-out preventer) and flowed gas to surface for 24 hours. That is quite unusual for a vertical, unstimulated well. Although, at that time, the flow was not considered commercial, it is very significant today when modern extraction technology can be applied.

Another significant point is that the 370 tcf technically recoverable gas referred to by the US EIA relates to only one interval of the shales, the Basal Ecca Shales, on the basis that these have a higher total organic content. These shales are around 100 to 150 metres thick. However, the gas that flowed from the well in our application area came from the shales that lie above that and are around 10 times the thickness, which suggests there may be upside to the EIA estimates.

### **Company Interview question:**

What about the history of the shale oil and gas industry in the Karoo Basin? Who are the current major oil and gas companies with licenses there? What about smaller market capitalisation companies similar to Challenger?

### **Managing Director, Robert Willes**

At the moment all the applications for shale gas exploration rights in the Karoo are pending, including Challenger's. There are junior listed oil and gas companies operating in South Africa, although Challenger is the only one in the shale gas space. Falcon is one of the smaller international companies, but Challenger is the only "pure play" ASX listed small cap player with exposure to this potential.

**Company Interview question:**

What is the general attitude of the South African Government to exploring for shale gas? How would you describe the current energy demand/supply balance in South Africa?

**Managing Director, Robert Willes**

There is a real energy crisis – the margin between power demand and supply capacity is tight and this has been the cause of periodic power supply emergencies with the power utility, Eskom, having to impose regular load-shedding and other restrictions. The coal-fired power generation fleet is ageing and there is a considerable push to build new capacity in, coal, gas, renewables and nuclear. The coal projects are expensive, and are running behind; progress is being made in renewables; and nuclear may be an option; but there is currently little gas available. In the interim, diesel is being used to make up the shortfall, resulting in the need for massive state support. At the same time, South Africa's gas-to-liquids projects are running low on feedstock, and serious consideration is being given to importing LNG, which is unlikely to be cheap.

The energy crisis is holding back the economy which in turn contributes to South Africa's very high unemployment levels. At the same time, there is growing awareness that shale gas development can make substantial contributions to the economy beyond just the tax and employment from upstream development. The US has provided a clear example that many governments around the world would like to emulate. In South Africa, independent economic consultants Econometrix modelled the benefits to the South African economy using 20 and 50 tcf resource development scenarios to demonstrate the scale of employment and very substantial value add to GDP that such a development could create – potentially 700,000 sustainable jobs and 200 billion of Rand to GDP for a 50 tcf gas resource.

The South African Government is supportive of moving ahead with shale gas exploration to establish whether this resource benefit can be realised. In the past few months we have seen a number of indications of this, with strong, positive statements from ministers, from the Deputy President, in the ANC 2014 Election Manifesto, and in President Zuma's State of the Nation Addresses both before and after the May elections.

Beyond shale, there is growing interest in South Africa's petroleum potential, with a number of major oil and gas companies looking to explore offshore. This provides South Africa with a great opportunity to establish an oil and gas industry with all the attendant economic potential.

**Company Interview question:**

Can you describe the current petroleum legislation and regulations in South Africa and any expected changes?

**Managing Director, Robert Willes**

South Africa currently has legislation, the Minerals and Petroleum Resources Development Act (MPRDA) that covers both mining and petroleum. The MPRDA is in the process of being amended.

The advent of shale gas has required the development of a new regulatory framework, the so-called Technical Regulations. These regulations have been in development for some time with a number of government departments involved, seeking to benefit from

international experience. The draft Technical Regulations were issued for comment in October last year. The industry, including Challenger, has engaged in consultation on the regulations and it is anticipated that these will soon be finalised.

An amendment bill to the MPRDA was passed by the South African parliament prior to the May elections and is currently with the President for signature. Some of the proposed terms, such as a 20% free carried interest for the State and a right for the State to purchase a further interest, had raised understandable concern with the oil and gas industry. Although these amendments were passed by Parliament, it would appear that they are now being re-considered with the new Minister for Mineral Resources reportedly having asked the President not to sign off on the current bill until it can be properly reviewed. This is an encouraging development that should be positive for our industry and which Challenger fully supports.

**Company Interview question:**

Do you have the licenses to explore at this stage?

**Managing Director, Robert Willes**

No, all applicants are at the same stage – that is, awaiting the award of licenses. The applications were submitted in 2010, but the process was put on hold by the declaration of a moratorium on hydraulic fracturing in 2011. This moratorium was lifted in September 2012 and it was decided that a new regulatory framework was required (the Technical Regulations I mentioned previously).

Interestingly, the Government has since declared a moratorium on new applications, but this expressly excludes the existing shale applications, including Challenger's. Government has effectively said that it won't accept any more applications for the time being, but that it will progress the existing ones.

**Company Interview question:**

When do you expect your exploration license may be issued? Once it is – what are the next steps in terms of on the ground programmes?

**Managing Director, Robert Willes**

We visited South Africa after the May election and there were two schools of thought about how this would be handled: one was that the MPRDA amendment bill that was passed by Parliament would be signed off by the President, allowing the process of assessing the exploration rights applications to proceed. The other was that the MPRDA would be revisited to make the legislation more suitable to the emerging oil and gas industry and more conducive to attracting the necessary investment in exploration.

Each has pros and cons; the former case implies that the process could move forward faster in the near term, but with legislation that may be harder to work with. The latter implies that some time may necessarily be required to revisit the proposed amendments, but with the potential benefits of clearer legislation and more appropriate terms for the industry.

Media reports subsequent to our visit would suggest that we are looking at the second scenario. As I mentioned, the new minister appears to have taken note of industry

concerns and has asked the President to hold off on finalising the amendment bill whilst he reviews the situation.

This leads to some uncertainty on timing, and I can understand that that this might be a concern to our shareholders, many of whom have loyally supported Challenger for quite some time. This development is actually good news, however, as it is likely to be beneficial to the industry as a whole, and therefore to Challenger. Any additional time taken to do this now could well be worthwhile in the medium to long term, setting the legislative foundations and saving time and money overall, so we're very encouraged by this news.

That said, it's not clear that the processing and award of exploration rights will necessarily await the legislation, particularly given the moratorium on new applications. It is possible that the trigger for this could be the finalisation of the Technical Regulations, which could happen sooner.

We will continue to keep close to the situation in South Africa as it unfolds, and continue to keep the market informed.

Once an exploration right is granted, our technical plan is to start with studies, which may include reprocessing the vintage seismic data. This would likely be followed by drilling a limited number of simple core holes prior to drilling, completing and fracture-stimulating a vertical well in order to assess the flow characteristics of the different shale horizons. Given the initial work to select a suitable site, the various approvals that may be required and the need to reach agreement with any affected land-owners, this well would probably be drilled a year or more after the award of the exploration right. Alongside this activity, there would be an ongoing programme of stakeholder engagement and consultation.

#### **Company Interview question:**

How is the concept of fracking being received in South Africa in the context of the emerging shale gas sector?

#### **Managing Director, Robert Willes**

Concerns have been and continue to be raised. The challenge for all stakeholders – ourselves included – is to commit to engage to create a common understanding of both the value of this resource to the country as a whole and how it can be accessed in the best interests of all.

If exploration in the Karoo succeeds, then the likelihood is that shale gas will be a part of the economy for decades to come. We absolutely want to be good neighbours to and part of the communities that we work with, as well as making a contribution to the wider economy, so our commitment will be to apply best practise in terms of exploration and engagement with communities and other stakeholders.

#### **Company Interview question:**

I read in a recent Quarterly Report that you are looking for a potential farm-in to your assets. What progress has been made? Can you comment on the broad terms you're seeking and the type of desired partner?

**Managing Director, Robert Willes**

Our aim is to execute a farm-in that will make both financial and strategic sense – in other words to create a strong partnership to take the business forward. I can't comment in detail, but the significance of our position in South Africa is certainly recognised and we continue to make good progress.

**Company Interview question:**

How well known is Challenger Energy as an emerging shale gas producer in South Africa?

**Managing Director, Robert Willes**

Since the beginning of this year particularly, Challenger and Bundu have begun to increase their profiles in South Africa. Challenger was invited to be the sole sponsor of the launch of the Australian Business Chamber of Commerce in Southern Africa in January, at which the then Minister for Mineral Resources was the keynote speaker and guest of honour. This proved to be a great way to begin building relationships with the South African media who have certainly picked up on the potential importance of shale gas to the national economy – and within days Challenger was being featured on CNBC Africa TV and in major trade journals. We believe this to be important in helping to establish a platform for more focused engagement with other South African stakeholders once the outcome of our exploration right application has been determined.

**Company Interview question:**

Can you give a brief background of your Board and senior management? What about Challenger's funding position and the expected use of those funds?

**Managing Director, Robert Willes**

Challenger has a very strong Board with a wealth of international, commercial and technical experience in both majors and small caps.

Our Chairman, Mike Fry, has over 30 years' experience of capital markets and is Chairman of Red Fork Energy and Norwest.

Bill Bloking has over 40 years' experience in oil and gas, having held senior roles in Exxon and BHP Billiton, and smaller market caps such as Norwest, Eureka Energy and Nido Petroleum (of which he is currently chair).

Our technical advisor, Paul Bilston, has 18 years' experience in the oil and gas sector, having held senior technical, commercial and management roles both in Australia and overseas. His experience encompasses roles in AGL Energy, AJ Lucas – where he was head of CSG, Worley and GHD. He is a former Managing Director of Challenger and a director of ASX listed Galilee Energy.

Peter Price, our representative in South Africa, is a respected mining engineer with over 50 years' experience. He was one of the team who first recognised the potential of the Karoo and drove the exploration right application process in 2010.

My own experience includes 24 years with BP with a range of international assignments and senior commercial and general management roles covering exploration, production, mergers and acquisitions, business development, LNG marketing, joint venture management, gas & power and corporate head office. I came to Australia with BP in 2003

and was responsible for managing BP's upstream growth assets – principally the North West Shelf, Browse and Greater Gorgon. I subsequently set up BP's business development team for Asia Pacific in Jakarta and was heavily involved in securing new upstream positions in Indonesia, including potentially the World's first CBM to LNG project in Kalimantan. More recently, I was CEO of ASX listed Eureka Energy during the hostile takeover by Aurora Oil and Gas, and have just joined the Board of Buru Energy.

On the funding side, we've so far sought only to raise modest sums for working capital purposes whilst working to support the exploration right application and progress potential farm-in discussions. Looking forward, our future funding strategy will be very much influenced by the outcome of the farm-in discussions.

### **Company Interview question:**

In summary, can you outline the company growth strategy and investor proposition?

### **Managing Director, Robert Willes**

There aren't many comparable benchmarks to use in Southern Africa, but looking at shale transactions that have occurred elsewhere in the world in the last couple of years may help to illustrate how value has been ascribed as assets are de-risked through the journey from exploration to production. In fact there is a chart in our last investor presentation that illustrates this. Whilst one should be cautious when comparing deals in different geographic locations, the chart suggests that at the very early stages deals would seem to be in the tens of dollars per acre, but that this moves up through the hundreds and thousands of dollars per acre as the assets are de-risked through exploration and appraisal, and higher still as they move into production. As an example Eureka Energy's main asset was around 1500 net acres of the Sugarloaf Project, which was moving into development in the Eagleford Shale in Texas when Eureka was acquired by Aurora Oil and Gas for A\$107m in 2012 – Aurora itself having more recently been acquired by Baytex. Significant investment is required along the way of course, but with an application pending for around one million acres surrounding a well in which gas flowed to surface the starting position looks very interesting.

Our strategy in the near term is to secure our exploration rights and a strategic partnership for our project in South Africa. This will provide a strong position from which to consider adding further assets and growing the firm.

### **Company Interview**

Thanks, Robert.

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