26 October 2011

Chief Executive's Annual Meeting Address

Chief Executive David Salisbury
NZOG Annual Meeting, Intercontinental, Wellington
Wednesday 26 October 2011

It is a pleasure to address you again. We recognise that it is very important to take the opportunity to meet with you and to discuss the performance of your company and the challenges and opportunities that we have tackled on your behalf.

At last year's Annual Meeting I stated that NZOG was working hard to implement our two-pronged business strategy: maximising value extraction from our existing asset portfolio; while securing new value-adding business opportunities.

We have been working to establish a couple of new core areas outside of Taranaki, targeting conventional oil and gas in proven hydrocarbon basins, working with quality business partners and with a manageable financial exposure.

Put simply, this means our focus has been on getting the most out of what we've got, while actively pursuing opportunities to grow the company. We remain firmly committed to this strategy and in the past 12 months have taken some significant steps towards meeting it.

NZOG is generating good operating cash flows from our interests in the Kupe and Tui fields which both lie in offshore Taranaki.

We have a portfolio of other opportunities in New Zealand and resulting from a systematic screening of suitable international new ventures we have identified Tunisia and Indonesia as our new areas of interest.

New Zealand Exploration

NZOG is involved in one permit in the Canterbury Basin and has a strong presence in the northern region of the offshore Taranaki Basin. The prospectivity of these permits continues to be assessed. There is also further exploration potential within the Tui and Kupe permits.

However, the most advanced opportunity lies in our permit PEP 51311 in the southern offshore Taranaki basin, to the south and west of Kupe.

Here NZOG has identified a stacked series of Miocene coastal sands, with estimates of mean prospective resources in excess of 200 million barrels of oil.

To give you some scale – that's a potential resource 5 times the size of Tui. And at current oil prices, a resource valued at over $20 Billion.

During the year NZOG worked to bring the prospect – now named Kakapo - to drill-ready status. New seismic modelling has identified a possible gas cap on the main postulated oil column, thereby upgrading the estimated chance of success.

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Australian listed resource company, Raisama Ltd, has come in as a joint venture partner. Raisama will get a 10% stake in the permit in return for paying 20% of the cost - with a cap - of the Kakapo-1 well. Other companies are reviewing detailed data as NZOG looks for an additional joint venture partner.

The 'drill or drop' commitment deadline for this permit is currently January 2012, with a requirement to drill by January 2013.

We have been very actively looking for a suitable rig which can drill this well for us. Right now, we are in discussions with the owners of a rig currently working in Australia which may be available in 2012 to come to New Zealand.

We have assembled a project team – of our own staff and external consultants - to ensure that good industry practice is applied in preparing for and drilling this well.

There have been calls from some quarters for a ban on oil drilling in New Zealand waters because of the current shipping disaster off the Bay of Plenty coast. That makes no sense whatsoever.

It would be like a bus driver falling asleep at the wheel and running off the road – and then calling for a ban on all air travel.

Kakapo is business as usual for Taranaki. Dozens of wells have been safely drilled. Kakapo is a straight-forward, relatively shallow, vertical well to test rock which may or may not be oil bearing. Rock samples may be taken but we will not be flowing any oil – if it's there – to the surface.

Kakapo will be safely drilled and offers enormous potential benefit to this country.

Expanded Horizons

A major discovery at Kakapo would be transformational for NZOG. However, this is exploration drilling. We rank this prospect very highly, but the historical rate of commercial success in offshore Taranaki is around 1 in every 10 wells.

New Zealand remains under explored and NZOG is committed to ongoing involvement in the identification, testing and development of New Zealand's petroleum resources.

However, the rate of exploration and general industry activity is quite low and the available opportunities for NZOG are unlikely to be sufficient to be confident we can meet our growth objectives from New Zealand alone.

Since 2008 we have been looking further afield. We have examined a range of opportunities, but found most of them had too much geological risk or were unattractive financially. However, through the screening process we found ourselves focusing on two particular areas of interest – Tunisia and Indonesia.

Tunisia

We were attracted to Tunisia due to its combination of good prospectivity, established exploration and production activity, reasonable fiscal terms, and relative ease of doing business.

Tunisia was of course the country where the Arab liberation movement began, at the end of last year. We firmly believe that the move towards more open democracy in Tunisia enhances its attractiveness as a place to invest.

Through our networks we were able to identify available acreage in a productive basin. The Diodore permit that we acquired in June this year is surrounded by discovered and producing oil and gas fields and from the existing data we have already identified a sizeable prospect within the permit.

We are now contracting a vessel to conduct a 460km seismic survey and that survey should be getting underway around Christmas time.

Once we have the data from that survey we intend to work the prospect up to drillable status and bring in partners ahead of committing to a drilling campaign, which could be as soon as 2013.

Diodore is just the first step in Tunisia. We have relocated a senior explorationist to Tunis and we are actively pursuing further opportunities.

Indonesia

Indonesia has a long oil and gas history but remains underexplored by western standards. In recent years the contract terms and business climate have improved considerably.

However, to succeed in Indonesia it is useful to have good local knowledge and contacts, so as part of our activities NZOG has established a strategic relationship with Bukit Energy, a new company put together by experienced oil professionals with a deep understanding of Indonesia.

A large portfolio of opportunities has been identified and reviewed, most of them in onshore Sumatra. This highly productive region offers a variety of entry points, including open acreage, regular bid rounds and farm-in possibilities, thereby offering us exposure to a consistent flow of possible investments.

The first opportunities have been secured.

The first was a Joint Study Agreement in northern Sumatra. This JSA allows for a six month study to be done on the prospectivity of the designated area, with priority rights to then apply for an exploration permit.

A second JSA has been applied for, also in Sumatra. NZOG is also in discussions to farm into a permit in central Sumatra. Other opportunities in Indonesia are under active assessment.

Pike River

While we have focussed in the past year on managing our existing assets and diversification by securing new growth opportunities, we have also had to address the impact of the Pike River mine tragedy.

Here at NZOG we watched, along with the rest of New Zealand and others around the world, as the tragic events at Pike River unfolded in November 2010. Within days of the first explosion, the decision was taken by NZOG to provide a $12m loan to Pike River Coal Ltd (PRCL), so that the mine staff could be paid and the rescue effort could be supported.

Subsequently the situation deteriorated with further explosions, fire and the confirmed loss of 29 lives. There was a great deal of uncertainty about the mine's future following this terrible tragedy and PRCL advised that it was facing insolvency. At the request of the PRCL Board, Receivers were appointed by NZOG.

NZOG's $12m loan has largely funded the receivership, including paying mine employees their statutory entitlements, stabilising the mine atmosphere and undertaking a sales process.

Without that funding, PRCL was unfunded and neither the Receivers' nor PRCL could take steps to stabilise and recover the mine, and protect the residual value of the investment in PRCL. No other source of funding was apparent and NZOG, as the largest creditor and shareholder, had the most to gain - and the most to lose – from a decision to provide further funding, or not.

At the outset, it was identified that PRCL had two key assets that needed to be preserved to maximise the value to investors and lenders:

1. The insurance; and
2. The mine license, access arrangements and associated infrastructure.

At the same time, the mine was on fire, 29 lives had been lost and there was considerable political, union, community and media interest in the events – with a variety of agendas and priorities involved.

NZOG has worked hard, and in our view effectively, to manage the interests of our shareholders in this very complex environment.

NZOG has not been directly involved in the operation of PRCL neither before nor after the receivership. However, during the receivership we have been kept well informed by the Receivers as they manage a difficult range of tasks.

This has included reaching an insurance settlement. This month a payment of $80m was received in full and final settlement of claims under PRCL's insurance policies.

Approximately $6.3m has been paid to the owners of leased mining equipment arising from their priority rights, leaving approximately $73.7m to put towards PRCL's debts.

The Bank of New Zealand was a first ranking secured creditor owed approximately $23.7m and has been paid in full.

As the other first ranking secured creditor, NZOG had legal priority to all of the remaining monies. However, NZOG recognises the huge and ongoing impact the tragic events have had on the West Coast community.

Hopefully, all of PRCL's creditors can receive full payment when the sale of the mine occurs. However, for the mine workers, contractors and suppliers this has been a very stressful time, both emotionally and financially.

It is a very complex situation that has gone well beyond a normal receivership. We therefore supported the Receivers using some of the insurance payout to make a voluntary early payment to all unsecured creditors – a decision which supports the sales process and the prospects of the mine re-opening.

Earlier this month the unsecured creditors voted overwhelmingly in favour of the proposal, under which unsecured creditors received a payment of the first $10,000 of their claim - or their full claim if less than $10,000 - and up to 20c in the dollar for any balance above that amount, up to a capped aggregate amount of $10.5m.

Unsecured creditors were not asked to reduce their total claim and will still be entitled to claim for the full remaining balance, once the Receivers complete the sales process.

As one of the participants in the early payment plan, NZOG will next week receive $3.0m as part-payment of its total unsecured debt of $15.3m. NZOG has already received $38.3m in part payment of our secured debt.

In the past month, NZOG has advanced the Receivers a further $4.3m under a $5m short term loan facility, to fund their ongoing work - including stabilisation and recovery of the access tunnel. We expect to recover the loan when the Receivers sell the mine.

Safe access to the tunnel is a necessary first step in the efforts to recover the lost men – and it also protects the value of the asset. We are pleased to see the progress that is now occurring with the tunnel re-entry plan.

The sales process is well advanced, with the Receivers having advised us that final bids were received last week and are being assessed.

Looking forward, we would expect the Receivers to conclude the sales process and the proceeds would go towards PRCL's remaining debts, including those owed to NZOG – which currently amount to around $35m.

PRCL would then most likely be wound up and the mine handed over by the Receivers to the new owners. NZOG's involvement with Pike River will come to an end. Meanwhile, and quite separately, the Commission of Inquiry, the Police and the Department of Labour will continue with their investigations.

Production

Operationally, in NZOG's core oil and gas business, it was a good year, with NZOG's two producing assets – Kupe and Tui – providing more than $100m in revenue during the financial year.

Tui

Tui production for the year ended 30 June 2011 was slightly over forecast, at 2.81 million barrels (mmbbls). NZOG's 12.5% share of production was just over 350,000 barrels.

NZOG's share of Tui oil sales was 321,400 barrels, providing over NZ$40m in revenue at an average price per barrel of US$96 or NZ$125.

In July 2011, the Tui Operator, AWE, announced that preliminary work had indicated that the estimate of the gross initial developed 2P reserves recoverable from the existing four well development of the Tui fields should be reduced.

Following some further review, the Operator has settled on a gross initial 2P developed figure of 41 mmbbls, and NZOG will also adopt this estimate.

Further work is being done on accessing possible additional volumes of oil with new or sidetracked wells and exploration targets adjacent to the Tui fields also remain under evaluation.

The reduction in reserves is obviously disappointing but is a standard industry risk and does not fall outside the range of probabilities that had been identified.

Before the downgrade, there had been a 90% confidence level - P90 - that 40mmbbls would be recovered and a 50% confidence level - P50 - that 50mmbbls would be recovered. The P50 has now moved closer to the P90 estimate. It is also worth noting that this latest reserves estimate is still 50% greater than the estimate when the project was sanctioned.

The impact on NZOG of the reserves recalculation is significant but should not be overstated. It amounts to approximately a 10% reduction in NZOG's total oil and gas reserves; and a 2% reduction in NZOG's expected production in the 2012 financial year.

NZOG estimates that its share of Tui production in the current financial year will be 270,000 barrels.

Kupe

Kupe has cemented its place as NZOG's most valuable asset and most significant revenue source.

Kupe went into permanent production in March 2010 and in November 2010 the production plant passed a rigorous regulatory inspection requiring a three week shutdown.

For the 2011 financial year, Kupe produced 17.6 petajoules (PJ) of sales gas, 1.84 mmbbls of light oil and almost 75,000 tonnes of LPG.

NZOG's 15% share of production amounted to 2.63 PJ of sales gas, 276,000 barrels of light oil and 11,200 tonnes of LPG. NZOG's revenue from the three Kupe products was over NZ$66m.

The Kupe field and the three production wells performed extremely well during the year. Pleasingly, the latest reserves review undertaken by the Operator, Origin Energy, concluded that there should be no change to the initial 2P reserves estimate, which had been increased significantly in July 2010.

Total production for the year was slightly below expectations, with production limits imposed from March 2011 due to faults with the gas compressor units. Replacement parts were installed and full plant capacity was restored in mid-July 2011.

August and September saw record production levels from Kupe, as the cold weather took hold and Genesis increased its daily nominations for gas to run its thermal power plants. With the increased gas offtake comes increased oil and LPG production.

NZOG estimates that its share of Kupe production in the current financial year will be approximately 3 PJ of sales gas, 12,800 tonnes of LPG and 320,000 barrels of oil.

Investing in Growth

NZOG is committed to a clear strategy and is taking positive steps towards achieving its strategic goals.

We are investing in growth, which does have a cost. Our total general and administration costs for the financial year were $11.1m. This headline number needs to be broken down to really understand our expenditure.

It includes a $500,000 donation to the Pike River Disaster Relief Trust, and another $300,000 in Pike River related expenditure. Then there are the regulatory and communication costs associated with being a publicly listed company, which come to more than $1m a year.

A significant proportion of the remaining expenditure was directly or indirectly (through staff time) spent on identifying and evaluating new investment opportunities. The cost of managing our existing oil and gas assets was around $5m, or less than 5% of the revenue earnt from those assets.

Tui production is currently expected to continue to until around 2020 and Kupe beyond that, to around 2025. Kupe, and to a lesser extent Tui, provide the solid base on which we can pursue future growth.

Unfortunately, the market does not currently fully recognise the core value of your company. Based on some reasonably conservative assumptions, NZOG has a core value of NZ$480m, against a current market capitalisation of NZ$245m.

The last financial year was undeniably a tough one for NZOG. The Pike River tragedy, the Tui reserves reduction and global economic events severely impacted on our share price. In these turbulent times, NZOG is not alone in being under-appreciated. Many of our peer companies across Australasia have also seen their share prices decline markedly.

NZOG will continue to work hard to build shareholder value, but we have to recognise that there are some influences beyond our control.

NZOG has a strong balance sheet, good operating cashflows and continues with its strategy to pursue sensible growth opportunities in the oil and gas sector, both at home and abroad.

We were already taking steps to broaden our portfolio to lessen the impact of one-off events and we are now making significant progress with that diversification.

I am hopeful that there will some further positive announcements before my departure at the end of 2011 and I believe the company is well positioned for the future.

David Salisbury
Chief Executive

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NZOG stock symbols:
NZX shares – NZO
ASX shares – NZO