

Date of issue

11.06.08

Company Update

INVESTMENT DATA

Share price	\$1.31
Issued capital	
Ordinary shares	133.9
Options/other	17.2
Fully diluted	151.2
Market Capitalisation	\$197.3
52 week low/high	\$0.55/\$1.55
Valuation	\$1.56

The Top 20 shareholders owned 48% of shares on issue (10/9-07)

Year end June		07a	08f	09f	10f
Revenue	\$m	0.0	0.0	0.0	6.8
EBITDA	\$m	-2.3	-2.3	-2.4	2.8
EBIT	\$m	-2.3	-3.1	-3.6	-0.6
NPAT (rep)	\$m	-1.9	-2.9	-3.4	-0.7
EPS (adj)	¢	-1.3	-1.7	-1.7	-0.4
EPS growth	%	N/A	N/A	N/A	N/A
PER	X	N/A	N/A	N/A	N/A
EV/EBITDA	X	-83	-80	-78	66
DPS	¢	0.0	0.0	0.0	0.0
Yield	%	0.0	0.0	0.0	0.0
Franking	%	0	0	0	0

Note: EPS is adjusted for tax and one-offs



Metgasco (MEL)

Buy

Valuation upgraded as progress is encouraging

Conventional gas discovery and BP contract opportunity added to valuation

Metgasco (ASX code: MEL) recently hosted a site visit to its Coal Seam Gas (CSG) project near Casino in northern NSW. The company is making unspectacular but steady progress on its flow testing of horizontal wells in the coal seams. In addition, a conventional gas discovery appears to have good upside potential from further testing and drilling.

Good progress has also been achieved on the pipeline route to Ipswich, plus contract discussions to supply BP's Bulwer Island refinery in Brisbane and a gas fired power station near Lismore adds potential value to MEL. With gas prices rising in the current market, MEL is well placed to meet this demand, although this is still subject to commercial flow rates being established from the CSG wells.

Bell Potter has upgraded the MEL valuation to \$1.56, up from \$1.05. The bulk of the increase is due to the BP contract opportunity of 15PJ pa (risky at 50%), enhanced value of the pipeline, and the conventional gas discovery at Riflebird. We maintain our recommendation to Buy MEL, although the stock still carries higher risk than the established CSG companies in Queensland, as the gas is harder to extract from the local coals.

Key objectives over the remainder of 2008

- To increase certified 2P (proven & probable) from 247PJ to a target of 660PJ to satisfy the CS Energy contract of 360PJ. The emphasis is on converting as much as possible of the 3P (possible) reserves of 1,389PJ into 2P and subsequently into 1P (proven).
- To demonstrate commercial productivity per well, as we are yet to observe the desired flow rates of 0.45m cubic feet per day (mmcf). De-watering is taking longer than anticipated and the best gas flow has only reached 0.2mmcf so far.
- Determine the significance of the conventional gas discovery at Riflebird-E14, through testing, seismic and additional drilling.
- Achieve Financial Close for the Richmond Valley Power Station (RVPS) in the December quarter 2008.
- Decide the size of the 145km pipeline to Ipswich before the end of the year, in parallel with lodging all license applications, with a commitment expected in mid 2009.

Recommendation: Buy maintained

MEL is trading at a 16% discount to our valuation of \$1.56. Our valuation does assume that the Casino CSG project is commercial, which is not yet proven, so there is a relatively high degree of risk in the stock. However, ongoing flow testing and the additional upside from a conventional gas discovery looks like enhancing the project, making MEL an attractive exposure to an emerging gas producer.

When comparing the Enterprise Valuations for CSG stocks, much of the risk in MEL appears factored in by the market, as the stock trades on an Enterprise Value/2P reserve of \$0.76/GJ, whereas the peer group is trading in a range from \$1.30 to well over \$3/GJ. A more significant re-rating than is suggested by our valuation of MEL is on the cards, once commerciality is demonstrated.

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CSG Project Update

MEL is making steady progress at the Casino CSG project in northern NSW. The coal seams in the area have very high gas content, but low permeability. This means that the coal seams require horizontal well completions to generate commercial flow rates. The company engaged US expertise from Vectra LLC and used an imported rig to drill six horizontals earlier this year. Three of these were drilled into the Richmond coal seam, which is of primary interest, and three were drilled into other, thinner coal seams.

Of the three Richmond horizontals, only two were completed over the planned length of almost 1,000m. Flow rates to date have reached 0.1 million cubic feet daily (mmcf) and 0.2mmcf respectively, with gradual decrease of water. The ramp-up of gas production is slower than anticipated but is continuing to build. It may take 6-12 months to reach commercial rates of 0.45mmcf, rather than 2-3 months. The slower pay-back is disappointing but as long as the wells ramp-up to the required rate (or more) it is not a major problem.

The other coal seams proved more difficult to drill, partly because they are thinner, but they may also require fracking (fluid and sand particles are pumped into the coal seam causing a fracture and creating a better conduit for gas flow into the well bore). The "I" seam and the "J" seam appear most prospective in this respect, with more work to follow.

MEL has also found that the wells drilled on the western flank of PEL 16 appear to have better permeabilities in the coals and could represent a sweet spot, so this is likely to be an area of increased focus. Another positive from the drilling program was that the 1,000m horizontal completions can be done within the planned budget of around \$0.7m per well.

MEL is expecting a new reserves assessment from MHA shortly, and we expect at least a 40% increase in 2P reserves from the current level of 247PJ, and a small amount of 1P reserves for the first time.

Conventional gas discovery

MEL is very excited about the Riflebird-E14 conventional gas discovery. The well has flowed 0.3mmcf through a small 16/64 inch choke from the Heifer Creek formation, a sandstone reservoir equivalent to the Hutton sandstone of the Eromanga and Surat basins, a high quality reservoir. The gas has some LPG and condensate content and could probably flow at much higher rates. Further testing will be carried out over the next month, with a separator to measure the composition of the gas. The gas shows were observed over a 49m interval, with between 9-15m of net pay at about 1,100m depth.

New seismic has been shot to define the structure properly, as the discovery well is thought to be located on the flank, with potential both updip and down the flank. It is also worth noting that another reservoir named the Ripley Road formation exists about 200m deeper than the Heifer Creek, equivalent to the productive Precipice formation in the Surat basin, but was not reached by this well.

It is very difficult to estimate the reserves potential of Riflebird at this stage but it could be as large as 50-100PJ of gas, which would be the first commercial size conventional gas discovery in the Clarence-Moreton basin. It could also be of sub-commercial size.

Additional contracts

MEL has existing MoUs with CS Energy for the Swanbank F power station near Ipswich, and for the small 30MW Richmond Valley Power Station at Casino (RVPS).

MEL has also disclosed that it is holding discussions with BP regarding a gas supply agreement to the Bulwer Island refinery, amounting to 15PJpa over 10 years. The gas supply would need a new pipeline to be built from Ipswich to the Port of Brisbane, as the current pipeline capacity is fully utilised.

As electricity demand continues to grow in the north-east of NSW, there is also a growing likelihood that a 200MW power station needs to be built near Lismore, with a location at McKee's Hill already identified. MEL would be ideally placed to supply gas, amounting to about 10PJpa.

Pipeline Project

MEL is progressing work on the 145km pipeline from Casino to Ipswich. The project has to deal with three different jurisdictions, but has received 'major project' status from the NSW Government, lodged environmental applications with the Commonwealth Government, plus a pipeline license for the 45km section in Queensland. The capex is currently estimated at \$120m and MEL plans to invite an infrastructure fund to become a partner in this project. A significant portion will be debt-funded.

The sizing will depend on the expected load, and if the discussions with BP and other Brisbane customers provide encouragement, we expect the pipeline to have more capacity than just for the CS Energy contract. Pipeline capacity is not just a function of diameter, as operating pressure can be used to increase the load, up to a point.

The company expects all the approvals to be in place by mid-CY09 with first deliveries to CS Energy in March 2011.

Funding

MEL has no debt and a modest cash position of \$9m. The company has a favourable funding agreement with CS Energy to develop the CSG reserves required for their contract, whereby CS Energy will pay another \$94.5m to earn a 50% interest in the three blocks within PEL16 earmarked for this gas supply.

However, further drilling to prove up reserves for CSG supply to RVPS, BP and others, plus conventional gas targets and the pipeline work will require more funds. Our modeling has assumed increased debt funding, but it is probable that additional equity raisings will be required to assist with the funding of the program.

Valuation Changes

The key reasons behind our valuation increase from \$1.05 to \$1.56 are as follows:

- \$0.41/share for the BP potential contract, which we have risked as a 50/50 chance but with a better gas price than the CS Energy contract
- \$0.17/share for the conventional gas discovery at Riflebird-E14
- \$0.12/share for the pipeline, up from \$0.06 as we include 50% of the BP volumes going through with only a marginal cost increase
- A few lesser adjustments up (eg. franking credits) and down (eg. capex increases, higher corporate costs and net cash)

Metgasco (MEL)						Share price: \$1.31					
As at 11/06/2008						Market cap (\$m): \$197m					
Recommendation: Buy											
Income Statement						Valuation Data					
Year end June 30	2007A	2008F	2009F	2010F	2011F	Year end June 30	2007A	2008F	2009F	2010F	2011F
Revenue	\$m	\$m	\$m	\$6.8m	\$24.1m	Adjusted net profit	-\$1.3m	-\$2.0m	-\$2.4m	-\$5.0m	\$3.3m
EBITDA	-2.3	-2.3	-2.4	2.8	15.3	Adjusted EPS	-1.3c	-1.7c	-1.7c	-0.4c	2.4c
DD&A	0.0	0.0	0.0	-1.8	-4.9	EPS growth	N/A	N/A	N/A	N/A	N/A
Exploration write-off	0.0	-0.7	-1.2	-1.6	-2.1	P/E ratio	N/A	N/A	N/A	N/A	54.4
EBIT	-2.3	-3.1	-3.6	-0.6	8.3	OpCFPS (excl. abnormals)	-2.4c	-5.3c	-1.5c	1.7c	4.3c
Interest	0.4	0.2	0.1	-0.1	-3.6	Price/OpCFPS	-55.1x	-24.7x	-84.2x	76.3x	30.2x
Other	0.0	0.0	0.0	0.0	0.0	DPS	0.0c	0.0c	0.0c	0.0c	0.0c
Abnormals	0.0	0.0	0.0	0.0	0.0	Yield	0.0%	0.0%	0.0%	0.0%	0.0%
Pre-tax profit	-1.9	-2.9	-3.4	-0.7	4.7	EV/EBITDA	-83.2x	-80.4x	-77.7x	66.4x	12.3x
Tax	0.0	0.0	0.0	0.0	-1.4	EV/EBIT	-82.7x	-61.5x	-52.5x	-331.3x	22.6x
Reported net profit	-1.9	-2.9	-3.4	-0.7	3.3	Profitability Ratios					
Adjusted net profit	-1.3	-2.0	-2.4	-0.5	3.3	Year end June 30	2007A	2008F	2009F	2010F	2011F
(adjusted net profit = pre-tax profit before abnormals minus tax at 30%)						EBITDA/sales	N/A	N/A	N/A	41%	63%
Cashflow						EBIT/sales	N/A	N/A	N/A	-8%	35%
Year end June 30	2007A	2008F	2009F	2010F	2011F	ROA (average)	-4%	-6%	-7%	-1%	2%
						ROE (average)	-5%	-8%	-10%	-2%	13%
						Dividend cover	N/A	N/A	N/A	N/A	N/A
						Effective tax rate	0.0%	0.0%	0.0%	0.0%	30.0%
Reconciliation						Liquidity & Leverage					
Net profit	-\$1.9m	-\$2.9m	-\$3.4m	-\$0.7m	\$3.3m	Year end June 30	2007A	2008F	2009F	2010F	2011F
Exploration write-off	0.0	0.7	1.2	1.6	2.1	Net debt	-\$17.2m	-\$7.9m	\$26.0m	\$96.2m	\$193.0m
Depreciation	0.0	0.0	0.0	1.8	4.9	Net debt/equity	N/A	N/A	109.9%	420.1%	737.3%
Change in working capital	0.0	-4.4	0.0	-0.2	-0.6	Interest cover	N/A	N/A	N/A	-3.8x	2.3x
Other	-0.5	0.2	0.1	-0.1	-3.6	DCF Valuation					
Net operating cashflow	-2.4	-6.3	-2.1	2.4	6.0	Development assets					
Investing cashflow							PJ net	\$m	\$/share		
Capex PPE & Development	-1.0	-6.5	-29.4	-70.3	-100.3	CSG Richmond Valley PS (100%)	25	4.9	0.03		
Exploration	-4.6	-2.1	-2.2	-2.3	-2.4	CSG CS Energy contract (50%)	180	74.5	0.49		
Acquisitions / Divestments	5.9	0.0	0.0	0.0	0.0	BP contract (100%) 50% risked	150	62.1	0.41		
Net investing cash flow	0.4	-8.6	-31.6	-72.6	-102.7	Gas pipeline to Ipswich (50%)		18.9	0.12		
Financing activities						Exploration assets					
Issue of shares	18.1	5.6	0.0	0.0	0.0	CSG opportunity for 200MW PS @ \$0.10/GJ	150	15.0	0.10		
Buy backs	0.0	0.0	0.0	0.0	0.0	CSG potential @ \$0.10/GJ	250	25.0	0.17		
Dividends paid	0.0	0.0	0.0	0.0	0.0	Conventional gas discovery @ \$0.50/GJ	50	25.0	0.17		
Borrowings	0.0	10.0	20.0	70.0	100.0	Franking credits		31.0	0.21		
Capital return to shareholders	0.0	0.0	0.0	0.0	0.0	Cash (Net debt)		9.5	0.06		
Others	0.0	0.0	0.0	0.0	0.0	DCF of Corporate Costs \$4m pa		-29.9	-0.20		
Net financing cash flow	18.1	15.6	20.0	70.0	100.0	TOTAL VALUATION		236.0	1.56		
Net change in cash held	16.1	0.7	-13.7	-0.3	3.2	Valuation sensitivities					
Balance Sheet						Gas sales (gross)					
Year end June 30	2007A	2008F	2009F	2010F	2011F			\$m	\$/share		
Assets						Base case (RVPS, CS Energy & BP)	35PJpa	236.0	1.56		
Cash assets	\$17.2m	\$17.9m	\$4.1m	\$3.9m	\$7.1m	Low case (RVPS & CS Energy)	20PJpa	128.5	0.85		
Receivables	1.8	0.0	0.0	0.3	1.2	High case (Additional 200MW PS)	45PJpa	278.7	1.84		
Other financial assets	0.0	0.0	0.0	0.0	0.0	Gas price (\$/GJ)					
Prepayments	0.3	0.0	0.0	0.0	0.1	Base case	\$3.00	236.0	1.56		
Total current assets	19.3	17.9	4.2	4.3	8.4	Low case	\$2.50	175.1	1.16		
						High case	\$3.50	304.7	2.02		
PPE & Development	1.4	7.9	37.3	105.8	201.3	Flow rate per well (mmcf/d)					
Exploration & Evaluation	10.1	11.5	12.5	13.4	17.3	Base case	0.45	236.0	1.56		
Other financial assets	0.0	0.0	0.0	0.0	0.0	Low case	0.3	114.9	0.76		
Intangible assets	0.0	0.0	0.0	0.0	0.0	High case	0.75	301.0	1.99		
Deferred tax assets	0.0	0.0	0.0	0.0	0.0	Capex per well (\$m)					
Total non-current assets	11.5	19.4	49.8	119.2	218.6	Base case	0.7	236.0	1.56		
Total assets	30.8	37.3	54.0	123.5	227.0	Low valuation case	1.0	193.2	1.28		
Liabilities						High valuation case	0.6	255.5	1.69		
Short-term debt	0.0	0.0	0.1	0.1	0.1	Pipeline gas throughput (gross)					
Payables	6.7	0.2	0.2	0.4	0.6	Base case	33PJpa	236.0	1.56		
Current tax liabilities	0.0	0.0	0.0	0.0	0.0	High case	43PJpa	274.3	1.81		
Provisions	0.0	0.0	0.0	0.1	0.1	Discount rates					
Other liabilities	0.0	0.0	0.0	0.0	0.0	Base case	10%	236.0	1.56		
Total current liabilities	6.8	0.3	0.4	0.5	0.8	Low case	12%	196.0	1.30		
						Worst case	14%	162.5	1.07		
Long-term debt	0.0	10.0	30.0	100.0	200.0	Comparisons					
Deferred tax liabilities	0.0	-0.1	0.0	0.0	0.0	Company	PJ	EV	EV/GJ		
LT provisions	0.0	0.0	0.0	0.0	0.0		2P	3P	2P	3P	
Total non-current liabilities	0.0	10.0	30.0	100.0	200.0	Arrow Energy (AOE)	553.7	2,790	\$2076m	\$3.75	\$0.74
Total liabilities	6.8	10.2	30.4	100.6	200.8	Queensland Gas (QGC)	1054	2,493	\$3379m	\$3.21	\$1.36
Net assets	24.0	27.1	23.6	22.9	26.2	Molopo (MPO)	213	467	\$294m	\$1.38	\$0.63
Equity						Sunshine Gas (SHG)	469	1,097	\$652m	\$1.39	\$0.59
Contributed equity	27.6	33.4	33.4	33.4	33.4	Eastern Star Gas (ESG)	185	1,300	\$671m	\$3.63	\$0.52
Retained earnings	-3.5	-6.3	-9.8	-10.5	-7.2	Sydney Gas (SGL)	83	109	\$146m	\$1.76	\$1.34
Total equity	24.0	27.1	23.6	22.9	26.2	Peers' average			\$2.52	\$0.86	
Diluted shares on issue	119.8	138.0	138.0	138.0	138.0	Metgasco (MEL)	247	1,389	\$188m	\$0.76	\$0.14
W/Avg diluted shares on issue	99.5	119.8	138.0	138.0	138.0	* All reserves independently certified					

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