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WTI Oil	US\$82.39/bbl
TAPIS	US\$82.58/bbl
Henry Hub	US\$5.47/mmbtu
Exch Rate	0.9299 AUD/USD

Code	RBS Oil Fcst	Fwd Curve	Fwd Curve & Spot Ex Rate
WPL	50.00	54.24	56.27
STO	16.99	19.27	20.40
OSH	6.95	7.68	7.87
AWE	2.87	3.05	3.08
BPT	1.10	1.20	1.22
TAP	1.05	1.11	1.11

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The Oily Rag

Oil and Gas Picks for 2010

Our top picks for 2010 are OSH for de-risked LNG exposure, HZN and ESG amongst the mid-caps and TXN, VPE and COI amongst the small caps. Our CSG review looks at possible winners this year, including AOE, ESG, COI, BUL and WCL. We're predicting a lot of activity in the CSG space after a disappointing 2H 2009. AOE moves to ensure Fisherman's Landing stays on track, Rockhopper has AWE's share price jumping and KAR's judgment day is nigh, with Poseidon-2 flow test results due any day now.

Table 1 : Top picks for 2010

	Code	Recom	Target Price	Current Price	Upside/downside
Oil Search	OSH	Buy	A\$6.95	A\$6.07	14%
Santos	STO	Buy	A\$17.00	A\$14.42	18%
Woodside	WPL	Hold	A\$50.00	A\$48.63	15%
Horizon Oil	HZN	Buy	A\$0.48	A\$0.38	3%
Eastern Star Gas	ESG	Buy	A\$1.18	A\$0.945	25%
Carnarvon Petroleum	CVN	NR	N/A	A\$0.61	N/A
Texon Petroleum	TXN	Buy	A\$0.60	A\$0.36	67%
Victoria Petroleum	VPE	Spec Buy	A\$0.53	A\$0.325	63%
Comet Ridge	COI	NR	N/A	A\$0.33	N/A

Priced at close of business 12 January 2010.

 NR = No Recommendation
 Source: Company data, RBS forecasts

Mid Caps Rally on Higher Oil Prices

Oil and gas mid caps have lagged their peers in recent times, but since 21st of December most have risen by 13 – 25%, outpacing the rise in WTI oil price. The only laggard has been NZO, which fell by 1.5% over the same period, most likely due to the failure of their oil exploration well Albacore-1 in the Taranaki Basin.

CSG Sector Update

After a positive start, 2009 turned into a tough year for many of the remaining pure CSG players. Despite rising reserves levels (now almost 21,000 PJ 2P reserves in the sector), concerns over the costs surrounding larger scale CSG to LNG developments and a slow-down in corporate activity amongst the smaller players saw share prices stall or slide. 2010 should be a better year as Final Investment Decision is reached on 2 or 3 LNG projects at Gladstone, further reserves increases (we estimate 30,000 PJ 2P by YE 2010) and the potential for further industry consolidation.

Other News Includes

- **Arrow Energy** (AOE – Buy TP A\$4.90) – Increased involvement in Fisherman's Landing
- **Rockhopper** (Bass Basin – **ORG/AWE/INP**) – Shares jump on good shows
- **Karoon Gas** (KAR) – Poseidon-2 production testing will reveal all
- **Moby Oil & Gas** (MOG) – Cornea-3 result fuzzy, side tracking at Braveheart
- **Eastern Star Gas** (ESG – Buy TP A\$1.18) – Production pilot hits 2 mmscfd after 4 weeks
- **Lolotoe-1 (OEX/PPP)** – drilling towards target depth after having to sidetrack well
- **Westside Corporation** (WCL) – Acquisition of Anglo Coal's CSG assets
- **MEO Australia** (MEO) – to announce the identity of its farminee shortly
- **Santos Ltd** (STO) – 6 more months to find a 3rd party buyer for its LNG

Top Oil and Gas Picks for 2010

From an oil price perspective, the past 12 months was divided into 2 distinct periods. From January to June, oil prices rallied from US\$39/bbl to US\$68/bbl by the end of May. From June to the end of the year, the oil price has traded between US\$60-80/bbl, however this largely reflected fluctuations in the strength of the US dollar. In A\$ terms, the oil price traded in a tighter range of A\$75-90/bbl from June to December.

Chart 1 : WTI Oil Price in 2009 (AUD)



Source: IRESS

Our forecast oil price in 2010 is US\$75/bbl WTI. Given the relatively flat near term outlook, playing the oil and gas space becomes a stock picking challenge. We have outlined some of our top picks in the sector for 2010 in the tables below, including reasons to buy and key risks.

Small Caps (<A\$250m)

In the small cap space, we like TXN, VPE and COI for different reasons (as outlined below). There are a number of other stocks we could have picked here, however many of them are potentially high risk but with large upside potential. Some that fall into this category include BUL, WCL, NGE, ITC and MOG.

Table 5 : Small Caps Key Picks

Company	Reasons to Buy	Key Risks
Texon Petroleum (TXN) Buy TP A\$0.60	<ul style="list-style-type: none"> Good mix of increasing oil and gas production from its five Leighton wells, with 400 boepd being produced from the Olmos reservoir already. The company has a further 24 proved and probable well locations it can drill to add to production. The Eagle Ford shale lies underneath the Olmos reservoir and has the potential to add considerable reserves and production to TXN. TXN is planning to farm down its interest in the Olmos reservoir in Leighton to fund Eagle Ford shale drilling. The Eagle Ford shale across TXN's leases could contain up to 50 mboe. TXN has two Leighton look-alikes in its portfolio – Mosman and Rockingham. 	<ul style="list-style-type: none"> Ability to fund its development plans – Eagle Ford shale wells will be deep, long horizontal lengths (up to 5,000 m) and require multiple fracs. They typically cost up to US\$5m each. Exploration risk – Mosman and Rockingham have yet to be drilled.
Victoria Petroleum (VPE) Spec. Buy TP A\$0.53	<ul style="list-style-type: none"> Existing oil production set to grow from 600 BOPD to 1,200 BOPD (net) in the next few weeks, before increasing to as high as 1,800 BOPD (net) by mid-late 2010. Aggressive oil drilling programme with 12 wells drilled by mid 2010. Includes a mix of oil exploration and appraisal wells that should see reserves and production increase over the next 1 – 3 years. 20 – 30% equity interest in two key CSG tenements with BG as JV partner and operator. Blocks may contain up to 2,500 Bcf gas in place between them – chance to enter into a gas sales agreement with BG to supply gas into their proposed Curtis Island LNG facility. 	<ul style="list-style-type: none"> Weather and equipment issues may defer or reduce anticipated oil production forecast. Some oil production growth contingent on successful appraisal drilling in 1H 2010. Extracting value from CSG requires a successful (and expensive) exploration and appraisal campaign, BG sanctioning its LNG project and VPE being able to negotiate a suitable offtake arrangement with BG.
Comet Ridge (COI) Not Covered	<ul style="list-style-type: none"> 100% interest in two blocks on the eastern flank of the Galilee Basin. The blocks are estimated to contain up to 36 Tcf of gas in place. Recently embarked on an 8 core hole drilling programme. The results from the core hole programme will assist in optimising the location of a pilot project, likely to be installed 2H 2010. Galilee Basin is the last place on the East Coast of Australia where you can pick up large blocks that may contain LNG-sized gas resources. It would be a logical target for winners at Gladstone to aggregate gas for future LNG trains. Similar board and management team to Sunshine Gas. 	<ul style="list-style-type: none"> Initial drilling results may disappoint as the wells are not optimally located for best results. It's still early days. There is still considerable exploration risk - gas contents and water production are key risks. Reserves certification may still be 12 - 24 months away.

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