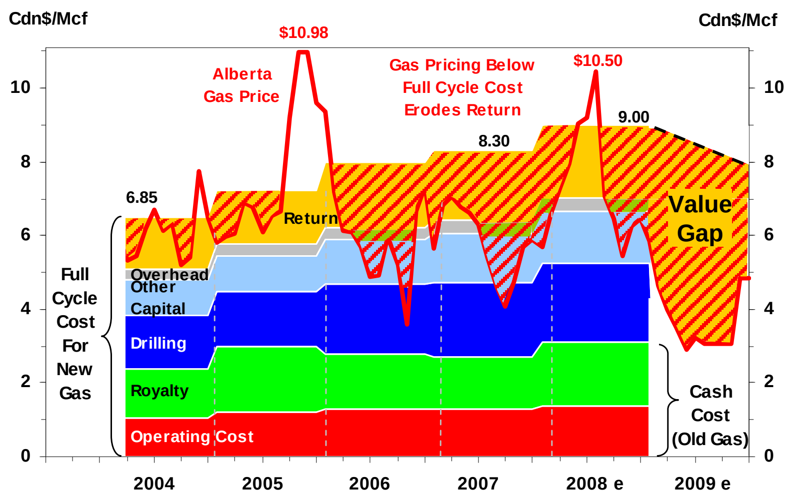
June 16, 2009

'Canadian Gas at a Cross Roads'
Options for Producers to Preserve Value!

SUMMARY: ***Massive value destruction is occurring for the shareholder, or unit holder, for each Mcf of gas produced today at low prices.*** Core gas reserves are being sold/depleted that simply *cannot* be replaced by the cash generated.

While Oil prices have recovered very quickly from their dramatic plunge, *Gas prices remain extremely low.* At a price of C$3.00/Mcf at AECO, ***gas is selling for a 2/3 discount to oil*** --- *disconnected* from the traditional oil/gas price relationship. For over 3 years, Ziff Energy has voiced its concern regarding the dire economics of new gas in Western Canada. The chart below shows an increasing 'lost Value' gap between producers' average full cycle cost to add new gas, and what the market is willing to pay.

Western Canada Full Cycle Gas Cost
New Gas is not Economic



Sources: Ziff Energy Group: 16th Improving Field Operating Costs Study (2008)
22nd Finding & Development Cost Study (2008)

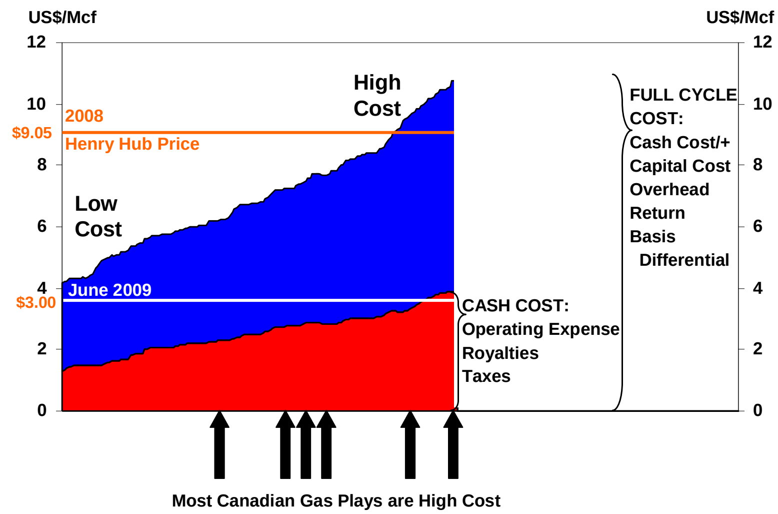
To validate our understanding, last year Ziff Energy undertook and released a major study on the economics of new gas in basins across all North America, including LNG and Northern Gas ('Economic Ranking of North American Gas Basins'). The results were even more dramatic than first thought: whereas a US study in 2007 informed the Alberta Government that Canadian gas plays were among the *most economic* in North America, Ziff Energy found the opposite, as the next Chart confirms. (A later study by Canada's National Energy Board, "Energy Brief – Natural Gas Supply Costs in Western Canada in 2007", Sept. 2009, reported similar high costs for most WCSB plays).

1117 Macleod Trail SE
Calgary, Alberta T2G 2M8
(403) 265-0600
Fax: (403) 261-4631
info@ziffenergy.com
1-800-853-6252

www.ziffenergy.com

4295 San Felipe, Suite 350
Houston, Texas 77027
(713) 627-8282
Fax: (713) 627-9034
info@ziffenergy.com
1-888-736-5780

Economics of New North American Gas Plays
('Full Cycle' Supply Cost Curve)



Source: 'Economics of North American Gas Basins' (Ziff Energy Group, 2008)

The drop in Alberta drilling, land bonuses, seismic activity etc. validates our analysis. Today, the Canadian Gas industry is far different than 2 decades ago. Paul Ziff, CEO says:

> "First, WCSB gas production has peaked --- 8 years ago, for conventional production. Unconventional gas (Tight, CBM, & Shale) is moderating the Western Canada decline, but not reversing it.
>
> Second, the Gas Reserve Life (or Reserves to Production Ratio) has plummeted from 20+ years to below 9 years, well below the US average."

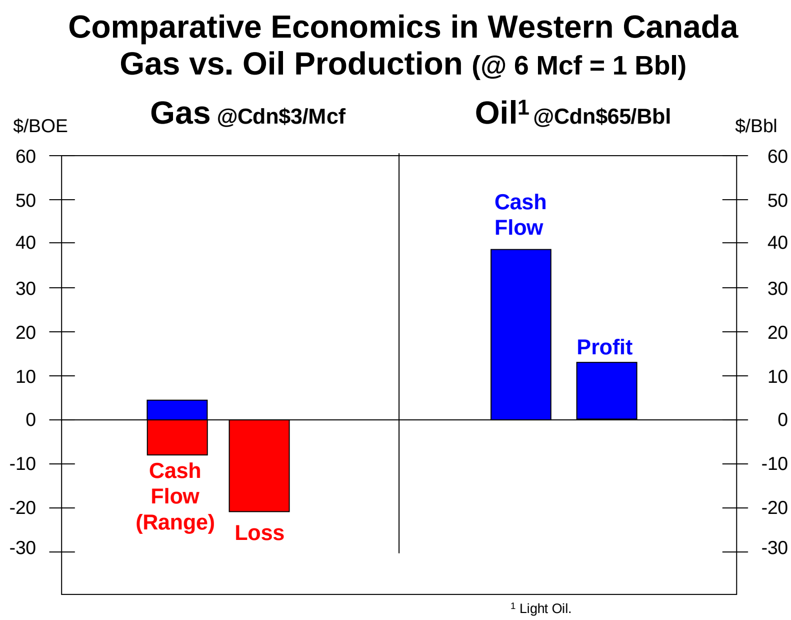
Seeing the large gap in gas vs. oil values – the largest in many years, Ziff Energy undertook research to compare the **fiscal results of 'Gas vs. Oil' production at current price levels** for a set of mainly oil producers vs. 'pure' gas producers. This represents today's economics**.**

Producer Economics – Gas vs. Oil
Current Price & Q1 Costs

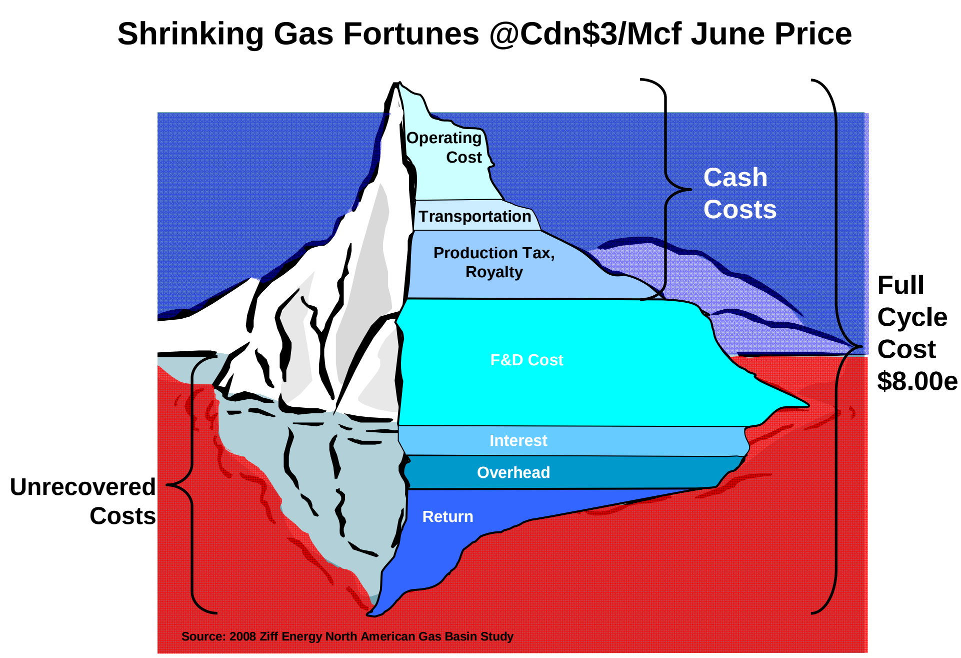
	'Gas' Producers		'Oil Producers'		Financial Ratio
Current PRICE	**C$ 3.00/Mcf**		**C$ 65/Bbl**		**22:1 (vs. 6:1)**
Less: Cash Operating Costs:					
• Royalty	(0.45)		(8)		
• Operating Cost	(1.50)		(12)		
• Transportation Cost	(0.35)		(1)		
Total	(2.30)	**0.70**	(20)	**44**	63:1
Less: G&A/Stock or units	(0.35)		(2)		
Interest	(0.25)		(2)		
CASH FLOW		**0.10**		**40**	400:1
Less: DD&A	(3.50)		(24)		
INCOME / **LOSS**		**(3.40)**		**16**	Infinite

June 2009 Prices; Q1 2009 Costs

Gas Producers are retaining a perilously low amount of cash flow, and every Mcf produced generates a large loss. We do note that Interest, G&A, Processing & Transportation (*if* firm service) and at least half of, Operating costs are fixed. Royalty cost drops right away --- Drilling and Operating costs are much 'stickier' on the way down.



With an average Gas Reserve Life under 9 years, Gas Producers need to replace 12% of their reserves each year, just to sustain current production. The 'Iceberg' analogy below shows that the cost to find & develop new gas averages $3.50/Mcf, and the current '***full cycle' cost is $8/Mcf*** (this will gradually moderate with lower levels of activity in the basin).



Paul Ziff concludes:

> "***Massive value destruction is occurring for the shareholder, or unit holder, for each Mcf of gas produced today.*** *Core gas reserves are being sold/depleted at market prices that simply cannot be replaced by the cash generated* --- so producers' reserve base shrinks, and in the near future more equity, or debt will need to be issued to fund replacing the gas produced today".

PRESERVING VALUE

Ziff Energy believes that there are solutions to preserve the Gas Producers' value, and sustain the Western Canada Gas Industry. The ***traditional 'tools'*** for a gas Producer are Fundamental and Financial.

FUNDAMENTAL:

1. Rigorous and persistent focus to be ***Low Cost Producer*** (driller, finder, operator); annually independently validate progress (similar to reserve & financial audits)

   - logically a quarter (25%) of Gas Producers can be 'Top Quartile'; but three quarters (75%) claim to be!

2. ***Reduce Capital Spending*** (CapEx) to match realistic expected Cash Flow

   - an operators reserves are 'cannibalized' (i.e. the reserve base is produced at a loss, and the borrowing base is reduced, decreasing borrowing amounts --- a 'death spiral')
   - this *pattern*, everyone spending cash flow when prices are high, *fuels inflation* of land costs & service costs, especially in Canada, and the Deepwater Gulf of Mexico

3. ***Shift Spending Focus*** from Gas ***to Oil***

   - Conventional oil prospectivity in Western Canada is limited – there are not many oil plays "waiting on the shelf", especially for 'pure' gas producers.

FINANCIAL:

1. ***Buy Back Shares*** ('Financial Engineering', to meet Analyst expectations)

   Majors and the largest Independents do this – but it doesn't add reserves; there is no impact on organic sustainability of the industry, or those companies. And aren't those shares cheaper today??

2. ***Hedging --*** this can be a powerful tool to give predictability of distributions or dividends and capital programs.

   Hedging is for a short duration (e.g. a year) --- hedges need to be replaced, although NYMEX is always optimistic! The goal is not to "beat the house", i.e. one is not trying to outsmart the market, but to generate predictability for investors and create a sustainable spending program. Executives often complain that they get no credit from Analysts for good hedges – those same analysts should look in the mirror at the success of their own institutions, before casting stones. What is the 'win' percentage of any top sports team?

3. ***Buy Reserves*** (when valuations are attractive) **–** good for an individual trust (very active) or company; but does not increase the overall basin reserves, and therefore the industry's 'sustainability'.

NEW OPTIONS for GAS SUSTAINABILITY:

Ziff Energy believes the traditional options are ***not*** sufficient for today's critical situation, and suggest **3 key options** be considered. Paul Ziff comments:

> ***"First, shut-in some gas production***, essentially 'holding gas reserves' until the market will pay a decent price, sufficient (or closer than now) to replace those reserves, to sustain your Company's future."
>
> [Chesapeake, the 2nd largest US gas producer (despite high debt) does this regularly, and EnCana and Paramount have just announced (June 15) some modest shut-ins. Some operators face greater challengers to do this: e.g. Trusts or high debt gas producers.]
>
> "In our opinion, the Shareholder or Unit holder is ***not*** well-served by the Operator giving away their gas reserves --- there is little or no contribution to the Replacement Cost, so one is only postponing the day of reckoning. The Financial equivalent is issuing new shares not at the market price, but at a large discount! Management's role is to 'lead' (please see Ziff Energy's 'Comment' Newsletter, Spring 2009 http://www.ziffenergy.com/download/newsletter/comment2009-03.pdf) and communicate to the investors, and bankers; the reason: to preserve shareholder value."
>
> Several analogies:
>
> - Natural Gas Liquids Business: marketers store in summer, to take advantage of higher winter prices.
> - Oil Marketers: were recently storing oil on tankers, waiting for oil prices to rebound [they did]
> - Gas Pipeline expansion from Western Canada -- 15 years ago the price of WCSB gas was very depressed, due to constrained pipeline capacity out of Western Canada. The combination of TCPL expansion, and the Producer-initiated Alliance Pipeline project expanded the 'take-away' capacity. The result was a dramatic decrease in the 'basis differential' (or discount), resulting in much higher Canadian gas prices.
>
> ***"Second, invest 'counter the cycle', over-spending Cash Flow when costs are low, and 'lock in' low F&D/Future DD&A (generates higher future profits); and under spend when costs are high***
>
> A few companies are doing this:
>
> - well-funded Majors:
>   - Exxon/Imperial at the Kearl Lake Oil Sands project,
>   - BP for Tight Gas
> - Junior Celtic (despite debt) is a notable exception, taking advantage of the Alberta Drilling Relief Program to cut net gas Drilling costs by half, effectively reducing their F & D costs (and future DD&A).
>
> Companies with a demonstrated low cost resource play and low debt levels can easily pursue this strategy. This strategy would not apply to 'early development' resource plays (e.g. Horn River Shale, where costs are still high at this early development stage)."
>
> ***"Third, a New Relationships with Suppliers, Banks, & Government***
>
> The conventional Western Canada Sedimentary Basin (WCSB) is mature and tired; not dead, but certainly not the lowest cost. The stakes are high. A collaborative strategy would require a new approach by Operators, Service companies, Banks, and Governments, to promote a ***sustainable gas future*** in Western Canada."

a. Suppliers (Drillers & Service Companies)

The up & down cycles are harmful for capability -- staffing and even equipment. For Service companies (especially the Trusts), there is a Value to predictability and sustainability. Alliances/Gain sharing have been tried; while challenging, they can align Producer & Service company interests. One analogy would be US retail mega-marketers who lend their Efficiency specialists to suppliers to jointly reduce costs, which leads to greater volume sales. The time may be somewhat early to develop these relationships with service companies --- we hear that costs are still higher in Western Canada as compared to the US. For unconventional resource plays, supplies of some key services and goods can delay development. Chesapeake solved this by buying into the service companies. Another option is a long term agreement, with fixed prices (a 'service cost hedge').

b. Banks & Investment Firms

Last year some Canadian **banks** were forecasting a $150-200/barrel oil price. Now they have slashed their price forecasts, with the effect of curtailing credit at exactly the time when its expansion would allow E & P companies to create higher value opportunities. While 'CYA' (or 'CYCR' – Cover Your Credit Rating) and higher facility fees are 'least risk' for lenders in the short term, they do not represent a collaborative long term relationship. Does anyone really doubt that energy prices will rise? Economic growth does not occur without energy; cars still run on gasoline, and North American winters are still cold! Energy risk is low.

Investment Analysts are too prone to 'flavour of the year' themes such as Shale gas & Bakken oil this year, previously SAGD, Tight Gas, CBM, etc. This reflects the exaggerated expectations of Wall Street/Bay Street for ***'unreal' returns*** that are multiples of the inflation rate. This psychology led to the Enron & gas marketer 'melt-downs', the creation of non-transparent securitization markets, and big risks and speculation being taken by pension funds such as La Caisse [not to mention crooks like Madoff]. The record of many of these same 'investment banks' (notably American, like Lehman, Goldman, etc.) speaks for itself. However, analysts penalize companies that reduce production/cash flow on a short term basis, to preserve value. The best analysts focus more on ***Management's long term strategy and execution.*** But most analysts focus on 'growth for growth's sake', e.g. producing more gas at current prices, and very short term cash flow. Considering that analysts give no credit for positive hedges, this is illogical. The quick 'grow & flip' (i.e. sell out) scenario is gone --- traditional value is 'in'.

c. Governments/Resource Owners

The Alberta Government Royalty Review stimulated the gas drilling downturn, based on flawed data and analysis. However the new well royalty program (March 3, 2009) provides some relief for the year from April 1, 2009 for new drilling, by lowering royalties for new wells to 5% for l year, and providing a $200/meter break corporately. 9 months still remain!! Governments can facilitate activity, or kill it [or buy into Service companies to support them in the aftermath of the drilling collapse]. We favour the former approach. The very mature UK North Sea has been maintained by a variety of government initiatives – maybe a model for Alberta?

# # #

This release is based on a recent speech by Paul Ziff, CEO, Ziff Energy Group, to the Canadian Association of Drilling Engineers (CADE) on June 10, 2009, and extensive research by **Ziff Energy Group**, a leading North American gas consulting firm, with offices in Calgary and Houston. Ziff Energy's many energy specialists provide sophisticated industry and operational business analysis and consulting to the energy industry in 2 dozen countries worldwide.