

WHAT SHOULD INVESTORS LOOK FOR (OR STAY AWAY FROM) IN A CBM PLAY?

A Conversation with Eric Nuttall Coalbed Methane Analyst, Sprott Asset Management

Part Two of a Two-Part Interview

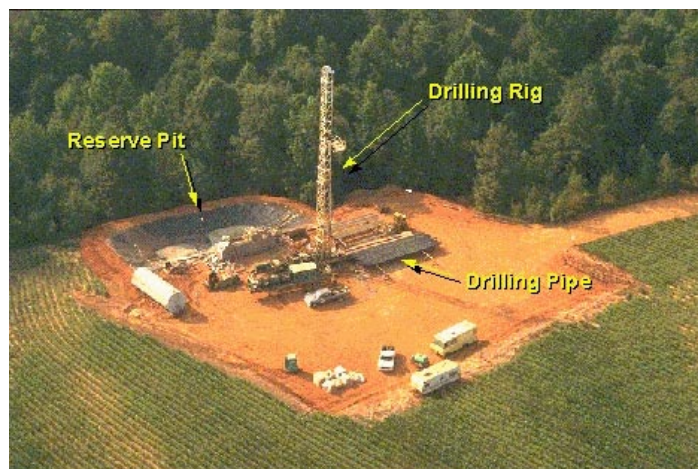
Summary: Eric Nuttall talked with StockInterview.com about the red-hot Coalbed Methane (CBM) sector in a two-part interview. He explained why CBM could continue to attract legions of investors and a wider audience over the next few years. The Sprott Asset Management research analyst also gave his tips and red flags on what to look for in the CBM sector and what to avoid. Which are his key criteria when performing an initial screening on CBM companies? What are the three ways to invest in CBM, from the riskiest to the safest?

StockInterview:

What is the first condition investors should investigate when evaluating a Coalbed Methane (CBM) company?

Eric Nuttall:

Over the past year or so, coalbed methane has become a very fashionable topic for oil and gas producers. Three years ago, no operators seemed to know that they had it. Today, most companies in their corporate presentations will be quick to tell you how many “prospective” acres they have. When evaluating the prospectivity of CBM acreage, the easiest thing to do is look for producing wells that are in close proximity. For Horseshoe Canyon (HSC), I would not be particularly enthused about anything below 100 mcf/d. If HSC productivity has been established by offsetting wells, a general metric that I use is to take the number of sections, multiply by 4 wells, and to assume an average well recoverability of 0.3 Bcf (billion cubic feet). This roughly calculates to 1.2Bcf of recoverable gas per section. In a \$9.00 natural gas environment, the net present value of an Mcf in the ground is approximately \$1.54, assuming that the coals will attain a first year rate of 120mcf/d, the average in the HSC fairway. Doing the math, a section of HSC prospective acreage in net present value terms is therefore worth \$1.85 million. So if a company has 20 sections of prospective acreage, and one were to not risk the acreage, the value of the land would be around \$37MM. It is important to note that this includes many assumptions, and HSC productivity can greatly vary within even a mile. But this is a quick and dirty formula.



Coalbed Methane drilling site

StockInterview:

What are the next few criteria you look for when you are doing your initial screening of CBM companies?

Eric Nuttall:

Because CBM requires very unique “manufacturing” techniques, a management team experienced in coalbed methane is very important. For example, that would include selecting the right frac job. This is evidenced by many conventional operators having farmed out their CBM acreage to those experienced in CBM production. Other than iden-

tifying prospectivity and establishing that there is an experienced management team, another important attribute is contiguity of acreage. CBM requires several fixed costs, such as compression. The economics of only one or two sections of land are fairly skinny, even in a \$9+ natural gas environment. Further, access to gas markets is important, since the value of stranded gas is markedly lower than that which can easily be tied into a pipeline.

StockInterview:

What should these wells be producing, what is average, what is low, what is high, what is sub-economic, what is robust?

Eric Nuttall:

Well I think it's safe to say that the Mannville coals will be developed using horizontal wells, which would imply well costs of around \$1 million to \$1.2 million. I'm only aware of approximately 40 horizontal Mannville wells being public, with average stabilized rates of around 300mcf/d. At \$7.00 gas, which is approximately where we are today, an economic cut-off would be a stabilized rate of 200 mcf/d. At \$9.00 AECO gas price, and if one were to assume that the historical average of 300 mcf/d stands, the economics are very sound with a Net Present Value per well of approximately \$850,000 per well and a pre-tax return on invested capital of 78 percent. Some operators such as Ember Resources (TSX: EBR) are using an expected case of 500mcf/d, which if that was achieved, would have a pre-tax return on invested capital of over 220 percent. In summary, low would be under 200mcf/d, high would be over 1MMcf/d, average is likely to be around 300-400mcf/d, and robust in a \$9 natural gas environment would be anything over 300mcf/d.

StockInterview:

How long does it take before a CBM claim matures in terms of its production?

Eric Nuttall:

It's somewhat unknown now, on horizontals, since there are so few wells whose data is publicly available, and because horizontals have only been used for a few years. With that said, it is expected that a horizontal Mannville well should stabilize after six months, plateau for up to two years, and then head into a shallow decline.

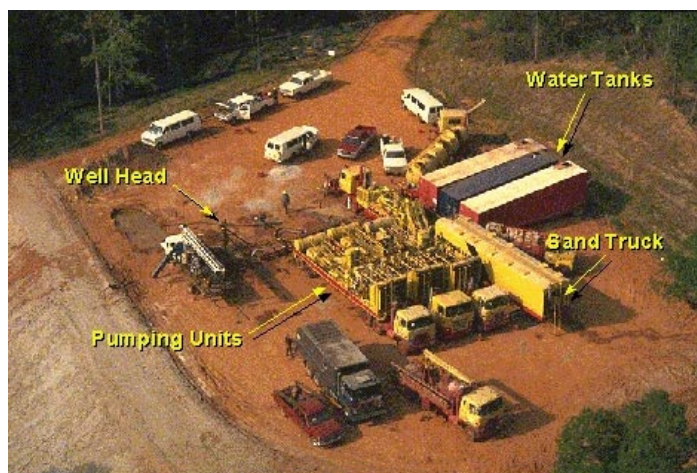
StockInterview:

But some have published that CBM wells could continue producing for decades?

Eric Nuttall:

It's thought that the reserve life of a Mannville horizontal well could exceed 20 years. Again, we don't have any wells that

have been on longer than I believe a year and a half. So it's somewhat extrapolation from the short production curves. A large benefit of coalbed methane is, in general, wells have a much lower decline rate than conventional wells. A decline rate is due to the natural loss of pressure from a reservoir. In Canada, the natural gas base decline rate is approximately 30 percent. That means on average the productivity of a natural gas well will be 30 percent lower each subsequent year. Horseshoe Canyon wells have an 8 to 10 percent decline after 5 years. It is thought Horizontal Mannville wells could have an equally shallow decline rate after the same period of time. The benefit of this should be pretty obvious.



Coalbed Methane production operation

StockInterview:

What are your three strategies for investing in the Coalbed Methane sector, depending upon how much risk you wish to tolerate?

Eric Nuttall:

There are three ways to invest in coalbed methane.

1. The first is by investing in a pure play, such as Canadian Spirit (TSX: SPI), Rockyview (TSX: RVE), Ember (TSX: EBR), or Mahalo (TSX: CBM). This approach presents the most torque, however it also possesses the highest degree of risk, especially in an emerging CBM play.
2. The second way is to invest in a conventional oil and gas company that has prospective CBM acreage, but which is not a core focus of the company. This can offer some hidden value to an investor, especially if the company intends on monetizing the asset. I like Real Resources (TSX: RER) for this reason. Real is a conventional producer trading below 5X cash flow

and will likely grow production this year by 30 percent. The company is sitting on 370 net sections that are prospective for Mannville CBM. Sproule Associates is preparing a contingent resource report and it is my suspicion that the company will spin out the assets in the form of a pure-play CBM explore co upon completion of the evaluation. This could net Real Resources an additional \$4.50 a share. Because the stock is currently trading around \$23.00, RER presents a fairly low-risk opportunity to gain exposure to coalbed methane. Crew Energy (TSX: CR) also has acreage that is prospective for Horseshoe Canyon CBM which is not reflected in its stock valuation.

- The third way to gain exposure to coalbed methane is to invest in oil and gas service companies that service the CBM producers, with the best investment opportunity likely Calfrac Well Services (TSX: CFW). There were approximately 3,000 CBM wells drilled in Alberta in 2005, and this number is expected to increase to 4,000 in 2006 and 4,800 in 2007. Every Horseshoe Canyon well, which is the majority of CBM wells being drilled, needs to be fraced. Further, each HSC well can have up to 30 different coal seams, and a high natural gas price allows a producer to economically fracture more of the marginal coals seams. This all means that the service sector should benefit greatly over the next few years as CBM activity continues to ramp.

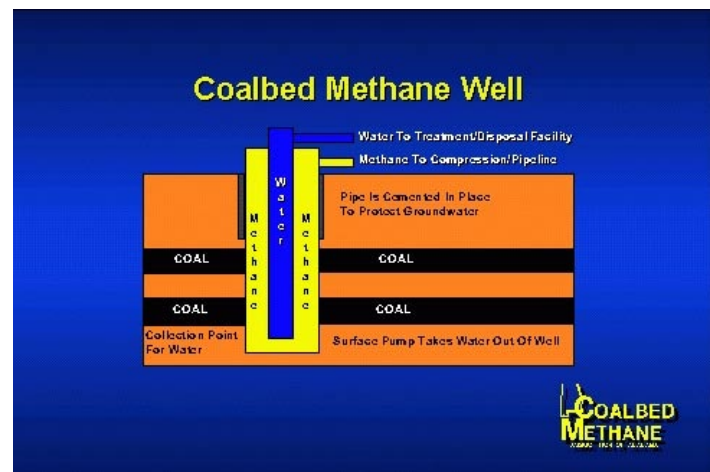
StockInterview:

How you feel about the Richards Oil and Gas, which was highly recommended by at least one major newsletter writer?

Eric Nuttall:

We're involved with Richards (TSX: RIX), and were early and significant shareholders when they came public at \$0.50. At the time when they went public, the company was severely undervalued based on the prospectivity of their Horseshoe Canyon acreage, while the company also possessed upside from their Ardley CBM potential. As the stock went from \$0.50 to \$2.60, in my opinion all of the upside from the Horseshoe Canyon was priced in. What remained was their Ardley CBM potential. The difficulty with Ardley coal is that all of the publicly available data on Ardley CBM wells, to date, have shown the presence of fresh water within the coals. There is extremely strong resistance to developing reservoirs containing fresh water. Special permitting is required. I would suggest that a company will never get approval for a freshwater Ardley CBM well. With that said, management believes that they have some dry Ardley potential. I'm somewhat in a wait-and-see mode. The potential upside is significant. However, the execution risk is still quite high in my opinion. Richards

is not a core holding currently, but they have a very strong technical team. If they're able to prove up dry Ardley CBM, then it could be a very exciting story.



Coalbed Methane Well

StockInterview:

There have been complaints, reported in the media from environmentalists and concerned citizens about the Alberta CBM companies and the impact it has had on their groundwater. How will this impact some of the Canadian CBM plays?

Eric Nuttall:

With the rate of growth in coalbed methane, there are bound to be some small environmental impact. But longer term, when the country and continent are in desperate need of a resource, it needs to be developed. In an environment of energy scarcity, the physical environment will always take a backseat to the need to heat our homes and run our economy. It is true that some incidents have occurred from the rapid acceleration of the industry. However, I'm convinced that the players in the CBM industry are dedicated to extracting the resource in a manner that is both environmentally sound and economically reasonable. From the perspective of an investor, I don't think that the environmental repercussions of CBM development should be a long-term worry. I do expect an increase in short-term rumblings at local levels.

StockInterview:

Any final word of advice to investors?

Eric Nuttall:

One final comment I would offer to an investor is to be somewhat weary of management teams professing to have large CBM potential. It's very important to analyze whether management has experience in coalbed methane, whether the acreage is in the defined trend, and if there have been demonstrated economic rates in close proximity to the company's acreage.

About...

Eric Nuttall, Research Analyst

Eric Nuttall is a Research Analyst with Sprott Asset Management Inc. He joined the firm in February 2003 after beginning his career with CIBC World Markets. Eric supports the investment managers with the development and analysis of investment ideas for all Sprott Funds, with a primary focus on oil and gas stocks. Eric graduated with high honors from Carleton University with an Honors Bachelor of International Business.



Eric Nuttall specializes in researching Coalbed Methane companies for Sprott Asset Management, one of North America's most successful and respected money managers.

Websites and Trading Symbols of featured companies :
Ember Resources (TSX: EBR)
Maholo Energy Ltd (TSX: CBM)
RockyView Energy (TSX: RVE)
Richards Oil & Gas Ltd. (TSX: RIX)
Canadian Spirit Resources (TSX: SPI)
Calfrac Well Services Ltd. (TSX: CFW)
Real Resources Inc. (TSX: RER)
Crew Energy Inc. (TSX: CR)

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