InterOil's renaissance

Having beefed up its balance sheet, InterOil is moving ahead with Papua New Guinea's biggest drilling campaign. Damon Evans reports

A new start: Drilling at the Raptor site

THE appointment of ex-BG Group chief, Chris Finlayson as chairman of troubled Papua New Guinea (PNG) explorer InterOil grabbed international headlines. Yet it was the low-key arrival of ex-BP and Woodside Petroleum executive Michael Hession a year ago that sparked InterOil's transformation.

The $2.8 billion US-listed company had been mired in controversy since it discovered the prolific Elk-Antelope gasfield in 2008, which could be the largest find in Asia in the past 20 years, and is certainly the largest undeveloped field in PNG to date.

Much of the controversy stemmed from its pioneering former chief executive, Phil Mulacek, who remained firmly fixed on developing and operating the field as a liquefied natural gas (LNG) project, which is normally only the remit of the major international oil companies. Meanwhile, in the absence of any concrete development plans, the company's detractors questioned the quality of the reservoir and true size of the resource – estimated anywhere between 3.5 trillion and 11 trillion cubic feet.

Moving ahead

Yet with a credible management team now in place, and a deal ironed out with French player Total, monetisation of the Elk-Antelope field as an LNG project is moving closer to reality. Analysts believe Elk-Antelope LNG will be a competitive global LNG project, making its development highly likely once reserves are established. If appraisal goes according to plan, then a 6.8 million tonne per year (t/y) two-train LNG development could be sanctioned by 2017 with first production in 2021.

For InterOil, Hession's arrival as chief executive in July last year provided a much-needed catalyst. "Mega projects, emerging provinces, and most recently LNG, are in my DNA. We had to move quickly to keep the company on track," Hession told *Petroleum Economist.*

But although he relishes a challenge, he faced an enormous one with InterOil. The company was fast running out of money and lacked credibility. It was on the verge of losing its licences, having failed to meet its work commitments, and was also stuck in difficult negotiations with ExxonMobil in a last-ditch attempt to develop Elk-Antelope.

"The company did not fully understand what it had. It didn't know the value or the potential of its asset base," said Hession.

Indeed, it was not the refinery, petrol stations nor the organisation that attracted Hession to InterOil. Instead, following some of his own due diligence, it was the "fantastic asset in a great address" that lured him.

"It was the gasfields, Elk-Antelope, Triceratops, and the exploration acreage in the frontier Eastern Papuan basin," he said.

InterOil's gasfields lie much closer to PNG's maiden LNG export plant in Port Moresby than the remote Highlands fields that feed the plant. In fact, InterOil's acreage is roughly equidistant between the Oil Search-ExxonMobil gasfields in the Highlands and the ExxonMobil-led liquefaction scheme in Port Moresby. On top of that, any proposed Elk-Antelope LNG development could share the export infrastructure already in place at the brownfield site in Port Moresby, making the development particularly attractive.

Analysis from Wall Street research firm Bernstein shows there could be at least $3 billion in savings relative to the $19 billion PNG LNG project, which started up earlier this year. At $16 billion, or around $2,000/tonne, Elk-Antelope would be one of the lowest-cost projects in the region. With a breakeven price delivered to Tokyo of $9 per million British thermal units the ExxonMobil-led liquefaction scheme is already one of the most competitive globally.

To boot there is some real exploration upside. InterOil holds a dominant position covering about one-fifth of the 76,000 square km frontier Eastern Papuan basin with at least 40 prospects and multi-trillion cubic feet potential.

All stop

But just one year ago with almost no cash and no financiers willing to lend the company any money, Elk-Antelope's development stalled. The government was fast losing patience. And even though InterOil was locked into exclusive negotiations with ExxonMobil, having exhausted its other alternatives, the company risked losing its prized assets.

"When you're an InterOil you don't want to be in a negotiation with just one party. You need competition," Hession said.

Still Hession remained resolute. In this business the only antidote to a supermajor is another supermajor, said Hession, who headed up Woodside's Browse LNG scheme in Australia before joining InterOil. While he is reticent to discuss detail, he deftly used his connections to pit several companies, including Shell, Total and ExxonMobil, against each other. But with the help of his newly appointed team, roped in from various supermajors, Hession created some constructive competition, which ultimately paid off.

French major Total won. They offered the best value deal with a rare uncapped upside that's worth about $400 million per extra trillion cf of gas discovered. The Paris-based company was eager to strike a deal with InterOil as it wanted another strategic project to underpin its established LNG business in Asia.

The arrangement saw InterOil net $401 million in March while locking in a further $138.7 million of milestone payments. The upside includes a wealthy schedule of bonus payments if appraisal proves more gas than the opening deal numbers reflect. Additional payments start kicking in at the certification of 3.5 trillion cf of gas, pretty much the minimum that InterOil and Total know is already there. If appraisal drilling bolsters the resource to 7.1 trillion cf, there should be ample gas for at least two LNG trains, making InterOil's deal worth $1.62 billion – more than half the company's market capital.

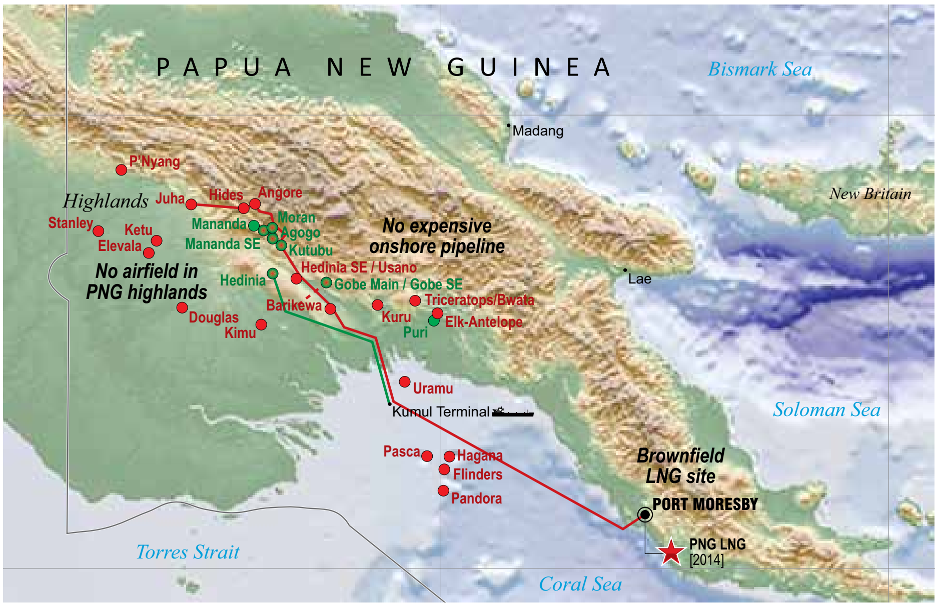
The outcome benefits PNG too as it has two major international companies competing to exploit its upstream potential. Aside from ExxonMobil's producing two-train PNG LNG project, analysts expect at least another three trains will be sanctioned over the next five years, including a third train at the ExxonMobil-operated plant.

If all goes to plan, InterOil could find itself on a fast track to a share in a two-train LNG scheme with potentially enough gas to fuel one more train at a later date. And as Hession tells investors, Elk-Antelope sits in 16,000 square kms of virgin exploration territory. To put that in context, the company's total acreage covers 22 Singapores or 10 Greater Londons.

Following the deal with Total and having sold off its downstream assets to focus upstream, InterOil has nearly $600 million cash in the bank, plus access to up to $300 million in finance, making Hession confident he can find more gasfields. With the total discovery of 26 trillion cf of gas already in PNG, the US Geological Survey estimates a further 24 trillion cf or 4 billion boe is still yet to be discovered, which bodes well for the intrepid explorer.

InterOil will drill up to eight wells, four exploration and up to four appraisal, over the next 12 months – the biggest drilling programme in PNG's history – leading to reserves certification at Elk-Antelope by end 2015.

Figure 1: PNG oil and gas infrastructure



Source: Petroleum Economist

More discoveries

Exploration geoscientist Laurie Brown, who has been involved with major oil and gas discoveries for the likes of BP, as well as Shell, in West Africa and Asia, believes there could be more fields of Antelope's quality. Along with Dave Holland, who was a central player in the Triceratops, Elk and Antelope discoveries, they have devised a strategy to crack the code in the vast emerging province.

PNG is dominated by two major hydrocarbon basins, the Eastern Papuan basin, where InterOil holds acreage, and the larger adjacent Western Papuan basin, which are separated by a major fault. Both are workable. But the Western Papuan basin has been more heavily explored than its Eastern cousin, with about 280 wells, resulting in key discoveries at Hides, Juha, P'Nyang, Kutubu, Stanley, Elevala and Ketu, many of which have helped underpin the initial PNG LNG project.

The Eastern Papuan basin, on the other hand, is under-explored with about 65 wells, and has yielded significant finds at Elk, Triceratops and above all, the world-class Antelope discovery. "We see these same signatures potentially throughout the greater acreage," Brown told investors recently.

In its four exploration licences InterOil typically holds a high controlling stake of more than 65%. "Seldom do we see this scale or materiality of position in a company of InterOil's size," added Brown. Moreover, InterOil's tenure for the next six years, with an option for a further five years, is a boon.

For Hession, the focus is aggressive expansion and value delivery through the drill bit. With about 40 potential targets there is at least 10 years of high-growth exploration running room in the basin. Some independent research suggests they could be targeting an estimated equivalent of 20 trillion cf. But the company remains tightlipped.

InterOil will drill four exploration wells in the present campaign, but has not released details on the size of the prospects.

Data from Bernstein shows the combined exploration programme will target about 6 trillion cf of un-risked gas and 100 million barrels of liquids (1.1 billion boe un-risked). Given the exploration probabilities, the risked prospective resource base is closer to 230 million boe or around 83 million boe net to InterOil.

Antelope Deep, due to spud in 2015, will be a key exploration well. It has the best probability of success, or a one-in-three chance, based on its proximity to Elk-Antelope and is targeting an estimated un-risked resource of up to 3 trillion cf. If successful it would add reserves for a one-train development and possibly point the way to a third train.

Based on the combined risks of all four prospects being drilled, which include Wahoo, Raptor and Bobcat, there is a one-in-two chance that InterOil will make at least one discovery in the four-well campaign, says Neil Beveridge, an Asian-focused oil and gas specialist at Bernstein. Although InterOil is more cautious, citing a one-in-10 chance of a discovery in its frontier acreage.

Bobcat-1, like Antelope Deep, also lies on the same trend as the Triceratops and Elk-Antelope finds, which gives it a higher chance of success. Wahoo-1 is the highest risk well.

Bobcat-1 and Raptor-1 are both drilling, while the Wahoo-1 wildcat was suspended due to excessive pressures. Although disappointing, the company's decision to return later suggests they could be close to success, having found a working hydrocarbon system, as well as a seal to keep a lid on it, they just need to prove up a reservoir.

But drilling in PNG is not cheap. The average cost per well is around $50 million, although Antelope Deep will be carried out by Total. Nevertheless the payoff could be huge.

Still the key contention surrounding InterOil remains the size of its resource base for a two-train LNG development.

One train looks assured, while InterOil is confident that two trains is more realistic. And given the stiff competition amongst the majors to get a slice of the action they presumably agree too. It's easy to see then why InterOil would make an attractive takeover target for a number of buyers.

ExxonMobil, Woodside, Total and PNG-focused Oil Search are all possible bidders.

ExxonMobil would have the most to gain given synergies with PNG LNG. While if Total believes in the upside reserves case, a buyout of InterOil would make financial sense, reckons Beveridge. Woodside, which is actively looking for an LNG company for $3 billion to $5 billion could also be interested.

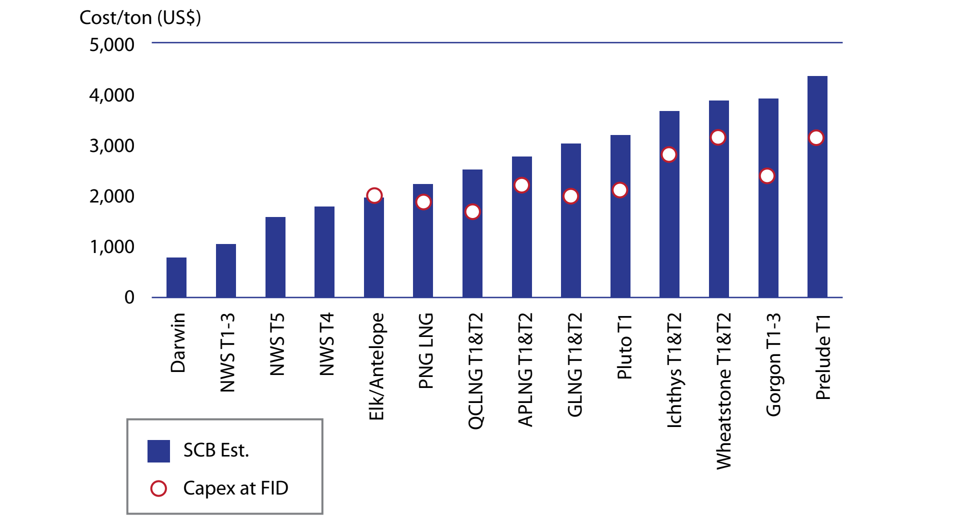
"Our dance card is filling up, although not quite the belle of the ball yet, we're heading that way. We're getting more and more calls from majors, investors, and banks wanting to do deals with us," said Hession. Indeed that's what credibility and a sensible investment approach brings.

For now though, Hession and his team are purely focused on maximising value and shoring up more discoveries.

With Southeast Asian LNG production falling and the Australian LNG boom over, the focus is shifting to PNG, which sits in the belly of Asia – predicted to be the largest market for natural gas globally by 2025.

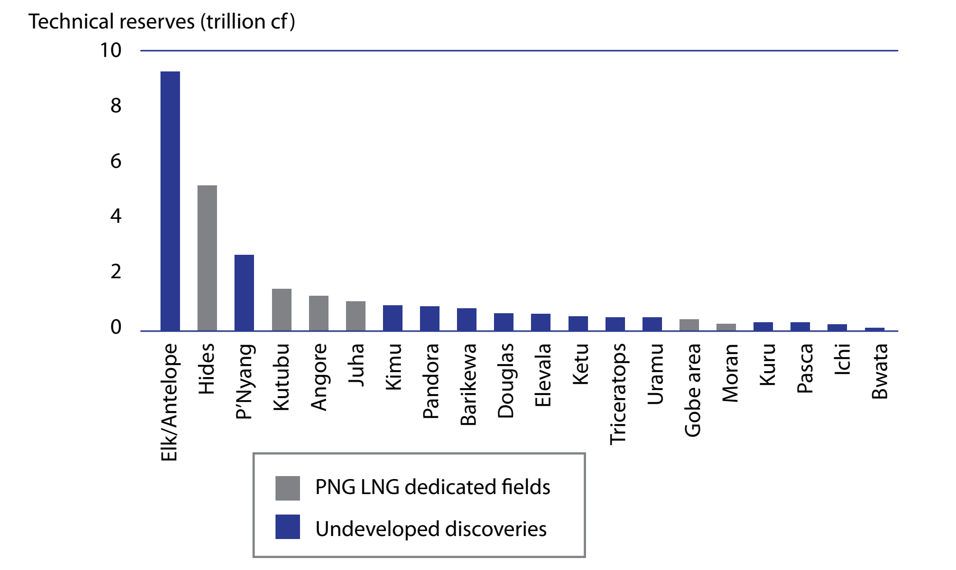
These are exciting times for InterOil and PNG, which is gas long in a continent that is gas short. ●

Figure 1: LNG project cost comparison



Source: Bernstein Estimates

Figure 2: PNG discoveries



Source: Bernstein Estimates