

7 January 2010

Produced and issued by: RBS Morgans

Spec. Buy

Important: The above recommendation has been made on a 12 month view and may not suit your investment needs or timeframe. The basis it is prepared on is summarised on the last page of this report. **PLEASE CONTACT YOUR ADVISER TO DISCUSS THIS GENERAL RECOMMENDATION BEFORE ACTING ON IT.**

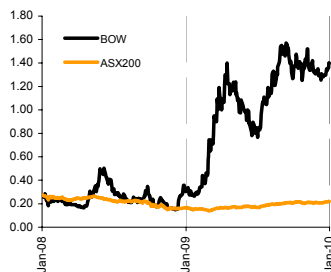
Price
A\$1.435

Market Cap
A\$398.4m

Net Cash
A\$95m

Shares on issue
277.6m

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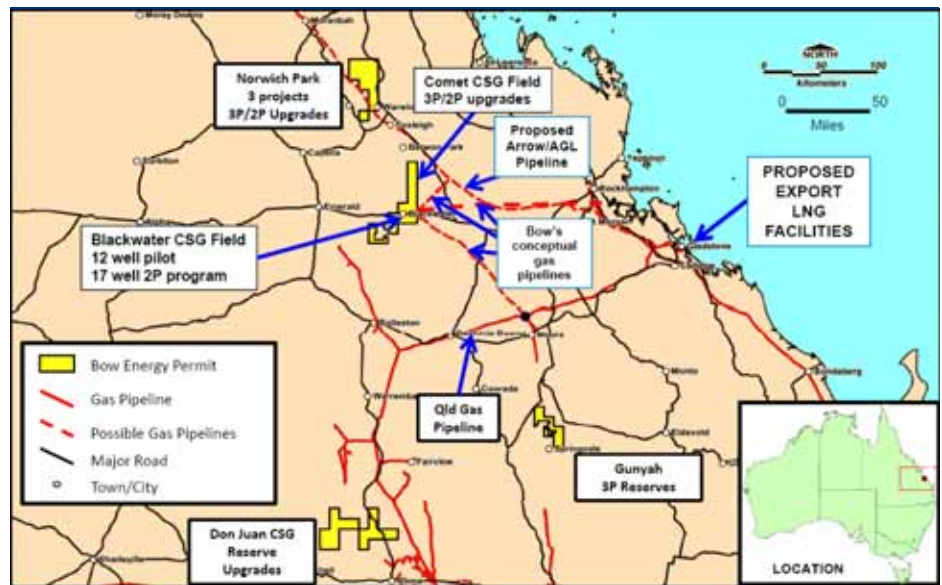
BOW100107

Bow Energy (BOW)

Navigating Blackwater Economics

BOW has plenty of CSG reserves at Blackwater (3P reserves of 1,447 PJ) and is constructing its own 30 MW gas fired power station. BOW's pilot project in 2010 will help define the economics of development – next step will be finding a high margin market. Does any East Coast LNG player need more gas?

Figure 1: Map of BOW's exploration tenements and proximity to market



Source: BOW presentation

BOW has certified plenty of gas, and there's more to come...

2009 delivered a 275% increase in BOW's share price, thanks to the rapid rise in its 3P reserves to 1,447 PJ (net to BOW). Its 2010 exploration campaign should see this increase to approximately 2,750 PJ and the certification of 2P reserves, and hopefully 1P reserves as well. 1P reserves certification would signal that the reserves certifier is convinced that commercial production is possible.

30MW of power generation by early 2011 will generate early cash flows

The construction of a 30MW power station provides an early path to cash flow generation for BOW. But with Blackwater – BOW's key CSG field – not connected to the domestic gas market by pipeline, further monetisation of its resource will require the construction of a pipeline to take the gas to market, underpinned by an offtake agreement.

Reasons to buy: Reserves growth, gas marketing progress and corporate appeal

BOW's acreage is in close proximity to Gladstone, and would make a logical acquisition for any LNG player that required additional production or reserves. Other reasons to buy include: A steady stream of reserves upgrades, pilot production results and progress on power generation construction.

Investment Summary

Bow Energy (BOW) is a coal seam gas (CSG) explorer with a number of exploration tenements in the Bowen Basin in Queensland. BOW is seeking to rapidly expand its reserves base and source high margin gas markets for its gas reserves. BOW's CSG 3P reserves are currently 1,447 PJ, with plans to increase this by 45% to 2,750 PJ by YE 2010.

Commercialisation of its reserve base requires the successful demonstration of economic gas production, which should occur during 2010. BOW will also construct and operate a 30 MW gas fired power station at its Blackwater CSG project, using gas produced from the production pilot being developed to certify 1P and 2P reserves.

Reasons to Buy

We have identified the following reasons to buy BOW.

- Large uncontracted gas volumes close to Gladstone.** BOW has talked up its desire to supply gas into LNG. Having a large uncontracted volume of gas on the doorstep of Gladstone would improve BOW's chances of achieving this outcome. It would however depend on the LNG project participants' desire to purchase 3rd party gas over its own gas resource.
- Potential for further reserves upgrades.** BOW has reached 1,447 PJ of 3P reserves and 55 PJ of 2P reserves. The company is already ahead of its own reserves targets, and still has reserves certification of its Comet project to come. The company is targeting 2,750 PJ of 3P reserves by YE 2010.
- Pilot project commencing next year** should lead to certification of 1P and 2P reserves.
- YE 2010 valuation metrics look to be attractive relative to some of its peers.** BOW looks inexpensive compared to some of its peers, in particular when its YE 2010 reserves target of 2,750 PJ is taken into account.
- Potential corporate target.** If BOW can demonstrate commercial flow rates are possible from its acreage and one or more of the LNG participants at Gladstone is keen to aggregate more CSG resources for additional LNG trains, BOW may be on the radar.

Relative Valuation Metrics

Table 1: CSG Company Enterprise Valuation Calculations (as at 6th January 2010)

Company	Code	Share Price	Estimated EV A\$ million	Current Reserves		Valuation Metric		YE 2010 Reserves		Valuation Metric	
				2P PJ	3P PJ	EV/2P A\$/GJ	EV/3P A\$/GJ	2P PJ	3P PJ	EV/2P A\$/GJ	EV/3P A\$/GJ
Arrow Energy	AOE	\$4.430	2817	2,405	5,082	1.17	0.55	3,405	7,195	0.83	0.39
Blue Energy	BUL	\$0.235	110	0	0	0.00	0.00	0	0	0.00	0.00
Bow Energy	BOW	\$1.410	296	55	1,447	5.39	0.20	450	2,750	0.66	0.11
Comet Ridge	COI	\$0.335	96	0	0	0.00	0.00	0	0	0.00	0.00
Eastern Corp	ECU	\$0.320	24	0	0	0.00	0.00	0	0	0.00	0.00
Eastern Star Gas	ESG	\$0.935	775	391	1,273	1.98	0.61	1,105	3,596	0.70	0.22
Exoma Energy	EXE	\$0.165	32	0	0	0.00	0.00	0	0	0.00	0.00
Icon Energy	ICN	\$0.380	123	0	0	0.00	0.00	0	150	0.00	0.82
Metgasco	MEL	\$0.700	115	298	1,538	0.39	0.07	400	2,064	0.29	0.06
Molopo	MPO	\$1.435	166	48	231	3.45	0.72	150	722	1.11	0.23
Westside Corp.	WCL	\$0.500	28	0	211	0.00	0.13	111	1,710	0.25	0.02

Source: RLMS, Company data, IRESS

Note: EV = Enterprise Value

Using YE 2010 reserves targets as a valuation metric guideline, BOW looks cheaper than AOE, ESG, MPO and ICN. However it should be noted that each company has their own unique issues, so it is not a case of comparing apples with apples.

Recent transaction have averaged A\$0.56/GJ on a 3P reserves level, and with BOW trading at A\$0.20/GJ on current 3P reserves and A\$0.11/GJ on the YE 2010 3P reserves target, BOW looks inexpensive. However we do caution on using these metrics as a basis for investment, as the price paid for reserves in recent transactions are in fact a combination of a number of factors,

such as the quality of CSG acreage, the potential size of the resource (beyond the certified reserves), the end market for the gas and the competitive intensity of the sale process.

Upcoming Catalysts / Milestones

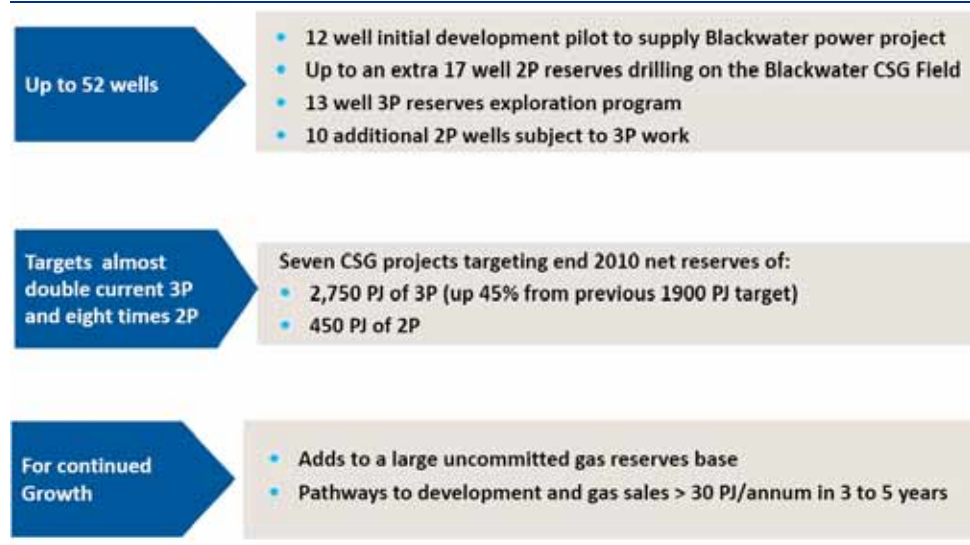
BOW's upcoming catalysts include the following:

- Certification of 3P reserves from Comet CSG project (expected by YE 2009)
- Announcements relating to gas supply discussions
- Results from the 2P pilot production wells

2010 Work Programme

BOW has announced an aggressive 2010 exploration and appraisal programme:

Figure 2 : Bow Energy 2010 drilling and reserves certification targets



Source: BOW presentation, 15/12/2009

In addition to this, BOW is planning on spending approximately A\$35m on the construction of a 30 MW gas fired power generator.

Key Risks

The following key risks have been identified for BOW.

- **Market access.** Blackwater acreage is not connected to a market – it will require a pipeline to be constructed to sell gas to domestic customers or LNG. Located 230 km west of Gladstone.
- **Poor results from pilot project.** Commercial gas flow rates have yet to be established from Blackwater. Pilot wells will be drilled in 2010 to ascertain the optimal drilling and completion techniques, as well as how much gas can flow from each well (peak gas production rate and total recovery). A poor flow rate result will mean that the cost of extraction will be high on a \$/GJ basis, meaning a higher margin market (such as LNG) may be required to make an economic rate of return from full field development.
- **Valuation metrics are only one component of corporate valuation** and should not be looked at in isolation. Other factors to consider include market access, resource size and coal seam quality.

Company Description

BOW's key tenement, which includes the Blackwater and Comet CSG fields, are strategically located to Gladstone – home of 5 proposed LNG projects. BOW's will initially feed its gas into a 30 MW gas fired power generator, which it will construct during 2010 and be online 1H 2011. Beyond this first stage of commercialisation, BOW will seek to market its gas volumes into one of the proposed LNG projects, or seek an alternate high margin gas customer (such as larger scale power generation).

BOW recently completed a successful equity raising, increasing BOW's total cash position to A\$95m. BOW plans to apply these funds to the following:

- Expansion of 3P reserves delineation;
- 2P reserves certification through successful pilot projects at Blackwater, Comet and Norwich Park, and;
- Construction of a 30 MW gas fired power generation capacity at Blackwater, utilising gas produced during the pilot stage.

Key Assets

Bow Energy's key assets are as follows:

- 100% interest in ATP 1025P, containing the Blackwater and Comet CSG fields
- 100% interest in ATP 1031P, containing the Norwich Park CSG field.
- 55% interest in ATP 593 and 771P, containing the Don Juan CSG field
- 100% interest in ATP 1053P, containing the Gunyah CSG field

BOW is operator of all of these assets. The Don Juan field is located in the Surat basin, whereas all other permits are targeting coals in the Bowen Basin.

Reserves / Resources

BOW has certified reserves in the Don Juan and Blackwater CSG fields. Current and target 2P and 3P reserves are outlined in the table below.

Table 2 : Current Reserves and YE 2010 Targets

CSG Project	3P Reserves (~PJ net to Bow)	2P Reserves	End 2010 Target (3P/2P)
Blackwater CSG Field	1,340	Initial early 2010	> 1,500/200
Comet Project	Early 2010	End 2010	> 500/100
Norwich Park Projects (3 projects)	Mid 2010	End 2010	> 500/100
Don Juan Project	107	55	150/50
Gunyah Project	End 2010	2011	100/na
Net PJ to Bow	1,447	55	> 2,750/450

Source: BOW presentation, 15/12/2009

Key to certifying 2P (and 1P) reserves in 2010 will be the completion of a successful pilot project in Blackwater CSG field. 2P reserves certification requires BOW to prove permeability of coal seams between adjacent wells over the field. 1P reserves certification requires BOW to demonstrate that commercial gas quantities can be produced.

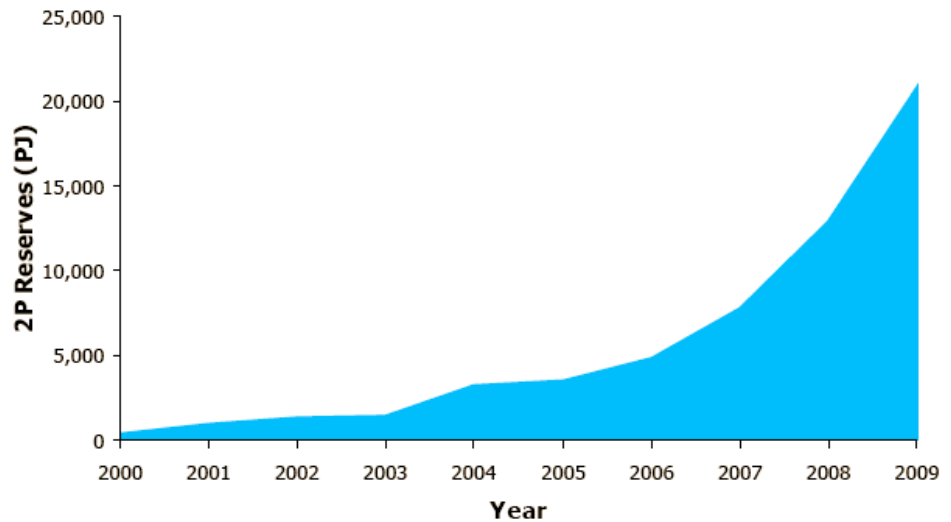
Coal Seam Gas Overview

Australian CSG Reserves

Australian CSG reserves have grown significantly, in particular over the past 4 years.

Chart 1 : Growth in Eastern Australia's CSG Reserves

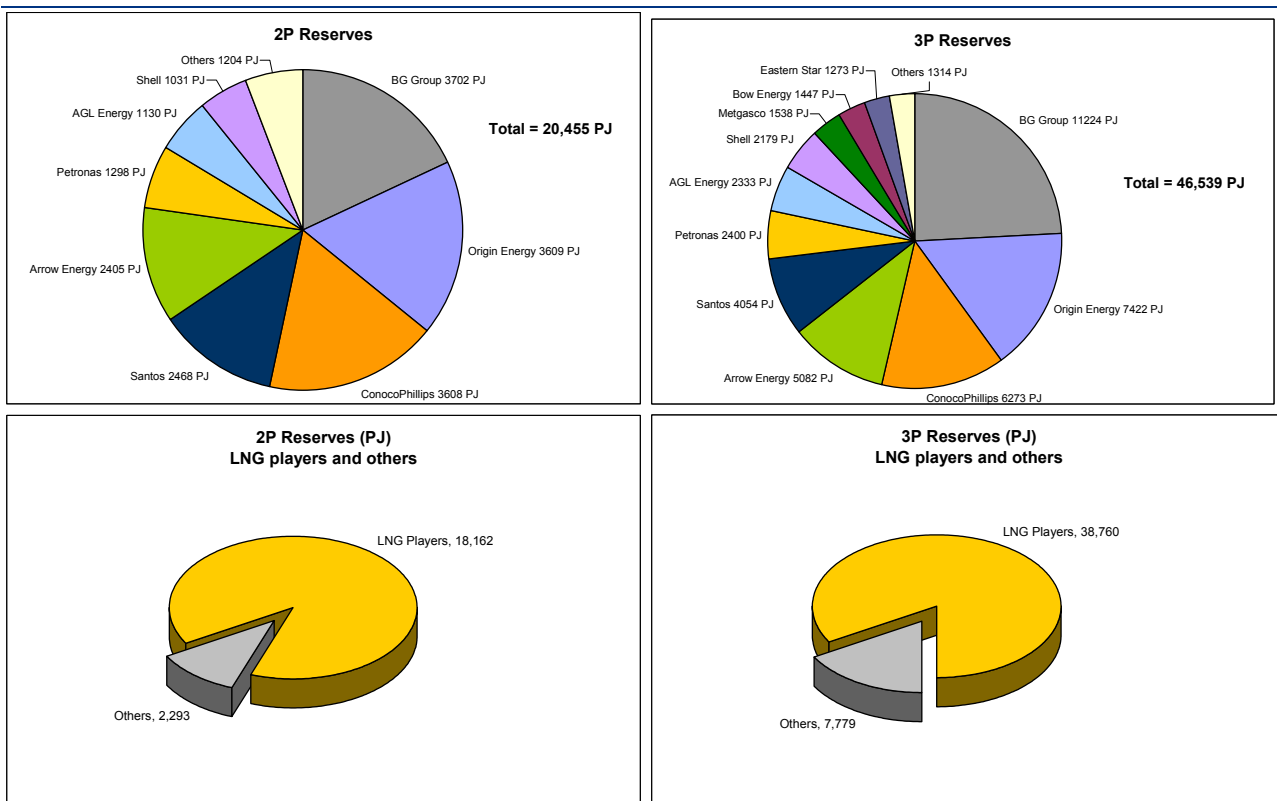
Eastern Australia's CSG Reserves 2000 - 2009



Source: Santos presentation, 25/09/2009 - RLMS

The current breakdown of 2P and 3P CSG reserves is as follows:

Chart 2 : CSG 2P and 3P reserves



Source: RLMS, company data

CSG Markets

Domestic

The domestic gas market is mainly comprised of large scale bilateral contracts between producers and customers. There is a spot market for gas in Victoria, and minor volumes can be sold on a short term basis in other east coast states. Most CSG is sold to larger customers such as AGL, Origin, CS Energy and Incitec Pivot.

Queensland CSG companies targeting the domestic market have three key issues: Finding a customer that requires CSG volumes in the profile that CSG is typically produced, and obtaining a competitive price and the delivery of the gas through the gas pipeline network. Queensland's total gas consumption is forecast to increase from 166 PJ in 2009 to 458 PJ per annum in 2029, mainly due to an increase in gas fired power generation capacity.

NSW gas market is forecast to grow from 130 PJ in 2009 to 199 PJ per annum in 2029. With CSG currently only accounting for approximately 8 PJ per annum of supply, indigenous CSG resources will have a competitive advantage compared to Victorian or Queensland gas due to not having to pay the transportation tariff to move gas into NSW.

Gas prices are typically in the A\$2.50 – A\$4.00/GJ on an ex-field basis, with prices trending higher as both domestic gas demand and potential LNG export options are crystallised. Key to achieving higher gas prices are the following factors: ability to commit to a stable, long term offtake arrangement; LNG projects broadly proceeding as planned; and some sort of CPRS being introduced, putting pressure on electricity prices.

In the absence of a domestic gas customer, CSG companies can develop their own electricity generation capacity. Companies such as Arrow Energy, Eastern Star Gas, Molopo, Metgasco and Bow Energy have proposed or developed such projects already. The key benefit of such an approach is that the producer is no longer reliant on finding a gas buyer – they can produce gas but sell electricity. Electricity prices have traded in the range of A\$40 – 60/MWhr, and the forward trend is generally upwards. The netback equivalent gas price for power sold at these prices can be more attractive than domestic gas sales prices.

LNG

There are currently five proposed CSG to LNG projects proposed at Gladstone: BG, Santos-Petronas, APLNG (Origin – ConocoPhillips), Shell and LNG Ltd. All projects talk of a 2014-2015 start-up timeframe, which, in reality, is unlikely to happen. A single 4 mtpa LNG facility requires approximately 250 PJ of gas from the field, which equates to 150% of Queensland's 2009 gas demand. We expect some slippage and/or cancellation of some of these projects, as well as a level of downstream consolidation to optimise capital investment.

A single 4 mtpa LNG train requires approximately 6,000 PJ of reserves to underpin a 20 year output. Proving up the reserves and developing the production capacity to feed each train will be an enormous challenge. Once a single train is approved for development, the owners will move to aggregate resources for additional trains. This resource aggregation for subsequent LNG trains will be an opportunity for non-CSG LNG players to enter into gas supply contracts or be acquired by the bigger companies.

LNG is sold at a price that is linked to the prevailing price of oil. Given the level of competition amongst the LNG project proponents at the moment, we anticipate that future CSG to LNG sales will have to be sold at a larger discount to oil parity than conventional LNG supplies. Even so, LNG sales provides a mechanism for CSG producers to sell their product at prices that are unlikely to be achieved in the domestic gas or electricity markets. The downside is that LNG projects require significant investment upfront. A 4 mtpa LNG facility could cost as much as A\$10 – 12 bn for the upstream (wells and gas treatment), pipeline and LNG facility.

Relative Valuation Metrics

The following table summarises the most up to date certified reserves data. It should be noted that some companies have not updated their reserves position recently (e.g. BG Group and Santos), so the actual certified volumes are likely to be much larger than those shown below.

Table 3: Company CSG Reserves and Resource Summary

Company	Active CSG Basins	Certified Reserves			Potential Resource Size (PJ)	Reserves Certifiers	Demonstrated Commercial Gas Flows?	Estimated Resource Quality
		1P PJ	2P PJ	3P PJ				
AGL Energy	Gloucester, Galilee	232	1,130	2,333	5,000	NSAI	Yes (Gloucester)	Medium
Anglo Coal / Mitsui	Southern Bowen	12	256	441	1,000	Unknown	Yes	Medium
Apollo Energy	Gunnedah	0	0	0	2,000	Unknown	No	Low-Med
Arrow Energy	Bowen/Surat/Other	367	2,405	5,082	52,360	NSAI/MHA	Yes (Bowen/Surat)	Medium
BG Group	Surat / Southern Bowen	749	3,702	11,224	13,000	Other	Yes (Surat)	Med-High
Blue Energy	Bowen, Galilee	0	0	0	7,500	MHA	No	Low-Med
Bow Energy	Bowen	0	55	1,447	3,500	MHA	No	Low-Med
Comet Ridge	Galilee	0	0	0	18,000	NSAI	No	Low-Med
ConocoPhillips	Surat, Bowen, Galilee	763	3,608	6,273	21,823	NSAI	Yes (Bowen/Surat)	Med-High
CS Energy	Surat	0	70	218	500	NSAI	Yes	Medium
Eastern Corp	Galilee	0	0	0	7,500	MHA	No	Low-Med
Eastern Star Gas	Gunnedah	21	391	1,273	5,000	NSAI	No (but imminent)	Medium
Exoma Energy	Galilee	0	0	0	17,500	MHA	No	Low-Med
Icon Energy	Surat	0	0	0	1,773	NSAI	No	Medium
Metgasco	Clarence Moreton	3	298	1,538	10,000	MHA	No	Low-Med
Molopo	Bowen	11	48	231	1,000	NSAI	Yes	Low-Med
Origin Energy	Surat, Bowen, Galilee	764	3,609	7,422	21,823	NSAI	Yes (Bowen/Surat)	Med-High
Petronas	Bowen, Surat	467	1,298	2,400	5,000	Other	Yes	Med-High
Santos	Bowen, Surat	707	2,468	4,054	50,000	Other	Yes	Med-High
Shell	Bowen/Surat/Other	157	1,031	2,179	22,440	NSAI/MHA	Yes (Bowen/Surat)	Medium
Toyota Tsusho Corp.	Surat	4	41	126	250	NSAI	Yes	High
Westside Corporation	Bowen, Galilee	0	0	211	10,500	MHA	No	Low-Med
Victoria Petroleum	Surat	0	45	88	1,500	NSAI	No	Low/High
TOTAL		4,257	20,455	46,539	278,969			

Source: RLMS, Company data, RBS Morgans estimates

Reserves Table Explanation

Certified reserves: The last published certified figures published by the company. Note that some companies have not updated their reserves figures for a while (e.g. BG Group – since November 2008, and Santos Ltd, since January 2009), so actual certified reserves are likely to be significantly higher than those listed in this table.

Potential Resource Size: The potential resource size is an RBS Morgans estimate. It has been derived from company data by applying a recovery factor to the estimated gas in place within each company's tenements. It represents a maximum theoretical recoverable volume for each company. Potential resource size is one of the more important variables a company would look at during an asset or corporate acquisition.

Reserves Certifiers: There are two main certifiers of CSG reserves: Netherland Sewell and Associates International (NSAI) and MHA Petroleum Consultants (MHA). Each take a very different approach to reserves certification, and should be taken into account by investors.

MHA tend to allow CSG companies to certify large volumes of 3P reserves for a relatively modest investment, without having to demonstrate commercial gas flow rates are possible. MHA's definition of 3P reserves is also closer to the traditional conventional 3P reserves definition, i.e. a 10% chance of exceeding this estimated. Certification of 1P reserves by MHA requires a demonstration of commercial gas flows.

NSAI tend to require a significant level of investment upfront, and a demonstrated commercial gas flow rate before any reserves are certified. Reserves are then only certified around wells with demonstrated commercial gas production, so 1P, 2P and 3P reserves continue to increase as

more money and pilot wells are drilled.

Demonstrated Commercial Gas Flows?: A key stage in the CSG process is to demonstrate that CSG can be produced at a flow rate that could generate an economic rate of return. Without a commercial flow rate, reserves certifiers will not certify 1P reserves (or 2P or 3P reserves if NSAI is the reserves certifier).

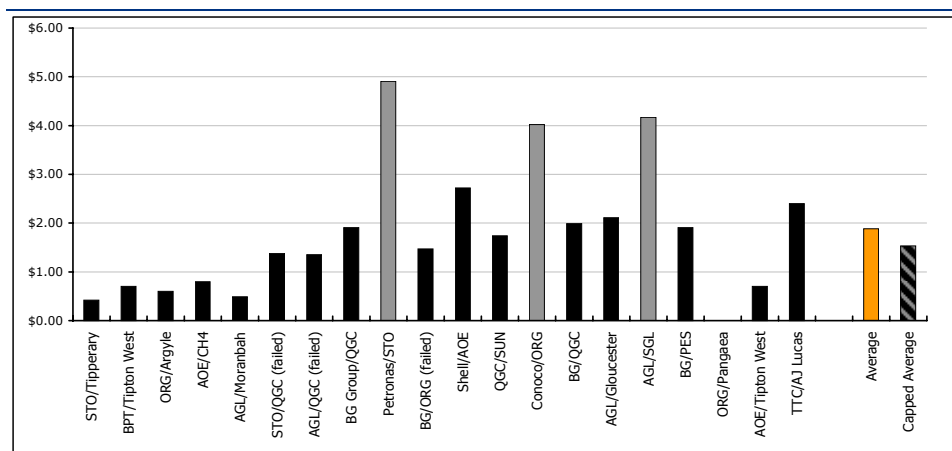
Estimated Resource Quality: CSG resource quality is a key parameter in determining the economics of CSG. Extraction cost is a function of the following parameters:

- Coal depth:** Drilling costs is an important component in calculating CSG extraction costs as CSG development typically requires a large number of wells. The deeper you need to drill to intersect the coals the more expensive the well. Below 900 metres a larger rig typically has to be used, which has a higher day rate.
- Coal thickness:** The thicker the coals the more gas is produced per well, improving the economics of extraction.
- Coal permeability:** Permeability is a measure of the ability of a fluid (gas or water) to move through a substance – in this case, coal. High permeability coal will produce gas and water at a faster rate. If the permeability is too low, then production rates can be enhanced via the use of fracture stimulation or drilling lateral or horizontal wells. Both techniques can dramatically increase the production rates, which improves the extraction economics, but offsetting this benefit is the additional cost required to drill lateral wells or fracture stimulate the coals. Coals with a natural permeability of less than 10 mD is considered to be “low”, but ideally the permeability would average > 25 mD. There is a strong relationship between coal depth and permeability. The deeper the coals the higher the pressures, which typically lead to more compressed coal matrix and therefore lower permeability.
- Gas Content:** Gas content measure the volume of gas that can be extracted from a unit volume of coal. CSG companies typically target coals with a gas content of > 4 m³/tonne. Three key factors influence the gas content of coal: coal rank, depth and permeability. Coal rank is a measure of the ‘maturity’ of the coal, with Bituminous coal considered the idea source for thermogenic gas creation. There is a relationship between coal depth and gas content – the deeper the coals the higher the gas content. There is also a relationship between coal permeability and gas content. Low permeability coal typically has a higher gas content than high permeability coal, as high permeability coals makes it easier for the gas within the coals to escape over time.
- Gas Saturation:** The gas saturation is the percentage of gas contained in the coal matrix. If a coal is 100% gas saturated, gas production would expect to commence as soon as the well is brought online. If the coals are less than 100% gas saturated then the well has to be “dewatered” before gas production will commence. The dewatering process removes a volume of water in the coal seams thereby reducing the pressure. As the pressure drops, the gas saturation of the coals increases. When it reaches 100% then free gas is liberated and the well will start to produce gas. This delay in the onset of gas production has an impact on CSG economics as it delays the start of revenue as well as the requirement to dispose of water production upfront. As a very general rule of thumb, a coal that is 80% gas saturated requires 12 months of continuous dewatering prior to commencing gas production.

Recent CSG Transaction Valuation Metrics

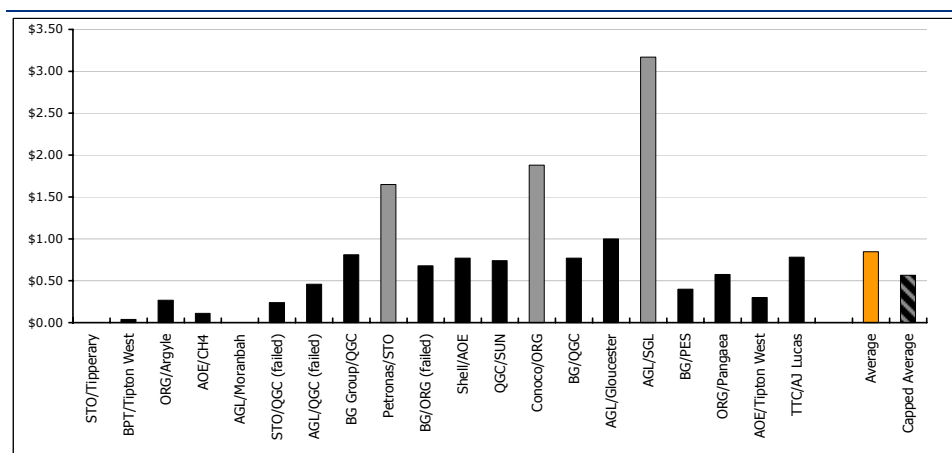
The following chart highlights the recent transactions in CSG. The charts display the transaction value divided by the 2P and 3P reserves at the time of the transaction.

Chart 3 : CSG Transaction Valuation Metrics (A\$/GJ) on 2P reserves



Source: RBS Morgans estimates, IRESS

Chart 4 : CSG Transaction Valuation Metrics (A\$/GJ) on 3P reserves



Source: RBS Morgans estimates, IRESS

Three valuation metrics are higher than the others– the Santos / Petronas, Origin / ConocoPhillips and AGL Energy / Sydney Gas transactions. These have been removed when calculating “capped average” valuation metric as they are deemed to be not representative of the majority of transactions.

Table 4 : Average Transaction Valuation Metrics

Reserve Basis	Average (all transactions) A\$/GJ	Capped Average (excl. top 3 transactions) A\$/GJ
2P Reserves	A\$1.88	A\$0.85
3P Reserves	A\$1.53	A\$0.56

Source: RBS Morgans estimates, IRESS

Whilst transaction metrics have been regularly used in the CSG industry as a benchmark against companies' enterprise value, it has a number of shortcomings. The transaction price paid is a function of not just the current 2P and 3P reserves. It also takes into account the quality of CSG acreage, the potential size of the resource (beyond the certified reserves), the end market for the gas and the competitive intensity of the sale process.

Certification of CSG reserves – in particular at the 3P level, can vary widely depending on the reserves certifier. Please refer to the description of the two major certifiers and their processes as part of the “Reserves Table Explanation” section.

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RECOMMENDATION STRUCTURE

Absolute performance, long-term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. The target price is the level the stock should currently trade at if the market accepted the analyst's view of the stock, provided the necessary catalysts are in place to effect the change in perception. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value the target price will differ from 'fair' value. Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

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REGULATORY DISCLOSURES

Subject companies: Bow Energy (BOW)

RBS Morgans Limited was a participating broker to the Bow Energy Ltd share placement in November 2009 and received fees in this regard.

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