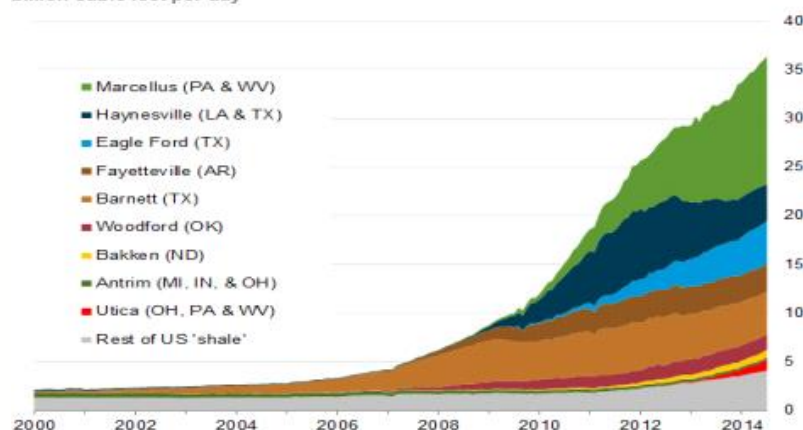


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MARKET MOVES

AOC AND XST ANNOUNCE CALIFORNIAN GAS PLAY

Monthly dry shale gas production
 billion cubic feet per day



Sources: EIA derived from state administrative data collected by DrillingInfo Inc. Data are through July 2014 and represent EIA's official shale gas estimates, but are not survey data. State abbreviations indicate primary state(s).



Australian Oil & Gas (AOC: ASX) and its partner in the Sacramento Basin **Xstate Resources** (XST: ASX), have finally delivered some detail on their much anticipated exploration plan.

One of several Californian gas targets has been identified as the **Demspey prospect**, sitting at a depth of about 3,200 metres with potential to yield over 1 Tcf of essentially dry gas.

Over the past five years, US gas has not been an attractive exploration target. Over that period, the US HH gas price has drifted between US\$2 and US\$6 per mmBtu, but was mostly around US\$3.30/mmBtu. Shale oil producers and targeted shale gas suppliers have lifted their supply by about 30 Bcf per day since 2008, with gas treated as a by-product to the more valuable liquids in many cases. However, last winter the gas price moved up to over USD\$6/mmBtu in the face of physical shortages and high usage. The betting now favours higher domestic gas prices as the likely licensing and development of local LNG export plants

progresses and more of the US's major transport systems and power generation moves towards gas from more expensive petroleum liquids and dirtier coal.

If LNG export gets the go-ahead at rates of around 40 mt pa, about 2.2 Bcf per day will effectively be taken out of the 70 Bcf per day US gas market, which is already a net importer of gas. StockAnalysis estimates that this competition for a 3% market share, combined with the underlying real cost of shale gas extraction of about US\$5.50/mmBtu, is likely to boost the US HH gas price towards US\$8/Gj by 2018 or even earlier as the market tightens up.

The northern Sacramento Basin has been a prolific gas producer, with over 9 Tcf delivered from shallow, Upper Cretaceous sections. AOC and XST will target less well explored Lower Cretaceous sediments where strong seismic and geological evidence suggests large gas targets.

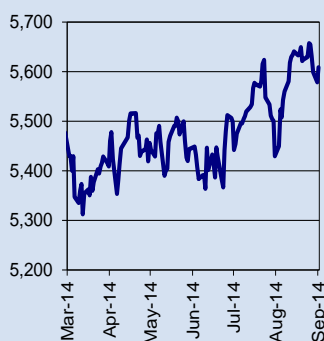
The companies suggest that the prospect, that has been mapped to have a 15 km² closure, could contain deliverable gas of over 1 Tcf. Favourable seismic interpretation gives some zones a 40% probability of success (POS).

(Continued on page 2)

Indices and Prices

All Ordinaries	5,608.20
Energy Index	14,967.20
Brent AU\$/bbl	106.97
AUS\$/US\$	0.9205
As at Close September 9 th , 2014	

All Ordinaries



S&P ASX 200 Energy Index



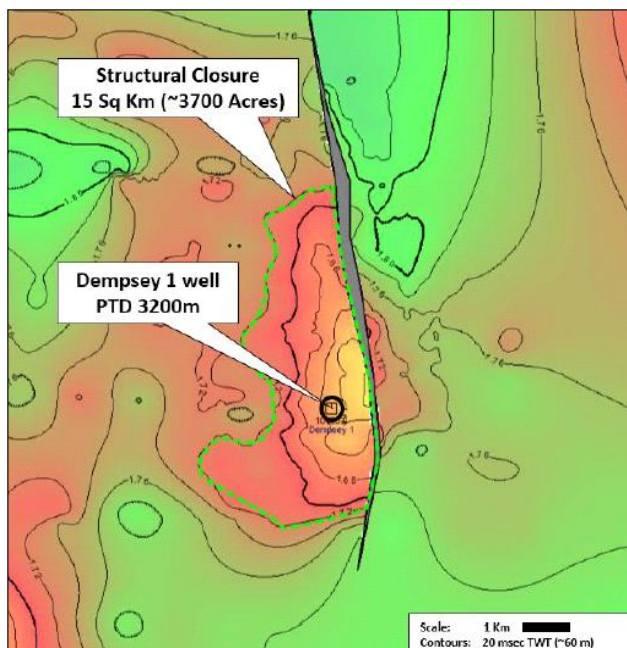
Brent Crude Oil \$A/barrel



A\$/US\$

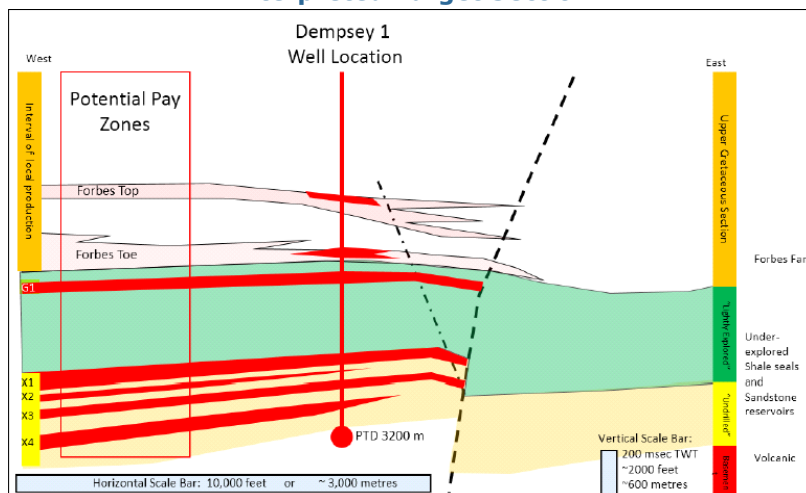


Dempsey Structure



Source: AOC

Interpreted Target Section



Schematic Cross Section illustrating 7 Reservoir Targets

StockAnalysis passes the BS detector over this estimate and assumes a target of 780 Bcf with a 14% POS. Using an insitu value of \$1 per Bcf and \$19/bbl for a small amount of associate liquids, this prospect delivers a juicy target value of over \$800 million for success.

AOC and XST have options to increase their equities to 60% and 25% respectively in the project but only have about \$2 million between them, which is hardly enough to pay the mobilisation costs for a drill rig, let along the estimated US\$5 million required to drill the well. Predictably, the companies are now on the farm-out trail to entice an operator to earn an interest by funding a one or two well programme.

StockAnalysis assumes perhaps harshly, that they are able to retain a 40% free carried interest in the programme, taking their respective interests back to 24% and 10% post farm-out.

Success at Dempsey would be a 10-bagger event for both companies, while StockAnalysis calculates a risked valuation of 22 cps to AOC and 5 cps to XST, which coincidentally correlates closely with their short term trading targets.

Dempsey is the first of a string of prospects identified through some excellent detective work, searching out old drilling and seismic records, as well as some old fashioned rock kicking geology.

Dempsey Value Matrix

Target	Prospective Res		POS	NPV
	mmbbl	Bcf	%	\$m
Dempsey	2	780	14%	\$ 818

In-ground Value Assumptions

Oil \$A/bbl	\$ 19 /bbl
gas \$/GJ	\$ 1.00 /PJ

Discovery Value per share	AOC	XST	Retain
Equities post farm-down	24%	10%	40%
Dempsey	\$ 1.63	\$ 0.37	
Total Risk Adjusted Value	\$ 0.22	\$ 0.05	
No of shares	92	182	
No of Options	29	39	
Current Price	\$0.155	\$0.040	

Discovery Leverage per share	1050%	926%
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Source: Strachan Corporate

Clearly, both companies will be undertaking some corporate manoeuvres to fund their exploration ambitions and ongoing administration cost. This will inevitably involve an issue of new equity and could possibly see the companies merging to form a Californian focused gas entity.

Directors of both companies have been amongst the most visible buyers of stock for over a year as they backed their judgement and quietly went ahead leasing tenements. StockAnalysis thinks that it might be time for Subscribers to follow them in and await an underwritten rights issue to come, on the back of announcing a farm-out funder.

Recommendation: There are few sellers for both stocks since Directors have been quietly soaking up itinerant sellers leaving both stocks quite illiquid at the current share price point. Liquidity will improve as the stock prices rise 30% towards risked valuation. Subscribers should buy carefully being aware that a new issue hanging over the market could deflate prices in the near term.



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