CEO Newsletter

29 March 2020

CARNARVON PETROLEUM LTD

Dear fellow shareholders,

We are all experiencing extraordinary times in our lives right now and a number of you have called me to ask questions about our business and to seek assurances that the business is in good shape.

In this newsletter I wanted to take a number of those questions and address them for the benefit of you all. Hopefully you find the following material helpful and respectful to you as owners of the business. And another form in which we endeavour to think and act differently.

Just a reminder that I will be seeking to provide clarity to information that is already in the market place. This is not the forum in which I can provide material that is price sensitive. That type of material will always be provided through the Australian Stock Exchange platform.

So with that proviso, lets address those questions:

Question 1: If Santos delay moving forward with Dorado for a significant period, would Carnarvon consider drilling a Buffalo well to prove up the Buffalo oil for future production?

Answer 1: Our cash is an important factor in the funding mix for the Dorado liquids development. Right now the Dorado development planning work, entailing engineering and pre-FEED work, is progressing to a specific plan. That work will then flow into the next phase of the development process which is the FEED (Front End Engineering Design) phase. If this situation changes we may then need to reconsider our position given the circumstances of any change. If the circumstances dictate a long delay in the project then it would make sense for us to consider the merits of utilising a portion of our cash to accelerate other value propositions. It is worth remembering at this point that we are also seeking a partner to join us in the Buffalo project where Carnarvon currently has 100% equity. Rest assured that we are in a strong position to be able to assess multiple options as circumstances dictate over time. But at this point in time, our focus is as we have articulated to the market, namely to advance the Dorado liquids development this year and into the new year and to continue to seek a partner to join us in our Buffalo project.

Question 2: Is our exploration DNA limited to investing offshore only? There are many opportunities onshore, such as the Perth Basin that could be put into production more quickly than our Dorado.

Answer 2: I think it would be very easy right now to get distracted with the romance of looking at other potential opportunities. One of our strengths is our focus on delivering on our goals within our area of expertise. We occasionally stop and check ourselves to ensure our 'focus' has us heading in the right direction and we certainly feel it is at present. We are attracted to the economics of the Dorado project and we've not seen another project to date that has presented something more attractive. Also, if we pursue other projects whilst advancing the Dorado liquids development we could find ourselves unnecessarily stressing our balance sheet and putting all of the Company's assets at risk.

Question 3: Can we take advantage of the current situation and, for example, secure a drilling rig to drill an Apus or Buffalo well at a lower cost?

Answer 3: We definitely like situations that present us with low-cost opportunities. We are in a strong position today because we have taken advantage of these types of situations in the past. But there are global and industry "red flags" right now that tell us to exercise a high level of caution before making any major commitments. There is no need to act in a rash or reactionary manner right now, especially in a way that could threaten our core business objectives. So while this is an attractive thought, and we're absolutely alert to all low cost opportunities, we do intend to limit our exposures to situations that we feel comfortable that we can manage.

Question 4: How do we move to production and revenue generation as quickly as possible so that the Company achieves more fair valuations?

Answer 4: There is a classic Warren Buffett line that goes something like "no matter how great the talent or efforts, some things just take time. You can't produce a baby in one month by getting nine woman pregnant". There is a natural timeframe for a development like Dorado and we are appropriately within industry norms for this. I would also add that in my time at Clough I saw many construction projects come under pressure to be accelerated with the results being adverse to the intention. But there is a key point to the question which is around realising full value for our assets and in terms of Dorado this is expected to peak around first production. Until then, the intrinsic value of the asset should increase as the cost associated with the "time value of money" and the "execution risk discount" diminish.

Question 5: Has the Board considered committing some of our cash to a share buy back at current share prices?

Answer 5: We focus on four areas for increasing value for the owners of the business (of which the Board and all our staff are included). They are through delivering value from our current assets such as the Dorado liquids development, through generating new value from say new discoveries, through minimising the issuance of any new shares and through reducing the total number of shares on issue through for example share buy backs. On face value now might look like a good time to buy back shares and reduce our total number of shares on issue. But cash can be difficult and expensive to replace and over the longer term, retaining cash to invest in Dorado we believe will provide us with a better return while ensuring the business remains very strong in the interim.

Question 6: The quickest way for Carnarvon to get to cash flow might be to acquire a production asset or a company with production. Has this been considered?

Answer 6: We have reviewed many production assets and companies with production over the years. In my experience, these endeavours are very time consuming, incredibly distracting for Boards and management, typically contain "warts" that might not be apparent on an initial assessment and at the end of the day do little to generate the sort of value increase per share that we're seeking. Sometimes they also result in spectacular value destructive outcomes. We've seen this recently with a company that made a production asset acquisition some years ago (noting that we declined to participate in that sale process). The company recently went into voluntary administration because of issues within the production facilities that proved financially terminal. The point is we're open to material value accretive and cash flow generative production opportunities. But if they are not low cost operations (including the cost to acquire them) then the outcomes can be much worse than simply remaining focused on our core business, especially in periods like now when the underlying commodity prices are low.

Question 7: What is the strength of our relationship with Santos? How much influence do we have in the decision making around Dorado?

Answer 7: We have a very good relationship with the Santos team and we very much respect their technical and management capabilities. We also feel that they are very good financial managers and we are currently aligned with their thinking on progressing the Dorado development and the exploration initiatives. In the 2012 farm out of the Phoenix project (that contains Dorado) to Apache we understood the benefits for us of having the expertise and capability of a larger partner. The consequence is that we rely on our operator partner (who is now Santos) to drive our project. As the junior partner in Dorado we have the ability to influence under the relevant operating agreement but our strong preference is to work collaboratively with the Santos team and that has worked very well for us to date.

Question 8: What do you think the price of oil will be at the end of 2020?

Answer 8: This would ordinarily be a favourite question of mine, but it's a challenging one to answer right now. We are seeing the impact of COVID-19 materially reducing oil demand while simultaneously the Saudis, Russians and US shale factions are fighting for market share (possibly the Saudi and Russian actions being strategically timed!). On the demand side I would expect to see a period in 2020 where it remains very weak but begins to improve maybe next year as the world moves back to normalcy. On the supply side, which I think is more relevant for longer term investment thinking, I recently read a Goldman Sachs report I liked that contained the following quote: "With OPEC+ now pursuing a market share strategy, we believe that this will bring about the healthy consolidation and rationalization of the industry [being US shale] we had hoped for in 2014/15 when we first constructed the New Oil Order lower-for-longer thesis. Our thesis was interrupted in 2016-2018 by Chinese stimulus, OPEC production cuts and US fiscal policy. By 2019, the industry returns [in US shale] were so poor due to too many inefficient indebted producers that capital was already fleeing at $65/bbl oil, a large part of why the international offering of Saudi Aramco struggled. Assuming this rationalization occurs over the next year (which was one of our top themes for 2020 even before this), the industry is likely to emerge in a much more healthy position with many of the zombie companies that were a dead weight on returns removed." So I think there are too many large variables at play right now to guess the oil price at the end of 2020. But I also think there are structural changes at play right now on the supply side that could improve the sector and its returns in the medium term. At the end of the day it is the oil price in the window around Dorado first production that I'm most interested in. In this context, oil futures and industry forecasts by respected institutions paint a much more positive picture for this time period than the current spot oil price.

Question 9: Have any companies approached us about an acquisition?

Answer 9: This is not a question that I can answer or want to speculate on. Our focus remains on delivering value from the business for the owners. Sometimes the market's assessment of that value differs from our assessment of the intrinsic value of the core assets over an appropriate time horizon. As I have covered above and in ASX announcements, my belief is that the impact of the virus will pass, markets and oil prices will recover and that this will occur within a time frame that will enable us to continue with our Dorado development work without too much delay. So, we remain focused and hard at work delivering what we have said to shareholders that we intend to deliver.

Question 10: Is Carnarvon working on a strategy to address the short selling in the stock?

Answer 10: As I write there are around 55 million shares in the Company that have been short sold, representing around 3.5% of the issued capital. The best advice that we've received to address this short selling is to increase the share price. Clearly this endeavour isn't going to plan right now! But once markets recover and we continue to focus on delivering Dorado, we should begin to mitigate this short selling position. Encouragingly, the short sellers need to buy back 55 million shares so that they can give them back to the shareholders who loaned them the shares in the first place. As you would expect I have a keen (and personal) interest in seeing this short selling position reduced.

Question 11: Is there any value in upgrading our seismic data over Buffalo, or do we wait for the drill bit result?

Answer 11: Part of the process of "uncovering" the Buffalo oil field opportunity occurred through running new seismic processing technology over previous seismic data sets. During the Buffalo farm out process we have had strong validation of the geophysics behind this work and that the current dataset is of sufficient quality to be able to drill. In time new 3D seismic is likely to be beneficial but we really want to drill the first well and prove the seismic work is absolutely valid. And a well result would provide immediate value validation for us.

Question 12: I would like to hear from Carnarvon a definitive statement making it very clear that the Company, with the collaboration of Santos, has a singular intention, and that is to become an oil producer on the NW Shelf of Australia; and as soon as it is possible to do so.

Answer 12: I very much like the frankness of this question and want to make sure everyone is clear that this is absolutely our intention as we see this generating a great deal of value per share for the owners.

Question 13: With the price of oil at the moment, are we looking at the lease potential of a cheap FPSO for the Dorado development?

Answer 13: The operator and our development team are looking at a suite of FPSO options (new and redeployed) and different contracting strategies around its ownership (such as purchase, lease, lease to purchase). Our project drivers include best return on our invested capital, lowest upfront capital required, earliest time frame to first production and best operational outcomes (such as flow rates, reliability, safety, environmental controls, etc). For us low cost is important, but value per share outcomes are more important. As an example, higher flow rates and better reliability (equipment up time) can influence the value proposition more than a low cost FPSO with say lower flow rate capacity and inherent reliability issues. The work on the FPSO is an important piece in the development and I expect we'll be able to provide more colour on this as the work progresses throughout the rest of this year.

Question 14: What are our holdings in US dollars?

Answer 14: In our December 2019 quarterly report we said that we held $10.8 million in US dollars. Where possible we aim to naturally hedge our currency position, meaning we hold a sufficient amount of a currency that we believe we might spend over a certain period or have committed to spend. Our current forecast US dollar exposure to FID is currently less than this amount.

I hope that you found the above answers a frank and honest response to the questions that were posed by our fellow owners. If I were to try to draw all of the questions and answers into a succinct summary, I would say that our plans are to protect our downside risk, to advance our core growth assets at a good pace and be looking for opportunities that don't compromise the first two points.

I appreciate we are in a period that involves a significant amount of volatility and this is presenting us with unprecedented challenges. As owners this can be a pretty unnerving time. However, I firmly believe that we will work through them all and we'll return to a period of normalcy. When that happens I can't say, but our business is in a very strong position and we have a portfolio that can be matured through this time which will have us well placed for the future.

Stay well and stay safe.

Adrian

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