Conference Call Thursday August 7, 2008 4:30 PM ET

Operator

Please stand by we are about to begin.

Good afternoon ladies and gentlemen and welcome to the FX Energy Incorporated Conference Call. Just a reminder that today's call is being recorded. At this time I would like to turn the Conference over to Mr. Clay Newton Vice President of Finance for FX Energy. Please go ahead Sir.

Clay Newton

Thank you, Lisa. Thank you everyone for joining us today. As Lisa mentioned, I'm Clay Newton, the Company's VP of Finance. Welcome to our quarterly earnings call.

Our call will go as follows: I'll start by briefly reviewing our quarterly financial results, after which David Pierce, our CEO will join us for some operational updates. After that, we'll take some questions.

Please be advised that the remarks that follow, including answers to your questions, include statements that we believe to be forward-looking statements within the meaning of the Private Securities Litigation Reform Act. These forward-looking statements are subject to risks and uncertainties that could cause actual results to be materially different from those currently anticipated.

Those risks include, among others, matters that we've described in an earnings release issued earlier today and in our filings with the Securities and Exchange Commission, including our most recent Form 10-K.

While the Company believes these forward-looking statements are reasonable, they are subject to factors such as drilling schedules and results, capital plans, commodity prices, and other factors that may cause our results to differ materially.

With that introduction out of the way, let's get started.

In the interest of time, and since substantial detail is available in our just filed 10-Q, I'm going to focus today on the big picture and talk about just a few key financial items.

From today's press release it's pretty obvious that the headline numbers for the quarter are all positive. We had earnings improvement. Our loss narrowed by 50% to only $(0.04) per share. Our cash flow, or EBITDAX as the Street defines it, rose 33%. Our top line revenues grew by 15%. And our balance sheet remains simple, clean, and quite liquid.

I think there are two main points we can draw from this. First, the exploration efforts in Poland and the operations efforts in the US continue to enjoy success, and that's showing up favorably in our financials. Second, our cash flow and our balance sheet remain capable of funding our expanded 2008 budget.

As for specific drivers for our financials, I'd first point out that product prices, and particularly gas prices, are up again, with no sign of abatement. On May 1st of this year, we received a 14% price increase across the board for our natural gas properties in Poland. Our partner, POGC, had requested a 33% increase from the regulator, which tells us that gas supplies remain tight, and that further upward movement might be expected. While the US gas market is strong, I'd argue that the Polish natural gas market has shown an even stronger, steadier upward trend over the past seven years. And it's easy to forget that we also have meaningful oil production. We've enjoyed the benefits of oil prices doubling just like everybody else.

As we have discussed before, the favorable impact of higher prices has been dampened by lower production. As we had projected previously, production from our Wilga well in eastern Poland has declined to a lower level than last year. However, both oil and gas production from the 1st quarter to the 2nd quarter of this year were flat, and we expect much of the same for the balance of the year. More importantly, next year, after we bring our Roszkow well online, we expect gas production to increase significantly.

Because of our higher oil and gas prices, and with a contribution from our oilfield services segment in the U.S., revenues were up this year over last year for both the 2nd quarter and the first six months. Revenues for the quarter were up from $4.5 million last year to a record $5.2 million this year. Revenues for the first six months were up from $8.7 to $9.4 million. With stable production and our current price environment, we expect revenues to continue to slightly outpace those of last year for the balance of this year. And, with our expected production increases next year, we expect our revenues next year to increase significantly as well.

As I mentioned earlier, our EBITDAX was up for both the second quarter and 1st half of this year. EBITDAX is a common measure in our industry, and is calculated by taking earnings and adding back interest, taxes, depreciation, amortization and other non-cash charges, and exploration expense. It's a common test to compare cash flows for all companies in an industry where two completely different forms of accounting are accepted. It's an indicator of an oil and gas Company's ability to internally fund exploration and development activities and to service debt. In our case, EBITDAX rose from $1.5 million for the 2nd quarter of last year to $2.0 million for the most recent quarter. Along with the expected increases in production and revenues, we expect to see significant increases in our EBITDAX in 2009 as well.

We are on track with executing our 2008 capital budget. At the beginning of this year, we announced a budget of at least $29 million that included 4 new wells, new production facilities and a bunch of new seismic. We've spent just over $15 million through the end of June, and we're clearly on track to do everything we'd planned to do.

Finally, even with the increased activity, we are in good shape from a liquidity point of view. With our cash on hand, our growing cash flows and our unused credit capacity, we believe that we are well positioned to carry out this year's budget, as well as a similar size budget next year out of cash flow and borrowing.

With that background, I'll now turn the call over to David Pierce, our CEO, who will discuss some operational updates and take your questions. David.

David Pierce

Thanks Clay.

The headline on the operations front is this: We are on plan. As Clay said, at the June 30 halfway point this year we had spent about half of our forecast capital budget. We forecast four wells; we've got three drilling right now and the fourth will start in about 60 days. We forecast to have construction underway at Roszkow, so we could get it into production early next year and I can report that permitting is well along and the construction schedule is on track. Our seismic projects are on track. At this point, every major project is proceeding according to plan.

And look at the bigger picture. We are generating more cash, drilling more wells, and conducting more diverse exploration and seismic programs than ever before in our existence. We have momentum.

Let's talk about Kromolice. From an operations perspective, this is the biggest news, that is the initial results from Kromolice-1. This well is testing a 3D defined structure called Kromolice North. We've cored and run drill stem tests and now we have logs. The logs indicate porosity ranging from about 11% to 22% and permeability in a pretty broad range from 0.1 clear up to 33 mD. Now, this is all in the expected range. But we have a total pay thickness in the range of 50 to 65 meters. Now that pay thickness is half again, or maybe even double, what we expected. Frankly, it is the biggest number of any of the Rotliegend wells we've drilled.

Let me try to put this into context. The nearest well to Kromolice-1 is our Sroda-4 discovery. Sroda-4 averaged 18 to 19% porosity with a gas column of about 33 meters. It has proved recoverable gas reserves of about 16 Bcf. Kromolice-1 is roughly comparable in porosity but 50% to 100% larger in terms of the gas column. Our biggest discovery to date, Roszkow, has about 23% porosity, 34 meters of pay, and proved recoverable gas reserves of 29 Bcf. Again the gas column at Kromolice-1 is about 50% to 100% larger.

So it looks like Kromolice-1 might have encountered a larger gas accumulation than anything we've drilled so far. But right now we only know what's in the well bore. We know the vertical dimension but we don't know the horizontal dimension or the geometry. So it's a bit early to declare victory here. There are a lot more steps left before we can declare with absolute certainty that this is a commercial well. And even more steps before we can estimate potential reserves. However, if production testing and other more conclusive technical work give us support, then we would expect to have more drillsites surrounding this well.

Better still, this gas accumulation might go beyond the immediate Kromolice North area as we had it mapped. We have previously theorized that Kromolice North might actually be connected to our Sroda-4 well, some 6 kilometers to the east. These most recent drilling results confirm that both wells are at the same depth and have the same initial pressure. Seismic tells us they're both on the same trend. So our theory is gaining credibility. If all of this comes together just right, we could have encountered a sizeable potential reservoir. But we also know there are numerous faults, and therefore risks, between Sroda-4 and Kromolice-1. To summarize, I'd have to say that these preliminary results are substantially better than we anticipated, they are very encouraging, but they are not yet conclusive. We will put our best efforts into remapping this area right now to see exactly where this new and very welcome data leads us.

Turning to Grundy-2, that well is drilling a deep, 2D defined double target: Main Dolomite reef and Rotliegend sandstone. We are currently drilling at 4,900 and change meters, that is 500 meters deeper than originally planned. We're down that deep because we've had gas shows and we've not seen free water in the Rotliegend. We also want to get down to the Carboniferous source rock, a little over 5,000 meters, which would be an important element for a potential tight gas play. When we finish drilling, which is still a few weeks away if we go all the way down to the Carboniferous, we'll run drill stem tests in the most promising sections of the Rotliegend. All the possibilities remain: the well could flow gas, or it could be a tight gas resource that we need to frac, or it could end up a noncommercial well. We simply won't know until we finish drilling, testing and logging in the Rotliegend. Altogether this could still be a couple of months away. After that, we'd like to go back uphole to test the Main Dolomite, which is already logged and behind pipe. As things stand right now, all we know for sure is that we have about 30 meters of porous Dolomite, which by itself is quite encouraging for the Main Dolomite play in this area. But at this moment we really have no idea whether this well will be great, or good, or no good at all. So just stay tuned.

The Sroda-6 well is drilling a big 3D defined structure called Sroda City. We are drilling now at about 2400 meters on the way to an estimated 3750. The target here is gas in the same Rotliegend sandstone that we've seen in Sroda-4 and -5, Kromolice, Zaniemysl, Winna Gora, Kleka and Roszkow. The location is about 4 kilometers northeast of our Sroda-4 discovery and about 15 kilometers along trend to the northwest from our Winna Gora discovery. If Sroda-6 stays on schedule we should be testing and logging in about 60 days.

That leaves Kromolice-2. This is the last well on our schedule for this year. It is scheduled to drill a separate, 3D defined structural target called Kromolice South. As the name suggests, the Kromolice South structure is located south of the Kromolice North structure. It is about 1 kilometer away. We are tendering for the rig right now and we expect to be drilling in October. Kromolice-2 will be our fourth well this year and the third well this year defined by 3D seismic.

Let's turn to production. As Clay mentioned, production from our Rotliegend wells is holding steady this year. And we have high expectations for production next year.

We are moving ahead with production facilities for our Roszkow field. We're making progress on permits and authorizations, the contractor is in place, the construction schedule is on track and we remain optimistic for production beginning in the first quarter of 2009. Just to remind everyone of the potential here, we've previously said that this well could begin production at rates up to 15 million cubic feet per day. Our 49% of Roszkow could be about 7.5 million cubic feet of gas per day. That would be more than double our current total oil and gas production from the US and Poland combined. Obviously, that would bring our cash flow up substantially. And we have two other wells that are awaiting hookup: Sroda-4 and Winna Gora. Personally, I am hoping for more. So 2009 has the potential to be a record production year for us.

Now the Grabowka field is the last topic I want to discuss under the production heading. This is an older field that we thought was worth re-entering. But we didn't want to tie up our exploration capital. So we entered into a joint venture last year with a local Polish company, P.L.Energia. They put up all the capital and we've now re-entered the first of three wells in that field; it tested at the upper end of our expectations. We have two more wells to workover later this quarter. If all goes to plan, we anticipate first production early next year. We expect to have more details available on this very shortly.

All in all, things are going very well. We are executing our 2008 plan. We have one well nearly finished, two more drilling and the fourth well is scheduled. Revenue is up, prices are up, and production appears to be headed up next year, too.

The last item I'd like to address is our plan for 2009. We haven't released a plan or discussed a capital budget for 2009, and probably will not do so until December at the earliest. But some of the elements of a plan for next year seem obvious.

Recently, we've had some real success in the Fences stable platform area. Each success there seems to expose additional possible targets. We are very pleased to have 3D seismic giving us more and better defined targets. It makes great sense to continue our focus on the Sroda area and on expanding it to the southeast. We've been working on this the last few years, and I believe it will continue to be our number one area again in 2009. With targets already shaping up, additional production and cash flow coming on line, and the support of our credit facility with Royal Bank of Scotland, I think we can anticipate more wells in this area next year.

We also see a role for Plawce in the coming year. This is the tight gas area in the far northwest of the Fences. We have gone back to expand our 3D coverage in this area and are working on the engineering aspects, which are very encouraging for the development of a large, tight gas resource. This will be a capital intensive project, so timing will depend on revenue and availability of funds.

That leaves our other high potential exploration areas: Kutno, the Northwest and Warsaw South concessions. We remain optimistic about bringing partners into these projects. We are just about to get drillsites firmed up in the Northwest and in Warsaw South. Our feeling is that with specific drilling targets defined, giving us the ability to get something drilled on each of these in the near term, they will be very attractive to industry. I can't promise what will happen, but we are very optimistic for these areas.

Now that concludes our remarks. I'd like to open this call to questions from our listeners.