

19 December 2016

Dear Shareholder,

CHAIRMAN'S YEAR-END MESSAGE

At this time of year, we traditionally take the time to reflect on the year that has been and look forward to the potential events of the coming year.

Given that your company is still awaiting the outcome of government process in South Africa, I think it would be fair to say that we do share the frustration that shareholders undoubtedly feel over the length of time that this has taken. That said, there has been tangible progress – most notably with the amendments to the legislative framework containing the key fiscal terms, the Mineral and Petroleum Resources Development Act (“MPRDA”) Amendment Bill (“Bill”), which is widely anticipated as a precursor to the determination of the long outstanding shale gas exploration rights applications in the Karoo.

While we have reported on the MPRDA throughout the year, I feel it is nevertheless worth summarising the key points:

- The Bill was previously passed but referred back to Parliament by the President. It currently grants the state a 20% free carried interest in new exploration and production rights, and the right to acquire a further unspecified interest in these rights. The Bill also lacks project certainty for the life of the exploration and any subsequent production right.
- The industry (via the key offshore and onshore industry associations) has engaged with government over an extended period to deliver constructive solutions for the MPRDA.
- As a result, recommended changes to the Bill were presented to the Upper House (National Council of Provinces) Select Committee by the Department of Mineral Resources (“DMR”) in early November.
- The DMR proposed that the state’s 20% free carried interest be changed to a 20% carried interest with a cost recovery mechanism during the production phase. The holder of an exploration right, which has been granted a production right, is entitled to apply for a downward adjustment of the 20% state carried interest. The Minister of Mineral Resources may grant this downward adjustment following consultation with the Minister of Finance, on a case by case basis, to ensure that projects remain financially viable. It is envisaged that project certainty will be created by agreeing and appending the production right terms and conditions to the exploration right (the terms of production will be settled at exploration stage), subject to renegotiation between the parties at the renewal of the 30-year production right.

- Currently black economic empowerment (“BEE”) participation under the MPRDA is governed by the Mining Charter but this does not specifically provide for upstream oil and gas operations, and the industry has not been involved in the consultation on this matter. The DMR proposed that the Minister of Mineral Resources be given the power to develop a Petroleum Charter for the upstream oil and gas industry, and that a lower 10% shareholding be reserved for BEE participation. The DMR explained that, after extensive consultation, and given the high cost and associated risk of oil and gas exploration, together with the state’s 20% carried interest, this level of BEE participation is considered more appropriate to the industry.
- In accordance with the President’s referral of the Bill back to Parliament, further public hearings are required to correct procedural defects in the initial public participation process.

Several provinces have now held their own briefing sessions with the DMR, though we understand that a number remain to be completed, following which public consultations will be held. It is expected that these public consultations will be held and completed by the end of March/April. Any proposed amendments that may result from this will then follow due process. Challenger’s website contains links to recent media interviews and articles that provide further context.

In parallel, the government-commissioned two-year Strategic Environmental Assessment (“SEA”) for Shale Gas Development has now completed its second phase with the publication of the final version of “Shale Gas Development in the Central Karoo: A Scientific Assessment of the Opportunities and Risks”. A link to these extensive reports is provided on Challenger’s website. The third and final phase will translate the scientific assessment into an operational decision-making framework. This is expected to conclude around March 2017 and is intended to provide the framework that will guide site and activity specific assessment processes, and provide government with the necessary tools to enable responsible decision-making into the future regarding shale gas development. This includes guidance on legislation, regulations, environmental impact assessment processes and monitoring.

During the year senior cabinet members have reinforced the role gas, including shale gas, needs to play in South Africa’s future energy mix, with the launch of the Liquefied Natural Gas Independent Power Producer Procurement Programme (“LNGIPPPP”). One of the primary objectives of this programme is to develop a gas economy in South Africa, including gas exploration and production from indigenous resources. Nqgura (Coega) (Eastern Cape Province) and Richards Bay (KwaZulu-Natal Province) have been identified as the two feasible sites to develop LNG projects for the first phase. Challenger anticipates that the programme will kick start investment in gas and power infrastructure that may benefit the future production of domestic gas, noting that Coega is proximate to Bundu’s exploration rights application area.

At the same time, although immediate power outages have abated, the country’s ongoing energy crisis continues to constrain economic development and investment.

All indications are that progress on the shale gas front may be anticipated in the near future.

Nevertheless, given past delays and remaining uncertainties around the timing of exploration rights awards, we have continued to work hard to contain costs and have been screening potential new projects to augment Challenger's portfolio.

On behalf of the Board, I would like to thank you for your continued support, and to wish you and your families well for the Festive Season and the year ahead.

Yours faithfully,



Michael Fry

Chairman

Challenger Energy Limited