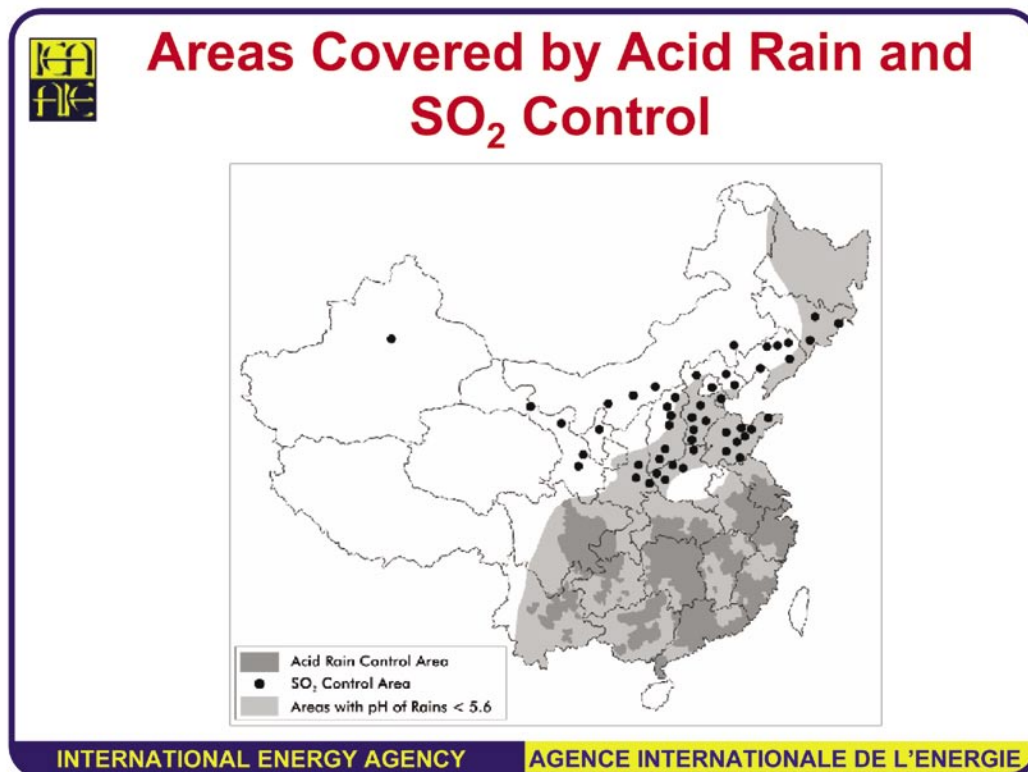


CHINA'S ENERGY PLAN TO REDUCE ITS DEPENDENCE UPON COAL

Reforms Sweeping China to Address Coal Mine Deaths, Air Pollution

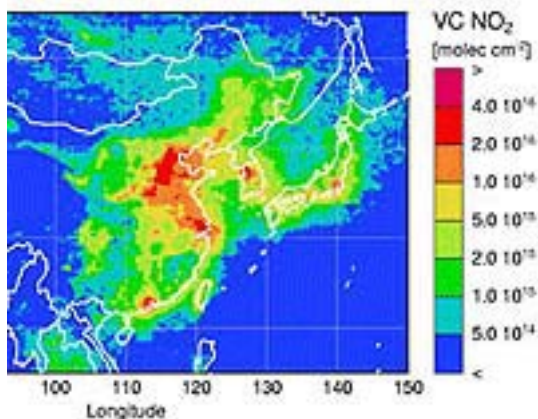


By James Finch

According to a U.S. Congressional – Executive Commission on China, which held a series of Issues Roundtables in late 2004, it was estimated that 12 Chinese mine workers die for every million tons of coal produced. Most are killed by methane gas explosions while inside the coal mines. *China Business Weekly* reported in July 2000, “To prevent gas explosions, China emits 6 billion cubic meters of methane from mines annually, seriously polluting the environment...” Last year, instruments on the world’s largest environment-monitoring satellite, the European Space Agency’s Envisat, revealed the world’s largest amount of nitrogen dioxide was hanging over Beijing and northeastern China. Because the country emits more

methane from its coal mining than any other coal producing country, China pollutes the earth’s atmosphere with about one-third of the total annual emissions of methane. According to the US Environmental Protection Agency, methane traps heat twenty times more than carbon dioxide, which impacts global warming.

On March 6th, *People’s Daily* reported, “Shanxi, China’s largest coal-producing province, plans to put the brakes on the further expansion of coal mining in the next five years.” Shanxi Governor Yu Youjun at a recent press conference announced, “We can not continue the rough way of development any more and must limit coal production strictly with the guidance of scientific concept of development.” While only slightly reducing the country’s aggressive GDP growth, China has instituted reforms to maximize its energy



Envisat Photo of China's Nitrogen Dioxide levels, September 2005



Premier Wen Jiabao wants a more environment-friendly society

efficiency and minimize the environmental damage and loss of human life. Not only is the country stamping down on the causes of these problems, it wants western technology to help become more efficient.

Since September 2005, Shanxi shut down nearly 5,000 illegal mines and fined or imprisoned more than 1,200 operators, including 60 local officials. Coal produced about 70 percent of China's energy supply in 2005. The Chinese government worries China's dependence upon coal could rise above 80 percent over the next five years. The country is second only to the U.S. as a net importer of petroleum. Nontraditional sources are being encouraged to clean up the environment and reduce China's dependence upon foreign oil. StockInterview.com has widely discussed China's scramble for uranium as the country has embarked upon the most aggressive nuclear power program since the United States in the 1970s. Along with nuclear energy, China hopes to exponentially expand its natural gas program as a means of lowering its astronomical levels of air pollution.

Chinese Premier Wen Jiabao told the National People's Congress earlier this month that the country's growth rate would be reduced to 7.5 percent over the country's next five year plan. Economic growth reached nearly 10 percent in 2005. The strain imposed on China's natural resources and labor has been taking its toll. According to the next five-year plan, China's government policy will concentrate on building a resource-efficient and environment-friendly society. Their idea is to sustain the high output while reducing waste.

That may not be so simple. On February 20th, China Daily reported, "The bulk of China's gas-fired power plants are on the verge of closure due to a shortage of natural gas." Wang Yonggan, secretary general of China Electricity Council, said nearly 40 percent of China's power plant capacity remained unused because of the lack of gas supplies. Wang warned a plan drafted the National Development and Reform Commission to increase China's gas power capacity to 30 gigawatts by 2010 (up from 10.7 now) would make "such targets impossible to reach," because of the gas shortfalls.

China's Ambitious Coal Bed Methane Gas Development

One of the more serious reforms being addressed is the energy crisis within the context of the environmental stigma now attached to China. Coal is a problem because, as toxic as it is known to be, it helps fuel China's growth, literally. But the dark rock has its bright side. Following the examples of the U.S. coal industry, predominantly in New Mexico's San Juan Basin, Wyoming's Powder River

Basin, and Alabama's Black Warrior Basin, and the more recent rise of Alberta's Horseshoe Canyon, China has aggressively moved into the development of its coal bed methane gas industry. The degasification of coal can not only increase mining safety, but it can be an economic method of natural gas production.

According to the U.S. Geological Survey Fact Sheet,

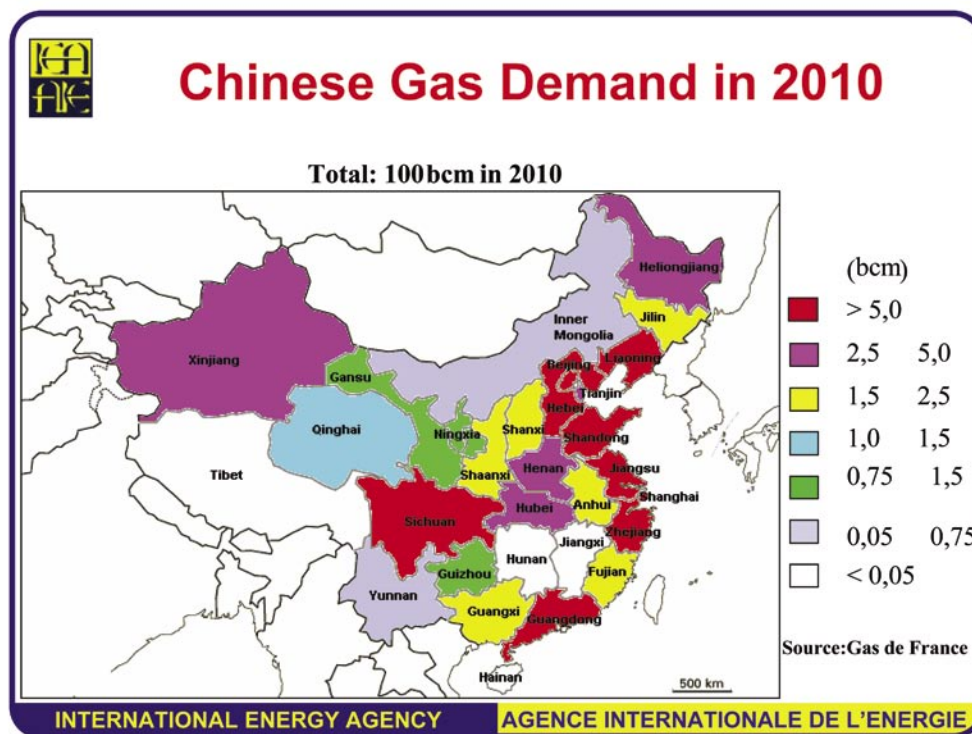
"The coalification process, whereby plant material is progressively converted to coal, generates large quantities of methane-rich gas which are stored within the coal. The presence of this gas has been long-recognized due to explosions and outbursts associated with underground coal mining. Only recently has coal been recognized as a reservoir rock as well as a source rock, thus representing an enormous undeveloped 'unconventional' energy resource."

In a 2005 report issued by the Federal Reserve Bank of Dallas, coal bed methane is being taken very seriously as an alternative energy source with strong growth potential in the U.S. energy mix,

"Geologists call it continuous gas, but it is also called unconventional gas or even weird gas. Whatever you choose to call it, you must give it due respect for its growing importance. The Department of Energy reports the share of unconventional gas doubled from 17 percent of Lower 48 natural gas supplies in 1990 to 35 percent in 2003. By 2025 it is projected to be 44 percent— matching the role of conventional gas—with the remaining 12 percent of domestic supplies imported."

By 2010, China hopes to increase its dependence upon cleaner burning fuels, such as nuclear and natural gas. However, the greatest immediate growth, for instance over the next five years, is likely to come from natural gas. Recent statistics show natural gas to be about 3 percent of China's energy mix. Numerous announcements over the past two years have been made that the country wants gas in its energy mix to reach 8 percent or more. For those who have traveled to China, it is no secret the country is in dire need of cleaner burning fuels.

Official statistics show that China uses 2.45 tons of water to produce a ton of coal. Coal bed methane, a byproduct, is often wasted. In 1996, China established China United Coalbed Meth-

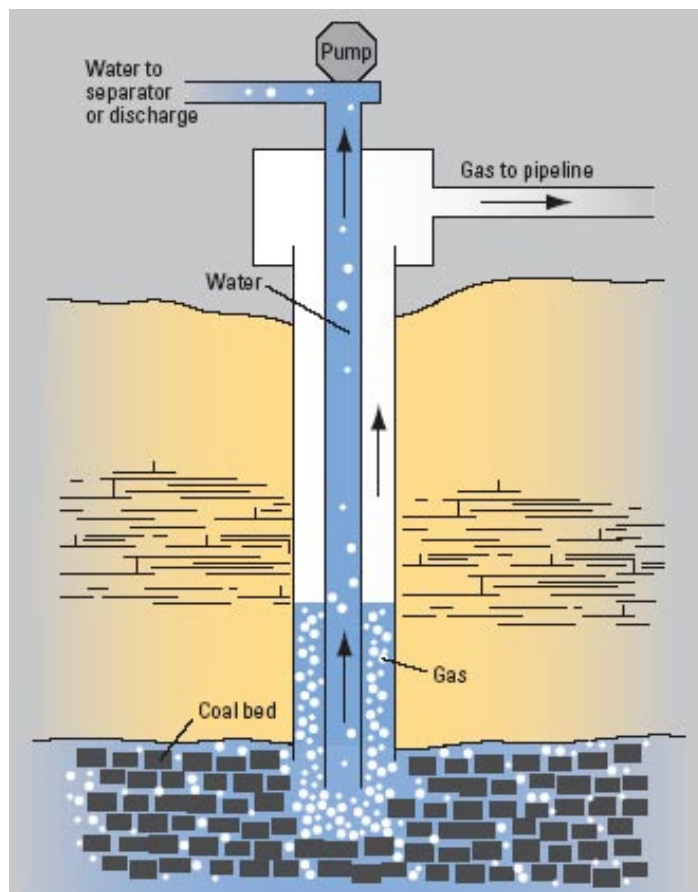


ane (CUCBM) to harness that byproduct and to help reduce the toxic pollution and alarming fatalities, generated by coal mining. CUCBM is a sole professional company with the exclusive right to explore and develop coalbed methane resources in joint ventures with foreign companies. It is controlled jointly by PetroChina Energy Company and the China Coal Energy Group Corporation.

Methane gas is found in the conventional anticlinal (downward sloping) trap, but it is stored in the earth and produced differently than natural gas. It is stored uniformly in a formation that extends over a wide area, but it is trapped in a rock formation which requires additional resources to free it from that trap. Over the past twenty years, new technologies were developed to drill for methane gas and to complete production wells. The industry has grown by leaps and bounds in the United States. For example, in New Mexico, gas production rules the modern era of hydrocarbons. Once completely driven by oil exploration, New Mexico now produces nearly four times as much gas as oil. China would be happy to approach a fraction of that ratio.

CBM development would also decrease China's plague of mine safety issues. In a white paper published by World Markets Research in 2002, the values of coal bed methane (CBM) were summarized as follows, "With a relatively small investment - around US\$10m per mine - the all-too frequent, horrific accidents related to CBM would come to an end. Over the years, CBM explosions have killed thousands of miners. In the future, we will see a lessening of these distressing fatalities with safety regulations, sensitive gas detectors and mine ventilation."

CUCBM has been actively developing China's coal bed methane industry by drawing upon the expertise, technology and capital of its foreign partners. "More high level technologies need to be deployed to ensure reliable power supplies," Ma Songde, China's vice minister of science and technology told Associated Press in late February. "By developing these technologies, we can resolve issues restricting growth and enhance growth." China is actively seeking foreign investment and cooperation in power generation, particularly in clean energy.



Coal Bed Methane Recovery Diagram, courtesy of the USGS



Daily convoy of LNG trucks responding to China's demand for energy

As a light hydrocarbon, coal bed methane is among the cleanest sources of energy. Published reports show that China's coal bed methane (CBM) resources, buried within a recoverable depth of 2000 meters, are estimated at approximately 36.81 trillion cubic meters. China has the world's third largest CBM resource. Following behind the United States, it is the second country to have conducted large-scale field exploration of coal bed methane.

According to a March 9th article in *People's Daily*, "China's coal bed methane industry made important headway in 2005." About 340 CBM wells were drilled across the country. That may not sound astonishing compared to the number of wells drilled in Canada, during the same year, which surpassed the 3,000 level for the first time. In that context, China remains nearly a virgin territory for CBM. CUCBM has been actively partnering with the world's giant oil companies and others to explore their vast CMB reserves. In 1998, Texaco (now Chevron-Texaco) was the first to partner with CUCBM and resulted in geological studies, exploratory wells and development contracts.

Since then, CUCBM has been extremely selective in choosing its joint venture partners to develop the ultra-valuable Production Sharing Contracts (PSCs). After attracting oil majors such as Texaco and Conoco-Phillips, only a total of 26 Production Sharing Contracts have been awarded to foreign-owned companies. Total coverage of those contracts now extends about 34,000 square kilometers of China's below surface coal basins. Foreign companies have investment more than \$150 million in the contracted blocks. CUCBM hopes to ramp up coal bed methane output by 2010 to help meet the national gas growth target of 10 billion cubic meters.

Pacific Asia Energy Corporation's CBM Contracts in China

The first Canadian publicly traded company awarded a Production Sharing Contract was Pacific Asia China Energy Inc (PACE), which holds the PSC through its wholly owned subsidiary, Asia Canada Energy Corp. Pacific Asia China Energy, which trades on Toronto's Venture Exchange under the ticker symbol of PCE (TSX: PCE), also holds a second PSC through another wholly owned subsidiary China Canada Energy Corporation. It was the former which interested us, the company's Guizhou Project in southern China.

In talking with Dr. David Marchioni, one of Canada's leading CBM geologists, he said of CUCBM, "The Chinese government doesn't want to hand out resources to people who don't do anything with them. They want them developed. They want to have gas. They want to have energy." Dr. Marchioni helped co-author "An Assessment of Coalbed Methane Exploration Projects in Canada," published by the Geological Survey of Canada. He is also president of Petro-Logic Services in Calgary, whose clients have included the Canadian divisions of Apache, BP, BHP, Burlington, Devon, El Paso Energy, and Phillips Petroleum, among others. He is also a director of Pacific Asia China Energy and is overseeing the company's CBM exploration program in China.

It was obvious PACE was moving quickly to comply with CUCBM's objectives of getting natural gas into the country's energy mix. The company first started trading in its current entity on January 4th of this year. By March 16th, the company announced it would begin drilling and testing its massive Boatian-Qingshan property in the Guizhou Province of China. The 970 square kilometer CMB concession – more than half the land mass of Rhode Island – may hold up to 11.2 trillion cubic feet of gas, as reported in a recently published technical report by Calgary-based Sproule International Ltd.

In a brief telephone interview with Dev Randhawa, PACE's Chief Executive, he told StockInterview, "When I asked Dr. Marchioni about the size of the CBM resource, he shocked me when he said, 'It's about the equivalent of a billion barrels of oil.'" Randhawa was preparing for his tenth trip to China since June 2004, when he began the process to acquire these privileged concession awards from CUCBM. As an aside, Randhawa typically arrives early into the front end of what often becomes a trend. Serving also as Chief Executive for Strathmore Minerals (TSX: STM; Other OTC: STHJF), Randhawa's team was among the handful of early junior uranium development companies to participate in what has now become the Great Uranium Bull Market of the second millennium. Since mid 2004, Strathmore's market capitalization has soared from under C\$20 million to a recent high of more than C\$165 million.

But what is the strategy here? If Alberta is now turning the corner and putting itself on the map as a serious CBM contender, why would one of Canada's top CBM geologists get excited and pursue a property in southern China. "We got access to a huge resource for little money," said Dr. Marchioni. "Instead of paying hundreds of millions for a concession this size, we paid a small fraction of that. Comparably, the project at Guizhou would have cost up to \$200 million to acquire in Alberta."

China needs to attract foreign capital, and may be generous up front, but did PACE buy a pig in the poke? We questioned him about the potential size of the resource. Marchioni responded, "The layman may think those are really big numbers, but you only have to look at the official reports. These are the numbers those guys think." He was referring to the Sproule assessment of the resource, which offered a three-case scenario, starting at nearly 1 billion cubic feet and reaching the upper limit of more than 11 trillion cubic feet. Still, their assessment for a "most likely scenario" was a hefty 5.2 trillion cubic feet. Marchioni added, "They were numbers we originally thought we had, and they've been confirmed."

How big is big in this case? "I think we could fully support some large plant of some sort," Marchioni explained. "This is more of a long-term thing where you would be looking at a major industrial development. You'd be looking to either have enough money yourself or you bring in partners to do things like liquefied natural gas or major gas-fired power station, liquefaction of coal (turning coal into petroleum liquids)."

Guizhou Project:



Huangshi Project:

*PACE can earn a 60% interest by funding up to US\$8 million for an exploration and pilot program.
Post exploration phase CUCBM finances their 40%.*

Marchioni was quite excited about the CBM project in Guizhou, “These are all big projects, but the resource is there to support such a project. Because the resource is so huge, you could support a project like that. There also are a lot of potential industrial users for gas in the region.” China Daily reported South China, where the Guizhou province is located, is facing gas shortage problems because of the high energy demands of Guangdong province.

And what does PACE bring to the Chinese? “Hopefully, they’ll have an operating CBM project or two contributing to their energy

mix, and contributing clean burning fuel to their energy mix, which is really what they want,” answered Marchioni. “We also bring access to outside technology from places that are producing CBM.” In tomorrow’s Part Two, we’ll discuss one such CBM technology that may change the nature of coal bed methane production. Stay tuned.

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