

## CHINA'S ENERGY CRISIS OFFERS OPPORTUNITIES FOR CBM COMPANIES

### Three CBM Companies with Extra-Large Chinese Land Positions

By James Finch

China's growing energy crisis is one reason the price of oil, natural gas and other commodities has sustained at higher levels. The country's mushrooming middle class, now numbering more than 300 million, was strongly responsible for the red-hot GDP growth in the first half of 2006, which increased its demand for more energy. After a decade of searching for new energy sources around the globe, the world's second largest energy consumer is now trying to also develop its resources by further opening its doors to foreign companies.

Because China draws about 70 percent of its energy for powering the country's economy from coal, the Chinese are turning more heavily to unconventional gas, known as coalbed methane (CBM). More than 30,000 coal mines releasing methane gas are responsible for about 40 percent of China's air pollution. Methane gas explosions cause the deaths of more than 6,000 Chinese coal miners every year. Until recently, the methane was a nuisance byproduct recklessly vented into the atmosphere. By capturing the gas, before mines start producing coal, the world's largest coal producer hopes to save lives and reduce air pollution while using methane as another energy source.

Integral to China's 11th five-year plan is the doubling of natural gas use in the energy-mix by 2010. Aggressive Chinese policies and plans hope to boost more gas consumption by the end of the decade. By awarding foreign companies large coalbed methane concessions to explore in Chinese provinces, China hopes to accelerate development of this energy source. After attracting the likes of Chevron and ConocoPhillips, China's state-owned China United Coalbed Methane Company (CUCBM) began offering production-sharing contracts with lesser known names.

Although much smaller companies – for example, Far East Energy Corporation – each one had connections within China to ob-



tain massive CBM gas concessions – slightly larger than the state of Delaware. Far East Energy, deceptively tiny as an energy company (market cap: \$136 million), developed its relationship with CUCBM through previous political connections. Chief Executive Michael McElwrath served briefly as Acting Assistant U.S. Secretary of Energy for Fossil Energy under President George Bush, Sr. Chief Financial Officer Bruce Huff was formerly President and Chief Operating Officer of Harken Energy, a company with which President Bush, Jr. was involved. A technical advisor, Don Gunther, was formerly Vice Chairman of the Bechtel Group, a company whose alumni populated the Reagan and Bush administrations.

In Far East Energy's case, the plum award was a 1.3-million-acre concession in China's coal rich Shanxi and Yunnan provinces. The properties have potential recoverable CBM resource of between 9.2 and 12.5 trillion cubic feet. They are situated near two major national pipelines running to both Beijing and Shanghai. According to the company's website, when the Shanxi project is fully developed, it could sustain an estimated 3,000 horizontal gas wells. If that's the case, this might become one of the world's largest CBM projects.

Chairman John Mihm had been a senior vice president for Phillips Petroleum, prior to the company's merger with Conoco, and was involved in supplying technical support for the ConocoPhillips Shanxi project before it was farmed out to Far East Energy. ConocoPhillips has an overriding-royalty interest of 3.5% on the Shanxi



Coal – the source of Coalbed Methane Gas



FEEC and Chinese officials mark the start of drilling on site in the Yunnan Province of Southern China



project. Far East Energy will have between a 66.5% and a 96.5% revenue interest, depending upon how CUCBM participates.

Test wells drilled on two of the company’s blocks have so far indicated gas contents ranging between 280 and 650 cubic feet per ton of coal. These initial results compare favorably with two of the most prolific CBM basins in the United States, New Mexico’s San Juan Basin (300 – 700 cu ft/ton) and Alabama’s Black Warrior Basin (250 – 500 cu ft/ton). According to Far East Energy, internal ConocoPhillips documents demonstrated strong promise and said the “coal was well cleated and coal samples have high gas contents.” One key factor in evaluating a CBM play is the thickness of the coal seams. At Shanxi, four coal seams average 9 feet thick with total of 60 feet in coalbed thickness.

Having been a previous director of Far East Energy, Tunaye Sai was able to develop his own connections in China. This led to his negotiating the Guizhou CBM concession in south central China – again another enormous block of 970 square kilometers – which was acquired by Canadian based AsiaCanada Energy. This became a wholly owned subsidiary of Pacific Asia China Energy, of which he serves as President and which began publicly trading on the Toronto Venture Exchange, this past January.

His concession was the first awarded to a Canadian company by the Chinese who had previously only dealt with U.S. and Australian-based companies. Since then, China has awarded concessions to three additional Canadian companies. Again, the potential gas content of these concessions is staggering. In the case of the Guizhou concession, it could conceivably host a high-case scenario of 11.2 trillion cubic feet of gas. In an interview we conducted with Eric Nuttall, CBM research analyst for Canada’s Sprott Asset Management, he estimated for each trillion cubic feet of gas, a company might anticipate a market capitalization as high as \$1 billion. Most CBM companies developing prospects in China, such as Far East Energy and Pacific Asia China Energy, are likely to be somewhat discounted because of country risk.

Not so for Green Dragon Gas, which this past week listed on London’s AIM market, with a market capitalization of US\$525 million. It placed just under six percent of its shares to raise \$22 million. Green Dragon holds five production-sharing CBM contracts covering some 1.6 million acres in Fengcheng and Shizhuang provinces. It

is estimated their holdings may host 16.6 trillion cubic feet of CBM gas. It appears the European investor is savvy to China’s prospects than those in North America. This was echoed during an interview with Pacific Asia China Energy executive vice president Steve Khan, who told us, “When we visit the London fund managers, they don’t have negative or a lesser view of China. They look at it as a great opportunity and they’re investing more funds there.”

The nuances of investing in natural gas or CBM plays outside of North America may escape some investors. Not many realize that all gas is local. For example, natural gas sold at the wellhead in Australia or the Middle East is a fraction of the cost sold to England or in North America. While companies developing CBM resources in China carry a discount to their North American counterparts, pricing in the Chinese gas market is more stable.

We talked with *Resource Opportunities* editor and geologist Lawrence Roulston, who told us, “I think the companies which are able to effectively exploit the CBM technology in China are going to be the pioneers in that area.” To date, less than 30 concessions have been awarded to foreign-owned companies by CUCBM. There have been rumors flying that another five to ten may be awarded in the coming year. As is often the case in China, the bureaucracy moves slowly – CUCBM began awarding CBM concessions in 1998 in the form of production-sharing contracts. Treated like winning lottery tickets, on average less than four per year have been handed out. CUCBM keeps between 30 and 40 percent of the production contract, and the development company pays all of the exploratory confirmation costs prior to production.

Again it is about having connections with the right people in China. Roulston explained, “I could walk into the Petroleum Club in Calgary, and meet a half dozen guys and talk to them. I could build on my leads, and probably in a day be talking about a deal. When



*Pacific Asia China Energy was awarded a production-sharing contract for a very large CBM concession in China's mountainous, but coal-rich Guizhou province. In 2005, Guizhou's coal output grew by 12 percent to 110 million tons.*

you go into China, unless you have somebody on your team that can get into the system and deal with the people, because of language issues, cultural issues and just having access to the information and knowing what sort of terms that they might be looking for." He concluded, "If I was to go over to China and try to do a deal to get access to a coalbed methane property, I wouldn't have a clue about how to begin." That's what separates the companies who've begun their CBM projects in China and why they could have outstanding long-term prospects there.

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