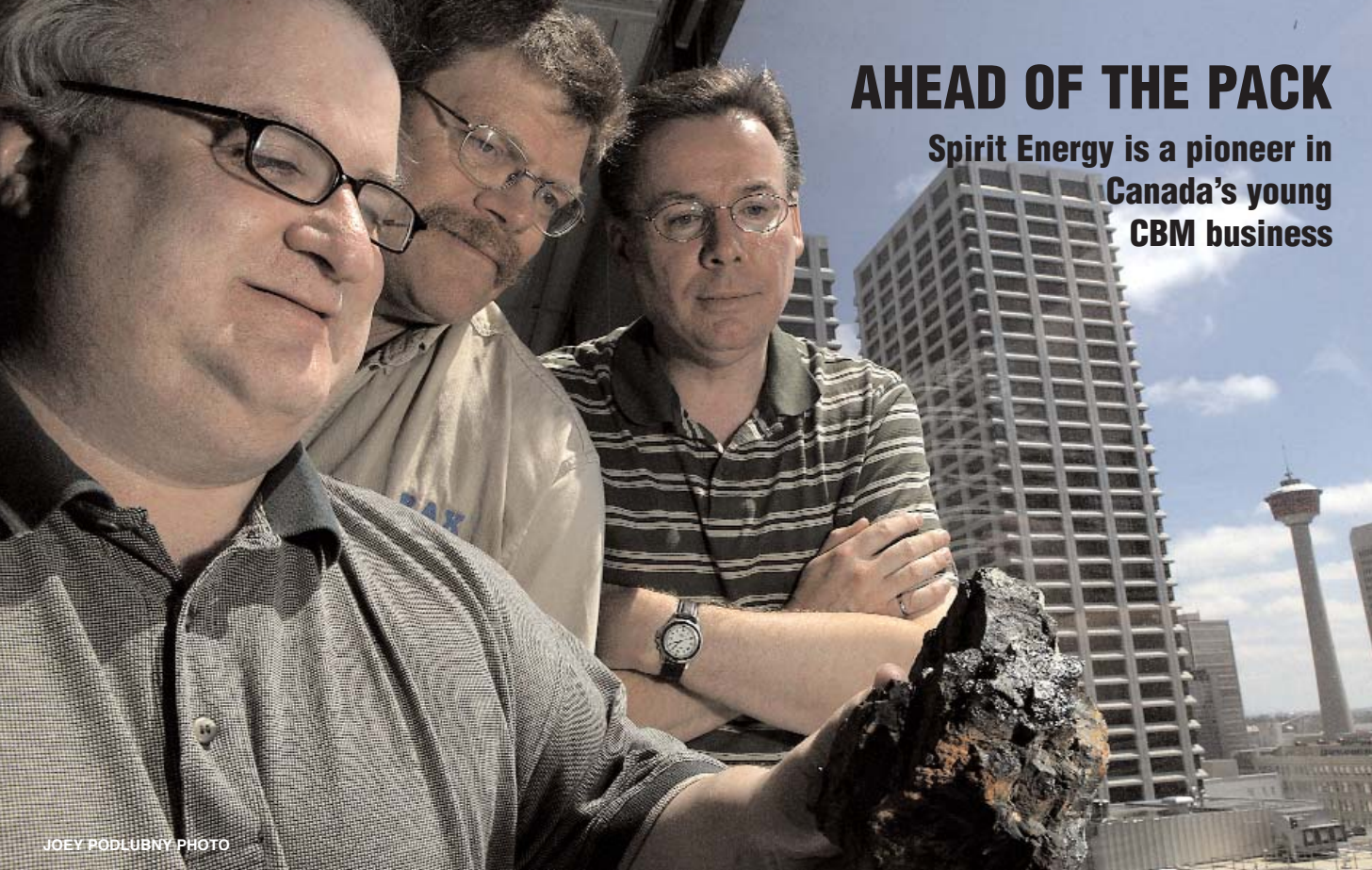


AHEAD OF THE PACK

Spirit Energy is a pioneer in
Canada's young
CBM business



JOEY PODLUBNY PHOTO

When a Toronto investor phoned Spirit Energy, a struggling junior company focused on coalbed methane exploration, and said: "I want to give you \$2 million," Spirit's co-founder Ken Sinclair did a cartwheel across his office (or so says his partner in the venture Phil Geiger). Having started their company out of Sinclair's garage, the two were elated at this validation from an unexpected source.

Sinclair, who is known as the "godfather" of Canada's coalbed methane industry because he has worked on CBM projects since 1988 and initiated Canada's first CBM association, made this prediction in March 2003: "A lot will happen when gas goes higher than \$3 to \$4." Not only was he correct, but his prediction has been exemplified by the transformation of his own company, Spirit Energy, in a mere year and a half from an entity barely out of the cocoon into one on the verge of taking flight.

Since the spring of 2003, the company has wooed

investors, purchased land and implemented a carefully phased approach that begins with research. It has seen its stock price rise from 40 cents to \$2.50 a share. The firm's recent maturation warranted a more formal name. Its founders decided to switch from Spirit to the more corporate-sounding CSRI (Canadian Spirit Resources Inc).

As a result of the sudden availability of cash in the past 18 months, the Canadian CBM world as a whole has undergone a metamorphosis. And one of the most significant differences for small companies like CSRI is their ability to raise capital. "It's a lot more easy to go out and raise money now," attested Sinclair.

In March 2002, the NYMEX price of natural gas was US\$3.02 per MMBtu. Today it is more than double that price. In the past year, Sinclair and Geiger have raised \$12 million from firms like Haywood Securities and Sprott Asset Management. The surprise offer of funding

from the Toronto-based private investor Eric Sprott, who runs Sprott Asset Management, put the icing on CSRI's cake.

Geiger took the phone call. "He (Sprott) called us one day and said 'I want to give you \$2 million.' We spent about five minutes on the phone." The investor did not want to risk the appearance of obtaining insider information that a longer conversation might give, explained Geiger.

Sprott was not just tire-kicking. Shortly after his call he backed his words with a large share purchase. "He's been known to get in early on the right companies," said Geiger. "He chose to get in back when we were trading at \$1.50. His investment has almost doubled." Sinclair added, "When other companies see people like Sprott investing they follow."

When Geiger and Sinclair established their company in May 2002, their recognition that they needed help from a large, cash-rich company to get them started spurred

their initial partnership with a major American producer, whose name they declined to reveal. The deal stipulated that Geiger and Sinclair would put up 25 per cent of the financing and the American company would supply the balance.

"How many companies would give two guys a chance?" said Geiger. "We thought it was a great deal."

When, like several other U.S. majors, this one decided in 2003 to sell a major portion of its Canadian assets, one of its legacies to Canada was the well-endowed little start-up called Spirit Energy. "It actually helped us as far as credibility," said Sinclair. "We raised seed money, and they supplied mapping." Financial backing from the American company also helped them come up with a ranked list of prospects.

"I think most companies have the same list," said Sinclair. Success lies in pinpointing where to drill. "That's the trick," said Geiger. "How do you manipulate the data? A lot of

companies are into the shotgun blast approach." Unless one has deep coffers, however, this technique is too expensive. Sinclair and Geiger are banking on their two decades of experience studying the idiosyncracies of coalbed methane to give them an edge over their competition.

With cash in hand, the partners have spent the past few months acquiring land. They now own leases to 32 sections in Northeast British Columbia. Competition to lay claim to property with CBM potential has become cut-throat. "I think there's competition wherever you look at coalbed methane," noted Sinclair.

It is particularly intense for concessions in northeast B.C. where an estimated 89.2 trillion cubic feet of natural gas from coal lies trapped beneath the province's lush forests. As a result, in the past 18 months the cost of securing a lease has more than doubled, rising to \$900 a hectare from between \$300 and \$400 per hectare.

CSRI's owners prefer to be 100 per cent owner/operators. "We've looked at farm-ins," said Geiger. "Why would we take 50 per cent when we can get 100 per cent?"

Companies need to select their targets carefully. "One of the critical things we also did in that area—we can't tell you exactly where—we spent some time figuring out where were the places not to go," said Geiger. "The Natives have claimed 120 per cent of B.C. as everyone knows. There are certain hot spots you don't want to touch."

These include "areas of critical community interest" such as the Peace-Moberly Tract, a 3,960-square kilometre section of untouched land that has become a haven for moose and other wild animals escaping the encroachment of industrial development. Leaders of the Saulteau and West Moberly

First Nations want to keep the tract as a preserve, but companies such as Burlington, EnCana and Canadian Natural Resources are vying for every hectare that might yield the precious reserves of natural gas. The First Nations have filed an appeal to a court order allowing the companies to forge ahead with development.

"The critical area has good prospects," admitted Sinclair, but with neither the desire nor the resources to engage in court battles, CSRI carefully reviews each lease for its potential to spark wrangles with community members nearby. "We're above board, honest with everybody," says Sinclair. "The natives see that. It's a question of doability."

"Why waste any effort?" interjected Geiger. "But you'd be surprised how many people do—because the resource is so big."

Although CBM hunters may all hold the same general list of prospects, there is still much that is unknown about the coal beneath the Western Canadian Sedimentary Basin and where the best prospects lie.

Companies that do have an idea would rather keep that information to themselves, which is one reason they hope the water issue does not come to plague them the way it has CBM producers in the U.S. There, angry farmers and environmentalists want to ensure that water is conserved better than it had been in the past.

In Canada, water conservation by CBM producers will likely grow in importance, but for now, Alberta Environment allows companies in the research stage to keep information about the quantity of water in reservoirs they are testing confidential for up to five years. And that is fine with Sinclair. "People are not talking about water quantities because it's a dead give-away of the quality of the basin,"

he said. "The reason is—then I know the permeability of that reservoir."

The government's position on the issue of water confidentiality may change, however, if the public begins to protest the amount of coalbed methane drilling companies are planning in populated or environmentally sensitive areas.

Another potential fight is looming over whether coal companies own the rights to the gas. Coal underlies nearly a third of western Canada, and the endowment has traditionally been the purview of coal-mining companies.

During an interview last spring, Sinclair said, "It makes sense to ally with coal companies." CSRI has been approached by a coal company to develop a prospect on Vancouver Island. However, they decided against it because of the potentially contentious environmental issues.

"The question is: who owns the gas in the coal? The coal companies feel they own it," Sinclair continued. "It has sparked numerous legal cases, mostly in the Lower 48."

The B.C. Government has ruled that for the next five years coal companies own the rights to the gas in the coal on freehold land. If the mining companies do not initiate exploration for CBM within the five year time line, "the government will take it back for others to bid on," said Sinclair.

Sinclair began working on CBM projects in the late 1980s when only a handful of companies devoted even a fraction of their budget to it. Having watched the phenomenal growth of CBM production in the U.S. as a young wellsite geologist with Corelabs in Oklahoma City, he was an early believer in the enormous potential of western Canada's resource. Such was his confidence that he organized the Canadian Coalbed Methane Forum, the

forerunner of the Canadian Society for Unconventional Gas (CSUG). From fewer than 20 on its roster two years ago, CSUG now has 66 members.

Canadian CBM experts are taking advantage of the path forged before them by the Americans. "If the U.S. is in Year 25," said Sinclair. "We're probably in Year Four or Five." In the areas of technical research, community relations and environmental mitigation, Canadians can learn from the successes and mistakes of their predecessors. "The work they're doing is an advantage," said Geiger. "You can leap frog. You're not reinventing the wheel."

The landscape could change again in the near future. The Energy Bill under consideration in the U.S. Congress includes a tax incentive for producers of unconventional gas. "If it gets approved I think it's going to be great for the Canadian industry as a whole," said Sinclair.

The reason is that it will deplete the field of competitors. A tax incentive would mean that "if you're an American company you're going to reallocate your capital south of the border," explained Geiger. "We think there will be a lot of farm-in opportunities," he added, noting that the majors could start calling on junior companies with CBM expertise.

Currently, approximately 55 million cubic feet a day of natural gas from coal is flowing to market through TransCanada Pipelines, but that could rise to 100 MMcf a day by year-end. The National Energy Board estimates CBM production will reach 400 MMcf per day by 2007 and hit 1.3 Bcf a day three years later.

Development of shale gas and tight sands are not far behind, says Geiger. For pioneers like Canadian Spirit, the time to sprint ahead of the pack is now.

— Andrea Lorenz