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eResearch

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Recommendation
Speculative Buy

Target Price
$1.50

Risk
High

Average Daily Trading Volume
105,000

Quick Facts

Recent Price	$0.99
Symbol	CEC:TSX-V
Shares O/S	29.1 million
Shares O/S FD	30.2 million
52 Wk. Range	$1.15-$0.82
Fiscal Year End	Dec. 31

C$MM	Net Rev.	EPS
2004e	$0.60	($0.01)
2005e	$2.73	$0.07
2006e	$14.16	$0.35

STRENGTHS
- **B.C. encouraging mining/energy projects**
- **Strong coal prices**
- **Strategically-located resource properties**
- **Methane gas development potential**

RISKS
- **Start-up Company; limited commercial production track record**
- **Ability to attain coal production objectives**
- **Further Canadian dollar appreciation**
- **No large scale commercial development and usage of methane gas**

CONCLUSION
- **A highly speculative investment with intriguing possibilities**

Compliance Energy Corporation

Data Source: BigCharts.com

Compliance Energy Corporation is a Canadian energy company headquartered in Vancouver, British Columbia and engaged in the development of coal resources in the Tulameen coal basin located in the interior of British Columbia.

SUMMARY & RECOMMENDATION

Compliance Energy Corporation ("Compliance Energy" or the "Company") is a recently-formed energy company that is in the early stages of commercializing some of its British Columbia-based resource properties. The Company is involved in: (1) the development and production of thermal coal; (2) the exploration and development of both metallurgical and thermal coal; (3) the development and eventual generation of electrical power from wood waste and coal; and (4) the exploration and development of its coal-bed methane gas properties.

Compliance Energy's activities are opportune as energy resource prices are soaring and the B.C. government has been extremely proactive in encouraging the expansion of its energy industry. At the same time, the Company is subject to certain risks, such as volatile energy markets, environmental concerns, and a rising Canadian dollar.

A major challenge facing the Company is the ability to finance the capital costs of: (1) developing and bringing into production its thermal and metallurgical coal properties on Vancouver Island; (2) building a wood waste/coal power plant; and (3) exploring and developing its coal-bed methane gas properties. Any expenditure shortfalls not covered by revenue from coal sales will need to be met with additional common share issues, which could cause some per share dilution.

At this early stage of the Company's development, we believe that an appropriate p/e multiple for the shares is 5x. Since meaningful earnings will not accrue until 2006, using this multiple on that year's earnings estimate gives a forecast of $1.75 per share, which is then discounted at 15% to derive our 12-months Target Price of $1.50.

As the Company establishes a track record by increasing its coal sales and by developing its other energy resources, the market is likely to become more confident in its future growth prospects. Accordingly, we believe the shares offer interesting capital appreciation potential to risk-tolerant investors over the medium to longer term.

THE COMPANY

Compliance Energy is a newly-formed energy company with its administrative headquarters based in Vancouver, British Columbia. Compliance Energy's shares trade on the TSX Venture Exchange under the symbol CEC.

Integrated energy company

The Company became a publicly-traded entity in 2000 and entered the coal mining business in 2002 through a reverse takeover of Compliance Coal Corporation, a private company whose main assets were licences to coal mining properties in the Tulameen Coal Basin near Princeton, B.C. Since then, the Company has constructed and put into production its open pit coal mine with processing facilities to produce 400,000 tonnes per year and made major efforts to become an integrated energy company through the acquisition of licences (a) to develop thermal and metallurgical coal on Vancouver Island, and (b) to explore for coal-bed methane gas in the Tulameen Coal Basin. In addition, the Company has completed scoping and feasibility studies for a wood waste/coal-fired 49 MW power plant that it would build close to its Princeton coal mine.

CORPORATE OVERVIEW

A. Positive Factors

- Resource properties close to developed infrastructure, including a major gas pipeline in southwestern B.C., and coastal shipping waters;
- Initiated production in 2003 of a thermal open-pit coal mine in one of British Columbia's major mining districts;
- Negotiated new coal sales contracts with provincial buyers, including B.C.'s largest cement producer, for all of its 2003 and 2004 production;
- Entered into a joint venture agreement with a Japanese partner to develop a thermal coal deposit in the Tulameen Coal Basin;
- Coal prices are rising because of substantial increases in world energy demand;
- Potential to export coal to off-shore markets;
- Direct benefit from the encouragement of mining and energy projects, as well as the development of independent power projects, by B.C.'s Energy Policy;
- Management has a successful track record with other mines;
- Entered into a joint venture agreement with a native partner for coal-bed methane gas exploration and development rights also in Tulameen Coal Basin; and
- Coal-bed methane gas development portrayed as one of the cornerstones of the B.C. government's new Energy Policy; and

B. Challenges

- Short commercial production track record as Company only in second year of operations for coal mine and wash plant;
- Continued Canadian dollar appreciation and U.S. dollar depreciation (coal prices quoted in U.S. dollars);
- Future coal supply increases from major coal-producing nations, such as China, Australia, and Indonesia, could be encouraged by recent coal price increases;

- Provincial thermal coal demand currently limited to cement production and greenhouse operations;
- Japanese joint venture partner in Tulameen Coal Basin project undergoing major restructuring and re-financing;
- Although there are other Canadian and U.S. markets where Compliance could sell its thermal coal, the Princeton power plant is largely dependent on winning a competitive bid to supply a B.C. Hydro contract and on maintaining community support (environmental problems may provoke a backlash);
- Future government, legal, regulatory changes and restrictions;
- Environmental concerns;
- Limited commercial production of coal-bed methane gas in Alberta to date - numerous experimental projects underway in B.C.; and
- Competition with other coal-bed methane gas projects in B.C. that may have greater reserves and lower production costs.

B.C. ENERGY POLICY

Significant provincial incentives

The B.C. government's Energy Policy, announced in November 2002, provides incentives to encourage the private sector to develop more energy resources and independent power projects in the province. Many aspects of this energy policy and other recently-announced provincial government mineral and energy polices will help Compliance Energy develop its resources.

The Energy Policy encourages the development of coal-bed methane gas and other unconventional resources in order to increase the province's energy supply and the regional opportunities for economic growth. A new royalty regime was introduced in March 2002 to address CBM's unique development and production challenges. The B.C. Oil and Gas Commission is preparing guidelines that will clarify the regulatory requirements for CBM projects. The Minister of Energy and Mines has been working with industry, aboriginals, and other stakeholders to provide information on potential resources, environmental impacts, and economic benefits associated with CBM.

The Energy Policy also requires energy distributors to work towards generating 50% of their electricity supply from clean sources. Compliance is proposing to build such a plant that will utilize wood and coal as fuel on a 50/50 basis and will provide employment and economic development in southeastern B.C.

Coal-fired electricity generation is currently not an important source of electricity in British Columbia in spite of the fact that B.C. remains the province with the greatest coal mining activity in Canada. Coal is becoming more economically attractive as the prices of oil and natural gas have risen dramatically, especially during the past two years. Further oil and gas price rises and volatility will lead to increased pressure to use coal as a replacement fuel. At the same time, the B.C. Ministry of Water, Land and Air Protection has adopted new emission guidelines for coal-fired plants. The Ministry is currently determining if more stringent stack limits are required.

In March 2004, the B.C. government announced that the 20% flow-through share tax credit for mining exploration would be extended for another year. When combined with the federal government's 15% mining tax credit, it creates one of the best tax credit programs in Canada. This credit lowers the net cost of a $1000 investment in mining flow-through shares to as low as $366. The B.C. government's goal is to double exploration investment to $100 million a year in the near future. The flow-through tax credit is one of many incentives the B.C. government has put in place to revitalize the mining sector. Other initiatives include eliminating the corporate capital tax, cutting corporate income taxes, eliminating PST on production machinery and equipment, reducing red tape, and streamlining the approval process.

New mining plan forthcoming

Following a year of consultations with the mining industry, the B.C. government is finalizing a mining plan outlining B.C.'s long-term vision and plans for mining. The B.C. Minister of State for Mining has said that coal will play a key role in the province's on-going economic turn-around.

COMPANY PROJECTS

A. COAL OPERATIONS

The Company holds coal mining licences in two areas of British Columbia - near Princeton in southeastern B.C., and on Vancouver Island.

In general terms, there are two types of coal. Thermal coal is used as fuel to generate coal-fired electricity, make cement and heat greenhouses, while metallurgical coal, also referred to as coking coal, is an input for steel production.

Output increasing

1. Princeton. The Company opened its thermal coal mine, near Princeton, in 2003. Thermal coal is used as a heat source in the production of cement and coal-fired electricity generation. In its first year of operation, 24,000 tonnes were mined, 12,000 tonnes of which were sold. However, output is expected to increase annually because Compliance is ramping up its operations through new capital expenditures on transportation infrastructure, additional mining shifts, and wash plant re-location. The new location for the wash plant will mean that less time will be required to transport the coal. Within two years, production is expected to reach 500,000 tonnes of thermal coal annually.

Good infrastructure

2. Vancouver Island. Additional coal mining licenses were acquired by the Company in September, 2004 for 2,938 acres on Vancouver Island from Trent River Coal, a private partnership. One of the Vancouver Island coal properties, the Bear, which will see an exploration program commenced on it early in 2005, contains only metallurgical coal, while the other property, Wolf Mountain, is mainly a thermal coal deposit. The Bear deposit is estimated to contain 28.6 million tonnes in metallurgical coal reserves, from which approximately 8.6 million tonnes can be mined through an open-pit scenario. The property has major advantages as it is close to developed infrastructure, transportation routes, an electrical power supply, and coastal tidewater. The Company plans to mine 70,000 tonnes of metallurgical coal in 2005 for a test shipment to offshore markets. The Wolf Mountain property has approximately 2.0 million tonnes of thermal and metallurgical coal that will require the development of an underground mine. The property is subject to a sales royalty of 2.5%.

The Company's main focus over the next several years will be to increase its revenue and profitability from its coal production by:

(i) reducing its transportation costs through the relocation of its wash plant to the mine site (the wash plant relocation, which is already well underway, will cost an estimated $500,000, will be completed by March 2005, and is not expected to disrupt Compliance's current clients since they are cement companies which do not require their shipments in the December to March period);

(ii) integrating its energy operations by building a wood waste/coal power plant near Princeton, B.C., that will utilize its nearby coal mine production as well as wood from the surrounding area;

(iii) bringing its Bear metallurgical coal deposit on Vancouver Island into commercial production as soon as possible to capitalize on high coal prices; and

(iv) building a rail siding, at a cost of $600,000, that would enable the Company to ship its coal via American rail lines to various American ports, or by road or rail to the port of Vancouver.

Corporate focus on increasing production

Joint Venture

Strategic Joint Venture

In 2002, Compliance entered into a joint venture agreement, known as the Compliance Basin Coal Joint Venture (the "JV") with Tokyo-based Sojitz Coal Development Ltd. Sojitz, which was formed in 2004 by a merger of two large, well-established Japanese companies, Nissho Iwai and Nichimen, is a highly diversified corporation with interests in construction, forestry, plastics, chemicals, mining, petroleum, textiles and international trade.

The JV acquired nine coal licences, covering 2,172 hectares, in August 2002 in the Tulameen Coal Basin, 30 km northwest of Princeton, British Columbia. Compliance Energy, which holds a 70% interest, is the operator of the project. Both joint venture partners market the mine output.

COMMENT: *Sojitz is a potential source of financing for the development of Compliance's metallurgical coal deposits on Vancouver Island and its planned power plant at Princeton.*

The B.C. Government has estimated the resource of the Tulameen Coal Basin to have the potential of 240 million tonnes of thermal coal. The JV property in the Tulameen Coal Basin is 5 km long by 4 km wide. The initial open-pit mine is 1.5 km long and varies in width, but is never greater than 0.5 km at any one point. The deposit has two seams - the main seam is 23 to 34 meters thick, while the lower seam is approximately 7 to 8 meters thick. The lower seam is not included in the current mine plans.

15-year supply

Based on the Company's feasibility study, the JV's initial open-pit mine, which does not require any drilling or blasting for coal removal, will supply sufficient coal for 15 years at a low strip ratio. The Company started production in 2003, but initial amounts were small - 12,000 tonnes in 2003 and 40,000 tonnes in 2004. Compliance is confident that its annual production can be increased substantially by doubling shifts, mining for a longer season, and reducing transportation time by moving the wash plant to the mine site. Future annual production, which will depend ultimately on demand and the Company's ability to sell its coal, will also benefit from the building of a rail siding to improve access to offshore markets.

As a consequence, in the next three years, with international demand for coal expected to remain strong, Compliance expects to increase production to 1,000,000 tonnes annually - with 250,000 tonnes in 2005, 500,000 tonnes in 2006, and 1,000,000 tonnes in 2007. No further exploration work is planned in this area at the present time because previous delineation work indicated that the ore body will produce 10 million tonnes of coal over the next 15 years.

Markets

The demand for thermal coal in B.C. is quite limited. Except for small amounts of thermal coal being used by cement plants and greenhouses, most of B.C. thermal and metallurgical coal is exported.

Promising outlook

The future looks more promising for B.C. coal producers. At the present time, B.C. has no coal-fired power generation. Hydro-electricity accounts for 86% of total energy produced in the province, and the balance is produced through thermal generation, mostly fuelled by natural gas. However, future thermal power plant developments in B.C. will likely use both wood and coal on a 50/50 basis, given that the B.C. government's Energy Policy, announced in November 2002, promotes "clean energy", i.e., a 50/50 mix. This opens up opportunities for coal companies like Compliance.

Compliance Energy provided test shipments and obtained approval of local customers for its product in 2003. Sales amounts to date are small - 12,000 and 40,000 tonnes, for 2003 and 2004 respectively. If the Company attains full annual production capacity at its Princeton mine, and brings its Vancouver Island coal properties into production, export markets will need to be found since there is only a limited market for thermal coal and no market for coking coal in British Columbia.

Coal market competitive and volatile

The coal export market is very competitive and volatile. Unlike the 1970s and early 1980s, when B.C. coking coal mines like Quintette were able to negotiate long-term coal contracts with the Japanese, coal contracts today are negotiated only for a one-time, or at most, a one-year term. The largest coal producing nations -- China, Australia and Indonesia -- compete vigorously for the major Asian coal markets such as Japan and Korea.

COMMENT: *Some of Compliance Energy's thermal coal could be used in a power plant that Compliance is planning to build near Princeton but, even at full capacity, this power plant cannot absorb all of the Princeton coal mine's production.*

Currently, Compliance Energy's only producing thermal coal competitor in the province is Quinsam Coal, which is owned by Hillsborough Resources Ltd. This development is an underground mine, which is riskier and more costly than an open pit mine. There are also shipments into B.C. from the Luscar Coal Valley Mine.

Outlook

At the present time, thermal coal production is the Company's only source of cash flow. Based on the Company's current coal production plans, we expect the Company's gross revenue from its coal mining operations to increase from $1.33 million in 2004 to $58.12 million by 2007. Our annual coal production forecasts are less than those of Compliance's management as we see production being ramped up more gradually over the next few years, given previous coal production patterns at other coal mines in B.C.

Revenue assumptions

Estimates of Compliance's future revenue stream from 2005-2008 are based on the following key factors:

1. Value of the Canadian dollar: an average of U.S.$0.80 during 2005-2008;
2. Coal prices: the price for Compliance's thermal coal and metallurgical coal will remain at Cdn $50/tonne and Cdn $85/tonne, respectively, over the forecast period;
3. Coal production: thermal coal production will rise to 250,000 tonnes in 2005, 500,000 tonnes in 2006, 750,000 tonnes in 2007, and 1,000,000 tonnes in 2008, whereas metallurgical coal production will rise to an annual exit rate of 250,000 tonnes in 2006, increase to 375,000 tonnes in 2007, and then rise to 500,000 tonnes in 2008;
4. Power plant production: revenues from power plant production will not be generated until 2009, the year after the forecast period;
5. "Other" Factors: Compliance will be able to sell all of its annual production.

Value of the Canadian Dollar

The value of the Canadian dollar is an important factor because, like many world-traded commodities, coal prices are quoted in U.S. dollars. The Canadian dollar has been appreciating against the U.S. dollar over the past two years because of high resource prices and the U.S.'s substantial current account and budget deficits that have been exerting downward pressure on the value of the American dollar. Some economists believe that the Canadian dollar will continue to appreciate in the next several months but then fall back to previous levels. In fact, the five major Canadian banks' dollar forecasts for 2005 range from a low of US$0.77 to a high of US$0.90.

COMMENT: *Our forecast of an average of US$0.80 for 2005 to 2008 reflects our view that the dollar will stabilize at its current level. We expect the dollar to stabilize at US$0.80 for the following reasons: (1)major policy changes by some of the world's fastest growing economies to avoid overheating (e.g. first interest rate hike in China in a decade occurred in the fall of 2004); (2) commodity price declines in the face of slower global economic growth; (3) tight monetary policy and high oil prices in the U.S, which will reduce demand for Canadian exports; and (4) the Bank of Canada will continue to attempt to soften the impact of an appreciating dollar on the export sector.*

COMMENT: *If coal prices fall as more of the world's coal supply comes into production, and the Canadian dollar continues to appreciate, Compliance Energy's future coal revenue estimates likely will not be realized. The Company could then face a challenge in raising its needed capital investment to finance the high cost of developing its resource properties and the building of its planned power plant.*

Coal Prices

Coal prices have soared in recent months since this is the time of year when price negotiations with the Japanese commence. Traditionally, metallurgical coal prices are finalized by the end of the calendar year, and thermal coal negotiations are completed by the following April. Substantial increases in natural gas prices in the last two years is one of the main reasons for the price rise of thermal coal, while metallurgical coal prices have increased as steel production has risen, especially in China and India. Thermal coal has been trading recently around $60 a tonne, up from an average of $22 two years ago, while this year's metallurgical coal negotiations will be heavily influenced by recent spot prices of $125 a tonne for deals recently concluded in China and India.

COMMENT: *We believe that our coal price estimates are realistic, given that the current high prices will result in more coal reserves being brought into production and, consequently, an increase in world coal supply, which would eventually constrain further price increases and, possibly, lead to price declines. Moreover, spot prices tend to be higher than contract prices since lower contract prices reflect the fact that the seller is negotiating not only for a price but for market certainty in the future.*

Coal Production

Canada produces approximately 70 million tonnes of coal a year - 28 million tonnes of metallurgical coal and 42 million tonnes of thermal coal. Currently, British Columbia produces 90% of Canada's metallurgical coal with the remainder sourced from Alberta. The majority of thermal coal is produced in Alberta (67%), while Saskatchewan produces 27%. Only 3% of Canada's total annual thermal coal is produced in British Columbia, with smaller amounts produced by New Brunswick and Nova Scotia. Compliance's planned annual production of 1,000,000 tonnes will be a significant addition to provincial thermal coal production. Canada is a small player on the world coal stage with China, the U.S., India, Australia, and South Africa all individually producing at least three times as much coal tonnage annually as Canada.

Power Plant Production

We have not included any revenue in our projections from the Company's power plant. Although Compliance management estimates that the power plant will be in production by 2008, we have chosen to adopt a more conservative scenario, whereby the power plant is not generating revenues until 2009.

Other Factors

In addition to increases in the price of coal and the stability of the value of the Canadian dollar, Compliance Energy's future success in the coal business is also dependent on other major factors, including its ability to bring its resources into production quickly and market them efficiently, and its adeptness in continuing to adhere to environmental regulations. Environmental concerns are an important factor, which may limit the use of coal. For instance, the Ontario government has announced that it will phase out all coal-fired electricity generation in the province by 2007 because of environmental concerns, although it is questionable whether this will be achievable within the stated time frame. More vocal opposition from environmentalists and a change in the provincial government in the next election in B.C., which has been called for May 17, 2005, may adversely impact the future of coal in the province as well.

B. COAL-BED METHANE GAS OPERATIONS

Coal-bed methane ("CBM") is the natural gas found in most coal deposits. CBM consists of pure methane gas which, when commercially produced, can be distributed by the existing natural gas pipeline system, and used as heating fuel and alternative transportation fuel.

Rapid growth of CBM production

In the United States, tax incentives introduced in the 1980s have led to the rapid growth of CBM production, and it now accounts for 7%-8% of total annual U.S. natural gas produced. Success in the U.S. is expected to be emulated in Canada.

Recent rises in oil and gas prices have increased interest in CBM. In fact, a major reason that oil and gas drilling activity increased in Canada this year has been because of the growth in coal-bed methane gas exploration. In contrast to conventional oil and gas drilling activity, which fell in Canada in 2004, CBM activity is expected to triple next year. Although CBM production costs tend to be higher because of the necessity of drilling more wells and water extraction, recent breakthroughs in technology are now allowing for greater recovery rates. Drilling activity is greatest in Alberta because the coal beds tend to be dryer than those in British Columbia, where water sometimes must be pumped out before the gas can be accessed. In the past the disposal of this water has caused environmental problems.

CMB projects

In addition to Compliance, a number of CMB projects, which are only at the exploration stage, are currently underway in B.C.: Petrobanks's projects in the Princeton area in southwest B.C.; nine projects in northwest B.C.; and one on Vancouver Island. The B.C. government is encouraging commercial production, which is expected to start in a few years, by making CBM the cornerstone of its Energy Policy, and by introducing a new royalty regime to address CBM's unique development and production challenges.

COMMENT: *Large-scale commercial production of CBM gas in B.C. may not begin for another five to seven years.*

In March 2004, Compliance Energy was selected by the British Columbia government as the successful bidder for the petroleum and natural gas rights (coal-bed methane) for 8,295 acres that cover the Tulameen Coal Basin. The B. C. government estimates that the area has the potential to produce approximately 50 billion cubic feet of methane gas. At the same time that Compliance Energy obtained these rights, the Company entered into an agreement, as senior partner, for a 75%-25% joint venture with the Upper Similkameen Indian Band. Compliance was granted a five-year drilling licence, which can be extended for an additional six years, if required. Compliance is now looking for a joint venture partner with coal bed methane expertise to develop the resource.

COMMENT: *Companies involved in the coal-bed methane industry were highly sought after by investors in 2004. Compliance management has stated that it intends to focus its near-term activities on its coal properties and electrical power generation operations (see below) rather than on its CBM properties. From an investor sentiment stand-point, we consider this to be a slight negative for Compliance share performance.*

We estimate that the potential gross revenue value of the methane gas rights for Compliance to be in the region of $277 million, based on 53 Bcf at $5.22 per million Btu (a recent spot price on the Calgary-based Natural Gas Exchange Inc.'s NGX electronic energy market). Prices are expected to rise in the next several years as demand for all sources of energy continues to rise.

COMMENT: *If that occurs, and provided the Company increases its focus on its CBM properties, this could be a real bonanza for Compliance.*

C. ELECTRICAL POWER GENERATION OPERATIONS

Although Compliance Energy's arrangement with Northland Power Inc. to bid on a power plant contract on Vancouver Island was not successful, the Company intends to pursue its electrical generating business vigorously. In this respect, Compliance has completed both a scoping study and a pre-feasibility study for a wood waste/ coal fired 49 MW power plant that the Company would build near Princeton, B.C.

Bid submission

Compliance intends to submit a bid to the B.C. government's request for submissions from independent power producers by May 2005. Presentations the Company has made about the power plant project to provincial Ministers and MLAs, as well as to the Princeton town council, have been well received, mainly because of the positive impact on employment and economic development. If successful in the bid process, Compliance would be able to input some of its power production into the provincial electricity grid.

Compliance Energy is now moving forward with the next stage of the project, which includes permitting, capital cost refinements, and securing power sales. This power plant, which would utilize Compliance Energy's coal, and wood waste from the surrounding area, would meet the classification of "Clean Air" under the B.C. government's recently released Energy Policy. The power plant, which Compliance expects to open in 2008, will cost about $100 million and is expected to generate approximately $26 million in annual revenues, upon completion.

COMMENT: *When built, Compliance will be able to write off the plant costs quickly because of generous capital cost allowances for clean air power plants under the federal Income Tax Act.*

MANAGEMENT AND DIRECTORS

Compliance Energy's administrative office is located in Vancouver, B.C., and the mine office is in Princeton, B.C. Its key executives have extensive mining experience.

Jim O'Rourke, P. Eng. - Chairman, CEO, and Director
Mr. O'Rourke is a mining executive with over 35 years of experience in mine evaluations, feasibility studies, financing, development, and operations. He has had hands-on experience with more than five major mine starts-ups. In 1995-1996, he was responsible for the financing and development of a $140 million open-pit copper mine, which was completed on schedule and on budget. He was Chairman of Aquest Minerals Corporation from 1998 to 2000 and, at Princeton Mining Company, he was Chairman in 1997, and President and CEO from 1987 to 1996.

Rod Shier, C.A. - CFO and Director
Mr. Shier has over 10 years experience in corporate financing and accounting in the mining industry. He was CFO of Aquest Minerals from 1998 to 2000, and CFO of Rea Gold Corporation from 1992 to 1997. He is experienced in many aspects of corporate equity and debt financing, mergers, acquisition structuring, negotiation of joint ventures, and commodity and foreign exchange hedging.

Larry Belik - Site Manager
Mr. Belik has over 30 years of coal mining and operating experience. Prior to Compliance, Mr. Belik was Senior Production Foreman for Fording Coal for 5 years. Mr. Belik obtained his Open Pit Shiftboss Certificate, Blasting Certificate, and Surface Mine Rescue Certificate from the provincial Ministry of Energy, Mines & Petroleum Resources.

Don Miller - Plant Manager, Basin Coal Project
Mr. Miller holds a Bachelor of Science degree from the University of Saskatchewan and his Mine Supervisors and Rescue certification from the Alberta Mine Safety Association. He has dealt extensively with the universities of Alberta and BC on various coal preparation issues. Mr. Miller worked in Luscar Coal's Coal Valley Mine wash plant for 23 years, and has experience in all areas of the coal preparation plant.

Paul Willis - Advisor
Mr. Willis has over 30 years of experience in energy, including 14 years at B.C. Hydro.

Russ Hallbauer, BSc, (Mining Engineering) - Advisor
Russ Hallbauer has over ten years of coal management experience.

Al Cloke - Advisor
Mr. Cloke has over 30 years experience in the mining industry, including three years on the board of the Canadian Coal Association.

Eric Bersford, P. Eng.- Consultant
Mr. Bersford has thirty years of experience in the coal business.

Jamieson Meritt, LLB - Director
Mr. Meritt has 10 years of experience in business and financial management.

FINANCIAL REVIEW AND OUTLOOK

Set out below are Compliance Energy's consolidated financial statements, including the balance sheet, statement of operations and deficit, and statement of cash flow. The Company's reporting year-end is December 31. Results are also shown for the nine months ended September 30, 2004.

Cash: In April 2004, Compliance Energy completed a private placement for $1.6 million. As at September 30, 2004, the Company had $2.2 million cash on hand. On February 10, 2005, the Company announced that it had closed on a private placement, which netted the Company about $5.6 million. The funds are earmarked for development activities at the Basin Coal and Bear projects and for working capital purposes, i.e., administrative and operating expenditures.

Cash Burn: Compliance Energy's non-discretionary expenses, i.e., office operating and administrative expenses, salaries, accounting fees, etc., for the year ended December 31, 2004 were approximately $15,000 per month, and for the three and nine months ended September 30, 2004, they averaged between $19,000 and $26,000 per month. For 2005, with increased activities, we believe the monthly cash burn amount will average $40,000, or almost $500,000 for the year. To the end of 2004, Compliance did not generate operating revenue and, therefore, was required to access the capital markets to raise the necessary funding to finance it activities. However, beginning in 2005, as coal production ramps up and sales are concluded, we forecast gross revenues reaching $18.45 million for the year, and net earnings of $2.34 million, with positive cash flow.

Expenditures: Management has indicated that there are certain cash expenditures that need to be made, totaling $2.45 million, as set out following:

(1) $100,000, which is the final payment on its purchase of five Vancouver Island coal licences on or before July 31, 2005 (This specific amount would be made only if Compliance decided to start to develop all of these properties);
(2) $1,250,000, which is the purchase price required to buy the land for the construction of its 49 MW wood-waste/coal-fired power plant, and is due on July 5, 2005. If Compliance does not buy the land, it can extend the purchase option for another year, for $40,000;
(3) $500,000, for the Princeton wash plant relocation; and
(4) $600,000, to construct the rail siding allowing easier access to off-shore markets.

The Company also has to finance the planned power plant. Its construction would not start until 2006 at the earliest.

Funding: With the recent private placement, Compliance has sufficient funds on hand to cover its expected 2005 "burn". The Company is not expected to need additional financing for some time, other than for capital projects.

Capital Structure: Compliance Energy has a satisfactory balance sheet with no debt and few liabilities. The Company has a small market cap, has only been publicly trading for two years, and is listed on the TSX-Venture Exchange. The current market capitalization is approximately $23 million based on 29.1 million shares outstanding. Management owns approximately 23% (8.4 million) of the outstanding shares, leaving approximately 77% (20.7 million) for the public float. There are approximately 9.2 million shares subject to escrow, and subject to a six-year hold-period that started in March 2003.

There are also options and warrants outstanding:

No. of Options	Exercise Price	Expiry Date	Comments
940,000	$0.30	January 2008	"In the money"

No. of Warrants	Exercise Price	Expiry Date	Comments
100,000	$0.40	November 2005	"In the money"

In our determination of fully diluted shares outstanding for the purpose of calculating cash flow per share or net asset value, we are including all of the options and all of the warrants since they are both well "in the money", and we expect that they will be exercised prior to their expiry. Thus, we are using 30.2 million shares as our fully diluted number for estimating per share cash flow and net asset value.

Income/(Losses): Since Compliance Energy has been in existence as a coal company only since 2002, it has incurred losses during its start-up phase. For the year ended December 31, 2003, the Company recorded a loss of $318,338, or $0.01 per share, as compared to a loss of $35,146, or nil per share, for the year ending December 31, 2002.

In the first nine months of 2004, the Company reported a loss of $206,110, equivalent to $0.01 per share. For all of 2004, we estimate that revenue will be around $1.9 million, and earnings per share will be essentially break-even to a slight loss.

Outlook: Looking ahead, with increasing coal production from its Tulameen Coal Basin mine, we forecast earnings per share to be $0.07 in 2005, rising to $0.35 in 2006. The dramatic increase in 2006 earnings results from an increase in thermal coal production to an estimated 500,000 tonnes from an estimated 250,000 tonnes in 2005, and a rise in metallurgical coal production from a test shipment level of 70,000 tonnes in 2005 to 250,000 tonnes in 2006. With the strong demand for coal on world markets, we are assuming that the Company will be successful in selling all that it produces. Our Valuation section is presented on page 17, after the consolidated financial statements.

Financial Statements: The Company's consolidated financial statements, since it went public, are set out following:

Table 2: Compliance Energy Corporation Consolidated Balance Sheet

	Sept. 30/04 (unaudited)	Dec. 31/03 (audited)	Dec. 31/02 (audited)
Assets			
Current Assets			
Cash	2,189,287	1,056,081	441,317
Amounts Receivable	620,778	126,529	136,119
Prepaid Expenses	3,019	25,519	3,019
Total	2,813,084	1,208,129	580,455
Reclamation Bonding	65,000	65,000	65,000
Capital Assets (PPE)	1,150,719	883,329	599,749
Resource Property*	2,359,298	1,474,111	732,397
TOTAL ASSETS	6,388,101	3,630,569	1,977,601
Liabilities			
Current Liabilities			
Accounts Payable	418,757	132,255	245,065
Due to Related Parties	0	85,000	76,000
Total	418,757	217,255	321,065
Deferred gain on joint venture	772,471	772,471	772,471
Total Liabilities	1,191,228	989,726	1,093,536
Shareholders' Equity			
Share Capital	5,705,671	2,943,531	920,665
Contributed Surplus	80,500	80,500	0
Share Issue Obligation	0	0	28,250
Deficit	-589,298	-383,188	-64,850
Total Shareholders' Equity	5,196,873	2,640,843	884,065
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	6,388,101	3,630,569	1,977,601

*The Resource Property consists of nine coal licences covering 2,172 hectares.

Source: Company reports

COMMENT: *Compliance has a satisfactory balance sheet, but it is going to change dramatically in the next few years as the Company needs to finance the cost of building its power plant. This is expected to be achieved through a combination of debt plus equity. For further comment, see the Statement of Cash Flow.*

Table 3: Compliance Energy Corporation Consolidated Statements of Operations and Deficit

($000s)	Nine Months To Sept 30: 2003	2004	Year Ending December 31: 2002	2003	Forecasts Ending December 31: 2004	2005	2006	2007	2008
Revenues									
Coal Sales	0	0	0	0	1,900	18,450	46,250	69,375	92,500
Less: Transport Costs	0	0	0	0	800	8,500	18,375	30,375	36,500
Operating Costs	0	0	0	0	880	6,400	12,150	20,250	25,000
Off-Site Costs	0	0	0	0	160	823	1,563	2,438	2,925
Net Coal Revenue	0	0	0	0	60	2,727	14,162	16,312	28,075
Compliance 70% share	0	0	0	0	42	2,697	13,870	15,829	25,555
Interest Income	0	3	3	3	3	3	3	3	3
Total Net Revenue	0	3	3	3	45	2,700	13,873	15,832	25,558
Expenses									
General & Admin	19	17	3	17	20	25	30	40	50
Professional Fees	40	94	26	87	110	120	120	120	120
Shareholder Communications	13	41	0	49	50	55	60	65	70
Transfer Agent & Filing Fees	11	18	5	19	20	20	20	20	20
Stock-based Compensation	0	0	0	81	90	100	100	100	100
Debt Interest Expense	0	0	0	0	0	0	0	800	7,200
Other Items	0	38	5	68	50	40	30	20	20
Total Expenses	83	209	38	321	340	360	360	1,165	7,580
Net Income/(Loss) For the Period	-83	-206	-35	-318	-295	2,340	13,513	14,667	17,978
Deficit, Beginning of the Year	-65	-383	-30	-65	-65	-359	1,981	15,494	30,161
Deficit, End of the Year	-147	-589	-65	-383	-359	1,981	15,494	30,161	48,139
Shares Outstanding (000s):	23,508	29,147	16,330	23,508	29,147	34,147	38,147	45,147	45,147
Income/(Loss) Per Share	($0.00)	($0.01)	($0.00)	($0.01)	($0.01)	$0.07	$0.35	$0.32	$0.40

Source: Company reports

COMMENT: *Compliance Energy is an early-stage development energy company that has not, as yet, attained production. As a result, so far in its brief life as a public company, it has not produced operating revenue, only expenses. Consequently, the Company has recorded Net Losses, and has had to fund its exploration and development work through access to the capital markets, which it has done successfully to date. Increased production from the Princeton mine in 2005 and the Bear Deposit on Vancouver Island in 2007 should generate significant cash flow in the future and help finance needed investments in infrastructure, and the payments required for leases and land for the power plant. In this respect, the Company will be raising equity in 2005 and both debt and equity in 2006 and 2007. For further comment, see the Statement of Cash Flow.*

Table 4: Compliance Energy Corporation Consolidated Statement of Cash Flow

	Actual: 2002A	2003A	Forecasts: 2004E	2005E	2006E	2007E	2008E
Net Income/(Loss)	-35	-318	-295	2,340	13,513	14,667	17,978
Non-Cash Items:							
Stock-based Compensation	0	81	90	100	100	100	100
Cash Flow from Operations	-35	-238	-205	2,440	13,613	14,767	18,078
Less: Capital Expenditures:							
Capital Assets (PPE)	-567	-284	-300	-600	-55,400	-75,300	-200
Resource Properties	-592	-742	-1,000	-700	-300	-300	-300
Other Items	-15	0	0	0	0	0	0
Free C. F. before W.C. Changes	-1,209	-1,263	-1,505	1,140	-42,087	-60,833	17,578
Changes in Non-Cash W.C. Items	203	-117	-300	0	0	0	0
Free Cash Flow	-1,006	-1,380	-1,805	1,140	-42,087	-60,833	17,578
Property Dispositions	0	0	0	0	0	0	0
Common Equity Issued, net	568	1,995	2,762	5,000	6,000	14,000	0
Debt Issued/(Repaid)	-80	0	0	0	34,000	56,000	-32,000
Other Items	958	0	0	0	0	0	0
Increase/(Decrease) in Cash	440	615	958	6,140	-2,087	9,167	-14,422
Cash/Equivalents, beginning of period	2	441	1,056	2,014	8,154	6,067	15,234
Cash/Equivalents, end of period	441	1,056	2,014	8,154	6,067	15,234	812

Source: Company reports

COMMENT: *Compliance does not, as yet, produce a profit. Cash Flow from Operations is expected to be negative in 2004, before turning positive in 2005. However, the substantial additions to the Company's asset base (Capital Assets) will cause large negative Free Cash Flow in 2006 and 2007, and require significant increases in the Company's total capital, both debt and equity. With Net Income and Cash Flow building strongly in 2007 and 2008 as the Company ramps up its production and sales, no additional financing is anticipated. Our assumptions include the following: (1) the 2005, 2006, and 2007 equity sales are done at $1.00, $1.50, and $2.00 per share respectively; and (2) the 2006 and 2007 debt issues are floated with a coupon of 8% and 9% respectively, with interest deferred until production commences. The 2006 debt is assumed extinguished in 2008.*

VALUATION

In the following table, we set out certain parameters and comparisons of Compliance Energy with other companies operating in the Canadian coal industry. Most of these comparative companies are also just beginning to build up their coal operations. As such, they do not yet have meaningful earnings and, therefore, no meaningful p/e multiples to be used for comparative purposes. We do not consider the Fording Canadian Coal Trust to be a true comparison, but is included here for interest purposes.

Table 5: Coal Industry Comparisons

Companies	Stock Symbol	Recent Share Price	Shares O/S (million)	Share-Holders Equity (MM)	Equity Per Share	Market Cap (million)	Market Cap to S.E.	Saleable Reserves (MM t)	Inferred Reserves (MM t)	Mkt Cap/ Inferred Res.
Fording Coal Trust	FDG.UN	$104.30	49.0	$263.6	$5.38	$5,111	19.4	731	2,500	$2.04
Grande Cache Coal	GCE	$13.62	37.1	$57.7	$1.56	$505	8.8	21	145	$3.48
Pine Valley Mining	PVM	$5.50	64.7	$17.3	$0.27	$356	20.6	20	80	$4.45
Western Canadian	WTN	$6.23	27.8	$20.9	$0.75	$173	8.3	35	109	$1.59
Hillsborough Resources	HLB	$1.78	32.3	$17.5	$0.54	$57	3.3	23	25	$2.30
Compliance Energy	**CEC**	**$0.90**	**29.1**	**$11.3**	**$0.39**	**$26**	**2.3**	**19**	**250**	**$0.10**

Source: eResearch

As previously shown in our financial projections, we estimate that Compliance will report earnings per share of $0.07 in 2005, $0.35 in 2006, and $0.32 in 2007. We consider an appropriate p/e multiple range for junior exploration coal companies to be 4x-6x. Since Compliance is ramping up production in 2005 and will not reach meaningful production until 2006, we will take the mid-point, i.e., 5x, of our p/e multiple range to be applied to the Company's estimated 2006 EPS. On that basis, our projected Target Price 24 months hence is $1.75 per share. Discounting for one year (at 15%) to derive a 12-months price projection gives us our Target Price of $1.50.

The sensitivity table below shows the impact of a five-cent swing in the value of the Canadian dollar, and illustrates how sensitive the potential share value is to the assumed value of the Canadian dollar.

Table 6: Exchange Rate Sensitivity Table

	Earnings Per Share At Exchange Rates			**Target Price @ 5x Multiple At Exchange Rate**		
	0.80	**0.85**	**0.90**	**0.80**	**0.85**	**0.90**
Year						
2005	0.07	0.04	0.02	0.35	0.20	0.10
2006	0.35	0.29	0.24	1.75	1.45	1.20
2007	0.32	0.25	0.18	1.60	1.25	0.90
2008	0.40	0.30	0.20	2.00	1.50	1.00

Source: eResearch

NOTES

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Sell:	Expected total return within the next 12 months is less than the T-Bill rate

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A company may have some but not necessarily all of the following characteristics of a specific risk rating to qualify for that rating:

High Risk: Financial - Little or no revenue and earnings, limited financial history, weak balance sheet, negative free cash flows, poor working capital solvency, no dividends.

Operational - Weak competitive market position, high cost structure, industry consolidating, business model/technology unproven or out-of-date.

Medium Risk: Financial - Several years of revenue and positive earnings, balance sheet in line with industry average, positive free cash flow, adequate working capital solvency, may or may not pay a dividend.

Operational - Competitive market position and cost structure, industry stable, business model/technology is well established and consistent with current state of industry

Low Risk: Financial - Strong revenue growth and earnings over several years, stronger than average balance sheet, strong positive free cash flows, above average working capital solvency, company may pay (and stock may yield) substantial dividends or company may actively buy back stock.

Operational - Dominant player in its market, below average cost structure, company may be a consolidator, company may have a leading market/technology position.

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