

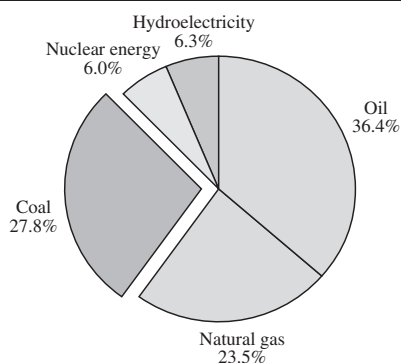
INDUSTRY OVERVIEW

This and other sections of this Prospectus contain information relating to the PRC economy and the PRC coal industry and international coal markets. The information contained within has been derived from official government publications or obtained during communications with PRC Government agencies. Neither we, the Underwriters nor any of their respective affiliates or advisers have independently verified the information directly or indirectly derived from these sources, and such information may not be consistent with other information compiled within or outside China. The Joint Sponsors and our Directors have reproduced the data and statistics extracted from such official government publications in a reasonably cautious manner.

THE WORLD COAL INDUSTRY

Coal is one of the most important energy resources in the world. According to *BP Statistical Review 2006*, worldwide primary energy consumption totaled 10,537.1 million tonnes oil equivalent in 2005, of which coal represented 27.8%, and oil and natural gas represented 36.4% and 23.5%, respectively.

Global Primary Energy Total Consumption in 2005



Source: *BP Statistical Review 2006*

World coal reserves are abundant. According to *BP Statistical Review 2006* estimates, the world's total proved coal reserve base represents approximately 155 years of production at current mining rates. Coal reserves have a wide distribution pattern, with particular concentration in countries including the United States, Russia, China, India and Australia. According to *BP Statistical Review 2006*, these countries controlled 27.1%, 17.3%, 12.6%, 10.2% and 8.6%, respectively, of the proved worldwide coal reserves at the end of 2005.

The continuous rise in global coal consumption in recent years has resulted from various macro factors, including global economic growth, price increases of other energies such as oil and natural gas and improvements in coal mining and processing technologies and productivity.

The Asia-Pacific region is one of the fastest growing economic regions and the largest and fastest growing energy market in the world. According to *BP Statistical Review 2006*, the region's total primary energy consumption increased from 2,589.5 million tonnes oil equivalent in 2000 to 3,423.7 million tonnes oil equivalent in 2005, representing a CAGR of 5.7%. This growth rate was much higher than the growth rates in North America and Europe, which were 0.5% and 1.1%, respectively, for the same period. In 2005, the Asia-Pacific region's primary energy consumption accounted for 32.5% of the worldwide total, higher than North America and Europe (including Eurasia), which accounted for 26.6% and 28.3% of the worldwide total, respectively, in the same year. Demand for energy, including coal, in the Asia-Pacific region is therefore considered to be high.

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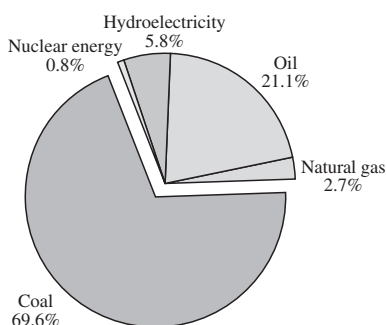
Many major coal consumers and producers are located in the Asia-Pacific region. According to *BP Statistical Review 2006*, coal consumption and production in this region in 2005 accounted for 56.3% and 57.0%, respectively, of global consumption and production. From 2000 to 2005, coal consumption and production in the Asia-Pacific region increased by a CAGR of 8.2% and 9.1%, respectively, far exceeding the growth rates of worldwide coal consumption and production during the same period, which were 4.4% and 5.0%, respectively.

We believe that, in addition to the macro factors mentioned above, the rapid growth of coal demand in the Asia-Pacific region is caused by: (i) the continuous growth of installed coal-fired power capacities in the Asia-Pacific region, which has directly impacted the regional demand for thermal coal; and (ii) the growth of the steel industry, which has directly resulted in increasing demand for coking coal.

THE PRC COAL INDUSTRY

According to *BP Statistical Review 2006*, China is the world's largest coal-producing country, with 2,190.0 million tonnes of raw coal output in 2005, which corresponds to 1,107.7 million tonnes oil equivalent and accounts for 37.4% of global coal production. China is also the world's largest coal-consuming country, with domestic coal consumption amounting to 1,081.9 million tonnes oil equivalent in 2005, accounting for 36.9% of global consumption. *BP Statistical Review 2006* considers coal to be China's most important energy resource, accounting for 69.6% of the country's total primary energy consumption in 2005.

Total Primary Energy Consumption in China in 2005



Source: *BP Statistical Review 2006*

The PRC coal industry is relatively mature compared to other industries, and has the following characteristics:

- abundant coal reserves;
- rapid growth in coal production, demand and transportation capacities; and
- increasingly market-driven pricing mechanisms.

However, the PRC coal industry also faces the following challenges:

- the need for a large transportation infrastructure due to the geographical distances between the locations of coal resources and major coal consumers;

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- the PRC coal industry is undergoing a transition involving the consolidation of numerous small mining operations utilizing outdated technologies into large coal mining operations utilizing advanced technologies; and
- increasingly stringent requirements for safe production and environmental protection.

With increased transportation capacities, improved production technologies, increasing industry consolidation and more extensive usage, coal will maintain its strategic importance as the primary energy source and raw material in China.

The foregoing characteristics and challenges are discussed and analyzed in more detail below:

Abundant Coal Reserves and their Distribution

Coal reserves in China are abundant but unevenly distributed. China ranks third in the world in terms of current proved coal reserves, following the United States and Russia. According to *BP Statistical Review 2006*, China had 114.5 billion tonnes of proved coal reserves at the end of 2005, representing 12.6% of world proved coal reserves. According to the PRC Government, 67% of all the proved coal reserves in China are deposited in Shanxi, Shaanxi, Inner Mongolia and Ningxia, 20% are deposited in Xinjiang, Gansu, Qinghai, Yunnan, Guizhou, Sichuan and Chongqing, and 13% are deposited in other areas including Jiangsu, Anhui, Shandong and Henan.

Coalfields in China with good mining conditions are mainly concentrated in Xinjiang, parts of Ningxia, as well as the area referred to in the industry as the “Tri-West Area”, which consists of Shanxi, Shaanxi and western Inner Mongolia. The Tri-West Area has favorable geological conditions for coal production. Coal reserves in this area are of high quality and contain a wide variety of coal. However, due to limited local consumption and long distances from major customers and major ports, these high-quality coal reserves have not been fully exploited. See “— Growing capacities in coal production and transportation”. The coal reserves in Jiangsu, Anhui, Shandong and Henan are also of a high quality and contain a wide variety of coal. Furthermore, they are close to transportation facilities as they are located in China’s more economically developed coastal regions. The coal reserves in these provinces, however, are relatively limited, representing only 9.2% of the reserves in China.

High Energy Demand in China and the Asia-Pacific Region

China’s economic growth in recent years has led to a surge in the demand for energy. China’s real GDP grew at a CAGR of 9.8% from 2001 to 2005 according to a report by the PRC’s Statistics Bureau in February 2006. In the same period, China’s total primary energy consumption grew at a CAGR of 11.7%.

Coal consumption in China amounted to 2.14 billion tonnes in 2005. The PRC Government estimates that the domestic demand for coal will increase to 2.5 billion tonnes by 2010.

The factors driving the growing demand for coal are as follows:

- *The power industry* — According to EIA data, China’s power industry is the second largest in the world after the United States. According to the Statistics Information Department of China Electricity Council, at the end of 2005, China’s total installed capacity was 508.4 GW, 75.6% of which was generated by coal-fired power plants. According to *China Coal Market Report 2005-2006*, the coal-fired power industry in China generated a total of 1,204.5 billion Kwh in 2001 and 2,018.0 billion Kwh in 2005, consuming 645.6 million tonnes and 1,110.0 million tonnes of coal, respectively. From 2001 to 2005, coal-fired power generation in China grew at a CAGR of 13.8%

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and the consumption of coal for coal-fired power generation grew at a CAGR of 14.5%. We believe the coal-fired power industry will continue to drive future demand for coal in China.

- *The steel industry* — China's steel industry has experienced rapid growth. According to *China Coal Market Report 2005-2006*, annual production of pig iron grew from 147.0 million tonnes in 2001 to 315.0 million tonnes in 2005. China's steel industry consumed 180.0 million and 340.0 million tonnes of coal in 2001 and 2005, respectively. From 2001 to 2005, annual production of pig iron grew at a CAGR of 21.0% and the underlying consumption of coal for the steel industry production grew at a CAGR of 17.2%. We believe that the steel industry will have a steady demand for coal in the foreseeable future.
- *The construction materials industry* — The construction materials industry in China encompasses a wide range of segments, including cement, glass and ceramics. Taking the cement industry for example, according to the *2001 and 2005 National Economic and Social Development Statistic Reports* issued by the Bureau of Statistics, as well as the *China Coal Market Report 2005-2006*, China produced 640.0 million tonnes of cement in 2001 and 1,060.0 million tonnes in 2005, and the cement industry consumed 113.1 million tonnes and 177.0 million tonnes of coal, respectively. From 2001 to 2005, annual production of cement grew at a CAGR of 13.4% and the underlying consumption of coal grew at a CAGR of 11.8%. Due to China's stable economic growth and its increasing urbanization, we believe that the construction materials industry and its demand for coal will grow rapidly.
- *The chemicals and fertilizer industry* — Coal is widely used as a basic industrial material. According to the *2001 and 2005 National Economic and Social Development Statistic Reports* issued by the Bureau of Statistics, as well as the *China Coal Market Report 2005-2006*, China produced 34.0 million tonnes of fertilizer in 2001 and 52.2 million tonnes in 2005, and the fertilizer industry consumed 54.7 million tonnes and 79.1 million tonnes of coal, respectively. From 2001 to 2005, annual production of fertilizer grew at a CAGR of 11.3% and the underlying consumption of coal grew at a CAGR of 9.6%. In China, the coal-based chemicals industry, which relies on coal as a basic raw material, is under development. High-value coal-based chemicals products include tar, raw benzene, methanol and urea. With the expansion and development of large chemicals production facilities, demand for coal as both a raw material and a fuel is expected to grow. According to a PRC official government source, the coal-based chemicals industry is likely to become a new source of growth in the demand for coal.

In the Asia-Pacific region, coal consumption had grown rapidly from 2000 to 2005 at a CAGR of 8.2%. The primary coal export markets for China are Japan, South Korea and China Taiwan. Japan is one of the world's leading importers of coal. According to *BP Statistical Review 2006*, Japan's coal consumption reached 121.3 million tonnes oil equivalent in 2005, while its domestic coal production amounted to only 0.6 million tonnes oil equivalent in the same year. It is expected that Japan will continue to rely heavily on coal imports to meet the growing demand in its power generation and other industries. Similar to Japan, South Korea relies on imported coal. Coal consumption in South Korea reached 54.8 million tonnes oil equivalent in 2005, while its domestic coal production amounted to only 1.3 million tonnes oil equivalent. In China Taiwan, coal consumption accounted for 38.1% of the total consumption of primary energy in 2005. With very limited coal reserves and low coal production, China Taiwan also relies on coal imports. China's coal industry enjoys a unique competitive advantage in the international coal market given China's geographical proximity to these major coal importers in the Asia-Pacific region. As a result, the international demand for China's coal is large and stable.

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China's coal exports are subject to a quota system imposed by the PRC Government. Under this system, only authorized coal exporters may apply for and obtain coal export quotas from the PRC Government. Currently, there are only four authorized coal exporters: ChinaCoal Group, Shenhua Group, China Minmetals Corporation and Shanxi Coal Import & Export Group Company. ChinaCoal Group, our parent company, is currently the largest coal exporter in China. See "Regulation — The Coal Industry — Coal Trading" section in this Prospectus. Although the PRC Government had encouraged coal exports in previous years, serious shortages in coal supply in China since late 2003 led to adjustments in a series of governmental policies including a reduction in the tax refund for exporting coal. See "Regulation — The coal industry — Export". Hence, according to the *China Coal Market Report 2005-2006* published by the Information Centre of the China Coal Transport and Distribution Association, China's coal export volume decreased from 86.7 million tonnes in 2004 to 71.1 million tonnes in 2005.

Growing Capacities in Coal Production and Transportation

The total production of raw coal in China increased from 1,381.5 million tonnes in 2001 to 2,190.0 million tonnes in 2005, representing a CAGR of 12.2%.

China's coal industry is characterized by the uneven distribution of coal reserves and the existence of a large number of small coal production companies. However, the number of large scale coal production enterprises is limited. As of 31 December 2005, according to *China Coal News* published on 3 April 2006, there were a total of 5,206 non-state owned coal production enterprises whose annual revenue exceeded RMB5.0 million and State-owned coal production enterprises. Among these, only 31 enterprises had an annual output of more than 10.0 million tonnes. These 31 enterprises had an aggregate production volume close to 900.0 million tonnes in 2005.

The table below lists the top ten largest raw coal production enterprises in China in 2005:

	<u>Raw coal production</u> (million tonnes)	<u>Percentage of total raw coal production in the PRC</u> (%)
Shenhua Group Corporation	149.7	6.8%
ChinaCoal Group	71.9	3.3%
Shanxi Coking Coal Group Company	60.8	2.8%
Datong Coal Mining Group Company	56.7	2.6%
Heilongjiang Longmei Mining (Group) Co., Ltd.	48.1	2.2%
Yankuang Group Company	37.0	1.7%
Yangquan Coal Group Co.	32.5	1.5%
Huainan Mining Group Co.	32.4	1.5%
Pingdingshan Coal Group Co.	32.1	1.5%
Jincheng Anthracite Group Co.	<u>30.1</u>	<u>1.4%</u>
Total	<u>551.3</u>	<u>25.2%</u>

Source: *Information of Coal Industry January 2006*

Most of China's coal resources are concentrated in the inland provinces of northern and northwestern China. In contrast, most industrial centers and many of China's coal-consuming enterprises are concentrated in the eastern and southern regions. According to the PRC Government, coal production in the Tri-West Area will reach 1,272 million tonnes by 2010, while coal consumption in this region will be merely 437 million

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tonnes. The Tri-West Area will remain the major coal supplying region for exports and for transport to other regions in China. Two-thirds of its coal is supplied to eastern China, central China, southern China, northern China and northeastern China. As a result of the uneven geographic distribution between coal production and consumption, transportation of coal to the eastern parts of China has been critical to China's coal industry. For most coal producers located in the inland areas of China, the railway system has been the most important means of coal transportation.

According to the February 2006 issue of *Economic Information on Coal* jointly published by the Information Department of China National Coal Association and the Dispatch Center of the SACMS, coal transported by railways increased by 79.3 million tonnes from 2004 to 2005 and reached 1,071 million tonnes, representing a year on year increase of 8.0%. Coal is transported to eastern China via a railway system consisting of the Daqin Line, Shuohuang Line, Shitai Line, Houyue Line, Longhai Line and Ningxi Line. The Daqin Line, 653 km long, is China's largest railway line in terms of transportation capacity dedicated to coal transportation. It connects the major coal production bases in the Tri-West Area with the major ports in eastern parts of China. The railway transportation capacity of the Daqin Line was 150 million tonnes of coal in 2004 and was increased to 200 million tonnes in 2005. The PRC Government plans to further increase the Daqin Line's annual transportation capacity to 400 million tonnes by 2010.

A large portion of outbound coal from the Tri-West Area and the Ningxia Autonomous Region is first transported by railway to major ports in China, and then by sea to customers in eastern and southeastern China and overseas. According to *Economic Information on Coal*, the amount of coal transported through major ports in China amounted to 371 million tonnes in 2005, representing approximately 16.9% of China's total coal production in the same year and an increase of 33.3 million tonnes, or 9.9%, from 2004. The major coal loading ports in China are Qinhuangdao, Tianjin, Qingdao, Rizhao and Lianyungang. The major coal unloading ports are Shanghai, Ningbo, as well as certain ports in the Guangdong and Fujian Provinces.

The PRC Government has significantly increased the transportation capacities of major railways and ports for coal transportation so as to alleviate the pressure on railway transportation by domestic coal companies and other enterprises. As demand for energy continues to rise, coal transportation will continue to play a critical role in the development of the coal industry in China. The PRC Government has provided significant support relating to the transportation requirements of large state-owned coal producers. As a result, these enterprises, including us, possess the distinct advantage of reliable access to rail and shipping capacities.

The Trend Towards Market-Driven Prices

Domestic coal prices have been mainly market-driven since 2002, when the PRC Government eliminated the price control measures for coal used in electric power generation. Prior to 2006, however, the PRC Government continued to implement temporary measures to intervene and control unusual fluctuations in thermal coal prices. This, among other reasons, has caused thermal coal contract prices for major users to be generally lower than spot market prices during the period. On 27 December 2005, the NDRC announced the elimination of such temporary thermal coal price intervention practices, thus completely removing control over thermal coal prices, including contract prices for major users.

China's domestic coking coal price is now completely market-driven. In addition to the demand by the steel industry, other factors affecting the price of coking coal include the overall performance of the Chinese economy, business cycles in the metallurgical industry, and coal production and transportation capacities. Since 2003, due to the shortage in coking coal supply and the rapid growth of global steel production, coking coal prices in the domestic and export markets have increased considerably. This increase was partially offset

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by the macro-economic adjustment and control policies implemented by the PRC Government in early 2004 designed to temporarily restrain the growth of the steel industry in China.

Competition in the Coal Market

Affected by factors such as geographical distance between coal mines and coal consumers, supply and demand and timely governmental adjustment, China's domestic coal enterprises mainly compete in the following aspects:

- *Reserves.* To ensure sustainable growth, coal enterprises compete for new resources, the exploration and development of which are subject to governmental approval.
- *Transportation capacities.* Coal enterprises compete for the limited rail and port transportation capacities.
- *Long-term customers.* Coal enterprises compete for long-term customers and sales contracts based on product quality and transportation capacities which can better support their production and operations.
- *Pricing.* Since the price for coal products has become increasingly market-driven, we expect that competition based on price will intensify.

Stricter Regulations on Safety and Environmental Protection

Safe production

Mining safety has always been an area of major concern in China's coal industry. According to SACMS data, there were 5,938 fatalities and 3,306 accidents in China in 2005. 2,480 of such accidents occurred in the coal mines owned and operated by local district governments and private enterprises, 410 occurred in State-owned regional coal mines and 416 occurred in key State-owned coal mines.

In China, both the PRC Government and the country's coal production enterprises have become increasingly aware of the importance of mining safety. The SACMS and the SAWS are the main regulators of mining safety and miners' health. See "Regulations — The coal industry". The PRC Government has also established a Cross-Ministry Coordination Force for Prevention of Gas Incidents in Coal Mines (煤礦瓦斯防治部際協調領導小組) to reduce accidents caused by gas in underground coal mines. In addition, the PRC Government continues to allocate funding in support of improving mining safety.

The PRC Government requires operators of coal mines to regard safe production as their top priority. The PRC Government requires coal production enterprises to set aside funds to maintain and improve safe production. In addition, coal production enterprises offer various training programs to educate their mining workers to raise their awareness of safety.

According to the statistics from the SACMS, in the past several years, with the collective efforts of the relevant authorities and coal production enterprises, the PRC Government has shut down over 60,000 small mining operations that were not equipped with the requisite facilities to ensure safe production. During the same period, the PRC Government increased its efforts in consolidating mining operations. A large number of coal mines have passed safety inspections and have progressively enhanced their standards of safe production.

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Environmental protection

In recent years, environmental protection has become an increasingly important factor for the PRC Government to consider when planning for economic development. The PRC Government plans to make further efforts to reduce the discharge and emission of pollutants, such as carbon dioxide and sulphur dioxide, released by certain major industrial sectors. China is a signatory to the Kyoto Protocol and the UNFCCC Convention on Climate Change.

China is making considerable efforts to develop clean coal technology. The PRC Government encourages the development of coal processing, coal blending and coal briquette technologies to improve coal selection and processing, as well as the use of advanced coal-burning and environmentally friendly technologies to increase utilization rates and reduce the emission of pollutants. The PRC Government also actively encourages the comprehensive utilization of coal resources by developing the usage of coal gangue, coal slurry, coal bed methane, the subsurface water and other by-products, as well as developing low thermal coal-fired electric power generators and building materials.

Outlook for the PRC's coal industry

Based on the foregoing, the continued development of the PRC's coal industry depends on the following government and corporate initiatives:

- *Accelerate the construction of large-scale coal production bases*

According to a PRC official government source, the PRC Government is implementing a strategy to establish 13 large coal production bases in the Shaanxi and Shanxi provinces and certain other regions. The objective is to create a number of large enterprises in the next three to five years, each with a minimum annual production capacity of 100 million tonnes. These 13 large coal production bases include 98 major coal mining areas with total coal resources of approximately 852.8 billion tonnes, representing 83.5% of China's total coal resources. In 2005, total production in these 13 coal production bases amounted to 1.8 billion tonnes, representing 83.6% of total coal production in China. In these coal production bases, the resource consolidation process will be considered by the PRC Government in granting mining rights. To centralize coal production, the PRC Government has stated that it will drive structural reforms of the domestic coal industry, develop large production bases and nurture large enterprises. Through structural reforms and integration at these production bases, the PRC Government's objective is to optimize resource allocation, increase production scale and provide a solid platform for the continuing growth of major coal enterprises.

- *Enhance productivity and eliminate outdated methods of production*

The PRC Government supports the restructuring of the coal industry and encourages large coal enterprises to acquire small and mid-sized mines in order to increase production scale and enhance competitiveness in the marketplace. The PRC Government's policy is to improve the overall productivity of the industry and the stability of the coal market by closing down small mines that utilize outdated technologies and are not equipped with the necessary facilities to ensure mining safety. The construction of coal mines must comply with governmental policies. To the extent possible, coal producers should expand their coal mining operations through integration of existing mines. To improve the safety and productivity of the coal industry, the PRC Government has stated that it will give priority to projects involving the construction of large, modernized open pit mines as well as underground mines that have annual production capacities of over 10 million tonnes. The PRC Government has stated that it will also give priority to integrated projects of coal

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mining and power generation, and projects of coal mining and coal-based chemical production, thereby strictly controlling the development of small mining operations.

- *Intensify, develop and manage coal resources*

The PRC Government is reforming the coal market based on existing laws and regulations over mineral resources and coal resources. The PRC Government divides coal resources into development, reserve and protection areas in order to establish the preservation mechanism for scarce and high-quality coal resources. Mining rights are controlled and allocated by the central government and the local government of the respective province, autonomous region or municipality directly under the central government. The PRC Government further regulates preservation of coal resources in accordance with the plan for national economic development.

- *Implement a compensation scheme for the exploitation of coal resources*

The PRC Government and the coal industry are focused on the preservation and efficient utilization of coal resources. Through the reform of the resource tax system and the implementation of a compensation scheme for coal resource exploitation, the PRC Government is committed to raising the entry barrier into the coal industry and further preventing the wasteful exploitation of coal resources in order to balance supply and demand. New fees for coal resources exploitation will no longer be calculated on production volume but will instead be based on reserve volume and recovery rate. Therefore, the cost of resources, environmental protection, safety, technology and labor insurance premiums are expected to constitute a higher percentage of the total mining cost.