



**PAN ORIENT ENERGY CORP.**

**2006 MANAGEMENT'S DISCUSSION AND ANALYSIS**

FOR THE YEAR ENDED DECEMBER 31, 2006

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following Management's Discussion and Analysis ("MD&A") is prepared effective May 1, 2007 and should be read in conjunction with the audited consolidated financial statements and notes thereto for the years ended December 31, 2006, and 2005. The financial statements have been prepared in accordance with accounting principles generally accepted in Canada.

The MD&A contains forward-looking information regarding the Company. Because forward-looking information addresses future events and conditions, it involves risks and uncertainties that could cause actual results to differ materially from those contemplated by the forward-looking information. These risks and uncertainties include, but are not limited to: commodity price levels; production levels; royalty and depletion rates; the recoverability of reserves; transportation availability and costs; operating and other costs; interest rates and currency exchange rates; and changes in environmental and other legislation and regulations.

Pan Orient Energy Corp. ("Pan Orient" or the "Company") is a junior oil and natural gas company based in Calgary, Alberta, which holds properties in northern Alberta and onshore Thailand and actively pursues opportunities in Asia for the acquisition of exploration acreage and exploration of oil and natural gas.

### Welwyn Reverse Take-Over

On April 8, 2005, Pan Orient Energy Corp. (formerly Welwyn Resources Ltd.) acquired of all of the issued and outstanding shares of Pan Orient Energy Ltd. This reverse take-over resulted in a change of control of Pan Orient, including the resignation of all of the then current officers and directors and the appointment of all of Pan Orient Energy Ltd.'s officers and directors to the corresponding positions of Pan Orient. As a result of the transaction, the former shareholders of Pan Orient Energy Ltd. acquired control of Pan Orient.

As Pan Orient Energy Ltd. is deemed to be the acquirer, the consolidated financial statements prior to April 8, 2005, reflect only the accounts of Pan Orient Energy Ltd. Prior to the Reverse Take-Over, the Company had not conducted any operations other than the acquisition of non-producing oil and gas properties and as such its interest income and administrative expenses prior to that date were capitalized as acquisition costs. Included in the financial statements are the accounts of Pan Orient (formerly Welwyn Resources Ltd.) from April 8, 2005, forward.

### Tiger Acquisition

On October 21, 2005, Pan Orient acquired 92 percent of the issued and outstanding shares of Tiger Petroleum Inc., ("Tiger"), as such the accounts of Tiger are included in the financial statements from October 21, 2005, forward. The remaining 8 percent of Tiger shares were acquired early in the first quarter of 2006, in exchange for 319,163 Pan Orient common shares, under the compulsory acquisition provisions contained in the Quebec Companies Act, and the Tiger shares were delisted from TSX venture exchange. Included on the Company's 2005 balance sheet is a non-controlling interest value related to the final 8 percent of shares that were acquired in January 2006.

### Andora Acquisition

During the three months ended September 30, 2006 the Company acquired 67 percent of the issued and outstanding shares of Andora Energy Corporation ("Andora"). This was done via a series of transactions resulting in: (i) the disposition of the Company's Canadian oil and natural gas properties (Sawn Lake assets) in exchange for 10,000,000 shares of Andora; (ii) the Company subscribing for 4,981,481 Andora common shares for \$6,275,000 cash; and (iii) the Company acquiring an additional 13,414,634 Andora common shares from existing Andora common shareholders for consideration of \$2,145,621 in cash and the issuance of 4,257,222 Pan Orient shares. Andora is a private oil and gas company with oil sand leases in the Sawn Lake area of Northern Alberta. The Company's 100% owned subsidiary (Pan Orient Energy Ltd.) and Andora then amalgamated, immediately prior to which time all of Pan Orient Energy Ltd.'s remaining assets were transferred to Pan Orient Energy Corp.

As a result of other parties owning the remaining 33% of Andora, Pan Orient's financial statements record a non-controlling interest representing the portion of assets and liabilities not owned by Pan Orient.

### Selected Quarterly Information

	2006				2005		
	Q4	Q3	Q2	Q1	Q4	Q3	Q2
<b>Revenues</b>							
Oil - Thailand	\$ 430,609	263,586	265,171	297,081	274,963	-	-
Royalties - Thailand	(52,150)	(36,808)	(37,247)	(53,075)	(33,288)	-	-
Interest - Canada	206,949	206,823	247,971	43,084	61,523	54,472	49,890
	<u>585,408</u>	<u>433,601</u>	<u>475,895</u>	<u>287,090</u>	<u>303,198</u>	<u>54,472</u>	<u>49,890</u>
<b>Expenses</b>							
Stock based compensation	518,412	254,331	677,024	323,354	101,553	96,920	484,600
General and administrative	710,536	390,792	432,441	209,491	173,199	110,776	117,644
<b>Foreign new ventures</b>							
expenditures	126,297	-	-	-	257,601	-	-
DD & A	444,311	135,205	120,738	143,609	98,054	2,943	2,943
Production and operating	535,360	64,642	115,033	109,171	67,969	-	-
Non-controlling interest	(29,139)	-	-	-	4,440	-	-
<b>Interest on convertible</b>							
debentures	-	-	-	-	4,017	-	-
Foreign exchange loss (gain)	(201,477)	(20,394)	51,653	29,093	-	-	-
Future income tax reduction	(1,072,000)	-	-	-	-	-	-
	<u>1,032,300</u>	<u>824,576</u>	<u>1,396,889</u>	<u>814,718</u>	<u>706,833</u>	<u>210,639</u>	<u>605,187</u>
Net loss	\$ (446,892)	(390,975)	(920,994)	(527,628)	(403,635)	(156,167)	(555,297)
Loss per share	\$ (0.01)	(0.01)	(0.03)	(0.02)	(0.02)	(0.01)	(0.02)

### OIL AND GAS ASSETS

The Company's principle oil and gas assets consist of a:

- 60 percent working interest in 2,000,000 acres of exploration and production licenses onshore Thailand. This is held in 2 concessions; L44/43 which currently has oil production and L33/43 which currently has no production. Pan Orient is the operator of both of these concessions.
- 100 percent working interest, with Pan Orient as operator, in a 1,000,000 acre concession onshore Thailand. This Concession was awarded to the Company in January 2007, and as such currently has no production or recognized reserves.
- 67 percent ownership of Andora Energy Corporation, a private oil and gas company with oil sand leases containing probable + possible recoverable reserves of 179 million barrels of oil, as defined by an independent third party engineering firm. This property currently has no production.

### HIGHLIGHTS

The Company recorded oil revenues of \$1,256,447 for the year ended December 31, 2006, an increase of 357% over the \$274,963 recorded in 2005. Thailand oil production averaged 118 bbl/d, net to Pan Orient, in the final three months of 2006, as results of the Company's drilling program started to be realized. Thailand oil production for the year averaged 69 bbl/d. Current production, as a result of the POE-9 oil discovery, averages approximately 440 bbl/d, net to Pan Orient. Oil prices averaged \$49.98/bbl during 2006. Oil revenues are expected increase substantially in the near future as the Company began drilling in April 2007 on its announced up to 37 well program.

Royalty expenses on Thailand oil production were \$179,280 during 2006 (up from \$33,288 in 2005), or 14% of sales. The included government royalty is 5% of gross production up to 2,000 bbl/d, and increases to 6.25% for gross production between 2,000 bbl/d and 5,000 bbl/d. Also included in royalty expense is a 10% gross overriding royalty on the bulk of production area in the Wichian Buri oil field. Drilling outside of this overriding royalty encumbered area will only be subject to the government royalty. The Company's recent POE-9 oil discovery is not subject to the gross overriding royalty. As a result royalties as a percentage of income are expected to decrease in 2007.

At December 31, 2006 the Company had approximately \$16.1 million of cash on hand, including \$0.6 million cash inside Andora. Interest income for the 2006 year was \$704,827, compared to \$165,885 in 2005.

Non-cash stock based compensation expenses totaled \$1,773,121 in 2006, up from \$683,073 in 2005. As required under Canadian GAAP, the Company uses the fair value method to account for its stock based compensation.

General and administrative expenses (G&A) for 2006 totaled \$1,743,260, as compared to \$401,619 in 2005. Activities ramped up in 2006 on many fronts. Firstly, Tiger was not acquired until October of 2005, and as such 2006 was the first full year of Thailand G&A. Secondly, the Thai staff level was dramatically increased in preparation for the second half of 2006 Phase I drill program. Lastly, the Andora acquisition, in September 2006, added G&A costs to Pan Orient for consolidated financial reporting purposes during the last three months of the year. The Company does not anticipate any significant G&A increases, as it feels it is adequately staffed for future growth in its Thai operations.

Thailand production and operating costs totaled \$824,206 (\$26.83/bbl, net of workovers) in 2006 (2005-\$67,969). Included in production and operating costs was a fourth quarter workover program of approximately \$150,000 on the pre-existing Thai wells. A significant portion of the Thailand operating costs are fixed, including expatriate production managers' salaries. Per barrel Thailand production and operating costs are expected to fall as production further increases.

Depletion, depreciation and accretion (DD&A) totaled \$843,863 during 2006 (2005- \$103,940). The largest component was depletion of \$678,000 (\$26.97/bbl) relating to Thailand oil production.

The Company expensed \$126,297 in foreign new venture expenditures in 2006 (2005- \$257,601). These expenses relate to costs incurred on the Company's NELP-VI bid in India during the year.

As a result of holding both Thai baht and US dollar currency, the Company posted a foreign exchange gain of \$141,125 in 2006.

The 2006 loss of \$2.3 million (\$0.07 per share) is mainly attributable to non-cash stock based compensation of \$1.8 million and DD&A of \$0.8 million offset by a future income tax reduction of \$1.1 million. During 2005, the Company posted a loss of \$1.1 million (\$0.05 per share).

During 2006, the Company raised approximately \$28.0 million, net of commissions and related expenses, via the issuance of 8 million shares in a brokered private placement. Cash expenditures during 2006 included approximately \$8.9 million related to the Company's 67% acquisition of Andora, \$11.3 million on petroleum and natural gas properties including drilling of 8 wells (Thailand), a 245 square kilometer 3D seismic shoot (Thailand), and Andora's purchase for \$2.8 million of a Sawn Lake gross overriding royalty, \$1.1 million for refundable customs deposits in Thailand, and a \$0.9 million net cash loss, while net non-cash working capital decreased \$1.7 million.

## **LIQUIDITY**

At December 31, 2006, Pan Orient had approximately \$17.1 million of working capital with \$16.1 million of that in cash deposits. Approximately \$0.6 million of working capital resides inside Andora and is available for its heavy oil program. The remaining \$16.5 million of working capital is inside of Pan Orient and its Thai subsidiaries and is available for:

- the approved Phase 2, Thai drill program, of up to 37 wells, which began in April 2007;
- the Company's three year firm work program of a minimum \$1.87 million USD on its 100% owned L53/48 Thai concession that was awarded in January 2007;
- the potential exercise by the Company of 2,250,000 Andora warrants for \$3,600,000 (\$1.60 per share). These warrants were received in conjunction with the 4,981,481 Andora common share subscription; and
- continued new venture activities focused on Thailand, India, Indonesia, and China.

If the Company requires additional capital beyond its existing cash, it will likely be sourced through additional equity financing.

Included in the accounts receivable balance of \$2.9 million are cash calls to the Company's joint venture partner, of \$2.15 million, which was collected subsequent to December 31, 2006.

The Company is listed on the TSX Venture Exchange. The fully-diluted number of common shares outstanding at the following dates were:

<u>Shares Outstanding</u>	<b>May 1 2007</b>	<b>December 31 2006</b>
Common shares	40,056,842	40,056,842
Employee stock options	3,793,150	3,793,150
Underwriter compensation options	240,000	240,000
Fully-diluted shares outstanding	<b>44,089,992</b>	<b>44,089,992</b>

#### **COMMITMENTS**

The Company has entered into agreements to lease premises in both Canada and Thailand, requiring future minimum payments totaling approximately \$1.1 million. Minimum annual payments during the next five fiscal years are as follows:

2007	\$ 180,570
2008	\$ 187,463
2009	\$ 163,288
2010	\$ 142,680
2011	\$ 142,680

The Company also has a commitment to spend \$500,000 USD on its Thai blocks during the first 6 months of 2007.

#### **SUBSEQUENT EVENT**

On January 9, 2007, the Company signed a new concession agreement with the government of Thailand for block L53/48, located onshore Thailand. The concession agreement includes a minimum three year first exploration phase commitment of \$1,870,000 USD, for which the Company posted a standby letter of credit, secured by cash, in 2007.

#### **CRITICAL ACCOUNTING POLICIES**

Pan Orient follows the full cost method to account for its petroleum and natural gas operations, whereby all costs of exploring for and developing petroleum and natural gas reserves are capitalized and accumulated in country-by-country cost centres. These capitalized costs will be depleted using the unit-of-production method based on estimates of proved reserves. The costs in cost centres from which there has been no commercial production are not subject to depletion until commercial production commences. These capitalized costs are assessed to determine whether it is likely such costs will be recovered in the future. Costs which are not likely recovered in the future are written-off.

The Company follows the liability method of accounting for income taxes. At the end of each reporting period the Company estimates its tax pool balances and quantifies differences between the tax pools and the accounting balances. The Company has an excess of tax pools over its accounting balances. The determination of the amount of the tax asset is a matter of judgment. With the complexity of income tax laws and the use of estimations in determining the utilization of income tax pools, the income tax asset or liability may differ from that recorded.

Tax liabilities require interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of time. Accordingly, the actual income tax asset or liability may differ from that recorded.

#### **CHANGE IN ACCOUNT POLICIES - FINANCIAL INSTRUMENTS**

Effective January 1, 2007, Pan Orient will be required to prospectively adopt new Canadian accounting standards relating to accounting for financial instruments. Under the new standards, Pan Orient must recognize all financial instruments and non-financial derivatives, including embedded derivatives, as assets or liabilities and report them in its financial statements. Fair value accounting is deemed to be the most relevant measure for financial instruments and the only relevant measure for derivative financial instruments. Fair value accounting involves recording the financial instrument in the balance sheet as either an asset or a liability with changes in the fair value reflected in net earnings, regardless of whether the change in fair value has been realized or not. In addition, the new standards provide that hedge accounting treatment is available for items designated as being part of an effective hedging relationship. Management is in the process of assessing all of its financial instruments and the corresponding impact on its financial statements.

#### **BUSINESS RISK**

Companies engaged in the oil and gas industry are exposed to a number of business risks, which can be described as operational, financial and political risks, many of which are outside of Pan Orient's control. More specifically these risks include risks of economically finding reserves and producing oil and gas in commercial quantities, marketing the production, commodity prices, environmental and safety risks, and risks associated with the foreign jurisdiction in which it operates. In order to mitigate these risks, the Company has an experienced base of qualified personnel, technical and financial in both Canada and Thailand, and maintains an insurance program that is consistent with industry standards. Further, the Company has focused its foreign operations in a known hydrocarbon basin in a jurisdiction that has previously established long-term oil and gas ventures with foreign oil and gas companies.

#### **DISCLOSURE CONTROLS AND PROCEDURES**

The Company's Chief Executive Officer and Chief Financial Officer are responsible for establishing and maintaining the Company's disclosure controls and procedures. The Company's Chief Executive Officer and Chief Financial Officer are kept fully apprised of all material information affecting the Company so that they may evaluate and discuss this information and determine the appropriateness and timing for public release. Access to such material information by the Chief Executive Officer and Chief Financial Officer is facilitated by the fact that there are a limited number of senior management and there is frequent and regular communication between them.

The Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the Company's disclosure controls and procedures as of December 31, 2006, have concluded that the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company would have been known to them. The CEO and CFO have individually signed certificates to this effect.

It should be noted that while the Company's Chief Executive Officer and Chief Financial Officer believe that the Company's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures or internal control over financial reporting will prevent all errors or fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. The design of a control system must reflect the fact that there are resource constraints and the benefits of controls must be considered relative to their costs.

#### **INTERNAL CONTROL OVER FINANCIAL REPORTING**

The CEO and CFO are responsible for designing internal controls over financial reporting or causing them to be designed under their supervision in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian Generally Accepted Accounting Principles.

Management has designed internal controls over financial reporting as at December 31, 2006. The Company has knowledgeable and competent accounting staff to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements. The relatively small number of staff makes the identification and authorization process relatively efficient however during our review of the design of internal controls over financial reporting it was noted that, due to the limited number of staff, it is not feasible to achieve complete segregation of incompatible duties nor does the Company have a sufficient number of financial personnel with all the technical accounting knowledge to address complex and non-routine accounting transactions that arise. This may lead to inaccuracies in financial reporting. This weakness is considered to be a common area of deficiency for many smaller listed companies. Additional accounting staff will be added as the Company grows and this is expected to ultimately remediate the weakness.

#### **ADDITIONAL INFORMATION**

Additional information relating to the Company can also be found on SEDAR at [www.sedar.com](http://www.sedar.com).



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