Consolidated Highlights

(unaudited) Year ended December 31,	**2007**	2006	2005
Financial *($000s)*			
Oil and gas revenue	**63,534**	51,501	36,056
Net (loss) earnings	**(1,091)**	5,080	12,831
Cash flow	**35,997**	27,962	23,351
Total assets	**175,765**	161,736	120,970
Net debt	**37,505**	29,709	18,020
Net (loss) earnings per share *($ per share)*			
Basic	**(0.02)**	0.10	0.27
Diluted	**(0.02)**	0.10	0.26
Cash flow per share *($ per share)*			
Basic	**0.67**	0.56	0.49
Diluted	**0.64**	0.53	0.47
Weighted average common shares *(000s)*			
Basic	**54,095**	50,378	47,239
Diluted	**56,318**	53,004	49,976
Production Volumes			
Natural gas *(mcf/d)*	**19,838**	16,610	11,087
Natural gas liquids *(bbls/d)*	**468**	324	72
Crude Oil *(bbls/d)*	**125**	94	24
Total *(boe/d)*	**3,899**	3,186	1,944
Sales Prices			
Natural gas *($/mcf)*	**7.12**	6.92	8.40
Natural gas liquids *($/bbl)*	**50.12**	59.92	55.42
Crude oil *($/bbl)*	**75.09**	71.37	68.37
Total *($/boe)*	**44.65**	44.29	50.83
Netbacks *($/boe)*			
Price	**44.65**	44.29	50.83
Financial instrument – unrealized	**(2.01)**	2.69	(0.07)
Royalties	**(6.57)**	(7.76)	(7.93)
Operating costs	**(7.97)**	(6.97)	(5.78)
Transportation	**(0.95)**	(0.97)	(0.83)
General and administrative	**(2.16)**	(2.07)	(2.54)
Total	**24.99**	29.21	33.68
Capital *($000s)*			
Drilling & completions	**26,718**	46,893	39,622
Facilities	**12,381**	17,785	9,990
Land & lease	**4,383**	5,230	6,289
Seismic	**2,416**	1,603	1,760
Capitalized G&A	**2,652**	1,953	1,402
Exploration and development capital	**48,550**	73,464	59,063
Property disposition	**–**	(10,842)	–
Other capital assets	**160**	269	94
Total	**48,710**	62,891	59,157
Drilling Activity			
Gross wells	**48.0**	41.0	58.0
Net wells	**26.3**	23.2	36.9

Corporate Information

Officers

Jean-Paul H. Lachance
Vice President, Engineering

R. Bruce McFarlane
Vice President, Exploration

Peter C. Parkinson
Vice President, Land

John W. Rossall
President and Chief Executive Officer

George D. K. Yee
Vice President, Finance,
Chief Financial Officer
and Corporate Secretary

Directors

Brian E. Hiebert (1),(2)
Chairman of the Corporate Governance and Compensation Committee

President, B&G Energy
Calgary, Alberta

Kyle D. Kitagawa (1),(2)
Chairman of the Audit Committee

Managing Director, North River Capital Corp.
Calgary, Alberta

Ian MacGregor (1),(2)
President, North West Capital
Calgary, Alberta

John W. Rossall
President and Chief Executive Officer
ProspEx Resources Ltd.
Calgary, Alberta

Stephen J. Savidant
Chairman of the Board of Directors

Independent Businessman
Calgary, Alberta

(1) Member of the Corporate Governance and Compensation Committee

(2) Member of the Audit Committee

Auditors
KPMG LLP
Calgary, Alberta

Solicitors
Bennett Jones LLP
Calgary, Alberta

Bankers
Canadian Imperial Bank of Commerce

Independent Reserves Evaluator
GLJ Petroleum Consultants Ltd.
Calgary, Alberta

Registrar and Transfer Agent
Olympia Trust Company
Calgary, Alberta

Stock Exchange Listing
The Toronto Stock Exchange
Trading Symbol: PSX

Website
www.psx.ca

Head Office
ProspEx Resources Ltd.
2500 Bow Valley Square III
255 - 5th Avenue SW
Calgary, Alberta T2P 3G6

Phone: (403) 268-3940
Fax: (403) 268-3987

ProspEx

Forward-Looking Information

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ProspEx Resources Ltd.

Annual Report 2007

ProspEx

Company Profile

PROSPEX RESOURCES LTD. ("ProspEx" or the "Company") is a Calgary-based junior oil and gas company focused on exploration for natural gas in the Western Canadian Sedimentary Basin. ProspEx has successfully executed a "drill bit" growth strategy for the past three years, with production increasing by roughly two and a half times over that period. In 2007 ProspEx continued to add production and reserves as a result of the quality of its assets, the skills of its technical team and the steps taken during the year to reduce finding and development costs. With the clear objective of becoming an intermediate-sized energy company, ProspEx is focused on continued growth through the drill bit, combined with new focus on acquisition opportunities. The Company exited the year with a strong balance sheet following a successful equity financing.

The Annual General Meeting of ProspEx's shareholders will be held on Tuesday, May 13, 2008, at 10:00 a.m. in the Lecture Theatre of the Metropolitan Centre, 333 - 4th Avenue S.W., Calgary, Alberta. All shareholders are welcome to attend. Those unable to do so are invited to complete, sign and return a form of proxy.

President's Message

TO OUR SHAREHOLDERS,

As I reflect on the year 2007 at ProspEx, the theme that stands out is one of strong results in the face of an exceptionally challenging business environment. Our drilling program continued to generate superior results, resulting in a year of significant growth – our production increased by 22 percent. Our finding and development costs were down substantially compared to 2006 due to steps we took to drive down our own cost base, combined with a decline in overall industry service costs. Just as importantly, we are in a very strong financial position, with an effective hedging program and a year end equity issue leading to year end debt equivalent to only one year's cash flow.

Operationally, our team has continued to deliver. By year end 2007, production had reached 3,922 barrels of oil equivalent ("boe") per day compared to 3,164 boe per day at year end 2006. This production growth was spread across the Company's asset base, with success in all three core areas contributing to growth in 2007. Our drilling program for the year was highlighted by some notable successes, including:

- A prolific discovery in the Deep Basin that came on stream in March 2007 and added close to 900 boe per day net to ProspEx over the remainder of the year;
- The extension of our West Central Cardium play at Harmattan, where new facilities were commissioned in May 2007 to bring on more than 400 boe per day of new production averaged over the last eight months of 2007. We expect to bring another 500 boe per day of production onstream in the first quarter of 2008;
- Continued drilling success in the Cardium at Ricinus and the successful acquisition of our largest partner's interests in the area resulted in a doubling of Ricinus production; and
- The first production from Granum, our new area in Southern Alberta, and the maintenance of our base of production and cash flow from the Medallion property.

All of these accomplishments were achieved in the midst of an exceptionally difficult business environment. Over the past year, there has been a confluence of external factors that combined to make 2007 a very challenging year for natural gas producers of our size in Alberta. At the start of the year, the capital markets recoiled from the Federal government's announcement in late 2006 of a change in taxation policy affecting income trusts. This triggered a wholesale revaluation of junior oil and gas stocks in sympathy with trust valuations. Later in the year, the "sub-prime" mortgage crisis in the U.S. led to further instability in the capital markets, from which these markets have yet to fully recover. In the commodity markets, a surging Canadian dollar reached levels not seen in more than 30 years, thereby depressing the prices that ProspEx receives in Canadian dollar terms. Further downward pressure on gas prices resulted from the warm winter of 2006/2007 and high levels of LNG imports to North America over the summer of 2007. And finally, in October the Province of Alberta announced a new royalty framework that is much more sensitive to gas prices, production rates and drilling depths. This new framework will result in higher royalties being levied on many wells, with lower royalties on lower productivity wells, adding complexity and further challenges to our industry.

Clearly, these changes in the business environment present challenges to ProspEx. We believe, however, that the Company is well positioned to meet these challenges, indeed we believe that the current business environment provides better opportunities to position ProspEx for profitable, long-term growth than we have seen since the inception of the Company in late 2004. From the start, we have set out to build a broad portfolio of investment opportunities capable of sustaining long-term growth. Taxation of income trusts is driving the business model of junior oil and gas companies towards this idea of longer-term growth, a model we have embraced from the outset. Similarly, the portfolio approach is anticipated to allow us to allocate capital to projects with better returns under the new royalty framework, helping to mute its impacts. While lower gas prices challenged the economics of some of our projects, oilfield service costs have declined markedly from the overheated highs of 2006 in response to lower activity levels. In fact, the Company achieved a better "recycle ratio" – a measure of the profitability of the capital we invest – in 2007 than we did in 2006.

We have diversified our asset base over the past three years and now have a broader portfolio of low, medium and higher risk exploration and development options to drive our drill bit growth strategy. Our exploration team has demonstrated that they can identify and drill higher risk/higher reward or "high impact" prospects that can significantly increase production and reserves. Our Deep Basin discovery in 2007 was an example of this type of success, coming on stream at 17 million cubic feet ("mmcf") per day – to put this in context, this well may end up as one of the ten most prolific gas wells drilled in Canada in 2007, out of the more than 10,000 gas wells drilled by industry over the year. Two high impact wells at Salter and Edson are being drilled in the first quarter of 2008 and offer upside to the Company's growth prospects. Although the nature of our assets suggests that our growth profile will be "lumpy", we expect to see continued success from our "bread and butter" drilling program, and continued growth in production and reserves.

Perhaps most importantly, the Company has a solid financial footing that should allow us to continue our programs in the face of lower natural gas prices. Our net debt at the end of 2007 was only $37.5 million, or approximately the same as our cash flow for 2007. We believe in funding our capital program through debt, judicious issues of new equity and cash flow protected by a hedging program. As a result, the Company's balance sheet should remain strong and will allow us to pursue new opportunities as they arise. We also have a significant volume of our production hedged through 2008, providing additional confidence that cash flow will be in place to fund our program.

The depressed price environment for natural gas over the last few years has reduced the value of many gas-prone assets and created a window of opportunity for companies with the financial and technical abilities to identify and execute acquisitions. We believe ProspEx is ideally suited to take advantage of that opportunity. As our Ricinus acquisition demonstrates, we have migrated to a more balanced strategy of acquisitions as well employing our proven strategy of growth through the drill bit.

We have a strong management team with the experience and skills to manage a larger organization, coupled with a highly skilled technical team. We have continued to build that team as our asset base expands, with a staff of 34 currently, compared to 26 at the start of 2007. We have generated a balanced portfolio of drilling opportunities that are expected to provide us "bread and butter" plays that generate cash flow and steady growth, as well as exploration prospects that can yield high impact wells. With our continued investment in people and assets, we are confident our drill bit growth will continue. We have also added a focused approach to acquisitions as a key strategy to take advantage of opportunities in the current business environment. We believe we have the talent to grow ProspEx to the "intermediate" production level, and our objective is to build the asset base capable of that level of production, with acquisitions as a key part of that strategy.

In closing, I would like to thank all the ProspEx people for their support in delivering what I believe are excellent results in a year of difficult challenges and I am looking forward to working together to take on the continued challenge and opportunity that 2008 will bring.

On behalf of the Board of Directors,

John W. Rossall

John W. Rossall
President and Chief Executive Officer

Operations Overview

PROSPEX OWNS RIGHTS to 143,000 net undeveloped acres of land, largely located within the gas saturated deep basin fairway along the western margin of Alberta. During 2007 the Company continued to pursue a drill bit growth strategy in these areas, with the objective of growing production and reserves while maintaining superior cost performance. The Company has also incorporated acquisitions into its growth strategy, with the acquisition of assets in the Ricinus area announced in late 2007. In 2008 the Company plans a capital program of $55 million, which is expected to fund the drilling of approximately 45 to 50 gross wells.

West Central Alberta

WEST CENTRAL ALBERTA is a key growth area for ProspEx. ProspEx owns 81,000 net acres of undeveloped lands in West Central Alberta, including higher risk/higher reward "high impact" exploration properties that provide a variety of growth opportunities with year-round access. ProspEx operates in four areas within West Central Alberta: Harmattan, Ricinus, Willesden Green and Garrington.

In 2007 the Company's greatest focus in West Central Alberta was on the Cardium formation in Harmattan and Ricinus, where six of the Company's nine West Central wells were drilled. ProspEx commissioned a new oil facility in Harmattan in May 2007 that produced over 400 boe per day over the balance of the year. Additional drilling along this trend was successful over the course of the year, and an additional 500 boe per day of new production is expected to come on stream late in the first quarter of 2008. At Ricinus, a successful drilling program prompted the acquisition of partner assets producing approximately 360 boe per day late in the year, doubling the Company's production in the area.

In Willesden Green and Garrington, the Company has a concentrated land position, typically held at high working interests. ProspEx drilled three wells in these areas in 2007. The primary targets in Willesden Green are the Glauconitic, Viking and the deeper Rock Creek; while in Garrington, the Company is pursuing both Ostracod and Elkton prospects. The Ostracod prospects are largely development drilling opportunities, which offset existing production, while the Mississippian Elkton play is a deeper exploration play driven by the interpretation of 3-D seismic data.

In 2008 ProspEx plans to spend approximately 35 percent of its capital budget in West Central Alberta.

Deep Basin

THE DEEP BASIN offers multiple productive horizons in a pervasively gas saturated environment with the potential to drill higher productivity wells. These characteristics make it another key growth area for ProspEx.

In the Kakwa area ProspEx is pursuing stacked sweet gas plays of Cretaceous age, from the shallower Cardium down to the Cadotte, Falher, Bluesky and Gething formations. The Company has a large land position in the area, which is held at high working interests. ProspEx drilled two wells in the area in 2007, both of which were successful. Elsewhere in the Deep Basin, ProspEx is working on proving up "resource play" opportunities anchored by the Cadomin formation and stacked with higher risk/reward opportunities in shallower zones. A notable exploration success was achieved in the Wapiti area in the first quarter of 2007, when a new exploration discovery was brought onstream at a rate of 17 mmcf per day.

ProspEx has allocated 30 percent of its capital budget to the Deep Basin in 2008.

Southern Alberta

IN SOUTHERN ALBERTA, the Company had its first production from a new producing area in Granum in 2007, with approximately 200 boe per day brought onstream in the second quarter. The Company participated in four wells in Granum. In addition, two wells were drilled by a partner pursuant to a farm-in agreement on ProspEx's lands. The Company also has a large land position at Medallion, located 15 miles south of Calgary. Medallion offers a "resource play" style of opportunity, with a series of stacked channels in the Belly River formation providing relatively low risk development drilling over a broad area.

In the face of depressed gas prices, ProspEx elected to reduce development activities in Medallion in favour of projects with higher anticipated returns in West Central Alberta and the Deep Basin. However, ProspEx has developed an inventory of approximately 150 net locations in the Medallion area and believes significant value can be realized by developing these locations in 2009 and beyond, when natural gas prices are expected to be higher. Beginning in 2009, the new royalty framework in Alberta should result in lower royalties on Crown lands in this area, further improving the economics of projects in Medallion.

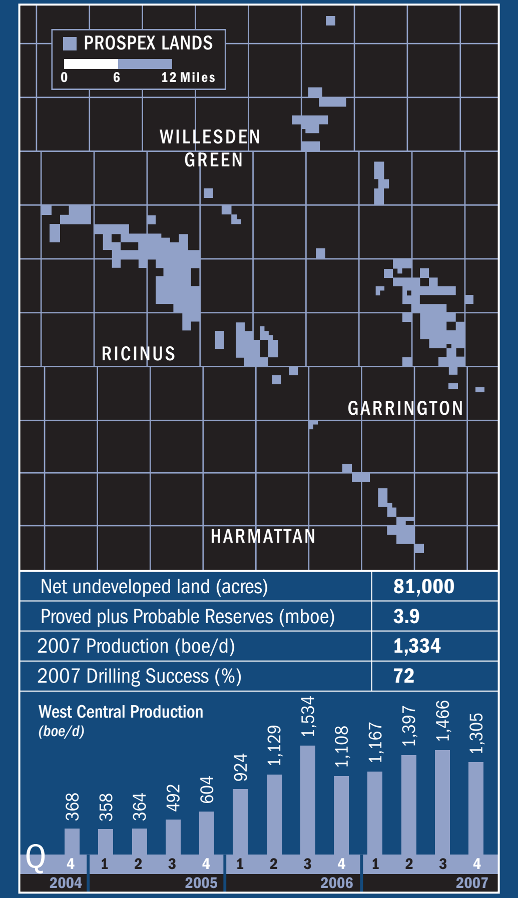
ProspEx has allocated 30 percent of its capital budget to Southern Alberta in 2008.

High Impact

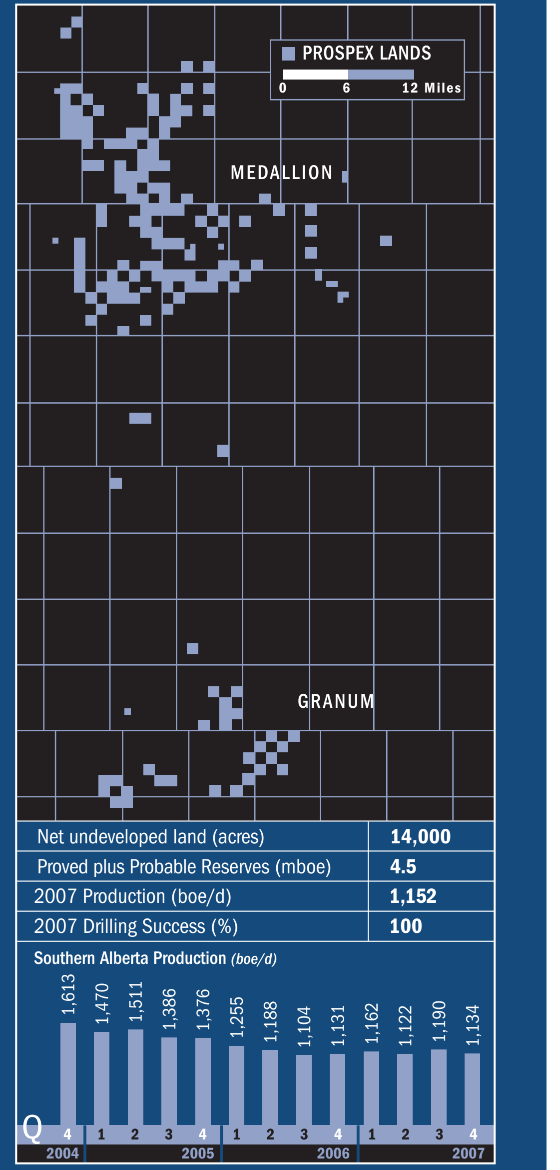
PROSPEX HOLDS AN INVENTORY of high risk/high reward "high impact" exploration opportunities that offer the potential of material production and reserves growth. Risk capital exposure to these plays is carefully managed. Although no high impact wells were drilled in 2007, regulatory approvals were secured for wells in a Mississippian foothills play at Salter and a Wabamun play at Edson that are being drilled in the first quarter of 2008. Success at either of these prospects would create follow up drilling opportunities.

The Company has allocated only five percent of its 2008 budget to these "high impact" projects.

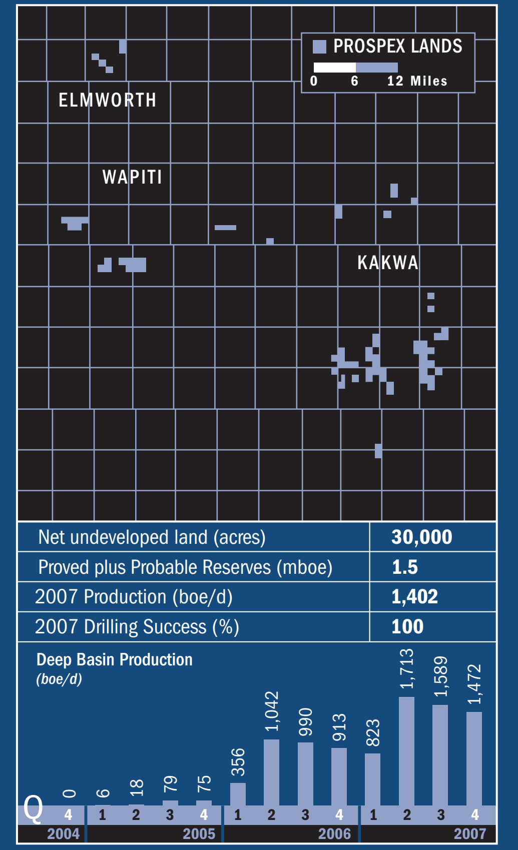
West Central Alberta



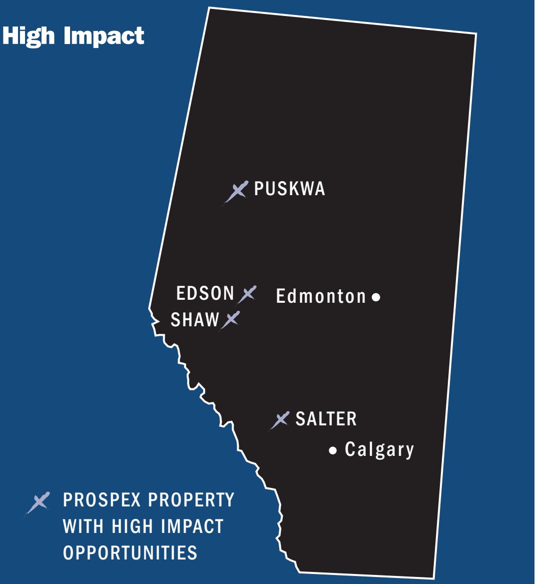
Southern Alberta



Deep Basin



High Impact



Oil and Gas Reserves Data

An independent evaluation of ProspEx's reserves at December 31, 2007 was conducted by GLJ Petroleum Consultants Ltd. ("GLJ") and prepared in accordance with the reporting guidelines of National Instrument 51-101 of the Canadian Securities Administrators ("NI 51-101"). Under NI 51-101, the "best estimate" for reserves is the Proved plus Probable category. In this category the Company's reserves increased by 9.9 billion cubic feet ("bcf") of natural gas and 14 thousand barrels ("mbbls") of oil and natural gas liquids ("NGL") for a total increase of 1,656 mboe in the period January 1, 2007 to December 31, 2007. ProspEx had no acquisition or disposition activity that effected reserves in 2007, as the Company's acquisition of assets in the Ricinus area closed in January of 2008.

The Company replaced 161 percent of 2007 production through exploration and development activities on a Proved basis, and 216 percent of 2007 production on a Proved plus Probable basis. Reserves growth was 15 percent on a Proved basis and 20 percent on a Proved plus Probable basis.

Reserves

Company Interest (working interest plus royalties receivable)

December 31, 2007	Oil (mbbls)	NGLs (mbbls)	Natural Gas (mmcf)	Oil Equivalent (mboe)
Proved Producing	35	448	22,924	4,303
Proved Developed Non-Producing	16	439	5,060	1,298
Proved Undeveloped	9	39	5,571	977
Total Proved (1)	60	926	33,554	6,578
Proved Plus Probable (1)	73	1,295	51,267	9,913

(1) *Columns may not add due to rounding.*

Company Interest Reserves Reconciliation

	Proved			Proved Plus Probable		
	Oil & NGLs (mbbls)	Natural Gas (mmcf)	Oil Equivalent (mboe)	Oil & NGLs (mbbls)	Natural Gas (mmcf)	Oil Equivalent (mboe)
Opening balance – Jan. 1, 2007	999	28,303	5,716	1,355	41,413	8,257
Drilling additions and improved recovery	611	11,711	2,563	821	18,210	3,857
Technical revisions & economic factors	(408)	782	(278)	(592)	(1,115)	(778)
Net addition	203	12,493	2,285	230	17,095	3,079
Acquisitions/Divestitures	0	0	0	0	0	0
Net additions including A+D	203	12,493	2,285	230	17,095	3,079
Production	217	7,241	1,423	217	7,241	1,423
Closing balance – December 31, 2007 (1)	986	33,554	6,578	1,368	51,267	9,913

(1) *Columns may not add due to rounding.*

Finding & Development Costs

	Total Proved	Proved Plus Probable
Change in future development capital *($000s)*	10,877	16,389
Exploration & development capital *($000s)*	48,550	48,550
Total 2007 capital subject to F&D calculation *($000s)*	59,427	64,939
Net reserves additions for the period *(mboe)*	2,285	3,079
2007 Finding & Development Costs *($/boe)*	26.01	21.09

Finding and development costs were $26.01 per boe on a Proved basis and $21.09 per boe on a Proved plus Probable basis, including revisions and future development costs but not including acquisitions and dispositions. Without revisions, but including future development costs, finding and development costs were $23.19 per boe on a Proved basis and $16.84 on a Proved plus Probable basis. These figures do not include any reserves attributable to the Company's acquisition of assets in the Ricinus area, which closed in January of 2008.

ProspEx has made substantial improvement in finding and development cost performance over the past year. Finding and development costs in 2007 were substantially lower than in 2006 due to improved industry conditions and a focus on cost reduction. In 2008, the Company will continue to work towards reducing finding and development costs.

Present Value of Cash Flows

ProspEx's reserves were evaluated using GLJ's January 1, 2008 price forecast. Cash flows are prior to income taxes and general and administrative expenses. Undeveloped land values are not included. Well abandonment costs have been included for wells that have reserves assigned.

	Discount Rate			
$000s	0%	8%	10%	12%
Proved Producing	107,792	83,888	79,684	75,949
Proved Developed Non-Producing	32,093	23,114	21,634	20,344
Proved Undeveloped	12,343	6,385	5,371	4,488
Total Proved (1)	152,228	113,387	106,689	100,782
Total Proved plus Probable (1)	230,151	157,362	145,853	135,942

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ProspEx Resources Ltd.

Financial Report 2007

ProspEx

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(unaudited)

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Land and lease	**4,383**	5,230	6,289
Seismic	**2,416**	1,603	1,760
Capitalized general and administrative	**2,652**	1,953	1,402
Property disposition	**–**	(10,842)	–
Other capital assets	**160**	269	94
Total	**48,710**	62,891	59,157

[(1)] Cash flow is defined as cash flow from operations before changes in non-cash working capital to analyze operating results. Cash flow does not have a standardized measure prescribed by Canadian generally accepted accounting principles and therefore may not be comparable with calculations with similar measures for other companies.

Management Discussion & Analysis

THIS MANAGEMENT'S DISCUSSION & ANALYSIS ("MD&A") is management's assessment of the financial and operating results of ProspEx Resources Ltd. ("ProspEx" or the "Company") as well as a prospective view of the Company's activities. The MD&A was prepared as at March 14, 2008 and should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2007. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") in Canada. Readers are referred to the advisories detailing "Disclosure Controls and Policies", "Advisories" and "Forward-Looking Statements" contained in the back of this MD&A. Additional information relating to ProspEx, including the Company's Annual Information Form (once filed), can be found at www.sedar.com. The Company anticipates filing its 2007 Annual Information Form prior to March 31, 2008.

Vision, Core Business and Strategy

ProspEx is a junior oil and gas exploration company based in Calgary, Alberta whose business activities are focused in the Western Canadian Sedimentary Basin. The Company's strategy is to create value through the generation and drilling of exploration prospects as well as through the exploitation and development of existing properties, combined with acquisitions of new properties.

Key Performance Drivers

ProspEx's goal is to add value by discovering and developing oil and gas reserves "through the drill bit", coupled with the selective acquisition of new assets. Efforts to achieve this are focused on utilizing experienced staff to develop and evaluate exploration projects while managing risk and controlling costs. Key performance drivers such as reserve replacement, production growth, operating netbacks, finding and development costs and recycle ratios are all monitored.

In addition, ProspEx strives to ensure it receives competitive prices for commodities sold. Sales prices and overall netbacks are considered in achieving ProspEx's goal of adding overall shareholder value.

Finally, financial performance measures including net income and cash flow on a per common share basis are used to assess overall performance.

Highlights of 2007

The year 2007 was highlighted by strong results in an exceptionally challenging business environment. The business environment was marked by weakening natural gas prices, changes to fiscal regimes including income trust taxation and the announcement of a new royalty framework in Alberta, and limited access to capital markets. Despite these challenges, ProspEx was able to grow annual production by 22 percent from 2006, reduce finding and development costs from the prior year and maintain a strong financial position through an effective hedging program and an equity issuance at year end.

During the year the Company participated in 48 (26.3 net) wells with a 93 percent net success rate. The drilling program was highlighted by a prolific discovery in the Deep Basin; extension of the Company's Cardium play at Harmattan, continued success drilling Cardium opportunities in Ricinus in West Central Alberta; and the first production from Granum, a new area in Southern Alberta.

Results of Operations

Net Income and Cash Flow

Full year cash flow was up 29 percent from $28.0 million in 2006 to $36.0 million in 2007. As operating netback per barrel of oil equivalent ("boe") remained consistent year over year the increase in cash flow is the result of higher production volumes. The Company incurred a net loss of $1.1 million for the year in 2007 compared to annual net earnings of $5.1 million in 2006. The decrease in net income was the result of higher depletion costs and the recognition of an unrealized financial instrument loss, partially offset by production revenue.

Revenue

($000s)	2007	2006
Natural gas	$ 48,466	$ 39,762
Realized gain on financial instruments	3,089	2,211
Total natural gas	51,555	41,973
Oil	3,428	2,451
Natural gas liquids	8,551	7,077
Oil and gas revenue	63,534	51,501
Unrealized financial instrument gain (loss)	(2,867)	3,132
Total revenue	$ 60,667	$ 54,633

Oil and gas revenue for the year ended December 31, 2007 was $63.5 million representing a 23 percent increase over revenue of $51.5 million in 2006. Revenue was up in the year due to a 22 percent increase in production and a one percent increase in average sales price.

Production

Area (boe/d)	2007	2006
Deep Basin	1,402	828
West Central Alberta	1,334	1,175
Southern Alberta	1,152	1,169
Other Areas	11	14
Total	3,899	3,186

By Product		
Natural gas *(mcf/d)*	19,838	16,610
Natural gas liquids *(bbls/d)*	468	324
Oil *(bbls/d)*	125	94
Total *(boe/d)*	3,899	3,186

Annual production for 2007 averaged 3,899 boe per day, an increase of 22 percent compared to 2006. Production growth in 2007 is attributable to the addition of new production in the West Central Alberta area where new facilities were commissioned during the second quarter at Harmattan, and exploration success in the Deep Basin area. Annual production was slightly below the original guidance of 4,000 to 4,200 boe per day as a result of third-party gas processing constraints at Harmattan, and delayed capital spending in the Deep Basin due to wet weather and uncertainty surrounding the proposed changes to Alberta Crown royalties.

Commodity Pricing

ProspEx Average Prices	2007	2006
Natural gas *($/mcf)*		
Sales price	**$ 6.69**	$ 6.55
Realized gain on financial instrument	**0.43**	0.37
Average realized natural gas price	**7.12**	6.92
Oil *($/bbl)*	**75.09**	71.37
NGL *($/bbl)*	**50.12**	59.92
Average realized price *($/boe)*	**44.65**	44.29
Unrealized financial instrument gain *($/boe)*	**(2.01)**	2.69
Total average price *($/boe)*	**$ 42.64**	$ 46.98

Benchmark pricing		
AECO C Spot *($/mcf)*	**$ 6.42**	$ 6.48
Edmonton Par – light oil *($/bbl)*	**$ 76.33**	$ 72.77

The Company realized a natural gas price of $7.12 per thousand cubic feet ("mcf") in 2007, three percent higher than the realized price for 2006 of $6.92 per mcf. While the AECO C Spot benchmark price declined slightly from 2006 to 2007, ProspEx realized a slight price increase as approximately half of the Company's production was subject to the AECO monthly index, which performed better than the AECO C spot prices in 2007. Realized natural gas prices also outperformed AECO spot price due to the higher heating content of the Company's natural gas production in the Deep Basin and West Central Alberta areas.

The 2007 annual realized oil price increased five percent over 2006, consistent with the increase in Edmonton Par price.

The annual average price realized for natural gas liquids ("NGL") decreased 16 percent from $59.92 per barrel in 2006 to $50.12 per barrel in 2007. This decline was due to an increase in the proportion of ethane in the Company's overall NGL mix, and the lower price received for ethane, which tends to track natural gas pricing.

Financial Instruments

In an effort to mitigate the effects of volatile commodity prices and ensure cash flow to fund exploration and development programs, ProspEx enters into financial instruments such as forwards, futures, swaps and costless collars. These financial instruments, which were predominantly costless collars in 2007, allow the Company to better forecast operating cash flow, in turn providing the Company with greater confidence in funding for its operations. In 2007 the Company's risk management program resulted in a net realized gain of $3.1 million compared to $2.2 million realized in 2006.

The fair values of unsettled financial instruments are recorded as a current asset or liability with the change in the fair value recorded as an unrealized gain or loss in the statements of earnings. As a result, changes in the fair value of financial instruments due to fluctuating forward natural gas prices and the purchase or expiration of financial contracts can lead to volatility in net earnings. The financial instruments unsettled as of December 31, 2007 are described in the financial instruments and risk management note to the annual consolidated financial statements. The fair value of unsettled financial instruments at December 31, 2007 was an asset of $0.2 million compared to an asset of $3.1 million at December 31, 2006 resulting in an unrealized financial instrument loss of $2.9 million for the year. The loss in value from December 31, 2006 was due to the expiration and realization of contracts in place, partially offset by the fair value of new contracts.

Subsequent to year end, ProspEx entered into collars for 10,000 gigajoules ("GJs") per day for the summer of 2008 and 4,000 GJs per day for the winter of 2008/2009. These contracts are described in the financial instruments and risk management note to the consolidated financial statements.

ProspEx is authorized by its Board of Directors to hedge up to 50 percent of its production at any given time; however, it is ProspEx's policy not to enter into any physical or financial fixed price contracts with a term of more than 18 months and any collar arrangements that go beyond two years.

Royalty Expense

($000s, except percentage and per boe amounts)		**2007**		2006
Crown	**$**	**6,219**	$	6,518
Freehold and GORR		**3,124**		2,506
Total Royalties	**$**	**9,343**	$	9,024
$ per boe	**$**	**6.57**	$	7.76
As a percentage of oil and gas revenue		**15**		18

Royalty expense in 2007 was $9.3 million or 15 percent of oil and gas revenue, compared to $9.0 million or 18 percent of oil and gas revenue for 2006. Royalty expense as a percentage of revenue is lower in the current year due to an additional $1.2 million of capital cost recovery credits received during the second quarter as a result of capital expenditures incurred to build production facilities. Royalties for the year were below guidance as the Company's risk management program resulted in realized natural gas prices which were above the 2007 market prices used for royalty calculations, and due to the capital cost recovery credits received during the year.

In October of 2007 the Alberta Government proposed changes to the royalty framework in Alberta. These proposed changes have yet to be enacted as legislation by the government, and many material details have yet to be clarified by the government. The Company has completed a preliminary evaluation of the impact of the new framework using the best information currently available and assumptions that it considers reasonable at this time. We believe that the impact on overall netbacks and net asset values will be modest. ProspEx will continue to carefully monitor any developments with respect to royalties and will assess the impact on the Company as more information becomes available.

Operating Costs

		2007		2006
Operating costs *($000s)*		**11,341**		8,104
Operating costs per boe	**$**	**7.97**	$	6.97

The Company's unit operating costs increased during 2007 compared to 2006 due to increased processing fees and costs associated with new production in West Central Alberta. Unit operating costs in the Deep Basin were essentially unchanged from 2006 to 2007, while Southern Alberta operating costs declined modestly.

2007 operating costs per boe were consistent with the Company's guidance of $8.00 per boe.

Transportation Expenses

		2007		2006
Transportation expenses *($000s)*		**1,343**		1,129
Transportation expenses per boe	**$**	**0.95**	$	0.97

Annual transportation expense per boe decreased two percent from 2006 to 2007 reflecting better utilization of firm transportation contracts during the second half of 2007.

General and Administrative Expenses

($000s)		2007		2006
Gross general and administrative	**$**	**6,683**	$	5,621
Recoveries		**(951)**		(1,262)
Capitalized expenses		**(2,652)**		(1,953)
Net general and administrative expenses	**$**	**3,080**	$	2,406
Net general and administrative expenses per boe	**$**	**2.16**	$	2.07

Increased gross general and administration costs compared to 2006 were the result of increased staff levels and inflationary pressure on salaries. Unit G&A costs exceeded guidance in 2007 as production was slightly lower than anticipated and salary costs were higher than forecasted.

Depletion, Depreciation and Accretion

		2007		2006
Depletion, depreciation and accretion *($000s)*		**33,889**		23,758
Depletion, depreciation and accretion per boe	**$**	**23.81**	$	20.43

Depletion, depreciation and accretion expense ("DD&A") per boe increased over the prior year as the cost of adding proved reserves over the past twelve months increased relative to historical levels.

Interest and Bank Charges

Interest and bank charges totaled $2.0 million in 2007 compared with $1.1 million in 2006. The increase in interest expense over the prior year resulted from higher average debt levels.

The Company has maintained a conservative level of leverage at year end with a net debt to annualized fourth quarter cash flow ratio of 1.0.

Stock-Based Compensation

Stock-based compensation expense remained consistent from 2006 to 2007 at $1.2 million.

Income Taxes

The Company had an income tax reduction of $0.4 million in 2007 as compared to an income tax provision of $2.8 million in 2006. Lower natural gas prices and the recognition of an unrealized financial instrument loss together with higher DD&A expenses resulted in a net loss for the year.

ProspEx has approximately $147.0 million of income tax pools at December 31, 2007 and does not anticipate being cash taxable in 2008. As a result of the December 2007 flow-through share financing, ProspEx has committed to incur $8.0 million in qualifying expenditures by the end of 2008.

Capital Expenditures

($000s)	**2007**	2006
Drilling and completions	**$ 26,718**	$ 46,893
Facilities	**12,381**	17,785
Land and lease	**4,383**	5,230
Seismic	**2,416**	1,603
Capitalized G&A	**2,652**	1,953
Property disposition	**–**	(10,842)
Other capital assets	**160**	269
Total capital expenditures	**$ 48,710**	$ 62,891

The Company invested $48.7 million in capital expenditures in 2007, compared to $62.9 million in 2006. Of the capital expenditures, $12.1 million was spent in the Deep Basin, $20.5 million in West Central Alberta and $12.4 million in Southern Alberta. Spending was down in 2007 as the Company executed a conservative capital spending program in response to weakening natural gas prices and uncertainty in the capital markets.

The decrease in annual capital spending for 2007 compared with 2006 is primarily due to a reduction in capital spent on drilling and completions in 2007. In 2007 the Company incurred $26.7 million in drilling and completion expenditures to drill 48 gross (26.3 net) wells. Although more net wells were drilled in 2007, a larger proportion of drilling was incurred in the Southern Alberta area, where the cost per well is lower.

Oil & Gas Reserves Data

An independent evaluation of ProspEx's reserves at December 31, 2007 was conducted by GLJ Petroleum Consultants Ltd. ("GLJ") and prepared in accordance with the reporting guidelines of National Instrument 51-101 of the Canadian Securities Administrators ("NI 51-101"). Under NI 51-101, the "best estimate" for reserve balances is the Proved plus Probable category. In this category the Company's reserves balances increased by 9.9 billion cubic feet ("bcf") of natural gas and 14 thousand barrels ("mbbls") of oil and natural gas liquids for a total increase of 1,656 mboe in the period January 1, 2007 to December 31, 2007. ProspEx had no acquisition or disposition activity that affected reserves in 2007, as the Company's acquisition of assets in the Ricinus area closed in January of 2008. The complete reserves disclosure as required under NI 51-101, will be contained in ProspEx's 2007 Annual Information Form, to be filed on SEDAR on or before March 31, 2008.

The Company replaced 161 percent of 2007 production through exploration and development activities on a Proved basis, and 216 percent of 2007 production on a Proved plus Probable basis. Reserves growth was 15 percent on a Proved basis and 20 percent on a Proved plus Probable basis.

The Proved reserve life index at December 31, 2007, calculated using fourth quarter 2007 production on an annualized basis, was 4.6 years. The Proved plus Probable reserve life index was 6.9 years.

Finding and development costs were $26.01 per boe on a Proved basis and $21.09 per boe on a Proved plus Probable basis, including revisions and future development costs (but not including acquisitions and dispositions). Without revisions, but including future development costs, finding and development costs were $23.19 per boe on a Proved basis and $16.84 on a Proved plus Probable basis. These figures do not include any reserves attributable to the Company's acquisition of assets in the Ricinus area, which closed in January of 2008.

ProspEx has made substantial improvement in finding and development cost performance over the past year. In 2006, finding and development costs were $31.14 per boe on a Proved basis and $37.87 per boe on a Proved plus Probable basis, including revisions and future development costs (but not including acquisitions and dispositions). Finding and development costs in 2007 were substantially lower than in 2006 due to improved industry conditions and a focus on cost reduction. In 2008, the Company will continue to work towards reducing finding and development costs.

Recycle ratio is the ratio of operating netback to finding and development costs, and is a measure of the economic efficiency of the capital program. On a Proved basis a recycle ratio of 1.1 was achieved, with a recycle ratio of 1.4 on a Proved plus Probable basis.

Liquidity & Capital Resources

At December 31, 2007 ProspEx had the following resources available to fund its capital expenditure program.

($000s)		
Working capital deficiency	$	(8,659)
Long-term debt		(28,846)
Bank facilities available		60,000
Total capital resources	$	22,495

The Company anticipates that it will continue to have adequate liquidity to fund future working capital and its 2008 capital program of $55.0 million, from operating cash flow and the capital resources listed in the table above.

Bank Debt

At December 31, 2007 the Company had a total credit facility of $60.0 million. The facility is available by way of Canadian and U.S. dollar prime rate based loans, LIBOR advances, bankers' acceptances and letters of credit. The credit facility is fully revolving until June 30, 2008 and may be extended at the mutual agreement of ProspEx and its lender for an additional year. If the credit facility is not extended, a full payment is required on July 1, 2009. This facility is secured by a $200.0 million demand debenture and a first floating charge on all petroleum and natural gas assets of ProspEx.

In January 2008 the Company expanded its credit facility by $5.0 million to bring the total credit facility to $65.0 million.

Share Capital

As at December 31, 2007, ProspEx had 56,453,422 common shares, 2,716,145 warrants, 4,655,917 options and no special performance units issued and outstanding. Each warrant and option, upon exercise, entitles the holder to one common share.

As at March 14, 2008, ProspEx had 56,561,813 common shares, 2,607,754 warrants, 5,267,417 options and no special performance units issued and outstanding.

On December 13, 2007 the Company issued 2.2 million common shares on a flow-through basis at a price of $3.70 per share for total gross proceeds of $8.0 million. With this share offering ProspEx has committed to incur $8.0 million in qualifying expenditures by December 31, 2008. Directors and Officers of the Company purchased a total of 15,600 of the flow-through shares for total proceeds of $0.1 million.

Subsequent Events

On January 22, 2008 the Company acquired certain assets in the Ricinus area of Alberta. These assets consist of 16 (11.9 net) wells with production of approximately 360 boe per day, along with associated gas gathering and field compression facilities. The consideration paid by the Company was $11.6 million after closing adjustments. The purchase of these assets was financed from the Company's credit facility.

As noted under bank debt, in January 2008 the Company expanded its credit facility by $5.0 million to bring the total credit facility to $65.0 million.

Contractual Obligations

The Company has committed to certain payments over the next five years as follows:

Payments due ($000s)	2008	2009	2010	2011	Thereafter
Long-term debt	$ –	$ 28,846	$ –	$ –	$ –
Drilling rig contract	2,468	106	–	–	–
Building lease	384	32	–	–	–
Process fees	505	400	300	47	–
Transportation	934	181	–	–	–
Other	12	8	2	–	–
Total	$ 4,303	$ 29,573	$ 302	$ 47	$ –

ProspEx has committed to incur $8.0 million in qualifying expenditures related to the December 2007 common share issuance.

Off-Balance Sheet Arrangements

The Company has not entered into any off-balance sheet transactions.

Fourth Quarter 2007 Results

The final quarter of 2007 was highlighted by commencement of the 2007/2008 winter drilling program. In the fourth quarter ProspEx participated in 16 (7.25 net) wells. Three (1.75 net) wells were drilled in West Central Alberta with two (1.5 net) wells cased, one (0.5 net) well was cased in the Deep Basin and one (1.0 net) well was drilled and completed in Granum in Southern Alberta. The remaining 11 (4.0 net) wells were partner operated wells drilled and cased at Medallion in Southern Alberta.

Production in the fourth quarter of 2007 averaged 3,922 boe per day. ProspEx exited 2007 with production of approximately 3,900 boe per day.

Cash flow for the fourth quarter of 2007 increased 23 percent to $9.4 million from $7.6 million in the same period of 2006. The increase in cash flow is the result of higher production offset by lower realized natural gas prices.

During the final quarter of 2007 the Company recorded a net loss of $0.2 million compared to net income of $2.1 million for the comparable period of 2006. The decrease in net income was due to a combination of lower realized natural gas prices, higher depletion costs and the recognition of an unrealized financial instrument loss, offset by higher volumes.

Summary of Quarterly Results

	2007				2006			
	Q4	**Q3**	**Q2**	**Q1**	Q4	Q3	Q2	Q1
Financial *($000s, except per share amounts)*								
Oil and gas revenue	**15,906**	**16,004**	**17,553**	**14,071**	13,536	14,071	12,704	11,190
Net earnings (loss)	**(180)**	**(1,352)**	**2,235**	**(1,794)**	2,143	440	868	1,629
Basic per share	**0.00**	**(0.03)**	**0.04**	**(0.03)**	0.04	0.01	0.02	0.03
Diluted per share	**0.00**	**(0.03)**	**0.04**	**(0.03)**	0.04	0.01	0.02	0.03
Average Daily Production								
Oil *(bbls/d)*	**125**	**82**	**210**	**83**	184	67	96	28
NGL *(bbls/d)*	**515**	**548**	**513**	**290**	276	515	287	212
Natural gas *(mcf/d)*	**19,690**	**21,743**	**21,108**	**16,757**	16,221	18,335	17,948	13,890
Total *(boe/d)*	**3,922**	**4,254**	**4,241**	**3,166**	3,164	3,639	3,375	2,555
Operating Netbacks *($/boe)*								
Price [(1)]	**44.09**	**40.89**	**45.48**	**49.38**	46.50	42.03	41.37	48.66
Royalties	**(5.41)**	**(7.79)**	**(3.97)**	**(9.85)**	(7.16)	(8.46)	(7.12)	(8.36)
Operating cost	**(8.06)**	**(8.42)**	**(7.86)**	**(7.38)**	(7.39)	(8.21)	(5.68)	(6.34)
Transportation cost	**(0.86)**	**(0.89)**	**(1.01)**	**(1.03)**	(0.96)	(0.98)	(1.07)	(0.83)
Operating netback	**29.76**	**23.79**	**32.64**	**31.12**	30.99	24.38	27.50	33.13

[(1)] *Price does not include unrealized financial instrument loss.*

Oil and gas revenue trends are mainly impacted by realized commodity prices and production volumes. Oil and gas revenue grew in conjunction with production volumes during the first three quarters of 2006 and then held relatively flat until the second quarter of 2007 as lower production was offset by strengthening prices. Revenue increased in the second quarter of 2007 due to increased production, but then declined due to decreases in natural gas prices received and production.

Production growth over the last eight quarters is attributable to an active and successful exploration and development drilling program.

Net earnings or losses are affected by production volumes, operating netback, taxation rates, the risk management program and the Company's depletion charge which is a result of the Company's success in adding new proven oil and natural gas reserves.

Operational and Other Business Risks

Need to Replace and Grow Reserves

The future oil and natural gas production of ProspEx, and therefore future cash flows, are highly dependent upon ongoing success in exploring the Company's current and future undeveloped land base, exploiting the current producing properties, and acquiring or discovering additional reserves. Without reserve additions through exploration, acquisition or development activities, reserves and production will decline over time as reserves are depleted.

The business of discovering, developing, or acquiring reserves is capital intensive. To the extent that cash flow from operations are insufficient and external sources of capital become limited or unavailable, the ability of ProspEx to make the necessary capital investments to maintain and expand its oil and natural gas reserves may be impaired.

There can be no assurance that ProspEx will be able to find and develop or acquire additional reserves to replace and grow production at acceptable costs.

Exploration, Development and Production Risks

Oil and natural gas exploration involves a high degree of risk, which even a combination of experience, knowledge and careful evaluation may not be able to overcome. There is no assurance that expenditures made on future exploration by ProspEx will result in new discoveries of oil and natural gas in commercial quantities. It is difficult to project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions such as over pressured zones, tools lost in the hole and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof.

The long-term commercial success of ProspEx depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. No assurance can be given that ProspEx will be able to continue to locate satisfactory properties for acquisition or participation. Moreover, if such acquisitions or participations are identified, ProspEx may determine that current markets, terms of acquisition and participation or pricing conditions make such acquisitions or participations uneconomic.

Future oil and gas exploration may involve unprofitable efforts, not only from dry wells, but from wells that are productive but do not produce sufficient net revenues to return a profit after drilling, operating and other costs. Completion of a well does not assure a profit on the investment or recovery of drilling, completion and operating costs. In addition, drilling hazards or environmental damage could greatly increase the cost of operations, and various field operations conditions may adversely affect the production from successful wells. These conditions include delays in obtaining government approvals or consents, shut-ins of connected wells resulting from extreme weather conditions, insufficient storage, processing or transportation capacity or other geological and mechanical conditions. While diligent well supervision and effective maintenance operations can contribute to maximizing production rates over time, production delays and declines from normal field operating conditions cannot be eliminated and can be expected to adversely affect revenue and cash flow levels to varying degrees.

In addition, oil and gas operations are subject to the risks of exploration, development and production of oil and natural gas properties, including encountering unexpected formations or pressures, premature declines of reservoirs, blow-outs, sour gas releases, fires and spills. Losses resulting from the occurrence of any of these risks could have a materially adverse effect on future results of operations, liquidity and financial condition.

Reserve Estimates

The production forecast and recoverable estimates contained in the ProspEx Engineering Report are only estimates and the actual production and ultimate recoverable reserves from the properties may be greater or less than the independent estimates of GLJ.

There are numerous uncertainties inherent in estimating quantities of reserves and cash flows to be derived therefrom, including many factors that are beyond the control of ProspEx. The reserve and cash flow information set forth herein represent estimates only. The reserves and estimated future net cash flow from the assets of ProspEx have been independently evaluated effective December 31, 2007 by GLJ. These evaluations include a number of assumptions relating to factors such as initial production rates, production decline rates, ultimate recovery of reserves, timing and amount of capital expenditures, marketability of production, future prices of oil and natural gas, operating costs and royalties and other government levies that may be imposed over the producing life of the reserves. These assumptions were based on price forecasts in use at the date the relevant evaluations were prepared and many of these assumptions are subject to change and are beyond the control of ProspEx. Actual production and cash flows will vary from these evaluations, and such variations could be material. The foregoing evaluations are based in part on the assumed success of exploitation activities intended to be undertaken in future years. The reserves and estimated cash flows contained in such evaluations will be reduced to the extent that such exploitation activities do not achieve the level of success assumed in the evaluations.

Volatility of Oil and Natural Gas Prices

The operational results and financial condition of ProspEx will be dependent on the prices received for oil and natural gas production. Oil and natural gas prices have fluctuated widely during recent years and are determined by supply and demand factors, including weather and general economic conditions as well as conditions in other oil and natural gas regions. Any decline in oil and natural gas prices could have an adverse effect on the operations, proved reserves, and financial conditions of ProspEx and could result in a reduction of the net production revenue of ProspEx causing a reduction in its oil and gas acquisition and development activities. In addition, bank borrowings that might be made available to ProspEx are typically determined in part by the borrowing base of the reserves of ProspEx. A sustained material decline in prices from historical average prices could reduce the borrowing base of ProspEx, therefore reducing the bank credit available to ProspEx and could require that a portion of such bank debt be repaid.

ProspEx uses the full cost method of accounting for oil and natural gas properties. Under this accounting method, capitalized costs are reviewed on a quarterly basis for impairment to ensure that the carrying amount of these costs is recoverable based on expected future cash flows. To the extent that such capitalized costs (net of accumulated depreciation and depletion) less future taxes exceed the present value of estimated future net cash flows from the proved oil and natural gas reserves of ProspEx, those excess costs would be required to be charged to operations.

Royalties

ProspEx is required to pay the Crown or other royalty owners for commodities produced. Crown royalty payments are subject to change and any changes may have an adverse impact on the profitability of a project. In October of 2007 the Alberta Government proposed changes to the royalty framework in Alberta. These proposed changes have yet to be enacted as legislation and many material details have yet to be clarified by the government. This framework, which has a proposed effective date of January 1, 2009, establishes new royalties for oil and gas that are calculated based on price, production and depth of wells. There may be modifications introduced to the framework prior to implementation as full details are yet to be disclosed.

Operational Hazards and Other Uncertainties

Oil and natural gas exploration operations are subject to all the risks and hazards typically associated with such operations, including hazards such as fire, explosion, blowouts and oil spills, each of which could result in substantial damage to oil and natural gas wells, production facilities, other property and the environment or in personal injury. In accordance with industry practice, ProspEx is not fully insured against all of these risks, nor are all such risks insurable. Although ProspEx will maintain liability insurance, where available, in an amount which it considers adequate and consistent with industry practice, the nature of these risks is such that liabilities could exceed policy limits, in which event ProspEx could incur significant costs that could have a material adverse effect upon its financial condition. Business interruption insurance may also be purchased for selected facilities, to the extent that such insurance is available. Oil and natural gas production operations are also subject to all the risks typically associated with such operations, including premature decline of reservoirs and the invasion of water into producing formations.

Oil and natural gas exploration and development activities are dependant on the availability of drilling and related equipment in the particular areas where such activities will be conducted. Demand for such equipment or access restrictions may affect the availability and/or cost of such equipment to ProspEx and may delay exploration and development activities. To the extent ProspEx is not the operator of its oil and gas properties, ProspEx will be dependent on other operators for timing of activities related to non-operating properties and will be largely unable to direct or control the activities of the operators.

Although property title reviews will be done according to industry standards prior to the purchase of most oil and natural gas producing properties or the commencement of drilling wells, such reviews do not guarantee or certify that an unforeseen defect in the chain of title will not arise to defeat the claim of ProspEx which could result in a reduction of the revenue received by ProspEx.

Competition

There is strong competition relating to all aspects of the oil and natural gas industry. ProspEx will actively compete for capital, skilled personnel, undeveloped land, reserve acquisitions, access to drilling rigs, service rigs and other equipment, access to processing facilities, pipelines and refining capacity, and in all other aspects of its operations with a substantial number of other organizations, many of which may have greater technical and financial resources than ProspEx.

Key Personnel

The success of ProspEx will depend in large measure on certain key personnel. The loss of the services of such key personnel could have a material adverse affect on ProspEx. ProspEx does not have key person insurance in effect for management. The contributions of these individuals to the immediate operations of ProspEx are likely to be of central importance. In addition, the competition for qualified personnel in the oil and natural gas industry is intense and there can be no assurance that ProspEx will be able to continue to attract and retain all personnel necessary for the development and operation of its business.

Environmental Risks

The oil and natural gas industry is subject to environmental regulation pursuant to a variety of international conventions and Canadian federal, provincial and municipal laws, regulations, and guidelines. A breach of such regulations may result in the imposition of fines or issuances of clean-up orders in respect of ProspEx or its assets. Such regulation may be changed to impose higher standards and potentially more costly obligations on ProspEx. There can be no assurance that future environmental costs will not have a material adverse effect on ProspEx.

Critical Accounting Estimates

ProspEx's significant accounting policies are contained in Note 1 to the consolidated financial statements. Certain of these policies are recognized as critical because in applying these policies management is required to make judgments, assumptions and estimates that have a significant impact on the financial results of ProspEx. The estimates used in applying these critical accounting policies have been discussed with the Audit Committee and are outlined below.

Oil and Gas Reserves

One hundred percent of the Company's proved plus probable oil and gas reserves as of December 31, 2007 were evaluated and reported on by an independent qualified reserves evaluator. The process of estimating oil and gas reserves is, however, complex and is subject to uncertainties and interpretations. Estimating reserves requires significant judgments based on available geological and reservoir data, past production and operating performance and forecasted economic and operating conditions. These estimates may change substantially as additional data from ongoing development, testing and production becomes available, and due to unforeseen changes in economic conditions which impact oil and gas prices and costs. The Company's reserves and revisions to those reserves have a significant impact on net earnings as they are a key component in calculating depletion of oil and gas assets and oil and gas asset impairments. Net revisions during the current period were not significant.

Asset Impairment

ProspEx follows the Canadian Institute of Chartered Accountants ("CICA") Accounting Guideline 16 for full cost oil and gas accounting. In accordance with full cost accounting, a ceiling test is performed on a quarterly basis, to test for impairment. An impairment loss may be recorded if the sum of the undiscounted cash flows expected from the production of the proved reserves and the lower of cost and market of unproved properties does not exceed the carrying values of the oil and gas assets. An impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties.

The cash flows used in testing for impairment are based on a number of estimates, the two most significant being future prices and reserves. The uncertainty in reserves is discussed above. The Company estimates its future prices based on the forward market, adjusted for basis, quality and transportation at the end of the period for the first ten years, after which the estimate of price is determined by the Company's independent reserve evaluator. Although these price estimates are independent of the Company, they are still subject to significant volatility. Operating costs are estimated using current operating costs per barrel plus an inflation factor.

Certain costs related to unproven properties are excluded from costs subject to depletion until proven reserves have been determined or their value is impaired. These properties are reviewed quarterly and any impairment is transferred to the costs being depleted.

Asset Retirement Obligation

The Company records a liability for the legal obligation associated with the retirement of long-lived assets and a corresponding increase in the related asset in accordance with the method outlined by the CICA. The future liability is comprised of estimates of future costs to abandon and restore a well site and natural gas processing plants. The estimation of these costs is based on engineering estimates using current costs and technology and in accordance with current legislation and industry practice. These estimates are reviewed annually and could impact net earnings through an adjustment to the depletion, depreciation and amortization rate used by the Company.

Income Taxes

ProspEx 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. ProspEx's income and other 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 significantly from that estimated and recorded by ProspEx.

New Accounting Pronouncements

Accounting Standards Adopted

On January 1, 2007 the Company adopted the new accounting standards for financial instrument recognition and measurement, financial instrument presentation and disclosure, hedging and comprehensive income. These standards require that financial assets and liabilities be carried at fair value on the balance sheet, except for loans and receivables, securities designated as held-to-maturity and non-trading financial liabilities, which are carried at amortized cost, unless they are designated as held-for-trading, in which case fair value is appropriate.

The Company uses derivative financial instruments to manage its exposure to volatility in commodity prices. Prior to January 1, 2007 and to date, the derivative financial instruments used have not been designated as hedges; they were and are recorded at fair value at inception with unrealized gains or losses reflected in earnings.

Prior to the adoption of the new standards, physical receipt and delivery contacts were not within the scope of the definition of a financial instrument. On adoption of the new standards, the Company elected to account for its commodity sales contracts and other non-financial contracts as non-financial derivatives, which results in fair value measurement.

The new standards require a statement of comprehensive income comprised of net earnings plus other comprehensive income. The Company did not have any other comprehensive income to report on the adoption of the new standards.

The adoption of these new standards on January 1, 2007 did not have a material impact on the reported results of operations or net financial position of the Company.

Recent Accounting Pronouncements

Three new Canadian accounting standards have been issued: "Financial Instruments – Disclosure", "Capital Disclosure" and "Goodwill and Intangible Assets". These new standards will require additional disclosure in the Company's financial statements commencing January 1, 2008 related to the Company's financial instruments as well as the management of capital and goodwill.

Disclosure Controls and Policies

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the Company is accumulated and communicated to the Company's management as appropriate to allow timely decisions regarding required disclosure. The Company's Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of December 31, 2007, that the Company's disclosure controls and procedures as at such date are effective to provide reasonable assurance that material information related to the Company, including its consolidated subsidiary, is made known to them by others within those entities. 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 will prevent all errors and 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.

Internal Controls Over Financial Reporting

The Chief Executive Officer and Chief Financial Officer of the Company are able to certify the design of the Company's internal controls over financial reporting as required under Multilateral Instrument 52-109 of the Canadian Securities Administration with no significant weaknesses in design of these internal controls that require commenting on in the MD&A.

There were no changes to the design of internal controls over financial reporting during 2007.

Advisories

Non-GAAP Measures

Within the MD&A references are made to terms commonly used in the oil and gas industry. The following terms are not defined by GAAP in Canada and are referred to as non-GAAP measures.

1. Cash flow is defined as cash flow from operations before the change in non-cash working capital. The MD&A contains the term "cash flow" which should not be considered an alternative to, or more meaningful than "cash flow from operations" as determined in accordance with GAAP. The Company considers cash flow to be a key measure as it demonstrates the Company's ability to generate the cash necessary to fund capital projects and to repay debt. Cash flow presented does not have any standardized meaning prescribed by Canadian GAAP and therefore it may not be comparable with the calculation of similar measures for other entities. Cash flow per share is calculated using the same weighted average number of common shares for the period as used in calculating the net earnings per share calculation.
2. Netbacks equal total revenue less royalties, operating costs and general and administrative costs on a boe basis. Total boes are calculated by multiplying the daily production by the number of days in the period.

Reserves

Reserves replacement ratio is calculated by dividing the sum of the reserves added, plus or minus any revisions, and dividing by the production volume over the period.

Reserve life index is calculated by dividing the reserves balance at year end by the annualized production rate during the prior quarter.

BOE

Barrel of oil equivalent amounts have been calculated using a conversion rate of six thousand cubic feet of gas to one barrel of oil. The term "boe" may be misleading if used in isolation. A boe conversion ratio of one barrel of oil to six mcf of gas is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the well head.

Finding and Development Costs

The aggregate of the exploration and development costs incurred in the most recent financial year and the change during that year in estimated future development costs generally will not reflect total finding and development costs related to reserve additions for that year.

Forward-looking Information

Certain information regarding ProspEx including, without limitation, management's assessment of future plans and operations, constitutes forward-looking information or statements under applicable securities law and necessarily involves assumptions regarding factors and risks that could cause actual results to vary materially, including, without limitation, assumptions and risks associated with oil and gas exploration, development, exploitation, production, marketing and transportation, loss of markets, volatility of commodity prices, currency fluctuations, royalty rates, imprecision of reserve estimates, environmental risks, competition, incorrect assessment of the value of acquisitions, failure to realize the anticipated benefits of acquisitions and ability to access sufficient capital from internal and external sources.

The reader is cautioned that these factors and risks are difficult to predict and that the assumptions used in the preparation of such information, although considered reasonable by ProspEx at the time of preparation, may prove to be incorrect. Accordingly, readers are cautioned that the actual results achieved will vary from the information provided herein and the variations may be material. Readers are also cautioned that the foregoing list of assumptions, factors and risk is not exhaustive. Additional information on the foregoing assumptions, risks and other factors that could affect ProspEx's operations or financial results are included in ProspEx's public disclosure documents on file with Canadian securities regulatory authorities. In particular see ProspEx's MD&A and the Risk Factors and Industry Conditions sections of ProspEx's 2007 Annual Information Form. ProspEx's reports may be accessed through the SEDAR website (www.sedar.com), at ProspEx's website (www.psx.ca) or by contacting the Company directly. Consequently, there is no representation by ProspEx that actual results achieved will be the same in whole or in part as those set out in the forward-looking information.

Furthermore, the forward-looking information and statements contained in this MD&A are made as of the date of this MD&A, and ProspEx does not undertake any obligation to update publicly or to revise any of the included forward-looking information and statements, whether as a result of new information, future events or otherwise, except as required by law. The forward-looking information and statements contained herein are expressly qualified by this cautionary statement.

MANAGEMENT'S REPORT

MANAGEMENT HAS PREPARED THE CONSOLIDATED FINANCIAL STATEMENTS in accordance with accounting principles generally accepted in Canada. If alternative accounting methods exist, management has chosen those methods it deems most appropriate in the circumstances. Financial statements are not precise as they include certain amounts based on estimates and judgments. Management believes such estimates have been based on careful judgments and have been properly reflected in the accompanying consolidated financial statements. Management has also prepared the financial information presented elsewhere in the annual report and ensured that it is consistent with information in the consolidated financial statements.

ProspEx Resources Ltd. maintains internal accounting and administrative controls designed to provide reasonable assurance that the financial information is relevant, reliable and accurate and that assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for reviewing and approving the consolidated financial statements and Management's Discussion and Analysis and, primarily through its Audit Committee, ensures that management fulfills its responsibilities for financial reporting.

The Audit Committee is appointed by the Board and is composed of Directors who are not employees of the Company. The Audit Committee meets periodically with management and with the external auditors to satisfy themselves that management responsibilities are being properly discharged, to review the consolidated financial statements and to recommend approval of the consolidated financial statements to the Board. The Audit Committee also considers, for review by the Board and approval by the shareholders, the engagement or reappointment of external auditors.

KPMG LLP, the external auditors, has audited the consolidated financial statements in accordance with the auditing standards generally accepted in Canada on behalf of the shareholders. KPMG LLP has full and free access to the Audit Committee.

John W. Rossall
President and Chief Executive Officer

George D.K. Yee
Vice President, Finance & Chief Financial Officer

Calgary, Canada
March 14, 2008

Auditors' Report

TO THE SHAREHOLDERS OF PROSPEX RESOURCES LTD.

We have audited the consolidated balance sheets of ProspEx Resources Ltd. as at December 31, 2007 and 2006 and the consolidated statements of earnings (loss), comprehensive earnings (loss) and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Calgary, Canada

March 14, 2008

Consolidated Balance Sheets

As at December 31,

($000s)	**2007**	2006
Assets		
Current assets		
Accounts receivable	**$ 12,900**	$ 13,220
Prepaid expenses	**988**	746
Unrealized financial instrument gain	**214**	3,081
	14,102	17,047
Property, plant and equipment, net *(note 3)*	**161,663**	142,649
Asset held for resale *(note 4)*	**–**	937
Future income tax asset *(note 5)*	**–**	1,103
Total assets	**$ 175,765**	$ 161,736
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	**$ 22,761**	$ 29,990
Long-term debt *(note 6)*	**28,846**	16,766
Asset retirement obligation *(note 7)*	**5,201**	4,157
Future income tax liability *(note 5)*	**3,214**	–
Total liabilities	**60,022**	50,913
Shareholders' Equity		
Share capital *(note 8)*	**92,204**	87,459
Contributed surplus *(note 8)*	**5,614**	4,348
Retained earnings	**17,925**	19,016
Total shareholders' equity	**115,743**	110,823
	$ 175,765	$ 161,736

Subsequent events *(note 12)*

See accompanying notes to consolidated financial statements.

On Behalf of the Board of Directors:

John W. Rossall
Director

Kyle D. Kitagawa
Director

Consolidated Statements of Earnings (Loss), Comprehensive Earnings (Loss) and Retained Earnings

For the Years Ended December 31,

($000s, except per share amounts)		**2007**		2006
Revenue				
Oil and gas	**$**	**63,534**	$	51,501
Unrealized financial instrument gain (loss)		**(2,867)**		3,132
Royalties		**(9,343)**		(9,024)
		51,324		45,609
Expenses				
Operating		**11,341**		8,104
Transportation		**1,343**		1,129
Depletion, depreciation and accretion		**33,889**		23,758
General and administrative		**3,080**		2,406
Interest and bank charges		**2,047**		1,133
Stock-based compensation		**1,156**		1,181
		52,856		37,711
Earnings (loss) before income taxes		**(1,532)**		7,898
Income Taxes *(note 5)*				
Capital		**–**		20
Future (reduction)		**(441)**		2,798
		(441)		2,818
Net earnings (loss) and comprehensive earnings (loss) for the year		**(1,091)**		5,080
Retained earnings, beginning of year		**19,016**		13,936
Retained earnings, end of year	**$**	**17,925**	$	19,016
Net earnings (loss) per share				
Basic	**$**	**(0.02)**	$	0.10
Diluted	**$**	**(0.02)**	$	0.10

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

For the Years Ended December 31, ($000s)	2007	2006
Operations		
Net earnings (loss) for the year	**$ (1,091)**	$ 5,080
Items not involving cash		
Depletion, depreciation and accretion	**33,889**	23,758
Stock-based compensation	**1,156**	1,181
Future income taxes (reduction)	**(441)**	2,798
Unrealized financial instrument loss (gain)	**2,867**	(3,131)
Asset retirement expenditures	**(383)**	(1,724)
	35,997	27,962
Changes in non-cash working capital	**(901)**	(3,874)
	35,096	24,088
Financing		
Issuance of shares	**8,020**	21,045
Increase in long-term debt	**12,080**	15,713
	20,100	36,758
Investing		
Exploration and development expenditures	**(48,550)**	(73,464)
Deposit on property acquisition *(note 12)*	**(1,175)**	–
Proceeds of property disposition	**–**	10,842
Expenditure on asset held for resale	**937**	(937)
Other capital expenditures	**(160)**	(269)
	(48,948)	(63,828)
Changes in non-cash working capital	**(6,248)**	2,982
	(55,196)	(60,846)
Change in cash	**–**	–
Cash, beginning of year	**–**	–
Cash, end of year	**$ –**	$ –

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

For the years ended December 31, 2007 and 2006.

1. Significant Accounting Policies

ProspEx Resources Ltd. ("ProspEx" or the "Company") is engaged in the acquisition, exploration, development and production of oil and natural gas in Canada. ProspEx was incorporated on August 13, 2004 and commenced operations on October 1, 2004 when certain assets of Esprit Exploration Ltd. were transferred to ProspEx under a Plan of Arrangement.

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Actual results may differ from these estimates.

(a) Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiary. A substantial portion of the Company's activities are conducted jointly with others and the consolidated financial statements reflect only the Company's proportionate interest in such activities.

(b) Property, Plant and Equipment

The Company follows the full cost method of accounting for exploration and development expenditures whereby all costs relating to the acquisition of, exploration for and development of oil and gas reserves, including asset retirement costs, are capitalized. Such costs include lease acquisition, geological and geophysical analysis, lease rentals on undeveloped properties, drilling both productive and non-productive wells, production equipment and overhead charges directly related to acquisition, exploration and development activities. Proceeds received from disposals of properties and equipment are credited against capitalized costs unless the disposal would alter the rate of depletion and depreciation by more than 20 percent, in which case a gain or loss on disposal is recorded.

Capitalized costs and estimated costs of future development of proved undeveloped reserves are depleted and depreciated by the unit of production method based on estimated gross proved reserves before royalties as determined by independent engineers. The costs of undeveloped properties are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties or impairment has occurred. Oil and gas reserves are converted to equivalent units using their relative energy content.

Oil and gas assets are evaluated in each reporting period to confirm that the costs are recoverable and do not exceed the fair value of the properties. The costs are assessed to be recoverable if the sum of the undiscounted cash flows expected from the production of proved reserves and the lower of cost and market of unproved properties exceed the carrying value of the oil and gas assets. If the carrying value of the oil and gas assets is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties. The cash flows are estimated using future product prices and costs and are discounted using the risk-free rate.

Amortization of capital assets not related to oil and gas assets is provided using the declining balance method at a rate from 20 to 50 percent per annum. Leasehold improvements are amortized using the straight-line method over the terms of the respective leases.

(c) Asset Retirement Obligation

The Company records the fair value of legal obligations associated with the retirement of long-lived tangible assets, such as producing well sites, in the period in which they are incurred and a corresponding increase in the carrying amount of the related long-lived asset. The liability accretes until the Company expects to settle the retirement obligation. The asset retirement costs are depleted using the unit of production method. Actual costs to retire tangible assets are deducted from the liability as incurred.

(d) Income Taxes

The Company follows the liability method of accounting for future income taxes. Under this method, future income tax assets and liabilities are determined based on differences between the amounts reported in the financial statements and the tax basis of the assets and liabilities, and are measured using the currently enacted, or substantively enacted, tax rates and laws expected to apply when these differences reverse.

(e) Stock-based Compensation

Stock options and special performance units granted have been accounted for based on the fair value method. The fair value is measured at the grant date and charged to earnings or capital assets over the vesting period with a corresponding increase in contributed surplus. For awards that vest on a graded basis, compensation cost is recognized on a pro-rata basis over the vesting period. Consideration paid to the Company on exercise of all options is credited to share capital. When stock options and special performance units are exercised, contributed surplus is reduced by the fair value originally attributed to them.

(f) Financial Instruments

In addition to the physical swap contracts, the Company uses derivative financial instruments to manage its exposure to volatility in commodity prices. These financial instruments are not used for trading or other speculative purposes.

Derivative instruments that qualify as hedges, and have been designated as hedges, are not recognized in the financial statements on inception. Gains or losses on commodity price financial instruments designated as hedges are reflected as adjustments to the related revenue when the gain or loss is realized.

Commodity price financial instruments that do not qualify as hedges, or have not been designated as such, are recorded at fair value on inception. Realized gains or losses on these financial instruments are reflected as adjustments to the related revenue when the gain or loss is realized; unrealized gains and losses on these instruments are recognized as adjustments to the related revenue at the end of each reporting period. The estimated fair value of these instruments is based on quoted market prices, or if quotes are not available, third-party market indications and forecasts are used.

(g) Earnings Per Share

The Company uses the treasury stock method to determine the dilutive effect of outstanding stock options, special performance units and warrants. Basic and diluted earnings per share are calculated using the weighted average number of common shares outstanding during the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. Anti-dilutive options and warrants are excluded from the calculation.

(h) Revenue Recognition

Revenue from the sale of crude oil, natural gas and natural gas liquids is recorded when title passes.

2. Change in Accounting Policy

On January 1, 2007 the Company adopted the new accounting standards for financial instrument recognition and measurement, financial instrument presentation and disclosure, hedging and comprehensive income.

The standards require that financial assets and liabilities be carried at fair value on the balance sheet, except for loans and receivables, securities designated as held-to-maturity and non-trading financial liabilities, which are carried at amortized cost (unless they are designated as held-for-trading, in which case fair value is appropriate).

The Company uses derivative financial instruments to manage its exposure to volatility in commodity prices. Prior to January 1, 2007 and to date, the derivative financial instruments used have not been designated as hedges; they were and are recorded at fair value at inception with unrealized gains or losses reflected in earnings.

Prior to the adoption of the new standards, physical receipt and delivery contracts were not within the scope of the definition of a financial instrument. On adoption of the new standards, the Company elected to account for its commodity sales contracts and other non-financial contracts as non-financial derivatives, which results in fair value measurement.

The new standards require a statement of comprehensive income comprised of net earnings plus other comprehensive income. The Company does not have any other comprehensive income to report on the adoption of the new standards.

The adoption of these new standards on January 1, 2007 did not have a material impact on the reported results of operations or net financial position of the Company.

3. Property, Plant & Equipment

($000s)	**2007**	2006
Exploration and development properties	**$ 229,213**	$ 176,769
Other	**878**	719
	230,091	177,488
Less accumulated depletion, depreciation and amortization	**(68,428)**	(34,839)
Total property, plant and equipment	**$ 161,663**	$ 142,649

At December 31, 2007, oil and gas properties included $19.6 million (2006 – $20.0 million) of unproved properties that have been excluded from the depletion calculation. Future development costs related to proved undeveloped reserves of $22.1 million (2006 – $12.2 million) are included in the depletion calculation.

In 2007 the Company capitalized $4.2 million (2006 – $3.7 million) of overhead and stock-based compensation directly related to acquisition, exploration and development activities.

The Company performed a ceiling test calculation at December 31, 2007, resulting in the undiscounted cash flows from proved reserves and the lower of cost and market of unproved properties exceeding the carrying values of oil and gas assets. The prices used in the ceiling test evaluation of the Company's oil and gas assets are summarized below:

	Gas ($ per thousand cubic feet)[1]	Natural gas liquids ($ per barrel)[1]	Oil ($ per barrel)[2]
2008	7.02	66.66	92.45
2009	7.75	64.14	87.80
2010	8.13	63.18	86.32
2011	8.16	63.57	86.89
2012	8.17	63.00	86.04
2013	7.60	57.94	81.10
2014	7.80	58.08	81.10
2015	7.97	58.21	81.10
2016	8.14	58.34	81.12
2017	8.31	59.54	82.76
2018	8.48	60.73	84.42
2019+	+2%	+2%	+2%

[1] *Weighted average plantgate price.* [2] *Weighted average wellhead price.*

4. Asset Held for Resale

At December 31, 2006 the Company had $0.9 million of equipment assembled that it intended to sell. The Company no longer intends to sell this equipment, as it is expected that this equipment will be utilized in the Company's field operations.

5. Future Income Taxes

The provision for future income taxes differs from the amount computed by applying the combined expected Canadian Federal and Provincial tax rates to earnings (loss) before income taxes. The reasons for these differences are as follows:

($000s)	**2007**	2006
Earnings (loss) before income taxes	**$ (1,532)**	$ 7,898
Rate *(%)*	**32.12**	34.50
Computed expected (reduction) provision for future income taxes	**(492)**	2,725
Increase (decrease) in taxes resulting from:		
Non-deductible crown payments	**–**	835
Resource allowance	**–**	(914)
Stock-based compensation	**371**	407
Effect of change in tax rate	**(458)**	91
Alberta royalty deduction pool additions	**–**	(251)
Other	**138**	(95)
	(441)	2,798
Capital taxes	**–**	20
Income tax expense (reduction)	**$ (441)**	$ 2,818

The components of the future income tax asset (liability) at December 31 are as follows:

($000s)		2007		2006
Tax assets (liabilities):				
Property, plant and equipment	**$**	**(3,744)**	$	1,482
Asset retirement obligation		**509**		533
Share issue costs		**590**		578
Unrealized financial instrument gain		**(69)**		(990)
		(2,714)		1,603
Valuation allowance		**(500)**		(500)
Future income tax asset (liability)	**$**	**(3,214)**	$	1,103

At December 31, 2007 the Company had estimated tax pools available to reduce future taxable income of $147.0 million (2006 – $149.7 million). ProspEx has committed to incur $8.0 million in qualifying expenditures related to the December 2007 flow-through share issuance by December 31, 2008.

6. Long-Term Debt

At December 31, 2007 the Company had a $60.0 credit facility with a Canadian chartered bank. The facility is available by way of Canadian and U.S. dollar prime rate based loans, LIBOR advances, bankers' acceptances and letters of credit. The credit facility is fully revolving until June 30, 2008 and may be extended at the mutual agreement of ProspEx and its lender for an additional year. If the credit facility is not extended, a full payment is required on July 1, 2009. This facility is secured by a $200.0 million demand debenture and a first floating charge on all petroleum and natural gas assets of ProspEx.

7. Asset Retirement Obligation

The Company has estimated the net present value of its total asset retirement obligation at December 31, 2007 to be $5.2 million (2006 – $4.2 million) based on a total future liability of $19.0 million. The total future liability was estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon the wells and facilities and the estimated timing of when the costs will be incurred. These payments are expected to be made over the next 34 years with the majority of costs incurred between 2037 and 2046. A seven percent discount rate and two percent inflation rate were used to calculate the present value of the asset retirement obligation.

($000s)		2007		2006
Balance at the beginning of the year	**$**	**4,157**	$	5,762
Liabilities incurred		**560**		450
Change in assumptions		**567**		(674)
Accretion expense		**300**		343
Liabilities settled		**(383)**		(1,724)
Balance at the end of the year	**$**	**5,201**	$	4,157

8. Share Capital

(a) Authorized

An unlimited number of common shares and non-voting common shares and an unlimited number of preferred shares are authorized for issuance.

(b) Common Shares and Common Share Performance Warrants Issued

	2007		2006	
	Number of Shares/Warrants (000s)	**Amount ($000s)**	Number of Shares/Warrants (000s)	Amount ($000s)
Common shares				
Balance at the beginning of the year	**53,790**	**$ 85,681**	48,932	$ 65,214
Issued on exercise of options	**72**	**243**	22	71
Flow-through shares issued – May 5, 2006	**–**	**–**	1,220	7,015
Flow-through shares issued – November 1, 2006	**–**	**–**	1,400	7,560
Flow-through shares issued – December 13, 2007	**2,170**	**8,029**	–	–
Shares issued – November 1, 2006	**–**	**–**	1,800	7,560
Flow-through shares tax adjustment	**–**	**(4,461)**	–	(2,047)
Shares issued under special performance unit plan	**252**	**3**	294	3
Shares issued on exercise of warrants	**169**	**353**	122	245
Issue costs, net of future tax reduction	**–**	**(351)**	–	(905)
Stock options and special performance units exercised	**–**	**1,046**	–	965
Balance at the end of the year	**56,453**	**$ 90,543**	53,790	$ 85,681
Common share performance warrants				
Balance at the beginning of the year	**2,908**	**$ 1,778**	3,032	$ 1,853
Exercised	**(169)**	**(104)**	(122)	(75)
Cancelled	**(23)**	**(13)**	(2)	–
Balance at the end of the year	**2,716**	**1,661**	2,908	1,778
Share Capital at end of year		**$ 92,204**		$ 87,459

On December 13, 2007 ProspEx issued 2,170,000 common shares on a flow-through basis at a price of $3.70 per share for total gross proceeds of $8.0 million. ProspEx has committed to incur $8.0 million in qualifying expenditures by December 31, 2008. Three officers of the Company, of which one is also a director, purchased a total of 15,600 of the flow-through shares for total proceeds of $57,720.

The estimated fair value of the warrants was recognized as a reduction of the common share capital with a corresponding increase to common share performance warrants.

(c) Contributed Surplus

($000s)		2007		2006
Balance at the beginning of the year	**$**	**4,348**	$	2,951
Stock-based compensation		**2,312**		2,362
Exercise of stock options & special performance units		**(1,046)**		(965)
Balance at the end of the year	**$**	**5,614**	$	4,348

(d) Stock Options and Special Performance Units

ProspEx has a stock option plan for directors, officers and employees that provides for the granting of options to acquire common shares. Under the terms of the plan, options normally vest equally over a three-year period, and expire five years after the date of grant. At December 31, 2007, options to acquire 5.6 million (2006 – 4.1 million) common shares were authorized for issuance under the stock option plan. Changes in outstanding options during the year ended December 31, 2007 and 2006 are summarized below:

	2007			2006		
	Options (000s)		**Weighted Average Exercise Price**	Options (000s)		Weighted Average Exercise Price
Outstanding at beginning of year	**3,354**	**$**	**3.49**	2,314	$	3.27
Granted	**1,725**		**3.96**	1,096		3.93
Exercised	**(72)**		**3.38**	(22)		3.22
Cancelled	**(351)**		**4.06**	(34)		3.37
Outstanding at end of year	**4,656**	**$**	**3.62**	3,354	$	3.49

ProspEx had a special performance unit (“SPU”) plan for directors, officers and employees. Over three years following the grant, one-third of the SPUs vest on the anniversary of the issuance subject to minimum share performance requirements. Once SPUs have vested they may be exercised in whole or in part, at any time within 30 days of the vesting date. Changes in SPUs during the years ended December 31, 2007 and 2006 are as follows:

(000s)	2007	2006
Outstanding at beginning of year	**436**	872
Exercised	**(406)**	(436)
Cancelled	**(30)**	–
Outstanding at end of year	**–**	436

The fair value of each stock option and SPU granted is estimated on the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions for grants as follows:

	2007	2006
Risk-free interest rate	**4%**	4%
Expected life	**5 years**	5 years
Expected volatility	**44%**	46%
Expected dividend yield	**Nil**	Nil

The estimated fair value of stock options granted in 2007 was $2.7 million (2006 – $1.8 million). This estimated fair value is being amortized to earnings and capitalized to property, plant and equipment over the vesting period. A total of $1.2 million (2006 – $1.2 million) of stock and unit-based compensation was recorded against income in 2007 and $1.2 million (2006 – $1.2 million) was capitalized.

(e) Per Share Amounts

Basic per share amounts are calculated using the weighted average number of common shares outstanding during the period. Diluted per share amounts are calculated based on the treasury stock method, which assumes that any proceeds obtained on exercise of options would be used to purchase common shares at the average price during the period. The weighted average number of shares outstanding is then adjusted by this amount. In computing diluted net earnings per share for the year ended December 31, 2007, a total of 2,223,429 (2006 – 2,625,929) common shares were added to the weighted average number of common shares outstanding of 54,094,873 (2006 – 50,378,377). A total of 4,655,917 (2006 – 1,096,500) options were excluded from the diluted calculations as they were not dilutive.

9. Financial Instruments and Risk Management

In addition to physical swap contracts, the Company uses derivative financial instruments to manage its exposure to volatility in commodity prices. These financial instruments are not used for trading or other speculative purposes. As all the derivative financial instruments entered into by the Company have not been formally designated as hedges, they are recorded at fair value at inception. Realized gains or losses on these financial instruments are reflected as adjustments to the related revenue when the gain or loss is realized; unrealized gains and losses on these physical and financial instruments are recognized as adjustments to the related revenue at the end of each reporting period. The estimated fair value of these financial instruments and physical contracts is based on quoted market prices, or if quotes are not available, third-party market indications and forecasts are used.

Type	Amount	Term	Price	Type
Collar	2,500 GJ/d	November 1, 2007 - March 31, 2008	$7.00 - $8.40 at AECO *($Cdn/GJ)*	Physical
Collar	2,500 MMBTU/d	November 1, 2007 - March 31, 2008	$6.76 - $8.40 at AECO *($US/mmbtu)*	Financial

The majority of the Company's accounts receivable are with customers and joint-venture partners in the oil and gas industry and are subject to normal industry credit risks. Customers and joint-venture partners are subject to an internal credit review to minimize the risk of non-payment.

The Company is exposed to a floating rate of interest on its long-term debt. The Company is also exposed to foreign currency fluctuations as oil prices received are referenced to U.S. dollar denominated prices and natural gas and natural gas liquids prices are influenced by U.S. dollar denominated markets. The Company has no financial contracts in place at December 31, 2007 to manage the foreign currency and interest rate exposure.

The fair values of the financial instruments, including accounts receivable, assets held for resale, accounts payable and accrued liabilities and long-term debt approximate their carrying values.

Subsequent to the year end the Company entered into the following contracts:

Type	Amount (GJ/d)	Term	Price ($/GJ)	Type
Collar	2,000	April 1, 2008 - October 31, 2008	$6.50 - $6.75 at AECO	Physical
Collar	1,000	April 1, 2008 - October 31, 2008	$6.50 - $6.90 at AECO	Physical
Collar	1,000	April 1, 2008 - October 31, 2008	$6.50 - $7.13 at AECO	Financial
Collar	2,000	April 1, 2008 - October 31, 2008	$6.50 - $7.45 at AECO	Financial
Collar	2,000	April 1, 2008 - October 31, 2008	$6.50 - $7.75 at AECO	Financial
Collar	2,000	April 1, 2008 - October 31, 2008	$6.75 - $7.62 at AECO	Financial
Collar	2,000	November 1, 2008 - March 31, 2009	$7.00 - $8.80 at AECO	Financial
Collar	2,000	November 1, 2008 - March 31, 2009	$7.00 - $9.15 at AECO	Financial

10. Additional Disclosures

Net interest paid during the year was $2.7 million (2006 – $1.4 million). Income taxes paid during the year were $nil (2006 – $nil).

11. Commitments

The Company has committed to certain payments over the next five years as follows:

Payments due ($000s)	2008	2009	2010	2011	Thereafter
Long-term debt	$ –	$ 28,846	$ –	$ –	$ –
Drilling rig contract	2,468	106	–	–	–
Office lease	384	32	–	–	–
Processing fees	505	400	300	47	–
Transportation	934	181	–	–	–
Other	12	8	2	–	–
Total	$ 4,303	$ 29,573	$ 302	$ 47	$ –

ProspEx has committed to incur $8.0 million in qualifying expenditures related to the December 2007 common share issuance.

12. Subsequent Events

On January 22, 2008 the Company acquired certain assets in the Ricinus area of Alberta. These assets consist of 16 (11.9 net) wells with current production of approximately 360 boe per day, along with associated gas gathering and field compression facilities. The consideration paid by the Company was $11.6 million after closing adjustments. The purchase of these assets was financed from the Company's credit facility. At December 31, 2007 a deposit of $1.2 million was outstanding that related to this purchase.

In January 2008 the Company expanded its credit facility by $5.0 million to bring the total credit facility to $65.0 million.

13. Reclassification

Certain amounts disclosed for prior years have been reclassified to conform to current period presentation.

Corporate Information

Officers

Jean-Paul H. Lachance
Vice President, Engineering

R. Bruce McFarlane
Vice President, Exploration

Peter C. Parkinson
Vice President, Land

John W. Rossall
President and Chief Executive Officer

George D. K. Yee
Vice President, Finance, Chief Financial Officer
and Corporate Secretary

Directors

Brian E. Hiebert (1),(2)
Chairman of the Corporate Governance
and Compensation Committee

President, B&G Energy
Calgary, Alberta

Kyle D. Kitagawa (1),(2)
Chairman of the Audit Committee

Managing Director, North River Capital Corp.
Calgary, Alberta

Ian MacGregor (1),(2)
President, North West Capital
Calgary, Alberta

John W. Rossall
President and Chief Executive Officer
ProspEx Resources Ltd.
Calgary, Alberta

Stephen J. Savidant
Chairman of the Board of Directors

Independent Businessman
Calgary, Alberta

(1) Member of the Corporate Governance and Compensation Committee

(2) Member of the Audit Committee

Auditors

KPMG LLP
Calgary, Alberta

Solicitors

Bennett Jones LLP
Calgary, Alberta

Bankers

Canadian Imperial Bank of Commerce

Independent Reserves Evaluator

GLJ Petroleum Consultants Ltd.
Calgary, Alberta

Registrar and Transfer Agent

Olympia Trust Company
Calgary, Alberta

Stock Exchange Listing

The Toronto Stock Exchange
Trading Symbol: PSX

Website

www.psx.ca

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