

ProspEx Resources Ltd.
Consolidated Balance Sheets
As at December 31,

(Stated in thousands of dollars)

	<u>2009</u>	<u>2008</u>
Assets		
Current assets		
Accounts receivable	\$ 7,800	\$ 10,770
Prepaid expenses	389	693
Future income tax asset (note 4)	27	-
Fair value of commodity contracts (note 8)	-	828
	<u>8,216</u>	<u>12,291</u>
Property, plant and equipment, net (note 3)	<u>145,939</u>	<u>190,693</u>
Total assets	<u>\$ 154,155</u>	<u>\$ 202,984</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 12,599	\$ 22,078
Current loss on sublease	226	-
Fair value of commodity contracts (note 8)	93	-
Future income tax liability (note 4)	-	240
	<u>12,918</u>	<u>22,318</u>
Long-term debt (note 5)	17,234	40,807
Asset retirement obligation (note 6)	3,810	6,462
Other long-term liabilities	198	-
Future income tax liability (note 4)	5,160	9,119
	<u>39,320</u>	<u>78,706</u>
Shareholders' Equity		
Common shares (note 7)	90,800	90,802
Common share performance warrants (note 7)	-	1,233
Contributed surplus (note 7)	8,987	6,758
Retained earnings	15,048	25,485
Total shareholders' equity	<u>114,835</u>	<u>124,278</u>
	<u>\$ 154,155</u>	<u>\$ 202,984</u>

Subsequent event (note 8)
See accompanying notes to consolidated financial statements.

On Behalf of the Board of Directors:

"signed"
John W. Rossall
Director

"signed"
Kyle D. Kitagawa
Director

ProspEx Resources Ltd.
Consolidated Statements of (Loss) Earnings, Comprehensive (Loss) Earnings and Retained Earnings
For the Years Ended December 31,

(stated in thousand of dollars, except per share amounts)

	2009	2008
Revenue		
Oil and gas	\$ 33,246	\$ 76,705
Unrealized financial instrument (loss) gain (note 8)	(921)	614
Royalties	(4,261)	(14,916)
	<u>28,064</u>	<u>62,403</u>
Expenses		
Operating	8,575	11,034
Transportation	1,099	1,373
Depletion, depreciation and accretion	26,613	33,084
General and administrative	4,314	3,032
Interest and bank charges	1,269	1,913
Sublease loss	524	-
Stock-based compensation	498	750
	<u>42,892</u>	<u>51,186</u>
(Loss) earnings before income taxes	(14,828)	11,217
Income tax expense (note 4)		
Future (reduction) expense	(4,391)	3,657
	<u>(10,437)</u>	<u>7,560</u>
Net (loss) earnings and comprehensive (loss) earnings for the year	(10,437)	7,560
Retained earnings, beginning of year	25,485	17,925
Retained earnings, end of year	<u>\$ 15,048</u>	<u>\$ 25,485</u>
Net (loss) earnings per share (note 7)		
Basic	\$ (0.18)	\$ 0.13
Diluted	<u>\$ (0.18)</u>	<u>\$ 0.13</u>

See accompanying notes to consolidated financial statements.

ProspEx Resources Ltd.
Consolidated Statements of Cash Flows
For the Years Ended December 31,

(stated in thousands of dollars)

	2009	2008
Operations		
Net (loss) earnings for the year	\$ (10,437)	\$ 7,560
Items not involving cash		
Depletion, depreciation and accretion	26,613	33,084
Stock-based compensation	498	750
Sublease loss	524	-
Rent inducements	213	-
Future income taxes (reduction)	(4,391)	3,657
Unrealized financial instrument loss (gain)	921	(614)
Asset retirement expenditures	(1,016)	(111)
Amortization of sublease loss	(118)	-
Amortization of rent inducements	(102)	-
	<u>12,705</u>	<u>44,326</u>
Changes in non-cash working capital	<u>(4,337)</u>	<u>3,576</u>
	<u>8,368</u>	<u>47,902</u>
Financing		
Issuance of shares, net of issue costs	(2)	1,678
(Decrease) increase in long-term debt	(23,573)	11,962
	<u>(23,575)</u>	<u>13,640</u>
Investing		
Exploration and development expenditures	(17,687)	(51,488)
Property acquisitions	(1,502)	(15,043)
Property dispositions	36,458	5,817
Deposit on property acquisition	-	1,175
Other capital expenditures	(83)	(168)
	<u>17,186</u>	<u>(59,707)</u>
Changes in non-cash working capital	<u>(1,979)</u>	<u>(1,835)</u>
	<u>15,207</u>	<u>(61,542)</u>
Change in cash	-	-
Cash, beginning of year	-	-
Cash, end of year	<u>\$ -</u>	<u>\$ -</u>

Additional cash flow disclosure (note 9)
See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

For the years ended December 31, 2009 and 2008

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%, 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 cost, less impairments, 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 cost, less impairments, 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 rates ranging from 20 to 50% 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 asset and 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 the exercise of all options is credited to share capital. When stock options and special performance units are exercised, share capital is increased and contributed surplus is reduced by the fair value originally attributed to them.

(f) Financial Instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument to another entity. Upon initial recognition all financial instruments, including derivatives, are recognized on the balance sheet at fair value. Subsequent measurement is then based on the financial instruments being classified into one of five categories: held for trading, held to maturity, loans and receivables, available for sale and other liabilities. The Company has designated its financial instruments into the following categories applying the indicated measurement methods:

Financial Instrument	Category	Measurement Method
Accounts receivable	Loans and receivables	Amortized cost
Accounts payable and accrued liabilities	Other liabilities	Amortized cost
Long-term debt	Other liabilities	Amortized cost
Fair value of commodity contract	Other liabilities or receivables as applicable	Fair value

The Company uses derivative financial instruments to manage its exposure to volatility in commodity prices. These financial instruments are not used for speculative purposes.

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 an adjustment to revenue at the end of each reporting period.

(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. 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. CHANGES IN ACCOUNTING POLICIES

(a) Financial Instruments - disclosures

In May 2009 amendments were made to Section 3862, Financial Instruments – Disclosures to include additional disclosures about the fair value of financial instruments and the liquidity risk associated with financial instruments. These amendments require a three level hierarchy that reflects the significance of the inputs used in making the fair value measurements. Refer to note 8 for the enhanced disclosures.

3. PROPERTY, PLANT & EQUIPMENT

(\$000s)	2009		2008	
Exploration and development properties	\$	272,124	\$	290,757
Other		1,129		1,046
		273,253		291,803
Less accumulated depletion, depreciation and amortization		(127,314)		(101,110)
Total property, plant and equipment	\$	145,939	\$	190,693

At December 31, 2009 oil and gas properties included \$22.6 million (2008 - \$24.3 million) of unproved properties and salvage value of \$7.8 million (2008 - \$11.2 million) that have been excluded from the depletion calculation. Future development costs related to proved undeveloped reserves of \$30.3 million (2008 - \$20.6 million) are included in the depletion calculation.

During 2009 the Company capitalized \$4.4 million (2008 - \$3.6 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, 2009 resulting in the undiscounted cash flows from proved reserves and the cost, less impairment, of unproved properties exceeding the carrying value 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
2010	5.72	69.83	86.23
2011	6.19	73.34	90.37
2012	6.47	75.02	92.46
2013	6.51	76.18	93.91
2014	6.68	77.48	95.52
2015	7.16	80.29	97.84
2016	7.42	81.95	99.81
2017	7.95	83.70	101.83
2018	8.52	85.51	103.88
2019	8.69	87.24	105.98
2020	8.86	88.98	108.10
2021	+2%	+2%	+2%

¹ Weighted average plantgate price.

² Weighted average wellhead price.

4. 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 (loss) earnings before income taxes. The reasons for these differences are as follows:

(\$000s)	2009	2008
(Loss) earnings before income taxes	\$ (14,828)	\$ 11,217
Rate (%)	29.00%	29.50%
Computed expected (reduction) provision for future income taxes	(4,300)	3,309
Increase (decrease) in taxes resulting from:		
Stock-based compensation expensed	144	221
Effect of change in tax rate	(293)	(206)
Other	58	333
Income tax (reduction) expense	\$ (4,391)	\$ 3,657

The current future income tax asset at December 31, 2009 of \$0.03 million (2008 – liability of \$0.2 million) results from the future tax impact of the fair value of the commodity contracts.

The components of the long term future income tax liability at December 31 are as follows:

(\$000s)	2009	2008
Property, plant and equipment	\$ (5,157)	\$ (10,697)
Asset retirement obligation	355	1,773
Share issue costs	142	305
	(4,660)	(8,619)
Valuation allowance	(500)	(500)
Future income tax liability	\$ (5,160)	\$ (9,119)

At December 31, 2009 the Company had estimated tax pools available to reduce future taxable income of \$124.5 million (2008 - \$154.6 million).

Capitalized stock based compensation resulted in an increase to future tax liabilities of \$0.2 million during the year ended December 31, 2009 (2008 - \$0.3 million).

5. LONG-TERM DEBT

At December 31, 2009 the Company had a \$33.0 million credit facility with a major Canadian bank. The facility revolves for 364 day periods, at which time the Company can request approval from the lender for an extension for an additional 364 day period or convert the outstanding bank indebtedness to a one year term loan. The facility is subject to an annual review on May 31, 2010. The amount of the facility is subject to a borrowing base test performed on a periodic basis by the lenders, based primarily on reserves and using commodity prices estimated by the lenders, as well as other factors. A decrease in the borrowing base could result in a reduction of the credit facility which may require a repayment to the lenders within sixty days of receiving notice of the new borrowing base. The credit facility provides that advances may be made by way of prime rate loans, guaranteed notes (bankers' acceptances) and letters of credit. At December 31, 2009, the Company provided guarantees and letters of credit of \$0.3 million. The credit facility is tested quarterly, in arrears, and bears interest based on a sliding scale. The interest rate varies depending on the Company's debt to cash flow ratio determined quarterly on a grid system, with the grid ranging from debt to cash flow ranges of lower than 1.0:1.0 to greater than 3.0:1.0.

The facility is secured by a general security agreement conveying a first floating charge over all real and personal property and after acquired assets. The Company is required to meet certain financial based covenants under the terms of this facility. As at December 31, 2009, the Company is in compliance with all covenants in accordance with the terms of the credit facility.

6. ASSET RETIREMENT OBLIGATION

The Company has estimated the net present value of its total asset retirement obligation at December 31, 2009 to be \$3.8 million (2008 - \$6.5 million) based on a total future liability before inflation of \$8.6 million (2008 - \$22.2 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 40 years with the majority of costs incurred between 2027 - 2031 and 2045 - 2049. A seven percent discount rate and two percent inflation rate were used to calculate the present value of the asset retirement obligation.

(\$000s)	2009	2008
Balance at the beginning of the year	\$ 6,462	\$ 5,201
Liabilities incurred	92	814
Change in assumptions	1,071	183
Dispositions	(3,192)	(26)
Accretion expense	393	401
Liabilities settled	(1,016)	(111)
Balance at the end of the year	\$ 3,810	\$ 6,462

7. SHAREHOLDERS' EQUITY

(a) Shares authorized

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

(b) Common Shares & Common Share Performance Warrants

	2009		2008	
	Number of Shares/Warrants (000s)	Amount (\$000s)	Number of Shares/Warrants (000s)	Amount (\$000s)
Common shares				
Balance at the beginning of the year	57,385	\$ 90,802	56,453	\$ 90,543
Issued on exercise of options	-	-	232	747
Shares issued on exercise of warrants	-	-	700	1,407
Flow-through shares tax adjustment	-	-	-	(2,218)
Issue costs, net of future tax reduction of \$nil (2008-\$14)	-	(2)	-	(34)
Adjustment to contributed surplus for options exercised	-	-	-	357
Balance at the end of the year	57,385	\$ 90,800	57,385	\$ 90,802
Common share performance warrants				
Balance at the beginning of the year	2,016	\$ 1,233	2,716	\$ 1,661
Exercised	-	-	(700)	(428)
Expired	(2,016)	(1,233)	-	-
Balance at the end of the year	-	\$ -	2,016	\$ 1,233

All outstanding performance warrants entitled the holder to acquire a common share at a price of \$1.40 and expired on October 1, 2009.

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

(c) Contributed Surplus

(\$000s)	2009	2008
Balance at the beginning of the year	\$ 6,758	\$ 5,614
Stock-based compensation	996	1,501
Exercise of stock options and special performance units	-	(357)
Warrants expired	1,233	-
Balance at the end of the year	\$ 8,987	\$ 6,758

(d) Stock Options

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, 2009, options to acquire 5.7 million (2008 – 5.6 million) common shares were authorized for issuance under the stock option plan. Changes in outstanding options during the year ended December 31, 2009 and 2008 are summarized below:

	2009		2008	
	Options (000s)	Weighted Average Exercise Price	Options (000s)	Weighted Average Exercise Price
Outstanding at beginning of year	5,160	\$ 3.44	4,656	\$ 3.62
Granted	2,309	0.82	907	2.64
Exercised	-	-	(232)	3.22
Forfeited	(775)	3.53	(171)	4.29
Expired	(1,433)	3.23	-	-
Outstanding at end of year	5,261	\$ 2.34	5,160	\$ 3.44

The following table summarizes stock options outstanding and exercisable at December 31, 2009:

Range of exercise price	Options outstanding			Options exercisable	
	Number outstanding at year end (000s)	Weighted average remaining contractual life (years)	Weighted average exercise price	Number exercisable at year end (000s)	Weighted average exercise price
\$0.61 – 0.92	1,110	4.5	\$ 0.66	-	\$ -
\$0.93 – 1.40	1,458	4.7	1.01	87	1.25
\$2.13 – 3.20	250	2.9	3.01	133	2.99
\$3.21 – 4.46	2,443	2.1	3.82	1,711	3.85
	5,261	3.4	\$ 2.34	1,931	\$ 3.68

The fair value of each stock option 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:

	2009	2008
Risk-free interest rate	2%	3%
Expected life	5 years	5 years
Expected volatility	102%	56%
Expected dividend yield	Nil	Nil

The estimated fair value of stock options granted in 2009 was \$1.3 million (2008 – \$1.0 million). This estimated fair value is being amortized to earnings and capitalized to property, plant and equipment over the vesting period. A total of \$0.5 million (2008 – \$0.8 million) of stock and unit-based compensation was recorded against income in 2009 and \$0.5 million (2008 – \$0.8 million) was capitalized.

(e) Per Share Amounts

Basic per share amounts are calculated using the weighted average number of common shares outstanding during the year. 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 year. The weighted average number of shares outstanding is then adjusted by this amount.

	2009	2008
Weighted average common shares basic	57,385,162	57,054,424
Dilutive securities:		
Stock options	-	100,413
Performance warrants	-	946,482
Diluted	57,385,162	58,101,319

As a result of the net loss from operations, the effect of outstanding stock options on per share amounts is anti-dilutive in 2009.

For the year ended December 31, 2009, a weighted total of 5,260,834 (December 31, 2008 – 7,176,656) options and warrants were excluded from the diluted calculations as they were anti-dilutive.

8. FINANCIAL INSTRUMENTS, RISK MANAGEMENT AND CAPITAL MANAGEMENT STRATEGY

Overview

The Company has exposure to a number of risks from its use of financial instruments including, without limitation:

- Credit risk
- Liquidity risk
- Market risk

This note presents information about the Company's exposure to each of the credit, liquidity and market risks and the Company's objectives, policies and processes for measuring and managing risk, and the Company's management of capital. Further quantitative disclosures are included throughout these financial statements.

The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with risk management policies.

Fair Value of Financial Instruments

The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities. The fair value of measurements recognized in the balance sheet are classified according to the following hierarchy based on the amount of observable inputs used to value the instrument.

- Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices are either directly or indirectly observable as of the reporting date. Level 2 valuations are based on

inputs, including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the market place.

- Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

	December 31, 2009			
	Fair Value	Level 1	Level 2	Level 3
Commodity Contracts	93	-	93	-
Long-term debt	17,234	-	17,234	-

The Company's use of financial instruments has been assessed on the fair value hierarchy described above and the natural gas contracts are classified as Level 2.

The carrying value of the Company's financial instruments, other than bank indebtedness approximate their fair value due to their short maturity. The fair value of the bank indebtedness approximates its carrying value as it bears interest at a floating rate and the margins charged by the lenders are indicative of current credit spreads.

Credit Risk

Credit risk relates to the Company's receivables from joint venture partners and petroleum and natural gas marketers and the risk of financial loss if a customer, partner or counterparty to a financial instrument fails to meet its contractual obligations. A substantial portion of the Company's accounts receivable are with customers in the energy industry and are subject to normal industry credit risk. The Company generally grants unsecured credit but routinely assesses the financial strength of its partners and marketers.

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company sells the majority of its production to one petroleum and natural gas marketer and therefore is subject to concentration risk. To date, the Company has not experienced any collection issues with its petroleum and natural gas marketers. Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company attempts to mitigate the risk from joint venture receivables by obtaining joint venturer approval of significant capital expenditures prior to expenditure. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint venturers; however in certain circumstances, it may elect to cash call a joint venturer in advance of the work.

As at December 31, 2009 the Company's receivables consisted of \$2.7 million (2008 - \$4.3 million) from joint venture partners, \$3.5 million (2008 - \$4.2 million) of receivables from petroleum and natural gas marketers and \$1.6 million (2008 - \$2.3 million) of other receivables. Of the \$7.8 million in total accounts receivable, \$0.1 million is aged over 90 days.

The carrying amount of accounts receivable represents the maximum credit exposure. The Company does not have an allowance for doubtful accounts as at December 31, 2009 or 2008 and did not provide for any doubtful accounts nor was it required to write-off any receivables during the years ended December 31, 2009 or 2008.

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as practicable, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non-

operated projects to further manage capital expenditures. To facilitate the capital expenditure program, the Company has a revolving reserve based credit facility, as outlined in Note 5. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month.

The following are the contractual maturities of financial liabilities due as at December 31, 2009:

Financial Liability (\$000's)	< 1 year	1 - 2 years	2 - 5 years	Thereafter
Accounts payable and accrued liabilities	\$ 12,599	-	-	-
Long term debt	-	17,234	-	-
Total	\$ 12,599	17,234	-	-

Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices, and interest rates will affect the Company's net earnings or the value of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns.

The Company utilizes both financial derivatives and physical delivery sales contracts to manage commodity price risks. All such transactions are conducted in accordance with the risk management policy that has been approved by the Board of Directors.

(a) Foreign Currency Exchange Risk

Foreign currency exchange rate risk is the risk that the fair value of financial instruments or future cash flows will fluctuate as a result of changes in foreign exchange rates. Although substantially all of the Company's petroleum and natural gas sales are denominated in Canadian dollars, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollars. Given that changes in exchange rate have an indirect influence, the impact of changing exchange rates can not be accurately quantified. The Company had no forward exchange rate contracts in place as at December 31, 2009.

(b) Commodity Price Risk

Commodity price risk is the risk that the fair value of financial instruments or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand. The Company has attempted to mitigate commodity price risk through the use of financial derivative and physical delivery sales contracts. The Company's contracts in place as of December 31, 2009 are as follows:

<u>Type</u>	<u>Amount (GJ/day)</u>	<u>Term</u>	<u>Price (\$/GJ at AECO)</u>	<u>Type</u>
Collar	2,000	Jan. 1 – Mar. 31, 2010	\$4.25 - \$5.67	Financial
Put	3,000	Jan. 1 – Mar. 31, 2010	\$5.00	Physical
Put	2,000	Mar. 1 – Mar. 31, 2010	\$4.75	Physical
Fixed	1,000	Apr. 1 – Oct. 31, 2010	\$5.18	Financial
Fixed	1,000	Apr. 1 – Oct. 31, 2010	\$5.385	Financial
Collar	1,000	Apr. 1 – Oct. 31, 2010	\$5.00 – \$6.16	Financial
Collar	1,000	Apr. 1 – Oct. 31, 2010	\$5.00 – \$5.90	Financial

Subsequent to year-end the Company entered into the following financial instruments:

<u>Type</u>	<u>Amount (GJ/day)</u>	<u>Term</u>	<u>Price (\$/GJ at AECO)</u>	<u>Type</u>
Collar	1,000	Apr. 1 – Oct. 31, 2010	\$4.90 – \$5.63	Financial
Collar	1,000	Apr. 1 – Oct. 31, 2010	\$5.00 – \$5.95	Financial
Collar	1,000	Apr. 1 – Oct. 31, 2010	\$4.75 – \$5.86	Financial

During the year ended December 31, 2009 the contracts in place resulted in an unrealized loss of \$0.9 million (2008 - \$0.6 million gain) and a realized gain of \$1.9 million (2008 - \$2.2 million loss).

With respect to commodity prices, during the year ended December 31, 2009, a one dollar increase in the price per GJ of natural gas relevant only to the Company's production dedicated to derivative financial instruments would have resulted in a net earnings decrease of \$0.1 million (2008 – increase of \$0.5 million). A one dollar decrease in the price per GJ of natural gas on the same production would have increased net earnings for the year ended December 31, 2009 by \$0.1 million (2008 – decrease of \$0.3 million).

(c) Interest Rate Risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its credit facility which bears a floating rate of interest. The Company had no interest rate swaps or financial contracts in place as at or during the year ended December 31, 2009. For the year ended December 31, 2009, a difference in the interest rate of 1% would change net earnings by an estimated \$0.2 million (2008 - \$0.3 million), assuming all other variables are constant.

Capital Management Strategy

The Company's policy on capital management is to attempt to maintain a prudent capital structure to allow the Company to fund future development. The Company considers its capital structure to include shareholders' equity, bank debt, and working capital.

(\$000s)	2009	2008
Shareholders' equity	\$ 114,835	\$ 124,278
Bank debt	17,234	40,807
Working capital deficiency excluding, current loss on sublease, fair value of commodity contracts and associated future income tax	4,410	10,615

The Company manages its capital programs in order to maintain a prudent capital structure as changes in economic conditions occur. The Company may and has from time to time issued shares and adjusted spending to manage current or projected operating cash flows and debt levels.

The Company monitors its capital base using the ratio of net debt to annual operating cash flow. This ratio is calculated as net debt, as defined as long-term debt less working capital (or plus working capital deficiency) excluding, current loss on sublease, fair value of commodity contracts and associated future income tax; divided by annual cash flow from operations before changes in non-cash working capital. The Company's guideline is to maintain a ratio of approximately 1.0 to 1.0, not exceeding 2.0 to 1.0. This ratio will fluctuate depending on fluctuations of the commodity and business cycles. The Company prepares annual capital expenditure budgets which are updated periodically to monitor this ratio. The annual budget is approved by the Board of Directors with updates reviewed by the Board throughout the year.

As at December 31, 2009 the Company's ratio of net debt to annual operating cash flow was 1.7 to 1.0 (2008 – 1.2 to 1.0).

The Company's share capital is not subject to any external restrictions. As at December 31, 2009, the Company is in compliance with all flow-through share expenditure requirements as well as all bank facility requirements.

There have been no changes to the Company's capital management strategy during the year ended December 31, 2009.

9. ADDITIONAL DISCLOSURE

Net cash interest paid during the year was \$1.0 million (2008 - \$1.3 million). Cash taxes paid during the year was \$nil (2008 – \$nil).

10. COMMITMENTS

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

Payments due (\$000s)	2010	2011	2012	2013	2014	Thereafter	Total
Long-term debt	\$ -	\$ 17,234	\$ -	\$ -	\$ -	\$ -	\$ 17,234
Building lease	934	1,051	1,356	1,433	358	-	5,132
Processing fees	379	63	-	-	-	-	442
Transportation	432	374	125	-	-	-	931
Other	7	-	-	-	-	-	7
Total	\$ 1,752	\$ 18,722	\$ 1,481	\$ 1,433	\$ 358	\$ -	\$ 23,746