



CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2006
(Unaudited)

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NOTICE TO READER

In accordance with National Instrument 51-102 *Continuous Disclosure Obligations* of the Canadian Securities Administrators, we hereby give notice that the auditor of Greentree Gas & Oil Ltd. has neither performed an audit, nor a review, of the comparative financial statements for the three-month and six-month periods ended June 30, 2006.



CONSOLIDATED BALANCE SHEETS

As at June 30, 2006, December 31, 2005 and June 30, 2005

	June 30, 2006 (\$) (Unaudited)	December 31, 2005 (\$)	June 30, 2005 (\$) (Unaudited)
ASSETS			
Current			
Accounts receivable	186,572	273,400	224,171
Prepaid expenses and other receivables	48,297	67,593	59,427
Current portion of future income taxes (note 9)	31,875	29,398	48,607
	<u>266,744</u>	<u>370,391</u>	<u>332,205</u>
Property, plant and equipment (note 4)	12,787,161	12,722,030	13,100,572
Asset retirement trust fund (note 5)	70,850	70,850	70,743
	<u>13,124,755</u>	<u>13,163,271</u>	<u>13,503,520</u>
LIABILITIES			
Current			
Bank indebtedness (note 6)	2,327,878	1,473,075	2,176,404
Accounts payable and accrued liabilities	667,787	1,188,663	1,716,878
Income and other taxes payable (note 9)	321,250	864,624	687,774
Current portion of long-term debt (note 7)	54,048	60,220	39,931
	<u>3,370,963</u>	<u>3,586,582</u>	<u>4,620,987</u>
Long-term debt (note 7)	550,654	195,401	157,563
Asset retirement obligations (note 8)	420,880	404,946	362,956
Future income taxes (note 9)	2,870,666	2,774,909	1,893,753
	<u>7,213,163</u>	<u>6,961,838</u>	<u>7,035,259</u>
SHAREHOLDERS' EQUITY			
Capital stock (note 10)	14,016,831	14,332,881	13,604,675
Warrants (note 10)	193,500	193,500	99,500
Contributed surplus	608,833	419,833	419,833
Deficit	(8,907,572)	(8,744,781)	(7,655,747)
	<u>5,911,592</u>	<u>6,201,433</u>	<u>6,468,261</u>
	<u>13,124,755</u>	<u>13,163,271</u>	<u>13,503,520</u>
Going concern (note 1)			
Commitments (note 15)			
Subsequent events (note 16)			
Signed on behalf of the Board:			
"Duncan Hamilton"	Director		
"Gary Bean"	Director		

See accompanying notes to the consolidated financial statements.



CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

For the three-month and six-month periods ended June 30, 2006 and June 30, 2005
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006 (\$)	2005 (\$)	2006 (\$)	2005 (\$)
Revenue				
Gas sales	379,311	408,976	889,733	784,434
Oil sales	90,502	99,057	123,100	123,763
Other	1,726	3,290	3,516	5,483
	<u>471,539</u>	<u>511,323</u>	<u>1,016,349</u>	<u>913,680</u>
Royalties	54,382	57,050	121,054	102,907
	<u>417,157</u>	<u>454,273</u>	<u>895,295</u>	<u>810,773</u>
Expenses				
Operations	201,597	170,500	401,747	343,259
Depletion and depreciation	202,401	218,883	394,044	414,078
General and administrative	310,292	140,721	402,788	289,289
Interest expense	47,294	31,956	85,800	57,099
Other taxes and related interest	(37,882)	(2,186)	(20,257)	10,191
Accretion of asset retirement obligations	8,504	6,560	16,734	13,177
	<u>732,206</u>	<u>566,434</u>	<u>1,280,856</u>	<u>1,127,093</u>
Loss before income taxes	(315,049)	(112,161)	(385,561)	(316,320)
Recovery of (provision for) income taxes (note 9)	<u>(66,474)</u>	<u>54,255</u>	<u>222,770</u>	<u>79,328</u>
Net loss	(381,523)	(57,906)	(162,791)	(236,992)
Deficit, beginning of period	<u>(8,526,049)</u>	<u>(7,597,841)</u>	<u>(8,744,781)</u>	<u>(7,418,755)</u>
Deficit, end of period	<u>(8,907,572)</u>	<u>(7,655,747)</u>	<u>(8,907,572)</u>	<u>(7,655,747)</u>
Net loss per share				
Basic and diluted (note 10)	<u>\$(0.01)</u>	<u>\$(0.00)</u>	<u>\$(0.00)</u>	<u>\$(0.01)</u>

See accompanying notes to the consolidated financial statements.



CONSOLIDATED STATEMENTS OF CASH FLOWS

For the three-month and six-month periods ended June 30, 2006 and June 30, 2005
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006 (\$)	2005 (\$)	2006 (\$)	2005 (\$)
Operating activities				
Net loss for the period	(381,523)	(57,906)	(162,790)	(236,992)
Items not affecting cash:				
Depletion and depreciation	202,401	218,883	394,044	414,078
Gain on disposal of assets	(1,869)	-	(1,869)	-
Accretion of asset retirement obligations	8,504	6,560	16,734	13,177
Stock-based compensation	189,000	-	189,000	-
Future income taxes	66,474	(57,182)	(222,770)	(85,255)
Asset retirement costs	(800)	(24,326)	(800)	(24,326)
	<u>82,187</u>	<u>86,029</u>	<u>211,549</u>	<u>80,682</u>
Net change in non-cash working capital (note 14)	(148,384)	168,405	(502,410)	(303,027)
	<u>(66,197)</u>	<u>254,434</u>	<u>(290,861)</u>	<u>(222,345)</u>
Financing activities				
Issuance of long-term debt	-	107,115	-	132,115
Repayment of long-term debt	(88,907)	(11,369)	(106,634)	(22,714)
	<u>(88,907)</u>	<u>95,746</u>	<u>(106,634)</u>	<u>109,401</u>
Investing activities				
Acquisition of property, plant and equipment	(227,569)	(320,220)	(459,177)	(619,474)
Proceeds from sale of assets	1,869	-	1,869	-
	<u>(225,700)</u>	<u>(320,220)</u>	<u>(457,308)</u>	<u>(619,474)</u>
Increase (decrease) in cash and cash equivalents	(380,804)	29,960	(854,803)	(732,418)
Cash and cash equivalents, beginning of period	(1,947,074)	(2,206,364)	(1,473,075)	(1,443,986)
Cash and cash equivalents, end of period	(2,327,878)	(2,176,404)	(2,327,878)	(2,176,404)

See accompanying notes to the consolidated financial statements.



NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2006

1. GOING CONCERN

These consolidated financial statements were prepared in accordance with Canadian generally accepted accounting principles applicable to a going concern which assumes that the Company will realize the carrying value of its assets and satisfy its obligations as they become due in the normal course of operations. For the three-month period ended June 30, 2006, the Company had a net loss of \$381,523 (loss of \$57,906 for the three-month period ended June 30, 2005) and negative cash flow from operating activities of \$66,197 (positive cash flow from operating activities of \$254,434 over the same period in 2005). As a result of recurring losses over the last several years, the Company had a deficit of \$8.91 million as at June 30, 2006 (\$7.66 million as at June 30, 2005) and had a net working capital deficiency of \$3.10 million at that date (\$4.29 million as at June 30, 2005).

The ability of the Company to continue as a going concern could depend on raising additional financing and achieving profitable operations sufficient to meet all obligations.

Although in the opinion of Management the use of the going concern assumption is appropriate, there can be no assurance that any steps Management is taking will be successful.

These consolidated financial statements do not reflect adjustments in the carrying values of the assets and liabilities, expenses, and the balance sheet classifications that would be used if the going concern assumption were not appropriate. Such adjustments could be material.

2. NATURE OF OPERATIONS

The Company is engaged primarily in the exploration for and production of natural gas and petroleum reserves in southwestern Ontario.

3. SIGNIFICANT ACCOUNTING POLICIES

BASIS OF CONSOLIDATION

The consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in Canada within the framework of the accounting policies summarized below. These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Southwest Petroleum Explorations Inc., together with the Company's proportionate share of the assets, liabilities, revenues, expenses and cash flows of the joint ventures in which it participates.

MEASUREMENT UNCERTAINTY

The timely preparation of consolidated financial statements requires that Management make estimates and assumptions and use judgment regarding assets, liabilities, revenues and expenses. Such estimates relate primarily to transactions and events that have not been settled as of the date of the consolidated financial statements. Accordingly, actual results may differ from estimated amounts as future confirming events occur.

Amounts recorded for depletion and depreciation, asset retirement obligations and amounts used in impairment test calculations are based upon estimates of petroleum and natural gas reserves and future costs to develop those reserves. By their nature, these estimates of reserves, costs and related future cash flows are subject to uncertainty, and the impact on the consolidated financial statements of future periods could be material.

CAPITALIZED COSTS

a) Petroleum and natural gas properties and production equipment

The Company follows the full-cost method of accounting for its petroleum and natural gas operations as determined by the Canadian Institute of Chartered Accountants ("CICA"), Accounting Guideline 16 ("AcG-16"). Under this method, all costs relating to the exploration for and development of oil and gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses, costs of drilling both producing and non-producing wells, production facilities and asset retirement costs. Proceeds from the sale of properties are applied against capitalized costs, without any gain or loss being realized, unless such sale would significantly alter the rate of depletion.

Depletion of petroleum and natural gas properties, and production equipment is provided using the unit-of-production method based upon estimated proved petroleum and natural gas reserves. The costs of significant 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. Estimated future costs to be incurred in developing proved reserves are included in costs subject to depletion. For depletion purposes, relative volumes of natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

Where a lease of petroleum and natural gas properties transfers substantially all of the benefits and risks of ownership related to the leased property from the lessor to the lessee, the Company accounts for the lease as a capital lease. Under this accounting treatment, the Company accounts for a capital lease as an asset and an obligation. The asset is amortized using the unit of production method.

b) Equipment

Equipment is stated at cost and is depreciated over its estimated useful life using the straight-line method at the following annual rates:

Field equipment	10-20%
Furniture and equipment	20%
Automobiles	25%
Computer hardware and software	30%

c) Asset retirement obligations

The Company recognizes the fair value of estimated asset retirement obligations on the consolidated balance sheet when a reasonable estimate of fair value can be made. Asset retirement obligations include those for which a company faces a legal obligation to retire tangible long-lived assets such as well sites, pipelines and facilities. Increases in the asset

retirement obligations resulting from the passage of time are recorded as accretion to the asset retirement obligations in the consolidated statement of operations and deficit. Actual expenditures incurred are charged against the accumulated obligations.

The asset retirement cost, equal to the estimated fair value of the retirement obligations, is capitalized as part of the cost of the related long-lived asset. Asset retirement costs are amortized using the unit-of-production method and are included in depletion and depreciation in the consolidated statement of operations and deficit.

d) Impairment test

At each reporting period, the Company performs an impairment test to determine the recoverability of capitalized costs associated with reserves. An impairment loss is recognized in net earnings or loss when the carrying amount of a cost center exceeds its fair value. The carrying amount of the cost center is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows from proved reserves plus the costs of unproved properties. If the sum of the cash flows is less than the carrying amount, the impairment loss is limited to the amount by which the carrying amount exceeds the sum of the fair value of proved and probable reserves and the costs of unproved properties that have been subject to a separate impairment test and contain no probable reserves.

FINANCIAL INSTRUMENTS

Financial instruments consist of accounts receivable, bank indebtedness, accounts payable and accrued liabilities, and long-term debt. Differences between the carrying value of these financial instruments and their estimated fair value are disclosed in note 12.

FLOW-THROUGH SHARES

Resource expenditure deductions for income tax purposes related to exploration and development activities funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. The liability for future income taxes is increased and capital stock is reduced by the estimated tax benefits transferred to shareholders at the time the resource expenditure deductions are renounced.

LOSS PER SHARE

Basic net loss per common share is determined by dividing net loss by the weighted average number of common shares outstanding during the year. Diluted loss per share is computed by giving effect to the potential dilution that would occur if stock options and warrants were exercised. The treasury stock method is used to determine the dilutive effect of stock options and warrants. The treasury stock method assumes that proceeds received from the exercise of in-the-money stock options are used to repurchase common shares at the average market rate for the year.

INCOME TAXES

The Company follows the liability method of accounting for income taxes. Under this method, current income taxes are recognized for the estimated income taxes payable for the current year. Future income tax assets and liabilities are recognized for temporary differences between the tax and accounting bases of assets and liabilities as well as for the benefit of losses available to be carried forward for future years for tax purposes that are more likely than not to be realized. Future assets and liabilities are measured using the enacted or substantively enacted tax rates and laws that are expected to be in effect when the temporary differences are expected to reverse.

REVENUE RECOGNITION

Revenue associated with the production and sale of natural gas and crude oil owned by the Company is recognized in the same period as when the purchaser has taken possession of the commodity. Other revenue is recognized in the period that the service is provided.

STOCK-BASED COMPENSATION PLAN

The Company has a stock option plan that is described in note 10.

The Company uses the fair-value method of accounting for stock options granted to employees and directors. Compensation costs are recognized over the vesting period. Fair values are determined using the Black-Scholes option pricing model.

CASH AND CASH EQUIVALENTS

Cash includes bank balances and indebtedness. Highly liquid investments having a maturity of three months or less are considered cash equivalents.

COMPARATIVE AMOUNTS

Certain comparative amounts have been reclassified to conform to current year presentation.

4. PROPERTY, PLANT AND EQUIPMENT

	June 30, 2006			June 30, 2005		
	Cost (\$)	Accumulated Depletion and Depreciation (\$)	Net Book Value (\$)	Cost (\$)	Accumulated Depletion and Depreciation (\$)	Net Book Value (\$)
Petroleum and natural gas properties	17,820,559	6,751,638	11,068,921	17,513,844	6,050,944	11,462,900
Production equipment	2,151,253	674,582	1,476,671	2,140,264	515,435	1,624,829
Production equipment under capital lease	220,000	16,455	203,545	-	-	-
Field equipment	353,054	345,764	7,290	345,994	344,955	1,039
Other	344,749	314,015	30,734	319,426	307,622	11,804
Totals	<u>20,889,615</u>	<u>8,102,454</u>	<u>12,787,161</u>	<u>20,319,528</u>	<u>7,218,956</u>	<u>13,100,572</u>

Petroleum and natural gas properties included costs of \$4,038,140 (June 30, 2005 - \$4,112,615) related to unproved properties, which are not being depleted.

Future asset retirement costs of \$222,320 (June 30, 2005 - \$204,469) have been capitalized as part of the cost of petroleum and natural gas properties.

No future capital expenditures (June 30, 2005 - \$470,000), as estimated by independent engineers, relating to the development of proved reserves have been included in costs subject to depletion.

No impairment in the carrying amount of the Company's petroleum and natural gas assets has been recorded in the three months ended June 30, 2006.

5. ASSET RETIREMENT TRUST FUND

The Company is legally required, under the provisions of the Oil, Gas and Salt Resources Act of Ontario, to maintain a drilling and abandonment security deposit.

6. BANK INDEBTEDNESS

As at June 30, 2006, the Company's operating facility had a maximum unrestricted amount of \$2,400,000 with no monthly reductions and bearing interest at prime plus 2% per year.

The operating facility agreement requires that the Company meet certain covenants including one relating to working capital ratio. As at June 30, 2006, the Company is in violation of the working capital ratio covenant. The Company's lending institution has provided written confirmation of their waiver of the breach of this covenant as at June 30, 2006.

7. LONG-TERM DEBT

	June 30, 2006 (\$)	June 30, 2005 (\$)
Various automobile financing arrangements	25,448	65,379
Pipeline financing	-	132,115
Obligation under capital lease	198,539	-
Other taxes payable	680,715	-
Total long-term debt	904,702	197,494
Less: current portion of automobile financing arrangements	22,217	39,931
Less: current portion of obligation under capital lease	31,831	-
Less: current portion of other taxes payable	300,000	-
Total current portion	354,048	39,931
Total long-term portion	550,654	157,563

The automobile financing arrangements relate to trucks used in the field. The trucks are pledged as collateral for various financing arrangements. The financing arrangements bear no interest and mature between March 4, 2007 and October 10, 2007.

The aggregate amount of principal repayments on the automobile financing arrangements are as follows:

	Automobile Financing Principal Repayments (\$)
2006	13,197
2007	<u>12,251</u>
	<u>25,448</u>

The aggregate amount of future minimum payments under the capital lease for pipeline and other production equipment are as follows:

	Future Minimum Lease Payments (\$)
2006	27,435
2007	54,871
2008	<u>162,153</u>
	244,459
Less: amount representing interest at 12.5%	<u>45,920</u>
Present value of minimum lease payments	198,539
Less: amount due within one year	<u>31,831</u>
	<u>166,708</u>

During the second quarter of 2006, the Company negotiated long-term payment terms with respect to special taxes and interest owing pursuant to the income tax matter described more fully in notes 9 and 16 to these consolidated financial statements. The current portion of this liability is included in other taxes and related interest in the consolidated balance sheet as at June 30, 2006.

The aggregate amount of future principal payments relating to these other taxes are as follows:

	Other Taxes Principal Repayments (\$)
2006	150,000
2007	300,000
2008	<u>230,715</u>
	<u>680,715</u>

8. ASSET RETIREMENT OBLIGATIONS

The following table presents the reconciliation of the beginning of quarter and end of quarter aggregate carrying amount of the obligations associated with the retirement of natural gas and oil assets for the second quarters of 2006 and 2005:

	June 30, 2006 (\$)	June 30, 2005 (\$)
Asset retirement obligations, beginning of the period	413,176	367,431
Liabilities incurred	-	-
Liabilities settled	(800)	(24,326)
Accretion expense	8,504	6,560
Revisions in estimated cash flows	-	<u>13,291</u>
Asset retirement obligations, end of the period	<u>420,880</u>	<u>362,956</u>

The total undiscounted amount of estimated cash flows required to settle the obligations is \$1,322,756 (June 30, 2005 - \$1,317,794), which has been discounted using a credit-adjusted risk-free rate of 8.5%. The majority of these obligations is not expected to be settled for years, or decades, in the future and will be funded from general Company resources at the time of retirement and removal.

9. INCOME TAXES

The provision (recovery) for income taxes differs from the amount anticipated based on the statutory combined federal and provincial tax rate.

	June 30, 2006 (\$)	June 30, 2005 (\$)
Anticipated income taxes (recovery) based on statutory income tax rate of 36.12% (June 30, 2005 – 36.12%)	(113,796)	(40,512)
Increase (decrease) in taxes resulting from:		
Resource allowance	(8,701)	(10,992)
Non-deductible tax and interest	(12,916)	(425)
Adjustment to loss carry-forwards and other tax pools and allowances	132,986	-
Federal large corporations tax	-	2,927
Stock-based compensation	68,267	11,498
Other	634	(5,253)
	<u>66,474</u>	<u>(54,255)</u>

The provision (recovery) of income taxes comprises the following:

	June 30, 2006 (\$)	June 30, 2005 (\$)
Provision (recovery) for current income taxes	-	2,927
Provision (recovery) of future income taxes		
- current	(3,533)	-
- deferred	70,007	(57,182)
	<u>66,474</u>	<u>(54,255)</u>

The future income tax liability is comprised of:

	June 30, 2006 (\$)	June 30, 2005 (\$)
Property, plant and equipment (excess of book value over tax value)	3,565,892	3,473,852
Share issue costs	(57,520)	(85,231)
Non-capital loss carryforwards	(511,833)	(1,412,376)
Asset retirement obligations	(152,022)	(131,099)
Other taxes	(5,726)	-
	2,838,791	1,845,146
Add: current portion	31,875	48,607
	<u>2,870,666</u>	<u>1,893,753</u>

At June 30, 2006, the Company had accumulated non-capital loss carried-forwards of approximately \$1.43 million for tax purposes, which expire between 2009 and 2011. As approximately \$10,000 of these losses are expected to expire without being utilized, the benefit associated with that portion of the accumulated non-capital loss carry-forwards has not been recognized in these consolidated financial statements.

In 2001 and prior years, the Company raised a total of \$10.8 million in gross proceeds through offerings of flow-through common shares. In the annual filings of renounced qualifying expenditures submitted to the Canada Revenue Agency ("CRA"), the gross

amounts raised each year were renounced to the flow-through shareholders. The determination of what constitutes qualifying expenditures is highly technical and requires the exercise of judgment. Subsequent to filing the renunciation documents for these years, Management had undertaken a review of qualifying expenditures as defined in current provisions of the Canadian Income Tax Act. The Company had approached the CRA to request amendments of the original T101 submissions. A settlement agreement was reached with the CRA during the first quarter of 2006, and pursuant to this agreement and to further relief provided to the Company subsequent to June 30, 2006 (see note 16), tax of \$680,715 remains outstanding as at June 30, 2006 (June 30, 2005 - \$601,000). Pursuant to a payment arrangement reached with the CRA in the second quarter of 2006, \$300,000 of this amount has been classified as a current liability and has been included within income and other taxes payable. The remainder of \$380,715 has been included in long-term debt (see note 7) in these consolidated financial statements.

10. CAPITAL STOCK

AUTHORIZED

Unlimited number of common shares.

ISSUED

	Number of shares	Amount \$
Common shares		
Balance – December 31, 2004	30,625,290	13,661,022
Future income tax effects of prior year flow-through shares	<u>-</u>	<u>(56,347)</u>
Balance – June 30, 2005	30,625,290	13,604,675
Shares issued to related parties in private placements, net of share issue costs and future income tax effects	100,000	29,128
Other shares issued in private placements, net of share issuance costs and future income tax effects	<u>2,400,000</u>	<u>699,078</u>
Balance, December 31, 2005	33,125,290	14,332,881
Future income tax effects of prior year flow-through shares	<u>-</u>	<u>(316,050)</u>
Balance, June 30, 2006	<u>33,125,290</u>	<u>14,016,831</u>

During 2005, as part of the 2,500,000 shares issued in a private placement, the Company issued 100,000 common shares to a related party on a flow-through basis for gross proceeds of \$35,000. The amount from the issue of these shares are presented net of proceeds allocated to share purchase warrants of \$3,760 and share issue costs of \$3,306, net of future income taxes of \$1,194.

During 2005, the Company issued 2,400,000 other common shares from a private placement on a flow-through basis for gross proceeds of \$840,000. The amount from the issue of these shares are presented net of proceeds allocated to share purchase warrants of \$90,240 and share issue costs of \$79,340 net of future income taxes of \$28,658.

STOCK OPTION PLAN

The Company has a stock option plan (the "Plan") for its directors, officers and employees to purchase common shares, which was last amended as of April 14, 2004.

Under the terms of the Plan, the Board of Directors may authorize the granting of options to purchase up to 3,312,529 common shares, provided that no individual may be granted options exceeding 5% of the issued and outstanding common shares of the Company. The option price per common shares granted under the plan may not be less than the closing market price on the date the option is granted less allowable discounts as permitted under the policies of the TSX Venture Exchange. The maximum term of any option is five years from the date the option is granted. Options are immediately exercisable upon granting.

The status of the Company's stock option plan as at June 30, 2006 and June 30, 2005 and during the three-month periods then ended is presented below:

	June 30, 2006			June 30, 2005		
	Share options	Weighted average exercise price (\$)	Weighted average grant-date market price (\$)	Share options	Weighted average exercise price (\$)	Weighted average grant-date market price (\$)
Outstanding – beginning of the period	1,260,000	0.58	0.63	1,365,000	0.62	0.67
Granted	675,000	0.35	0.38	-	-	-
Exercised	-	-	-	-	-	-
Expired	(85,000)	(1.50)	(1.45)	(100,000)	(1.15)	(1.15)
Outstanding – end of the period	1,850,000	0.45	0.50	1,265,000	0.58	0.63

The following table outlines information about stock options outstanding at June 30, 2006:

Exercise price (\$)	Number of options outstanding	Weighted average remaining contractual life (yrs.)
1.03	25,000	1.42
0.50	1,150,000	2.38
0.35	675,000	4.79
	1,850,000	3.25

The Company granted 675,000 options during the three-month period ended June 30, 2006. The fair value of the options granted was estimated at \$189,000 at the date of grant using the Black-Scholes option-pricing model and this expense is included in general and

administrative expenses in the consolidated statement of operations and deficit. The following assumptions were used in the calculations on the April 13, 2006 grant date:

Risk free interest (%)	4.31%
Expected life (years)	5.0
Expected volatility	91%

WARRANTS

	Number of warrants	Amount \$
Balance – December 31, 2004	393,201	99,500
<u>January 1, 2005 to June 30, 2006</u>		
Flow-through share purchase warrants issued	833,333	94,000
Common share purchase warrants expired	<u>(393,201)</u>	<u>-</u>
Balance – June 30, 2006	<u>833,333</u>	<u>193,500</u>

During 2005, the Company granted 833,333 warrants as part of a private placement. Each warrant entitles the holder to acquire one flow-through common share of the Company at a price of \$0.70 per common share until December 27, 2007. The warrants granted in 2005 were charged against share capital in the amount of \$94,000. The fair values of the warrants were calculated using the Black-Scholes warrant valuation model at the date of granting. No new warrants were granted during the first or second quarters of 2006. The Company had 833,333 warrants outstanding as at June 30, 2006.

NET LOSS PER SHARE

	Three-months ended June 30, 2006			Three-months ended June 30, 2005		
	Net Loss (\$)	Weighted average number of shares	Per-share amount (\$)	Net Loss (\$)	Weighted average number of shares	Per-share amount (\$)
Basic loss per share to common shareholders	(381,523)	33,125,290	(0.01)	(57,906)	30,625,290	(0.00)
Diluted loss per share to common shareholders	(381,523)	33,125,290	(0.01)	(57,906)	30,625,290	(0.00)

Options to purchase 1,850,000 common shares (June 30, 2005 – 1,265,000 common shares) at a weighted average price of \$0.45 per common share (June 30, 2005 - \$0.58 per common share) and warrants to purchase 833,333 common shares (June 30, 2005 – 393,201 common shares) at a price of \$0.70 per common share (June 30, 2005 - \$0.60 per common share) were not included in the computation of diluted loss per share because they were anti-dilutive.

11. INTEREST IN JOINT VENTURE

The joint venture is involved in the exploration for, and production of, petroleum and natural gas. The Company's share of the assets, liabilities, revenues, expenses and cash flows of joint venture are as follows:

	June 30, 2006 (\$)	June 30, 2005 (\$)
Property, plant and equipment	130,392	146,131
Current liabilities	-	5,204
Revenues (net of royalties)	3,457	6,183
Expenses	5,114	3,277
Cash flows provided from (used for):		
Operating activities	3,457	8,844
Investing activities	-	(4,346)
Financing activities	(3,457)	(4,498)
Non-cash transactions:		
Contributions of petroleum and natural gas properties, from a participant	-	673

12. FINANCIAL INSTRUMENTS

FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES

The carrying values of cash, accounts receivable, accounts payable and accrued liabilities approximates their fair value due to the immediate or short-term maturity of these financial instruments. The fair value of the long-term debt as at June 30, 2006 (book value of current and long-term portions as at that date is \$904,702 – see note 7) calculated using an interest rate of 7.0% is approximately \$957,442.

INTEREST RATE RISK

The Company is exposed to interest rate risk arising from fluctuations in interest rates on its operating facility.

CREDIT RISK

The Company is exposed to financial risk that arises from the credit quality of the entities to which it provides its natural gas, crude oil, other by-products and services. Credit risk arises from the possibility that the entities to which the Company provides these commodities and services may experience financial difficulty and be unable to fulfill their obligations. The Company's revenues are dependent on a selective customer base and bad debts have not been significant. As such, concentrations of credit risk are considered to be minimal.

13. RELATED PARTY TRANSACTIONS

TRANSACTIONS WITH RELATED PARTIES

During the second quarters of 2006 and 2005, the following transactions occurred in the ordinary course of business between the Company and a law firm of which a partner is a director and shareholder of the Company.

	June 30, 2006	June 30, 2005
	\$	\$
<i>Transactions during the period:</i>		
Administrative expenses paid to related party	9,977	7,689
<i>Balance at end of the period:</i>		
Due to related party	285,193	333,368

These transactions were recorded at the exchange amount, which is the amount agreed to by the transacting parties and which approximate fair market value. The balances are included in accounts payable and accrued liabilities in the consolidated balance sheets.

14. SUPPLEMENTAL CASH FLOW INFORMATION

	Three months ended June 30, 2006	Three months ended June 30, 2005
	\$	\$
(Increase) decrease in:		
Accounts receivable	(16,871)	(56,337)
Prepaid expenses and other receivables	8,403	(9,836)
Increase (decrease) in:		
Accounts payable and accrued liabilities	(102,034)	245,764
Income and other taxes payable	<u>(37,882)</u>	<u>(11,186)</u>
	<u>(148,384)</u>	<u>168,405</u>
Cash paid during the period for:		
Interest	46,555	29,795
Income taxes	-	-
Non-cash transactions:		
Asset retirement costs – revisions in estimated cash flows (note 8)	-	13,291
Asset retirement obligations (note 8)	-	13,291

15. COMMITMENTS

FLOW-THROUGH SHARE COMMITMENT

Pursuant to the flow-through share private placement in late 2005, the Company has an obligation to incur \$875,000 in qualified exploration and/or development expenditures by December 31, 2006. As at June 30, 2006, the Company had incurred \$249,441 of qualifying expenditures.

OFFICE LEASE COMMITMENT

As at June 30, 2006, the Company is obligated to make future minimum lease payments under an operating lease (excluding additional rent for operating cost recoveries) for its administrative offices as follows:

Year	Minimum Lease Payments (\$)
2006	4,478
2007	9,026
2008	9,167
2009	9,309
2010	6,289

COMPRESSOR LEASE AGREEMENT

The Company leases two compressors from a US entity. As at June 30, 2006 the company is obligated to make future lease payments under operating leases for the two compressors as follows:

Year	Lease Payment (\$US)
2006	29,400
2007	32,000

16. SUBSEQUENT EVENTS

PRIVATE PLACEMENTS

On July 14, 2006, the Company closed its final tranche on a private placement for 1,116,363 flow-through units comprised of 1,116,363 flow-through common shares and 372,121 flow-through share purchase warrants for gross proceeds of \$368,400. Finders were paid cash commissions of \$25,788 plus 66,982 flow-through share purchase warrants. Both the warrants included in the units and the finder's warrants entitle the holder, upon exercise of

each whole warrant, to purchase one flow-through common share of the Company at a price of \$0.66 per flow-through common share at any time within 24 months of the date of issue of the warrant.

On August 10, 2006, the Company announced that it had proposed another private placement to sell both flow-through and non-flow-through units. At the time of writing, only the first tranche of this private placement had been completed (announced on August 14, 2006), as follows:

- 1,621,258 flow-through units consisting of 1,621,258 flow-through common shares and 540,419 flow-through share purchase warrants were issued for gross proceeds of \$535,015. For this part of the first tranche of the private placement, finder's were paid cash commissions of \$37,451 plus 90,909 flow-through share purchase warrants. Both the warrants included in the units and the finder's warrants entitle the holder, upon exercise of each whole warrant, to purchase one flow-through common share of the Company at a price of \$0.66 per flow-through common share at any time within 24 months of the date of issue of the warrant.
- 381,666 non-flow-through units consisting of 381,666 non-flow-through common shares and 190,833 non-flow-through share purchase warrants were issued for gross proceeds of \$114,500. The warrants included in these units entitle the holder, upon exercise of each whole warrant, to purchase one non-flow-through common share of the Company at a price of \$0.50 per non-flow-through common share at any time within 24 months of the date of issue of the warrant. For this part of the first tranche of the private placement, finder's were paid cash commissions of \$11,450.

As these events do not relate to conditions that existed on June 30, 2006, the effect of these transactions has not been reflected in these consolidated financial statements.

GRANTING OF INTEREST RELIEF ON TAX LIABILITY

Pursuant to certain provisions of the Income Tax Act (Canada), Management of the Company had previously initiated a formal request for the reduction or elimination of interest and penalties on the Company's debt to the CRA relating to the income tax matter described in note 9 to these consolidated financial statements.

On August 1, 2006, the CRA granted the cancellation of all interest and penalties accruing up to August 1, 2006 on the above-mentioned debt. The effect of this relief up to June 30, 2006 has been recognized in these consolidated financial statements as a reduction of \$47,664 in other taxes and related interest payable, which had been previously accrued. Management estimates the overall interest and penalty relief to August 1, 2006 will be approximately \$60,000.