



**CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 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 nine-month periods ended September 30, 2006.



## CONSOLIDATED BALANCE SHEETS

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

	September 30, 2006 (\$) (Unaudited)	December 31, 2005 (\$)	September 30, 2005 (\$) (Unaudited)
<b>ASSETS</b>			
<b>Current</b>			
Accounts receivable	450,637	273,400	262,241
Prepaid expenses and other receivables	49,891	67,593	47,846
Current portion of future income taxes (note 9)	43,286	29,398	35,972
	<u>543,814</u>	<u>370,391</u>	<u>346,059</u>
<b>Property, plant and equipment</b> (note 4)	12,898,216	12,722,030	12,966,748
<b>Asset retirement trust fund</b> (note 5)	71,612	70,850	70,743
	<u>13,513,642</u>	<u>13,163,271</u>	<u>13,383,550</u>
<b>LIABILITIES</b>			
<b>Current</b>			
Bank indebtedness (note 6)	1,834,381	1,473,075	2,363,821
Accounts payable and accrued liabilities	664,734	1,188,663	1,318,475
Income and other taxes payable (note 9)	285,623	864,624	692,154
Current portion of long-term debt (note 7)	50,886	60,220	76,938
	<u>2,835,624</u>	<u>3,586,582</u>	<u>4,451,388</u>
<b>Long-term debt</b> (note 7)	510,593	195,401	197,043
<b>Asset retirement obligations</b> (note 8)	425,010	404,946	386,123
<b>Future income taxes</b> (note 9)	2,751,899	2,774,909	1,908,492
	<u>6,523,126</u>	<u>6,961,838</u>	<u>6,943,046</u>
<b>SHAREHOLDERS' EQUITY</b>			
<b>Capital stock</b> (note 10)	15,000,982	14,332,881	13,604,675
<b>Warrants</b> (note 10)	334,500	193,500	99,500
<b>Contributed surplus</b>	608,833	419,833	419,833
<b>Deficit</b>	(8,953,799)	(8,744,781)	(7,683,504)
	<u>6,990,516</u>	<u>6,201,433</u>	<u>6,440,504</u>
	<u>13,513,642</u>	<u>13,163,271</u>	<u>13,383,550</u>

Going concern (note 1)

Commitments (note 15)

Signed on behalf of the Board:

"Duncan Hamilton" \_\_\_\_\_ Director

"Gary Bean" \_\_\_\_\_ Director



## CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

For the three-month and nine-month periods ended September 30, 2006 and September 30, 2005  
(Unaudited)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2006	2005	2006	2005
	(\$)	(\$)	(\$)	(\$)
<b>Revenue</b>				
Gas sales	363,806	442,749	1,253,539	1,227,183
Oil sales	77,135	111,257	200,235	235,020
Other	9,390	3,199	12,906	8,682
	<u>450,331</u>	<u>557,205</u>	<u>1,466,680</u>	<u>1,470,885</u>
Royalties	56,298	60,527	177,352	163,434
	<u>394,033</u>	<u>496,678</u>	<u>1,289,328</u>	<u>1,307,451</u>
<b>Expenses</b>				
Operations	174,807	153,242	576,554	496,501
Depletion and depreciation	199,027	200,684	593,071	614,762
General and administrative	88,051	86,427	490,839	375,716
Interest expense	44,972	39,030	130,772	96,129
Other taxes and related interest	10,291	1,380	(9,966)	11,571
Accretion of asset retirement obligations	12,555	13,298	29,289	26,475
	<u>529,703</u>	<u>494,061</u>	<u>1,810,559</u>	<u>1,621,154</u>
<b>Loss before income taxes</b>	(135,670)	2,617	(521,231)	(313,703)
<b>Recovery of (provision for) income taxes (note 9)</b>	<u>89,443</u>	<u>(30,374)</u>	<u>312,213</u>	<u>48,954</u>
<b>Net loss</b>	(46,227)	(27,757)	(209,018)	(264,749)
<b>Deficit, beginning of period</b>	<u>(8,907,572)</u>	<u>(7,655,747)</u>	<u>(8,744,781)</u>	<u>(7,418,755)</u>
<b>Deficit, end of period</b>	<u>(8,953,799)</u>	<u>(7,683,504)</u>	<u>(8,953,799)</u>	<u>(7,683,504)</u>
<b>Net loss per share</b>				
Basic and diluted (note 10)	<u>\$(0.00)</u>	<u>\$(0.00)</u>	<u>\$(0.01)</u>	<u>\$(0.01)</u>

See accompanying notes to the consolidated financial statements.



## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the three-month and nine-month periods ended September 30, 2006 and September 30, 2005  
(Unaudited)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2006	2005	2006	2005
	(\$)	(\$)	(\$)	(\$)
<b>Operating activities</b>				
Net loss for the period	(46,227)	(27,757)	(209,017)	(264,749)
Items not affecting cash:				
Depletion and depreciation	199,027	200,684	593,071	614,762
Gain on disposal of assets	-	(588)	(1,869)	(588)
Accretion of asset retirement obligations	12,555	13,298	29,289	26,475
Stock-based compensation	-	-	189,000	-
Future income taxes	(89,443)	27,374	(312,213)	(57,881)
Asset retirement costs	(8,425)	(1,278)	(9,225)	(25,604)
	<u>67,487</u>	<u>211,733</u>	<u>279,036</u>	<u>292,415</u>
Net change in non-cash working capital (note 14)	(264,789)	(420,512)	(767,199)	(723,539)
	<u>(197,302)</u>	<u>(208,779)</u>	<u>(488,163)</u>	<u>(431,124)</u>
<b>Financing activities</b>				
Issuance of long-term debt	-	87,885	-	220,000
Repayment of long-term debt	(82,775)	(11,398)	(189,409)	(34,112)
Issuance of common shares	943,416	-	943,416	-
Issuance of common share purchase warrants	141,000	-	141,000	-
	<u>1,001,641</u>	<u>76,487</u>	<u>895,007</u>	<u>185,888</u>
<b>Investing activities</b>				
Acquisition of property, plant and equipment	(310,082)	(56,160)	(769,259)	(675,634)
Proceeds from sale of assets	-	1,035	1,869	1,035
Asset retirement trust fund	(760)	-	(760)	-
	<u>(310,842)</u>	<u>(55,125)</u>	<u>(768,150)</u>	<u>(674,599)</u>
<b>Increase (decrease) in cash and cash equivalents</b>	<b>493,497</b>	<b>(187,417)</b>	<b>(361,306)</b>	<b>(919,835)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>(2,327,878)</b>	<b>(2,176,404)</b>	<b>(1,473,075)</b>	<b>(1,443,986)</b>
<b>Cash and cash equivalents, end of period</b>	<b>(1,834,381)</b>	<b>(2,363,821)</b>	<b>(1,834,381)</b>	<b>(2,363,821)</b>

See accompanying notes to the consolidated financial statements.



## **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

September 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 September 30, 2006, the Company had a net loss of \$46,227 (loss of \$27,757 for the three-month period ended September 30, 2005) and negative cash flow from operating activities of \$197,302 (negative cash flow from operating activities of \$208,779 over the same period in 2005). As a result of recurring losses over the Company's history, the Company had a deficit of \$8.95 million as at September 30, 2006 (\$7.68 million as at September 30, 2005) and had a net working capital deficiency of \$2.29 million at that date (\$4.11 million as at September 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 period presentation.

## 4. PROPERTY, PLANT AND EQUIPMENT

	September 30, 2006			September 30, 2005		
	Cost (\$)	Accumulated Depletion and Depreciation (\$)	Net Book Value (\$)	Cost (\$)	Accumulated Depletion and Depreciation (\$)	Net Book Value (\$)
Petroleum and natural gas properties	18,053,159	6,907,373	11,145,786	17,522,526	6,200,715	11,321,811
Production equipment	2,211,391	712,833	1,498,558	1,975,419	552,464	1,422,955
Production equipment under capital lease	220,000	20,548	199,452	220,000	1,426	218,574
Field equipment	353,054	346,007	7,047	345,994	345,060	934
Other	362,093	314,720	47,373	320,079	317,605	2,474
<b>Totals</b>	<b><u>21,199,697</u></b>	<b><u>8,301,481</u></b>	<b><u>12,898,216</u></b>	<b><u>20,384,018</u></b>	<b><u>7,417,270</u></b>	<b><u>12,966,748</u></b>

Petroleum and natural gas properties included costs of \$4,069,784 (September 30, 2005 - \$4,084,162) related to unproved properties, which are not being depleted.

Future asset retirement costs of \$222,320 (September 30, 2005 - \$214,338) have been capitalized as part of the cost of petroleum and natural gas properties.

No future capital expenditures (September 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 September 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 September 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 Company has pledged as security a \$10 million debenture with a floating charge over all assets of the Company with a negative pledge and undertaking to provide fixed charges on the Company's major producing petroleum and natural gas reserves at the request of the lender, a general assignment of book debts, insurance assignment showing the lender as first loss payee, an assignment of revenues and monies under material contracts, and a guarantee from Southwest Petroleum Explorations Inc., supported by debenture security.

## 7. LONG-TERM DEBT

	September 30, 2006 (\$)	September 30, 2005 (\$)
Various automobile financing arrangements	18,849	53,981
Obligation under capital lease	190,996	220,000
Other taxes payable (long-term)	<u>612,082</u>	-
<b>Total long-term debt</b>	<b><u>821,927</u></b>	<b><u>273,981</u></b>
Less: current portion of automobile financing arrangements	18,041	35,132
Less: current portion of obligation under capital lease	32,845	41,806
Less: current portion of other taxes payable (long-term)	<u>260,448</u>	-
<b>Total current portion</b>	<b><u>311,334</u></b>	<b><u>76,938</u></b>
<b>Total long-term portion</b>	<b><u>510,593</u></b>	<b><u>197,043</u></b>

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:

	<b>Automobile Financing Principal Repayments (\$)</b>
2006	6,598
2007	<u>12,251</u>
	<b><u>18,849</u></b>

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

	<b>Future Minimum Lease Payments (\$)</b>
2006	13,718
2007	54,871
2008	<u>162,154</u>
	230,743
Less: amount representing interest at 12.5%	<u>39,747</u>
Present value of minimum lease payments	190,996
Less: amount due within one year	<u>32,845</u>
	<b><u>158,151</u></b>

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 related to the 1996 through 2001 taxation years. The current portion of this liability and related interest is included in income and other taxes payable in the consolidated balance sheet as at September 30, 2006.

The aggregate amount of future principal payments relating to these other taxes can only be estimated at September 30, 2006, as monthly payments pursuant to the payment terms

negotiated are constant, but interest on the outstanding debt will vary based on the prescribed rates released on a quarterly basis by the federal Department of Finance. Thus, the aggregate amount of future principal payments relating to these other taxes have been estimated based on the prescribed rate of 8% - the rate in effect as at September 30, 2006 – as follows:

	<b>Other Taxes – Principal Payments (\$)</b>
2006	63,080
2007	265,735
2008	<u>283,267</u>
	<b><u>612,082</u></b>

## 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 third quarters of 2006 and 2005:

	<b>September 30, 2006 (\$)</b>	<b>September 30, 2005 (\$)</b>
<b>Asset retirement obligations, beginning of the period</b>	420,880	362,956
<b>Liabilities incurred</b>	-	-
<b>Liabilities settled</b>	(8,425)	(1,278)
<b>Accretion expense</b>	12,555	13,298
<b>Revisions in estimated cash flows</b>	<u>-</u>	<u>11,147</u>
<b>Asset retirement obligations, end of the period</b>	<b><u>425,010</u></b>	<b><u>386,123</u></b>

The total undiscounted amount of estimated cash flows required to settle the obligations is \$1,318,272 (September 30, 2005 - \$1,321,077), 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.

	Three months ended September 30, 2006 (\$)	Three months ended September 30, 2005 (\$)
Anticipated income taxes (recovery) based on statutory income tax rate of 36.12% (September 30, 2005 – 36.12%)	(49,004)	945
Increase (decrease) in taxes resulting from:		
Resource loss (allowance)	(10,325)	(17,982)
Non-deductible tax and interest	1,078	408
Adjustment to loss carry-forwards and other tax pools and allowances	(31,391)	29,582
Federal large corporations tax	-	3,000
Stock-based compensation	-	-
Other	199	14,421
	<u>(89,443)</u>	<u>30,374</u>

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

	September 30, 2006 (\$)	September 30, 2005 (\$)
Provision (recovery) for current income taxes	-	3,000
Provision (recovery) of future income taxes		
- current	(10,786)	-
- deferred	(78,657)	27,374
	<u>(89,443)</u>	<u>30,374</u>

The future income tax liability is comprised of:

	September 30, 2006 (\$)	September 30, 2005 (\$)
Property, plant and equipment (excess of book value over tax value)	3,565,408	3,484,242
Share issue costs	(84,818)	(66,761)
Non-capital loss carryforwards	(610,099)	(1,405,493)
Asset retirement obligations	(153,514)	(139,468)
Other taxes	(8,364)	-
	2,708,613	1,872,520
Add: current portion	43,286	35,972
	<u>2,751,899</u>	<u>1,908,492</u>

At September 30, 2006, the Company had accumulated non-capital loss carried-forwards of approximately \$1.70 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.

## 10. CAPITAL STOCK

### AUTHORIZED

Unlimited number of common shares.

### ISSUED

	Number of shares	Amount \$
<b>Common shares</b>		
<b>Balance – December 31, 2004</b>	<b>30,625,299</b>	<b>13,661,022</b>
Future income tax effects of prior year flow-through shares	-	<u>(56,347)</u>
<b>Balance – September 30, 2005</b>	<b>30,625,299</b>	<b>13,604,675</b>
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>
<b>Balance, December 31, 2005</b>	<b>33,125,299</b>	<b>14,332,881</b>
Future income tax effects of prior year flow-through shares	-	(316,050)
Shares issued in private placements, net of share issuance costs and future income tax effects	<u>3,686,662</u>	<u>984,151</u>
<b>Balance, September 30, 2006</b>	<b><u>36,811,961</u></b>	<b><u>15,000,982</u></b>

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.

The future income tax effects on the gross proceeds of the 2005 offerings were recognized as a charge against capital stock in the first quarter of 2006, when the Company filed the renunciation documents with the tax authorities.

On July 14, 2006, the Company closed a private placement in which 1,116,363 common shares were issued on a flow-through basis for gross proceeds of \$368,400. The amount from the issue of these shares are presented net of proceeds allocated to share purchase warrants of \$37,000 and share issue costs of \$47,151 net of future income taxes of \$17,031.

On September 18, 2006, the Company closed a private placement in which 1,923,467 common shares were issued on a flow-through basis and 646,832 common shares were issued on a non-flow-through basis for gross proceeds totaling \$828,794. The amount from the issue of these shares are presented net of proceeds allocated to share purchase warrants of \$104,000 and share issue costs of \$65,627 net of future income taxes of \$23,704.

### 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 3,036,529 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 September 30, 2006 and September 30, 2005 and during the three-month periods then ended is presented below:

	September 30, 2006			September 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	1,850,000	0.45	0.50	1,265,000	0.58	0.63
Granted	-	-	-	-	-	-
Exercised	-	-	-	-	-	-
Expired	-	-	-	(5,000)	(1.03)	(1.29)
<b>Outstanding – end of the period</b>	<b>1,850,000</b>	<b>0.45</b>	<b>0.50</b>	<b>1,260,000</b>	<b>0.58</b>	<b>0.63</b>

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

Exercise price (\$)	Number of options outstanding	Weighted average remaining contractual life (yrs.)
1.03	25,000	1.17
0.50	1,150,000	2.13
0.35	<u>675,000</u>	<u>4.54</u>
	<b><u>1,850,000</u></b>	<b><u>3.00</u></b>

#### WARRANTS

	Number of warrants	Amount \$
<b>Balance – September 30, 2005</b>	<b>393,201</b>	<b>99,500</b>
<u>October 1, 2005 to December 31, 2005</u>		
Flow-through share purchase warrants issued	833,333	94,000
Non-flow-through share purchase warrants expired	<u>(393,201)</u>	<u>-</u>
<b>Balance – December 31, 2005</b>	<b>833,333</b>	<b>193,500</b>
<u>January 1, 2006 to September 30, 2006</u>		
Flow-through share purchase warrants issued	1,176,603	104,500
Non-flow-through share purchase warrants issued	<u>323,416</u>	<u>36,500</u>
<b>Balance, September 30, 2006</b>	<b><u>2,333,352</u></b>	<b><u>334,500</u></b>

On July 5, 2006 as part of a private placement that closed on July 14, 2006, the Company granted a total of 439,103 flow-through share purchase warrants to subscribers and finders. Each of these flow-through share purchase warrant entitles the holder to acquire one flow-through common share of the Company at a price of \$0.66 per common share until July 5, 2008. The fair value of these warrants was calculated using the Black-Scholes valuation model at the date of granting assuming a risk-free interest rate of 4.45%, expected life of 2 years, and expected volatility percentage of 95%.

On August 15, 2006, as part of a private placement that closed on September 18, 2006, the Company granted a total of 631,328 flow-through share purchase warrants and 190,833 non-flow-through share purchase warrants to subscribers and finders. Each of the flow-through share purchase warrants entitles the holder to acquire one flow-through common share of the Company at a price of \$0.66 per common share until August 15, 2008. Each of the non-flow-through share purchase warrants entitles the holder to acquire one non-flow-through common share of the Company at a price of \$0.50 per common share until August 15, 2008. The fair value of these warrants was calculated using the Black-Scholes valuation model at the date of granting assuming a risk-free interest rate of 4.16%, expected life of 2 years, and expected volatility percentage of 100%.

On September 18, 2006, as part of a private placement that closed on that date, the Company granted a total of 106,172 flow-through share purchase warrants and 132,583 non-flow-through share purchase warrants to subscribers and finders. Each of the flow-through share purchase warrants entitles the holder to acquire one flow-through common share of the Company at a price of \$0.66 per common share until September 18, 2008. Each of the non-flow-through share purchase warrants entitles the holder to acquire one non-flow-through common share of the Company at a price of \$0.50 per common share until September 18, 2008. The fair value of these warrants was calculated using the Black-Scholes valuation model at the date of granting assuming a risk-free interest rate of 4.01%, expected life of 2 years, and expected volatility percentage of 94%.

## NET LOSS PER SHARE

	Three-months ended September 30, 2006			Three-months ended September 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	(46,227)	35,293,595	(0.00)	(27,757)	30,625,299	(0.00)
Diluted loss per share to common shareholders	(46,227)	35,293,595	(0.00)	(27,757)	30,625,299	(0.00)

Options to purchase 1,850,000 common shares (September 30, 2005 – 1,260,000 common shares) at a weighted average price of \$0.45 per common share (September 30, 2005 - \$0.58 per common share), warrants to purchase 833,333 flow-through common shares at a price of \$0.70 per flow-through common share, warrants to purchase 1,176,603 flow-through common shares at a price of \$0.66 per flow-through common share, and warrants to purchase 323,416 non-flow-through common shares (September 30, 2005 – 393,201 non-flow-through common shares) at a price of \$0.50 per non-flow-through common share (September 30, 2005 - \$0.60 per non-flow-through 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:

	September 30, 2006 (\$)	September 30, 2005 (\$)
Property, plant and equipment	125,834	147,443
Current liabilities	-	5,204
Revenues (net of royalties)	3,135	5,758
Expenses	4,558	4,893
Cash flows provided from (used for):		
Operating activities	3,135	3,168
Investing activities	-	(52)
Financing activities	(3,135)	(3,116)

## 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 September 30, 2006 calculated using an interest rate of 7.0% is approximately \$842,211 (book value per note 7 - \$821,927).

### 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 third 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.

	<b>3 months ended September 30, 2006</b>	<b>3 months ended September 30, 2005</b>
	\$	\$
<i>Transactions during the period:</i>		
Administrative expenses and share issue costs paid to related party	23,321	3,555
<i>Balance at end of the period:</i>		
Due to related party	289,656	319,566

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 September 30, 2006	Three months ended September 30, 2005
	\$	\$
(Increase) decrease in:		
Accounts receivable	(264,065)	(38,070)
Prepaid expenses and other receivables	(1,594)	11,581
Increase (decrease) in:		
Accounts payable and accrued liabilities	(3,054)	(398,403)
Income and other taxes payable	<u>3,924</u>	<u>4,380</u>
	<u>(264,789)</u>	<u>(420,512)</u>
<b>Cash paid during the period for:</b>		
Interest	46,352	37,623
Income taxes	-	-
<b>Non-cash transactions:</b>		
Settlement of long-term debt with sale-leaseback of pipeline and other production equipment (note 7)	-	220,000
Asset retirement costs and obligations (note 8)	-	11,147

## 15. COMMITMENTS

### FLOW-THROUGH SHARE COMMITMENTS

Pursuant to the terms of private placements which closed in December 2005 and July 2006, the Company has an obligation to incur \$309,000 in qualified exploration and/or development expenditures by November 30, 2006 and a further \$875,000 by December 31, 2006. As at September 30, 2006, the Company had incurred \$446,203 of qualifying expenditures towards these commitments.

Pursuant to the terms of private placements that closed in July 2006 and September 2006, the Company has an obligation to incur \$694,144 in qualified exploration and/or development expenditures by December 31, 2007.

### OFFICE LEASE COMMITMENT

As at September 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	2,245
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 September 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	14,700
2007	32,000