



**CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2006**

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Auditors' Report

To the Shareholders of
Greentree Gas & Oil Ltd.

We have audited the consolidated balance sheets of **Greentree Gas & Oil Ltd.** as at December 31, 2006 and 2005 and the consolidated statements of operations and accumulated deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Grant Thornton LLP

Hamilton, Ontario
April 23, 2007

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CONSOLIDATED BALANCE SHEETS

As at December 31,

	2006 (\$)	2005 (\$)
ASSETS		
<i>Current</i>		
Accounts receivable	633,038	273,400
Prepaid expenses and other receivables	96,559	67,593
Current portion of future income taxes (note 10)	48,254	29,398
	<u>777,851</u>	<u>370,391</u>
Property, plant and equipment (note 4)	11,009,938	12,722,030
Asset retirement trust fund (note 5)	71,928	70,850
	<u>11,859,717</u>	<u>13,163,271</u>
LIABILITIES		
<i>Current</i>		
Bank indebtedness (note 6)	2,282,780	1,473,075
Accounts payable and accrued liabilities	1,171,437	1,188,663
Income and other taxes payable (note 8)	295,472	864,624
Current portion of long-term debt (note 7)	46,130	60,220
	<u>3,795,819</u>	<u>3,586,582</u>
Long-term debt (note 7)	149,271	195,401
Income and other taxes payable (note 8)	291,202	-
Asset retirement obligations (note 9)	446,806	404,946
Future income taxes (note 10)	2,432,307	2,774,909
	<u>7,115,405</u>	<u>6,961,838</u>
SHAREHOLDERS' EQUITY		
Capital stock (note 11)	15,277,945	14,332,881
Warrants (note 11)	334,500	193,500
Contributed surplus (note 12)	617,433	419,833
Deficit	(11,485,566)	(8,744,781)
	<u>4,744,312</u>	<u>6,201,433</u>
	<u>11,859,717</u>	<u>13,163,271</u>
Going concern (note 1)		
Commitments (note 17)		
Subsequent events (note 18)		
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 years ended December 31,

	2006 (\$)	2005 (\$)
Revenue		
Gas sales	1,621,344	1,982,028
Oil sales	205,584	314,613
Other	19,163	11,942
	<u>1,846,091</u>	<u>2,308,583</u>
Royalties	220,741	260,271
	<u>1,625,350</u>	<u>2,048,312</u>
Expenses		
Operations	764,668	705,818
Depletion and depreciation	3,465,180	915,248
General and administrative	653,444	514,178
Interest expense	177,673	150,924
Other taxes and related interest	7,671	205,891
Accretion of asset retirement obligations	38,291	37,317
	<u>5,106,927</u>	<u>2,529,376</u>
Loss before income taxes	(3,481,577)	(481,064)
Recovery of (provision for) income taxes (note 10)	<u>740,792</u>	<u>(844,962)</u>
Net loss	(2,740,785)	(1,326,026)
Deficit, beginning of year	<u>(8,744,781)</u>	<u>(7,418,755)</u>
Deficit, end of year	<u>(11,485,566)</u>	<u>(8,744,781)</u>
Net loss per share		
Basic and diluted (note 11)	<u>(0.08)</u>	<u>(0.04)</u>

See accompanying notes to the consolidated financial statements.



CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31,

	2006 (\$)	2005 (\$)
Operating activities		
Net loss	(2,740,785)	(1,326,026)
Items not affecting cash:		
Depletion and depreciation	3,465,180	915,248
Gain on disposal of assets	(1,872)	(588)
Accretion of asset retirement obligations	38,291	37,317
Stock-based compensation	197,600	-
Future income taxes	(740,792)	844,962
Asset retirement costs	(9,225)	(25,604)
	<u>208,397</u>	<u>445,309</u>
Net change in non-cash working capital (note 16)	<u>(1,035,878)</u>	<u>(1,175,259)</u>
	<u>(827,481)</u>	<u>(729,950)</u>
Financing activities		
Increase in bank indebtedness	809,705	29,089
Issuance of long-term debt	-	220,000
Repayment of long-term debt	(260,165)	(52,471)
Net proceeds on issuance of common shares	1,324,398	698,354
Change in non-cash working capital relating to issuance of common shares	20,539	84,741
Issuance of common share purchase warrants	141,000	94,000
	<u>2,035,477</u>	<u>1,073,713</u>
Investing activities		
Acquisition of property, plant and equipment	(1,743,125)	(723,422)
Change in non-cash working capital relating to acquisition of property, plant and equipment	531,506	378,731
Proceeds from sale of assets	4,701	1,035
Asset retirement trust fund	(1,078)	(107)
	<u>(1,207,996)</u>	<u>(343,763)</u>
Decrease in cash and cash equivalents	-	-
Cash and cash equivalents, beginning of year	<u>-</u>	<u>-</u>
Cash and cash equivalents, end of year	<u><u>-</u></u>	<u><u>-</u></u>

See accompanying notes to the consolidated financial statements.



NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 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 year ended December 31, 2006, the Company had a net loss of \$2,740,785 (net loss of \$1,326,026 for the year ended December 31, 2005) and negative cash flow from operating activities of \$827,481 (negative cash flow from operating activities of \$729,950 for the year ended December 31, 2005). As a result of recurring losses over the Company's history, the Company had a deficit of \$11.49 million as at December 31, 2006 (\$8.74 million as at December 31, 2005) and had a net working capital deficiency of \$3.02 million at that date (\$3.22 million as at December 31, 2005).

The ability of the Company to continue as a going concern will depend on raising additional financing and achieving profitable operations sufficient to meet all obligations. The Company's operating facility agreement (see Note 6) requires that the Company meet certain covenants including one relating to working capital ratio. As at December 31, 2006, the Company is in violation of the working capital ratio covenant and no waiver has been granted.

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. Also, amounts recorded for stock-based compensation are based on historical price volatility and assumptions regarding hold periods. By their nature, these calculation and estimates are subject to uncertainty, and the impact on the consolidated financial statements of future periods could be material.

PROPERTY, PLANT AND EQUIPMENT

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 statements 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 statements 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 14.

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. The net number of shares issued and purchased are included in the denominator in calculating diluted earnings per share as the total number of shares outstanding.

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 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 11.

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 and cash equivalents include cash on hand, cash balances with banks and short-term investments with original maturity of 90 days or less. Bank borrowings are considered to be financing activities.

RECENT ACCOUNTING PRONOUNCEMENTS

The Company has assessed new and revised accounting pronouncements that have been issued that are not yet effective and determined that the following may potentially have some applicability to the Company's future financial reporting:

a) Accounting changes

As at January 1, 2007, the Company is required to adopt revised Canadian Institute of Chartered Accountants ("CICA") Section 1506, "*Accounting Changes*", which provides expanded disclosures for changes in accounting policies, accounting estimates and corrections of errors. Under the new standard, accounting changes should be applied retrospectively unless otherwise permitted or where impracticable to determine. As well, voluntary changes in accounting policy are made only when required by a primary source of GAAP or the change results in more relevant and reliable information. The Company does not expect application of this revised standard to have a material impact on its consolidated financial statements.

b) Comprehensive income

As of January 1, 2007, the Company is required to adopt new CICA Section 1530, "*Comprehensive Income*". Under the new standards, comprehensive income has been introduced which will provide for certain gains and losses, including foreign currency translation adjustments and other amounts arising from changes in fair value, to be temporarily recorded outside of net earnings/loss. These new standards are not anticipated to have a significant impact on the Company's consolidated financial statements.

c) Financial instruments

As of January 1, 2007, the Company is required to adopt new CICA Section 3855, "*Financial Instruments – Recognition and Measurement*". Under the new standards, all financial instruments, including derivatives, are to be included in the Company's consolidated balance

sheet and measured, in most cases, at fair values. As the Company does not use complex financial instruments, these new standards are not anticipated to have a significant impact on the Company's consolidated financial statements.

Commencing with the Company's December 31, 2008 year-end, the Company will be required to adopt new CICA Section 3862, "*Financial Instruments – Disclosures*" and new CICA Section 3863, "*Financial Instruments – Presentation*", which will replace Section 3861, "*Financial Instruments – Disclosure and Presentation*". The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed.

d) Hedges

As of January 1, 2007, the Company will be required to adopt CICA Section 3865, "*Hedges*", which specifies how to apply hedge accounting and what disclosures are necessary when it is applied. These new standards are not anticipated to have a significant impact on the Company as it currently does not engage in hedge transactions.

e) Capital disclosures

Commencing with the Company's December 31, 2008 year-end, the Company will be required to adopt CICA Section 1535, "*Capital Disclosures*" which provides for more detailed information on information about the entity's objectives, policies and processes for managing capital, as well as compliance with any externally imposed capital requirements, where they may exist.

COMPARATIVE AMOUNTS

Certain comparative amounts have been reclassified to conform to current year's presentation. Cash and cash equivalents is defined as cash and short-term investments with an original maturity of 90 days or less. The cash and cash equivalents amount on the 2005 Consolidated Statement of Cash Flows has been restated to remove \$29,089 as a decrease in cash and cash equivalents and show this amount as a cash inflow financing activity.

In addition, net changes in non-cash working capital should reflect only non-cash working capital items that do not relate to investing or financing activities. The net changes in non-cash working capital amount on the 2005 Consolidated Statement of Cash Flows has been restated to remove a cash inflow of \$463,472 and show \$378,731 of this amount as a cash inflow investing activity relating to the acquisition of property, plant and equipment and the remaining \$84,741 as a cash inflow financing activity relating to the issuance of common shares.

4. PROPERTY, PLANT AND EQUIPMENT

	2006			2005		
	Cost (\$)	Accumulated Depletion and Depreciation (\$)	Net Book Value (\$)	Cost (\$)	Accumulated Depletion and Depreciation (\$)	Net Book Value (\$)
Petroleum and natural gas properties	18,907,778	9,666,061	9,241,717	17,534,934	6,443,027	11,091,907
Production equipment	2,333,379	810,709	1,522,670	2,019,273	601,873	1,417,400
Production equipment under capital lease	220,000	33,364	186,636	220,000	8,107	211,893
Field equipment	353,852	346,367	7,485	345,994	345,164	830
Other	<u>368,520</u>	<u>317,090</u>	<u>51,430</u>	<u>319,586</u>	<u>319,586</u>	<u>-</u>
Totals	<u>22,183,529</u>	<u>11,173,591</u>	<u>11,009,938</u>	<u>20,439,787</u>	<u>7,717,757</u>	<u>12,722,030</u>

Petroleum and natural gas properties included costs of \$4,492,686 (December 31, 2005 - \$3,927,613) related to unproved properties, which are not being depleted and are not impaired.

Future asset retirement costs of \$235,114 (December 31, 2005 - \$222,320) have been capitalized as part of the cost of petroleum and natural gas properties.

Future capital expenditures of \$45,000 (December 31, 2005 - nil), as estimated by independent engineers, relating to the development of proved reserves have been included in costs subject to depletion.

An impairment in the carrying amount of the Company's petroleum and natural gas assets of \$2,259,569 has been recorded for the year ended December 31, 2006 (2005 - nil), and a corresponding increase in depletion and depreciation has been recorded. The prices used in the evaluation of the carrying value of the Company's reserves for the purposes of the impairment test are as follows:

	Natural Gas (\$ per mcf)	Crude Oil (\$ per bbl)
2007	8.72	67.75
2008	9.32	66.72
2009	9.33	67.02
2010	9.33	65.04
2011	9.52	62.71
% increase thereafter	2.0	2.0

WAVEFRONT ENERGY & ENVIRONMENTAL SERVICES INC.

During the year, the Company entered into an agreement with Wavefront Reservoir Technologies Inc., a subsidiary of Wavefront Energy & Environmental Services Inc. ("Wavefront") to co-develop the Company's Rodney South oil pool. Under the agreement, Wavefront will supply its Powerwave™ technology and fund up to \$2.25 million for initial capital expenditures and working capital requirements. The Company will act as operator of the project and will contribute the petroleum leases, existing seismic and geological data, and the use of its existing field facilities. The Company will also provide its field maintenance and administrative support staff. In consideration for Wavefront's contributions, it will receive a royalty of 70% net cash flows from production of existing Rodney South oil pool wells and any additional producing wells drilled on the Rodney South unit pursuant to the agreement, until payout. Subsequent to payout, Wavefront will receive a royalty of 50% net cash flows from production of existing Rodney South oil pool wells and any additional producing wells drilled on the Rodney South unit pursuant to the agreement. As at December 31, 2006, the project was still in the pre-production stage.

LIBERTY OIL AND GAS LTD.

During the year, the Company entered into an agreement with Liberty Oil and Gas Ltd. ("Liberty"). Under the agreement, Liberty will farm in on certain petroleum leases held by the Company in Tilbury West Township, Essex County and Aldborough Township, Elgin County. Liberty will contribute 25% of drilling and completion costs on two test wells, subject to casing point elections for each of the wells, to earn a 20% working interest in the leases. Drilling of the two wells was in progress as at December 31, 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. The amount of the deposit is determined by regulations set by the Minister of Natural Resources (Ontario).

6. BANK INDEBTEDNESS

As at December 31, 2006, the Company's operating facility had a maximum unrestricted amount of \$2,400,000 with monthly reductions of \$25,000 commencing January 31, 2007 and bearing interest at prime plus 2% per year (8% as at December 31, 2006).

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

	2006 (\$)	2005 (\$)
Various automobile financing arrangements	12,251	42,554
Obligation under capital lease	<u>183,150</u>	<u>213,067</u>
Total long-term debt	<u>195,401</u>	<u>255,621</u>
Less: current portion of automobile financing arrangements	12,251	30,303
Less: current portion of obligation under capital lease	<u>33,879</u>	<u>29,917</u>
Total current portion	<u>46,130</u>	<u>60,220</u>
Total long-term portion	<u>149,271</u>	<u>195,401</u>

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 (\$)
2007	<u>12,251</u>
	<u>12,251</u>

Under the terms of the lease, combined principal and interest payments of \$4,573 per month are made, plus a final instalment of \$121,000 due September 15, 2008. Interest is computed at an incremental borrowing rate of 12.5% per annum. The aggregate amount of future minimum payments under the capital lease for pipeline and other production equipment are as follows:

	Future Minimum Lease Payments (\$)
2007	54,871
2008	<u>162,154</u>
	217,025
Less: amount representing interest at 12.5%	<u>33,875</u>
Present value of minimum lease payments	183,150
Less: amount due within one year	<u>33,879</u>
	<u>149,271</u>

	2006 (\$)	2005 (\$)
Asset retirement obligations, beginning of the year	404,946	361,801
Liabilities incurred	17,155	-
Liabilities settled	(9,225)	(25,604)
Accretion expense	38,291	37,317
Revisions in estimated cash flows	<u>(4,361)</u>	<u>31,432</u>
Asset retirement obligations, end of the year	<u>446,806</u>	<u>404,946</u>

The total undiscounted amount of estimated cash flows required to settle the obligations is \$1,404,420 (December 31, 2005 - \$1,323,565), which has been discounted using a credit-adjusted risk-free rate of 8.5%. The majority of these obligations are not expected to be settled for several years in the future and will be funded from general Company resources at the time of retirement and removal.

10. INCOME TAXES

The recovery for income taxes differs from the amount anticipated based on the statutory combined federal and provincial tax rates.

	2006 (\$)	2005 (\$)
Anticipated income tax recovery based on statutory income tax rate of 36.12% (2005 - 36.12%)	1,257,546	173,760
Increase (decrease) in tax recovery resulting from:		
Resource allowance	34,312	76,039
Non-deductible tax and interest	6,974	29,856
Adjustment to loss carry-forwards and other tax pools and allowances	(674,579)	(1,123,450)
Stock-based compensation	(71,373)	-
Adjustments to net future tax liabilities for tax rate reduction	133,617	-
Recognition of deductible temporary lease difference	64,882	-
Other	<u>(10,587)</u>	<u>(1,167)</u>
	<u>740,792</u>	<u>(844,962)</u>

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

	2006 (\$)	2005 (\$)
Recovery of (provision for) current income taxes	-	-
Recovery of (provision for) future income taxes		
- current	9,871	6,061
- long-term	730,921	(851,023)
	<u>740,792</u>	<u>(844,962)</u>

The future income tax liability is comprised of:

	2006 (\$)	2005 (\$)
Property, plant and equipment (excess of book value over tax value)	2,625,305	3,617,360
Share issue costs	(77,657)	(72,174)
Non-capital loss carryforwards	-	(653,318)
Asset retirement obligations	(153,724)	(146,266)
Other taxes	(9,871)	(91)
	2,384,053	2,745,511
Add: current portion of asset	48,254	29,398
	<u>2,432,307</u>	<u>2,774,909</u>

As at December 31, 2006, the Company had accumulated non-capital loss carried-forwards of approximately \$1.80 million for federal tax purposes and \$2.01 million for provincial tax purposes, which expire between 2009 and 2011. As they are expected to expire without being utilized, the benefit associated with the accumulated non-capital loss carry-forwards has not been recognized in these consolidated financial statements.

11. CAPITAL STOCK

AUTHORIZED

Unlimited number of common shares.

ISSUED	Number of shares	Amount \$
Common shares		
Balance – December 31, 2004	30,625,299	13,661,022
Future income tax effects of prior year flow-through shares	-	(56,347)
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	33,125,299	14,332,881
Future income tax effects of prior year flow-through shares	-	(316,050)
Shares issued to related parties in private placements	754,286	195,000
Other shares issued in private placements, net of share issuance costs and future income tax effects	<u>4,484,662</u>	<u>1,066,114</u>
Balance, December 31, 2006	<u>38,364,247</u>	<u>15,277,945</u>

During 2005, 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 issuance of these shares is 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 renouncement 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 is presented net of future income tax effects of \$111,611 (renouncement on \$309,000 of these proceeds occurred November 30, 2006), 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.

On December 22, 2006, as part of 464,286 flow-through shares and 1,088,000 non-flow-through shares issued in a private placement, the Company issued 214,286 flow-through shares and 540,000 non-flow-through shares to related parties for gross proceeds of \$195,000. Other shares issued on this private placement for gross proceeds of \$207,000, are presented net of share issue costs of \$21,018 net of future taxes of \$7,592.

STOCK OPTION PLAN

The Company has a stock option plan (the "Plan") for its directors, officers, employees and consultants 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 share 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 December 31, 2006 and December 31, 2005 and during the years then ended is presented below:

	2006			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 year	1,260,000	0.58	0.63	1,535,000	0.64	0.68
Granted	725,000	0.35	0.37	-	-	-
Exercised	-	-	-	-	-	-
Expired	(85,000)	(1.50)	(1.45)	(275,000)	(0.93)	(0.94)
Outstanding – end of year	1,900,000	0.45	0.49	1,260,000	0.58	0.63

The following table provides further information on options granted during the year:

	Number of options granted during year	Weighted average exercise price (\$)	Weighted average grant-date fair value (\$)
Options whose exercise price exceeds grant-date market price	50,000	0.30	8,600
Options whose exercise price is less than grant-date market price	<u>675,000</u>	0.35	<u>189,000</u>
Options granted during the year	<u>725,000</u>	0.35	<u>197,600</u>

The following table outlines information about stock options outstanding at December 31, 2006:

Exercise price (\$)	Number of options outstanding	Weighted average remaining contractual life (yrs.)
1.03	25,000	0.92
0.50	1,150,000	1.88
0.35	675,000	4.29
0.30	<u>50,000</u>	<u>4.84</u>
	<u>1,900,000</u>	<u>2.88</u>

The fair value of each option granted is estimated at the date of grant using the Black-Scholes option pricing model. The weighted average fair value per option at the date of grant in 2006 was \$0.27 (2005 – no options issued). Under the Black-Scholes model, the weighted average assumptions for grants were as follows:

	2006	2005
Risk free interest	4.28%	-
Expected life (years)	5.0	-
Expected volatility	91%	-
Expected dividend yield	0.0%	0.0%

All options vested immediately upon the date of grant.

WARRANTS

	Number of warrants	Amount \$
Balance – December 31, 2004	393,201	99,500
Flow-through share purchase warrants issued	833,333	94,000
Non-flow-through share purchase warrants expired	<u>(393,201)</u>	<u>-</u>
Balance – December 31, 2005	833,333	193,500
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>
Balance, December 31, 2006	<u>2,333,352</u>	<u>334,500</u>

On July 5, 2006, as part of a private placement that closed on July 14, 2006, the Company issued 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.

On August 15, 2006, as part of a private placement that closed on September 18, 2006, the Company issued 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.

On September 18, 2006, as part of a private placement that closed on that date, the Company issued 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.

In respect of all the above warrants, fair value was calculated using the Black-Scholes valuation model at the date of issuance. The weighted average assumptions at date of grant used for the issuance of warrants were as follows:

	2006	2005
Risk free interest	4.22%	3.80%
Expected life (years)	2.0	2.0
Expected volatility	98%	88%
Expected dividend yield	0.0%	0.0%

LOSS PER SHARE

	2006			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	(2,740,785)	34,643,598	(0.08)	(1,326,026)	30,652,687	(0.04)
Diluted loss per share to common shareholders	(2,740,785)	34,646,978	(0.08)	(1,326,026)	30,652,687	(0.04)

As at December 31, 2006, options to purchase 1,850,000 common shares (2005 – 1,260,000 common shares) at a weighted average price of \$0.45 per common share (2005 – \$0.58 per common share), warrants to purchase 833,333 flow-through common shares (2005 – 833,333 flow-through common shares) at a price of \$0.70 per flow-through common share (2005 – \$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 at a price of \$0.50 per non-flow-through common share were not included in the computation of diluted loss per share because they were anti-dilutive.

12. CONTRIBUTED SURPLUS

	2006 (\$)	2005 (\$)
Balance, beginning of year	419,833	419,833
Stock-based compensation, new options issued	<u>197,600</u>	<u>-</u>
Balance, end of year	<u>617,433</u>	<u>419,833</u>

13. 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:

	2006 (\$)	2005 (\$)
Property, plant and equipment	125,093	140,778
Current liabilities	-	1,586
Revenues (net of royalties)	15,531	28,641
Expenses	15,685	18,748
Cash flows provided from (used for):		
Operating activities	15,531	26,161
Investing activities	-	(178)
Financing activities	(15,531)	(25,983)
Non-cash transactions:		
Contributions of petroleum and natural gas properties, from a participant	-	6,479

14. FINANCIAL INSTRUMENTS

FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES

The carrying values of bank indebtedness, 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 December 31, 2006 having a book value of \$195,401 (2005 - \$255,621) calculated using an interest rate of 7.0% (2005 – 6.5%) is approximately \$207,223 (2005 – \$275,269).

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.

15. RELATED PARTY TRANSACTIONS

TRANSACTIONS WITH RELATED PARTIES

During the year, the following transactions occurred in the normal course of business between the Company and a law firm of which a partner is a director and shareholder of the Company.

	2006	2005
	\$	\$
<i>Transactions during the year:</i>		
Administrative expenses and share issue costs paid to related party	40,797	45,486
<i>Balance at end of the year:</i>		
Due to related party	117,820	335,057

During the year, the following transactions occurred in the normal course of business between the Company and non-management directors of the Company.

	2006	2005
	\$	\$
<i>Transactions during the year:</i>		
Directors' fees	27,250	-
<i>Balance at end of the year:</i>		
Due to non-management directors	27,250	-

During the prior year, the following transactions occurred in the normal course of business between the Company and a director and shareholder of the Company (none during 2006).

	2006	2005
	\$	\$
<i>Transactions during the year:</i>		
Administrative expenses paid to related party	-	15,000
<i>Balance at end of the year:</i>		
Due to related party	-	5,000

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

TRANSACTIONS WITH DIRECTORS/SHAREHOLDERS

During 2005, a director and shareholder, who is a partner in the above-noted law firm, purchased flow through shares and flow-through share purchase warrants for gross proceeds of \$35,000.

During 2006, a director and shareholder, who is a partner in the above-noted law firm, purchased non-flow-through shares for gross proceeds of \$135,000. In addition, another director and shareholder purchased flow-through shares for gross proceeds of \$60,000.

16. SUPPLEMENTAL CASH FLOW INFORMATION

	2006 \$	2005 \$
(Increase) decrease in:		
Accounts receivable	(114,283)	47,440
Prepaid expenses and other receivables	(28,966)	(7,238)
Increase (decrease) in:		
Accounts payable and accrued liabilities	(814,626)	(1,396,502)
Income and other taxes payable	<u>(78,003)</u>	<u>181,041</u>
	<u>(1,035,878)</u>	<u>(1,175,259)</u>
Cash paid during the period for:		
Interest	196,466	138,709
Income and other taxes	270,298	20,654
Non-cash transactions:		
Conversion of pipeline loan to capital lease	-	220,000
Asset retirement costs – additions (Note 9)	17,155	-
Asset retirement costs – revisions in estimated cash flows (Note 9)	(4,361)	31,432

17. COMMITMENTS

FLOW-THROUGH SHARE COMMITMENTS

Pursuant to the terms of private placements that closed during the year, the Company has a remaining obligation as at December 31, 2006 to incur \$754,500 in qualified exploration and/or development expenditures by December 31, 2007.

OFFICE LEASE COMMITMENT

As at December 31, 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 (\$)
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 December 31, 2006 the Company is obligated to make future lease payments under operating leases for one of the compressors as follows:

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

18. SUBSEQUENT EVENTS

SHARES-FOR-DEBT CONVERSION

On January 31, 2007, the Company completed a shares-for-debt conversion with a law firm of which one of the partners is a director and shareholder of the Company. The Company issued 320,000 common shares at a price of \$0.25 per share to settle \$80,000 owed to the law firm. The amount is included in accounts payable and accrued liabilities in these consolidated financial statements as at December 31, 2006.

STOCK OPTIONS

On January 31, 2007, the Company granted incentive stock options to purchase an aggregate of 575,000 common shares pursuant to its stock option plan to directors, officers and employees. The options expire on January 30, 2012 and are exercisable at a price of \$0.25 per share.

DEBT FINANCING

On April 20, 2007, the Company entered into a short-term arrangement with a lender to borrow \$100,000, repayable on December 31, 2007 and bearing interest at 12.5%.