

Consolidated Financial Statements of

Iteration Energy Ltd.

December 31, 2006 and 2005

AUDITORS' REPORT

To the Shareholders of
Iteration Energy Ltd.

We have audited the consolidated balance sheets of Iteration Energy Ltd. as at December 31, 2006 and 2005 and the consolidated statements of earnings (loss) and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our 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.

Ernst + Young LLP

Calgary, Canada
March 21, 2007

Chartered Accountants

Iteration Energy Ltd.

Consolidated Balance Sheets

As at

(in thousands of dollars)

	December 31, 2006	December 31, 2005
ASSETS (Note 5)		
Current		
Cash	\$5,222	\$ 25,134
Accounts receivable	12,402	19,421
Prepays and other current assets	1,206	1,266
	18,830	45,821
Future income taxes	876	-
Property, plant and equipment (Notes 3 and 4)	193,550	115,257
Goodwill (Note 3(a))	20,568	20,568
	\$233,824	\$ 181,646
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Bank indebtedness (Note 5)	\$ 28,640	\$ -
Accounts payable and accrued liabilities (Note 6)	25,257	33,753
Income taxes payable	-	186
Capital lease obligations (Note 7)	-	730
	53,897	34,669
Future income taxes	-	2,928
Leasehold inducements	331	471
Asset retirement obligations (Note 8)	9,198	4,492
	63,426	42,560
Commitments and contingencies (Notes 9, 11, 12, and 13)		
Shareholders' equity		
Share capital (Note 9)	175,195	139,467
Warrants outstanding (Notes 3(a) and 9(e))	4,166	4,166
Deficit	(8,963)	(4,547)
	170,398	139,086
	\$ 233,824	\$ 181,646

See accompanying notes to consolidated financial statements.

On behalf of the Board:

James T. Grenon, Chairman

Brian L. Illing, CEO & President

Iteration Energy Ltd.

Consolidated Statements of Earnings (Loss) and Deficit

<i>(in thousands of dollars, except per share amounts)</i>	Year Ended December 31,	
	2006	2005
		(Note 3(b))
Revenue		
Production revenue	\$ 64,539	\$ 65,771
Royalties, net of Alberta Royalty Tax Credit	(12,969)	(13,325)
	51,570	52,446
Other production revenue	223	435
Interest income	275	522
	52,068	53,403
Expenses		
Production	12,539	7,594
Transportation	1,299	1,108
General and administrative	4,084	3,993
Stock based compensation expense (Note 9 (d))	25	4,048
Interest on current debt	1,225	480
Accretion expense	471	280
Depletion and depreciation	40,115	29,986
	59,758	47,489
Earnings (loss) before the following	(7,690)	5,914
Recovery of investment tax credits (Note 10)	1,376	1,409
Earnings (loss) before income taxes	(6,314)	7,323
Income taxes (Note 10)		
Current income tax expense (recovery)	(169)	623
Future income tax expense (recovery)	(1,729)	2,880
	(1,898)	3,503
Net earnings (loss)	(4,416)	3,820
Deficit, beginning of year	(4,547)	(8,367)
Deficit, end of year	\$ (8,963)	\$ (4,547)
Basic and diluted net earnings (loss) per common share (Note 9(f))	\$(0.08)	\$ 0.08

See accompanying notes to the consolidated financial statements

Iteration Energy Ltd.

Consolidated Statements of Cash Flows (audited)

<i>(in thousands of dollars)</i>	Year Ended December 31,	
	2006	2005
OPERATING ACTIVITIES		
Net earnings (loss)	\$ (4,416)	\$ 3,820
Add (deduct) non-cash items:		
Depletion and depreciation	40,115	29,986
Accretion expense	471	280
Recovery of investment tax credits	(1,376)	(1,409)
Future income tax expense (recovery)	(1,729)	2,880
Amortization of leasehold inducements	(140)	(191)
Stock-based compensation (Note 9 (d))	25	4,048
Asset retirement expenditures	(23)	(446)
	32,927	38,968
Net change in non-cash working capital (Note 14)	(1,562)	(722)
	31,365	38,246
INVESTING ACTIVITIES		
Proceeds from sale of property, plant and equipment (Note 3(b))	693	80,813
Acquisition of subsidiary, net of cash acquired (Note 3(a))	-	(244)
Acquisition of oil and gas properties	(51,529)	-
Additions to oil and gas properties	(63,235)	(44,896)
Additions to other capital assets	(79)	(14)
Proceeds on disposal of assets held for sale	-	2,119
Net change in non-cash working capital (Note 14)	213	879
	(113,937)	38,657
FINANCING ACTIVITIES		
Proceeds from (repayment of) bank indebtedness	28,640	(51,518)
Common shares issued for cash	37,285	266
Share issue costs	(2,257)	(38)
Principal payment – equipment finance obligation	-	(325)
Principal payment – capital lease obligation	(730)	(436)
Net change in non-cash working capital (Note 14)	(278)	282
	62,660	(51,769)
Increase (decrease) in cash	(19,912)	25,134
Cash, beginning of year	25,134	-
Cash, end of year	\$ 5,222	\$ 25,134

See Note 14 for supplemental disclosure

See accompanying notes to the consolidated financial statements

Iteration Energy Ltd.

Notes to the Consolidated Financial Statements Year Ended December 31, 2006 and 2005

(Tabular amounts in thousands of dollars, unless otherwise noted)

1. NATURE OF OPERATIONS

Iteration Energy Ltd. (“Iteration” or the “Company”) is a public company that trades on the Toronto Stock Exchange and is incorporated under the Business Corporations Act (Alberta). Iteration is engaged in the exploration, development and production of petroleum and natural gas in Canada.

2. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of Iteration Energy Ltd., (the “Company” or “Iteration”) have been prepared in accordance with Canadian generally accepted accounting principles. The timely preparation of financial statements requires that management make estimates and assumptions, and use judgment regarding assets, liabilities, revenues and expenses. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, actual results may differ from estimated amounts. In the opinion of management, these consolidated financial statements have been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

a) Basis of Consolidation

These consolidated financial statements include the accounts of Iteration, its wholly owned subsidiary and its partnership.

b) Cash

Cash consists of amounts in various accounts with financial institutions maintained by the Company.

c) Property, plant and equipment

Cost

The Company follows the full cost method of accounting whereby all costs relating to the acquisition of, exploration for and development of oil and gas reserves are capitalized in a single Canadian cost center. Such costs include lease acquisition, lease rentals on undeveloped properties, geological and geophysical, drilling both productive and non-productive wells, production equipment and overhead charges directly related to acquisition, exploration and development activities.

Proceeds from the sale of oil and gas properties and related equipment are applied against capitalized costs with no gain or loss recognized unless such a disposition would change the depletion rate by 20 percent or more. Gains and losses are recognized upon the disposition of other assets.

Other capital assets are recorded at cost.

Depletion and depreciation

All costs of acquisition, exploration and development of oil and gas reserves, associated tangible plant and equipment costs (net of salvage value), and estimated costs of future development of proven undeveloped reserves are depleted and depreciated by the unit of production method based on estimated gross proven reserves as determined by independent engineers.

Costs of unproved properties and seismic costs on undeveloped land are initially excluded from oil and gas properties for the purpose of calculating depletion. When proven reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion.

The relative volumes of oil and natural gas reserves and production are converted to equivalent barrels of oil based on the relative energy content of each product on a 1 barrel to 6 thousand cubic feet basis.

Depreciation of capital assets not related to oil and gas properties is provided using the declining balance method at rates between 20 and 30%. Leasehold improvements are amortized on a straight-line basis over the term of the lease.

Impairment

The Company calculates its ceiling test by comparing the carrying value of its oil and gas properties to the sum of undiscounted cash flows expected to result from the future production of proved reserves and the sale of unproved properties. Cash flows are based on third party quoted forward prices, adjusted for transportation and quality. Should the ceiling test result in an excess of carrying value, the Company would then measure the amount of impairment by comparing the carrying amounts of its oil and gas properties to an amount equal to the estimated net present value of expected future cash flows from proved plus probable reserves and the sale of unproved properties. A risk-free interest rate of 6% (2005: 6%) is used to arrive at the net present value of the future cash flows.

The carrying value of undeveloped properties (land and seismic data) is reviewed periodically and written down to net realizable value if impairment is determined.

d) Goodwill

Goodwill is recorded at cost and not amortized. The Company tests for potential impairment of goodwill on an annual basis and, should it be determined that goodwill is impaired, the asset is written down at that time. As at December 31, 2006, no impairment write down of goodwill was required.

e) Leases

Leases that transfer substantially all the benefits and risks of ownership to the Company are recorded as capital leases. Assets under capital lease are included in property, plant and equipment with offsetting long-term capital lease obligations being recorded as liabilities. All other leases are classified as operating leases under which lease costs are expensed in the period incurred.

f) Asset Retirement Obligations

The Company recognizes the fair value of a liability for an asset retirement obligation in the period in which it is incurred and records a corresponding increase in the carrying value of the related long-lived asset. The fair value is determined through a review of engineering studies, industry guidelines, and management's estimate on a site by site basis. The liability is subsequently adjusted for the passage of time, and is recognized as an accretion expense in the statement of earnings (loss). The liability is also adjusted due to revisions in either the timing or the amount of the original estimated cash flows associated with the liability. The increase in the carrying value of the asset is amortized using the unit of production method based on estimated gross proven reserves as determined by independent engineers. Actual costs incurred upon the settlement of the obligations are charged against the liability.

g) Leasehold Inducements

The value of leasehold inducements received is deferred and amortized on a straight-line basis as a reduction of rental expense over the term of the related lease.

h) Revenue Recognition

Oil and natural gas sales are recognized as revenue when the commodities are delivered to purchasers.

i) Hedging and Forward Sales Contracts

In certain circumstances, fixed price commodity contracts or commodity derivative contracts are used to reduce the Company's exposure to adverse fluctuations in commodity prices to protect future cash flow used to finance the Company's capital expenditure program. The Company uses hedge accounting for gains and losses relating to commodity derivative contracts that settle via net cash payment and that meet the criteria for hedge accounting. These gains and losses are recognized as part of natural gas sales concurrently with the hedged transaction. The Company does not enter into derivative financial instruments for trading or speculative purposes.

Realized and unrealized gains and losses associated with commodity derivative contracts which have been terminated or cease to be effective prior to maturity, are deferred as other current, or non-current, assets or liabilities on the balance sheet, as appropriate, and recognized in earnings in the period in which the underlying hedged transaction is recognized. In the event a designated hedged item is sold, extinguished or matures prior to the termination of the related derivative instrument, any previously deferred gain or loss on such derivative instrument is recognized in earnings (loss) at that time.

j) Joint Operations

The Company conducts exploration, development and production activities jointly with others and, accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

k) Stock Based Compensation

Under the Company's stock option plan, options to purchase common shares may be granted to directors, officers and employees at current market prices.

Options issued by the Company in 2003 and the first three months of 2004 are accounted for in accordance with the fair value method of accounting for stock-based compensation, and as such the cost of the option is charged to earnings (loss) with an offsetting amount recorded to contributed surplus, based on an estimate of the fair value determined using the Black-Scholes options pricing model.

The Company's stock option plan was amended effective April 1, 2004, as approved by the Company's shareholders, to provide stock option holders the choice upon exercise to receive a cash payment in exchange for surrendering the option. The cash payment is equal to the appreciated value of the stock option as determined based on the difference between the option's exercise price and the Company's share price at the time of exercise. The Company records a liability for the cash payment and a stock based compensation expense or recovery dependent on changes in the Company's share price and the number of options outstanding.

l) Future Income Taxes

The Company follows the liability method of accounting for income taxes. Under this method, future tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. Income tax expense for the year is the tax payable for the year and any change during the year in future income tax assets and liabilities. A valuation allowance is recorded to the extent that there is uncertainty regarding utilization of future tax assets.

m) Per Common Share Amounts

The Company uses the treasury stock method to determine the dilutive effect of stock options and warrants. This method assumes that proceeds from the exercise of stock options and warrants would be used to purchase common shares at the average market price during the year.

n) Measurement Uncertainty

The amount recorded for depletion and depreciation of oil and gas properties, the provision for asset retirement obligations and the ceiling test calculation are based on estimates of gross proven reserves, production rates, commodity prices, future costs and other relevant assumptions. Accruals for revenue and expenses are prepared based on estimates when actual amounts are not yet known. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future years could be significant.

o) Flow-through Common 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 estimated tax benefits transferred to shareholders are recorded as future income taxes and a reduction to share capital when the expenditures are renounced.

3. ACQUISITIONS AND DISPOSITIONS

(a) Iteration Energy Inc.

On March 21, 2005 the Company acquired all of the shares of Iteration Energy Inc. The acquisition was accounted for by the purchase method and the purchase price was allocated as follows:

Allocation of purchase price (\$'000's):

Cash	\$	2,175
Goodwill		20,568
Total purchase price	\$	22,743

Consideration was comprised of :

Issue of 5,750,000 common shares using an ascribed value of \$2.81 per share	\$	16,158
Issue of 5,000,000 warrants using an ascribed value of \$0.8332 per warrant		4,166
Cash		2,419
Total consideration	\$	22,743

The goodwill arises as a result of the consolidation of Iteration Energy Ltd. and Iteration Energy Inc and therefore is not considered to be a deductible amount for income tax purposes.

The results of operations for Iteration Energy Inc. have been included in the consolidated financial statements since March 21, 2005.

The fair value of the warrants granted was estimated to be \$4,166,000 as at the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

Risk-free interest rate (%)	3.75
Expected life (years)	3.50
Expected volatility (%)	35.72
Expected dividend yield (%)	-

(b) Sale of Lavoy Area Properties

On March 24, 2005, with an effective date of January 1, 2005, the Company sold its Lavoy area properties to two unrelated third parties for gross proceeds totaling \$85,000,000. After adjustments for operating results and capital expenditures for the period between the effective date and the closing date, the Company received net proceeds of \$80,813,000. The proceeds were applied to eliminate bank debt, with the remaining proceeds applied to working capital.

Operating results from the Lavoy area are included in the consolidated financial statements to March 24, 2005, the closing date of the sale. No gain or loss on the disposition was recognized as crediting the net proceeds to capital costs did not result in a change of 20 percent or more in the depletion and depreciation rate.

(c) **Acquisition of East Central Alberta Properties**

On June 27, 2006, with an effective date of April 1, 2006, the Company purchased five producing properties from an unrelated third party for a gross purchase price of \$42,325,000. After adjustments for operating results and capital expenditures between the effective date and the closing date, the Company paid \$41,426,000. The purchase price was initially funded from bank debt. The Company commenced reporting production from the acquisition on July 1, 2006.

4. PROPERTY, PLANT AND EQUIPMENT

	December 31, 2006	December 31, 2005
	(\$'000's)	(\$'000's)
Oil and gas properties	\$ 315,455	\$ 197,126
Other	683	604
	316,138	197,730
Less accumulated depletion and depreciation	122,588	82,473
	\$ 193,550	\$ 115,257

At December 31, 2006, unproved properties and seismic expenditures amounting to \$30,231,000 (December 31, 2005: \$13,936,000) have been excluded from the depletion calculation. Future development costs on proven undeveloped reserves of \$10,022,000 (December 31, 2005: \$1,650,000) are included in the depletion calculation.

For the year ended December 31, 2006, the Company capitalized \$1,864,000, (year ended December 31, 2005: \$976,000) of overhead directly related to exploration and development activities.

Iteration performs a ceiling test calculation at least annually in accordance with the Canadian Institute of Chartered Accountant's full cost accounting guidelines. No write-down was required for the year ended December 31, 2006 and December 31, 2005, based on the following expected future commodity prices.

	Edmonton Light Crude Oil \$/Barrel (Cdn)	Alberta AECO Spot Price \$/Gigajoule (Cdn)	British Columbia Average Plantgate \$/MMBtu (Cdn)	Edmonton NGL Mix \$/bbl (Cdn)
2007	70.80	6.85	7.00	50.80
2008	69.30	7.05	7.25	50.10
2009	67.70	7.40	7.60	49.50
2010	66.10	7.50	7.70	48.60
2011	64.20	7.70	7.90	47.60
Thereafter		2% annual increase		

The benchmark prices were adjusted for quality and transportation in determining cash flow for ceiling test purposes.

5. BANK INDEBTEDNESS

The Bank Indebtedness represents the drawn portion of a \$50 million credit facility that the Company has established with a Canadian Chartered Bank. A general security agreement and a guarantee and postponement of claim have been provided as security. Under the terms of the Credit facility, the Company may borrow via;

- i) Prime based loans bearing interest at the lender's prime bank rate;

- ii) Bankers acceptances, bearing interest at the banker's acceptance rate plus an acceptance fee of 87.5 basis points per annum;
- iii) Libor based loans in US currency bearing interest at the Libor rate plus 87.5 basis points per annum;
- iv) Letters of guarantee and letters of credit, bearing interest on the face amount at 87.5 basis points per annum, for financial guarantees, and 58.3 basis points per annum, for non-financial guarantees.

The facility requires monthly payments of interest only, calculated in arrears. In addition, there is a standby fee, calculated at 10 basis points per annum on the undrawn balance. During 2006, the effective rate of interest on the bank indebtedness outstanding was 6% per annum. Subsequent to year end, the credit facility was increased to \$65 million.

6. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities consist of the following:

	December 31, 2006 (\$'000's)	December 31, 2005 (\$'000's)
Trade accounts payable	\$16,278	\$ 24,756
Joint venture accounts payable	2,491	1,270
Royalties payable	3,208	3,676
Stock based compensation	4,108	4,082
Other	(828)	(31)
Total	\$25,257	\$ 33,753

7. CAPITAL LEASE OBLIGATIONS

During 2004, the Company entered into an agreement to lease a new compressor for a two-year term ending October 2006. Assets under capital lease amounting to \$1,277,000 are included in property, plant and equipment and depreciated with other equipment costs on the unit of production method. The interest rate implicit in the lease was 7.35%. The Company paid out the compressor lease, and acquired the compressor, in October, 2006 for \$0.3 million.

8. ASSET RETIREMENT OBLIGATIONS

The total future asset retirement obligations were estimated by management based on the Company's net working interest in all wells and facilities, estimated costs to reclaim and abandon wells and facilities and the estimated timing of the costs to be incurred in future periods. The Company estimates the undiscounted cash flows related to asset retirement obligations, adjusted for inflation, to be incurred over the estimated reserve life of the underlying assets (which is estimated to be from 2007 through 2036) will total approximately \$18,490,000 (December 31, 2005: \$10,756,000). The fair value at December 31, 2006 is \$9,198,000 (December 31, 2005: \$4,492,000) using a discount rate of six percent and an inflation rate of two percent. As at December 31, 2006, no funds have been set aside to settle this obligation.

	December 31, 2006 (\$'000's)	December 31, 2005 (\$'000's)
Balance, beginning of year	\$ 4,492	\$ 8,234
Liabilities incurred on acquisition of properties (note 3)	2,837	-
Decrease in liabilities due to property disposition (note 3)	-	(3,873)
Increase in liabilities from drilling activity	2,366	296
Decrease in liabilities from revision of estimates	(945)	-
Settlement of liabilities	(23)	(445)
Accretion expense	471	280
Balance, end of year	\$ 9,198	\$ 4,492

9. SHARE CAPITAL

(a) Authorized

Unlimited number of voting common shares without par value.
Unlimited number of preferred shares issuable in series

(b) Common Shares Issued

	Year ended December 31, 2006		Year ended, December 31, 2005	
	Number of Shares	Amount (\$'000's)	Number of Shares	Amount (\$'000's)
Balance, beginning of year	48,895,347	\$ 139,467	43,071,681	\$ 126,618
Shares issued on public offering	6,200,000	25,110	-	-
Flow through shares issued on public offering	2,300,000	12,075	-	-
Issued on acquisition of Iteration Energy Inc. (Note 3(a))	-	-	5,750,000	16,158
Shares issued on exercise of stock options	34,500	100	73,666	266
Share issue costs, net of tax effect of \$700,000 in 2006 (2005: \$7,000)	-	(1,557)	-	(25)
Tax benefits renounced on prior year flow through share offering	-	-	-	(3,550)
Balance, end of year	55,129,847	\$ 175,195	48,895,347	\$ 139,467

(c) Flow Through Shares

During 2006, the Company issued common shares on a flow-through basis for gross proceeds of \$12,075,000 to finance certain oil and gas expenditures to be incurred in 2007. The renouncement of these expenditures was made to the purchasers of these shares in 2007 and accordingly, share capital will be reduced by the amount of the tax benefits to be realized associated with these expenditures (\$3,743,000) at that time. Under the look back provision governing flow-through shares, the Company is required to incur these eligible expenditures prior to December 31, 2007.

During 2004, the Company issued common shares on a flow-through basis for gross proceeds of \$10,558,000. The renouncement of these expenditures was made to the purchasers of these shares in 2005 and accordingly, share capital was reduced by the amount of the tax benefits associated with these expenditures (\$3,550,000) and the corresponding future tax liability was recognized. As at December 31, 2005, the Company had incurred sufficient expenses to satisfy the flow through share renunciation.

(d) Stock Options

The Company has a stock option plan that provides for the issuance of options to its directors, officers, employees and non-employees to acquire up to 10% of the issued and outstanding common shares. The dates on which options vest are set by the Board of Directors at the time of grant. The exercise price of an option granted is the closing price of the Company's stock on the last trading date prior to the grant date. The dates on which options expire are also set by the Board of Directors at the time of grant and cannot exceed ten years.

Outstanding stock options to acquire common shares through the stock option plan, including contingent options as discussed further below, are as follows:

	Year ended December 31, 2006		Year ended December 31, 2005	
	Number of Options	Weighted average exercise price \$	Number of Options	Weighted average exercise price \$
Outstanding, beginning of year	4,798,122	2.98	747,200	4.93
Granted	1,234,600	4.38	4,902,500	2.97
Exercised for cash	-	-	(163,331)	3.86
Exercised for shares	(34,500)	(2.90)	(73,666)	3.62
Forfeited	(114,000)	(5.72)	(614,581)	5.02
Outstanding, end of year	5,884,222	3.22	4,798,122	2.98
Options exercisable, end of year	1,617,096	2.98	16,958	4.25

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

Range of exercise prices	Number outstanding December 31, 2006	Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number exercisable December 31, 2006	Weighted average exercise price \$
\$2.90 to \$4.00	4,671,500	3.17	2.92	1,583,838	2.94
\$4.01 to \$5.00	1,138,100	4.01	4.32	10,033	4.91
\$5.01 to \$9.00	74,622	3.95	5.27	23,225	5.28
	5,884,222	3.34	3.22	1,617,096	2.98

The Company's stock option plan was amended by shareholders effective April 1, 2004 to provide stock option holders the choice, upon exercise, to receive a cash payment in exchange for surrendering the option. The cash payment is equal to the appreciated value of the stock option as determined based on the difference between the option's exercise price and the Company's share price at the time of exercise. For the year ended December 31, 2006, stock based compensation expense of \$25,000 (2005: expense of \$4,048,000), was recognized based on the increase in value of the outstanding stock options. This was determined using the December 31, 2006 closing share price, as compared to the closing share price at December 31, 2005 respectively. Future fluctuations in the stock based compensation expense or recoveries are dependent on the movement of the Company's share price and the number of options outstanding. Based on the December 31, 2006 share price of \$4.40, had all of the 5,884,222 stock options outstanding been vested, aggregate stock based compensation expense and a corresponding liability of \$7,071,000 would have been recognized. Of this amount, \$4,108,000 has been recognized as a liability at December 31, 2006.

Included in the options disclosed above are 589,000 "conditional" stock options granted during the year to employees, none of whom are officers or directors, at a weighted average exercise price of \$4.28 per share. The options have a three year vesting period and a term of four years. These options are conditional because the granting of these options has resulted in the number of common shares available to be issued under the stock option plan exceeding the maximum number allowed (currently 10% of issued and outstanding common shares). The conditional nature of these options can only be removed by ratification of the granting of the options to the employees by the shareholders of the Company at the 2007 annual general meeting. In the event that the shareholders do not ratify the Shareholder Proposal with respect to these conditional options, all of the conditional options granted will immediately and automatically terminate without payment.

Concurrent with the granting of the options, the Board adopted a stock appreciation rights ("SAR") plan and granted 589,000 SARs to the employees who were granted the conditional options, with the same exercise price, vesting conditions and term as the options. Upon the exercise of each SAR, the employee will be entitled to receive a cash payment equal to the difference between the closing price of the common shares on the date immediately preceding the date of exercise, and the weighted average exercise price of \$4.28 per SAR. In the event that the shareholders ratify the Shareholder proposal with respect to the conditional options, all SARs granted will immediately and automatically terminate without payment and the options granted will remain in effect.

Subsequent to year end;

- 207,500 conditional options/SARs with an average exercise price of \$4.76 were issued to new employees;
- 344,200 options with an exercise price of \$2.90 were exercised for common shares of the Company.
- 4,333 options with an average exercise price of \$4.87 and 12,000 conditional options/SARs with an exercise price of \$4.35 were forfeited by employees who left the Company.

(e) Warrants

On March 21, 2005, warrants to purchase 5,000,000 common shares at \$2.90 were issued to Iteration Energy Inc. shareholders (Note 3(a)). On May 7, 2005, all of the warrants vested. The warrants expire on September 21, 2008.

(f) Per Share Amounts

	Year ended December 31,	
	2006	2005
Weighted average common shares outstanding	52,751,751	47,590,642
Effect of dilutive warrants	-	1,500,437
Effect of dilutive options	-	-
Weighted average diluted common shares outstanding	52,751,751	49,091,079

The options and warrants outstanding for the year ended December 31, 2006 are not included in the computation of diluted common shares outstanding as the Company realized a net loss during this period. For the year ended December 31, 2005, the options are not included in the computation of diluted common shares outstanding as the effect would be anti-dilutive.

10. INCOME TAXES

The provision for future income taxes recorded in the financial statements differs from the amount that would be obtained by applying the statutory income tax rate to the earnings (loss) before tax as follows:

	Year ended December 31,	
	2006	2005
	(\$'000's)	(\$'000's)
Earnings (loss) before tax	(6,314)	\$ 7,323
Statutory Canadian corporate tax rate	34.50 %	37.62 %
Anticipated tax expense (recovery)	(2,178)	2,755
Non-deductible Crown payments	1,505	3,083
Alberta Royalty Tax Credit	(37)	(122)
Resource allowance	(1,410)	(3,250)
Rate adjustment	190	(252)
Other	201	666
Future income tax expense (recovery)	(1,729)	2,880

The rate adjustment of \$190,000 represents the impact of the decrease in future income tax rates from 35.50% to 31.00%.

The Company's future income tax liability at December 31, 2006 and 2005 is comprised of the following:

	2006	2005
	(\$'000's)	(\$'000's)
Income tax rate (%)	31.00	33.62
Property plant and equipment, having different income tax and accounting basis	429	13,172
Deferred partnership income	9,496	9,358
Scientific research pools	(5,292)	(6,885)
Non capital loss carry forwards	-	(8,115)
Share issue costs	(1,282)	(1,328)
Accrued stock based compensation	(1,273)	(1,361)
Asset retirement obligation	(2,851)	(1,510)
Unamortized leasehold inducements	(103)	(158)
Capital lease obligations	-	(245)
Future income taxes (asset)	(876)	2,928

The current income tax recovery of \$169,000 for the year ended December 31, 2006 (2005: expense of \$623,000) consists of the following:

	2006	2005
	(\$'000's)	(\$'000's)
Part 1 tax reassessment	(29)	57
Capital tax	-	120
Part X11.6 tax	-	278
Part 1 tax reassessment – predecessor corporations	(140)	168
Current tax expense (recovery)	(169)	623

The Company also has approximately \$2,952,000 of unclaimed investment tax credits available to reduce future years' income taxes payable, the benefit of which has not been reflected in these financial statements. The investment tax credits ('000's) expire as follows:

2007	1,132
2008	964
2009	856

11. OPERATING LEASES

The Company has entered into various operating leases with respect to its premises. The leases expire June 30, 2009 and require the following future minimum lease payments, by calendar year ('000's):

2007	687
2008	687
2009	344

12. FINANCIAL INSTRUMENTS

a) Fair Value

Financial instruments consist of cash, accounts receivable, accounts payable, income taxes payable, capital lease obligations and bank indebtedness. The carrying value of these instruments approximates fair value unless otherwise stated.

b) Fixed Price Contracts

The following plant gate sales contract was outstanding as at December 31, 2006:

Transaction Type	Volume (mcf/d)	Contract Price (mcf)	Expiry
Cogeneration Fuel Supply	35	\$2.170 - \$2.396	October 31, 2009

Based on independent price forecasts, had this contract been closed on December 31, 2006, a loss of \$163,000 would have been realized. No accrual has been made for this loss in the current financial statements.

Subsequent to year end, the Company entered into three fixed price contracts for physical delivery of natural gas as follows:

Term	Volume (mcf/d)	Contract Price (mcf)	Price Basis
April 1, 2007 – October 31, 2007	5,270	7.91 floor, 8.54 ceiling	AECO monthly
April 1, 2007 – October 31, 2007	5,270	7.44	Station 2
April 1, 2007 – October 31, 2007	2,630	7.44	Station 2

c) Credit Risk

Substantial portions of the Company's accounts receivable are with entities in the oil and gas industry. The Company generally extends unsecured credit to these companies, and therefore, the collection of accounts receivable may be affected by changes in economic or other conditions and may accordingly impact the Company's overall credit risk. Management believes the risk is mitigated by the size, reputation and diversified nature of the companies to which they extend credit. The Company has not previously experienced any material credit losses on the collection of receivables.

d) Interest Rate Risk

The Company is exposed to changes in the prime interest rate on its bank debt.

13. CONTINGENCIES

The Company is party to various lawsuits as at December 31, 2006. It is management's opinion that, based on the best currently available information, the amount of any potential exposure and the outcome of these law suits is not determinable at this time. As a result, no provisions for these items have been recorded in these financial statements.

Pursuant to a purchase and sale agreement, the Company has indemnified the purchaser of a former subsidiary company for up to \$1,000,000 of income tax and legal expenses incurred with respect to specifically identified income tax returns. Any obligation pursuant to the terms of this indemnification will be recorded in the period in which the obligation is incurred.

The Company indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their service to the Company to the extent permitted by law. The Company has acquired and maintains liability insurance for its directors and officers.

14. SUPPLEMENTAL DISCLOSURE ON CONSOLIDATED STATEMENTS OF CASH FLOWS

Changes in non-cash working capital were comprised of the following:

	Year ended December 31,	
	2006 (\$'000's)	2005 (\$'000's)
Accounts receivable	7,019	(8,730)
Prepays and other current assets	135	999
Accounts payable and accrued liabilities	(8,521)	8,015
Income taxes payable	(260)	155
Net change	(1,627)	439

	Year ended December 31,	
	2006 (\$'000's)	2005 (\$'000's)
Net change by activity:		
Operating	(1,562)	(722)
Investing	213	879
Financing	(278)	282
Net change	(1,627)	439

Additional information:

	Year ended December 31,	
	2006 (\$'000's)	2005 (\$'000's)
Cash interest paid	1,225	480
Cash taxes paid	15	623

15. COMPARATIVE FIGURES

Certain figures provided for 2005 have been reclassified to conform to the presentation adopted in 2006.