

Unaudited Consolidated Financial Statements of

Iteration Energy Ltd.

June 30, 2006 and 2005

Iteration Energy Ltd.

Consolidated Balance Sheets (unaudited)

As at

(in thousands of dollars)

	June 30, 2006	December 31, 2005
ASSETS		
Current		
Cash	\$ 3,987	\$ 25,134
Accounts receivable	11,626	19,421
Prepays and other current assets	973	1,266
	16,586	45,821
Property, plant and equipment (Notes 3, 4 and 5)	183,457	115,257
Goodwill (Note 3(b))	20,568	20,568
	\$ 220,611	\$ 181,646
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Bank loan (Note 5)	\$ 30,146	\$ -
Accounts payable and accrued liabilities (Note 14)	14,193	33,753
Income taxes payable (recoverable)	(171)	186
Capital lease obligations (Note 6)	504	730
	44,672	34,669
Future income taxes (Note 9)	2,667	2,928
Leasehold inducements	401	471
Asset retirement obligations (Note 7)	8,451	4,492
	56,191	42,560
Commitments and contingencies (Notes 3, 10, 11, and 12)		
Shareholders' equity (Note 8)		
Share capital	163,624	139,467
Warrants outstanding (Notes 3(b) and 8(d))	4,166	4,166
Deficit	(3,370)	(4,547)
	164,420	139,086
	\$220,611	\$ 181,646

See accompanying notes to consolidated financial statements.

Iteration Energy Ltd.

Consolidated Statements of Earnings (Loss) and Deficit (unaudited)

<i>(in thousands of dollars, except per share amounts)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenue				
Production revenue	\$ 12,394	\$ 10,939	\$ 29,711	\$ 31,096
Royalties, net of Alberta Royalty Tax Credit	(2,502)	(2,277)	(6,754)	(6,756)
	9,892	8,662	22,957	24,340
Other production revenue	107	156	207	373
Interest income	67	120	234	137
	10,066	8,938	23,398	24,850
Expenses				
Production	2,324	653	4,203	3,734
Transportation	132	105	546	402
General and administrative	645	1,006	1,422	2,712
Stock based compensation expense (recovery)(Note 8 (c))	(102)	793	(1,682)	1,071
Interest on current debt	172	35	227	589
Accretion expense	125	56	205	262
Depletion and depreciation	9,503	5,043	17,119	17,857
	12,799	7,691	22,040	26,627
Earnings (loss) before the following	(2,733)	1,247	1,358	(1,777)
Recovery of investment tax credits	-	1,409	-	1,409
Loss on disposal of investment (Note 3(a))	-	-	-	(63)
Earnings (loss) before taxes	(2,733)	2,656	1,358	(431)
Income taxes (Note 9)				
Future income tax expense (recovery)	(1,170)	1,997	212	1,035
Current income tax expense (recovery)	(91)	186	(31)	504
	(1,261)	2,183	181	1,539
Net earnings (loss)	(1,472)	473	1,177	(1,970)
Deficit, beginning of period	(1,898)	(10,810)	(4,547)	(8,367)
Deficit, end of period	\$ (3,370)	\$ (10,337)	\$ (3,370)	\$ (10,337)
Basic and diluted net earnings (loss) per common share (Note 8(e))	\$ (0.03)	\$ 0.01	\$ 0.02	\$ (0.04)

See accompanying notes to the consolidated financial statements

Iteration Energy Ltd.

Consolidated Statements of Cash Flows (unaudited)

<i>(in thousands of dollars)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
OPERATING ACTIVITIES				
Net earnings (loss)	\$ (1,472)	\$ 473	\$ 1,177	\$ (1,970)
Add (deduct) non-cash items:				
Depletion and depreciation	9,503	5,043	17,119	17,857
Accretion expense	125	56	205	262
Recovery of investment tax credits	-	(1,409)	-	(1,409)
Future income tax expense (recovery)	(1,170)	1,997	212	1,035
Amortization of leasehold inducements	(30)	(36)	(69)	(81)
Loss on disposal of investment	-	-	-	42
Stock-based compensation (Note 7 (c))	(102)	793	(1,682)	1,071
	6,854	6,917	16,962	16,807
Asset retirement expenditures	-	(155)	-	(262)
Net change in non-cash working capital (Note 13)	(2,294)	(7,645)	(3,061)	(14,037)
	4,560	(883)	13,901	2,508
INVESTING ACTIVITIES				
Proceeds from sale of property, plant and equipment (Note 3(c))	529	1,926	679	84,535
Acquisition of subsidiary, net of cash acquired (Note 3(b))	-	-	-	(353)
Acquisition of oil and gas properties	(42,171)	-	(51,062)	-
Additions to oil and gas properties	(10,021)	(3,278)	(31,158)	(8,484)
Additions to other capital assets	(24)	(5)	(24)	(5)
Proceeds on disposal of assets held for sale	-	-	-	2,119
Net change in non-cash working capital (Note 13)	(10,139)	(1,175)	(6,809)	829
	(61,826)	(2,532)	(88,374)	78,641
FINANCING ACTIVITIES				
Proceeds from (repayment of) bank loan	30,146	-	30,146	(51,518)
Common shares issued for cash	25,210	-	25,210	-
Share issue costs	(1,526)	-	(1,526)	(38)
Principal payment – equipment finance obligation	-	(305)	-	(325)
Principal payment – capital lease obligation	(112)	(109)	(226)	(214)
Net change in non-cash working capital (Note 13)	-	183	(278)	183
	53,718	(231)	53,326	(51,912)
Increase (decrease) in cash	(3,548)	(3,646)	(21,147)	29,237
Cash, beginning of period	7,535	32,883	25,134	-
Cash, end of period	\$ 3,987	\$ 29,237	\$ 3,987	\$ 29,237

See Note 13 for supplemental disclosure

See accompanying notes to the consolidated financial statements

Iteration Energy Ltd.

Notes to the Unaudited Interim Consolidated Financial Statements Period Ended June 30, 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 unaudited interim consolidated financial statements of Iteration have been prepared in accordance with Canadian generally accepted accounting principles and are consistent with those set out in the audited consolidated financial statements for the year ended December 31, 2005. These interim consolidated financial statements do not include all disclosures provided in the December 31 financial statements and should be read in conjunction with the Company’s consolidated financial statements for the year ended December 31, 2005.

3. ACQUISITIONS AND DISPOSITIONS

(a) Sale of Mar Oil Company

During January 2005, the Company disposed of its wholly owned subsidiary, Mar Oil Company. Iteration received as consideration an unsecured promissory note with a maximum \$1,000,000 conditional principal amount, based on the value of the proven reserves as of July 1, 2006, discounted at 15%, on the lands held by Mar Oil Company plus net working interest revenue received on these lands to July 1, 2006. The promissory note is payable in annual installments, calculated based on cash flow from the lands, commencing on August 31, 2007.

The Company did not assign value to the promissory note on the disposal of Mar due to the unsecured nature of the promissory note and uncertainties with regard to its ultimate repayment. A loss on the disposition of Mar in the amount of \$63,000 was recognized.

(b) 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
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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
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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 (%)	-

(c) 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.

(d) 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 \$42,048,000. The purchase price was initially funded from bank debt. The Company commenced reporting production from the acquisition July 1, 2006.

4. PROPERTY, PLANT AND EQUIPMENT

	June 30, 2006 (\$'000's)	December 31, 2005 (\$'000's)
Oil and gas properties	\$ 282,421	\$ 197,080
Other	628	650
	283,049	197,730
Less accumulated depletion and depreciation	99,592	82,473
	\$ 183,457	\$ 115,257

At June 30, 2006, unproved properties and seismic amounting to \$20,270,000, (December 31, 2005: \$13,936,000) have been excluded from the depletion calculation. Future development costs on proven undeveloped reserves of \$2,150,000 (December 31, 2005: \$1,650,000) are included in the depletion calculation.

For the three and six months ended June 30, 2006, the Company capitalized \$447,000 and \$864,000 respectively, (three and six months ended June 30, 2005: \$363,000 and \$703,000 respectively) of overhead directly related to exploration and development activities.

Property, plant and equipment include assets under capital lease having a carrying value of \$1,047,000 as at June 30, 2006 (December 31, 2005: \$1,090,000).

5. BANK LOAN

The Bank Loan represents the drawn portion of a \$50 million credit facility that the Company has established with a Canadian Chartered Bank. The facility is secured by a general security agreement and a guarantee and postponement of claim. The facility requires monthly payments of interest only, calculated monthly in arrears. Interest on the outstanding balance is calculated at the bank's prime rate. In addition, there is a standby fee, calculated at 10 basis points per annum on the undrawn balance.

6. 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 is 7.35%. Current future minimum lease payments under the capital lease at June 30, 2006 are \$504,000 (December 31, 2005: \$730,000)

7. 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 2006 through 2046) will total approximately \$17,548,000 (December 31, 2005: \$10,756,000). The fair value at June 30, 2006 is \$8,451,000 (December 31, 2005: \$4,492,000) using a discount rate of six percent and an inflation rate of two percent. As at June 30, 2006, no funds have been set aside to settle this obligation.

	June 30, 2006 (\$'000's)
Balance, beginning of period	\$ 4,492
Liabilities incurred on acquisition of properties (note 3)	2,837
Increase in liabilities from drilling activity	1,862
Decrease in liabilities from revision of estimates	(945)
Settlement of liabilities	-
Accretion expense	205
Balance, end of period	\$ 8,451

During the quarter the estimated abandonment provision per well was decreased from \$40,000 per well to \$35,000 per well and the estimated abandonment cost per pipeline segment was decreased from \$25,000 per pipeline segment to \$10,000 to more accurately reflect actual costs being incurred to abandon pipeline segments and well sites.

8. 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

	Six months ended June 30,		Year ended, December 31,	
	2006		2005	
	Number of Shares	Amount (\$'000's)	Number of Shares	Amount (\$'000's)
Balance, beginning of period	48,895,347	\$ 139,467	43,071,681	\$ 126,618
Shares issued on public offering	6,200,000	25,110		
Issued on acquisition of Iteration Energy Inc. (Note 3(b))	-	-	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	-	(1,053)	-	(25)
Tax benefits renounced	-	-	-	(3,550)
Balance, end of period	55,129,847	\$ 163,624	48,895,347	\$ 139,467

On June 27, 2006, the Company issued 6,200,000 subscription receipts, pursuant to a short form prospectus dated June 22, 2006, for gross proceeds of \$25,110,000. Costs incurred with respect to this offering were \$1,526,000. The Company has recorded a future income tax benefit of \$473,000 with respect to this amount. Each subscription receipt was converted into one common share of the Company. Net cash proceeds received from the offering were applied to reduce bank debt.

(c) 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 are as follows:

	Six months ended June 30, 2006		Year ended December 31, 2005	
	Number of Options	Weighted average exercise price \$	Number of Options	Weighted average exercise price \$
Outstanding at January 1	4,798,122	2.98	747,200	4.93
Granted	487,100	4.51	4,902,500	2.97
Exercised for cash	-	-	(163,331)	3.86
Exercised for shares	(34,500)	(2.90)	(73,666)	3.62
Forfeited	-	-	(614,581)	5.02
Outstanding at end of period	5,250,722	3.12	4,798,122	2.98
Options exercisable at end of period	1,596,130	2.96	16,958	4.25

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

Range of exercise prices	Number outstanding June 30, 2006	Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number exercisable June 30, 2006	Weighted average exercise price \$
\$2.90 to \$4.00	4,590,500	3.66	2.90	1,583,838	2.94
\$4.01 to \$5.00	504,600	4.85	4.28	6,667	4.95
\$5.01 to \$9.00	155,622	4.95	5.77	5,625	5.63
	5,250,722	3.81	3.12	1,596,130	2.96

As approved by Iteration's shareholders, the Company's stock option plan was amended 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 three and six months ended June 30, 2006, a recovery of stock based compensation expense of \$102,000 and \$1,682,000 respectively (2005: expense of \$793,000 and \$1,071,000 respectively), was recognized based on the reduction in value of the outstanding stock options. This was determined using the June 30, 2006 closing share price, as compared to the closing share price at March 31, 2006 and 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 June 30, 2006 share price of \$4.13, had all of the 5,250,722 stock options outstanding been vested, stock based compensation expense and a corresponding liability of \$5,660,000 would have been recognized. Of this amount, \$2,400,000 has been recognized as a liability at June 30, 2006.

(d) Warrants

Warrants to purchase 5,000,000 common shares at \$2.90 were issued to Iteration Energy Inc. shareholders (Note 3(b)). The warrants vested the first day after the common shares of the Company traded at a weighted average price of not less than \$4.50 per common share for any 45 consecutive calendar days within a 42-month period. On May 7, 2005, all of the warrants vested. The warrants expire on September 21, 2008.

(e) Per Share Amounts

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Weighted average common shares outstanding	50,973,803	48,821,681	49,940,317	46,312,012
Effect of dilutive warrants	-	1,806,167	2,140,039	-
Effect of dilutive options	-	-	1,325,593	-
Weighted average diluted common shares outstanding	50,973,803	50,627,848	53,405,949	46,312,012

The options and warrants outstanding for the three months ended June 30, 2006 and the six months ended June 30, 2005 are not included in the computation of diluted common shares outstanding as the Company realized a net loss during these periods and the effect would be anti-dilutive.

9. INCOME TAXES

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

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
	(\$'000's)	(\$'000's)	(\$'000's)	(\$'000's)
Income (loss) before tax	\$ (2,733)	\$ 2,656	\$ 1,358	\$ (431)
Statutory Canadian corporate tax rate	34.50 %	37.62 %	34.50 %	37.62 %
Anticipated tax expense (recovery)	(942)	999	468	(162)
Non-deductible Crown payments	356	562	761	1,495
Alberta Royalty Tax Credit	(11)	(6)	(22)	(36)
Resource allowance	(276)	(547)	(710)	(1,450)
Rate adjustment	(83)	(105)	(166)	18
Other	(214)	1,094	(119)	1,170
Future income tax expense (recovery)	\$ (1,170)	\$ 1,997	\$ 212	\$ 1,035

The rate adjustment of \$214,000 represents the impact of the decrease in future income tax rates from 35.50% to 31.00%.

The current income tax expense (recovery) of (\$31,000) for the six months ended June 30, 2006 (2005: \$504,000) consists of the following:

	2006 (\$'000's)	2005 (\$'000's)
Part I tax reassessment	\$ (31)	\$ 45
Capital tax	-	80
Part X11.6 tax	-	210
Part I tax reassessment – predecessor corporations	-	169
Current tax expense	\$ (31)	\$ 504

The Company also has approximately \$4,328,000 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:

2006	\$ 1,376
2007	1,132
2008	964
2009	856

10. 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 (\$'000's);

2006	\$ 344
2007	687
2008	687
2009	344

11. FINANCIAL INSTRUMENTS

a) Fair Value

Financial instruments consist of cash, accounts receivable, accounts payable, income taxes payable (receivable), capital lease obligations and bank loans. 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 June 30, 2006:

Transaction Type	Volume (GJ/d)	Contract Price (GJ)	Expiry
Cogeneration Fuel Supply	33	\$2.058 - \$2.272	October 31, 2009

Based on independent price forecasts, had this contract been closed on June 30, 2006, a loss of \$116,000 would have been realized. No accrual has been made for this prospective loss in the current financial statements.

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.

12. CONTINGENCIES

The Company is party to various lawsuits as at June 30, 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 lawsuits 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.

13. SUPPLEMENTAL DISCLOSURE ON CONSOLIDATED STATEMENTS OF CASH FLOWS

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

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
	(\$'000's)	(\$'000's)	(\$'000's)	(\$'000's)
Accounts receivable	\$ 4,955	\$ 156	\$ 7,795	\$ 318
Prepays and other current assets	228	706	292	1,247
Accounts payable and accrued liabilities	(17,491)	(9,052)	(17,878)	(14,498)
Income taxes payable	(125)	(447)	(357)	(92)
Net change	\$ (12,433)	\$ (8,637)	\$ (10,148)	\$ (13,025)
	2006	2005	2006	2005
	(\$'000's)	(\$'000's)	(\$'000's)	(\$'000's)
Net change by activity:				
Operating	\$ (2,294)	\$ (7,645)	\$ (3,061)	\$ (14,037)
Investing	(10,139)	(1,175)	(6,809)	829
Financing	-	183	(278)	183
Net change	\$ (12,433)	\$ (8,637)	\$ (10,148)	\$ (13,025)

Additional information:

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
	(\$'000's)	(\$'000's)	(\$'000's)	(\$'000's)

Cash interest paid	\$ 172	\$ 35	\$ 227	\$ 583
Cash taxes paid	-	306	-	547

14. ACCOUNTS PAYABLE

Accounts payable consists of the following:

	June 30, 2006 (\$'000's)	December 31, 2005 (\$'000's)
Trade accounts payable	\$ 5,086	\$ 25,102
Joint venture accounts payable	3,575	878
Royalties payable	3,110	3,674
Stockbased compensation	2,402	4,082
Other	20	17
Total	\$14,193	\$ 33,753

15. COMPARATIVE FIGURES

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