GALLEON ENERGY INC.

Financial Statements

December 31, 2010

Management's Responsibility for Financial Reporting

The accompanying financial statements and all information in the annual report are the responsibility of management. Management has prepared the financial statements in accordance with Canadian generally accepted accounting principles. In the opinion of management, the financial statements have been prepared within acceptable limits of materiality and, when necessary, management has made informed judgments and estimates in accounting for transactions that were not complete at the balance sheet date. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances as indicated in the notes to the financial statements. Financial information contained elsewhere in the annual report has been prepared and reviewed by management to ensure it is consistent with the financial statements.

Management has established systems of internal controls over financial reporting to provide reasonable assurance regarding the reliability of the Corporation's financial reporting and the preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles.

The Audit and Reserves Committee is appointed by the Board of Directors, and comprises directors that are not employees of the Corporation. The Committee meets regularly with management, as well as the external auditors, to discuss internal controls over the financial reporting process, auditing matters and financial reporting issues, to satisfy itself that each party is discharging its responsibilities, and to review the financial statements and the external auditors' report. The Board of Directors has approved the financial statements.

Steve Sugianto
President and Chief Executive Officer

Shivon M. Crabtree
Vice President Finance and
Chief Financial Officer

March 10, 2011

INDEPENDENT AUDITORS' REPORT

To the Shareholders of Galleon Energy Inc.

We have audited the accompanying consolidated financial statements of Galleon Energy Inc., which comprise the consolidated balance sheets as at December 31, 2010 and 2009, and the consolidated statements of earnings (loss), comprehensive income (loss), and retained earnings and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

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 comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Galleon Energy Inc. as at December 31, 2010 and 2009 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

Chartered Accountants
Calgary, Canada
March 10, 2011

GALLEON ENERGY INC.
Consolidated Balance Sheets

As at December 31

($000s)	**2010**	**2009**
ASSETS		
CURRENT		
Accounts receivable (note 10)	28,829	41,270
Deposits and prepaid expenses	3,361	6,190
Future income taxes (note 8)	-	2,884
Fair value of financial derivatives (note 10)	20,815	4,241
	53,005	54,585
Goodwill (notes 3 and 4)	-	34,891
Equipment inventory	5,876	6,116
Property and equipment (notes 3, 5, and 6)	934,494	1,041,140
	993,375	**1,136,732**
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	49,369	55,531
Capital lease (note 3)	-	1,545
Bank loan (note 6)	135,682	217,243
Future income taxes (note 8)	3,630	-
Fair value of financial derivatives (note 10)	6,411	13,789
	195,092	288,108
Asset retirement obligations (note 5)	43,094	41,499
Fair value of financial derivatives (note 10)	14,980	-
Future income taxes (note 8)	70,500	94,262
	323,666	423,869
SHAREHOLDERS' EQUITY		
Share capital (note 7)	587,028	599,334
Contributed surplus (note 7)	36,983	28,884
Retained earnings	45,698	84,645
	669,709	712,863
	993,375	**1,136,732**

See accompanying notes

Approved on behalf of the Board of Directors:

"Signed"
William L. Cooke
Director

"Signed"
Daryl Gilbert
Director

GALLEON ENERGY INC.
Consolidated Statements of Earnings (Loss), Comprehensive Income (Loss) and Retained Earnings

	Year ended December 31	
($000s, except per share amounts)	**2010**	**2009**
REVENUE		
Petroleum and natural gas revenue	207,831	213,144
Royalties, net of GCA	(31,390)	(32,712)
Realized gain on financial derivatives (note 10)	10,552	6,651
Unrealized gain (loss) on financial derivatives (note 10)	8,972	(10,784)
Other income	-	752
	195,965	177,051
EXPENSES		
Operating	51,405	56,714
Transportation	8,806	8,165
General and administration	14,773	15,911
Restructuring costs (note 12)	1,242	-
Interest	10,086	9,226
Stock-based compensation (note 7)	4,072	6,114
Accretion	2,860	2,651
Depletion and depreciation	128,284	127,930
Goodwill allocated to disposed properties (note 3)	4,736	-
Impairment of goodwill (note 4)	30,155	-
	256,419	226,711
Loss before taxes	(60,454)	(49,660)
Income taxes (note 8)		
Capital and other taxes	203	426
Future income tax recovery	(21,710)	(15,514)
	(21,507)	(15,088)
NET LOSS AND COMPREHENSIVE LOSS	**(38,947)**	**(34,572)**
RETAINED EARNINGS, BEGINNING OF PERIOD	84,645	119,217
RETAINED EARNINGS, END OF PERIOD	45,698	84,645
NET LOSS AND COMPREHENSIVE LOSS PER SHARE (note 7)		
Basic	(0.46)	(0.43)
Diluted	(0.46)	(0.43)
Weighted average Class A shares – basic	84,770,976	79,656,109
– diluted	84,770,976	79,656,109

See accompanying notes

GALLEON ENERGY INC.
Consolidated Statements of Cash Flows

($000s)	Year ended December 31 2010	2009
Cash provided by (used in):		
OPERATING ACTIVITIES		
Net loss	(38,947)	(34,572)
Items not requiring cash:		
Future income tax recovery	(21,710)	(15,514)
Depletion and depreciation	128,284	127,930
Accretion	2,860	2,651
Goodwill allocated to disposed properties	4,736	-
Impairment of goodwill	30,155	-
Stock-based compensation	4,072	6,114
Unrealized loss (gain) on financial derivatives	(8,972)	10,784
Abandonment costs	(491)	(1,281)
Change in non-cash working capital	3,378	11,615
	103,365	107,727
FINANCING ACTIVITIES		
Issue of common shares	337	53,855
Repurchase of common shares	(4,154)	(32)
Share issue costs	-	(2,737)
Capital lease payments	(1,545)	(2,106)
Bank loan repayment	(81,561)	(31,772)
	(86,923)	17,208
INVESTING ACTIVITIES		
Disposals of equipment inventory	240	6,033
Additions to oil and gas properties	(136,570)	(106,095)
Acquisitions of oil and gas properties (note 3)	(17,791)	-
Dispositions of oil and gas properties (note 3)	131,949	8,451
Change in non-cash working capital	5,730	(33,324)
	(16,442)	(124,935)
CHANGE IN CASH	-	-
CASH, BEGINNING AND END OF PERIOD	-	-
SUPPLEMENTARY INFORMATION		
Cash interest paid	9,599	9,522
Cash taxes paid	371	1,005

See accompanying notes

Unless otherwise stated, amounts presented in these notes are in Canadian dollars and tabular amounts are in thousands of Canadian dollars, except number of shares and per share amounts.

1. ACCOUNTING POLICIES

Nature of Business and Basis of Presentation

Galleon Energy Inc. ("Galleon" or the "Corporation") was incorporated under the Business Corporations Act of Alberta on March 27, 2003. The business of the Corporation is the acquisition of, exploration for and development of petroleum and natural gas properties in western Canada. Galleon is listed on the TSX under the symbol "GO".

The financial statements include the accounts of the Corporation, its wholly owned subsidiary 1175176 Alberta Ltd, and its wholly owned partnership Galleon Energy Partnership, on a consolidated basis.

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"), and have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the accounting policies summarized below.

Measurement uncertainty

The amounts recorded for depletion and depreciation of property and equipment, the provision for asset retirement obligations, the provision for income taxes, the ceiling test calculation and the goodwill impairment test are based on estimates of proven and probable reserves, production rates, oil and natural gas prices, future costs, future prices, and other relevant assumptions. Accruals for royalties and costs are prepared based on estimates when actual amounts are not yet known. Stock-based compensation amounts are determined using certain assumptions (see note 7). The fair value of financial derivatives is based on quoted market prices (see note 10). By their nature, these estimates and assumptions are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future years could be significant.

Cash and cash equivalents

Cash and cash equivalents may include highly liquid short-term investments with initial maturities of three months or less. They are recorded at cost which approximates fair market value.

Property and equipment

Petroleum and natural gas properties and equipment

The Corporation follows the full cost method of accounting whereby all costs related to the exploration for and development of petroleum and natural gas reserves, whether productive or unproductive, are capitalized in one Canadian cost centre. Such costs include land acquisition, drilling, equipping, geological and geophysical and overhead expenses related to exploration and development activities. These costs are depleted on the unit-of-production method using estimated gross proven petroleum and natural gas reserves as determined by independent professional engineers. Petroleum and natural gas reserves are converted to a common unit of measure on an energy equivalent basis of six mcf of gas to one barrel of oil. Costs of acquiring and evaluating unproven properties are excluded from the depletion calculation until it is determined whether or not proven reserves are attributable to the properties or impairment occurs. Proceeds from the sale of petroleum and natural gas properties and related equipment are applied against capitalized costs, with no gain or loss recognized, unless such a sale would result in a change in the rate of depletion of 20% or more.

Drilling credits earned under government incentive programs are recorded as a reduction of petroleum and natural gas properties.

Ceiling test

The Corporation evaluates its petroleum and natural gas assets in each reporting period to determine that the costs are recoverable. If the sum of the anticipated undiscounted cash flows from proved reserves, based on expected future escalating product prices and costs, exceeds the carrying value of the assets, the costs are considered recoverable. If the carrying value is not considered recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from production of the proved and probable reserves.

Office furniture and equipment

Office furniture, equipment and other assets are recorded at cost and depreciated on a declining balance basis at rates ranging from 10% - 30% per year.

Equipment inventory

The Corporation records equipment inventory as a long-term asset on the balance sheet.

Leases

The Corporation's leases are classified as either capital or operating. Capital leases are those which transfer substantially all the benefits and risks of ownership to the lessee. Assets acquired under capital leases are depleted along with the petroleum and natural gas properties. Obligations recorded under capital leases are reduced by the principal portion of lease payments as incurred and the imputed interest portion of capital lease payments is charged to interest expense. Payments under operating leases are expensed as incurred.

Goodwill

Goodwill, at the time of acquisition, represents the excess of the purchase price of a business over the fair value of net assets acquired; thereafter, goodwill is assessed for impairment at least annually. If the fair value of the business is less than the book value, a second test is performed to determine the amount of the impairment. The amount of the impairment is determined by deducting the fair value of the business' other assets and liabilities from the fair value of the business to determine the implied fair value of goodwill and comparing that amount to the book value of goodwill. Any excess of the book value of goodwill over the implied fair value is the impairment amount and will be charged to income in the period of the impairment.

Asset retirement obligations

The Corporation follows the recommendations for asset retirement obligations as set out in the CICA Handbook section 3110. This standard requires the recognition and measurement of liabilities related to the legal obligation to abandon and reclaim property, plant and equipment incurred upon acquisition, construction, development and/or normal use of the asset. The initial liability must be measured at fair value and subsequently adjusted for the accretion of discount and changes in the fair value. The asset retirement cost is capitalized as part of property and equipment and depleted into earnings based on units of production. Actual costs incurred upon settlement of the obligations are charged against the liability.

Revenue recognition

Petroleum and natural gas sales are recognized when delivery of the product has been completed and title passes to an external party.

Financial instruments

The financial instruments recognized on the Corporation's balance sheet are deemed to approximate their estimated fair values. All financial assets except derivatives are classified as loans or receivables and are accounted for on an amortized cost basis. All financial liabilities are classified as other liabilities. Derivative instruments are classified as held-for-trading and are recorded on the balance sheet at fair value (see note 10) with actual amounts received or paid on the settlement of the derivative financial instrument recorded in revenue. There were no financial assets on the balance sheet which were designated as available-for-sale.

Joint interests

The Corporation's petroleum and natural gas activities may be conducted jointly with others. These financial statements reflect only the Corporation's proportionate interest in such activities.

Future income taxes

The liability method is used in accounting for income taxes. Under this method, future income tax assets and liabilities are recognized based on differences between the financial reporting and tax bases of assets and liabilities, and measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period in which the change is substantively enacted.

Flow-through shares

The Corporation has financed a portion of its exploration and development activities through the issuance of flow-through shares. Under the terms of the flow-through share agreements, the tax attributes of the related expenditures are renounced to subscribers. To recognize the foregone tax benefits to the Corporation, the carrying value of the shares issued is reduced by the tax effect of the tax benefits renounced to subscribers when the renouncements are filed.

Fair values

The carrying values of accounts receivable and accounts payable approximate their fair values due to their short-term nature. The carrying value of the bank loan approximates its fair value due to the floating interest rate on the facility. The carrying value of the financial derivatives approximates current market prices for comparable contracts.

Stock-based compensation

The Corporation follows the accounting standard on stock-based compensation as presented in the CICA Handbook section 3870. This standard requires the recognition of stock-based compensation expense for "awards to" or "grants to" employees and non-employees using the fair value method.

The standard requires the fair value of all stock-based compensation awards to be expensed over the vesting period of the award with an offsetting credit to contributed surplus. The Black-Scholes option pricing model has been used to calculate the fair value of the stock options granted. Consideration paid by optionees on the exercise of stock options is credited to share capital, together with the related stock-based compensation expense previously included in contributed surplus.

2. CHANGES IN SIGNIFICANT ACCOUNTING POLICIES

Future accounting policies

The Canadian Accounting Standards Board (AcSB) has confirmed that the use of the International Financial Reporting Standards ("IFRS") will be required in 2011 for publicly accountable profit-oriented enterprises. IFRS will replace Canada's GAAP for those enterprises that are responsible to large or diverse groups of stakeholders. The official changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. Corporations will be required to provide comparative IFRS information for the fiscal year of 2010.

The Corporation's conversion project consists of the following phases: 1) initial diagnostic and planning, 2) impact analysis and evaluation, and 3) implementation and review. The Corporation has completed the initial diagnostic and planning, and the impact analysis and evaluation phases. Major differences between Canadian GAAP and IFRS have been identified and quantified. The implementation and review phase is nearing completion.

The impact of the transition to IFRS on the internal controls over financial reporting is being updated as the implementation and review of the Corporation's IFRS accounting policies is being completed.

The opening balance sheet as at January 1, 2010 is substantially determined. The Corporation is preparing IFRS based comparative statements for each of the quarters ended in 2010.

3. PROPERTY AND EQUIPMENT

As at December 31, 2010	Cost $	Accumulated depletion $	Net book value $
Petroleum and natural gas properties & equipment	1,539,284	(605,980)	933,304
Office furniture and equipment	2,664	(1,474)	1,190
	1,541,948	**(607,454)**	**934,494**

As at December 31, 2009	Cost $	Accumulated depletion $	Net book value $
Petroleum and natural gas properties & equipment	1,517,757	(477,996)	1,039,761
Office furniture and equipment	2,553	(1,174)	1,379
	1,520,310	**(479,170)**	**1,041,140**

During the year ended December 31, 2010 the Corporation sold properties in the Puskwa area of Alberta for cash consideration, net of adjustments, of $131.4 million. Proceeds from the sale were applied against property and equipment, with no gain or loss recognized, as the sale did not change the depletion rate by 20% or more. Goodwill was reduced by $4.7 million as a result of the sale.

During year ended December 31, 2010 the Corporation purchased non-producing assets in the Kakut area of Alberta for cash consideration of $17.5 million.

As at December 31, 2010, $51.4 million (December 31, 2009 - $86.6 million) of undeveloped land and seismic have been excluded from and $176.3 million (December 31, 2009 - $199.7 million) in future development costs have been added into the full cost pool for depletion purposes. For the year ended December 31, 2010, $1.3 million (December 31, 2009 – $1.1 million) of exploration salaries have been capitalized.

The final payment required under the equipment capital lease was made during the year ended December 31, 2010.

As at December 31, 2010, the Corporation had recorded drilling credits of $20.9 million as a reduction of property and equipment.

The Corporation has performed the ceiling test using the following benchmark reference prices at December 31, 2010 for the years 2011 to 2016 and adjusted for commodity differentials specific to the Corporation. Beyond year 2016, the price forecast escalates on average 2.0% per year. A foreign exchange rate of $0.98 US to $1.00 CDN was used. No impairment was required.

Benchmark Reference Price Forecasts:

	2011	2012	2013	2014	2015	2016
WTI oil USD/Bbl	88.00	90.78	93.64	96.57	99.58	101.58
Alberta spot gas Cdn/Mcf	3.98	4.69	5.38	6.02	6.31	6.44

4. GOODWILL

The Corporation reviewed the valuation of goodwill as of December 31, 2010 and determined that the fair value of the reporting unit had declined below its carrying value. Based upon this review, an impairment of goodwill of $30.2 million (December 31, 2009 - $nil) was recorded as a non-cash charge to earnings as of December 31, 2010.

5. ASSET RETIREMENT OBLIGATION

The Corporation's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The Corporation estimates the total undiscounted amount of cash flows required to settle its asset retirement obligation is approximately $128 million, which will be incurred over the next 40 years. Credit adjusted risk free rates of 5% and 8% and an inflation rate of 2% were used to calculate the fair value of the asset retirement obligation.

Year ended December 31	2010 $	2009 $
Balance, beginning of year	41,499	39,905
Accretion expense	2,860	2,651
Liabilities incurred	1,985	1,909
Disposition of liabilities	(1,839)	(1,685)
Settlement of liabilities	(491)	(1,281)
Change in estimates	(920)	-
Balance, end of year	**43,094**	**41,499**

6. AVAILABLE CREDIT FACILITY

The Corporation has $250 million in credit facilities available consisting of a $225 million extendible 364 day revolving term facility and a $25 million non-revolving facility. The $25 million facility is available subject to mutual approval of the banking syndicate and the Corporation, including repayment terms. Collateral for the facilities consists of a demand debenture for $500 million collateralized by a first floating charge over all of the property and equipment of the Corporation. At December 31, 2010, an amount of $135.7 million was drawn against the credit facilities (December 31, 2009 - $217.2 million).

The facilities bear interest at the bank's prime or banker's acceptance rates plus a rate margin. The margin ranges from 1.5% per annum to 5.5% per annum, based upon the Corporation's debt to cash flow ratio. For the year ended December 31, 2010, the effective interest rate was 5.8% (December 31, 2009 –3.8%).

An annual review is scheduled to occur on or before May 28, 2011. As at December 31, 2010, the Corporation is in compliance with all covenants, obligations and conditions of its credit agreement.

7. SHARE CAPITAL

Authorized

Unlimited number of preferred shares with no par value

Unlimited number of voting Class A shares with no par value

Unlimited number of voting Class B shares with no par value

Class A Shares	Number of Shares	Amount $
Balance at December 31, 2008	**75,170,733**	**547,298**
Issued for cash on exercise of stock options	230,250	695
Common shares purchased (d)	(10,100)	(32)
Issued for cash (c)	7,500,000	36,000
Issued for cash (b)	2,200,000	17,160
Share issue costs, net of tax of $712	-	(2,025)
Transfer from contributed surplus on exercise of options	-	238
Balance at December 31, 2009	**85,090,883**	**599,334**
Tax effect of flow through shares (a)	-	(4,462)
Issued for cash on exercise of stock options	77,000	337
Transfer from contributed surplus on exercise of options	-	123
Common shares purchased and cancelled (d)	(1,187,800)	(4,154)
Transfer to contributed surplus on cancellation of shares (d)	-	(4,150)
Balance at December 31, 2010	**83,980,083**	**587,028**

a) The tax effect of $4.5 million related to the renouncement in February 2010 of flow-through shares issued in 2009 was recorded in 2010.

b) On November 2, 2009, the Corporation issued 2,200,000 flow-through Class A shares at $7.80 per share by way of a private placement for gross proceeds of $17,160,000. The Corporation was obligated to incur qualifying exploration expenses of $17,160,000 prior to December 31, 2010. As at December 31, 2010, all of the required qualifying expenditures have been incurred.

c) On June 23, 2009, the Corporation issued 7,500,000 Class A shares at $4.80 per share for cash proceeds of $36.0 million.

d) On November 24, 2008, the Corporation received regulatory approval for a Normal Course Issuer Bid ("Bid") to purchase, for cancellation, up to a maximum of 5,610,908 shares of the Corporation. The Bid commenced on November 26, 2008 and terminated on November 25, 2009. In 2009 the Corporation purchased 10,100 shares for total consideration of $32,627.

On November 26, 2009, the Corporation received regulatory approval for a renewal of the Bid, with approval to purchase, for cancellation, up to a maximum of 1,000,000 Class A shares of the Corporation. The renewal commenced on December 1, 2009 and terminated on November 30, 2010. Regulatory approval for an amendment to the Bid, increasing the maximum number of shares that may be purchased to 2,000,000, was received on September 17, 2010.

During the year ended December 31, 2010, the Corporation purchased 1,187,800 shares for cancellation for $4,154,000, of which all of the shares were cancelled at December 31, 2010. Share capital has been reduced and contributed surplus has been increased by an additional $4,150,000, being the difference between the assigned value of the shares at the date of purchase and the purchase price of the shares.

On November 29, 2010, the Corporation received regulatory approval for a Bid to purchase for cancellation up to a maximum of 2,000,000 shares of the Corporation. The Bid was effective December 1, 2010 and will terminate on November 30, 2011, or such earlier time as the Bid is completed or terminated at the option of the Corporation.

The Corporation has a share option plan which was approved on May 19, 2005 and amended on August 25, 2005, June 19, 2007 and May 13, 2008. The exercise price of each option may not be less than the closing price of the Corporation's Class A shares on the day immediately prior to the date of the grant. Compensation expense is recognized as the options vest. With options granted prior to November 2008, one third of the options vested immediately, and one third vested on each of the first and second anniversaries of the date of the grant. With options granted commencing November, 2008, the vesting period is one third on each of the next three anniversaries of the date of the grant. The options expire five years from the date of grant. The Corporation may grant up to 10% of the aggregate number of Class A shares outstanding and no one optionee is permitted to hold options entitling such optionee to purchase more than 5% of the aggregate number of issued and outstanding Class A shares. Class A shares have been reserved for all options granted.

Year ended December 31	2010 $	2009 $
Contributed surplus, beginning of year	28,884	23,009
Stock-based compensation expense	4,072	6,114
Transfer to share capital on exercise of options	(123)	(238)
Transfer from share capital on cancellation of shares	4,150	-
Paid on surrender of share options	-	(1)
Contributed surplus, end of year	**36,983**	**28,884**

The fair value of options granted during the year was estimated at the date of grant using a Black-Scholes Option Pricing Model with the following assumptions: risk-free interest rates of 1.8 - 2.0%; dividend yield of 0%; volatility factors of the market price of the Corporation's common shares of 59-63%; and an average expected life of the options of 3 years. Options granted in 2010 had fair values of between $1.53 and $2.40 per option.

Options	Number of Shares	Weighted Average Exercise Price $
Outstanding, December 31, 2008	**7,037,651**	**11.87**
Granted	5,526,000	6.26
Forfeited	(514,500)	(10.98)
Surrendered for cancellation	(5,085,067)	(13.92)
Exercised	(230,250)	(3.02)
Outstanding, December 31, 2009	**6,733,834**	**6.08**
Granted	2,569,000	4.30
Forfeited	(2,023,334)	(5.96)
Expired	(52,500)	(13.17)
Exercised	(77,000)	(4.38)
Outstanding, December 31, 2010	**7,150,000**	**5.44**

The following table summarizes information regarding stock options at December 31, 2010:

	Options Outstanding			Options Exercisable	
Exercise Price $	Number Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price $	Number Exercisable	Weighted Average Exercise Price $
3.45 - 4.74	2,710,000	4.3	4.08	532,168	4.64
5.22 - 7.74	4,440,000	3.9	6.27	1,308,000	6.37
	7,150,000	**4.0**	**5.44**	**1,840,168**	**5.87**

Earnings per share

The Corporation utilizes the treasury stock method in the determination of diluted per share amounts. Under this method, the diluted weighted average number of shares is calculated assuming the proceeds that arise from the exercise of outstanding and in the money options are used to purchase common shares of the Corporation at their average market price for the period. For the year ended December 31, 2010, 7,150,000 options have been excluded from the diluted earnings per share calculation as they are anti-dilutive (December 31, 2009 – 6,733,834).

8. INCOME TAXES

The future income tax asset and liability are comprised of the following temporary differences as at:

At December 31	2010 $	2009 $
Property and equipment	75,622	99,668
ACRI benefit	(1,302)	(1,260)
Share issue costs	(681)	(1,770)
Asset retirement obligation	(1,753)	(1,193)
Non-capital losses	(23,223)	(28,932)
Partnership income tax deferral	25,612	27,749
Capital leases	-	(402)
Financial derivative	(145)	(2,482)
Future income tax liability	74,130	91,378
Current future income tax asset (liability)	(3,630)	2,884
Long term future income tax liability	**70,500**	**94,262**

The provision for income tax differs from the amount that would have been expected if the reported earnings had been subject only to the statutory Canadian income tax rate of 28.1% (December 31, 2009 – 29.1%).

Year ended December 31	2010 $	2009 $
Loss before income taxes	(60,454)	(49,660)
Corporate tax rate	28.06%	29.07%
Expected tax (recovery)	(16,963)	(14,436)
Increase (decrease) in taxes resulting from:		
Non-deductible items	38	47
Stock-based compensation	1,142	1,777
Impairment of goodwill	8,461	-
Goodwill allocated to disposed properties	1,329	-
Disposition of properties	(11,821)	-
Statutory tax rate changes	(3,812)	(2,676)
Deductible capital taxes	(84)	(106)
Other	-	(120)
Future income tax recovery	**(21,710)**	**(15,514)**

At December 31, 2010 the Corporation has approximately $590.0 million (December 31, 2009 – $625.0 million) of tax deductions available for Canadian income tax purposes.

9. COMMITMENTS

Office Lease Payments

At December 31, 2010 the Corporation is committed to future minimum payments under operating leases for office space as follows:

	Amount $
2011	1,793
2012	1,793
2013	1,793
2014	1,793
2015	1,793
Thereafter	2,689

Fracturing and Coiled Tubing Services

The Corporation has entered into a contract for fracturing and coiled tubing services under which the Corporation has committed to a minimum payment of $6.0 million in 2011.

Litigation

The Corporation is involved in various claims and legal actions arising from the normal course of business. The Corporation does not expect that the outcome of these proceedings will have a material adverse effect on the Corporation as a whole.

10. FINANCIAL INSTRUMENTS AND FINANCIAL RISK FACTORS

Fair value of financial assets and liabilities

The Corporation's financial instruments recognized in the balance sheet consist of accounts receivable, accounts payable, bank loan and financial derivatives ("financial instruments"). The carrying value of accounts receivable and accounts payable approximated their fair values at December 31, 2010 due to their short-term nature. The carrying value of the bank loan approximates fair value due to the floating interest rate on the facility. The fair value of the financial derivatives is recognized on the balance sheet as described below.

Credit risk

Credit risk is the risk that a customer or counterparty will fail to perform an obligation or fail to pay amounts due causing a financial loss. The Corporation's accounts receivable are with customers and joint venture partners in the oil and gas industry and are subject to normal credit risks. A portion of the Corporation's production is currently sold through joint venture partners under normal industry sale and payment terms. As at December 31, 2010, approximately 48% of the accounts receivable balance is due from three customers, compared to 41% due from three customers at December 31, 2009. These customers are considered to have high credit worthiness. The Corporation generally grants unsecured credit but routinely assesses the financial strength of its customers and joint venture partners. No provision has been made for past due receivables as of December 31, 2010 as the Corporation has assessed there are no impaired receivables.

At December 31	2010 $
Less than 90 days	24,911
Greater than 90 days	3,918
Total	28,829

Liquidity risk

Liquidity risk arises through excess financial obligations over available financial assets due at any point in time. The Corporation's objective in managing liquidity risk is to maintain sufficient available reserves in order to meet its liquidity requirements at any point in time. The Corporation believes that it has access to sufficient capital through internally generated cash flows and external equity sources, and to undrawn committed credit facilities to meet current spending forecasts. The Corporation's current liabilities mature within a one year period.

Interest rate risk

The Corporation is exposed to interest rate risk as changes in interest rates may affect future cash flows and the fair value of its financial instruments. The Corporation's primary debt facility has a floating interest rate that will fluctuate based on prevailing market conditions. Cash flows are sensitive to changes in interest rates on this instrument. Given the amount of debt employed, the Corporation's strategy is to manage interest rate risk. If interest rates on the floating instrument were to change by 1% it is estimated that annual cash flow would change by approximately $1.3 million.

Market risk

Market risk is the risk of uncertainty arising from possible market price movements and their impact on the future performance of the business. The market price movements that could adversely affect the value of the Corporation's financial assets, liabilities and expected future cash flows include commodity price risk and interest rate risk. It is estimated that annual budgeted cash flow would change approximately by $0.8 million and by $1.4 million, respectively, due to a $1 USD WTI and a $0.25/Mcf CDN change in oil and natural gas prices.

The Corporation has the following financial contracts in place as at December 31, 2010:

Natural Gas:		
January 1, 2010 - December 31, 2011	5,000 GJ/d	CDN $5.85/GJ
January 1, 2010 - December 31, 2011	5,000 GJ/d	CDN $5.75/GJ
April 1, 2010 - March 31, 2011	5,000 GJ/d	CDN $5.76/GJ
January 1, 2011 - December 31, 2011	20,000 GJ/d	CDN $5.20/GJ
April 1, 2011 - December 31, 2011	5,000 GJ/d	CDN $5.60/GJ

Crude Oil:		
Fixed Price:		
January 1, 2011 – December 31, 2011	500 Bbl/d	WTI CDN $92.00/Bbl
January 1, 2011 – December 31, 2011	1,000/Bbl/d	WTI CDN $84.15/Bbl
Costless Collars:		
January 1, 2011 – December 31, 2011	1,000 Bbl/d	WTI CDN $77.10-$90.00/Bbl
Other:		
January 1, 2012 – December 31, 2012	1,000 Bbl/d	WTI US $85.00/Bbl Call
January 1, 2012 – December 31, 2012	527 Bbl/d	WTI US $85.00/Bbl Call
January 1, 2012 – December 31, 2012	1,100 Bbl/d	WTI US$ 85.00/Bbl Swaption

Interest Rate Swap:	
Notional Amount CAD $100 million	Term: January 20, 2009 – January 20, 2011
Fixed rate 1.1% - Floating rate is reset against CAD--CDOR on each 3 month anniversary	

The Corporation has entered into the above contracts for the purpose of protecting funds generated from operations from the volatility of commodity prices and interest rates. The Corporation recognizes the fair value of its financial derivatives on the balance sheet each reporting period with the change in fair value recognized as an unrealized gain or loss on the statement of earnings. At December 31, 2010 the fair value is estimated to be a net liability of $0.6 million, composed of a $20.8 million short term asset, a $6.4 million short-term liability, and a $15.0 million long-term liability.

The fair value of a financial instrument is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. The Corporation characterizes inputs used in determining fair value using a hierarchy that prioritizes inputs depending on the degree to which they are observable. The three levels of the fair value hierarchy are as follows:

- Level 1 - inputs represent quoted prices in active markets for identical assets or liabilities. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

- Level 2 - inputs other than quoted prices included in Level 1 that are observable, either directly or indirectly as of the reporting date. Level 2 valuations are based on inputs which can be observed or corroborated in the market place from sources such as the New York Mercantile Exchange and the Natural Gas Exchange.

- Level 3 - inputs that are less observable, unavailable or where the observable data does not support the majority of the instrument's fair value.

The fair value determinations for the Corporation's financial derivatives are based upon Level 3 inputs, having been provided by the counterparties with whom the transactions were completed and reviewed by the Corporation for reasonableness.

11. CAPITAL STRUCTURE FINANCIAL POLICIES

The Corporation defines capital as total debt and shareholders' equity comprised of retained earnings and share capital. The Corporation's primary capital management objective is to maintain a strong balance sheet affording the Corporation financial flexibility to achieve goals of continued growth and access to capital. The basis for the Corporation's capital structure is dependent on the Corporation's expected business growth and changes in the business environment. The Corporation manages its capital structure and makes adjustments according to market conditions to maintain flexibility while achieving the objectives stated above. To manage the capital structure, the Corporation may adjust capital spending, issue new shares, issue new debt or repay existing debt.

The Corporation monitors its progress through the following two measures utilizing book values: net debt to funds from operations and total debt to total debt and shareholders' equity. Net debt to funds from operations is calculated as current liabilities and long term debt less current assets divided by the most recent quarters annualized funds from operations. Total debt to total debt plus shareholders' equity is calculated as short term debt plus long term debt divided by short term debt plus long term debt plus shareholders' equity. The Corporation's strategy is to maintain net debt to funds from operations at or below a level of 1.5 to 1. While the Corporation may exceed this rate from time to time, variations are viewed as short term, and efforts are made after a period of variation to bring the measure back in line.

The Corporation's strategy concerning capitalization is to utilize more equity than debt. This is measured by targeting total debt to total debt plus shareholders' equity at a ratio of less than 0.4 to 1. The Corporation has no externally imposed capital requirements.

At December 31 ($000's except ratio amounts)	Target Measure	2010	2009
Components of ratios			
Current assets (excluding fair value of financial derivatives and future income taxes)		32,190	47,460
Current liabilities (including short term debt and excluding fair value of financial derivatives and future income taxes)		185,051	274,319
Net debt		152,861	226,859
Total debt (bank loan and capital lease)		135,682	218,788
Shareholders' equity (share capital plus retained earnings)		632,726	683,979
Total capitalization (total debt plus shareholders' equity)		768,408	902,767
Funds from operations [1]		100,478	97,393
Net debt/funds from operations	< 1.5 times	1.5	2.3
Total debt/total debt plus shareholders' equity	< 0.4 times	0.2	0.2

1 Funds from operations is a non-GAAP measure and is based on cash flow from operating activities before changes in non-cash working capital and abandonment expenditures.

The decrease in the net debt to funds from operations ratio from 2009 to 2010 resulted primarily from the 33% decrease in net debt.

12. RESTRUCTURING COSTS

In March 2010 the Board of Directors initiated a process to identify and consider strategic alternatives, with a view to enhancing shareholder value. The strategic review process was completed in July 2010. In conjunction with the sale of assets in the Puskwa area of Alberta in the second quarter of 2010, the Corporation restructured its technical and operational teams. Expenses of $1.2 million related to the restructuring process were incurred during the year ended December 31, 2010.

13. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the current period's consolidated financial statement presentation.