President's Message

Our business model continued to be driven by natural gas prices which were well below the price required to profitably add new production and produce existing reserves. We believe these prices are unsustainably low, however throughout 2012 they continued to dominate our business and impact our performance. The natural gas market has shown some signs of recovery in the first quarter of 2013 and our hope is that the supply issues are mitigated and the strengthening continues throughout 2013. Emerald Bay will need to weather the storm by maintaining our focus towards growing our oil production in Texas, and monitor pricing in Alberta to determine the proper time to take our wells out of the current "shut-in" status and return to production status and future development.

2012 Highlights:

- Sold non-strategic assets to remove bank facility and reduce working capital.
- Raised over $2 million dollars to reduce debt and fund the 2012 exploration budget.
- Increased South Texas land position in Medina and Guadalupe Counties, Texas
- Drilled two exploratory wells to confirm zone of interest and one salt water disposal well in Guadalupe County.
- Drilled 12 (3 net) development wells in Medina County.

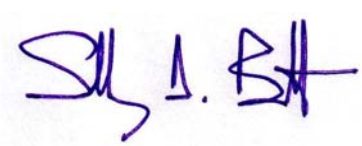
2013 Highlights and Objectives:

- Raised just under $400 thousand dollars to reduce working capital and capital expenditures in Guadalupe County.
- Drilled 2 (.50 net) more wells in the Guadalupe County exploration program.
- The vertical "pilot" hole has been drilled to confirm our zone we are preparing to drill horizontally. The vertical rig has been moved off and the horizontal rig and directional tools are expecting to begin drilling the horizontal operation during the week of May 13th, 2013.
- Facility construction and electrical installations are underway as we prepare to tie-in and begin production operations in May, 2013.
- Increased our current land position in Guadalupe County. Four independent projects are now in various stages of exploration and development in Guadalupe County.
- Another 12-well drilling program is to be drilled in the Taylor-Ina field in Medina County, Texas through our 25% ownership in Production Resources Inc. Currently, 5 wells are drilled, cased, cemented, and perforated in this program. The frac program is anticipated to commence the week of May 6th, 2013.
- The Company continues its land and production acquisitions in South Texas, and formations of interest will continue to be where the Company has specific experience; such as the Escondido, Olmos, Austin Chalk, Eagle Ford, Buda, Edwards, and Pearsall formations.

In Closing

We will continue to pursue a carefully designed capital expenditure program, including acquisitions and dispositions, which would allow us to add production, reserves and cash flow in a cost effective manner while maintaining a level of flexibility in our balance sheet.

Best Regards,



Shelby Beattie, President and Chief Executive Officer

MANAGEMENT'S DISCUSSION & ANALYSIS

This Management's Discussion and Analysis (MD&A) should be read in conjunction with Emerald Bay Energy Inc. (the "Company") audited annual financial statements for the year ended December 31, 2012. Certain information regarding the Company contained herein may constitute forward-looking statements under applicable securities laws. Such statements are subject to known or unknown risks and uncertainties that may cause actual results to differ materially from those anticipated or implied in the forward-looking statements.

Additional information relating to the Company is available on SEDAR at www.sedar.com. The Company is listed on the Canadian Stock Exchange under the symbol "EBY". The MD&A is dated May 1, 2013.

BASIS OF PRESENTATION

The financial data presented below has been prepared in accordance with International Financial Reporting Standards. All amounts are reported in Canadian dollars unless otherwise indicated.

Application of Accounting Estimates

The significant accounting policies used by the Company are disclosed in Note 3 to the annual financial statements. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Management reviews its estimates on a periodic basis. The emergence of new information and changed circumstance may result in actual results or changes to estimates that differ materially from current estimated amounts.

Non-IFRS and Non-GAAP Measures

This MD&A includes the following measures that are from time to time used by the Company, but do not have any standardized meaning under IFRS and may not be comparable to similar measures presented by other companies:

a) "Funds from operations" - should not be considered an alternative to, or more meaningful than "cash flow from operating activities" as determined in accordance with IFRS as an indicator of the Company's financial performance. Funds from operations is determined by adding non-cash expenses to the net income or loss for the period, deducting decommissioning liability expenditures and does not include the change in working capital applicable to operating activities. Management believes that in addition to cash flow from operating activities, funds from operations is a useful supplemental measure as it provides an indication of the results generated by the Company's principal business activities before the consideration of how such activities are financed.

b) "Operating netback" - Operating netbacks are calculated by deducting royalties and operating costs, including transportation costs, from revenues.

c) "Working capital" – working capital includes total current assets and total current liabilities. The working capital ratio is calculated by deducting total current liabilities.

Going Concern

At December 31, 2012, the Company had not yet achieved profitable operations, had accumulated a deficit of $13,778,755 since its inception (December 31, 2011 - $11,965,082), had negative cash flows from operations of $2,176,975 (December 31, 2011 - $468,601) and had a working capital deficiency of $3,077,609 (December 31, 2011 - $3,504,110) (defined as current assets less current liabilities), and expects to incur further losses in the development of its business. The ability to continue as a going concern is dependent on obtaining continued financial support, completing public equity financing, or generating profitable operations in the future. Management is committed to raising additional capital to meet its exploration and operating obligation, however, additional equity financing is subject to the global financial markets and economic conditions, which have recently been disrupted and are volatile, and the debt and equity markets, which have been distressed, particularly for junior petroleum and natural gas companies. All of these factors, together with weak natural gas prices and the current unstable economic conditions, indicate the existence of material uncertainty related to events or conditions that may cast significant doubt as to whether the Company can continue as a going concern and, therefore, it may be unable to realize its assets and discharge its liabilities in the normal course of business.

BOE Presentation

The term “barrels of oil equivalent” (boe) may be misleading, particularly if used in isolation. A boe conversion of six thousand cubic feet of natural gas to one barrel of oil (6:1) is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Readers should be aware that historical results are not necessarily indicative of future performance.

FORWARD-LOOKING STATEMENTS

Certain statements contained within the Management’s Discussion and Analysis, and in certain documents incorporated by reference into this document, constitute forward looking statements. These statements relate to future events or our future performance. All statements other than statements of historical fact may be forward looking statements. Forward looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "budget", "plan", "continue", "estimate", "expect", "forecast", "may", "will", "project", "predict", "potential", "targeting", "intend", "could", "might", "should", "believe" and similar expressions. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward looking statements.

In particular, this MD&A may contain the following forward looking statements pertaining to, without limitation, the following:

The Company’s future production volumes and the timing of when additional production volumes will come on stream; the Company’s realized price of commodities in relation to reference prices; the Company’s future commodity mix; future commodity prices; the Company’s expectations regarding future royalty rates and the realization of royalty incentives; the Company’s expectation of future operating costs on a per unit basis; future general and administrative expenses; future development and exploration activities and the timing thereof; the future tax liability of the Company; the expected rate of depletion, depreciation and accretion; the estimated future contractual obligations of the Company; the future liquidity and financial capacity of the Company; and, the Company’s ability to fund its working capital and forecasted capital expenditures. In addition, statements relating to "reserves" or "resources" are deemed to be forward looking statements, as they involve the implied assessment, based on certain estimates and assumptions, that the resources and reserves described can be profitably produced in the future.

With respect to the forward looking statements contained in the MD&A, the Company has made assumptions regarding: future commodity prices; the impact of royalty regimes and certain royalty incentives; the timing and the amount of capital expenditures; production of new and existing wells and the timing of new wells coming on-stream; future proved finding and development costs; future operating expenses including processing and gathering fees; the performance characteristics of oil and natural gas properties; the size of oil and natural gas reserves; the ability to raise capital and to continually add to reserves through exploration and development; the continued availability of capital, undeveloped land and skilled personnel; the ability to obtain equipment in a timely manner to carry out exploration and development activities; the ability to obtain financing on acceptable terms; the ability to add production and reserves through exploration and development activities; and, the continuation of the current tax and regulation.

We believe the expectations reflected in forward looking statements contained herein are reasonable but no assurance can be given that these expectations will prove to be correct and such forward looking statements included in, or incorporated by reference into, this MD&A should not be unduly relied upon. These statements speak only as of the date of this MD&A or as of the date specified in the documents incorporated by reference into this Management's Discussion and Analysis, as the case may be. The actual results could differ materially from those anticipated in these forward looking statements as a result of the risk factors set forth below and elsewhere in this MD&A, which include volatility in market prices for oil and natural gas; counterparty credit risk; access to capital; changes or fluctuations in production levels; liabilities inherent in oil and natural gas operations; uncertainties associated with estimating oil and natural gas reserves; competition for, among other things, capital, acquisitions of reserves, undeveloped lands and skilled personnel; stock market volatility and market valuation of the Company's stock; geological, technical, drilling and processing problems; limitations on insurance; changes in environmental or legislation applicable to our operations, and our ability to comply with current and future environmental and other laws; changes in income tax laws or changes in tax laws and incentive programs relating to the oil and gas industry, changes in the regulatory regimes under which the Company operates, changes in the political and social environment that may impact the Company and the other factors discussed under "Risk Factors" in the following annual MD&A. Readers are cautioned that the foregoing lists of factors are not exhaustive. The forward looking statements contained in this MD&A and the documents incorporated by reference herein are expressly qualified by this cautionary statement. The forward looking statements contained in this document speak only as of the date of this document and the Company does not assume any obligation to publicly update or revise them to reflect new events or circumstances, except as may be required pursuant to applicable securities laws.

RESTATEMENT OF PRIOR YEAR

During the preparation of the December 31, 2012 financial statements, it was determined that the Company's prior year financial statements required correction for the following reasons:

Previously, the Company had not made provisions for shareholder indemnity liability and Part XII.6 taxes payable relative to flow through shares issued in 2009 and 2010. The summary of the adjustments to the December 31, 2011 financial statements and the January 1, 2011 statement of financial position is as follows:

January 1, 2011	As previously reported	Adjustments	As restated
	$	$	$
Accounts payable and accrued liabilities	2,596,174	20,839	2,617,657
Shareholder indemnity liability	-	55,441	55,441
Deficit	9,786,167	76,280	9,862,447

December 31, 2011	As previously reported	Adjustments	As restated
	$	$	$
Accounts payable and accrued liabilities	2,333,903	20,839	2,354,742
Shareholder indemnity	-	181,020	181,020
General and administrative expense	1,229,864	125,579	1,355,443
Opening deficit	9,786,167	76,280	9,862,447
Deficit	11,763,223	201,859	11,965,082

SELECTED YEAR TO DATE FINANCIAL INFORMATION

	Three months ended December 31			Year ended December 31		
	2012	**2011**	**Change %**	**2012**	**2011**	**Change %**
FINANCIAL						
Gross revenue	12,387	213,434	(94.2)	147,315	1,082,351	(86.4)
Total assets	3,034,972	3,667,179	(17.2)	3,004,972	3,667,179	(17.2)
Cash flow from (used in) operations	(753,636)	325,774	(131.3)	(2,176,975)	(468,601)	(364.6)
Net comprehensive loss	(567,355)	(1,548,932)	63.4	(1,813,673)	(2,102,635)	15.1
Per share – basic and diluted		(0.03)		(0.02)	(0.03)	
Capital expenditures	38,365	10,240	274.7	64,198	88,236	(27.2)
Related party loan	1,121,565	-	-	1,121,565	301,157	272.4%
Bank loan	-	2,675,000	-	-	2,675,000	(100%.0)
OPERATIONS						
Production sales						
Oil (bbls/d)	0	5	(100.0)	3	7	(57.1)
Natural gas (mcf/d)	46	296	(84.4)	39	406	(90.4)
NGL (bbls/d)	0	12	(100.0)	0	12	(100.0)
Total (boe/d @ 6 mcf: 1 bbl)	8	66	(87.9)	10	86	(88.4)
Average pricing						
Natural gas ($/mcf)	3.19	3.35	(5.8)	2.63	3.83	(31.3)
Oil and NGL's($/bbl)	(17.10)	77.19	(177.8)	81.27	77.55	4.8
Combined ($/boe)	16.17	34.79	(53.5)	39.44	34.54	14.2
Expenses						
Production expense & transportation ($/boe)	83.00	17.93	362.9	59.23	19.00	211.7
Royalty expense ($/boe)	28.50	5.44	423.9	4.31	4.64	(7.1)
Net Back Combined ($/boe)	(95.32)	11.41	(735.4)	(24.10)	10.90	(121.1)

Financial and Operations Results

Revenue from the sale of petroleum and natural gas is recorded on a gross basis when title passes to an external party and is recognized based on volumes delivered to customers at contractual delivery points and rates. The costs associated with the delivery, including production, transportation and production-based royalty expenses are recognized in the same period in which the related revenue is earned and recorded.

Petroleum and natural gas revenue was $12,387 and $147,315 for the three and twelve months ended December 31, 2012, respectively, from revenue of $213,434 and $1,082,351 for the three and twelve months ended December 31, 2011, respectively.

Natural gas prices decreased to $3.19/mcf and $2.63/mcf in the three and twelve months ended December 31, 2012, respectively, versus $3.35/mcf and $3.83/mcf in the three and twelve months ended December 31, 2011, respectively. Oil and NGL combined prices decreased to $(17.10) in the three months ended December 31, 2012 from $77.19 in the three months ended December 31, 2011 and increased to $81.27 in the twelve months ended December 31, 2012 from $77.55 in the twelve months ended December 31, 2011. The average sales price on a boe basis was $16.17 and $39.44 in the three and twelve months ended December 31, 2012, respectively, compared to $34.79 and $34.54 in the three and twelve months ended December 31, 2011.

During the three and twelve months ended December 31, 2012, the average sales volume on a boe/d basis decreased to 8 boe/d and 10 boe/d, respectively, compared with 66 boe/d and 86 boe/d for the three and twelve months ended December 31, 2011.

During the three and twelve months ended December 31, 2012, cash flows used in operations decreased to ($753,636) and ($2,176,975), respectively, from $325,774 and ($468,601) during the three and twelve months ended December 31, 2011.

Year over year, the Company's revenue declined significantly due to the following: the continued low natural gas prices; certain Canadian assets have been shut-in to preserve existing reserves while the natural gas prices remain low; and the

Company disposed of a significant portion of its US oil and natural gas interest. The Canadian assets will remain shut-in and additional natural gas drilling programs within Canada will remain on hold until prices rebound.

OPERATING RESULTS

SALES	Average Daily Volumes			Average Prices		
	December 31, 2012	December 31, 2011	Percent Change %	December 31, 2012	December 31, 2011	Percent Change %
Natural Gas (mcf)	39	406	(90.4)	2.63	3.83	(31.3)
Oil (bbls)	3	7	(57.1)	82.76	90.55	(8.6)
NGL (bbls)	0	12	(100.0)	69.29	70.10	(1.2)
Barrels of Oil Equivalent (boe)	10	86	(88.4)	39.44	34.54	14.2

For the year ended December 31, 2012 natural gas sales decreased by 90.4% to 39 mcf/d from 406 mcf/d the previous year. This decrease was mainly due to certain Canadian assets have been shut-in to preserve existing reserves while the natural gas prices remain low; and the Company disposed of a significant portion of its US oil and natural gas interest. certain wells being shut in due to the lower natural gas prices, as well as previously drilled wells not being brought on line until natural gas prices rebound.

Natural gas prices decreased during the year ended December 31, 2012 to $2.63/mcf versus $3.83/mcf during the same period in 2011.

Oil production for the year ended December 31, 2012 decreased to 3 bbls/d compared to 7 bbls/d for the year ended December 31, 2011.

During the year ended December 31, 2012, the average price received for oil was $82.76/barrel versus $90.55/barrel during the previous year. The majority of the Company's production is medium viscosity crude which receives higher pricing.

During the years ended December 31, 2012 NGL sales decreased 100% to nil/bbl/d compared to 12 bbl/d for the year ended December 31, 2011.The average NGL price decreased to $69.29/bbl compared to $70.10/bbl received in 2011.

During the year ended December 31, 2012, the average sales volume on a boe/d basis decreased to 10 boe/d compared with 86 boe/d for the period ended December 31, 2011.

The average sales price on a boe basis was $39.44/boe in 2012, an increase from $34.54/boe received in 2011.

On a barrel of oil equivalent basis, during the year ended December 31, 2012 oil and NGL accounted for 30% of total sales and natural gas accounted for 70% of total sales, compared to 2010 when oil and NGL accounted for 22%, with natural gas accounted for 78% of total sales.

FINANCIAL RESULTS

Revenue from the sale of petroleum and natural gas is recorded on a gross basis when title passes to an external party and is recognized based on volumes delivered to customers at contractual delivery points and rates. The costs associated with the delivery, including production, transportation and production-based royalty expenses are recognized in the same period in which the related revenue is earned and recorded.

Year ended December 31,	2012 ($)	2011 ($)	Percent Change (%)
Petroleum and natural gas revenue	147,315	1,082,351	(86.4)
Royalties, petroleum and natural gas	(16,105)	(145,361)	(88.9)
Production expenses, petroleum and natural gas	(221,221)	(595,445)	(62.8)
Operating netback, petroleum and natural gas	(90,012)	341,545	(126.4)
Net loss	(1,813,673)	(2,102,635)	15.1
Net loss per share (basic and diluted)	(0.02)	(0.03)	33.3
Revenue per boe	39.44	34.54	14.2
Royalty per boe	4.31	4.64	(7.1)
Operating costs per boe	59.23	19.00	211.7
Operating netback per boe	(24.10)	10.90	(321.1)

Petroleum and natural gas revenue decreased to $147,315 for the year ended December 31, 2012 from revenue of $1,082,351 during the year ended December 31, 2011. Revenue on a boe basis increased to $39.44/boe from $34.54 during the year ended December 31, 2011.

Royalties decreased to $16,105 during the year ended December 31, 2012 compared to the same period in 2011 of $145,361. Royalty per boe for the year ended December 31, 2012 averaged $4.31/boe, which was decrease from $4.64/boe during the year ended December 31, 2011.

Production expenses in the year ended December 31, 2012 decreased to $221,221 from the year ended December 31, 2011 of $595,445. Operating costs/boe for the year ended December 31, 2012 increased to $59.23/boe from $19.00/boe in the year ended December 31, 2011.

Operating netback from petroleum and natural gas sales decreased to ($90,012) during the year ended December 31, 2012 from $341,545 during the year ended December 31, 2011.

Operating netback/boe decreased to ($24.10)/boe from $10.90/boe.

The Company's revenue decrease reflects significantly due to the following: the continued low natural gas prices; certain Canadian assets have been shut-in to preserve existing reserves while the natural gas prices remain low; and the Company disposed of a significant portion of its Canadian and US oil and natural gas interest. The Canadian assets will remain shut-in and additional natural gas drilling programs within Canada will remain on hold until prices rebound.

Royalties per unit of Production			
Year ended December 31,	2012	2011	Percent Change %
Gas ($/mcf)	(.35)	0.37	(194.6)
Oil ($/bbl)	9.61	6.27	53.3
NGL ($/bbl)	63.88	18.69	241.8
Total ($/boe)	4.31	4.64	(7.1)

The royalties per mcf for natural gas decreased to $(.35)/mcf from $.37/mcf in 2011. Oil royalties increased to $9.61/bbl from $6.27/bbl in 2011. NGL royalties increased to $63.88/bbl from $18.69/bbl in 2011. Combined royalties for all products decreased to $4.31/boe in 2012 from $4.64/boe the previous year.

GENERAL & ADMINISTRATIVE EXPENSES

After recoveries, general and administrative expenses ("G&A") increased to $1,525,259 during the twelve months ended December 31, 2012 from $1,355,443 for the same period during 2011. The increase in the Company's G&A is reflective of the expanding activities and progression of the exploration program in Texas, which require additional costs including professional fees, consulting fees and travel costs.

GENERAL & ADMINISTRATIVE EXPENSES			
Year ended December 31,	2012 ($)	2011 ($)	Percent Change (%)
Net G&A Expenses	1,525,259	1,355,443	12.5

STOCK BASED COMPENSATION

During the year ended December 31, 2012, there were no stock options granted, cancellations or exercises, and 300,000 stock options expired unexercised. Compensation expense of $nil was recognized during the year ended December 31, 2012 (December 31, 2011 - $79,982).

DECOMMISSIONING LIABILITIES

Decommissioning liabilities are the present value of management's estimate of future costs to be incurred to properly abandon and reclaim the properties held by the Company. Accretion expense is the increase in the decommissioning liability resulting from the passage of time. Decommissioning liabilities decreased from $201,664 as at December 31, 2011 to $182,278 as at December 31, 2012. The decrease was primarily due to the disposal of certain Canadian and US oil and gas interests that existed as at December 31, 2011.

DEPLETION & DEPRECIATION

Depletion and depreciation expense, an accounting measure of our finding and on-stream costs, is calculated using the ratio of capital costs to proven reserves. Capital costs include the net book value of historical costs incurred and estimated future expenditures to develop proved reserves.

DEPLETION, DEPRECIATION & ACCRETION			
Year ended December 31,	2012 ($)	2011 ($)	Change Percent %
Depletion, depreciation and accretion	85,251	394,232	(78.4)

During the year ended December 31, 2012, depletion and depreciation expenses were lower at $85,251 compared to $394,232 during the same period in 2011. The decrease was primarily due to the following: lower commodity prices during 2012 compared to 2011, resulting in lower production volumes as the Company's opted to shut-in substantially all of its Canadian oil and natural gas assets; and the sale of a significant portion of the Canadian assets during the first quarter of 2012.

IMPAIRMENT

IMPAIRMENT			
Year ended December 31,	2012 ($)	2011 ($)	Change Percent %
Impairment of property and equipment	160,967	356,515	(54.8)
Impairment of assets held for sale	-	385,341	(100.0)
Impairment of evaluation and exploration assets	-	25,081	(100.0)

As at December 31, 2012, the Company reviewed its oil and gas assets for indicators of impairment such as changes in future prices, future costs and reserves. Based on this review, certain of the Company's CGUs were tested for impairment. The recoverable amount of each CGU was estimated based on the higher of the value in use and the FVLCTS. The estimate of FVLCTS was determined using a discount rate of 10% percent and forecasted cash flows, with escalating prices and future development costs, as obtained from the reserve report. The prices used to estimate the FVLCTS are those used by independent industry reserve engineers.

Based on the assessment at December 31, 2012, the carrying amount of the property and equipment in the Company's Canadian CGU was determined to be $160,967 higher (December 31, 2011 – Canadian CGU $356,515) than its recoverable amount, and an impairment loss was recognized.

CASH FLOWS FROM OPERATIONS

During the year ended December 31, 2012, cash flows used in operations decreased to ($2,176,975) from ($468,601) during the same period in 2011. This decrease was primarily due to significantly lower petroleum and natural gas revenue and working capital fluctuations.

Funds used in operations during the year ended December 31, 2012 increased to ($1,896,226) from the previous year's ($1,971,007). The increase in funds used in operations was predominately due to lower revenues and higher general and administrative costs and operating costs (proportionately compared to petroleum and natural gas revenue) during 2012 as compared to 2011.

CAPITAL EXPENDITURES

CAPITAL EXPENDITURES			
Year ended December 31,	2012 ($)	2011 ($)	Percent Change (%)
Exploration and evaluation expenditures	397,668	-	100.0
Capital expenditures	64,198	88,236	(27.2)

The increase in exploration and evaluation assets is due to the exploration program on the Company's Texas assets. The assets have yet to show technological feasibility and commercial viability and accordingly are considered exploration and evaluation assets.

The slight decrease in capital expenditures during 2012 as compared to 2011 continue to reflect the low natural gas prices, which continue to delay certain projects in Canada until there is a rebound in the commodity price. Capital expenditures during the year are primarily lease rental payments.

EQUITY INVESTMENT IN PRI

The Company holds a 25% equity interest in Production Resources Inc ("PRI"), and records 25% of PRI's net income or loss into its records. During 2012, PRI's net income was $568,306, of which the Company has reflected $109,228 into its comprehensive loss (December 31, 2011 - $16,900). The increase in PRI's net income was primarily due to the on-going drilling program. PRI drilled 15 new wells during 2012 compared to 10 in 2011, and anticipates drilling an additional 15 to 20 wells during 2013.

QUARTERLY FINANCIAL INFORMATION

The following is a summary of selected quarterly information that has been derived from the unaudited financial statements of the Company. This summary should be read in conjunction with unaudited financial statements of the Company as contained in the public record.

Quarterly Financial Information ($000 except per share and unit values)	**Dec 31 2012**	**Sep 30 2012**	**Jun 30 2012**	**Mar 31 2012**	**Dec 31 2011**	**Sep 30 2011**	**Jun 30 2011**	**Mar 31 2011**
Petroleum and natural gas sales	12	46	27	62	213	260	349	260
Net income (loss)	(597)	(305)	(641)	(270)	(1,548)	150	(150)	(555)
Net loss per share								
Basic and diluted	(0.01)	(0.00)	(0.01)	(0.00)	(0.03)	0.00	(0.00)	(0.01)
Average daily sales								
Natural gas (mcf/d)	46	16	14	81	296	401	501	423
Oil/NGL (bbls/d)	-	6	4	4	17	18	22	15
Barrels of oil equivalent (boe/d)	8	8	7	18	66	85	105	86
Average sales prices								
Natural Gas ($/mcf)	3.19	1.59	1.68	2.68	3.35	3.84	4.03	3.93
Oil/NGL ($/bbl)	(17.10)	85.70	60.55	110.31	77.19	69.86	83.45	78.91
Barrels of oil equivalent ($/boe)	16.17	61.16	43.19	38.49	34.79	33.20	36.47	33.33
Operating costs ($/boe)	83.00	51.58	116.72	29.06	17.93	18.01	20.52	18.97
Royalty Expense ($/boe)	28.50	1.16	(19.84)	3.47	5.44	5.76	3.42	4.38
Operating netback ($/boe)	(95.33)	8.42	(53.69)	5.95	11.41	9.43	12.53	9.98

Explanation of Quarterly Variances

On a quarter by quarter basis production volumes continue to trend downward as prices continue to be significantly lower on a quarter by quarter basis for natural gas prices. Throughout 2012 and 2011 projects were delayed and certain Canadian wells were shut in until such time that commodity prices begin to increase. The net loss in the quarters is largely a result of these factors.

Net comprehensive loss increased during the fourth quarter for both the year ended December 31, 2012 and December 31, 2011, primarily due to the impairment of property and equipment taken during both years, the recognition of the shareholder indemnities and, during the year ended December 31, 2011, the impairments taken on the exploration and evaluation assets and the assets held for sale.

The impairments have all been recognized in the fourth quarter.

LIQUIDITY & CAPITAL RESOURCES

In order to resolve its working capital deficiency of $3,077,609, and to access additional share equity, the Company will be emphasizing development of its U.S. properties. The Company began projects and has received expressions of interest from third parties interested in investing substantial sums in the Company if it focuses on its US properties. The Company's US prospects should produce better returns due to higher oil prices compared with natural gas, it has greater drilling potential and more locations. Given the Company's recurring operating losses it is critical that the Company refocus to an area with the potential of growth and positive cash flow and income that the U.S. has.

Bank Loan

As at December 31, 2011, the Company had in place a revolving operating demand loan (the "Revolving Loan") with a Chartered Canadian Bank (the "Lender"). The maximum amount available under the Revolving Loan was $1,575,000, with a per annum interest rate of the Lender's prime rate plus 3.00%. Interest was calculated daily and payable monthly on the outstanding principal amount drawn. At December 31, 2011, the Company had drawn $1,550,000 of the Revolving Loan. During the year ended December 31, 2012, the Company entered into an amending agreement whereby the Company was to reduce the Revolving Loan by $1,500,000 through the sale of certain Canadian oil and gas assets, which the Company fulfilled. Accordingly, on March 20, 2012, the Company repaid the Revolving Loan in its entirety. An amending fee of $10,000 was paid to the Lender, and additionally, a $50,000 payable for a previous amendment was also paid to the Lender. Total interest incurred pursuant to the Revolving Loan during the year ended December 31, 2012 was $20,980 (December 31, 2011 - $118,386).

As at December 31, 2011, the Company had in place a non-revolving demand loan (the "Non-revolving Loan") with the Lender. The maximum amount available under the Non-revolving Loan was $1,775,000. Interest on the Non-revolving Loan was calculated daily and payable monthly on the outstanding principal amount at a rate per annum equal to the bank's prime rate plus 5.00%. At December 31, 2011, the Company had drawn $1,125,000 of the Non-revolving Loan. On June 18, 2012, the Company repaid the Non-revolving loan in its entirety through the acquisition of a related party loan. The Company incurred professional fees of approximately $120,000 to payout the Non-revolving Loan. Total interest incurred pursuant to the Non-revolving Loan during the year ended December 31, 2012 was $46,123 (December 31, 2011 - $63,019).

Related party loan

During the year ended December 31, 2011, the Company received a loan for $301,157 from a party who also holds an equity investment in PRI (the "Lender"). The funds received under the loan were used to provide additional working capital to the Company. Interest on the loan was calculated daily and payable monthly on the outstanding principal amount at a rate of 10% per annum. Included in the February 17, 2012 private placement was 6,000,000 units issued to the Lender as repayment of the loan. Total interest incurred pursuant to the loan during the year ended December 31, 2012 was $nil (December 31, 2011 - $10,000).

On June 15, 2012, a corporation owned by the Lender advanced $1,500,000 to the Company under a separate loan agreement (the "Loan Agreement") with a maturity date of August 15, 2013. The proceeds of the loan were used primarily to repay the Non-revolving Loan with the remaining proceeds used for general working capital. Interest on the loan is 10% per annum, payable monthly, on the outstanding principal amount. Pursuant to the Loan Agreement, the Company was required to make a principal repayment in the amount of $500,000 on or before August 15, 2012, which was amended to require a principal repayment of $300,000 due on November 30, 2012. The Company fulfilled this requirement through a cash repayment of $133,845 and through the transfer of certain of its US assets to the related party at a deemed value of $166,155. At December 31, 2012, the related party loan is $1,121,565.

The Company may, at any time, repay the loan in full without notice or penalty. If the Company is in default of the requirements included in the Loan Agreement or the Lender believes the Company's ability to repay the loan is impaired, the Lender may demand repayment of the loan or accelerate the date for payment. As at December 31, 2012, pursuant to the loan, the Company had incurred interest of $74,083.

Pursuant to the Loan Agreement, the Company issued to the Lender 5,000,000 share purchase warrants. Each warrant is exercisable into one common share of the Company at a price of $0.10 per common share until the expiry date of August 15, 2013. The warrants have been valued at $147,195.

Security for the loan consists of a $1,500,000 promissory note plus interest at the rate of 10% per annum, compounded monthly, a General Security Agreement in favour of the Lender to include a specific assignment of production proceeds, and security over the US assets of the Company. The Lender has required the Company to submit to them certain reports including monthly production reports.

Convertible related party debt

On January 1, 2012, the Company entered into a loan agreement (the “Loan Agreement”) with a corporation owned and controlled by a party who is also a significant shareholder of the Company (the “Lender”) whereby the Company received a $150,000 USD loan with a maturity date of December 31, 2012. The proceeds of the loan were used to continue the Company’s exploration program in Texas. Interest on the loan is 12% per annum, payable monthly, on the outstanding principal amount and compounds monthly. As at December 31, 2012, pursuant to the loan, the Company has incurred interest of $21,643.

At the option of the Lender, and subject to regulatory approval, the entire principal amount, or any portion outstanding, may be converted to shares in the Company with a discount of 25% to the market trading price at the time of conversion, at any time during the term.

Security for the loan consists of a $150,000 promissory note and monthly production from certain Texas assets equivalent to the principal portion of the loan and any unpaid interest. On January 1, 2013, it was mutually agreed upon between the Lender and the Company to extend the loan under the same terms to December 31, 2013.

OUTSTANDING SHARE DATA

On February 17, 2012, the Company completed a private placement issuing 14,240,000 units. Each unit was issued at $0.05 for total proceeds of $712,000. Each unit consists of one common share of the Company and one share purchase warrant. Each warrant entitles the holder to purchase one additional common share of the Company at $0.10 per share, exercisable for 1 year from the original issue date. The Company has allocated $346,581 of the unit value to warrants.

On July 5, 2012, the Company completed a private placement, issuing 4,841,730 units. Each unit was issued at $0.07 for total proceeds of $338,921. Each unit consists of one common share of the Company and one share purchase warrant. Each warrant entitles the holder to purchase one additional common share of the Company at $0.10 per share, exercisable for 1 year from the original issue date. The Company has allocated $187,838 of the unit value to warrants.

On October 25, 2012, the Company completed a private placement, issuing 29,680,000 units. Each unit was issued at $0.05 for total proceeds of $1,484,000. Each unit consists of one common share of the Company and one share purchase warrant. Each warrant entitles the holder to purchase one additional common share of the Company at $0.10 per share, exercisable for 1 year from the original issue date. The Company has allocated $668,362 of the unit value to warrants.

The Company incurred an aggregate of $155,586 in cash share issue costs for the placements completed during 2012, of which $83,572 was allocated to share capital and $72,014 was allocated to warrants. Finders options totaling 3,113,000 were also issued pursuant to the 2012 placements and were valued at $93,657, of which $50,739 was allocated to share capital and $42,918 was allocated to warrants

The Company is authorized to issue an unlimited number of common shares and an unlimited number of preferred shares issuable in series. As of the date hereof, the Company's issued share capital and the outstanding securities that are convertible into or exercisable or exchangeable for any voting or equity securities of the Company is as follows

	May 1, 2013	**December 31, 2012**
Common Shares	140,671,689	132,721,689
Warrants (i)	61,711,730	59,995,730
Stock Options (ii)	7,380,000	7,380,000

Notes:

i) 4,600,000 of the warrants entitle the holder to acquire one additional common share for $0.10 per share until February 25, 2013. 1,634,000 of the warrants entitle the holder to acquire one additional common share for $0.10 per share until April 11, 2013. 14,240,000 of the warrants entitle the holder to acquire one additional common share for $0.10 per share until August 17, 2013. 4,841,730 of the warrants entitle the holder to acquire one additional common share for $0.10 per share until July 5, 2013. 29,680,000 of the warrants entitle the holder to acquire one additional common share for $0.10 per share until October 25, 2013. 5,000,000 of the warrants entitle the holder to acquire one additional common share for $0.10 per share until August 15, 2013. 7,950,000 of the warrants entitle the holder to acquire one additional common share for $0.10 per share until April 4, 2013.

ii) 2,455,000 of the Stock Options entitle the holders to acquire an equal number of common shares at $0.10 per share until April 6, 2015. 4,925,000 of the Stock Options entitle the holders to acquire an equal number of common shares at $0.10 per share until August 25, 2016.

OFF BALANCE SHEET ARRANGEMENTS

The Company is not party to any arrangements that would be excluded from the balance sheet.

RELATED PARTIES

Related party transactions not disclosed elsewhere in these financial statements are as follows:

a) The following amounts are due from related parties:

	December 31, 2011 $	December 31, 2010 $
Note receivable from officer (i)	**238,164**	231,609
Fair value allowance (ii)	**(216,515)**	(216,515)
Net note receivable	**21,649**	15,094
Advance fees (iii)	**6,529**	9,529
	28,178	24,623

(i) A promissory note was issued to an officer of the Company bearing interest at 3% per annum and there is no fixed maturity date, unless the officer’s employment is terminated or he is petitioned into bankruptcy wherein the note and accrued interest becomes immediately payable. The note is secured by 393,000 common shares of the Company which had a fair value of $23,580 at December 31, 2012 (December 31, 2011 - $15,094).

(ii) The fair value allowance was initially determined on December 31, 2008 based on the market value of the secured shares. During the year ended December 31, 2012, there was no additional allowance provided to the estimated fair value of the 393,000 common shares held as security as fair value did not exceed the carrying amount (December 31, 2011 - $9,805).

(iii) During the year ended December 31, 2008, a director was advanced $59,473 in relation to efforts to finance and advance the Company's drilling technology. At December 31, 2012 $6,529 (December 31, 2011 - $9,529) remains outstanding. There is no guarantee that such efforts will be successful and if such efforts are not successful, the full balance will be repaid. The original repayment date of December 31, 2010 has been extended to December 31, 2013.

b) Additional related party transactions not disclosed elsewhere in the financial statements are as follows:

(i) Aggregate fees of $47,500 (December 31, 2011 - $96,300) were charged by directors of the Company. Of this amount $47,500 (December 31, 2011 - $78,450) was recorded in the statement of comprehensive loss and $nil (December 31, 2011 - $17,850) was capitalized to property and equipment.

(ii) Aggregate fees of $41,400 (December 31, 2011 - $72,275) were charged by a U.S. corporation, which is owned and controlled by an officer and a director of the Company for costs it incurred for operation of the Company's U.S. properties. Of this amount $41,400 (December 31, 2011 - $53,725) was recorded in the statement of comprehensive loss and $nil (December 31, 2011 - $18,550) was capitalized to property and equipment.

(iii) Aggregate fees of $181,287 (December 31, 2011 - $85,202) were charged by corporations, which are owned and controlled by other equity investors in PRI, and were all recorded as general and administrative costs.

(iv) Included in accounts payable at December, 2012 was $87,943 owing to related parties of the Company (December 31, 2011 - $37,410).

Key management compensation

	December 31, 2012	December 31, 2011
	$	$
Compensation	**409,185**	362,912
Share based payments	**-**	60,393
Total	**409,185**	423,305

COMMITMENTS

a) On January 15, 2012, the Company entered into a lease agreement with a related party for the lease of office space. Under a lease agreement, the Company has committed to monthly payments of $2,771 for the lease of its office space until January 31, 2015.

b) The Company has entered into various vehicle loan agreements with total annual principal repayments for fiscal years 2013 through to 2015 as follows: $24,688, $26,110 and $15,868.

c) The Company raised capital through the issuance of flow through shares in 2009, 2010 and 2011 which provided indemnity to the subscriber for additional taxes payable if the Company was unable to, or failed to, renounce the qualifying expenditures as agreed. The Company was not able to spend $824,338 of the flow through funds raised. The Company is exposed to costs for the indemnification of the subscribers. The Company has estimated a potential liability on the amount of $321,497 at December 31, 2012 (December 31, 2011 - $181,020, January 1, 2011 - $55,441). The Company has also estimated a potential liability for penalties and taxes on the amounts of $39,320 in 2012 (December 31, 2011 - $35,348, January 1, 2011 - $ 20,839) included in accounts payable and accrued liabilities. The accrued amount is subject to measurement uncertainty due to the tax filing positions of the subscribers, their tax rates and the amount of personal taxes that may be payable and the interpretation of the indemnity agreement, which will not be known until potentially affected subscribers are reassessed for their tax positions by the Canada Revenue Agency and these amounts become known to the Company.

SUBSEQUENT EVENTS

Subsequent to December 31, 2012, the Company entered into the following transactions:

a) On January 28, 2013, the Company extended the term of 14,240,000 share purchase warrants that were originally issued on February 17, 2012 (note 15(b)(vii)) from twelve months to eighteen months. All other terms of the warrants remain the same.

b) On April 3, 2013, the Company closed a private placement through the issuance of 7,950,000 units (the “Units”) for gross proceeds of $397,500 ($0.05/Unit). Each Unit consisted of one common share of the Company and one common share purchase warrant (the “Warrant”). Each full Warrant entitles the holder to purchase one additional common share of the Company for $0.10/common share for a period of 12 months from the issuance of the Units. The Company incurred cash share issue costs of $32,250 and issued an aggregate of 645,000 finder’s options to those who facilitated the private placement. Each finder’s option is exercisable into one Unit of the Company on the same terms and conditions as those received by the subscribers under the private placement.

RISK FACTORS AND RISK MANAGEMENT

The oil and gas industry is subject to risks in (among others):

Commodity Price Risk

The Company has sold its entire product on the spot market. While the Company currently has no hedges in place, historically the Company has participated in these contracts when it is considered beneficial.

Production Risk

The Company believes it has a stable production base from a variety of wells. However, the Company remains subject to the risk that a significant decrease in production from some wells could result in a material decrease in the Company's production and associated cash flow.

Reserve Replacement Risk

The Company's production is subject to natural declines and the Company plans to replace production with acquisitions and developing new reserves. To remain financially viable, the Company must be able to replace reserves at a lesser cost on a per unit basis than its cash flow on a per unit basis. The Company closely monitors the capital expenditures made for the purpose of increasing its petroleum and natural gas reserves.

Regulatory Risk

Government royalties, income tax laws, environmental laws and regulatory requirements can have a significant impact on the Company's finances and operations. The Company strives to remain knowledgeable regarding changes to the regulatory regime under which it operates, in both Canada and the United States. Sudden regulatory or royalty changes by future government action is unpredictable and cannot be forecast by the Company.

Climate Change Risk

North American climate change policy is evolving and changing at both regional and national levels. The Company expects that some of its operations may be subject to future regional, provincial and/or federal climate change regulations to manage greenhouse gas. The exact scope and timing of new climate change measures is difficult to predict.

FINANCIAL INSTRUMENTS

The Board of Directors oversees managements' establishment and execution of the Company's risk management framework. Management has implemented and monitors compliance with risk management policies. The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities.

(a) Fair values

The Company's financial instruments consist of cash and cash equivalents, short-term investments, trade and other receivables, due from related parties, accounts payable and accrued liabilities, the shareholder indemnity, the related party loan, the convertible related party debt, the current portion of long-term debt and the long-term debt.

Financial Instrument	**Classification**	**Carrying Value $**	**Fair Value $**
Cash and cash equivalents	Fair value through profit and loss	532,130	532,130
Short-term investments	Fair value through profit and loss	49,745	49,745
Trade and other receivables	Loans and receivables	601,824	601,824
Due from related parties	Loans and receivables	28,178	28,178
Accounts payable and accrued liabilities	Other financial liabilities	2,728,097	2,728,097
Shareholder indemnity	Other financial liabilities	321,497	321,497
Related party loan	Other financial liabilities	1,121,565	1,121,565
Convertible related party debt	Other financial liabilities	149,235	149,235
Current portion of long-term debt	Other financial liabilities	24,688	24,688
Long-term debt	Other financial liabilities	41,978	41,978

The significance of inputs used in making fair value measurements are examined and classified according to a fair value hierarchy. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly. Level 3 valuations are based on inputs that are unobservable and significant to the overall fair value measurement.

At December 31, 2012, the Company's cash and short term investments have been subject to Level 1 valuation.

(b) Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint venture partners and oil and natural gas marketers.

Virtually all of the Company's trade and other receivables are from companies in the oil and gas industry and are subject to normal industry credit risks. Credit risks arise principally from the amounts owing to the Company from oil and natural gas marketers and joint venture partners. Management does not believe that any significant concentration of trade and other receivables exists that will result in any loss to the Company based on past payment experience. Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish relationships with large marketers. However, the receivables are from participants in the petroleum and natural gas sector and collection of the outstanding balances is dependent on industry factors such as commodity price fluctuations and escalating costs. The Company does not typically obtain collateral from petroleum and natural gas marketers or others in the event of non-payment.

At December 31, 2012, the Company's trade and other receivables have been aged as follows:

Days outstanding	December 31, 2012 $
0-30 days	210,508
31-60 days	54,213
61-90 days	18,979
Greater than 90 days	318,124
Total	601,824

A provision for doubtful accounts of $nil has been recorded at December 31, 2012 (December 31, 2011 - $32,000).

Cash and cash equivalents consist of cash bank balances held in both interest and non-interest bearing accounts. The Company manages credit exposure of cash by selecting financial institutions with high credit ratings.

(c) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. At December 31, 2012, the Company's maximum exposure to liquidity risk is the total current liabilities of $4,345,082 (December 31, 2011 - $5,697,034).

The current liabilities and commitments are due as follows:

Accounts payable and accrued liabilities	$2,728,097	Due within 90 days
Related party loan	$1,121,565	Maturity date of August 15, 2013
Convertible related party debt	$149,235	Maturity date of December 31, 2013
Current portion of long-term debt	$24,688	Due within 12 months
Long-term debt	$41,978	Due within 36 months
Shareholder indemnities	$321,497	Due on demand

The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Company's reputation.

To achieve this objective, the Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non operated projects to further manage capital expenditures. The Company also attempts to match its payment cycle with collection of oil and natural gas revenue on the 25th of each month.

(d) Market risk:

Market risk is the risk that changes in market prices, such as commodity prices, foreign exchange rates and interest rates will affect the Company's loss or the value of the financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while maximizing returns.

(i) Commodity price risk:

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for oil and natural gas are impacted by not only the relationship between the Canadian and United States dollar but also world economic events that dictate the levels of supply and demand. All of the Company's oil and gas production is sold at spot rates exposing the Company to the risk of price movements.

During 2010, the Company entered into a commodity call option effective from January 1, 2012 to December 31, 2012 at a strike price of USD $90.00 per BBL. On February 2, 2012, the Company terminated the commodity call option for consideration of $116,114 and recognized an unrealized gain of $161,770 to reverse the financial contract liability recorded at December 31, 2011 (December 31, 2011 – unrealized loss of $8,003).

The realized gain recorded by the Company on the commodity call option for the year ended December 31, 2012 was $nil (December 31, 2011 - $106,642).

A 10% increase or decrease in the commodity price throughout the year would result in approximately a $12,000 increase or decrease in net operating loss for the year ended December 31, 2012, after holding operating expenses constant and increasing or decreasing royalties accordingly.

(ii) Currency risk

The Company is exposed to the financial risk related to the fluctuation of foreign exchange rates. The Company operates in Canada and the United States and a portion of its expenses are incurred in US dollars. The Company does not hedge its exposure to fluctuations in the exchange rate. Future changes in exchange rates could have a material effect on the Company's business including its intended capital plans, its financial condition and results of operations.

Certain of the Company's financial instruments are exposed to fluctuations in the US dollar, including cash and cash equivalents, trade and other receivables and accounts payable and accrued liabilities. As at December 31, 2012, an increase or decrease of 10% to the foreign exchange rate between the US dollar and the Canadian dollar applied to the average level of US denominated cash and cash equivalents would have had approximately a $39,000 (December 31, 2011 - $37,200) impact on the Company's comprehensive loss for the year.

(iii) Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. As at December 31, 2012, all of the Company's debt, including the related party loan and the convertible related party debt, bears fixed interest rates and accordingly, is not subject to market interest rate fluctuations (December 31, 2011 - if interest rates had been 1% higher/lower, with all other variables held constant, on the floating bank interest rate there would have been an impact of approximately $29,700 on the Company's comprehensive loss for the year).

The Company has no interest rate swaps or financial contracts in place as at or during the year ended December 31, 2012 or during the year ended December 31, 2011.

(e) Capital management:

The Company's capital consists of shareholders' deficit, the related party loan, the convertible related party debt and working capital. The Company will adjust its capital structure to manage its current and future debt, drilling programs and potential corporate acquisitions through the issuance of shares, sourcing additional debt financing and adjustments to capital spending. The Company's objective for managing capital is to maximize long-term Shareholder value by ensuring adequate capital to achieve the Company's objectives. The Company is not subject to any external capital requirements.

Management reviews its capital management approach on an ongoing basis and believes its current approach is reasonable given the size of the Company. There has been no change in management's approach to capital management during the year.

OUTLOOK

Based on the continuation of low natural gas prices, the Company has transitioned its development focus to oil development in both Texas and Alberta. The initial impact of this transition shows a lower production volume in our overall output, but the increases in Oil output are starting to show. The daily production rates in the Company's PRI affiliate is not reported in the Company's average daily production rate. These volumes will be periodically reported through press releases after we are confident we have completed our land acquisition efforts in the area.

The Company will continue to pursue a carefully designed capital expenditure program, including acquisitions and dispositions, which would allow us to add production, reserves and cash flow in a cost effective manner while maintaining a level of flexibility in our balance sheet. We are confident that we have prepared ourselves to emerge from this environment operationally strong, and we expect to be well positioned to respond quickly when the business environment improves. Our proven management and dedicated team of professionals are engaged and committed to developing our high-quality asset base.

CRITICAL ACCOUNTING ESTIMATES

The preparation of the financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected. Specific amounts and disclosures affected by estimates and assumptions are:

<u>Significant judgments</u>

Determination of cash-generating units ("CGU")

Property and equipment are aggregated into CGUs based on their ability to generate largely independent cash flows and are used for impairment testing. The determination of the Company's CGUs is subject to management's judgment.

Deferred taxes

The provision for income taxes is based on judgments in applying income tax laws and estimates on the timing, likelihood and reversal of temporary differences between accounting and tax bases of assets and liabilities.

<u>Significant estimates and assumptions</u>

Reserves

Oil and gas development and production properties are depleted on a unit of production basis at a rate calculated by reference to proved reserves determined in accordance with the Society of Petroleum Engineers rules and incorporating the estimated future cost of developing and extracting those reserves. Oil and gas reserves are also used to evaluate impairment of PP&E properties. Commercial reserves are determined using estimates of oil and natural gas in place, recovery factors, discount rates and forward future prices. Future development costs are estimated using assumptions as to the number of wells required to produce the commercial reserves, the cost of such wells and associated production facilities, and other capital costs. There are numerous uncertainties inherent in estimating oil and gas reserves. Estimating reserves is very complex, requiring many judgments based on geological, geophysical, engineering and economic data. These estimates may change, having either a positive or negative impact on the statement of comprehensive loss as further information becomes available and as the economic environment changes.

Decommissioning liabilities

The Company estimates the decommissioning obligations for oil and natural gas wells and their associated production facilities and pipelines. In most instances, removal of assets and remediation occurs many years into the future. Amounts recorded for the decommissioning obligations and related accretion expense require estimates regarding removal date, future environmental legislation, the extent of reclamation activities required, the engineering methodology for estimating costs, future removal technologies in determining the removal costs, and discount rates to determine the present value of these cash flows.

Exploration and evaluation ("E&E") assets

The accounting policy for E&E assets is described in note 3. The application of this policy requires management to make certain estimates and assumptions as to future events and circumstances as to whether economic quantities of reserves have been found.

Share-based compensation

The fair value of stock options and warrants granted is recognized using the Black-Scholes option pricing model. Measurement inputs include the Company's share price on the measurement date, the exercise price of the option, the expected volatility of the Company's shares, the expected life of the options, expected dividends and the risk-free rate of return. The Company estimates volatility based on the historical share price in the publicly traded markets. The expected life of the options is based on historical experience and estimates of the holder's behavior. Dividends are not factored in as the Company does not expect to pay dividends in the foreseeable future. Management also makes an estimate of the number of options that will be forfeited and the rate is adjusted to reflect the actual number of options that actually vest.

Recoverability of assets

The Company assesses impairment on its assets that are subject to amortization when it has determined that a potential indicator of impairment exists. Impairment exists when the carrying value of a non-financial asset or CGU exceeds its recoverable amount, which is the higher of its fair value less costs to sell and its value in use. The Company used the calculation of fair value less costs to sell to determine the fair value of its CGU's. In determining the fair value less costs to sell, the amount is most sensitive to the future commodity prices, discount rates, and estimates of proved and probable reserves, to determine an implied fair value of the CGU being tested.

Provision for doubtful accounts

The provision for doubtful accounts is reviewed by management on a monthly basis. Trade receivables are considered for impairment on a case-by-case basis when they are past due or when objective evidence is received that a customer will default. Management makes these assessments after taking into consideration the customer's payment history, their credit worthiness and the current economic environment in which the customer operates to assess impairment. The Company's historical bad debt expenses have not been significant and are usually limited to specific customer circumstances. However, given the cyclical nature of the oil and natural gas industry along with the current economic operating environment, a customer's ability to fulfill its payment obligations can change suddenly and without notice.

FUTURE ACCOUNTING AND REPORTING CHANGES

The Company has reviewed the new and revised accounting pronouncements that have been issued but are not yet effective and determined that the following may have an impact on the Company and will become effective beginning on or after January 1, 2013:

IFRS 10 – "Consolidated Financial Statements", which builds on existing principles and standards and identifies the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company.

IFRS 11 – "Joint Arrangements", which establishes the principles for financial reporting by entities when they have an interest in arrangements that are jointly controlled.

IFRS 12 – "Disclosure of Interest in Other Entities", which provides the disclosure requirements for interests held in other entitles including joint arrangements, associates, special purpose entities and other off balance sheet entities.

IFRS 13 – "Fair Value Measurement", which defines fair value, requires disclosure about fair value measurements and provides a framework for measuring fair value when it is required or permitted within the IFRS standards.

IAS 27 – "Separate Financial Statements", which provides amendments to IAS 27 to coincide with the changes made in IFRS 10, but retains the current guidance for separate financial statements.

IAS 28 – "Investments in Associate and Joint Ventures", which revised the existing standard and prescribes the accounting for investments and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

IFRS 7 – "Financial Instruments: Disclosures" and IAS 32 "Financial Instruments: Presentation", provides amendments to the previously issued IFRS 7 "Financial Instruments: Disclosures" and IAS 32 "Financial Instruments: Presentation", to provide clarity over the current offsetting model and develop common disclosure requirements to enhance the understanding of the potential effects of offsetting arrangements. Amendments to IFRS 7 are effective on January 1, 2013 with required retrospective application and early adoption permitted. Amendments to IAS 32 are effective on January 1, 2014 with required retrospective application and early adoption permitted.

IAS 1 – "Presentations of Items of OCI: Amendments to IAS 1 Presentation of Financial Statements", which provides for the amendment of the presentation of net earnings and OCI and also requires that items are grouped within OCI based on whether the items may be subsequently reclassified to profit or loss. Amendments to IAS 1 are effective for the Company beginning on January 1, 2012 with retrospective application and early adoption permitted. The adoption of this standard did not have a material impact on the Company's financial statements.

The following pronouncement will become effective for the financial reporting period beginning on or after January 1, 2015:

IFRS 9 – "Financial Instruments", which is the result of the first phase of the IASB's project to replace IAS 39 – "Financial Instruments: Recognition and Measurement". The new standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only two classification categories: amortized cost and fair value. The adoption of this standard should not have a material impact on the Company's financial statements.