Emerald Bay Energy

Emerald Bay Energy Inc.
Financial Statements
For the years ended December 31, 2004 and 2003

Contents

BDO

BDO Dunwoody LLP
Chartered Accountants
and Advisors

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Auditor's Report

To the Shareholders of
Emerald Bay Energy Inc.

We have audited the balance sheets of Emerald Bay Energy Inc. as at December 31, 2004 and 2003 and the statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2004 and 2003 and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

Signed "BDO Dunwoody LLP"

Chartered Accountants

Calgary, Alberta
April 27, 2005

Emerald Bay Energy Inc.
Balance Sheets
Audited

As at December 31	2004	2003
Assets		
Current		
Cash and cash equivalents	**$ 98,160**	$ 964,995
Accounts receivable	**480,293**	192,197
Prepaid expenses and deposits	**55,321**	57,280
Due from related parties (Note 8)	**-**	12,282
	633,774	1,226,754
Due from related parties (Note 8)	**202,212**	215,735
Property and equipment (Note 5)	**2,056,461**	618,390
License	**61,765**	65,882
	$ 2,954,212	$ 2,126,761
Liabilities and Shareholders' Equity		
Current		
Bank loan (Note 7)	**$ 360,000**	$ -
Accounts payable and accrued liabilities	**2,069,007**	532,771
	2,429,007	532,771
Future taxes (Note 10)	**-**	146,000
Asset retirement obligation (Note 6)	**97,344**	61,204
	2,526,351	739,975
Contingencies (Note 12)		
Going concern assumption (Note 2)		
Shareholders' equity		
Share capital (Note 9(b))	**1,991,825**	1,991,825
Contributed surplus (Note 10)	**22,183**	-
Deficit	**(1,586,147)**	(605,039)
	427,861	1,386,786
	$ 2,954,212	$ 2,126,761

Signed "Shelby D. Beattie" Director
Shelby D. Beattie

Signed "Leonard D. Rice"" Director
Leonard D. Rice

The accompanying notes are an integral part of these financial statements.

Emerald Bay Energy Inc.
Statements of Operations and Deficit

For the years ended December 31		2004		2003
Revenue				
Petroleum and natural gas sales	**$**	**1,216,492**	$	1,324,794
Royalties		**(203,977)**		(323,628)
Alberta royalty tax credits		**-**		28,425
		1,012,515		1,029,591
Expenses				
Operating		**240,072**		284,526
General and administrative		**938,758**		672,805
Research and development (Note 16)		**440,880**		275,256
Depletion, amortization and accretion		**206,525**		119,564
Bad debts		**-**		50,038
Interest		**8,670**		17,605
		1,834,905		1,419,794
Loss from operations		**(822,390)**		(390,203)
Other income (expenses)				
Interest		**10,571**		15,351
Alberta royalty tax credits (Note 12)		**(280,305)**		-
		(269,734)		15,351
Loss before income taxes		**(1,092,124)**		(374,852)
Income taxes (recovery) (Note 11)				
Current		**35,000**		-
Future		**(146,016)**		(77,000)
		(111,016)		(77,000)
Loss for the year		**(981,108)**		(297,852)
Deficit, beginning of year		**(605,039)**		(307,187)
Deficit, end of year	**$**	**(1,586,147)**	$	(605,039)
Loss per common share basic and diluted (Note 9(d))	**$**	**(0.084)**	$	(0.044)
Weighted average number of shares		**11,708,304**		6,727,306

The accompanying notes are an integral part of these financial statements.

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Emerald Bay Energy Inc.
Statements of Cash Flows

For the years ended December 31	2004	2003
Cash flows from operating activities		
Loss for the year	**$ (981,108)**	$ (297,852)
Adjustments for:		
Depletion, amortization and accretion	**202,408**	119,564
Amortization of license fee	**4,117**	4,118
Future income taxes	**(146,000)**	(77,000)
Stock option expense (Note 10)	**22,183**	-
Alberta royalty tax credits (Note 12(b))	**280,305**	-
	(618,095)	(251,170)
Changes in non-cash operating balances		
Accounts receivable	**(288,096)**	65,704
Prepaid expenses and deposits	**1,959**	(41,700)
Accounts payable and accrued liabilities	**(57,396)**	145,807
	(961,628)	(81,359)
Cash flows from investing activities		
Purchases of property and equipment	**(1,604,339)**	(277,749)
Proceeds on disposition of property and equipment	**-**	28,052
Changes in non-cash investing balances	**1,313,327**	-
	(291,012)	(249,697)
Cash flows from financing activities		
Bank loan advances (repayment)	**360,000**	(412,500)
Repayment of related party loans	**25,805**	200,742
Issuance of share capital, net of issue costs	**-**	1,470,720
	385,805	1,258,962
Increase (decrease) in cash and equivalents	**(866,835)**	927,906
Cash and equivalents, beginning of year	**964,995**	37,089
Cash and equivalents, end of year	**$ 98,160**	$ 964,995
Supplemental cash flows disclosure:		
Interest paid	**$ 8,670**	$ 17,605

The accompanying notes are an integral part of these financial statements.

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1. Nature of Operations

Emerald Bay Energy Inc. (the "Company") was incorporated under the Business Corporations Act of Alberta on May 9, 1997 and is listed on the TSX Venture exchange. The Company is engaged in the exploration for and development of petroleum and natural gas properties principally in Alberta and Texas and is developing a lateral drainhole drilling technology.

2. Going Concern Assumption

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities and commitments in the normal course of business. The Company has a $1,795,233 working capital deficiency at December 31, 2004 and continues to incur losses. The Company is also in violation of certain financial banking covenants which could result in the lender demanding repayment of the loan (Note 4). Consequently there is significant doubt about the Company's ability to continue as a going concern.

Management are committed to raising additional capital to meet exploration and operating obligations. While management has been successful in the past in obtaining financing, there is no assurance that sufficient funds will be raised in the future. Subsequent to the year end the Company completed a $565,000 private placement share issuance net of issue costs (Note 18 (a)). In addition, the Company received $569,000 on issuance of a private placement expected to close in early May 2005 (Note 18 (b)). The Company's ability to continue as a going concern is dependent upon the Company 's ability to raise additional equity to meet its current working capital shortfall and provide for future operational needs. Future lateral drainhole drilling operations are dependent on successful testing results and access to additional funding.

These financial statements do not give effect to adjustments to the carrying values of assets and liabilities and reported revenue and expenses that would be necessary should the Company be unable to continue as a going concern.

3. Summary of Significant Accounting Policies

The financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The financial statements have, in management's opinion, been properly prepared using careful judgement with reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

3. Summary of Significant Accounting Policies - continued

a) Property and equipment
The Company follows the full cost method of accounting for oil and gas operations whereby all costs of exploring for and developing oil and gas reserves are initially capitalized in each of its cost centres. Such costs include land acquisition costs, geological and geophysical expenses, carrying charges on non- producing properties, costs of drilling and overhead charges directly related to acquisition and exploration activities.

Costs capitalized, together with the costs of production equipment, are depleted on the unit-of-production method based on the estimated gross proved reserves. Petroleum products and reserves are converted to equivalent units of natural gas at approximately 6,000 cubic feet to 1 barrel of oil.

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion calculations.

Proceeds from the sale of petroleum and natural gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would significantly alter the rate of depletion.

In applying the full cost method, the Company calculates a ceiling test whereby the carrying value of property and equipment is compared to the sum of the undiscounted cash flows expected to result from the future production of proved reserves and the sale of unproved properties for each of the Company's cost centres. Cash flows are based on third party quoted forward prices, adjusted for transportation and quality differentials. Should the ceiling test result in an excess of carrying value, the Company would then measure the amount of impairment by comparing the carrying amounts of property and equipment to an amount equal to the estimated net present value of future cash flows from proved plus probable reserves and the sale of unproved properties. The Company's risk-free interest rate is used to arrive at the net present value of the future cash flows. Any excess carrying would be recorded as a permanent impairment.

Furniture and equipment are carried at cost and amortized over the estimated useful lives of the asset on a straight-line basis over three to five years.

b) Joint operations
Substantially all of the exploration and production activities of the Company are conducted jointly with others and these consolidated financial statements reflect only the Company's proportionate interest in such activities.

3. Summary of Significant Accounting Policies - continued

c) Asset retirement obligation
The Company recognizes the fair value of an obligation associated with the retirement of petroleum and natural gas properties in the period the asset is put into use. The related costs are capitalized as part of the carrying value of the asset and depleted in accordance with the Company's policies. Change in the present value of the liability due to the passage of time are adjusted in subsequent periods and charged to expense.

d) Revenue recognition
Revenue associated with the sales of petroleum and natural gas production owned by the Company is recognized when the title passes from the Company to its customers. Transportation costs are not netted against revenue but included with production costs, as they are not material to show separately. Alberta Royalty Tax Credits are deducted from royalty expense. Commodities sold by the Company below or above its working interest share in the related resource properties may result in production underliftings, which is recorded in inventory. Product inventories are valued at the lower of average cost and net realizable value on a first-in, first-out basis.

e) Flow-through shares
Expenditure deductions for income tax purposes related to exploratory activities funded by flow-through equity instruments are renounced to investors in accordance with income tax legislation. The Company provides for the future effect on income taxes related to flow-through equity instruments as a reduction of share capital and an increase in future income tax liabilities when the expenditures are renounced to subscribers at the effective date of renunciation.

f) Financial instruments
The Company carries various financial instruments. Unless otherwise indicated, it is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values.

3. Summary of Significant Accounting Policies - continued

g) Measurement uncertainty

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Accounts receivable are stated after evaluation as to their collectibility and an appropriate allowance for doubtful accounts is provided where considered necessary. The amounts recorded for depletion and depreciation of property and equipment, the ceiling test and asset retirement obligation and accretion expense are based on estimates of gross proven reserves, production rates, oil and gas prices, future costs, discount rates and other relevant assumptions. The financial statements include accruals based on the terms of existing joint venture agreements. Due to varying interpretations of the definition of terms in these agreements the accruals made by management in this regard may be significantly different from those determined by the Company's joint venture partners. These estimates and assumptions are reviewed periodically and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. The capital expenditures classification made with respect to the renouncement of flow-through shares is based on estimates from geologic information obtained and the classification of the expenditures may be challenged by the taxation authorities and in this regard the assessments may be different from that of management.

The Black Scholes option valuation model was development for use in estimating the fair value of trade options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

h) Future income taxes

The liability method is used in accounting for income taxes. Under this method, future tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities, and measured using substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse. Where uncertainty exists relating to the ability to utilize a tax asset, a valuation allowance is recorded.

i) Cash and cash equivalents

Cash and cash equivalents include bank balances and all highly liquid instruments purchased with an original maturity of three month or less.

3. Summary of Significant Accounting Policies - continued

j) Stock based compensation plan
Effective January 1, 2003, the Company prospectively adopted the new Canadian accounting standard with respect to stock based compensation. The standard requires that the fair value method of accounting be applied for stock options awarded to directors, officers and employees after January 1, 2003. Compensation expense is recorded over the vesting period using the estimated fair value of the option on the grant date. Consideration paid on the exercise of stock options is recorded as share capital.

k) Per share amounts
Basic loss per common share is computed by dividing losses by the weighted average number of common shares outstanding for the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options and other dilutive instruments, in accordance with new standards approved by the Canadian Institute of Chartered Accountants.

l) License fee
License fee relates to patent rights of certain lateral drainhole drilling technology. Commencing in 2003 this license fee is being amortized over the remaining life of the patent (17 years). If the license fee is determined not to have value, it will be written off in the period the determination is made.

m) Research and development
Research and development costs are charged to net income in the period in which they are incurred, except for significant development costs meeting Canadian generally accepted criteria for deferral.

Investment tax credits are accrued when qualifying expenditures are made and there is reasonable assurance that the credits will be realized. The Company accounts for the investment tax credits using the cost reduction method.

n) Government assistance
Government assistance and grants related to research and development expenditures are reflected as a reduction of the cost of such expenses. Government assistance relating to specific expenses is recorded as a reduction of the expense when the related expenditures are incurred. When government assistance is received which relates to expenses of future periods, the amount is deferred and amortized to income as the related expenses are incurred.

o) Foreign currency
The Company translates amounts of foreign currency into Canadian dollars on the following basis:

(i)monetary assets and liabilities – at the rate of exchange prevailing at the period end;
(ii) non-monetary items – at the rate of exchange prevailing at the dates of the transactions;
(iii) revenues and expenses – at the monthly average rate of exchange; and
(iv) gains and losses on translation of current monetary assets and liabilities are included in income.

4. Change in Accounting Policies

a) Property and equipment:
Effective December 31, 2003, the Company adopted Accounting Guideline 16 Oil and Gas Accounting – Full Cost. This Guideline deals with the application of the full cost method of accounting for oil and gas exploration and development activities. Had the Company not adopted the Guideline, upon application of the ceiling test the Company's carrying value would not have been in excess of the ceiling value.

b) Asset retirement obligations
Effective January 1, 2003, the Company adopted the new Canadian accounting standard for asset retirement obligations. Prior to January 1, 2003, an estimate of future abandonment and restoration costs was provided for using the unit of production method over estimated gross proved reserves. The Company accrued a liability of $18,155 for a total asset retirement obligation at January 1, 2003 and increased property and equipment by the same amount. There was no effect on the Company's deficit. The liability for the expected cash flows is discounted at 8% and is expected to be settled between 2010 and 2014.

5. Property and Equipment

		2004	
	Cost	**Accumulated Depletion and Depreciation**	**Net Book Value**
Petroleum and natural gas properties	**$ 2,795,651**	**$ 782,593**	**$ 2,013,058**
Office furniture and equipment	**88,626**	**45,223**	**43,403**
	$ 2,884,277	**$ 827,816**	**$ 2,056,461**

		2003	
	Cost	Accumulated Depletion and Depreciation	Net Book Value
Petroleum and natural gas properties	$ 1,191,970	$ 600,350	$ 591,620
Office furniture and equipment	62,370	35,600	26,770
	$ 1,254,340	$ 635,950	$ 618,390

No general administrative expenses have been capitalized to property and equipment.

The Company applied the ceiling test to its petroleum and natural gas properties at December 31, 2004 and determined that there was no impairment of costs requiring a write-down in either of its cost centres.

5. Property and Equipment - continued

For the purposes of the December 31, 2004 impairment test of petroleum and natural gas properties, the following benchmark prices were used in Canada:

	Gas Reference Price	Oil Reference Price
2005	$ 6.35	$ 47.75
2006	6.10	45.50
2007	5.90	43.25
2008	5.75	40.75
2009	5.75	39.50
Average % change thereafter	2%	2%

6. Asset Retirement Obligation

At the date of completion of drilling and testing, the Company identifies obligations related to oil and gas properties and records a liability equal to the present value of expected future assets retirement obligations (“ARO”). The total future ARO was estimated by management based on the Company’s net ownership interest in all wells estimated costs to reclaim and abandon the wells and the estimated timing of the costs to be incurred in future periods. The Company has estimated the net present value of its total ARO to be $97,344 as at December 31, 2004 (2003 - $61,204) based on a total future liability of $219,978 (2003 – $160,031) and incorporated the Company’s credit-adjusted risk-free interest rate of 7.5%. These payments are expected to be made over the next 10 years.

The following table reconciles the Company’s asset retirement obligations:

	2004	2003
Asset retirement obligation, beginning of year	**$ 61,204**	$ 19,517
New liabilities incurred	**25,600**	37,634
Liabilities settled	**-**	-
Accretion expense	**10,540**	4,034
Asset retirement obligation, end of year	**$ 97,344**	$ 61,185

7. Bank Loan

The Company has a $500,000 (2003 - $390,000) revolving production loan facility, of which $360,000 (2003 - $nil) plus accrued interest, has been drawn at December 31, 2004. Interest is calculated at the bank's prime rate plus 1.5% (2003 – prime rate plus 1.5%).

Security for the loan consists of a revolving line of credit agreement, a general security agreement over all present after acquired property, a $2 million debenture at the bank prime rate plus 2% over all oil and gas properties and an assignment of any long-term contracts. The Company is currently in violation of certain financial banking covenants. The Company's banking covenants require it to maintain a working capital ratio of not less then 1 to 1 and debt to equity ratio of no greater than 2 to 1. As at December 31, 2004 the Company's working capital ratio was 0.31 to 1 and debt to equity ratio was 5.8 to 1.

8. Due From Related Parties and Related Party Transactions

a) The following amounts are due by related parties:

		2004		2003
Current assets – due from related parties				
Loan due from president (i)	**$**	**-**	$	12,282
Due from related parties				
Loan due from officer (ii)	**$**	**-**	$	13,523
Note receivable from officer (iii)		**202,212**		202,212
	$	**202,212**	$	215,735

(i) Loan due from the president and an officer
During 2004, the amounts owed in 2003 by the president and officer were repaid.

(ii) Note receivable from officer
This promissory note bearing interest at 3% (2003 – 6%) per annum and repayable by December 31, 2007. In 1999 this official purchased shares of the Company under the terms of the promissory note from a shareholder group. This same group purchased oil and gas from the Company under the terms of a promissory note. On January 25, 2000, the notes were assigned resulting in the officer owing the Company $202,212. The note is secured by 393,000 common shares of the Company and a personal guarantee from a director of the Company. The value of the security provided to the Company at both December 31, 2004 and December 31, 2003 exceeds the book value of the promissory note.

b) Except as disclosed elsewhere in the financial statements, the Company was involved in the following related party transactions for the year ended December 31, 2004.

8. Due From Related Parties and Related Party Transactions

(i) Directors and officers, have charged the Company $213,084 (2003 - $272,000) for professional and administrative services.

(ii) A law firm in which a director is a partner has charged the Company $19,510 (2003 - $75,000) in legal fees. Included in accounts payable is $5,270 (2003-$nil) owing to this firm.

(iii) A company controlled by a director has charged the Company $83,000 (2003 - $97,000) in consulting fees with respect to the research and development of their lateral drainhole drilling technology. Included in accounts payable is $24,610 (2003-$4,420) owing for these consulting fees. A company owned and controlled by a director has charged the Company $72,923 (2003 - $56,428) with respect to the operations costs and has paid the Company $82,809 (2003 - $40,195) in net revenue with respect to the operations of a certain wells in the USA. Included in accounts receivable is $45,667 (2003-$11,924) related to this revenue.

iv) The officer referred to in Note 8(a)(ii) paid $6,366 (2003 - $15,351) of interest on the note. Accounts payable includes $nil (2003 - $nil) of unpaid interest.

Transactions in the normal course of operations are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

9. Equity Instruments

a) Authorized
Unlimited number of common voting shares
Unlimited number of preferred shares, issuable in series.

b) Common shares issued for cash

	Number		Amount
Balance, December 31, 2002	6,274,228	$	878,104
Private placement (i)	1,608,000		415,000
Flow through shares (ii)	3,826,076		1,339,126
Tax effect of flow through shares	-		(490,000)
Share issue costs (net of future tax $133,000)	-		(192,805)
Balance December 31, 2003 and 2004	11,708,304		1,949,425
Warrants outstanding December 31, 2002	-		-
Fair value ascribed to warrants issued (ii)	1,108,000		42,400
Warrants outstanding, December 31, 2003 and 2004	1,108,000		42,400
Equity instruments balance December 31, 2004		$	1,991,825

9. Equity Instruments - continued

(i) During 2003, the Company complete two private placements to arm's length parties via the issuance of 500,000 common shares at $0.25 per share for total consideration of $125,000 and the issuance of 1,108,000 units at $0.30 for total consideration of $332,400. Each unit consisted of one common share and one share purchase warrant (each exercisable into one common share for a period ending December 2005). The total consideration of $332,400 is estimated to relate to the common shares as to $290,000 and the warrants as to $42,400.

The $42,400 fair value of the 1,108,000 warrants outstanding at December 31, 2004 was estimated using the Black-Scholes option pricing model with the following assumptions: dividend yield (Nil), expected volatility (0.03), risk-free interest rate (5.0%), and weighted average life of 2 years.

(ii) Pursuant to a prospectus dated November 4, 2003, the Company issued 3,826,076 flow through common shares for gross proceeds of $1,339,127 ($0.35 per share). The Company spent all of these flow through funds by the end of 2004 on qualifying expenditures.

c) Stock options

The Company has established a stock option plan whereby the Company may grant directors, officers, employees and consultants up to a maximum of 10% of the issued common shares. The exercise price of each option equals the market price of the Company's shares on the date of grant. Stock options vest evenly over a 3 year period from the date of grant and expire 5 years after the date of grant.

	December 31, 2004			December 31,2003		
	Number of options		**Weighted average exercise price**	Number of options		Weighted Average Exercise price
Stock options, beginning of year	**620,000**	**$**	**0.22**	620,000	$	0.22
Granted	**550,000**		**0.32**	--		--
Expired	**(327,096)**		**(0.21)**	--		--
Stock options outstanding, end of year	**842,904**	**$**	**0.29**	620,000	$	0.22
Exercisable, end of year	**278,602**	**$**	**0.23**	541,396	$	0.22

9. Equity Instruments - continued

The stock options outstanding as at December 31, 2004 are as follows:

	Options outstanding			Options exercisable	
Exercise prices	**Options outstanding**	**Weighted average remaining term (years)**	**Weighted average exercise price**	**Options exercisable**	**Weighted average exercise price**
$0.19	**117,904**	**3.0**	**$ 0.19**	**78,602**	**$ 0.19**
$0.25	**200,000**	**.2**	**0.25**	**200,000**	**0.25**
$0.32	**525,000**	**4.5**	**0.32**		**0.32**
	842,904	**3.3**	**$ 0.29**	**278,602**	**$ 0.23**

The stock options outstanding as at December 31, 2003 are as follows:

	Options outstanding			Options exercisable	
Exercise prices	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
$0.19	117,904	4.0	$ 0.19	39,300	$ 0.19
$0.21	302,096	1.0	0.21	302,096	0.21
$0.25	200,000	1.2	0.25	200,000	0.25
	620,000	1.6	$ 0.22	541,396	$ 0.22

d) Diluted loss per share
The exercise of options and warrants would be anti-dilutive.

10. Stock Compensations

On March 29, 2004 the Company granted 550,000 stock options at a price of $0.32 per share, a three year vesting period and a 5 year term. The Company recorded compensation expense when stock options were issued to employees, as disclosed in Note 2(k).

The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (Nil), expected volatility (0.55), risk-free interest rate (3.4%), and weighted average life of 5 years. The estimated value of $88,000 is being amortized to income over the 3 year vesting period. The 2004 stock option expense of $22,183 is included in general administration costs with a corresponding credit to contributed surplus.

11. Income Taxes

The effective rate of income tax varies from the statutory rate as follows:

		2004		2003
Combined tax rate		**39.12%**		40.74%
Expected income tax provision at statutory rate	**$**	**(427,000)**	$	(137,000)
Non-deductible crown charges		**58,000**		100,000
Resource allowance		**(3,000)**		(27,000)
Non-taxable Alberta royalty adjustments		**110,000**		(10,000)
Investment tax credits		**9,000**		-
Other		**-**		(3,000)
Rate change		**(24,000)**		
Valuation allowance		**131,000**		-
Actual income tax provision	**$**	**(146,000)**	$	(77,000)

Subject to confirmation by income tax authorities, the Company has the following approximate undeducted tax pools:

		2004		2003
Cumulative Canadian oil and gas property expenses	**$**	**257,000**	$	250,000
Cumulative Canadian development expenses		**257,000**		18,000
Foreign exploration and development expenses		**263,000**		260,000
Undepreciated capital cost		**189,000**		162,000
Share issue costs		**196,000**		360,000
Scientific research and experimental development		**737,000**		140,000
Attributed Canadian royalty Income		**852,000**		715,000
Non-capital losses expiring 2014		**67,000**		-

These pools are deductible from future income at rates prescribed by the Canadian Income Tax Act.

The components of the Company's future income tax asset (liability) are a result of the origination and reversal of temporary differences and are comprised of the following:

Nature of temporary differences		2004		2003
Property and equipment, ARO, License Fee	**$**	**(355,000)**	$	24,000
Share issue costs		**66,000**		120,000
Scientific Research and Experimental Development		**195,000**		47,000
Investment tax credits		**104,000**		71,000
Attributed Canadian royalty income		**98,000**		82,000
Unexpended flow-through funds		**-**		(490,000)
Loss carry-forward		**23,000**		-
Valuation allowance		**(131,000)**		-
Future income tax (liability) asset	**$**	**-**	$	(146,000)

12. Contingencies

a) In 2000, the Company commenced legal action against a joint venturer claiming underpayment of a net profit royalty in the amount of $139,000. The joint venturer has issued a counterclaim for $15,000, claiming an overpayment of this royalty. In the opinion of management, the outcome of these claims is not determinable at this time.

b) In 2003, Alberta Revenue issued notices of reassessment to the Company disallowing claims for Alberta royalty tax credits (“ARTC”) made in the Alberta Corporate Income tax returns for the years 1998 – 2001. The Company disagrees with these reassessments and the Company has filed a notice of objection with Alberta Revenue. A provision for $280,305 has been recorded in the financial statements for the repayment of these ARTC’s and related interest. The final outcome of this matter is not determinable at this time.

In view of the above matter, management has not accrued any further ARTC’s.

13. Commitments

a) Leases
The Company’s total obligations, under an automobile lease and an office lease agreement, exclusive of occupancy costs, are as follows:

2005	$	15,500

b) The Company has agreed to indemnify directors and officers under the bylaws of the Company to the extent permitted by law. The nature of the indemnifications prevent the Company from making a reasonable estimate of the maximum potential amount it could be required to pay to any beneficiary of such indemnification agreement.

14. Financial Instruments

As disclosed in Note 2(g), the Company holds various forms of financial instruments. The nature of these instruments and the Company’s operations expose the Company to fair value, industry credit, and commodity price risks. The Company manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

a) Credit risk
Substantially all of the Company’s cash is held at one Canadian Chartered bank and as such, the Company is exposed to the risks of that institution.

The majority of the accounts receivable are in respect of oil and natural gas operations. The Company generally extends unsecured credit to these customers, and therefore, the collection of accounts receivable may be affected by changes in economic or other conditions. Management

14 Financial Instruments - continued

believes the risk is mitigated by the size and reputation of the companies to which they extend credit. The Company has not experienced any material credit loss in the collection of receivables to date.

At year-end, the largest account comprised 26% of accounts receivable (2003 - two companies comprised 91%).

b) Commodity price risk
The Company is exposed to fluctuations in commodity prices.

c) Interest rate risk
The Company's short-term borrowings are subject to floating rates. The floating rate debt is subject to interest rate cash flow risk, as the required cash flows to service the debt will fluctuate as a result of changes in market rates.

As at December 31, 2004, increase or decrease in net income before taxes for each 1% changes in interest rates on floating rate debt amounts to approximately $800. In prior years, the Company was not subject to interest rate risk.

d) Foreign Exchange Risk
A portion of the Company's sales are made to customers in the United States. Accordingly the related financial assets and liabilities are subject to fluctuations in exchange rates. The Company does not have any exposure to highly inflationary foreign currencies.

As at December 31, 2004, the increase or decrease in income before taxes for each 1% change in the value of the Canadian dollar against the dollar amounts to approximately $100.

15. Segmented Information

(a) The Company's activities include oil and gas production and development of certain lateral drainhole drilling technology. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

Description – Dec 31, 2004	**Oil & gas production**	**Lateral drainhole drilling technology**	**Total**
Petroleum and natural gas sales	**$ 1,216,492**	**$**	**$ 1,216,492**
Interest revenue	**$ 10,571**	**$**	**$ 10,571**
Depletion, amortization and accretion	**$ 202,408**	**$ 4,117**	**$ 206,525**
Interest expense	**$ 8,670**	**$**	**$ 8,670**
Income tax recovery	**$ (93,016)**	**$ (53,000)**	**$ (146,016)**
Segment loss	**$ (589,111)**	**$ (391,997)**	**$ (981,108)**
Segment assets	**$ 2,892,447**	**$ 61,765**	**$2,954,212**
Capital expenditures	**$ 1,604,339**	**$**	**$1,604,339**

Description – Dec 31, 2003	Oil & gas production	Lateral drainhole drilling technology	Total
Petroleum and natural gas sales	$ 1,324,794	$	$ 1,324,794
Interest revenue	$ 15,351	$	$ 15,351
Depletion, amortization and accretion	$ 115,446	$ 4,118	$ 119,564
Interest expense	$ 17,605	$	$ 17,605
Income tax recovery	$ (77,000)	$	$ (77,000)
Segment loss	$ (22,596)	$ (275,256)	$ (297,852)
Segment assets	$ 2,060,879	$ 65,882	$ 2,126,761
Capital Expenditures	$ 277,749	$	$ 277,749

15. Segmented Information - continued

(b) Company's oil and gas production is further split into geographical segments: Canada and the United States of America ("US"). The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

Description – Dec 31, 2004	**Canada**	**US**	**Total**
Petroleum and natural gas sales	**$1,128,087**	**$ 88,405**	**$1,216,492**
Property and equipment	**$1,850,214**	**$ 206,247**	**$2,056,461**
License	**$ 61,765**	**$ -**	**$ 61,765**

Description – Dec 31, 2003	Canada	US	Total
Petroleum and natural gas sales	$ 1,268,118	$ 56,676	$ 1,324,794
Oil & gas production assets	$ 379,942	$ 238,988	$ 618,930
License	$ 65,882	$ -	$ 65,882

16. Research and Development

		2004		2003
Gross research and development expenditures	**$**	**535,612**	$	275,256
Government grant		**(94,732)**		-
	$	**440,880**	$	275,256

The Company has complied with all provisions in its agreements related to government grant and there were no defaults in the covenants and conditions contained in the agreements.

17. Comparative Figures

Certain of the prior year's figures have been reclassified to conform with the current year's presentation.

18. Subsequent Events

a) On February 18, 2005 the Company completed a private placement of 3,000,000 units at an issued price of $0.20 per unit, for consideration of $600,000. Each unit consists of one common share and one share purchase warrant that may be exercised to acquire additional common shares at $0.25 per share at any time in the two years following the closing of the private placement. All of the common shares issued pursuant to the private placement are subject to a 4 month hold period. 1,757,500 units of the private placement were acquired by directors and officers of the Company. The Company incurred issuance costs of $35,000 cash and issued 160,000 agent warrants which may be exercised to acquire additional common shares at $0.25 per share for a one year period.

b) By April 27, 2005, the Company had received $569,000 from unit subscriptions of a private placement that is expected to be completed in early May 2005. The Company expects to receive a total of $700,000 for the sale of these units. The private placement is expected to be completed in early May 2005.