

**Terra Energy Corp.
Consolidated Financial Statements
For the years ended December 31, 2004 and 2003**

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Auditors' Report

**To the Shareholders of
Terra Energy Corp**

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

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation 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 8, 2005

Terra Energy Corp.
Consolidated Balance Sheets
2004 2003

As at December 31

Assets

Current

| | | |
|---------------------------------------------|-----------|------------|
| Cash and cash equivalents | \$ - | \$ 512,051 |
| Accounts receivable | 2,397,420 | 1,651,014 |
| Income taxes receivable | 28,801 | 231,450 |
| Current portion of promissory note (Note 5) | - | 559,726 |
| Prepaid expenses | 859,865 | 124,124 |
| | 3,286,086 | 3,078,365 |

| | | |
|-----------------------------------|--------------|---------------|
| Deferred financing costs (Note 9) | 2,969,500 | - |
| Due from related parties (Note 6) | - | 15,000 |
| Oil and gas properties (Note 7) | 64,308,278 | 12,530,580 |
| | \$70,563,864 | \$ 15,623,945 |

Liabilities and Shareholders' Equity

Current

| | | |
|------------------------------------------|------------|------------|
| Bank overdraft | \$ 295,529 | \$ - |
| Revolving line of credit (Note 8) | - | 7,567,154 |
| Accounts payable and accrued liabilities | 11,154,141 | 3,003,452 |
| Subordinated debt (Note 9) | 10,000,000 | - |
| | 21,449,670 | 10,570,606 |

| | | |
|---------------------------------------|------------|------------|
| Asset retirement obligation (Note 10) | 4,021,143 | 742,568 |
| Future income taxes (Note 14) | 4,816,300 | 1,758,923 |
| Long-term financing (Note 8) | 15,862,373 | - |
| Preferred shares (Note 11) | 1,148,641 | 1,148,641 |
| | 47,298,127 | 14,220,738 |

Shareholders' Equity

| | | |
|-------------------------------|--------------|---------------|
| Share capital (Note 12) | 20,780,818 | 3,429,753 |
| Contributed surplus (Note 13) | 4,196,192 | - |
| Deficit | (1,711,273) | (2,026,546) |
| | 23,265,737 | 1,403,207 |
| | \$70,563,864 | \$ 15,623,945 |

Commitments and Contingencies (Note 18)

Approved on behalf of the Board:

Signed "Theodore Anderson"
Theodore Anderson, Director

Signed "Anthony Harvey"
Anthony Harvey, Director

Terra Energy Corp.
Consolidated Statements of Income and Deficit

For the years ended December 31

2004

2003
(Restated
– Note 4 (b))

Revenue

| | | |
|------------------------------------|--------------------|--------------------|
| Petroleum and natural gas revenues | \$ 16,470,399 | \$ 12,114,261 |
| Royalties | <u>(3,047,851)</u> | <u>(2,601,836)</u> |
| | <u>13,422,548</u> | <u>9,512,425</u> |

Expenses

| | | |
|----------------------------|-------------------|------------------|
| Production | 5,489,997 | 3,658,846 |
| General and administrative | 2,753,486 | 2,183,813 |
| Accretion expense | 270,012 | 76,378 |
| Stock based compensation | 562,000 | - |
| Depletion and amortization | 3,870,000 | 2,050,622 |
| Interest on long-term debt | 285,758 | 534,572 |
| | <u>13,231,253</u> | <u>8,504,231</u> |

| | | |
|-------------------------------------------------------------------|----------------|------------------|
| Income from operations before other items and income taxes | <u>191,295</u> | <u>1,008,194</u> |
|-------------------------------------------------------------------|----------------|------------------|

Other items

| | | |
|--------------------------------|----------|----------------|
| Interest income | - | 57,072 |
| Realized foreign exchange gain | - | 250,967 |
| | <u>-</u> | <u>308,039</u> |

| | | |
|-----------------------------------|----------------|------------------|
| Income before income taxes | <u>191,295</u> | <u>1,316,233</u> |
|-----------------------------------|----------------|------------------|

Income tax expense (Note 14)

| | | |
|-------------------|--------------------|----------------|
| Current | 7,089 | 36,000 |
| Future (recovery) | <u>(1,117,675)</u> | <u>479,779</u> |
| | <u>(1,110,586)</u> | <u>515,779</u> |

| | | |
|--------------------------------|------------------|----------------|
| Net income for the year | <u>1,301,881</u> | <u>800,454</u> |
|--------------------------------|------------------|----------------|

| | | |
|-------------------------------------------------------|--------------------|----------------|
| Retained earnings (deficit), beginning of year | <u>(2,026,546)</u> | <u>738,012</u> |
|-------------------------------------------------------|--------------------|----------------|

| | | |
|---------------------------------------------------------------------|------------------|----------|
| Purchase of common shares exceeding carrying value (Note 12) | <u>(215,792)</u> | <u>-</u> |
|---------------------------------------------------------------------|------------------|----------|

| | | |
|------------------|------------------|--------------------|
| Dividends | <u>(770,816)</u> | <u>(3,565,012)</u> |
|------------------|------------------|--------------------|

| | | |
|-----------------------------|-----------------------|-----------------------|
| Deficit, end of year | <u>\$ (1,711,273)</u> | <u>\$ (2,026,546)</u> |
|-----------------------------|-----------------------|-----------------------|

| | | |
|--------------------------------------------|----------------|----------------|
| Earnings per common share – basic | <u>\$ 0.05</u> | <u>\$ 0.04</u> |
| Earnings per common share - diluted | <u>\$ 0.05</u> | <u>\$ 0.04</u> |

| | | |
|--------------------------------------------------------------|-------------------|-------------------|
| Weighted average number of shares outstanding – basic | <u>28,140,691</u> | <u>18,547,304</u> |
|--------------------------------------------------------------|-------------------|-------------------|

| | | |
|----------------------------------------------------------------|-------------------|-------------------|
| Weighted average number of shares outstanding - diluted | <u>28,862,446</u> | <u>18,547,304</u> |
|----------------------------------------------------------------|-------------------|-------------------|

Terra Energy Corp.
Consolidated Statements of Cash Flows

| For the years ended December 31 | 2004 | 2003 |
|----------------------------------------------------------------|---------------------|--------------------|
| Cash flows from operating activities | | |
| Net income for the year | \$ 1,301,881 | \$ 800,454 |
| Items not involving cash: | | |
| Future tax provision | (1,117,675) | 479,179 |
| Accretion expense | 270,012 | 76,378 |
| Stock based compensation | 562,000 | - |
| Depletion and amortization | 3,870,000 | 2,050,622 |
| Cash flow from operations | <u>4,886,218</u> | <u>3,406,633</u> |
| Changes in non-cash working capital balances (Note 15) | <u>2,079,783</u> | <u>(1,313,000)</u> |
| | <u>6,966,001</u> | <u>2,093,633</u> |
| Cash flows from financing activities | | |
| Proceeds from revolving line of credit | 8,295,219 | 2,867,154 |
| Proceeds from subordinated debt | 10,000,000 | - |
| Issue costs on subordinated debt | (662,500) | - |
| Issue of preferred shares | - | 2,500,000 |
| Issue common shares | 16,759,821 | - |
| Repayment of long-term debt | - | (2,310,920) |
| Repurchase of common shares | (289,858) | - |
| Dividends paid | (105,000) | (2,500,000) |
| | <u>33,997,682</u> | <u>556,234</u> |
| Cash flows from investing activities | | |
| Purchase of oil and gas properties | (44,110,090) | (2,728,306) |
| Interest on promissory note | (72,540) | (28,296) |
| Payments (to) from related parties | (91,092) | 575,567 |
| Cash assumed on acquisition of Rhodes Resources Corp. | 2,502,459 | - |
| | <u>(41,771,263)</u> | <u>(2,181,035)</u> |
| Increase (decrease) in cash and cash equivalents | (807,580) | 468,832 |
| Cash and cash equivalents, beginning of year | 512,051 | 43,219 |
| Cash and cash equivalents (bank overdraft), end of year | \$ (295,529) | \$ 512,051 |

December 31, 2004 and 2003

1. NATURE OF OPERATIONS

Terra Energy Corp. (the "Corporation") was formed on January 30, 2004 as a result of the amalgamation of Rhodes Resources Corp. ("Rhodes"), Terrapet Energy Corp. ("Terrapet"), and Terra Energy Corp ("Terra") pursuant to the Business Corporations Act of Alberta. The amalgamated Corporation operates under the name Terra Energy Corp. The Corporation's principal business is the exploration, development, and production of oil and natural gas.

The amalgamation has been recorded as a reverse takeover by Terrapet and the comparative financial statements represent a continuation, for accounting purposes, of the financial statements of Terrapet and its subsidiaries ("Terrapet Consolidated").

2. SIGNIFICANT ACCOUNTING POLICIES

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

Consolidation

These consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries, Constar Resources Ltd. and Terra Energy Partnership. The latter is a general partnership between Terra Energy Corp. and Constar Resources Ltd.

Revenue Recognition

Revenue from the sales of petroleum and natural gas are recognized, net of related royalties, when the risks and rewards of ownership pass to the purchaser, including delivery of the product, the selling price being fixed or determinable and collectibility being reasonably assured. Settlement adjustments, if any, are reflected in revenue when the amounts are known.

Cash and cash equivalents

Cash and cash equivalents are comprised of cash on deposit and cheques issued in excess of deposits, cash on hand and short-term deposits with maturity dates less than 90 days.

Deferred Financing Costs

Financing costs relating to the issue of debt instruments are deferred on the balance sheet and are amortized to income over the respective terms of the debt instrument.

Joint Venture Operations

Some of the Corporation's oil and gas activities are conducted jointly with others. These consolidated financial statements reflect only the Corporation's proportionate interest in such activities.

December 31, 2004 and 2003

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

Oil and Gas Properties

The Corporation follows the full cost method of accounting whereby all costs related to the exploration, acquisition and development of petroleum and natural gas reserves are initially capitalized. Such costs include lease acquisition costs, geological and geophysical expenditures, lease rentals on non-productive properties, costs of drilling both productive and non-productive wells, equipment costs and general and administrative expenses applicable to these activities.

In applying the full cost method, the Corporation performs a ceiling test on properties which restricts the capitalized costs less accumulated depletion from exceeding an amount equal to the estimated undiscounted value of future net revenues from proved oil and gas reserves, as determined by independent engineers, based on sales prices achievable under existing contracts and posted average reference prices in effect at year end and current costs, and after deducting estimated, production related expenses, abandonment and reclamation costs, and income taxes. If the carrying value of the cost center exceeds the undiscounted cash flows, an impairment loss will be determined. The impairment loss is measured as the amount by which the carrying amount of assets capitalized in a cost center exceeds the fair value of proved and probable reserves and the costs less any impairment of unproved properties that have been subject to a separate test for impairment and contain no probable reserves.

Gains or losses on sales of properties are recognized only when crediting the proceeds to costs would result in a change of 20% or more in the depletion and amortization rate.

Amortization and depletion of petroleum and natural gas properties and equipment is provided for using the unit-of-production method based on estimated proven petroleum and natural gas reserves before any royalty deductions as determined by independent engineers. For the purpose of this calculation, petroleum and natural gas reserves are converted to a common unit of measurement on the basis of their relative energy content where six thousand cubic feet of gas equates to one barrel of oil. Costs of acquiring and evaluating unproven properties are excluded from costs subject to amortization and depletion until it is determined whether proven reserves are attributable to the properties or impairment occurs.

Other equipment is recorded at cost and amortized at an annual rate of 30%.

Asset Retirement Obligation

Asset retirement costs and liabilities associated with site restoration and abandonment of tangible long-lived assets are initially measured at a fair value which approximates the cost a third party would incur in performing the tasks necessary to retire such assets. The fair value is recognized in the consolidated financial statements as the present value of expected future cash flows. Subsequent to the initial measurement, the effect of the passage of time on the liability for the asset retirement obligation (accretion expense) and the amortization of the asset retirement cost are recognized in the results of operations.

Future Income Taxes

The Corporation follows the asset and liability method for accounting for income taxes. Under this method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases, and measured using substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse.

December 31, 2004 and 2003

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

Flow-through shares

Expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are to be renounced to investors in accordance with income tax legislation. Share capital is reduced by the estimated cost of the renounced tax deductions for expenditures renounced.

Derivative Financial Instruments

The Corporation trades petroleum products and derivative instruments. The Corporation enters into commodity contracts in the normal course of its business to establish future sales and purchase prices and manage the future cash flow risk associated with price volatility of the commodities traded. Commodity contracts may be designated as hedges of financial risk exposure of anticipated transactions if, both at the inception of the hedge and throughout the hedge period, the changes in fair value of the contract substantially offset the effect of the commodity price changes on the anticipated transactions and if it is probable that the transactions will occur. The Corporation monitors its commodity exposures and ensures that contracted amounts do not exceed the amounts of underlying exposures.

Gains and losses are recognized on the delivery of the petroleum product or settlement of the financial contract. The Corporation defers the impact of changes in the market value of these contracts until such time as the associated transactions are completed. Where anticipated transactions are no longer expected to occur, with the effect that the risk that was hedged no longer exists, unrealized gains and losses are recognized in income at the time such determination is made.

Cash flows arising in respect of these contracts are recognized under cash flow from operating activities.

Foreign Currency Translation

Monetary assets and liabilities denominated in foreign currencies have been translated into Canadian dollars at the rate of exchange prevailing at period end. Revenue and expense items are translated at the average rate of exchange for the year.

Measurement Uncertainty

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment with reasonable limits of materiality.

The amounts recorded for depletion and amortization of petroleum and natural gas properties and equipment, the liability for retirement obligations and the amount recorded for future income taxes are based on estimates. The impairment test is based on estimates of proved reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the consolidated financial statements of changes and estimates in future periods could be significant.

December 31, 2004 and 2003

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

Measurement Uncertainty (continued)

The consolidated 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 Corporation's joint venture partners. The effect on the consolidated financial statements resulting from such adjustments, if any, will be reflected prospectively.

Stock Based Compensation

Effective January 1, 2003, the Corporation adopted the recommendations of CICA Handbook Section 3870, Stock Based Compensation and Other Stock-Based Payments. This section requires that direct awards of stock and liabilities based on the price of common stock be measured at fair value at each reporting date, with the change in fair value reported in the statements of income and encourages, but does not require, the use of the fair value method for all other types of stock-based compensation plans.

Per share amounts

Basic earnings per share are computed by dividing earnings by the weighted average number of Class A shares outstanding during the year. Diluted per share amounts reflect the potential dilution that could occur if stock options or warrants to purchase common shares were exercised and converted to common shares. The treasury stock method of calculating diluted per share amounts is used whereby any proceeds from the exercise of stock options or warrants are assumed to be used to purchase common shares of the Corporation at the average market price during the year.

Financial instruments

The Corporation carries a number of financial instruments as detailed on the balance sheet. It is management's opinion that the Corporation 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, unless otherwise noted.

December 31, 2004 and 2003

3. BUSINESS ACQUISITIONS

- a) On November 25, 2003, the Corporation purchased all the outstanding shares of Constar Resources Ltd. (Constar). The acquisition was accounted for by the purchase method. These consolidated financial statements include the results of operations of Constar from this date. Any net income arising from the acquired net assets prior to the effective date have been recorded as an adjustment to the assets acquired. Details of the acquisition are as follows:

Fair values of net assets acquired:

| | |
|-----------------------------|-------------------|
| Current assets | \$ 102,834 |
| Future income tax asset | 116,000 |
| Oil and gas properties | 1,699,751 |
| Current liabilities | (882,985) |
| Asset retirement obligation | (105,850) |
| | <u>\$ 929,750</u> |

Consideration given:

| | |
|---------------------------------------------------|-------------------|
| Share capital issued – Series VI Preferred Shares | <u>\$ 929,750</u> |
|---------------------------------------------------|-------------------|

- b) On January 30, 2004, Terrapet Energy Corp. ("Terrapet"), Rhodes Resources Corp. ("Rhodes"), and Terra Energy Corp. ("Terra") amalgamated to form Terra Energy Corp.

The shareholders of Rhodes received 5,417,374 common shares of the Corporation based on a five to one share exchange ratio for their existing shareholdings at January 30, 2004. The common shareholder of Terrapet received 18,547,304 common shares of the Corporation in exchange for 22,500,000 common shares of Terrapet. The Series VI preferred shareholders of Terrapet received 3,429,752 common shares of the Corporation in exchange for 3,429,752 Series VI preferred shares of Terrapet.

The amalgamation transaction has been recorded as a reverse takeover by Terrapet and these consolidated financial statements represent a continuation, for accounting purposes, of the financial statements of Terrapet and its subsidiaries Terragrande Energy Corp. and Constar Resources Ltd. The comparative amounts presented are those of Terrapet Consolidated.

Prior to January 30, 2004 Terrapet and Rhodes were related as a result of common ownership and management. The amalgamation transaction has been recorded at the exchange value as there was a substantive change in the ownership interest by non-related parties of Rhodes. The purchase price determination has also been supported by independent reserve evaluation.

December 31, 2004 and 2003

3. BUSINESS ACQUISITIONS (continued)

The determination of purchase price and the allocation to assets and liabilities is shown below.

Fair values of net assets acquired:

| | |
|------------------------------|---------------------|
| Current assets | \$ 2,502,459 |
| Other current assets | 160,000 |
| Oil and gas properties | 3,757,194 |
| Current liabilities assumed | (317,299) |
| Future income tax liability | (695,086) |
| Asset retirement obligations | (37,168) |
| | <u>\$ 5,370,100</u> |

Consideration given:

| | |
|---------------------------------------------|---------------------|
| Share capital issued, net of issue costs | \$ 4,495,100 |
| Stock options and warrants issued (Note 13) | 875,000 |
| | <u>\$ 5,370,100</u> |

The fair value for 536,700 share options and 1,884,167 warrants was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yield (Nil); expected volatility at 30%; risk-free interest rate of 3.5%; with varying lives between 6 months and 3.75 years.

- c) On December 28, 2004 the Corporation purchased all of the outstanding shares of Fossil Bay Resources Ltd. ("Fossil Bay"), through a wholly owned subsidiary, Terra Resources Inc. ("Terra Resources"). Fossil Bay and Terra Resources immediately amalgamated to form Terra Resources Inc. Terra Resources Inc. was then wound up into Terra Energy Corp.

The determination of purchase price and the preliminary allocation to assets and liabilities is shown below. The purchase price determination is preliminary because certain items such as determination of the final tax bases and fair values of the assets and liabilities as of the acquisition date have not been entirely completed.

Fair values of net assets acquired:

| | |
|-----------------------------|---------------------|
| Current assets | \$ 207,100 |
| Future income tax asset | 865,900 |
| Current liabilities assumed | (28,000) |
| | <u>\$ 1,045,000</u> |

Consideration given:

| | |
|--------------------------------|---------------------|
| Cash | \$ 255,000 |
| Share capital issued (Note 12) | 790,000 |
| | <u>\$ 1,045,000</u> |

December 31, 2004 and 2003

3. BUSINESS ACQUISITIONS (continued)

- d) On December 31, 2004 the Corporation, acquired certain oil and gas properties from a non-related industry partner in consideration for cash. In connection with the acquisition the Corporation received income tax pools of approximately \$32.0 million, subject to assessment by tax authorities. The acquisition has been accounted for using the purchase method, with results of operations included from the date of acquisition. Details of the acquisition are as follows:

| | |
|--------------------------------------------|----------------------|
| Fair values of net assets acquired: | |
| Current assets | \$ 224,495 |
| Oil and gas properties | 32,390,549 |
| Asset retirement obligation | <u>(1,009,200)</u> |
| | \$ 31,605,844 |
| | |
| Consideration given: | |
| Cash | \$ 31,547,844 |
| Acquisition costs | <u>58,000</u> |
| | \$ 31,605,844 |

4. CHANGE IN ACCOUNTING POLICIES

- a) The Canadian Institute of Chartered Accountants has issued a new accounting guideline on Hedging Relationships (AcG 13), which is effective for 2004. This guideline, in addition to supplementing and interpreting existing hedging requirements under Canadian GAAP, establishes certain other conditions required before hedge accounting may be applied. It is management's opinion that all outstanding commodity price derivative contracts satisfy the necessary requirements to be designated a hedging relationship (Note 18(g)).
- b) Transportation Costs - Effective for fiscal years beginning on or after October 1, 2003, the CICA issued Handbook Section 1100 "Generally Accepted Accounting Principles" which defines the sources of GAAP that companies must use and effectively eliminates industry practice as a source of GAAP. In prior years, it had been industry practice for companies to net transportation charges against revenue rather than showing transportation charges as a component of operating expense on the consolidated statement of income. Effective January 1, 2003, the Company has recorded revenue gross of transportation charges and has recorded transportation charges as an operating expense on the consolidated statement of income. This adjustment of \$655,885 (2003 - \$482,364) has no impact on net earnings, per common share calculations, or cash flow for the Corporation.
-

December 31, 2004 and 2003

5. PROMISSORY NOTE

During the current year, a dividend of \$665,816 was declared on Class "A" Common shares and paid in order to retire the promissory note prior to the amalgamation with Rhodes Resources Corp. (Note 16a). The promissory note due from the parent company was payable on demand, bore interest at 7.5% annually, and was secured by a promissory note. Any payments received were applied, firstly, to accrued interest and the balance, if any, as a reduction of principal. The promissory note of \$665,816 was offset by amounts payable to the parent company of \$106,092. The fair value of this note was not disclosed as it was not practicable to determine fair value with sufficient reliability.

6. RELATED PARTY TRANSACTIONS

Except as disclosed elsewhere in these consolidated financial statements, the Corporation had the following related party transactions:

- a) The Corporation entered into transactions with the following related parties:

Capital Strategies Canada Corp., controlled by the officers of the Corporation
 Rhodes Resources Corp., related due to common control (Note 6 (f))
 Rhodes Resources Inc., related due to common control
 Rhodes Petroleum Corp., related due to common control
 Terra Capital Corp., significant shareholder (44%)
 Forterra Properties Inc., related due to common control
 Pioneer Land Services Ltd. – a director, is an employee of Pioneer
 Borden Ladner Gervais LLP – Corporate Secretary and director are partners with the law firm

- b) Transactions

| | 2004 | 2003 |
|-----------------------------------------------------------------------------------------------------------------------------|------------|--------------|
| Interest revenue – Rhodes Resources Inc. | \$ - | \$ 46,452 |
| Expenses | | |
| Management fee – Terra Capital Corp. (Note 6(d)) | 619,431 | 1,397,453 |
| Consulting – Pioneer Land Services Ltd. | 13,676 | |
| Legal Consulting – Borden Ladner Gervais LLP | 115,406 | |
| Compressor Rental – Rhodes Petroleum Corp., of which \$37,050 is included in accounts payable. | 37,050 | |
| Rent – Capital Strategies Canada Corp. | 3,750 | 26,673 |
| | \$ 789,313 | \$ 1,424,126 |
| Other | | |
| Recorded as part of Oil and Gas Properties – Pioneer Land Services Ltd., of which \$31,000 is included in accounts payable. | \$ 79,105 | \$ - |
| Recorded as part of Share issuance cost – Borden Ladner Gervais LLP, of which \$144,000 is included in accounts payable. | 216,000 | - |
| | \$ 295,105 | \$ - |

December 31, 2004 and 2003

6. RELATED PARTY TRANSACTIONS (continued)

- c) Revenue and expense transactions are in the normal course of operations and have been valued in these consolidated financial statements at the exchange amount which is the amount of consideration established and agreed to by the related parties.
- d) Management fees have been paid to Terra Capital Corp for management personnel services, vehicles, office furniture, and equipment leasing. Prior to amalgamation and up to March 31, 2004 all personnel were employees of Terra Capital Corp. Subsequent to amalgamation, new employment contracts were implemented with all employee and effective April 1, 2004 employees were paid by the Corporation.
- e) During 2003, the Corporation declared a dividend in kind to its common shareholder for certain petroleum and natural gas properties with a carrying value of \$296,697. The transaction was recorded at carrying values of the assets conveyed. No gain or loss was recognized.
- f) During 2003 the Corporation issued 2,500,000 preferred shares at \$1 per share in consideration for a cash payment by its parent company, Terra Capital Corp. These shares are redeemable by the Corporation at \$1 per share. Subsequent to year end, these preferred shares were converted to common shares upon amalgamation with Rhodes Resources Corp.
- g) During 2003, the Corporation purchased all the outstanding shares of Rhodes Resources Inc., a company under common control. The assets consisted of oil and gas properties with a net book value of \$100,000. A note payable for \$100,000 by the Corporation to Rhodes Petroleum Corp. was issued for consideration of this transaction (Note 5). Rhodes Resources Inc. was immediately wound up into the Corporation.

7. OIL AND GAS PROPERTIES

| | 2004 | 2003 |
|-------------------------------------------------------------|----------------------|---------------|
| Cost | | |
| Oil and gas properties | | |
| Exploration, development and related equipment expenditures | \$ 25,032,278 | \$ 6,690,597 |
| Property costs, net of dispositions | 42,339,604 | 8,079,947 |
| Asset retirement obligation | 3,670,049 | 623,689 |
| | 71,041,931 | 15,394,233 |
| Accumulated depletion | (6,733,653) | (2,863,653) |
| Net book value | \$ 64,308,278 | \$ 12,530,580 |

December 31, 2004 and 2003

7. OIL AND GAS PROPERTIES (continued)

The Corporation has recorded an additional asset retirement obligation for 2004 of \$3,046,360 (2003 - \$151,472), of which \$751,001 relating to oil and gas properties acquired on December 31, 2004 (Note 3(d)) was excluded from the depletion base.

Included in exploration, development and related equipment expenditures are \$443,100 (2003 - \$303,000) of equipment and supplies which was excluded from the depletion base.

Included in property cost are undeveloped land costs of approximately \$1.8 million (2003 - \$nil) and \$32,390,549 relating to the oil and gas properties acquired on December 31, 2004 (Note 3(d)), which was excluded from the depletion base.

General administrative expenses of \$240,000 (2003 - \$Nil) have been capitalized to property and equipment.

The Corporation applied the ceiling test to its capitalized assets at December 31, 2004 and determined that there was no impairment of such carrying costs.

The following table outlines benchmark prices used in the impairment test at December 31, 2004:

| Year | WTI Crude Oil US\$/bbl | Exchange Rate US\$/CDN\$ | Edm Light Crude Cdn\$/bbl | AECO Natural Gas CDN\$/GJ |
|-----------------------------|---------------------------|-----------------------------|------------------------------|------------------------------|
| 2005 | 42.00 | 0.83 | 49.60 | 6.45 |
| 2006 | 39.50 | 0.83 | 46.60 | 6.20 |
| 2007 | 37.00 | 0.83 | 43.50 | 6.05 |
| 2008 | 35.00 | 0.83 | 41.10 | 5.80 |
| 2009 | 34.50 | 0.83 | 40.50 | 5.70 |
| Thereafter (inflation %) | 2%/yr | 0%/yr | 2%/yr | 1%/yr |

December 31, 2004 and 2003

8. REVOLVING LOAN

The Corporation has available a revolving line of credit of up to \$18.0 million (2003 - \$8.0 million), which bears interest at prime plus 0.50% (2003 – 0.25%), a monthly standby of fee of 0.175% of the undrawn portion, and is due January 2006. The facility is secured by a general security agreement, a floating charge debenture in the amount of \$35 million and an unlimited liability guarantee by Terra Energy and Constar Resources Ltd. At December 31, 2004, the Corporation was indebted on the revolving line of credit in amount of \$15,862,373 (2003 - \$7,567,154).

During the year ended December 31, 2004 the Corporation renegotiated its credit facility to require repayment with at least one year's notice from the bank. As a result the liability has been classified as a non-current liability. In addition, the credit facility includes a change of control clause whereby in the event of any change of control, the creditor, at their discretion, may terminate the credit facility and therefore the entire amount outstanding will be due and payable upon demand.

As at December 31, 2004 the Corporation was in compliance with all loan covenants.

9. SUBORDINATED DEBT

During the year, the Corporation had available a standby mezzanine financing credit facility of \$15.0 million, with an interest rate of 10% per annum. At December 31, 2004, the Corporation had drawn \$10.0 million on this facility. The unadvanced portion of \$5.0 million was cancelled and is no longer available to be drawn subsequent to December 31, 2004.

The facility charged a standby fee of 5% on the unadvanced portion of \$5.0 million and a closing fee of 0.75% on the advanced portion of \$10.0 million. The Corporation also issued 5 million warrants, with each warrant to purchase one common share, at prices between \$1.20 and \$1.60 (Note 12). These amounts have been included as part of deferred financing charges and will be amortized over the next six months. The facility shall be repaid in full on or prior to June 30, 2005 (Note 19 (a)). The facility is secured by a floating charge debenture on the Corporation's assets, subordinated to the Corporation's existing security issued in relation to the Revolving Loan (Note 8).

The proceeds were used to purchase certain properties (Note 3(d)).

10. ASSET RETIREMENT OBLIGATION

Effective January 1, 2003, the Corporation changed its policy on accounting for liabilities associated with site restoration and abandonment of its oil and gas properties. The undiscounted amount of expected cash flows required to settle the asset retirement obligations is estimated at \$5,866,000 (2003 - \$1,157,960). The liability for the expected cash flows, as reflected in the consolidated financial statements, has been discounted at 9% (2003 – 9%).

December 31, 2004 and 2003

10. ASSET RETIREMENT OBLIGATION (continued)

The schedule below is a reconciliation of the Corporation's liability for the year ended December 31, 2004:

| | <u>2004</u> | <u>2003</u> |
|--------------------------------------------|---------------------|-------------------|
| Asset retirement obligation at January 1 | \$ 742,568 | \$ 514,718 |
| Current period liabilities | 3,008,563 | 151,472 |
| Current period accretion expense | 270,012 | 76,378 |
| Asset retirement obligation at December 31 | <u>\$ 4,021,143</u> | <u>\$ 742,568</u> |

Costs attributable to these commitments and contingencies are expected to be incurred between 2006 and 2015 and are to be funded mainly from the Corporation's cash provided by operating activities. Although the ultimate impact of these matters on net earnings cannot be determined at this time, it could be material for any one quarter or year.

11. PREFERRED SHARES

The Corporation has issued and outstanding Series I to V, 8% cumulative preferred shares, which are redeemable and retractable at \$1 per share. The number of shares outstanding at December 31, 2004 was 1,148,641 (2003 – 1,148,641), which are all held by a senior officer of the Corporation. All dividends have been paid to December 31, 2004. As these shares are retractable at the option of the holder and redeemable at the option of the Corporation, a liability in the amount of \$1,148,641 (2003 - \$1,148,641) has been reflected in the Corporation's consolidated financial statements. The holder of the preferred shares has waived the right to redeem these shares prior to January, 2006. As a result, the liability has been classified as long-term debt. During the current year, dividends of \$81,664 were paid. These amounts have been recorded as of long term debt interest.

During 2003, the Corporation paid a dividend to its parent of \$2,500,000 on Class A common shares. Additional Class A common share dividends of \$1,065,012 were paid in kind (Note 16(e) and (h)). The parent then subscribed for \$2,500,000 Series VI 8% cumulative preferred shares at \$1 per share. These shares were non-retractable and redeemable after February 1, 2004. As a part of the transaction described in Note 3, these preferred shares were exchanged for common shares during the current year.

December 31, 2004 and 2003

12. SHARE CAPITAL

a) Authorized

- i) Unlimited number of common voting shares
- ii) Unlimited number of preferred shares

Issued

b) Common Shares Issued:

| | Number | Amount |
|---------------------------------------------------------------------------------------------------------------------------------|--------------------|----------------------|
| Balance, December 31, 2003 | 22,500,000 | \$ 1 |
| Share reduction as a result of amalgamation (Note 3 b) | (3,952,696) | - |
| | 18,547,304 | 1 |
| Issued for preferred Series VI share conversion (Note 3 b) | 3,429,752 | 3,429,752 |
| Issued on acquisition (amalgamation) of Rhodes Resources Corp. (Note 3 b) | 5,417,374 | 4,495,100 |
| Issued on acquisition (amalgamation) of Fossil Bay Resources Ltd. (Note 3 c) | 616,113 | 790,000 |
| Issued as consideration for certain oil and gas properties (Note 16 b) | 200,000 | 250,000 |
| Issued on exercise of warrants | 807,150 | 685,302 |
| Issued on exercise of options | 118,464 | 100,714 |
| Issued pursuant to flow through share agreement, net of tax effected share issuance costs, at \$1.40 per share | 3,450,000 | 4,127,681 |
| Issued pursuant to flow through share agreement, net of tax effected share issuance costs, at \$1.40 per share | 5,596,854 | 7,242,119 |
| Issued pursuant to flow through share agreement, net of tax effected share issuance costs, at \$1.40 per share | 1,075,000 | 1,418,550 |
| Issued pursuant to share placement agreements net of tax effected share issuance costs, at \$1.25 per share | 3,000,000 | 2,974,371 |
| Income tax effect of flow through share renouncement related to flow shares issued through the Corporation and its predecessors | | (4,977,200) |
| Reclassification of contributed surplus amounts (Note 13) | | 318,500 |
| Shares repurchased | (249,400) | (74,072) |
| Balance, December 31, 2004 | 42,008,611 | \$ 20,780,818 |

On October 31, 2003 Terrapet completed a 220,588:1 stock split. All number of shares and per share amounts has been restated to reflect the stock split for 2003.

December 31, 2004 and 2003

12. SHARE CAPITAL (continued)

The Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 250,000 common shares to April 22, 2005. During the period ended December 31, 2004, 249,400 common shares were purchased.

Series VI Preferred Shares Issued:

| | Number | Amount |
|----------------------------------------------|-------------|--------------|
| Balance December 31, 2003 | 3,429,752 | \$ 3,429,752 |
| Reduction due to conversion to common shares | (3,429,752) | (3,429,752) |
| Balance, December 30, 2004 | - | \$ - |

No cumulative dividends are in arrears at December 31, 2004.

Pursuant to an escrow agreement and the policies of the TSX Venture Exchange, 19,731,522 common shares of the Corporation were deposited in escrow at the amalgamation date. The shares have been released as follows:

- (i) 4,636,826 on February 12, 2004
- (ii) 236,844 on March 20, 2004
- (iii) 4,636,826 on August 12, 2004
- (iv) 236,844 on September 20, 2004

The remaining escrowed common shares shall be released as follows:

- (i) 4,636,826 on February 12, 2005.
- (ii) 236,844 on March 20, 2005.
- (iii) 4,636,826 on August 12, 2005
- (iv) 236,844 on September 20, 2005
- (v) 236,842 on March 20, 2006.

On February 12, 2005 and March 20, 2005 4,636,826 and 236,844 common shares, respectively, were released.

December 31, 2004 and 2003

12. SHARE CAPITAL (continued)

c) Stock Options:

The Corporation has adopted an Employee Stock Option Plan whereby officers, directors, employees, and consultants may be granted options of up to 3,000,000 to purchase common shares of the Corporation subject to various vesting periods and other terms and conditions specified in the stock option plan. At December 31, 2004 options have been granted to purchase 2,483,000 common shares (December 31, 2003 - nil) ranging at prices between \$0.75 and \$1.00 with expiry dates between December 31, 2005 and February 11, 2009.

Details of all options outstanding are as follows:

| | Number | Weighted Average Exercise Price |
|--------------------------------------------------------------------------------------------------------------------------------|------------------|------------------------------------------|
| Employee Stock Options | | |
| Balance December 31, 2003 | - | \$ - |
| Granted on acquisition (amalgamation) of Rhodes Resources Corp. under stock option plan | 312,000 | 0.75 |
| Granted under the stock option plan in the current year | 2,797,000 | 1.00 |
| Exercised during the current period | (105,000) | (0.76) |
| Expired during the current period | (521,000) | (0.99) |
| Employee Stock Options Balance, December 31, 2004 | 2,483,000 | \$ 0.98 |
| Agent Options | | |
| Balance December 31, 2003 | - | - |
| Granted on acquisition (amalgamation) of Rhodes Resources Corp. These options expire between December, 2005 and January, 2006. | 224,400 | 1.00 |
| Granted as part of flow through share issuance. These options will expire August 29, 2006 | 241,500 | 1.40 |
| Granted as part of share issuance. These options will expire December 31, 2006 | 601,780 | 1.40 |
| Exercised during the current period | (13,464) | (1.00) |
| Balance December 31, 2004 | 1,054,216 | \$ 1.32 |
| Other Options | | |
| Balance December 31, 2003 | 400,000 | 1.00 |
| Cancelled upon amalgamation with Terra Energy Corp. and Rhodes Resources Corp. | (400,000) | (1.00) |
| Granted as part of amalgamation of Terra Energy Corp. and Rhodes Resources Corp. These options expire December 31, 2006. | 329,730 | 1.21 |
| Total Options Balance December 31, 2004 | 3,866,946 | \$ 1.10 |

December 31, 2004 and 2003

12. SHARE CAPITAL (continued)

| Options Exercise Price \$ | Weighted Average Remaining Contract Life | Outstanding December 31, 2004 | Weighted Average Share Price for Outstanding Options \$ | Exercisable December 31, 2004 | Weighted Average Share Price for Exercisable Options \$ | Weighted Average Term for Exercisable Options |
|---------------------------|------------------------------------------|-------------------------------|---------------------------------------------------------|-------------------------------|---------------------------------------------------------|-----------------------------------------------|
| 0.75 | 4.13 years | 222,000 | | 210,000 | | |
| 1.00 | 4.13 years | 2,111,000 | | 333,000 | | |
| 1.00 | 1.00 years | 210,936 | | 210,936 | | |
| 1.16 | 4.95 years | 150,000 | | 30,000 | | |
| 1.21 | 2.00 years | 329,730 | | 329,730 | | |
| 1.40 | 1.67 years | 241,500 | | 241,500 | | |
| 1.40 | 2.00 years | 601,780 | | 601,780 | | |
| | 3.83 years | 3,866,946 | 1.10 | 1,956,946 | 1.18 | 2.49 years |

d) Stock-based compensation

For stock options granted to employees, compensation expense of \$562,000 has been recorded for the period ending December 31, 2004 with the offsetting charge to contributed surplus. The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yields (Nil); expected volatility at 50%; risk-free interest rate of 3.5%; weighted average life of 3-4 years.

e) Warrants

The Corporation issued in exchange for warrants previously granted by Rhodes Resources Corp., the following warrants:

- i) 1,066,667 warrants exercisable to purchase one common share at \$1.00 per common share. During the current year 436,000 warrants were exercised. Of these amounts there were 630,667 warrants outstanding with 320,000 expiring March 7, 2005, and 310,667 expiring October 28, 2005.
- ii) 687,500 warrants exercisable to purchase one common share at \$1.10 per share until December 31, 2004, and at \$1.20 per share until December 31, 2005 at which time these warrants will expire. During the current year, 321,000 warrants were exercised. Of these amounts, 366,500 warrants have not been exercised at December 31, 2004.
- iii) 70,000 warrants exercised to purchase one common share at \$1.10 per share until January 29, 2005 and \$1.20 until January 29, 2006. No amounts were exercised at December 31, 2004

During the current year the Corporation issued the following warrants:

- i) 1,250,000 warrants exercisable to purchase one common share at \$1.20 per share until December 31, 2006 (Note 9).

December 31, 2004 and 2003

12. SHARE CAPITAL (continued)

- e) Warrants (continued)
- ii) 1,250,000 warrants exercisable to purchase one common share at \$1.40 per share until June 30, 2007 (Note 9).
 - iii) 2,500,000 warrants exercisable to purchase one common share at \$1.40 per share until December 31, 2006 and at \$1.60 per share until June 30, 2007 when these warrants expire (Note 9).
 - iv) 1,500,000 warrants exercisable to purchase one-half common share at \$1.40 per share until December 30, 2006 and at \$1.60 per share until December 31, 2007 when these warrants expire.
 - v) The Corporation issued in exchange for warrants previously issued by Fossil Bay Resources Ltd. 88,856 warrants exercisable to purchase one common share at \$15.00 per share until June 30, 2005 when these warrants expire.

13. CONTRIBUTED SURPLUS

Contributed Surplus consists of the fair value of both share warrants issued for various financing agreements and for the stock based compensation on employee stock options. Values were determined using the Black Scholes Model using the assumptions of no dividends being paid; risk free interest rates of 3%; and an expected volatility of 50%.

The details of contributed surplus are as follows:

| | Amount |
|---------------------------------------------------------------------------------------------------|------------------|
| Balance, December 31, 2003 | - |
| Issued for options and warrants assumed upon acquisition (amalgamation) of Rhodes Resources Corp. | 875,000 |
| Stock based compensation provision for the year | 562,000 |
| Issued for agent's options granted during the year | 279,042 |
| Issued for warrants granted during the year | 2,798,650 |
| Reclassification resulting from exercise of options and warrants | (318,500) |
| Balance, December 31, 2004 | 4,196,192 |

December 31, 2004 and 2003

14. FUTURE INCOME TAXES

- a) The components of future income tax balances are as follows:

| | <u>2004</u> | <u>2003</u> |
|-----------------------------------------|---------------------|---------------------|
| Oil and gas properties | \$ 1,610,901 | \$ 527,450 |
| Unexpended flow through renounced | 4,282,577 | - |
| Deferred partnership income | 2,492,096 | 1,231,473 |
| Attributed crown royalty income benefit | (180,000) | - |
| Non-capital loss carryforwards | (3,652,242) | - |
| Share issuance costs | 830,520 | - |
| Deferred financing costs | (567,552) | - |
| Future income tax liability | <u>\$ 4,816,300</u> | <u>\$ 1,758,923</u> |

- b) The provision for income taxes recorded in the consolidated financial statements differs from the amount which would be obtained by applying the statutory income tax rate of 39% (2003 - 35%) to the earnings for the following years as follows:

| | <u>2004</u> | <u>2003</u> |
|-----------------------------------------------------------|-----------------------|-------------------|
| Expected income tax expense | \$ 74,605 | \$ 460,678 |
| Crown royalties | 870,417 | 637,592 |
| Resource allowance | (701,507) | (411,524) |
| Change in income tax rate | - | (177,061) |
| Stock based compensation and other non-deductible items | 219,180 | - |
| Adjustment to opening tax pool balances | 195,000 | - |
| Recognition of previously unrecognized income tax benefit | (1,805,548) | 6,094 |
| Other | 37,267 | - |
| Actual income tax expense | <u>\$ (1,110,586)</u> | <u>\$ 515,779</u> |

15. STATEMENT OF CASH FLOWS

Change in non-cash working capital items

| | <u>2004</u> | <u>2003</u> |
|------------------------------------------|---------------------|-----------------------|
| Accounts receivable | \$ (585,406) | \$ (1,125,595) |
| Inventory | - | (50,863) |
| Income taxes | 202,649 | (14,592) |
| Prepaid expense | (733,741) | (61,761) |
| Accounts payable and accrued liabilities | 3,196,281 | (60,189) |
| | <u>\$ 2,079,783</u> | <u>\$ (1,313,000)</u> |

December 31, 2004 and 2003

15. STATEMENT OF CASH FLOWS (continued)

Other information

| | 2004 | 2003 |
|-----------------------|------------|------------|
| Interest paid | \$ 285,758 | \$ 453,022 |
| Income taxes received | \$ 140,818 | \$ - |
| Income taxes paid | \$ 74,778 | \$ 6,302 |

16. NON-CASH TRANSACTIONS

- a) In lieu of settlement of the promissory note, dividends of \$665,816 (2003 - \$1,065,012) were declared for balances due to related parties (Note 5).
 - b) During the current year, certain properties were purchased from an unrelated party for \$1 million. As part of the consideration, 200,000 common shares valued at an estimated fair market value \$250,000 were issued by the Corporation to the vendor.
 - c) Equipment previously included in inventory in the amount of \$443,102 (2003 - \$nil) has been reclassified to oil and gas properties.
 - d) During 2003 and prior to the amalgamation, the Corporation acquired Rhodes Resources Inc. in exchange for a note payable of \$100,000 (Note 5).
 - e) During 2003 and prior to the amalgamation, petroleum and natural gas properties with a carrying value of \$296,697 were exchanged for a dividend in kind of this amount (Note 6(b)).
 - f) Various capital expenditures in the amount of \$5,308,883 (2003 - \$446,875) were incurred in the year and paid subsequent to year end. An additional \$92,400 was included in year accounts payable for share issue costs which have been treated as a non-cash item.
 - g) During 2003 and prior to the amalgamation, the Corporation issued Series VI Preferred Shares in exchange for net assets of Constar Resources Ltd. for \$929,752 (Note 3).
 - h) During 2003 and prior to the amalgamation, a dividend of \$768,315 was declared by the Corporation to satisfy an amount due to related parties.
-

December 31, 2004 and 2003

17. FINANCIAL INSTRUMENTS

As disclosed in Note 2, the Corporation holds various forms of financial instruments. The nature of these instruments and the Corporation's operations expose the Corporation to interest rate, commodity price and industry credit risks. The Corporation manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

Credit Risk

Credit risk arises from the possibility that the entities to which the Corporation sells its oil and gas production to may experience difficulty and be unable to fulfill their obligations. The Corporation is exposed to financial risk that arises from the credit quality of the entities to which it provides services.

Interest Rate Risk

The Corporation manages its exposure to interest rate risk through floating rate borrowings. 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, the increase or decrease in net earnings before taxes for each 1% change in interest rates on floating rate debt amounts to approximately \$158,673 (2003 - \$75,670) per annum. The related disclosure regarding these debt instruments is included in Note 8 of these consolidated financial statements.

Currency Risk

Currency risk is the risk to the Corporation's earnings that arise from fluctuations of foreign exchange rates and the degree of volatility of these rates. The Corporation does not use derivative instruments to reduce its exposure to foreign currency risk.

Commodity Price Contracts

The Corporation is party to certain off-balance sheet derivative instruments, including crude oil and natural gas swap contracts. The Corporation enters into these contracts for the purpose of protecting its future earnings and cash flow from operations from the volatility of crude oil and natural gas commodity prices. The swap contracts reduce the fluctuations in petroleum and natural gas revenues by locking in fixed forward prices on a portion of the Corporation's crude oil and natural gas production.

Fair Value Risk

The fair value of related party loans may be different from the carrying value, as these amounts are unsecured, non-interest bearing and are payable on demand. No assessment of the fair value of these financial instruments has been completed as there is no readily available market price.

December 31, 2004 and 2003

18. COMMITMENTS AND CONTINGENCIES

- a) The Corporation is subject to various regulatory and statutory requirements relating to the protection of the environment. These requirements, in addition to contractual agreements and management decisions, result in the accrual of estimated future removal and site restoration costs. Any changes in these estimates will affect future earnings.

Costs attributable to these commitments and contingencies are expected to be incurred over an extended period of time and are to be funded mainly from the Corporation's cash provided by operating activities. Although the ultimate impact of these matters on net earnings cannot be determined at this time, it could be material for any one quarter or year.

- b) The Corporation had outstanding letters of credit to various parties for a total of \$250,000 which expire at various dates during 2005.

Subsequent to the year end, additional letters of credit were obtained for \$ 702,000. Of these amounts, \$73,000 will expire on the 1st day of each month until November, 2005. The remaining \$45,000 will expire in January, 2006.

- c) The Corporation is currently involved in litigation with an industry participant who is claiming \$685,850 in respect of breach of contract related to payment on account of Authorizations for Expenditures related to the development of certain lands and pipelines. The Corporation is contesting this claim. It is management's opinion that an adequate provision has been recorded in these consolidated financial statements. Additional amounts, if any, required to resolve these matters, will be recorded in the period of determination.
- d) The Corporation is currently involved in litigation with three registered landowners who are claiming \$85,000 in respect of breach of contract and trespass related to activities on or near land owned by the plaintiffs. The Corporation is contesting this claim. No provision has been recorded in these consolidated financial statements. Additional amounts, if any, required to resolve these matters, will be recorded in the period of determination.
- e) The Corporation is currently involved in litigation brought by an industry participant relating to a claim of ownership or equitable ownership in a natural gas lease covering a one-quarter Section of land. The Corporation is contesting this claim. No provision has been recorded in these consolidated financial statements, as no damage amount has been quantified in this claim. Amounts, if any, required to resolve this matter will be recorded in the period of determination. In addition, the Company has \$160,000 included in accounts receivable from this industry participant which the Corporation as agreed not to demand until final settlement of this lawsuit. It is management's opinion that the amount accrued will be recovered. This accrual is subject to measurement uncertainty.
- f) The Corporation is under a lease agreement for its office premise until October, 2005. The monthly rental and common area payments pursuant to the lease agreement is \$12,758.
-

December 31, 2004 and 2003

18. COMMITMENTS AND CONTINGENCIES (continued)

- g) The Corporation has entered into contracts to hedge commodity prices. The terms of the contracts are summarized as follows:

| Contract Type | Floor Price | Ceiling Price | Remaining Volume | Contract Term |
|---------------|------------------------------------------------------------|------------------|------------------|-----------------------------------------|
| Financial | \$6.00 per GJ Floor with Protection of \$1.00 per GJ | \$8.95 per GJ | 365,000GJ | November 1, 2004 to October 31, 2005 |
| Financial | \$35.35 | N/A | 36,500bbl | January 1, 2005 to December 31, 2005 |
| Financial | \$36.65 | N/A | 36,500bbl | January 1, 2005 to December 31, 2005 |

N/A – not applicable

The amount that the Corporation would be required to pay if all the contracts were cancelled at December 31, 2004 would approximate \$833,334 (2003 - \$219,000).

- h) The Corporation has available a swap facility of up to \$3.0 million. The Corporation may enter commodity swap contracts with terms of less than one year and may not exceed 2/3 of the Corporation's average daily production, net of royalties, for the fiscal quarter prior to the date the contract is entered into. The facility is secured by a general security agreement, a floating charge debenture in the amount of \$35 million and an unlimited liability guarantee by Terra Energy, Terragrande Energy Limited, and Constar Resources Ltd. At December 31, 2004 and 2003, there were no swap contracts outstanding.
- i) The Corporation is required to incur exploration and development activities by December 31, 2005 of approximately \$13,915,600 as a result of flow through shares issued 2004. As at December 31, 2004, the Corporation has incurred qualifying expenditures of approximately \$1,466,000.

19. SUBSEQUENT EVENTS

- (a) The subordinated debt balance (Note 9) of \$10 million dollars outstanding at December 31, 2004 was repaid on March 29, 2005.
- (b) Subsequent to year end the Corporation issued 6,561,200 Share Units with each consisting of one common share and one half common share warrant for gross proceeds of \$8,201,500 and 3,366,361 Flow-Through Shares for gross proceeds of \$4,712,905. The Corporation also issued 694,929 agent's options as part of the share issuance. These options are exercisable for one common share at \$1.40 and expire January 26, 2007.