

**Terra Energy Corp.**  
**Consolidated Financial Statements**  
**For the years ended December 31, 2007 and**  
**2006**

Contents

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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, 2007 and 2006 and the consolidated statements of operations, comprehensive income (loss) and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Corporation'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 consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2007 and 2006 and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

(signed) "Deloitte & Touche LLP"

February 29, 2008 except for note 16 which is dated April 14, 2008

Chartered Accountants

**Terra Energy Corp.**  
**Consolidated Balance Sheets**  
**As at December 31**

**2007**

**2006**

**Assets**

**Current**

Accounts receivable	\$ 7,960,046	\$ 5,752,846
Financial instruments (Note 3)	-	1,841,861
Prepaid expenses	1,076,879	1,261,720

**9,036,925**                      8,856,427

**Oil and gas properties (Note 5)**

**157,024,959**                      138,704,967

**\$166,061,884**                      \$147,561,394

**Liabilities and Shareholders' Equity**

**Current**

Bank overdraft (Note 6)	\$ 1,828,943	\$ 8,412,852
Accounts payable and accrued liabilities	21,485,964	10,775,251
Asset retirement obligation (Note 7)	398,798	-
Financial instruments (Note 3)	567,483	-

**24,281,188**                      19,188,103

**Deferred credit (Note 13)**

**182,670**                      249,090

**Long-term financing (Note 6)**

**54,631,003**                      35,478,837

**Asset retirement obligation (Note 7)**

**5,166,555**                      5,033,926

**Future income taxes (Note 11)**

**12,933,520**                      10,245,725

**97,194,936**                      70,195,681

**Shareholders' Equity**

**Share capital and warrants (Note 9(b))**

**65,195,721**                      73,004,715

**Contributed surplus (Note 10)**

**9,365,272**                      7,838,602

**Deficit**

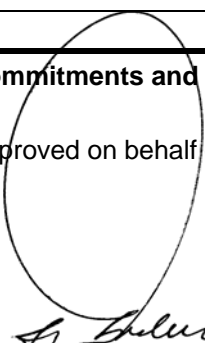
**(5,694,045)**                      (3,477,604)

**68,866,948**                      77,365,713

**\$166,061,884**                      \$147,561,394

**Commitments and contingencies (Notes 14 and 15), Subsequent events (Note 16)**

Approved on behalf of the Board:



Theodore Anderson, Director



Robert Penner, Director

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**Terra Energy Corp.****Consolidated Statements of Operations, Comprehensive Income (Loss) and Deficit****For the years ended December 31****2007****2006**

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**Revenue**

Petroleum and natural gas	<b>\$49,334,797</b>	\$45,101,148
Realized gain on financial instruments (Note 3)	<b>1,035,524</b>	937,211
Unrealized gain or (loss) on financial instruments (Note 3)	<b>(2,409,344)</b>	1,841,861
	<b>47,960,977</b>	47,880,220
Royalties	<b>(10,397,746)</b>	(9,107,294)
	<b>37,563,231</b>	38,772,926

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**Expenses**

Production	<b>15,356,361</b>	13,289,212
General and administrative	<b>4,310,677</b>	3,950,746
Accretion	<b>462,300</b>	415,645
Stock based compensation	<b>1,182,479</b>	2,743,436
Depletion and amortization	<b>17,335,354</b>	13,586,765
Interest on long-term debt	<b>3,483,975</b>	2,288,280
Unrealized foreign exchange gain (Note 3)	<b>(336,420)</b>	-
Realized foreign exchange gain (Note 3)	<b>(50,293)</b>	(807,660)
	<b>41,744,433</b>	35,466,424

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**Income (loss) before income taxes****(4,181,202)**3,306,502

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**Income tax expense (Note 10)**

Current tax	<b>1,374</b>	32,346
Future tax (recovery)	<b>(2,416,905)</b>	2,386,504
	<b>(2,415,531)</b>	2,418,850

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**Net income (loss) and Comprehensive income (loss) for the year****(1,765,671)**

887,652

**Deficit, beginning of year****(3,477,604)**

(1,259,194)

**Repurchase of common shares (Note 9(b))****(450,770)**

(3,106,062)

**Deficit , end of year****\$ (5,694,045)**\$ (3,477,604)

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## Income (loss) per share (Note 9(e))

Basic	\$	(0.02)	\$	0.01
Diluted	\$	(0.02)	\$	0.01

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**Terra Energy Corp**  
**Consolidated Statements of Cash Flows**  
**For the years ended December 31**

	2007	2006
<b>Cash flows from operating activities</b>		
Net income (loss) for the year	\$(1,765,671)	\$ 887,652
Items not affecting cash:		
Future income taxes	(2,416,905)	2,386,504
Accretion	462,300	415,645
Stock based compensation	1,182,479	2,743,436
Unrealized loss (gain) on financial instruments (Note 3)	2,409,344	(1,566,348)
Unrealized gain on foreign exchange	(336,420)	-
Amortization of deferred credit	(66,420)	(38,869)
Depletion, depreciation and amortization	17,335,354	13,586,765
	<b>16,804,061</b>	<b>18,414,785</b>
Changes in non-cash working capital from operations (Note 12)	2,754,669	269,043
	<b>19,558,730</b>	<b>18,683,828</b>
<b>Cash flows from financing activities</b>		
Proceeds from long-term financing	19,488,586	5,868,446
Increase (decrease) in bank overdraft	(6,583,909)	8,412,852
Issuance of common shares, net of issuance costs	211,356	20,453,165
Repurchase of preferred shares (Note 8)	-	(1,148,641)
Repurchase of common shares	(3,022,229)	(6,339,284)
	<b>10,093,804</b>	<b>27,246,538</b>
<b>Cash flows from investing activities</b>		
Additions to oil and gas properties	(39,170,209)	(57,513,729)
Disposition of oil and gas properties	3,583,990	8,824,779
Reimbursement of leasehold improvements (Note 13)	-	298,905
Changes in non-cash working capital from investing (Note 12)	5,933,685	(10,667,637)
	<b>(29,652,534)</b>	<b>(59,057,682)</b>
<b>Increase (decrease) in cash and cash equivalents</b>	<b>-</b>	<b>(13,127,316)</b>
<b>Cash and cash equivalents (bank overdraft), beginning of year</b>	<b>-</b>	<b>13,127,316</b>
<b>Cash and cash equivalents, end of year</b>	<b>\$ -</b>	<b>\$ -</b>

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

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**1. NATURE OF OPERATIONS**

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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 in Western Canada.

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**2. SIGNIFICANT ACCOUNTING POLICIES**

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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 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.

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.

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.

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

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**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

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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 quoted benchmark prices in effect at year end and current costs, and after deducting estimated, production related expenses, abandonment and reclamation costs. 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 associated 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.

Asset Retirement Obligation ("ARO")

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 out 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. Revisions to the estimated undiscounted cost would also be an increase or decrease to the ARO. Actual costs incurred upon settlement of the ARO are charged against the ARO to the extent of the liability recorded. Any difference between the actual costs incurred upon settlement of the ARO and the recorded liability is recognized in the Corporation's earnings in the period in which the settlement occurs.

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

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**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

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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.

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. A future tax liability is recognized upon the renunciation of tax pools and related filings with the tax authorities, and share capital is reduced.

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 accordance 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.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which were fully tradable with no vesting restrictions. This option valuation model requires the input of highly subjective assumptions including the expected stock price volatility. Because the Corporation's stock options and performance incentive warrants have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the calculated fair value, such value is subject to measurement uncertainty.

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

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

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**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

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Measurement Uncertainty (continued)

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

The Corporation follows the fair value method for stock options granted to employees, directors and service providers. The Corporation recognizes compensation expense, with corresponding increase to contributed surplus, based on the fair value of the options at the time of grant over the vesting period of grant. The contributed surplus balance is reduced as the options are exercised with the amount initially recognized being credited to share capital.

Per Share Amounts

Basic earnings per share are computed by dividing earnings by the weighted average number of common 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

All financial instruments are initially recognized at fair value on the balance sheet. The Company has classified each financial instrument into one of the following categories: held-for-trading (assets and liabilities), loans and receivables, financial assets available-for-sale, financial assets held-to-maturity, and other financial liabilities. Subsequent measurement of financial instruments is based on their classification.

Financial assets and liabilities "held-for-trading" are subsequently measured at fair value with changes in those fair values recognized in net earnings. Financial assets "available-for-sale" are subsequently measured at fair value with changes in fair value recognized in other comprehensive income, net of tax.

Financial assets "held-to-maturity: "loans and receivables", and "other financial liabilities" are subsequently measured at amortized cost using the effective interest method.

Cash and cash equivalents, commodity contracts, foreign exchange contracts and short term investments which are designated as "held-for-trading" and measured at fair value. Accounts receivable and advances which are designated as "loans and receivables" and measured at amortized cost. Accounts payable and accrued liabilities, bank loan and long-term debt which are designated as "other financial liabilities" and measured at amortized cost.

Transaction costs and premiums or discounts directly attributable to the issuance of long-term debt are added to the fair value of the debt upon initial recognition and expensed to earnings using the effective interest method.

## **2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

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### Changes in Accounting Policies

The Company has adopted two new standards issued by the Canadian Institute of Chartered Accountants relating to accounting for and disclosure of financial instruments which are applicable for fiscal periods beginning on or after October 1, 2006.

Section 1506 – “Accounting Changes” was adopted as of January 1, 2007. The major impact of this Section is to provide disclosure regarding when an entity has not applied a new source of GAAP that has been issued but is not yet effective.

Section 3855 – “Financial Instruments – Recognition and Measurement” prescribes when a financial asset, financial liability or non-financial derivative is to be recognized on the balance sheet as well as its measurement amount, which is dependent upon its classification. This Section also specifies how gains and losses on financial instruments are to be presented.

Section 3865 – “Hedges” expands on and replaces Accounting Guideline 13 – “Hedging Relationships” by specifying how hedge accounting is to be applied and what disclosures are necessary when it is applied. The Company holds no derivative financial instruments or embedded derivatives and does not apply hedge accounting under Section 3865. The Company selected January 1, 2007 as its transition date for accounting for any potential embedded derivatives.

Section 1530 – “Comprehensive Income” introduces new standards for the reporting and disclosure of comprehensive income. Comprehensive income is the change in equity of the Company during the reporting period from transactions and other events and circumstances from non-owner sources such as changes in the fair value of financial instruments designated as cash flow hedges.

Because the Company has no items related to other comprehensive loss under Section 1530, comprehensive loss for the year is equivalent to net loss.

Section 3251 – “Equity” establishes standards for the presentation of equity and changes in equity during the reporting period, effective for fiscal years on or after October 1, 2006.

These standards have been adopted on a prospective basis and did not result in a change to the financial statements.

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

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**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

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Accounting Pronouncements

Section 3862 – “Financial Instruments - Disclosures” and Section 3863 – “Financial Instruments - Presentation” are required to be adopted for years commencing on or after October 1, 2008. The Company will adopt these standards on October 1, 2008. It is expected that the only effect on the Company will be incremental disclosures regarding the significance of financial instruments for the Company’s financial position and performance and further disclosures regarding the nature, extent and management of risks arising from financial instruments to which the Company is exposed.

Section 1535 – “Capital Disclosures” requires disclosure of the objectives, policies and processes for managing capital and compliance with externally imposed capital requirements. This section will be adopted as of January 1, 2008.

Section 3031 – “Inventories” will be adopted on January 1, 2008. This new standard is not expected to have a significant impact on the Company’s financial statements other than for incremental disclosures.

Section 3064 – “Goodwill and intangible assets”. In February 2008, the Canadian Institute of Chartered Accountants (“CICA”) issued Section 3064, Goodwill and intangible assets, replacing Section 3062, Goodwill and other intangible assets and Section 3450, Research and development costs. Various changes have been made to other sections of the CICA Handbook for consistency purposes. The new Section will be applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Company will adopt the new standards for its fiscal year beginning January 1, 2009. It establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The Company is currently evaluating the impact of the adoption of this new Section on its consolidated financial statements. (The Company does not expect that the adoption of this new Section will have a material impact on its consolidated financial statements.)

A decision of the CICA Accounting Standards Board (the “AcSB”) will require the Company to report under International Financial Reporting Standards in 2011, although specific requirements of the transition continue to be under review by the AcSB. The Company is monitoring the requirements but is unable to assess the impact on the financial statements at this time.

### **3. FINANCIAL INSTRUMENTS**

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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, foreign exchange, 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 grants unsecured credit to its customers and is exposed to financial risk that arises from the credit quality of the entities to which it provides services.

#### Interest Rate Risk

The Corporation is exposed 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, 2007, the increase or decrease in net earnings before taxes for each 1% change in interest rates on floating rate debt amounts to approximately \$546,310 (2006 - \$354,788) per annum. The related disclosure regarding these debt instruments is included in Note 6 of these consolidated financial statements.

#### Foreign Exchange Risk

The price received by the Corporation is affected by the Canadian/US dollar exchange rate that may fluctuate over time. The Corporation diversifies its debt by borrowing by way of Canadian Banker's Acceptances and US dollar LIBOR loans and by entering into forward foreign exchange contracts associated with the US dollar LIBOR loans.

#### Commodity Price Risk

The Corporation is party to certain derivative instruments, including crude oil and natural gas contracts. The Corporation enters into these contracts to manage commodity price risk in future earnings and cash flow. These contracts reduce the Corporation's exposure to 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.

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

**3. FINANCIAL INSTRUMENTS (continued)**

At December 31, 2007 the Corporation had outstanding derivative contracts, the terms of which are summarized as follows:

Contract Type	Floor Price	Ceiling Price	Volumes Per Day	Contract Term
Financial	Sell \$92.00 per Bbl	N/A	100 Bbls	January 1, 2008 to December 31, 2008
Financial	Buy \$8.70 per GJ	N/A	3,000 GJ	January 1, 2008 – March 31, 2008
Financial	Sell \$8.05 per GJ	N/A	1,000 GJ	November 1, 2007 to March 31, 2008
Financial	Sell \$7.45 per GJ	N/A	1,000 GJ	April 1, 2007 to March 31, 2008
Financial	Buy \$8.00 per GJ	\$8.60 per GJ	1,000 GJ	November 1, 2007 to March 31, 2008
Financial	Sell \$8.00 per GJ	\$8.60 per GJ	1,000 GJ	November 1, 2007 to March 31, 2008
Financial	Sell \$7.95 per GJ	N/A	1,000 GJ	April 1, 2007 to March 31, 2008
Financial	Buy \$8.20 per GJ	\$9.21 per GJ	1,000 GJ	November 1, 2007 to March 31, 2008
Financial	Buy \$8.25 per GJ	\$9.40 per GJ	1,000 GJ	November 1, 2007 to March 31, 2008
Financial	Buy \$8.50 per GJ	\$9.00 per GJ	1,000 GJ	November 1, 2007 to March 31, 2008
Financial	Sell \$8.20 per GJ	\$9.21 per GJ	1,000 GJ	November 1, 2007 to March 31, 2008
Financial	Sell \$8.25 per GJ	\$9.40 per GJ	1,000 GJ	November 1, 2007 to March 31, 2008
Financial	Sell \$8.50 per GJ	\$9.00 per GJ	1,000 GJ	November 1, 2007 to March 31, 2008

Contract Type	Contract Amount	CAD/USD Exchange Rate	Settlement Amount	Settlement Date
Financial	\$74,524 USD	\$1.0584	\$78,876 CAD	February 22, 2008
Financial	\$4,200,000 USD	\$1.0621	\$4,460,820 CAD	February 22, 2008

The mark to market adjustment of these contracts, based on price quotation in an active market, has been recognized as a liability in the amount of \$567,483 at December 31, 2007 (December 31, 2006 – an asset of \$1,841,861).

At December 31, 2006 the Corporation had outstanding derivative contracts, the terms of which are summarized as follows:

Contract Type	Floor Price	Ceiling Price	Volumes Per Day	Contract Term
Financial	Sell \$86.00 per Bbl	N/A	200 Bbls	June 1, 2006 to May 31, 2007
Financial	Buy \$80.65 per Bbl	N/A	200 Bbls	June 1, 2006 to May 31, 2007
Financial	Sell US \$77.25 per Bbl	N/A	100 Bbls	January 1, 2007 to December 31, 2007
Financial	Buy US \$76.40 per Bbl	N/A	100 Bbls	January 1, 2007 to December 31, 2007
Financial	Sell \$7.50 per GJ	N/A	1,000 GJ	November 1, 2006 to October 31, 2007
Financial	Sell \$6.50 per GJ	\$8.92 per GJ	1,000 GJ	November 1, 2006 to October 31, 2007
Financial	Sell \$7.50 per GJ	N/A	1,500 GJ	December 1, 2006 to December 31, 2007
Financial	Sell \$7.65 per GJ	N/A	1,000 GJ	December 1, 2006 to October 31, 2007
Financial	Sell \$6.65 per GJ	N/A	2,000 GJ	March 1, 2007 to March 31, 2007
Financial	Sell \$7.75 per GJ	N/A	1,000 GJ	January 1, 2007 to December 31, 2007

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

**4. 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:

Rhodes Petroleum Corp. - controlled by an officer of the Corporation  
Pioneer Land Services Ltd. – a Director is an employee of Pioneer  
Borden Ladner Gervais LLP – a Director is partner with the law firm  
Fasken Martineau DuMoulin LLP – in 2006 the Corporate Secretary was a partner with the law firm

- b) Transactions

	<b>2007</b>	2006
Expenses		
Consulting – Pioneer Land Services Ltd.	\$ 1,463	\$ 5,091
Legal Consulting – Borden Ladner Gervais LLP	346,194	212,902
Joint Venture revenues and expenses – Rhodes Petroleum Corp.	-	17,875
Legal Consulting – Fasken Martineau LLP	375	51,453
	<b>\$ 348,032</b>	<b>\$ 287,321</b>
Other		
Recorded as part of Oil and Gas Properties – Pioneer Land Services Ltd	\$ 18,030	\$ 50,842
Recorded as part of Share issuance cost – Borden Ladner Gervais LLP	71,123	68,000
Recorded as part of Oil and Gas Properties – Borden Ladner Gervais LLP	29,866	-
Recorded as part of Oil and Gas Properties – Rhodes Petroleum Corp.	301	-
	<b>\$ 119,320</b>	<b>\$ 118,842</b>

- 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 and represents actual values charged to related parties.
- d) During 2007, officers and directors purchased nil (2006 – 323,000) shares of the Corporation through private placement offerings at same prices as those offered to arms length subscribers.

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

**5. OIL AND GAS PROPERTIES**

	<b>2007</b>	2006
Oil and gas properties	<b>\$ 203,612,731</b>	\$ 167,957,385
Accumulated depletion	<b>(46,587,772)</b>	(29,252,418)
Net book value	<b>\$ 157,024,959</b>	\$ 138,704,967

At December 31, 2007, included in oil and gas properties is \$3,096,702 (2006 - \$3,474,408) worth of equipment inventory not in use and development costs for wells where reserves have yet to be assigned. These costs were excluded from the depletion base. Undeveloped land costs of approximately \$18.7 million (2006 - \$18.5 million) are also not being depleted. General administrative expenses of \$1,059,914 (2006 - \$772,352) have been capitalized to oil and gas properties.

The Corporation applied a ceiling test to its capitalized assets at December 31, 2007 and determined that there was no impairment.

The following table outlines benchmark prices used in the impairment test at December 31, 2007:

Year	WTI Crude Oil US\$/bbl	Exchange Rate US\$/CDN\$	Edm Light Crude Cdn\$/bbl	AECO Gas CDN\$/GJ	Natural Gas
2008	92.00	1.00	91.10	6.75	
2009	88.00	1.00	87.10	7.55	
2010	84.00	1.00	83.10	7.60	
2011	82.00	1.00	81.10	7.60	
2012	82.00	1.00	81.10	7.60	
2013	82.00	1.00	81.10	7.60	
After 2018 (inflation %)	2%/yr	0%/yr	2%/yr	2%/yr	

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

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**6. LONG-TERM FINANCING**

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The Corporation has a revolving line of credit, with a syndicate of chartered banks, of up to \$70 million (2006 - \$55 million), which bears interest at prime plus 0.50% (2006 – 0.25%). The facility is secured by a general security agreement, a floating charge debenture in the amount of \$150 million and an unlimited liability guarantee by Terra Energy Corp. and Constar Resources Ltd. At December 31, 2007, the Corporation was indebted on the revolving line of credit in amount of \$54,631,003 (2006 - \$35,478,837). The outstanding cheques issued in the amount of \$1,828,943 are shown as bank overdraft until they clear against the revolving line.

The Corporation's bank credit facility is structured as a 364 day revolving credit facility with a one year term out. If the credit facility is not renewed at maturity, the corporation is required to pay the outstanding balance one year from the maturity. The credit facility is subject to a renewal in May 2008. 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, 2007 and 2006, the Corporation was in compliance with all loan covenants.

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**7. ASSET RETIREMENT OBLIGATION**

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The undiscounted amount of expected cash flows required to settle the asset retirement obligations is estimated at \$15,565,360 (2006 - \$15,328,566). The liability for the expected cash flows, as reflected in the consolidated financial statements, has been discounted at 9% (2006 – 9%) and the inflation rate used is 2% (2006 – 2%).

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

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	<b>2007</b>	2006
Opening balance, beginning of year	<b>\$ 5,033,926</b>	\$ 4,577,373
Liabilities disposed	<b>(164,030)</b>	(138,675)
Revisions to estimates	<b>(32,601)</b>	(81,180)
Liabilities settled	-	(84,219)
Liabilities incurred	<b>265,758</b>	344,982
Accretion	<b>462,300</b>	415,645
Ending balance, end of year	<b>\$ 5,565,353</b>	\$ 5,033,926

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

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**7. ASSET RETIREMENT OBLIGATION (continued)**

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The majority of costs attributable to these commitments and contingencies are expected to be incurred between 2008 and 2017 and are to be funded mainly from the Corporation's cash provided by operating activities. The actual costs may differ from those estimated. 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.

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**8. PREFERRED SHARES**

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The Corporation had issued and outstanding Series I to V, 8% cumulative preferred shares, which were redeemable and retractable at \$1 per share. During the fourth quarter of 2006, the board of directors approved the repurchase of the preferred shares at face value. The preferred shares have been repurchased for cancellation. The holder of the preferred shares had waived the right to redeem these shares prior to January 1, 2007. As a result, the liability had been classified as long-term debt. During the current year, dividends of Nil (2006 - \$79,402) were paid. These amounts have been recorded as part of long term debt interest.

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**9. SHARE CAPITAL**

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

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

**9. SHARE CAPITAL (continued)**

b) Issued and outstanding

	2007		2006	
	Number of Shares	Amounts	Number of Shares	Amounts
<b>Common shares</b>				
Balance, beginning of year	76,900,833	\$ 72,570,457	68,093,883	\$ 57,375,841
Issued on exercise of warrants	-	-	2,286,650	3,269,485
Issued on exercise of options	206,000	214,480	2,102,000	2,484,245
	<b>77,106,833</b>	<b>72,784,937</b>	72,482,533	63,129,571
<b>Flow-through shares issued:</b>				
November 21, 2007 at \$1.90	-	-	8,270,000	15,713,000
	-	-	8,270,000	15,713,000
Tax effect of flow through share renouncement	-	(5,106,725)	-	(4,254,388)
Reclassification of contributed surplus (note 10)	-	90,067	-	1,014,501
Reclassification of warrants	-	-	-	873,757
Shares repurchased for cancellation	(2,809,349)	(2,571,459)	(3,851,700)	(3,233,222)
Cash share issue costs, net of tax of \$2,025 (2006 -\$329,857)	-	(1,099)	-	(672,762)
	<b>(2,809,349)</b>	<b>(7,589,216)</b>	(3,851,700)	(6,272,114)
<b>Balance, end of year</b>	<b>74,297,484</b>	<b>65,195,721</b>	76,900,833	72,570,457
<b>Share purchase warrants</b>				
Balance, beginning of year	1,093,700	434,258	7,752,277	3,608,371
Expired	(1,093,700)	(434,258)	(4,469,427)	(2,300,356)
Exercised	-	-	(2,189,150)	(873,757)
Balance, end of year	-	-	1,093,700	434,258
<b>Total Common Shares and Warrants</b>	<b>74,297,484</b>	<b>\$ 65,195,721</b>	77,994,533	<b>\$ 73,004,715</b>

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

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**9. SHARE CAPITAL (continued)**

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During 2006 and 2007, the Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 10,000,000 common shares (5.0 million per year).

In the twelve month period ended December 31, 2007, the Corporation purchased 2,809,349 common shares for total costs of \$3,022,229, at an average price of \$1.08 per common share. Share capital was reduced by \$2,571,459 and the excess of \$450,770 being charged to deficit.

In the twelve month period ended December 31, 2006, the Corporation purchased 3,851,700 common shares for total costs of \$6,339,284, at an average price of \$1.65 per common share. Share capital was reduced by \$3,233,222 and the excess of \$3,106,062 being charged to deficit.

Of the repurchased shares, 477,849 were being held for cancellation at December 31, 2007 (December 31, 2006 – 1,978,200).

c) Stock Options

The Corporation's Employee Stock Option Plan provides for officers, directors, employees, and consultants to be granted options of up to 10 percent of the issued and outstanding common shares of the Corporation. These options entitle the holder to purchase common shares of the Corporation subject to various vesting periods and other terms and conditions specified in the stock option plan.

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
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**9. SHARE CAPITAL (continued)**

c) Stock Options (continued)

Details of all options outstanding after giving effect to the re-pricing of 2,107,000 employee stock options previously granted (Note 9d) are as follows:

	2007		2006	
	Number of Options	Weighted average exercise price	Number of Options	Weighted average exercise price
<b>Employee Stock Options</b>				
Balance, beginning of year	<b>5,802,000</b>	<b>1.58</b>	4,201,000	1.24
Granted	<b>1,756,000</b>	<b>1.32</b>	3,365,500	1.80
Exercised	<b>(206,000)</b>	<b>(1.04)</b>	(1,610,500)	(1.11)
Expired	<b>(659,000)</b>	<b>(1.36)</b>	(154,000)	(1.89)
<b>Balance, end of year</b>	<b>6,693,000</b>	<b>1.35</b>	5,802,000	1.58
<b>Agent Options</b>				
Balance, beginning of year	<b>654,959</b>	<b>1.40</b>	1,383,209	1.40
Exercised	-	-	(491,500)	(1.40)
Expired	<b>(654,959)</b>	<b>(1.40)</b>	(236,780)	(1.40)
<b>Balance, end of year</b>	-	-	654,929	1.40
<b>Other Options</b>				
Balance, beginning of year	-	-	329,730	1.21
Expired	-	-	(329,730)	(1.21)
<b>Balance, end of year</b>	-	-	-	-
<b>Total Options, balance, end of year</b>	<b>6,693,000</b>	<b>1.35</b>	6,456,929	1.56

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

**9. SHARE CAPITAL (continued)**

c) Stock Options (continued)

During 2007, the Corporation granted options to officers, directors, employees, and consultants to purchase 1,756,000 (2006 – 3,365,500) common shares ranging at prices between \$1.03 and \$1.38. Of these options 94,000 have since expired.

Options outstanding as at December 31, 2007:

<i>Options Exercise Price \$</i>	<i>Weighted Average Remaining Contract Life</i>	<i>Outstanding December 31, 2007</i>	<i>Exercisable December 31, 2007</i>
\$1.00	1.12 years	890,000	573,000
\$1.03	4.97 years	175,000	35,000
\$1.08	2.91 years	1,721,000	881,600
\$1.15	2.61 years	104,000	32,000
\$1.26	2.03 years	76,000	76,000
\$1.35	1.12 years	100,000	100,000
\$1.36	4.49 years	1,203,000	521,400
\$1.38	4.08 years	88,000	25,600
\$1.51	2.47 years	400,000	288,000
\$1.60	2.47 years	60,000	36,000
\$1.66	3.12 years	355,000	355,000
\$1.70	3.53 years	860,000	344,000
\$1.89	2.76 years	60,000	36,000
\$1.90	3.19 years	300,000	300,000
\$1.94	3.19 years	186,000	186,000
\$2.05	2.47 years	115,000	115,000
	<b>3.07 years</b>	<b>6,693,000</b>	<b>3,904,600</b>

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

**9. SHARE CAPITAL (continued)**

Options outstanding as at December 31, 2006:

<i>Options Exercise Price \$</i>	<i>Weighted Average Remaining Contract Life</i>	<i>Outstanding December 31, 2006</i>	<i>Exercisable December 31, 2006</i>
\$1.00	2.13 years	990,000	376,000
\$1.15	3.08 years	245,500	45,500
\$1.40	0.03 years	654,929	654,929
\$1.50	3.47 years	60,000	12,000
\$1.51	3.47 years	1,133,000	519,200
\$1.66	2.12 years	553,000	553,000
\$1.66	3.08 years	32,000	32,000
\$1.70	4.53 years	1,195,600	582,000
\$1.80	4.18 years	268,000	60,000
\$1.82	2.17 years	25,000	25,000
\$1.85	3.05 years	40,000	40,000
\$1.89	3.75 years	204,400	78,400
\$1.89	4.11 years	210,000	42,000
\$1.90	2.12 years	300,000	300,000
\$1.94	3.45 years	106,000	106,000
\$1.94	2.12 years	120,000	120,000
\$2.02	3.88 years	10,000	2,000
\$2.05	3.48 years	115,000	115,000
\$2.10	4.29 years	160,000	32,000
\$2.19	3.05 years	26,500	26,500
\$2.27	3.48 years	8,000	8,000
	2.96 years	6,456,929	3,729,529

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
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**9. SHARE CAPITAL (continued)**

d) Stock Based Compensation

For stock options granted to employees compensation expense of \$1,182,479 has been recorded for the year ended December 31, 2007 (2006 - \$2,743,436) with the offsetting charge to contributed surplus. The fair value of share options granted was estimated using the Black Scholes option-pricing model with the following assumptions: Dividend yield Nil (2006 – Nil); expected volatility at 50% to 66% (2006 –66%); risk-free interest rate of 3.5% to 4.0% (2006 – 4.0% to 6.0%); weighted average life of 1.39 years (2006 – 1.14 years).

For the options granted during 2007, the estimated fair value expected to be recognized over the vesting period is approximately \$2,318,370 (2006 - \$2,838,901).

During the year the exercise prices of 2,107,000 employee stock options previously granted ranging from \$1.15 to \$2.27 were re-priced to \$1.08. The options held by the directors and senior officers were excluded from the re-pricing.

e) Per share amounts

The following table summarizes the calculation of basic net income and diluted net income per share.

	<b>2007</b>	2006
Net income (loss) available to common shareholders	<b>\$(1,888,740)</b>	\$ 887,652
Weighted-average number of common shares outstanding - basic	<b>75,124,521</b>	71,515,707
Dilutive effect of stock options	-	560,464
Dilutive effect of warrants	-	934,996
Weighted-average number of common shares outstanding– diluted	<b>75,124,521</b>	73,011,167
Net income per share (\$/share)		
Basic	<b>\$(0.02)</b>	\$0.01
Diluted	<b>\$(0.02)</b>	\$0.01

For 2007, 6,693,000 stock options (2006 - 1,591,900) and Nil warrants (2006 – Nil) are anti-dilutive and have been excluded from the calculation of diluted earnings per share.

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
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**10. CONTRIBUTED SURPLUS**

The details of contributed surplus are as follows:

	<b>2007</b>	2006
Balance, beginning of year	\$ 7,838,602	\$ 3,809,311
Stock based compensation	1,182,479	2,743,436
Warrants expired	434,258	2,300,356
Reclassification resulting from exercise of options and warrants to common shares	(90,067)	(1,014,501)
<b>Balance, end of year</b>	<b>\$ 9,365,272</b>	<b>\$ 7,838,602</b>

**11. INCOME TAXES**

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

	<b>2007</b>	2006
Oil and gas properties	\$ 9,138,212	\$ 7,323,104
Valuation allowance	1,111,765	1,222,941
Deferred partnership income	6,943,379	7,809,953
Attributed crown royalty income benefit	(550,082)	(450,678)
Non-capital loss carryforwards	(2,895,430)	(4,610,380)
Share issuance costs	(644,079)	(1,049,215)
Other	(170,245)	-
<b>Future income tax liability</b>	<b>\$ 12,933,520</b>	<b>\$ 10,245,725</b>

The future tax liability is calculated based on management's best estimates of available tax pool balances and non-capital losses available. In calculating the current provision management has made certain estimates and taken certain filing positions based on current and proposed legislation. Tax provision calculations are based on substantively enacted rates and projected profitability. As such, by their nature, the tax provision is subject to measurement uncertainty. Tax filings made by the Corporation are subject to review and confirmation by Canada Revenue Agency. ("CRA"). Such review and reassessment may result in changes to the available tax pools. Adjustments, if any, resulting from CRA's review of the Corporation's tax filings will be reflected in the period of adjustment.

**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
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**11. INCOME TAXES (continued)**

- 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 33.0% (2006 - 33.0%) to the earnings as follows:

	<b>2007</b>	2006
Expected income tax expense (recovery)	<b>\$ (1,379,797)</b>	\$ 1,091,146
Crown royalties, net of ARTC	-	1,384,851
Large corporations tax	-	13,542
Resource allowance	-	(707,598)
Stock based compensation	<b>390,218</b>	905,334
Effect of change in tax rate	<b>(1,067,830)</b>	(240,850)
Adjustment to opening tax pool balances	<b>(186,277)</b>	-
Other	<b>(173,219)</b>	(27,575)
<b>Actual income tax expense (recovery)</b>	<b>\$ (2,416,905)</b>	<b>\$ 2,418,850</b>

- c) The Corporation has exploration and development expenditures (direct and successor) and undepreciated capital costs which may be carried forward indefinitely to reduce future taxable income:

	<b>2007</b>	2006
Canadian oil and gas property expenses (COGPE)	<b>\$ 31,798,807</b>	\$ 43,845,400
Canadian development expenses (CDE)	<b>31,641,766</b>	21,630,800
Canadian exploration expenses (CEE)	<b>17,631,405</b>	17,258,700
Foreign development expenses (FDE)	<b>1,870,172</b>	2,078,017
Foreign development expenses successored (FDE)	<b>3,705,883</b>	3,705,883
Undepreciated capital costs	<b>34,340,320</b>	30,160,000
Non-capital loss carryforwards	<b>9,651,434</b>	13,970,800
Share issue costs	<b>2,146,930</b>	3,179,400
Alberta royalty deduction	<b>5,000,741</b>	4,097,100
	<b>\$137,787,458</b>	<b>\$139,926,100</b>

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
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**12. STATEMENT OF CASH FLOWS**

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<b>Change in non-cash working capital</b>	<b>2007</b>	<b>2006</b>
Accounts receivable	\$ (2,207,200)	\$ 2,219,612
Prepaid expenses	184,841	(451,373)
Accounts payable and accrued liabilities	10,710,713	(12,166,833)
	<b>8,688,354</b>	<b>(10,398,594)</b>
Change in non-cash working capital from investing	5,933,685	(10,667,637)
Change in non-cash working capital from operations	2,754,669	269,043
	<b>\$ 8,688,354</b>	<b>\$ (10,398,594)</b>

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<b>Other information</b>	<b>2007</b>	<b>2006</b>
Interest paid	\$ 2,799,509	\$ 2,288,280
Taxes paid	\$ 1,374	\$ 32,346

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**13. DEFERRED CREDITS**

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The Corporation was reimbursed \$299,000 of leasehold improvements. The amount is being amortized over the term of the lease, and rent expense has been reduced accordingly.

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**14. LEASE COMMITMENTS**

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The Corporation has lease commitments relating to the office space expiring November 30, 2010. The estimated operating lease rental payments for the office space, after deducting sublease income are as follows:

<b>Year</b>	<b>Amount</b>
2008	\$ 164,900
2009	\$ 213,200
2010	\$ 221,400

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
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**15. COMMITMENTS AND CONTINGENCIES**

- a) The Corporation is involved in various claims arising in the normal course of business. While the outcome of these matters is uncertain and there can be no assurance that such matters will be resolved in the Corporation's favour, the Corporation does not currently believe that the outcome of adverse decisions in any proceedings related to these matters or any amount which it may be required to pay would have a material adverse impact on its financial position, results of operations or liquidity.
- b) The Corporation had outstanding letters of credit to various parties for a total of \$625,927 (2006 - \$395,000) which expire at various dates during 2008.
- c) At December 31, 2007, the Corporation has incurred all of its required exploration expenditure obligations arising from the flow through shares issued in 2006.
- d) The Corporation has firm transportation and processing contracts expiring between October 31, 2008 and December 31, 2012. The monthly transportation and processing fees pursuant to the contacts are \$508,509.
- e) The Corporation has employment agreements with two executive officers defining the terms of employment. Under the terms of the agreements, one executive is entitled to 6 months of compensation for termination without cause or in the event of a change of control and the other executive receives 1.5 years of compensation.

**16. SUBSEQUENT EVENTS**

- a) Subsequent to December 31, 2007, the Corporation entered into the following financial commodity contracts:

Contract Type	Floor Price	Ceiling Price	Volumes Per Day	Contract Term
Financial	Sell \$95.00 per Bbl	N/A	100 Bbls	February 1, 2008 to December 31, 2008
Financial	Sell \$90.55 US per Bbl	N/A	200 Bbls	January 1, 2009 to December 31, 2009
Financial	Sell \$8.23 per GJ	N/A	2,000 GJ	October 1, 2008 to December 31, 2008
Financial	Sell \$7.55 per GJ	N/A	5,000 GJ	July 1, 2008 to September 30, 2008
Financial	Sell \$ 8.40 per GJ	N/A	4,000 GJ	January 1, 2009 to March 31, 2009
Financial	Sell \$7.66 per GJ	N/A	2,000 GJ	April 1, 2008 to June 30, 2008
Financial	Sell \$7.84 per GJ	N/A	2,000 GJ	July 1, 2008 to September 30, 2008
Financial	Sell \$8.60 per GJ	N/A	2,000 GJ	January 1, 2009 to March 31, 2009
Financial	Sell \$8.60 per GJ	N/A	1,000 GJ	January 1, 2009 to March 31, 2009
Financial	Sell \$8.00 per GJ	N/A	5,000 GJ	October 1, 2008 to December 31, 2008

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**Terra Energy Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2007 and 2006**

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**16. SUBSEQUENT EVENT (continued)**

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- b) On February 8<sup>th</sup>, 2008 the Corporation completed the sale to an industry partner of five (5) Sections of Montney petroleum and natural gas rights located within its Fort St. John Core Operating Area for gross proceeds of \$5,000,000.
  
- c) On April 14<sup>th</sup>, 2008 the Corporation announced that it has agreed to the sell approximately 110 Sections of Montney petroleum and natural gas rights in North East British Columbia for gross proceeds of \$67,100,000.