



Terra Energy Corp.
Consolidated Financial Statements
For the years ended December 31, 2009 and 2008

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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, 2009 and 2008 and the consolidated statements of operations and retained earnings, comprehensive income (loss) and accumulated other comprehensive loss, 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 financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

Deloitte & Touche LLP

Calgary, Alberta
March 17, 2010

Chartered Accountants

Terra Energy Corp.
Consolidated Balance Sheets

As at December 31	2009	2008
<i>(\$ thousands)</i>		
Assets		
Current		
Accounts receivable	\$ 15,519	\$ 12,843
Prepaid expenses	2,706	2,090
Other assets (Note 5)	740	583
	18,965	15,516
Oil and gas properties (Notes 6 and 7)	203,516	137,552
	\$ 222,481	\$ 153,068
Liabilities and Shareholders' Equity		
Current		
Bank overdraft (Note 9)	\$ 2,007	\$ 4,463
Accounts payable and accrued liabilities	17,921	17,950
Current portion of capital lease obligation (Note 8)	310	-
Asset retirement obligation (Note 10)	1,174	589
Financial instruments (Note 3)	154	-
	21,566	23,002
Deferred credit (Note 15)	50	116
Long-term financing (Note 9)	54,390	6,316
Capital lease obligation (Note 8)	975	-
Asset retirement obligation (Note 10)	8,921	5,357
Future income taxes (Note 11)	21,776	23,799
	107,678	58,590
Shareholders' Equity		
Share capital (Note 12)	84,636	67,880
Warrants (Note 12)	3,253	-
Contributed surplus (Note 13)	11,402	9,681
Retained earnings	15,529	16,917
Accumulated other comprehensive loss	(17)	-
	114,803	94,478
	\$ 222,481	\$ 153,068

Approved on behalf of the Board

(signed) Theodore Anderson
Theodore Anderson
Director

(signed) Robert Penner
Robert Penner
Director

Terra Energy Corp.
Consolidated Statements of Operations and Retained Earnings

For the years ended December 31	2009	2008
<i>(\$ thousands, except per share amounts)</i>		
Revenue		
Petroleum and natural gas	\$ 62,869	\$ 81,705
Realized gain (loss) on financial instruments (Note 3)	3,243	884
Unrealized gain (loss) on financial instruments (Note 3)	(154)	567
	65,958	83,156
Royalties	(11,038)	(16,950)
	54,920	66,206
Expenses		
Production	19,502	17,112
General and administrative	7,232	4,401
Accretion of asset retirement obligation (Note 10)	562	471
Stock based compensation (Note 12)	1,839	1,836
Depletion and amortization	27,563	21,747
Interest on long-term debt	1,629	1,547
Unrealized foreign exchange loss	-	336
Realized foreign exchange (gain) loss	-	7
	58,327	47,457
Income (loss) before income taxes and other income	(3,407)	18,749
Gain on disposition of Petroleum & Natural Gas rights (Note 6)	-	15,088
Income (loss) before income taxes	(3,407)	33,837
Income tax expense (recovery) (Note 11)		
Current tax	-	5
Future tax	(3,423)	10,866
	(3,423)	10,871
Net income	16	22,966
Retained earnings (deficit), beginning of year	16,917	(5,694)
Repurchase of common shares (Note 12)	(1,404)	(355)
Retained earnings, end of year	\$ 15,529	\$ 16,917
Income per share (Note 12)		
Basic	\$ -	\$ 0.31
Diluted	\$ -	\$ 0.30

Terra Energy Corp.
Consolidated Statement of Comprehensive Income (Loss) and
Accumulated Other Comprehensive Loss

For the years ended December 31	2009	2008
<i>(\$ thousands)</i>		
Net income	\$ 16	\$ 22,966
Other comprehensive loss		
Unrealized loss on available for sale investments, net of tax (Note 5)	(17)	-
Comprehensive income (loss)	\$ (1)	\$ 22,966
Accumulated other comprehensive loss, beginning of year	-	-
Other comprehensive loss	(17)	-
Accumulated other comprehensive loss, end of year	\$ (17)	\$ -

Terra Energy Corp.
Consolidated Statements of Cash Flows

For the years ended December 31	2009	2008
<i>(\$ thousands)</i>		
Cash flows from operating activities		
Net income for the year	\$ 16	\$ 22,966
Items not affecting cash:		
Future income taxes (recovery)	(3,423)	10,866
Accretion of asset retirement obligation	562	471
Stock based compensation	1,839	1,836
Unrealized loss (gain) on financial instruments (Note 3)	154	(567)
Unrealized loss on foreign exchange	-	336
Gain on disposition of Petroleum & Natural Gas rights	-	(15,088)
Asset retirement obligations settled (Note 10)	(831)	(385)
Amortization of deferred credit	(66)	(66)
Depletion, depreciation and amortization	27,563	21,747
	25,814	42,116
Changes in non-cash working capital from operations (Note 14)	549	(8,538)
	26,363	33,578
Cash flows from financing activities		
Proceeds from (repayment of) long-term financing	48,074	(48,651)
Increase (decrease) in bank overdraft	(2,456)	2,634
Issuance of common shares, net of issuance costs	19,125	2,538
Repurchase of common shares	(4,875)	(1,730)
	59,868	(45,209)
Cash flows from investing activities		
Additions to oil and gas properties	(26,945)	(59,095)
Acquisition of oil and gas properties	(75,285)	-
Disposition of oil and gas properties	23,994	72,204
Additions to other assets	(177)	(584)
Changes in non-cash working capital from investing (Note 14)	(3,683)	(894)
Cash paid on business combination (Note 7)	(4,135)	-
	(86,231)	11,631
Increase (decrease) in cash and cash equivalents	-	-
Cash and cash equivalents, beginning of year	-	-
Cash and cash equivalents, end of year	\$ -	\$ -

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

Terra Energy Corp.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

Tabular amounts in thousands, except per share amounts

I. 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. and is listed on the Toronto Stock Exchange under the symbol "TT". The Corporation's principal business is the exploration, development, and production of oil and natural gas in Western Canada.

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., Tecton Energy Canada 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

Substantially all 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.

Terra Energy Corp.
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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 unproved 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.

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.

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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 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 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.

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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 Corporation 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.

Bank overdraft, commodity contracts, and foreign exchange contracts are designated as “held-for-trading” and measured at fair value. Accounts receivable are designated as “loans and receivables” and measured at amortized cost. Other assets are classified as “available for sale” with any changes in fair value being recognized in other comprehensive income. Accounts payable and accrued liabilities, capital lease obligations, and long-term financing are designated as “other financial liabilities” and measured at amortized cost.

Changes in Accounting Policies

On January 1, 2009, the Corporation adopted the Canadian Institute of Chartered Accountants (CICA) Section 3064, Goodwill and intangible assets, replacing Section 3062, Goodwill and other intangible assets and Section 3450, Research and development costs. This section clarifies the criteria for the recognition of assets, intangible assets and internally developed intangible assets. No changes were required to these financial statements as a result of this change.

In January 2009, the CICA issued EIC-173, “Credit Risk and the Fair Value of Financial Assets and Financial Liabilities” which requires the Corporation to consider its own credit risk as well as the credit risk of its counterparty when determining the fair value of financial assets and liabilities, including derivative instruments. The accounting treatments provided in EIC-173 have been applied in the preparation of these financial statements and, as required, have been applied retrospectively without restatement of prior periods. The adoption of this standard did not have an impact on the financial statements.

Effective December 31, 2009, the Corporation adopted amendments to CICA Handbook Section 3862, Financial Instruments - Disclosures. The amendments include enhanced disclosures related to the fair value of financial instruments and the liquidity risk associated with financial instruments. These amendments are consistent with recent amendments to financial instrument disclosure standards in International Financial Reporting Standards (“IFRS”). The additional disclosures have been provided in Note 3.

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Accounting Pronouncements

In January 2009, the AcSB issued Section 1582, Business Combinations, which replaces former guidance on business combinations. Section 1582 establishes principles and requirements of the acquisition method for business combinations and related disclosures. This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 2011 with earlier application permitted. The Corporation does not expect that the adoption of this new Section will have a material impact on its consolidated financial statements.

In January 2009, the AcSB issued Sections 1601, Consolidated Financial Statements, and 1602, Non-controlling Interests, which replaces existing guidance. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 provides guidance on accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. These standards are effective on or after the beginning of the first annual reporting period beginning on or after January 2011 with earlier application permitted. The Corporation does not expect that the adoption of this new Section will have a material impact on its consolidated financial statements.

3. FINANCIAL INSTRUMENTS AND CAPITAL MANAGEMENT

The Corporation is exposed to financial risk on a range of financial instruments including accounts receivable, other assets, capital lease obligations, accounts payable and accrued liabilities, bank overdraft, long term financing and financial derivative contracts. The Corporation manages its exposure to financial risks by operating in a manner that minimizes its exposure to the extent practical. The main financial risks affecting the Corporation are discussed below:

Credit Risk

Credit risk arises when a failure by counterparties to discharge their obligations could reduce the amount of future cash inflows from financial assets on hand at the balance sheet date. The Corporation's accounts receivable at the balance sheet date arise from sales of crude oil, natural gas liquids and natural gas. Industry standard dictates that commodity sales are settled on the 25th day of the month following the month of production. The Corporation markets its oil and natural gas through several marketers so that the exposure to any one entity is minimized.

Joint venture receivables are generated from conducting joint operating or capital operations with joint venture partners. Collections from these operations are usually paid within three months of the joint venture bill being issued to the partner. Circumstances can arise which extend the terms of collection beyond this period as specific items on these joint venture billings may need to be resolved between partners. Smaller partners may be cash called to pay for their share of costs in advance of a project. The Corporation also has the ability to take measures such as withholding production volumes as recourse for collections on receivables.

The Corporation monitors receivable accounts and actively pursues collection and payment. If any accounts are considered impaired, they will be charged to an allowance for doubtful accounts. During the period ended December 31, 2009 there was no allowance for doubtful accounts recorded due to historical success of collecting receivables. The Corporation does not have any significant credit risk exposure with respect to accounts receivable to any single counterparty or any group of counterparties having similar characteristics.

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The carrying value of accounts receivable approximates its fair value due to the relatively short periods to maturity on this instrument. The maximum exposure to credit risk is represented by the carrying amount on the balance sheet. There are no material financial assets that the Corporation considers past due and at risk of collection.

Interest Rate Risk

Interest rate risk refers to the risk that the value of a financial instrument or cash flows associated with the instrument will fluctuate due to changes in market interest rates. The Corporation is exposed to interest rate risk as it can borrow funds at floating interest rates as disclosed in Note 9. The Corporation currently does not use interest rate hedges or fixed interest rate contracts to manage the Corporation's exposure to interest rate fluctuations.

At December 31, 2009, the increase or decrease in net income before taxes for each 1% change in interest rates on floating rate debt amounts to approximately \$544,000 (December 31, 2008 – \$63,000) per annum.

Commodity Price Risk

The Corporation is exposed to fluctuations in commodity prices for crude oil, natural gas and natural gas liquids. Commodity prices are affected by many factors including supply and demand. The Corporation monitors these risks and, when appropriate, utilizes financial instruments to manage its exposure to these risks. The Corporation had the following outstanding financial instruments at December 31, 2009:

Contract Type	Price	Volumes per day	Contract Term
Financial	Buy \$5.37 per GJ	5,000 GJ	April 1, 2010 to October 31, 2010
Financial	Sell \$0.285 basis per mmbtu	12,000 mmbtu	February 1, 2010 to March 31, 2010
Financial	Sell \$0.39 basis per mmbtu	12,000 mmbtu	April 1, 2010 to October 31, 2010
Financial	Sell \$0.37 basis per mmbtu	12,000 mmbtu	November 1, 2010 to March 31, 2011

The mark to market adjustment of these contracts has been recognized as a liability of \$153,889 at December 31, 2009 (2008 – nil). A \$0.10 increase in the natural gas price would result in a change of \$107,000 to the mark to market adjustment. A \$0.01 increase in AECO basis would result in a change of \$51,000 to the mark to market adjustment.

Subsequent to December 31, 2009, the Corporation entered into additional financial instruments (See Note 17).

Liquidity Risk

Liquidity risk includes the risk that, as a result of the Corporation's operational liquidity requirements:

- The Corporation will not have sufficient funds to settle a transaction on the due date; or
- The Corporation will be forced to sell financial assets at values which are less than what they are worth.

The Corporation's operating cash requirements, including amounts projected to complete the Corporation's existing capital expenditure program, are continuously monitored and adjusted as input variables change. These variables include, but are not limited to, available credit, oil and natural gas production from existing wells, results from new wells drilled, commodity prices, cost overruns on capital projects and regulations relating to prices, taxes, royalties, land tenure, allowable production and availability of markets. As these variables change, liquidity

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risks may necessitate the Corporation to conduct equity issues or obtain project debt financing. The Corporation also mitigates liquidity risk by maintaining an insurance program to minimize exposure to insurable losses.

Following is a list of the financial liabilities at December 31, 2009 and their contractual maturities:

	Total	Current Within 1 Year	Within 1 to 3 Years	Within 4 to 5 Years
Bank overdraft	\$ 2,007	\$ 2,007	\$ -	\$ -
Accounts payable and accrued liabilities	17,921	17,921	-	-
Financial instruments	154	154	-	-
Office lease	426	426	-	-
Long-term financing ⁽¹⁾	54,390	-	54,390	-
Gathering and processing contracts	25,886	7,679	11,802	6,405
Capital lease obligation (note 8)	1,409	385	1,024	-
Total	\$ 102,193	\$ 28,572	\$ 67,216	\$ 6,405

⁽¹⁾ Excludes any interest related costs

Foreign Exchange Risk

The Corporation is exposed to fluctuations in foreign exchange rates which will have an impact on commodity prices, foreign denominated cash on hand, foreign denominated payables and foreign denominated long-term financing held by the Corporation.

Commodities are sold to marketers at prices that are commonly based upon reference prices denominated in a foreign currency. Any changes in the foreign exchange rates will have a direct impact on petroleum and natural gas revenue received by the Corporation. Foreign denominated cash held by the Corporation is subject to revaluations at period ends with any changes being reflected as realized foreign exchange gains and losses. Changes in the value of payables and long-term financing denominated in a foreign currency are reflected as unrealized foreign exchange gains and losses. Upon settlement, the unrealized foreign exchange gain or loss is reversed and a realized foreign exchange gain or loss is recorded.

Fair Value

The carrying values of the financial assets and financial liabilities approximate their fair value due to the short term to maturity of these instruments. The Corporation categorizes its financial instruments carried at fair value into one of three different levels depending on the observability of the inputs employed in the measurement.

Level I:

Level I includes assets and liabilities measured at fair value based on unadjusted quoted prices for identical assets or liabilities in active markets that are accessible at the measurement date. An active market for an asset or liability is considered to be a market where transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. At December 31, 2009, the Corporation valued bank overdraft and available for sale investments using Level I inputs.

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Level 2:

Level 2 includes assets and liabilities measured at fair value using directly or indirectly observable inputs other than quoted prices included in Level 1. Level 2 valuations are based on inputs including quoted forward prices, time value, volatility factors and broker quotes that can be observed or corroborated in the market for the entire duration of the derivative instrument. At December 31, 2009, the Corporation valued all derivative financial instruments using Level 2 inputs.

Level 3:

Level 3 includes all assets and liabilities measured at fair value based on inputs which are less observable, unavailable or where the observable data does not support a significant portion of the instrument's fair value. At December 31, 2009, the Corporation did not have any assets or liabilities which it valued using Level 3.

The following table includes all the fair value measurements recognized in the balance sheet at December 31, 2009:

	Level 1	Level 2	Level 3	Total
Bank overdraft	\$ (2,007)	-	-	\$ (2,007)
Available for sale investments	740	-	-	740
Derivative contracts	-	\$ (154)	-	(154)
	\$ (1,267)	\$ (154)	-	\$ (1,421)

Capital Management

The Corporation's objective when managing capital is to safeguard its ability to continue as a going concern so that it can continue to provide returns to shareholders and benefits for other stakeholders. This objective remains unchanged from previous periods. The Corporation manages the capital structure, and makes adjustments to it, in light of changes in economic conditions and the risk characteristics of the underlying assets. The Corporation's objective is met by retaining adequate equity to provide for the possibility that cash flows from assets will not be sufficient to meet future cash flow requirements. The Board of Directors does not establish quantitative return on capital criteria for management. The Corporation defines capital as the aggregate of total equity, bank overdraft and long-term financing less cash and cash equivalents, which at December 31, 2009 was \$171,200,325 (December 31, 2008 - \$105,256,596).

The Corporation is subject to covenants on its operating credit facility with its lender. At December 31, 2009, the Corporation was in compliance with these financial covenants.

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:
 - Pioneer Land Services Ltd. – a Director is an employee of Pioneer
 - Borden Ladner Gervais LLP – a Director is partner with the law firm

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b) Transactions

	2009	2008
Expenses		
Legal Consulting – Borden Ladner Gervais LLP	\$ 556	\$ 183
Other		
Recorded as part of Oil and Gas Properties – Borden Ladner Gervais LLP	176	11
Recorded as part of Oil and Gas Properties – Pioneer Land Services Ltd.	-	16
Recorded as part of share issuance costs – Borden Ladner Gervais	96	-
	\$ 272	\$ 27

Related party 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 unrelated parties. At December 31, 2009, the Corporation had \$61,000 (2008 – nil) owing to related parties.

5. OTHER ASSETS

At December 31, 2009, the Corporation held 5,104,400 common shares of a publicly traded company representing approximately 8% of the outstanding shares of the company. The Corporation has classified the investment as an “available for sale” financial asset with any changes in fair value being recognized in other comprehensive income. For the year ended December 31, 2009, an unrealized loss of \$17,127 (net of tax of \$3,022) was recognized in other comprehensive income, and the fair value of the financial asset was decreased by \$20,149 (2008 – Nil).

6. OIL AND GAS PROPERTIES

	2009	2008
Oil and gas properties	\$ 299,457	\$ 205,886
Accumulated depletion	(95,941)	(68,334)
Net book value	\$ 203,516	\$ 137,552

Undeveloped land costs of approximately \$21,733,956 (2008 - \$6,964,030) are not being depleted. In 2009, general administrative expenses of \$954,495 (2008 - \$1,059,912) were capitalized to oil and gas properties.

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The Corporation applied a ceiling test to its capitalized assets at December 31, 2009 and determined that there was no impairment. The following table outlines benchmark prices used in the impairment test at December 31, 2009:

Year	WTI Crude Oil US\$/bbl	Exchange Rate US\$/CDN\$	Edm Light Crude CDN\$/bbl	AECO Natural Gas CDN\$/GJ
2010	80.00	0.950	83.26	5.96
2011	83.00	0.950	86.42	6.79
2012	86.00	0.950	89.58	6.89
2013	89.00	0.950	92.74	6.95
2014	92.00	0.950	95.90	7.05
2015	93.84	0.950	97.84	7.16
After 2015 (inflation %)	2%/yr	0%/yr	2%/yr	2%/yr

In 2009, the Corporation completed the acquisition of properties located in the Peace River Arch regions of northeast British Columbia and northwest Alberta. The purchase price was approximately \$74.9 million with an effective date of April 1, 2009. Asset retirement obligations associated with the properties acquired were \$3,405,767. The acquisition was financed through proceeds from a bought-deal equity financing (the "Offering") of subscription receipts resulting in the issuance of 14,000,000 subscription receipts at a price of \$1.45 per subscription receipt and drawing down on the Corporation's bank credit facility. Upon closing of the Peace River Arch acquisition, each subscription receipt entitled the holder to receive, for no additional consideration, one unit ("Unit") of the Corporation. Each Unit is comprised of one common share of the Corporation and one-half of one common share purchase warrant. Each whole common share purchase warrant shall be exercisable into one common share of the Corporation at a price of \$1.90 per common share for a period of 24 months.

The following table details the estimated purchase price allocation for the Peace River Arch properties:

Net assets acquired:	
Petroleum and natural gas properties and equipment	\$ 78,263
Asset retirement costs	(3,406)
Total net assets acquired	\$ 74,857

In 2009, the Corporation completed the sale of its non-operated interests in the Boundary Lake Units 1 and 2 for gross proceeds of approximately \$24 million.

In 2008, the Corporation sold approximately 110 sections of Montney Petroleum and Natural Gas ("P&NG") rights for net proceeds received of \$66.5 million. Full cost accounting requires a pooling of all costs. The disposition of a specific asset within that pool must be allocated an appropriate share of all costs, resulting in the use of a deemed cost of disposition in the calculation of a gain. All costs related to the exploration, acquisition and development of petroleum and natural gas reserves are initially capitalized under the full cost method of accounting. 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. This calculation resulted in a deemed cost of disposition of \$48.0 million, which resulted in a gain of \$15.1 million.

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7. BUSINESS COMBINATION

On June 17, 2009, the Corporation acquired all the outstanding shares of Tecton Energy Canada ULC (“Tecton”) with the issuance of 2,580,645 common shares at a value of \$1.47 per share and \$4.1 million of cash. The value of the common shares issued is based upon the volume weighted average market price over a period before and after the date the terms of the business combination are announced. The acquisition was accounted for using the purchase method of accounting where the Corporation is identified as the acquirer. The purchase price allocation at December 31, 2009 is as follows:

Accounts receivable	15
Prepaid expenses	232
Oil and gas properties	9,849
Accounts payable and accrued liabilities	(106)
Asset retirement obligation	(213)
Future income taxes	(1,848)
	<hr/> 7,929
Consideration was comprised of:	
Common shares (2,580,645)	3,794
Cash	4,033
Transaction costs	102
Total	<hr/> 7,929

The results from operations include net revenue from this transaction effective June 17, 2009.

8. CAPITAL LEASE OBLIGATIONS

During the fourth quarter of 2009, the Corporation entered into a new lease arrangement that resulted in the recognition of a fixed asset addition and capital lease obligation of \$1,285,422. The lease obligation bears interest at 6.51% and is secured by the related equipment. The lease term expires in December, 2011, with a final purchase obligation of \$639,513 at which time ownership of the equipment will transfer to the Corporation.

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At December 31, 2009, future minimum lease payments consist of the following:

2010	\$	385
2011		1,024
		1,409
Less amount representing interest		(124)
		1,285
Current portion		(310)
	\$	975

Fixed assets classified as capital leases are depreciated on a unit-of-production basis over the life of the reserves consistent with the Corporation's amortization and depletion policy for petroleum and natural gas properties and is included in depletion, depreciation and accretion expense. At December 31, 2009, there had been no accumulated depletion and amortization recorded on these assets.

9. LONG-TERM FINANCING

The Corporation has a revolving line of credit, with a syndicate of chartered banks, of up to \$80 million (2008 - \$70 million), which bears interest at prime plus 2.1% (2008 – prime). 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, 2009, the revolving line of credit was drawn down \$54,389,879. Outstanding cheques issued in the amount of \$2,007,318 are shown as bank overdraft until they clear against cash.

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. 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 would be due and payable upon demand.

10. ASSET RETIREMENT OBLIGATION

The undiscounted amount of expected cash flows required to settle the asset retirement obligations is estimated at \$25,830,645 (2008 - \$16,453,119). The liability for the expected cash flows, as reflected in the consolidated financial statements, has been discounted at 9% (2008 – 9%) and the inflation rate used is 2% (2008 – 2%).

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

	2009	2008
Balance, beginning of year	\$ 5,946	\$ 5,565
Liabilities disposed	-	(327)
Revisions to estimates	395	(134)
Liabilities settled	(831)	(385)
Liabilities incurred	4,023	756
Accretion	562	471
Balance, end of year	\$ 10,095	\$ 5,946

The majority of costs attributable to these obligations are expected to be incurred between 2010 and 2017. The actual costs may differ from those estimated.

II. INCOME TAXES

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

	2009	2008
Oil and gas properties	\$ 18,129	\$ 14,978
Valuation allowance	926	1,112
Deferred partnership income	9,255	13,654
Attributed crown royalty income benefit	(550)	(550)
Non-capital loss carryforwards	(5,526)	(5,039)
Share issuance costs	(414)	(356)
Other	(44)	-
Future income tax liability	\$ 21,776	\$ 23,799

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.

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- 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 29.0% (2008 - 30.0%) to the earnings as follows:

	2009	2008
Expected income tax expense (recovery)	\$ (988)	\$ 10,152
Capital tax	-	5
Stock based compensation	533	551
Effect of change in tax rate	(1,782)	-
Adjustment to opening tax pool balances	(1,005)	(88)
Other	(181)	251
Actual income tax expense (recovery)	\$ (3,423)	\$ 10,871

- 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:

	2009	2008
Canadian oil and gas property expenses (COGPE)	\$ 37,769	\$ -
Canadian development expenses (CDE)	31,030	20,319
Canadian exploration expenses (CEE)	11,341	22,143
Foreign development expenses (FDE)	1,683	1,870
Foreign development expenses successored (FDE)	3,706	2,594
Undepreciated capital costs	25,307	26,697
Non-capital loss carryforwards	33,083	24,842
Share issue costs	1,655	1,186
Alberta royalty deduction	5,001	5,001
	\$ 150,575	\$ 104,652

The tax pools disclosed have not been reduced by approximately \$31.9 million in partnership income from February 1, 2009 to December 31, 2009, which has been deferred to January 31, 2010 (2008 – \$45.5 million).

12. SHARE CAPITAL

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

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b) Common Shares issued and outstanding

	December 31, 2009		December 31, 2008	
	Number of Shares	Amounts	Number of Shares	Amounts
Common shares				
Balance, beginning of year	74,886	\$ 67,880	74,296	\$ 65,196
Issued on business combination	2,581	3,794	-	-
Issued on equity financing	14,000	16,000	-	-
Issued on exercise of options	313	316	2,128	2,538
Reclassification of contributed surplus (note 13)	-	118	-	1,520
Shares purchased for cancellation	(3,791)	(3,472)	(1,538)	(1,374)
Balance, end of year	87,989	\$ 84,636	74,886	\$ 67,880

On July 15, 2009, the Corporation issued 14,000,000 Units at \$1.45 per Unit for gross proceeds of \$20,300,000. The total costs related to the issuance were \$1,046,375 (net of tax of \$444,946). Each Unit consisted of one common share of the Corporation and one-half of one common share purchase warrant. Each warrant shall be exercisable into one common share of the Corporation ("Warrant Share") at a price of \$1.90 per common share for a period of 24 months. The Corporation has estimated a fair value of \$3,252,735 for the Warrants using a Black-Scholes pricing model. The pricing model used the following assumptions: a risk-free interest rate of 2.0%; weighted average term of 2.0 years; and a volatility of 71%.

On June 9, 2008 the Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 3,700,000 common shares from June 9, 2008 to June 9, 2009. On August 26, 2009, the Corporation obtained permission from the Toronto Stock Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 4,442,099 common shares from August 28, 2009 to August 27, 2010.

For the year ended December 31, 2009, the Corporation purchased 3,791,000 common shares for total costs of \$4,875,162, at an average price of \$1.29 per common share. Share capital was reduced by \$3,471,200 and the excess of \$1,403,961 was charged to retained earnings.

For the year ended December 31, 2008, the Corporation purchased 1,538,251 common shares for total costs of \$1,729,698, at an average price of \$1.12 per common share. Share capital was reduced by \$1,374,113 and the excess of \$355,585 was charged to retained earnings.

Of the purchased shares, 97,300 were being held for cancellation at December 31, 2009 (December 31, 2008 – 783,000).

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c) Warrants

	December 31, 2009		December 31, 2008	
	Number	Amounts	Number	Amounts
Warrants				
Balance, beginning of year	-	\$ -	-	\$ -
Issued on equity financing	7,000	3,253	-	-
Balance, end of year	7,000	\$ 3,253	-	\$ -

d) 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.

Details of all options outstanding at December 31, 2009 are as follows:

	December 31, 2009		December 31, 2008	
	Number of Options	Weighted average exercise price	Number of Options	Weighted average exercise price
Employee Stock Options				
Balance, beginning of year	6,655	1.53	6,693	1.35
Granted	3,838	1.37	2,244	1.73
Exercised	(313)	(1.01)	(2,127)	(1.20)
Expired	(2,118)	(1.53)	(155)	(1.38)
Balance, end of year	8,062	1.48	6,655	1.53

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During 2009, the Corporation granted options to officers, directors and employees to purchase 3,838,000 (2008 – 2,244,300) common shares ranging in prices between \$1.33 and \$1.54 (2008 - \$1.26 and \$2.25). Options outstanding at December 31, 2009:

Range of Exercise Price	Weighted Average Remaining Contract Life	Outstanding December 31, 2009	Exercisable December 31, 2009
\$1.08 - \$1.30	1.05 years	703	516
\$1.31 - \$1.37	3.88 years	3,805	1,934
\$1.38 - \$1.60	3.33 years	1,368	557
\$1.61 - \$1.83	1.39 years	1,446	1,280
\$1.84 - \$2.00	1.15 years	518	518
\$2.01 - \$2.19	0.68 years	222	222
	2.83 years	8,062	5,027

e) Stock Based Compensation

For stock options granted to employees, compensation expense of \$1,838,638 has been recorded for the year ended December 31, 2009 (2008 - \$1,835,701) with the offsetting charge to contributed surplus. The fair value of stock options granted in the period was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yield Nil; expected volatility of 69% to 74% (2008 – 56% to 68%); risk-free interest rate of 2.0%; weighted average term of 3.74 years (2008 – 2.53 years).

For options granted during the year, the estimated fair value expected to be recognized over the vesting period is approximately \$2,711,700 (2008 - \$1,512,928).

f) Per share amounts

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

	2009	2008
Net income available to common shareholders	\$ 16	\$ 22,966
Weighted-average number of common shares outstanding – basic	80,335	74,972
Dilutive effect of stock options	70	562
Weighted-average number of common shares outstanding – diluted	80,405	75,534
Net income per share (\$/share)		
Basic	-	0.31
Diluted	-	0.30

For the year ended December 31, 2009, 4,693,700 stock options (2008 – 3,375,500) were anti-dilutive and have been excluded from the calculation of diluted income per share.

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13. CONTRIBUTED SURPLUS

The details of contributed surplus are as follows:

	2009	2008
Balance, beginning of year	\$ 9,681	\$ 9,365
Stock based compensation	1,839	1,836
Reclassification resulting from exercise of options and warrants to common shares	(118)	(1,520)
Balance, end of year	\$ 11,402	\$ 9,681

14. SUPPLEMENTAL CASH FLOW INFORMATION

	2009	2008
Change in non-cash working capital		
Accounts receivable	\$ (2,676)	\$ (4,883)
Prepaid expenses	(616)	(303)
Accounts payable and accrued liabilities	(31)	(4,246)
	(3,323)	(9,432)
Change in non-cash working capital from investing	(3,683)	(894)
Change in non-cash working capital from operations	549	(8,538)
Business combination	(189)	-
	\$ (3,323)	\$ (9,432)
Other information		
Interest paid	\$ 1,580	\$ 1,680
Taxes paid	-	5

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15. DEFERRED CREDIT

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.

16. COMMITMENTS AND CONTINGENCIES

The Corporation is subject to certain office and equipment leases, and gathering and processing contracts (Note 3).

- 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 \$605,744 (2008 - \$525,927) which expire at various dates during 2010.
 - c) 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 1.0 year 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.
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17. SUBSEQUENT EVENTS

- a) On February 10, 2010, the Corporation completed an asset exchange arrangement involving the exchange of oil & gas assets, with cash forming no part of the consideration. Under the terms of the Arrangement, the Corporation has acquired approximately 120 gross (70 net) sections of land located in several key areas of high activity in Northeast British Columbia. In consideration for the assets acquired, the Corporation assigned and conveyed to the counterparty all of its rights and interest in a specified resource play which has been under development by the Corporation for more than two years.

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- b) Subsequent to December 31, 2009, the Corporation entered into the following financial commodity contracts, which in effect offset certain "Sell" contracts in place at December 31, 2009:

Contract Type	Price	Volumes perday	Contract Term
Financial	Buy \$0.285 basis per mmbtu	12,000 mmbtu	February 1, 2010 to March 31, 2010
Financial	Buy \$0.37 basis per mmbtu	12,000 mmbtu	November 1, 2010 to March 31, 2011

- c) Subsequent to December 31, 2009, the Corporation entered into a foreign exchange contract to sell \$10 million USD at an exchange rate of 1.0526 until January, 2012.
- d) On March 24, 2010, the Corporation closed a "bought-deal" financing agreement of 5 million common shares at \$1.80 per common share and 6.25 million flow-through common shares at \$2.16 per flow-through common share, for aggregate gross proceeds of \$22,500,000.