

Terra Energy Corp.

**Management's Discussion & Analysis
for the years ended December 31, 2006 and December 31, 2005**

This Management's Discussion and Analysis ("MD&A") of financial condition and results of operations of Terra Energy Corp. ("Terra Energy" or the "Corporation") is dated March 26, 2007. It should be read in conjunction with the audited year end consolidated financial statements of the Corporation for the years ended December 31, 2006 and December 31, 2005.

Terra Energy's Board of Directors and Audit Committee have reviewed and approved the December 31, 2006 annual consolidated financial statements and related MD&A.

All references to dollar values refer to Canadian dollars unless otherwise stated.

This MD&A provides certain financial measures that do not have a standardized meaning prescribed by Canadian generally accepted accounting principles ("GAAP"). These non-GAAP financial measures may not be comparable to similar measures presented by other issuers.

This MD&A contains the terms "cash flow from operations" and "cash flow from operations per share", which should not be considered an alternative to, or more meaningful than, cash flow from operating activities as determined in accordance with Canadian generally accepted accounting principles as an indicator of the Corporation's performance. Cash flow from operations per share is calculated using the same weighted average basic and diluted number of shares outstanding used in the calculation of net income (loss) per share. All references to cash flow throughout this MD&A are based on cash flow before changes in non-cash working capital.

Petroleum and natural gas volumes are converted to an equivalent measurement basis referred to as a "barrel of oil equivalent" ("boe") using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil ("6:1"). The 6:1 conversion ratio is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Readers are cautioned that boe figures may be misleading, particularly if used in isolation.

The continuous disclosure materials of the Corporation, including its annual MD&A and audited financial statements, Information Circular and Proxy Statement, material change reports and press releases issued by the Corporation are available through the SEDAR system at www.sedar.com.

FORWARD LOOKING ADVISORY

Statements in this document may contain forward-looking information. Such information is subject to known and unknown risks, uncertainties and other factors that could influence actual results or events, and cause actual results or events to differ materially from those stated, anticipated or implied in the forward looking information. As such, readers are cautioned not to place undue reliance on the forward- looking information, as no assurances can be provided as to future results, levels of activity or achievements. In addition, the reader is cautioned that historical results are not necessarily indicative of future performance.

DISCLOSURE CONTROLS AND PROCEDURES

Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed is recorded, processed, summarized and reported with the time periods specified by securities regulations and that information required to be disclosed is accumulated and communicated to management.

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Corporation's disclosure controls and procedures as of December 31, 2006 and have concluded that they are adequate and effective to ensure accurate and complete disclosure.

DESIGN OF INTERNAL CONTROLS OVER FINANCIAL REPORTING

Effective for the year end 2006, securities regulations state that the Corporation is to design and implement internal controls over financial reporting and disclose in its MD&A any material changes in the Corporation's internal control over financial reporting that occurred during the Corporation's most recent interim period. Internal controls are processes designed and implemented by management to provide reasonable assurance regarding the reliability the Corporation's financial reporting and the preparation of financial statements and other financial information for external purposes in accordance with Canadian GAAP. For the year ended December 31, 2006, the Chief Executive Officer and the Chief Financial Officer have designed internal controls over financial reporting, or caused them to be designed under their supervision. Management has concluded that internal controls are adequately designed in this regard, considering the employees involved and the control procedures in place, including management and Audit Committee oversight and quarterly external auditor reviews. Occasionally, the Corporation requires outside assistance and advice on taxation, new accounting pronouncements and complex accounting and reporting issues, which is common with companies of a similar size. It should be noted, that the Corporation's control system, no matter how well designed, can provide only reasonable, but not absolute, assurance of detecting, preventing and deterring errors or fraud.

CORPORATE HISTORY

Terra Energy is a publicly traded corporation, amalgamated under the Business Corporations Act of Alberta, and formed as a result of the amalgamation of Terra Energy Corp., Terrapet Energy Corp., and Rhodes Resources Corp. on January 30, 2004. This MD&A along with the associated financial statements referenced above include the accounts of the Corporation and its wholly-owned subsidiary Constar Resources Ltd. and Terra Energy, a general partnership between Terra Energy Corp. and Constar Resources Ltd.

The Corporation's principal business is the exploration, development and production of petroleum and natural gas in Western Canada.

SELECTED ANNUAL INFORMATION

Financial

<i>Twelve months ended December 31</i>	2006	<i>% Growth</i>	<i>2005</i>	<i>% Growth</i>	<i>2004</i>
Gross Revenue	\$47,880,220	18.9%	\$40,256,230	144.4%	\$16,470,399
Cash Flow From Operations	\$18,414,785	27.9%	\$14,396,980	194.6%	\$4,886,218
Earnings	\$887,652	(24.6%)	\$1,177,532	(9.6%)	\$1,301,881
Total Assets	\$147,561,394	17.3%	\$125,747,508	78.2%	\$70,563,864
Long-term Financing and Preferred Shares	\$35,478,837	15.3%	\$30,759,032	80.8%	\$17,011,014
Dividends	Nil	n/a	Nil	n/a	Nil
Weighted Average Shares – Basic	71,515,707	23.8%	57,772,818	105.3%	28,140,691
Weighted Average Shares – Diluted	73,011,167	18.5%	61,621,001	113.5%	28,862,446
Shares at Year End – Basic	76,900,833	12.9%	68,093,883	62.1%	42,008,611

Operational

<i>Twelve months ended December 31</i>	2006	<i>% Growth</i>	<i>2005</i>	<i>% Growth</i>	<i>2004</i>
Production					
Average Daily Production (boe/d)	2,819	36.2%	2,069	88.7%	1,096
Reserves					
Proved Reserves (boe)	9,901,833	8.1%	9,159,733	44.6%	6,334,583
Proved Plus Probable Reserves (boe)	16,160,167	13.9%	14,191,400	68.9%	8,402,067
Reserve Value (P+P PV 10%)	\$210,365,000	(6.7%)	\$225,425,000	132.0%	\$97,148,500
Undeveloped Land (Net Acres)	187,878	30.0	145,079	90.1%	76,317
Wells Drilled					
Gross	18.0	(21.7%)	23.0	130.0%	10.0
Net	13.8	(14.3%)	16.1	151.6%	6.4

RESULTS OF OPERATIONS

Production

<i>Three months ended December 31</i>	2006	2005	% Growth
	Average	Average	
Oil (bbl/d)	335	405	(17.3%)
Natural Gas (mf/d)	11,139	8,750	27.3%
Liquids (bbl/d)	405	235	72.3%
Combined (boe/d)	2,597	2,098	23.8%

The prior year's fourth quarter production volumes have been restated to be consistent with the current method of using sales volumes.

<i>Twelve Months Ended December 31</i>	2006	2005	% Growth
	Average	Average	
Oil (bbl/d)	362	488	(25.8%)
Natural Gas (mcf/d)	12,777	8,332	53.3%
Liquids (bbl/d)	328	192	70.8%
Combined (boe/d)	2,819	2,069	36.2%

Operations

<i>Three months ended December 31</i>	2006	2005	2006	2005	% Growth
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Gross Revenues	\$12,192,470	\$13,396,129	\$51.03	\$69.39	(26.5%)
Royalties	\$2,269,462	\$3,047,340	\$9.50	\$15.79	(39.8%)
Production Expenses	\$3,617,811	\$2,880,188	\$15.14	\$14.92	1.5%
Operating Netback	\$6,305,197	\$7,468,601	\$26.38	\$38.69	(31.8%)
General & Administrative Expenses	\$1,006,799	\$992,570	\$4.21	\$5.14	(18.1%)
Interest Expense	\$666,752	\$112,644	\$2.79	\$0.58	381.0%
Realized Foreign Exchange (Gain)	(\$13,583)	-	(\$0.06)	-	n/a
Non-cash Expenses	\$3,639,443	\$2,583,545	\$15.23	\$13.38	13.8%
Income Before Income Taxes	\$1,005,786	\$3,779,842	\$4.21	\$19.58	(78.5%)
Income Tax Expense	\$621,692	\$372,393	\$2.60	\$1.93	n/a
Net Income (Loss)	\$384,094	\$3,407,449	\$1.61	\$17.65	(90.9%)
Per Share – Basic	\$0.01	\$0.06			
Per Share - Diluted	\$0.01	\$0.06			

<i>Twelve Months Ended December 31</i>	2006	2005	2006	2005	% Growth
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Gross Revenues	\$47,880,220	\$40,256,230	\$46.53	\$53.32	(12.7%)
Royalties	\$9,107,294	\$8,311,435	\$8.85	\$11.01	(19.6%)
Production Expenses	\$13,289,212	\$13,016,861	\$12.92	\$17.24	(25.1%)
Operating Netback	\$25,483,714	\$18,927,934	\$24.77	\$25.07	(1.2%)
General & Administrative Expenses	\$3,950,746	\$3,666,320	\$3.84	\$4.86	(20.9%)
Interest Expense	\$2,288,280	\$758,360	\$2.22	\$1.00	122.0%
Realized Foreign Exchange (Gain)	(\$807,660)	-	(\$0.78)	\$0.00	n/a
Non-cash Expenses	\$16,745,846	\$13,219,448	\$16.28	\$17.51	(7.0%)
Income Before Income Taxes	\$3,306,502	\$1,283,806	\$3.21	\$1.70	89.0%
Income Tax Expense (Recovery)	\$2,418,850	\$106,274	\$2.35	\$0.14	1,578.6%
Net Income (Loss)	\$887,652	\$1,177,532	\$0.86	\$1.56	(44.9%)
Per Share – Basic	\$0.01	\$0.02			
Per Share - Diluted	\$0.01	\$0.02			

Revenue

<i>Three months ended December 31</i>	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Gross Revenue	\$12,192,470	\$13,396,129	\$51.03	\$69.39	(26.5%)

Revenues decreased 9.0% to \$12,192,470 for the three month period ended December 31, 2006 compared to \$13,396,129 for the same period ended December 31, 2005. Terra Energy realized an all in price per unit of production for the three month period ended December 31, 2006 of \$51.03, down 26.5% compared to the realized price per unit of production of \$69.39 per boe for the same period ended December 31, 2005. The reduction in commodity prices, especially in natural gas which was 46.1% lower for the three month period ended December 31, 2006 compared to the same period ended December 31, 2005, more than offset the 23.8% increase in production volumes.

<i>Twelve Months Ended December 31</i>	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Gross Revenue	\$47,880,220	\$40,256,230	\$46.53	\$53.32	(12.7%)

Revenues increased 18.9% to \$47,880,220 for the twelve month period ended December 31, 2006 compared to \$40,256,230 for the same period ended December 31, 2005. Terra Energy realized an all in price per unit of production for the twelve month period ended December 31, 2006 of \$46.53 per boe, down 12.7% compared to the realized price per unit of production of \$53.32 per boe for the same period ended December 31, 2005. Revenues were higher in 2006 as a result of a 36.2% increase in production year over year. Revenue on a per unit of production basis were lower year over year as a result of a 28.2% reduction in realized natural gas prices.

Below is a breakdown of prices realized by the Corporation for the three month and twelve month periods ended December 31, 2006:

<i>Three Months Ended December 31</i>	2006	2005	% Change
Crude Oil (\$ / bbl)	\$66.94	\$41.41	61.7%
Natural Gas Liquids (\$ / bbl)	\$35.29	\$81.86	(56.9%)
Natural Gas (\$ / mcf)	\$6.95	\$12.89	(46.1%)

<i>Twelve Months Ended December 31</i>	2006	2005	% Change
Crude Oil (\$ / bbl)	\$70.58	\$48.12	46.7%
Natural Gas Liquids (\$ / bbl)	\$41.79	\$47.16	(11.4%)
Natural Gas (\$ / mcf)	\$6.63	\$9.24	(28.2%)

Factors affecting Terra Energy's realized prices include:

- Approximately 70% of Terra Energy's production is natural gas. During the past 12 months, natural gas prices fell from their highs of \$14.57 per mcf late in 2005 to lows of \$3.51 per mcf during the summer of 2006. An oversupply of natural gas in storage in the US combined with a mild summer and no hurricane activity tempered natural gas prices in 2006.
- Terra Energy entered into several commodity price hedges during the first half of 2006, all of which ended up "in the money", thus increasing the realized natural gas and crude oil prices. Due to weakness in forward markets later in the year, Terra Energy did not enter into any material hedges and as a result, sold the majority of its production at prevailing market prices.
- Terra Energy's realized crude oil prices were higher in 2006 as a result of higher market prices and the maturity of two financial contracts which hedged 200 bbls/d of crude oil at an average price of \$36.00 in 2005.

Royalties

<i>Three months ended December 31</i>	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Royalties	\$2,269,462	\$3,047,340	\$9.50	\$15.79	(39.8%)

For the three month period ended December 31, 2006, royalties decreased 25.5% to \$2,269,462 compared to \$3,047,340 for the three month period ended December 31, 2005 as a result of lower revenues during the quarter. The effective royalty rate fell to 18.6% from 22.7% for the respective periods. Royalties on a per unit of production basis were 39.8% lower at \$9.50 per boe for the three month period ended December 31, 2006 compared to \$15.79 per boe for the previous year. Royalties fell on a per unit of production basis as a result of lower commodity prices during the quarter and the continued benefit of the reclassification of certain natural gas wells located in BC to a lower royalty regime.

<i>Twelve Months Ended December 31</i>	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Royalties	\$9,107,294	\$8,311,435	\$8.85	\$11.01	(19.6%)

For the twelve month period ended December 31, 2006, royalties increased 9.6% to \$9,107,294 compared to \$8,311,435 for the previous year as a result of higher revenues year over year. The effective royalty rate fell to 19.0% from 20.6% during the year. The effective royalty rate as a percentage of revenue fell year over year through a combination of reclassification of certain natural gas wells in BC to a lower royalty rate and natural gas and crude oil hedging gains which are reported as revenues, but are not subject to royalties.

Royalties on a per unit of production fell 19.6% to \$8.85 per boe compared to \$11.01 per boe last year as a result of lower revenue on a per unit of production basis resulting from lower natural gas prices realized by the Corporation.

Production Expenses

<i>Three months ended December 31</i>	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Production Expenses	\$3,617,811	\$2,880,188	\$15.14	\$14.92	1.5%

For the three month period ended December 31, 2006, production expenses increased 25.6% to \$3,617,811 compared to \$2,880,188 for the previous year as a result of higher production volumes and certain one-time production expenses which are not expected to be reoccurring. During the three month period ended December 31, 2006, Terra Energy incurred approximately \$300,000 in one-time expenditures in Lousana, conducting vent-flow and tubing repairs, all of which are included in the Corporation's production expenses.

On a per unit of production basis, production expenses rose 1.5% to \$15.14 per boe compared to \$14.92 per boe for the corresponding period last year as a result of one-time production expenses related to repairs in Lousana. As more production comes onstream in subsequent quarters, Terra Energy expects production expenses on a per unit of production basis to fall.

<i>Twelve Months Ended December 31</i>	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Production Expenses	\$13,289,212	\$13,016,861	\$12.92	\$17.24	(25.1%)

For the twelve month period ended December 31, 2006, production expenses increased by 2.1% to \$13,289,212 compared to \$13,016,861 for the previous year. Operational efficiencies generated from the 36.2% increase in production year over year almost completely offset the incremental expenses arising from the addition of new production. Entering 2006, many of Terra Energy's facilities were underutilized and not running at optimal operation levels. As a result of the completion of key infrastructure projects during the year, Terra Energy brought on over 1,000 boe/d of production onstream through existing Terra Energy facilities.

Production expenses on a per unit of production basis fell 25.1% to \$12.92 per boe compared to \$17.24 per boe for the previous year. The increase in production generated operating efficiencies generated from a 36.2% increase in production which contributed to lower production expenses on a per unit of production basis.

General and Administrative Expenses

<i>Three months ended December 31</i>	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
General & Administrative Expenses	\$1,006,799	\$992,570	\$4.21	\$5.14	(18.1%)

For the three month period ended December 31, 2006 general and administrative expenses rose 1.4% to \$1,006,799 compared to \$992,570 for the previous year. The small increase in general and administrative expenses were a result of higher compensation year over year for employees combined with a reduction in the interest payments relating to outstanding exploration expenditure requirements. On a per unit of production basis, general and administrative expenses fell by 18.1% to \$4.21 per boe compared to \$5.14 for the same period last year. General and administrative expenses on a per unit of production fell as a result of flat expenditures year over year combined with a 23.8% increase in production.

<i>Twelve Months Ended December 31</i>	2006	2005	2006	2005	% Change
			<i>(\$ / boe)</i>	<i>(\$ / boe)</i>	<i>(\$ / boe)</i>
General & Administrative Expenses	\$3,950,746	\$3,666,320	\$3.84	\$4.86	(20.9%)

For the twelve months ended December 31, 2006 general and administrative expenses rose 7.8% to \$3,950,746 compared to \$3,666,230 for the previous year. The increase in general and administrative expenses related to an increase in employee compensation and a general increase in overall administrative expenses year over year. On a per unit of production basis, general and administrative expenses fell 20.9% to \$3.84 per boe from \$4.86 per boe a year ago. The reduction in cost on a per unit of production basis was a result of a 36.2% increase in production year over year.

Interest Expense

<i>Three months ended December 31</i>	2006	2005	2006	2005	% Change
			<i>(\$ / boe)</i>	<i>(\$ / boe)</i>	<i>(\$ / boe)</i>
Interest Expenses	\$666,752	\$112,644	\$2.79	\$0.58	381.0%

For the three month period ended December 31, 2006, interest expenses increased 491.9% to \$666,752 compared to \$112,644 for the previous year. The increase in interest expense was due to higher levels of indebtedness during the quarter due to an expanded capital expenditures program and an increase in interest rates year over year. On a per unit of production basis, interest expense increased 381.0 % to \$2.79 per boe from \$0.58 per boe a year ago.

<i>Twelve Months Ended December 31</i>	2006	2005	2006	2005	% Change
			<i>(\$ / boe)</i>	<i>(\$ / boe)</i>	<i>(\$ / boe)</i>
Interest Expenses	\$2,288,280	\$758,360	\$2.22	\$1.00	122.0%

For the twelve month period ended December 31, 2006 interest expense increased by 201.7% to \$2,288,280 compared to \$758,360 for the previous year. The increase in interest expenses was due to a higher level of indebtedness during the year as a result of higher capital expenditures. On a per unit of production basis, interest expense increased by 122.0% to \$2.22 per boe from \$1.00 per boe.

Non Cash Expenses

<i>Three months ended December 31</i>	2006	2005	2006	2005	% Growth
			<i>(\$ / boe)</i>	<i>(\$ / boe)</i>	<i>(\$ / boe)</i>
Depletion and Amortization	\$3,405,528	\$2,332,000	\$14.25	\$12.08	18.0%
Accretion Expense	\$64,395	\$69,545	\$0.27	\$0.36	(25.2%)
Stock Based Compensation	\$143,356	\$182,000	\$0.60	\$0.94	(36.2%)
Unrealized Foreign Exchange Gain	\$26,164	-	\$0.11	n/a	n/a
Total Non Cash Items	\$3,639,443	\$2,583,545	\$15.23	\$13.38	13.8%

For the three month period ended December 31, 2006 non cash expenses increased 40.9% to \$3,613,189 compared to \$2,583,545 for the previous year. Depletion and amortization increased during the quarter as a result of higher production volumes and capital additions during the quarter which are added to the Corporation's depletion base. On a per unit of production basis, non cash expenses increased by 13.8% to \$15.23 per boe compared to \$13.38 a year ago primarily due to an increase in depletion.

<i>Twelve Months Ended December 31</i>	2006	2005	2006	2005	% Growth
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Depletion and Amortization	\$13,586,765	\$8,932,000	\$13.20	\$11.83	11.6%
Accretion Expense	\$415,645	\$377,948	\$0.40	\$0.50	(20.0%)
Stock Based Compensation	\$2,743,436	\$940,000	\$2.67	\$1.24	115.3%
Financing Fee Amortization	\$0	\$2,969,500	\$0.00	\$3.93	-100.0%
Total Non Cash Items	\$16,745,846	\$13,219,448	\$16.28	\$17.51	(7.0%)

For the twelve month period ended December 31, 2006 non cash expenses increased 26.7% to \$16,745,846 compared to \$13,219,448 for the previous year. On a per unit of production basis, non cash expenses decreased by 7.0% to \$16.28 per boe compared to \$17.51 per boe a year ago.

Depletion and amortization expense increased by 52.1% as a result of a 36.2% increase in production and the addition of Terra Energy's 2006 capital expenditures program to the depletion and amortization base. Stock based compensation increased 191.9% as a result of the issuance of replacement stock option to employees who exercised stock options during the first quarter. The exercise price of the replacement options reflected the closing price of Terra Energy's shares at the date of issue in accordance with the Corporation's stock option plan. Although the total number of options granted did not increase, the replacement stock options are exercisable immediately, therefore, requiring the Corporation to expense the total non cash value of the stock options using the Black-Scholes pricing model in the period the replacement options are granted.

Income Taxes

<i>Three months ended December 31</i>	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Current Tax	\$0	\$71,727	\$0.00	\$0.37	(100.0%)
Future Tax	\$621,692	\$300,666	\$2.60	\$1.56	66.7%
Total Income Taxes	\$621,692	\$372,393	\$2.60	\$1.93	34.7%

For the three month period ended December 31, 2006, cash income taxes fell 100.0% to \$0 from \$71,727 during the previous year. Future Income tax rose as a result of deferred partnership income. For the three month period ended December 31, 2006, future income taxes increased 66.9% to \$621,692 compared to \$372,393 for the previous year. On a per unit of production basis, income taxes rose 34.7% to \$2.60 per boe from \$1.93 per boe a year ago.

<i>Twelve Months Ended December 31</i>	2006	2005	2006	2005	% Change
			(\$ / boe)	(\$ / boe)	(\$ / boe)
Current Tax	\$32,346	\$106,274	\$0.03	\$0.14	(78.6%)
Future Tax (Recovery)	\$2,386,504	\$0	\$2.32	\$0.00	n/a
Total Income Taxes	\$2,418,850	\$106,274	\$2.35	\$0.14	1,578.6%

For the twelve month period ended December 31, 2006, current income taxes fell 69.6% to \$32,346 from \$106,274 during the previous year. Future income taxes for the three month period ended December 31, 2006 increased 2,176.1% to \$2,418,850 compared to \$106,274 for the previous year. Income taxes rose as a result of an increase in deferred partnership income. On a per unit of production basis, income taxes rose 1,578.6% to \$2.35 per boe from \$0.14 per boe a year ago.

With approximately \$139.9 million available in tax pools at December 31, 2006, the Corporation does not expect to incur any material cash taxes in 2007. Terra Energy's tax pool balance for the years ended December 31, 2006 and December 31, 2005 are broken down below:

	2006	2005
Canadian oil and natural gas property expenses (COGPE)	\$43,845,400	\$38,436,100
Canadian development expenses (CDE)	\$21,630,800	8,133,600
Canadian exploration expenses (CEE)	\$17,258,700	11,759,800
Foreign development expenses (FDE)	\$5,783,900	6,014,700
Undepreciated capital costs	\$30,160,000	25,178,300
Loss carryforwards expiring between 2006 and 2016	\$13,970,800	15,780,900
Share issue costs	\$3,179,400	3,112,900
Alberta royalty deduction	\$4,097,100	1,765,000
	\$139,926,100	\$110,181,300

Selected Quarterly Financial Information

	2006				2005			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Revenues	\$12,192,470	\$10,994,495	\$12,905,705	\$11,787,550	\$13,396,129	\$10,514,578	\$8,412,842	\$7,932,681
Cashflow from Operations	\$2,762,328	\$4,601,864	\$5,981,723	\$5,068,870	\$6,291,660	\$3,931,050	\$364,659	\$3,809,611
Net Income Per Share (Basic)	\$384,094	(\$244,582)	\$978,550	(\$230,410)	\$3,407,449	\$604,997	(\$1,841,190)	(\$993,724)
Per Share (Diluted)	\$0.01	(\$0.00)	\$0.01	(\$0.00)	\$0.06	\$0.01	(\$0.03)	(\$0.02)
Per Share (Diluted)	\$0.01	(\$0.00)	\$0.01	(\$0.00)	\$0.06	\$0.01	(\$0.03)	(\$0.02)
Total Assets	\$147,561,967	\$142,445,050	\$143,389,046	\$136,561,790	\$125,747,508	\$101,725,924	\$73,371,351	\$70,084,396
Bank Debt	\$35,478,837	\$40,210,749	\$43,916,125	\$35,105,320	\$29,610,391	\$18,296,782	\$17,212,490	\$14,716,518
Working Capital	(\$10,331,676)	(\$13,911,818)	(\$7,177,516)	(\$8,649,825)	(\$756,450)	\$4,987,839	(\$8,940,230)	(\$6,576,739)

LIQUIDITY AND FINANCIAL CONDITION

	December 31, 2006	December 31, 2005
Working Capital	(\$10,331,676)	(\$756,450)
Oil and gas properties	\$138,704,967	\$103,561,874

The working capital deficit at December 31, 2006 was \$10,331,676 compared to a deficit of \$756,450 at December 31, 2005. Terra Energy's working capital deficit increased as a result of a reduction in cash and an increase in bank overdraft outstanding as at December 31, 2006. The bank overdraft amount of \$8,412,852 as at December 31, 2006 relates to outstanding cheques. Upon the cashing of the cheques, all amounts owed under the bank overdraft will be classified under long-term financing.

Terra Energy's bank credit facility is structured as a \$55.0 million 364 day revolving credit facility with a one year term-out. If the credit facility is not renewed at maturity, the Corporation has the ability to repay any amounts outstanding on the credit facility one year from maturity. As a result of this one year repayment feature, Terra Energy has classified its bank credit facility as a long-term financial obligation.

Payments Due by Period

	Total	Less Than 1 year	1 - 3 years	4 – 5 years	After 5 Years
Long Term Debt	\$35,478,837	-	\$35,478,837	-	-
Office Lease	\$715,953	\$116,502	\$599,451	-	-
Purchase Obligations (1)	-	-	-	-	-
Total Contractual Obligations	\$36,194,790	\$116,502	\$36,078,288	-	-

(1) The Corporation has firm transportation and processing contracts expiring between October 31, 2007 and 2009. The monthly fees pursuant to the contracts are \$230,000. These costs are included as incurred in the Corporation's operating expenses.

Capitalized resource properties as at December 31, 2006 were \$138,704,967 net of accumulated depletion, compared to \$103,561,874 as at December 31, 2005. Oil and gas properties increased as a result of continued developments of oil and gas properties as well as the acquisition of undeveloped Crown land. For the twelve month period ended December 31, 2006, Terra Energy incurred \$48,688,950 in net capital expenditures broken down as:

<i>Twelve Months Ended December 31</i>	2006	2005
Exploration	\$16,279,554	\$21,869,229
Development	\$17,069,471	\$15,554,694
Undeveloped Land	\$11,815,536	\$7,515,737
Geological / Geotechnical	\$732,249	\$693,597
Facilities	\$9,834,760	\$5,125,978
Other Assets	\$1,782,159	\$367,405
Total Capital Expenditures	\$57,513,729	\$51,126,640
Net Property Acquisitions	(\$8,824,779)	(\$3,119,327)
Total Capital Expenditures	\$48,688,950	\$48,007,314

Terra Energy incurred net capital expenditures of \$48,688,950 for the twelve month period ended December 31, 2006. Terra Energy drilled 18 gross (13.84 net) wells with a success rate of 77.8% in 2006. Terra Energy completed three large scale infrastructure projects, connecting Septimus to Terra Energy's Wilder field, connecting Boudreau to Terra Energy's underutilized Red Creek facility and completed the first segment of the Corporation's South Peace Gathering System by connecting two wells in Tower to a third party's natural gas processing facility. Terra Energy focused its undeveloped land budget in the first half of 2006, targeting key sections of undeveloped land which were required to protect new discoveries.

Terra Energy financed its 2006 capital expenditures program through a combination of cashflow, non-core asset dispositions, proceeds from equity issues, proceeds from warrant and option exercises and bank financing.

In 2006, Terra Energy renegotiated its bank credit facility by increasing total authorized credit to \$55.0 million and by syndicating the Corporation's credit facility to two financial institutions. The credit facility matures in May 2007. As at December 31, 2006, the Corporation was in compliance with all banking covenants.

On November 21, 2006, Terra Energy announced it closed a \$15,713,000 flow-through equity issue with a syndicate of underwriters by issuing 8,270,000 flow-through shares at a price of \$1.90 per share. Of the amount, 15,010,000 flow-through shares were acquired by the syndicate of underwriters and 703,000 was acquired by officers, directors, consultants and associates of the Corporation.

On February 23, 2007, Terra Energy announced its 2007 Capital Expenditures Plan. Terra Energy is budgeting expenditures of \$34.1 million in 2007. Terra Energy focus in 2007 will be the construction of infrastructure projects designed to bring the significant behind pipe reserves onstream and on exploration activities for the Corporation to meet its 2007 CEE obligations of approximately \$15.7 million arising from the equity issue discussed above.

Cash Flow

For the twelve month period ended December 31, 2006, the Corporation generated cash flows from operations of \$18,414,785 (\$0.26 per basic share), an increase of 27.9% compared to \$14,396,980 (\$0.25 per basic share) for the twelve month period ended December 31, 2005.

Cash flow from operations (“Cash Flow”), representing cash generated from operating activities before changes in non-cash working capital items, is a non-GAAP measure. Management utilizes Cash Flow as a key measure to assess the ability of the Corporation to finance operating activities and capital expenditures. Additionally, Cash Flow has been described and presented in order to provide shareholders and potential investors with information regarding the Corporation’s liquidity and its ability to generate funds to finance its operations. This performance indicator may not be comparable to similar measures used by other companies.

The following table presents the non-GAAP financial measure “cash flow from operations”.

<i>Three months ended December 31</i>	2006	2005
Net income (loss) for the period	\$384,094	\$3,407,449
Future income tax provision	\$621,691	\$300,666
Accretion expense	\$64,395	\$69,545
Stock based compensation	\$143,356	\$182,000
Unrealized gain on financial instruments	(\$1,834,472)	\$0
Realized loss on financial instruments	\$0	\$0
Amortization of deferred charges	(\$22,264)	\$0
Depletion and amortization	\$3,405,528	\$2,332,000
Cash flow from operations	\$2,762,328	\$6,291,660

<i>Twelve Months Ended December 31</i>	2006	2005
Net income (loss) for the period	\$887,652	\$1,177,532
Future tax provision (recovery)	\$2,386,504	-
Accretion expense	\$415,645	\$377,948
Stock based compensation	\$2,743,436	\$940,000
Financing fee amortization	-	\$2,969,500
Unrealized gain on financial instruments	(\$1,841,861)	-
Realized loss on financial instruments	\$275,513	-
Amortization of deferred charges	(\$38,869)	-
Depletion and amortization	\$13,586,765	\$8,932,000
Cash flow from operations	\$18,414,785	\$14,396,980

Sensitivity Analysis

The following table shows sensitivities to cashflow from operations as a result of fluctuations to produce prices and other market factors. The table is based on budgeted 2007 prices and production volumes

Change to Annual Cashflow From Operations	Change	\$ Change
Price per barrel of oil (US\$ WTI)	+ / - US\$1.00	\$100,000
Price per mcf of natural gas (C\$ AECO)	+ / - C\$0.10	\$500,000
Interest rate on debt	+ / - 1.00%	\$500,000

Capital Resources

The Corporation's share capital is as follows:

	December 31, 2006		December 31, 2005	
	No. of Shares	Amounts	No. of Shares	Amounts
Common Shares	76,900,833	\$72,570,457	68,093,883	\$57,375,841

During the twelve months ended December 31, 2006, 2,102,000 employee / agent options and 2,286,650 warrants were exercised generating approximately \$2,484,245 and \$3,268,485 in proceeds, respectively. During the twelve month period ended December 31, 2006, 3,851,700 common shares were repurchased by the Corporation for \$6,339,284 at an average price of \$1.65 per common share. The Corporation recorded \$3,233,222 as a reduction of share capital and the excess of \$3,106,062 being charged to deficit. As at December 31, 2006, 1,978,200 repurchased shares are held for cancellation.

Preferred Shares

	December 31, 2006	December 31, 2005
Series	n/a	Series I to V
Shares Outstanding	n/a	1,148,641
Dollar Value	n/a	\$1,148,641

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, the Board of Directors approved the repurchase of the preferred shares for cancellation at face value. As at December 31, 2006, Terra Energy has no issued and outstanding preferred shares.

COMMITMENTS AND CONTINGENCIES

The Corporation had outstanding letters of credit to various parties for a total of \$395,000 (2005- \$561,155). The amounts expire at various dates during 2007.

The Corporation is involved in various claims and litigations 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.

The Corporation is required to incur exploration and development activities by December 31, 2007 of approximately \$15,713,000 as a result of flow-through shares issued in November 2006. At December 31, 2006, the Corporation has incurred qualifying expenditures of approximately \$1,829,099 towards this obligation.

At December 31, 2006, the Corporation has incurred all of the required qualifying exploration expenditure obligations arising from the flow-through shares issued in 2005.

The Corporation has firm transportation and processing contracts expiring between October 31, 2007 and 2009. The monthly transportation and processing fees pursuant to the contacts are approximately \$230,000.

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.

OFF-BALANCE SHEET ARRANGEMENTS

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.

At December 31, 2006 the Corporation had entered into commodity 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

The mark to market value of the above commodity products transactions of \$1,841,861 has been recorded as an asset as at December 31, 2006.

Below is a summary of commodity products transactions Terra Energy entered into subsequent to December 31, 2006:

Contract Type	Floor Price	Ceiling Price	Volumes Per Day	Contract Term
Financial	Sell \$7.40 per GJ	N/A	2,000 GJ	March 1, 2007 to July 31, 2007
Financial	Sell \$6.53 per GJ	N/A	1,000 GJ	April 1, 2007 to October 31, 2007
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 October 31, 2008
Financial	Sell \$8.00 per GJ	\$8.60 per GJ	1,000 GJ	November 1, 2007 to March 31, 2008
Financial	Sell \$7.10 per GJ	N/A	1,000 GJ	April 1, 2007 to October 31, 2007
Financial	Sell \$8.00 per GJ	N/A	2,000 GJ	November 1, 2007 to December 31, 2007
Financial	Sell \$7.95 per GJ	N/A	1,000 GJ	April 1, 2007 to March 31, 2008
Financial	Sell \$8.05 per GJ	N/A	1,000 GJ	December 1, 2007 to December 31, 2007
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

RELATED PARTY TRANSACTIONS

The Corporation entered into transactions with the following related parties:

Capital Strategies Canada Corp., controlled by two officers of the Corporation
Rhodes Petroleum Corp., controlled by an officer of the Corporation
Terra Capital Corp., a significant shareholder (31%)
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 – the Corporate Secretary is partner with the law firm

Transactions

	2006	2005
Expenses		
Service fees – Terra Capital Corp. (Note 5(d))	-	\$295,913
Consulting – Pioneer Land Services Ltd.	\$5,091	16,519
Legal Consulting – Borden Ladner Gervais LLP	212,902	157,870
Joint Venture revenues and expenses – Rhodes Petroleum Corp., of which \$17,875 is included in accounts receivable in 2006.	17,875	-
Legal Consulting – Fasken Martineau LLP	51,453	60,011
	<u>\$287,321</u>	<u>\$530,313</u>
Other		
Recorded as part of Oil and Gas Properties – Pioneer Land Services Ltd.	\$50,842	\$107,867
Recorded as part of share issuance cost – Borden Ladner Gervais LLP	68,000	62,498
Recorded as part of share issuance cost – Fasken Martineau LLP	-	17,860
Acquisition of PN&G and office equipments recorded as part of oil and gas properties - Terra Capital Corp.	-	124,000
	<u>\$118,842</u>	<u>\$312,225</u>

- a) 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.
- b) Fees have been paid to Terra Capital Corp. for personnel services, for leasing of office furniture, vehicles and equipment.
- c) Prior to amalgamation and up to March 31, 2004, all personnel were employees of Terra Capital Corp. During 2004, all personnel entered into employment arrangements directly with Terra Energy, except for one senior officer whose employment agreement was executed November 18th, 2005.
- d) The Corporation leased vehicles, office furniture, and equipment pursuant to a lease to purchase agreement with Terra Capital Corp. At December 31, 2005, the Corporation completed its lease to purchase obligations.
- e) During 2006, officers and directors purchased 323,000 (2005–20,989) shares of the Corporation through private placement offerings.
- f) The Corporation had previously issued and outstanding Series I to V, 8% cumulative preferred shares, which are redeemable and retractable at \$1 per share. These were all held by a senior officer of the Corporation. All dividends have been paid to December 31, 2006. During the fourth quarter, the Board of Directors of the Corporation approved the repurchase of the preferred shares at face value. The preferred shares have been repurchased for cancellation. Liability in the amount of \$nil (2005 - \$1,148,641) has been reflected in the Corporation's consolidated financial statements. During the current year, dividends of \$79,402 (2005 - \$91,891) were paid. These amounts have been recorded as of long term debt interest.

CRITICAL ACCOUNTING ESTIMATES

In preparing financial statements in accordance with generally accepted accounting principles, management undertakes certain judgments and estimates. Changes in these judgments and estimates could have a material impact on the financial results and condition. The following discussion outlines accounting policies and practices that are critical to determining the Corporation's financial results.

Proved Oil and Gas Reserves

Under Canadian Securities Regulations National Instrument 51-101 "Standards of Disclosure for Oil and Gas Activities" (NI 51-101), "proved" reserves are those reserves that can be estimated with a high degree of certainty to be recoverable (it is likely that the actual remaining quantities recovered will exceed the estimated proved reserves). In accordance with this definition, the level of certainty targeted by the reporting Corporation should result in at least a 90% probability that the quantities actually recovered will equal or exceed the estimated reserves. There was no such consideration of probability under National Policy 2B (NP 2B). In the case of "probable" reserves, which are obviously less certain to be recovered than proved reserves, NI 51-101 states that it must be equally likely that the actual remaining quantities recovered will be greater or less than the sum of the estimated proved plus probable reserves. With respect to the consideration of certainty, in order to report reserves as proved plus probable, the reporting Corporation must believe that there is at least a 50% probability that the quantities actually recovered will equal or exceed the sum of the estimated proved plus probable reserves. The implementation of NI 51-101 has resulted in a more rigorous and uniform standardization of reserve evaluation.

The oil and gas reserve estimates are made using all available geological, reservoir and historical production data. Estimates are reviewed and revised as appropriate. Revisions may occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Corporation's plans.

Ceiling Test

Under the Canadian Institute of Chartered Accountants (CICA) full cost accounting guidelines, the Corporation calculates a ceiling test annually whereby the carrying value of petroleum and natural gas properties is compared to

estimated future cash flow from the production of proved reserves. The Corporation has early adopted the requirement of CICA Accounting Guideline 16 "Oil and Gas Accounting - Full Cost" ("AcG 16"). The requirements of the guideline were to be followed for all fiscal years beginning on or after January 1, 2004. At December 31, 2006, the Corporation calculated the ceiling test using AcG 16 without any material adverse impact on the Corporation's financial position or results of operations.

Asset Retirement Obligation

CICA Handbook Section 3110 "Asset Retirement Obligations" requires accrued reclamation and abandonment obligations be recognized on the balance sheet by increasing oil and gas properties offset by a liability of an equal amount. Estimates are required to determine the future obligation. The asset and liability are initially measured at fair value, being the discounted future value of the liability, and then capitalized as part of the cost of the asset and subsequently amortized over the life of the asset. The liability then accretes until the retirement obligation is settled.

Litigation

The Corporation is involved in various claims and litigation arising from 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 pending or threatened proceeding related to these and other matters or any amount which it may be required to pay by reason thereof, would have a material adverse effect on its financial position or results of operations.

Depletion and Depreciation Expense

Terra Energy uses the full cost method of accounting for exploration and development activities whereby all costs associated with these activities are capitalized, whether successful or not. The aggregate of capitalized costs, net of certain costs related to unproved properties, and estimated future development costs is amortized using the unit-of-production method based on estimated proved reserves. Changes in estimated proved reserves or future development costs have a direct impact on depletion and depreciation expense. Certain costs related to unproved properties and major development projects may be excluded from costs subject to depletion until proved reserves have been assigned, at which point they would be included in the depletion calculation, or for impairment, for which any write-down would be charged to depletion and depreciation expense.

Stock Based Compensation and Share Purchase Warrants

The Corporation calculates the fair value of the options granted and share purchase warrants issued. This calculation is based on estimates which could differ significantly from actual results. This could have a significant impact on the financial statements.

Income Taxes

The determination of Terra Energy's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded.

Financial Instruments

The Corporation's results are impacted by external market risks associated with fluctuations in commodity prices, operational and safety and environmental risks. The Corporation partially mitigates its exposure to market risks through the use of various financial instruments and physical contracts. The Corporation does not utilize derivative instruments for speculative purposes.

Flow-Through Shares

Effective for equity issuances after 2004, the Corporation records the future income taxes associated with the renunciation of expenditures for income tax purposes on the date the Corporation renounces the expenditures. This change is in accordance with Abstract 14 from the Emerging Issues Committees of the CICA.

RISK FACTORS RELATING TO OIL AND GAS EXPLORATION, DEVELOPMENT AND PRODUCTION

Uncertain Discovery of Viable Commercial Prospects

The Corporation's future success may be dependent upon its ability to economically locate commercially viable oil or gas deposits. The Corporation can make no representations, warranties or guaranties that it will be able to consistently identify viable prospects, or that such prospects will be commercially exploitable. An inability of the Corporation to consistently identify and exploit commercially viable hydrocarbon deposits would have a material and adverse effect on the Corporation's business and financial position. Exploratory drilling is subject to numerous risks, including the risk that no commercially productive oil and gas reservoirs will be encountered. The cost of drilling, completing and operating wells is often uncertain, and drilling operations may be curtailed, delayed or canceled as a result of a variety of factors, including unexpected formation and drilling conditions, pressure or other irregularities in formations, blowouts, equipment failures or accidents, as well as weather conditions, compliance with governmental requirements and/or shortages or delays in the delivery of equipment. The inability to successfully locate and drill wells that will economically produce commercial quantities of oil and gas could have a material adverse effect on the Corporation's business and financial position. The Corporation's properties are in various stages of exploration and development. Whether the Corporation ultimately drills a property may depend on a number of factors including funding, the receipt of additional seismic data or reprocessing of existing data, material changes in oil or gas prices, the costs and availability of drilling equipment, success or failure of wells drilled in similar formations or which would use the same production facilities, changes in estimates of costs to drill or complete wells, the Corporation's ability to attract industry partners to acquire a portion of its working interest to reduce exposure to drilling and completion costs, decisions of the Corporation's joint working interest owners, and/or restrictions under provincial regulators.

Volatility of Oil and Natural Gas Contracts

The ultimate profitability, cash flow and future growth of the Corporation will be affected by changes in prevailing oil and gas prices. Oil and gas prices have been subject to wide fluctuations in recent years in response to changes in the supply and demand for oil and natural gas, market uncertainty, competition, regulatory developments and other factors which are beyond the control of the Corporation. It is impossible to predict future oil and natural gas price movements with any certainty. An extended or substantial decline in oil and gas prices would have a material adverse effect on (i) the Corporation's access to capital, and (ii) the Corporation's financial position and results of operations.

Increased Operating Costs

Higher operating costs for our underlying properties will directly decrease the amount of cash flow received by the Corporation. Electricity, chemicals, supplies, reclamation and abandonment, and labour costs are a few of the operating costs that are susceptible to material fluctuation.

Title of Assets

Although the Corporation conducts title reviews in accordance with industry practice prior to any purchase of resource assets, such reviews do not guarantee that an unforeseen defect in the chain on title will not arise and defeat our title to the purchased assets. If such a defect were to occur, our entitlement to the production from such purchased assets could be jeopardized.

Uncertainty of Estimates of Reserves and Future Events

Certain statements included in this report contain estimates of the Corporation's oil and gas reserves and the discounted future net revenues from those reserves, as prepared by independent petroleum engineers. There are numerous uncertainties inherent in such estimates including many factors beyond the control of the Corporation. The estimates are based on a number of assumptions including constant oil and gas prices, and assumptions regarding future production, revenues, taxes, operating expenses, development expenditures and quantities of recoverable oil and gas reserves. Such estimates are inherently imprecise indications of future net revenues, and actual results might vary substantially from the estimates based on these assumptions. Any significant variance in these assumptions could materially affect the estimated quantity and value of reserves. In addition, the Corporation's reserves might be subject to revisions based upon future production, results of future exploration and development, prevailing oil and gas prices and other factors. Moreover, estimates of the economically recoverable oil and gas reserves, classifications of such reserves and estimates of future net cash flows prepared by independent engineers at different times may vary substantially. Information about reserves constitutes forward-looking statements. Further, the future success of the Corporation depends upon its ability to find, develop and acquire oil and gas reserves that are economically recoverable. As a result, the Corporation must locate, acquire and develop new oil and gas reserves to replace those being depleted by production. Without successful funding for acquisitions and exploration and development activities, the Corporation's reserves will decline. No assurances can be made that the Corporation will be able to find and develop or acquire additional reserves at an acceptable cost.

Competition

The Corporation engages in the highly competitive industry of exploration for and production of oil and gas. The Corporation competes directly and indirectly with major and independent oil and gas companies in its exploration for and development of desirable oil and gas properties. Many companies and individuals are engaged in the business of acquiring interests in and developing oil and gas properties in Canada, and the industry is not dominated by any single competitor or a small number of competitors. Many of such competitors have substantially greater financial, technical, sales, marketing and other resources, as well as greater historical market acceptance than does the Corporation. The Corporation will compete with numerous industry participants for the acquisition of land and rights to prospects, and for the equipment and labour required to operate and develop such prospects. Competition could materially and adversely affect the Corporation's business, operating results and financial condition. Such competitive disadvantages could adversely affect the Corporation's ability to participate in projects with favourable rates of return.

Shortage of Supplies and Equipment

The Corporation's ability to conduct operations in a timely and cost effective manner is subject to the availability of natural gas and crude oil field supplies, rigs, equipment and service crews. Although none are expected currently, any shortage of certain types of supplies and equipment could result in delays in our operations as well as in higher operating and capital costs.

Interruption From Severe Weather

The Corporation's operations are conducted principally in the central region of Alberta, Northeastern British Columbia and Saskatchewan. The weather in these areas can be extreme and can cause interruption or delays in our drilling and construction operations.

Dependence on Third-Party Pipelines

In fiscal 2006, substantially all of Terra Energy's sales of natural gas production were through deliveries to local third-party gathering systems to processing plants. In addition, the Corporation relies on access to interprovincial pipelines for the sale and distribution of substantially all of our gas. As a result, a curtailment of our sale of natural gas by pipelines or by third-party gathering systems, an impairment of our ability to transport natural gas on interprovincial pipelines or a material increase in the rates charged to us for the transportation of natural gas by reason of a change in federal or provincial regulations or for any other reason, could have a material adverse effect upon us. In such event, we would have to obtain other transportation arrangements. There can be no assurance that we would have economical transportation alternatives or that it would be feasible for us to construct pipelines. In the event such circumstances

were to occur, our netbacks from the affected wells would be suspended until, and if, such circumstances could be resolved.

Operating Hazards and Uninsured Risks

The oil and gas business involves a variety of operating risks, including fire, explosion, pipe failure, casing collapse, abnormally pressured formations, adverse weather conditions, governmental and political actions, premature reservoir declines and environmental hazards such as oil spills, gas leaks and discharges of toxic gases. The occurrence of any of these events with respect to any property operated or owned (in whole or in part) by us could have a material adverse impact on us. The Corporation and the operators of our properties, maintain insurance in accordance with customary industry practices and in amounts that we believe to be reasonable. However, insurance coverage is not always economically feasible and is not obtained to cover all types of operational risks. The occurrence of a significant event that is not insured or insured fully could have a material adverse effect on our financial condition.

Restoration, Safety and Environmental Risks

Our operations are in Saskatchewan, Alberta and Northeastern British Columbia. Certain laws and regulations exist that require companies engaged in petroleum activities to obtain necessary safety and environmental permits to operate. Such legislation may restrict or delay us from conducting operations in certain geographical areas. Further, such laws and regulations may impose liabilities on us for remedial and clean-up costs, personal injuries related to safety and environmental damages, such liabilities collectively referred to as “asset retirement obligations”.

Expiration of Licenses and Leases

The Corporation’s properties are held in the form of licenses and leases and working interests in licenses and leases. If the Corporation or the holder of the license or lease fails to meet the specific requirement of a license or lease, the license or lease may terminate or expire. There can be no assurance that any of the obligations required to maintain each license or lease will be met. The termination or expiration of the Corporation’s licenses or leases or the working interests relating to a license or lease may have a material adverse effect on the Corporation’s results of operations and business.

Canadian Government Regulation and Industry Conditions

The Kyoto protocol, ratified by the Canadian federal government in December 2002, came into force on February 16, 2005. The protocol commits Canada to reducing greenhouse gas emissions to six percent below 1990 levels over the period 2008-2012. The Canadian government released a framework outlining its Climate Change action plan on April 13, 2005. The plan contains few technical details regarding the implementation of the government’s greenhouse gas reduction strategy. The Climate Change Working Group of the Canadian Association of Petroleum Producers continues to work with the Canadian and Alberta governments to develop an approach for implementing targets and enabling greenhouse gas control legislation, which protects the industry’s competitiveness, limits the cost and administrative burden of compliance and supports continued investment in the sector. As the Canadian government has yet to release a detailed Kyoto compliance plan, the Corporation is unable to predict the impact of potential regulations upon its business; however, it is possible that the Corporation would face increases in operating costs in order to comply with the greenhouse gas emissions legislation.

Canadian Government Regulation and Environmental Matters

The oil and natural gas industry is subject to extensive controls and regulations imposed by various levels of the federal and provincial governments of Canada. It is not expected that any of these controls or regulations will affect the operations of the Corporation in a manner materially different than they would affect other oil and gas companies of similar size. All current legislation is a matter of public record and the Corporation is unable to accurately predict what additional legislation or amendments may be enacted. All of the governmental regulations noted below may be changed from time to time in response to economic or political conditions. The Corporation’s management believes that the

trend of more expansive and stricter environmental laws and regulations will continue. The implementation of new or modified environmental laws or regulations could have a material adverse impact on the Corporation.

The Corporation is subject to various Canadian federal and provincial laws and regulations relating to the environment. The Corporation believes that it is currently in compliance with such laws and regulations. However, such laws and regulations may change in the future in a manner which will increase the burden and cost of compliance. In addition, the Corporation could incur significant liability under such laws for damages, clean-up costs and penalties in the event of certain discharges into the environment. In addition, environmental laws and regulations may impose liability on the Corporation for personal injuries, clean-up costs, environmental damage and property damage as well as administrative, civil and criminal penalties. The Corporation maintains limited insurance coverage for accidental environmental damages, but does not maintain insurance for the full potential liability that could be caused by such environmental damage. Accordingly, the Corporation may be subject to significant liability, or may be required to cease production in the event of the noted liabilities.

Provincial Regulation – Royalties Incentives and Land Tenures

In addition to federal regulations, each province has regulations which govern land tenure, royalties, production rates, extra-provincial export, environmental protection and other matters. The royalty regime is a significant factor in the profitability of oil and natural gas production. Royalties payable on production from lands other than Crown lands are determined by negotiations between the mineral owner and the lessee. Crown royalties are determined by government regulation and are generally calculated as a percentage of the value of the gross production. The rate of royalties payable generally depends in part on prescribed reference prices, well productivity, geographical location, field discovery date and the type or quality of the petroleum product produced. From time to time the provincial governments of Canada have established incentive programs which have included royalty rate reductions, royalty holidays and tax credits for the purpose of encouraging oil and natural gas exploration or enhanced planning projects. Crude oil and natural gas located in the western provinces is owned predominantly by the respective provincial governments. Provincial governments grant rights to explore for and produce oil and natural gas pursuant to leases, licenses and permits for varying terms from two years and on conditions set forth in provincial legislation including requirements to perform specific work or make payments. Oil and natural gas located in such provinces can also be privately owned and rights to explore for and produce such oil and natural gas are granted by lease on such terms and conditions as may be negotiated.

**Terra Energy Corp.
Consolidated Financial Statements
For the years ended December 31, 2006 and 2005**

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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, 2006 and 2005 and the consolidated statements of operations 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, 2006 and 2005 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"

Calgary, Alberta
February 26, 2007

Chartered Accountants

**Terra Energy Corp.
Consolidated Balance Sheets**

As at December 31	2006	2005
Assets		
Current		
Cash and cash equivalents	\$ -	\$ 13,127,316
Accounts receivable	5,752,846	7,972,458
Financial instruments (Note 3)	1,841,861	275,513
Prepaid expenses	1,261,720	810,347
	8,856,427	22,185,634
Oil and gas properties (Note 6)	138,704,967	103,561,874
	\$ 147,561,394	\$125,747,508
Liabilities and Shareholders' Equity		
Current		
Bank overdraft (Note 7)	\$ 8,412,852	\$ -
Accounts payable and accrued liabilities	10,775,251	22,942,084
	19,188,103	22,942,084
Deferred credit (Note 15)	249,090	-
Long-term financing (Note 7)	35,478,837	29,610,391
Asset retirement obligation (Note 9)	5,033,926	4,577,373
Future income taxes (Note 13)	10,245,725	3,934,690
Preferred shares (Note 10)	-	1,148,641
	70,195,681	62,213,179
Shareholders' Equity		
Share capital (Note 11(b))	73,004,715	60,984,212
Contributed surplus (Note 12)	7,838,602	3,809,311
Deficit	(3,477,604)	(1,259,194)
	77,365,713	63,534,329
	\$ 147,561,394	\$125,747,508
Commitments and contingencies (Notes 16 and 17)		

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 Deficit

For the years ended December 31	2006	2005
Revenue		
Petroleum and natural gas revenues	\$ 45,101,148	\$ 42,419,132
Realized gain or (loss) on financial instruments (Note 4)	937,211	(2,438,415)
Unrealized gain on financial instruments (Note 4)	1,841,861	275,513
	<u>47,880,220</u>	<u>40,256,230</u>
Royalties	(9,107,294)	(8,311,435)
	<u>38,772,926</u>	<u>31,944,795</u>
Expenses		
Production	13,289,212	13,016,861
General and administrative	3,950,746	3,666,320
Accretion expense	415,645	377,948
Stock-based compensation	2,743,436	940,000
Depletion, depreciation and amortization	13,586,765	8,932,000
Financing fee amortization (Note 8)	-	2,969,500
Interest on long-term debt	2,288,280	758,360
Realized foreign exchange gain (Note 3)	(807,660)	-
	<u>35,466,424</u>	<u>30,660,989</u>
Income before income taxes	<u>3,306,502</u>	<u>1,283,806</u>
Income tax expense (Note 13)		
Current tax	32,346	106,274
Future tax	2,386,504	-
	<u>2,418,850</u>	<u>106,274</u>
Net income for the year	887,652	1,177,532
Deficit, beginning of year	(1,259,194)	(1,711,273)
Repurchase of common shares (Note 11(b))	<u>(3,106,062)</u>	<u>(725,453)</u>
Deficit, end of year	\$ (3,477,604)	\$ (1,259,194)
Income per share (Note 11(f))		
Basic	\$ 0.01	\$ 0.02
Diluted	\$ 0.01	\$ 0.02

Terra Energy Corp.
Consolidated Statements of Cash Flows

For the years ended December 31	2006	2005
Cash flows from operating activities		
Net income for the year	\$ 887,652	\$ 1,177,532
Items not affecting cash:		
Future income taxes	2,386,504	-
Accretion of asset retirement obligations	415,645	377,948
Stock-based compensation	2,743,436	940,000
Financing fee amortization	-	2,969,500
Unrealized gain on financial instruments (Note 4)	(1,841,861)	(275,513)
Realized gain on financial instruments	275,513	-
Amortization of deferred credit	(38,869)	-
Depletion, depreciation and amortization	13,586,765	8,932,000
Cash flow from operations	<u>18,414,785</u>	<u>14,121,467</u>
Changes in non-cash working capital from operations (Note 14)	<u>269,043</u>	<u>2,520,168</u>
	<u>18,683,828</u>	<u>16,641,635</u>
Cash flows from financing activities		
Proceeds from long-term financing	5,868,446	13,748,018
Increase in bank indebtedness	8,412,852	(295,529)
Repayment of subordinated debt	-	(10,000,000)
Issuance of common shares, net of issuance costs	20,453,165	38,475,035
Repurchase of preferred shares (Note 10)	(1,148,641)	-
Repurchase of common shares	(6,339,284)	(1,205,585)
	<u>27,246,538</u>	<u>40,721,939</u>
Cash flows from investing activities		
Additions to oil and gas properties	(57,513,729)	(51,182,314)
Disposition of oil and gas properties	8,824,779	3,175,000
Reimbursement of leasehold improvements (Note 15)	298,905	-
Changes in non-cash working capital from investing (Note 14)	(10,667,637)	3,771,056
	<u>(59,057,682)</u>	<u>(44,236,258)</u>
(Decrease) increase in cash and cash equivalents	(13,127,316)	13,127,316
Cash and cash equivalents, beginning of year	13,127,316	-
Cash and cash equivalents, end of year	\$ -	\$ 13,127,316

Years Ended December 31, 2006 and 2005

1. NATURE OF OPERATIONS

Terra Energy Corp. (the "Corporation") was formed on January 30, 2004 as a result of the amalgamation of Rhodes Resources Corp. ("Rhodes"), Terrapet Energy Corp. ("Terrapet"), and Terra Energy Corp ("Terra") pursuant to the Business Corporations Act of Alberta. The amalgamated Corporation operates under the name Terra Energy Corp. The Corporation's principal business is the exploration, development, and production of oil and natural gas 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 accordance 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 within 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, 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 original maturity dates less than 90 days.

Deferred Financing Costs

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

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.

Years Ended December 31, 2006 and 2005

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

Oil and Gas Properties

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

In applying the full cost method, the Corporation performs a ceiling test on properties which restricts the capitalized costs less accumulated depletion from exceeding an amount equal to the estimated undiscounted value of future net revenues from proved oil and gas reserves, as determined by independent engineers, based on sales prices achievable under existing contracts and quoted benchmark prices in effect at year end and current costs, and after deducting estimated, production related expenses, future development costs and certain abandonment costs, as applicable. 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.

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 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 liability method of 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 substantively enacted income tax rates and laws that will be in effect when the differences are expected to reverse.

Years Ended December 31, 2006 and 2005

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

Flow-through Shares

Expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are to be renounced to investors in accordance with income tax legislation. A future tax liability is recognized upon the renunciation of tax pools and related filings with the tax authorities, and share capital is reduced.

Derivative Financial Instruments

The Corporation utilizes derivative financial instruments to manage its exposure to fluctuations in commodity prices, foreign exchange rates and interest rates.

Financial instruments that do not qualify as hedges or are not designated as hedges, are recorded at fair value on the balance sheet. The change in fair value from the prior reporting period is recognized in earnings. Realized gains or losses from financial instruments which qualify for hedge accounting related to commodity prices are recognized as a part of revenues in the same period that the related sales occur.

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 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 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 a 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 fair values are determined using the Black-Scholes option-pricing model. Consideration received upon the exercise of stock options is recorded as an increase in share capital.

Years Ended December 31, 2006 and 2005

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

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.

Comprehensive Income

Beginning in fiscal year 2007, the Corporation will be required to adopt the new Section 1530 "Comprehensive Income" standard issued by the Canadian Institute of Chartered Accountants. Under this section, a new financial statement, Consolidated Statement of Other Comprehensive Income, has been introduced that provides for, among other things, that foreign currency translation adjustments from self-sustaining foreign operations be temporarily recorded outside the income statement. The Corporation is evaluating the impact of this new standard, but management does not anticipate that this will have a material impact on the Corporation's financial position or results of operations.

3. FINANCIAL INSTRUMENTS

The Corporation carries a number of financial instruments. It is management's opinion that the Corporation is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted. The nature of these instruments and the Corporation's operations expose the Corporation to interest rate, commodity price and industry credit risks. The Corporation manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

Credit Risk

The Corporation is exposed to credit risk from financial instruments to the extent of non-performance by third parties and non-performance by counterparties to forward commodity agreements. The Corporation minimizes credit risk associated with possible non-performance by financial instrument counterparties by entering into contracts with only highly rated counterparties and by controlling third party credit risk with credit approvals. Credit risk also arises from the possibility that the entities to which the Corporation sells its oil and gas production 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 manages its exposure to interest rate risk through floating rate borrowings. The floating rate debt is subject to interest rate cash flow risk, as the required cash flows to service the debt will fluctuate as a result of changes in market rates.

As at December 31, 2006, the increase or decrease in net earnings before taxes for each 1% change in interest rates on floating rate debt amounts to approximately \$354,788 (2005 - \$352,884) per annum. The related disclosure regarding these debt instruments is included in Note 7 of these consolidated financial statements.

Years Ended December 31, 2006 and 2005

3. FINANCIAL INSTRUMENTS (Continued)

Foreign Exchange Risk

The price of commodities sold by the Company is affected by the Canadian/US dollar exchange rate that may fluctuate over time. During 2006, Terra Energy diversified its debt by borrowing by way of Canadian and US dollar Banker's Acceptances. Terra Energy entered into forward foreign exchange contracts to crystallize the foreign exchange gain associated with the US dollar Banker's Acceptances. As the result of these forward exchange contracts, the Corporation crystallized \$807,660 in foreign exchange gain. There were no foreign exchange contracts outstanding at December 31, 2006.

Commodity Contracts

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.

At December 31, 2006, the Corporation had entered into commodity 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

The mark to market adjustment of these contracts has been recognized as an asset in the amount of \$1,841,861 at December 31, 2006.

Years Ended December 31, 2006 and 2005

4. REVENUE

As at December 31, 2006, petroleum and natural gas revenue includes realized gain (net of loss) on financial instruments of \$937,211 (2005 - loss of \$2,438,415) and unrealized net gain on financial instruments of \$1,841,861 (2005 - \$275,513).

5. RELATED PARTY TRANSACTIONS

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

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

Capital Strategies Canada Corp., controlled by two officers of the Corporation
 Rhodes Petroleum Corp., controlled by an officer of the Corporation
 Terra Capital Corp., a significant shareholder (31%)
 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 - the Corporate Secretary is partner with the law firm

- b) Transactions

	2006	2005
Expenses		
Service fees - Terra Capital Corp. (Note 5(d))	\$ -	\$ 295,913
Consulting - Pioneer Land Services Ltd.	5,091	16,519
Legal Consulting - Borden Ladner Gervais LLP	212,902	157,870
Joint Venture revenues and expenses - Rhodes Petroleum Corp., of which \$17,875 is included in accounts receivable in 2006	17,875	-
Legal Consulting - Fasken Martineau LLP	51,453	60,011
	\$ 287,321	\$ 530,313
Other		
Recorded as part of Oil and Gas Properties - Pioneer Land Services Ltd	\$ 50,842	\$ 107,867
Recorded as part of Share issuance cost - Borden Ladner Gervais LLP	68,000	62,498
Recorded as part of share issuance cost - Fasken Martineau LLP	-	17,860
Acquisition of PN&G and office equipments recorded as part of oil and gas properties - Terra Capital Corp.	-	124,000
	\$ 118,842	\$ 312,225

- 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.

Years Ended December 31, 2006 and 2005

5. RELATED PARTY TRANSACTIONS (Continued)

- d) In 2005, fees were reimbursed to Terra Capital Corp for personnel services, for leasing of office furniture, vehicles and equipment.

Prior to amalgamation and up to March 31, 2004 all personnel were employees of Terra Capital Corp. During 2004, all personnel entered into employment arrangements directly with Terra Energy, except for one senior officer whose employment agreement was executed November 18th, 2005.

The Corporation leased vehicles, office furniture, and equipment pursuant to a lease to purchase agreement with Terra Capital Corp. At December 31, 2005, the Corporation bought out the underlying leased assets.

- e) During 2006, officers and directors purchased 323,000 (2005 - 20,989) shares of the Corporation through private placement offerings for the same prices as offered to arms length participants.
- f) The Corporation has issued and outstanding Series I to V, 8% cumulative preferred shares, which are redeemable and retractable at \$1 per share. These were all held by a senior officer of the Corporation. All dividends have been paid to December 31, 2006. During the fourth quarter, the board of directors approved the repurchase of the preferred shares at face value. The preferred shares have been repurchased for cancellation. Liability in the amount of \$nil (2005 - \$1,148,641) has been reflected in the Corporation's consolidated financial statements. During the current year, dividends of \$79,402 (2005 - \$91,891) were paid. These amounts have been recorded as of long term debt interest.

6. OIL AND GAS PROPERTIES

	2006	2005
Oil and gas properties	\$ 167,957,385	\$ 119,227,527
Accumulated depletion	(29,252,418)	(15,665,653)
Net book value	\$ 138,704,967	\$ 103,561,874

At December 31, 2006, included in oil and gas properties is \$3,474,408 (2005 - \$1,886,871) worth of equipment inventory not in use and development costs for wells where no reserves have been assigned. These costs were excluded from the depletion base. Undeveloped land costs of approximately \$18.5 million (2005 - \$10.2 million) is currently not being depleted. General administrative expenses of \$772,352 (2005 - \$658,772) have been capitalized to oil and gas properties.

The Corporation applied a ceiling test to its capitalized assets at December 31, 2006 and determined that there was no impairment.

Years Ended December 31, 2006 and 2005

6. OIL AND GAS PROPERTIES (Continued)

The following table outlines benchmark prices used in the impairment test at December 31, 2006:

Year	WTI Crude Oil US\$/bbl	Exchange Rate US\$/CDN\$	Edm Light Crude Cdn\$/bbl	AECO Natural Gas CDN\$/GJ
2007	62.00	0.87	70.25	7.20
2008	60.00	0.87	68.00	7.45
2009	58.00	0.87	65.75	7.75
2010	57.00	0.87	64.50	7.80
2011	57.00	0.87	64.50	7.85
2012	57.50	0.87	65.00	8.15
After 2018 (inflation %)	2%/yr	0%/yr	2%/yr	2%/yr

7. LONG-TERM FINANCING

The Corporation has a revolving line of credit, with a syndicate of chartered banks, of up to \$55 million (2005 - \$40 million), which bears interest at prime plus 0.25% (2005 - prime plus 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, 2006, the Corporation was indebted on the revolving line of credit in amount of \$35,478,837 (2005 - \$29,610,391). The outstanding cheques issued in the amount of \$8,412,852 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 2007. 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, 2006 and 2005, the Corporation was in compliance with all loan covenants.

Years Ended December 31, 2006 and 2005

8. SUBORDINATED DEBT

During 2004, the Corporation had available a standby mezzanine financing credit facility of \$15 million, with an interest rate of 10% per annum. At December 31, 2004, the Corporation had drawn \$10 million on this facility. The unadvanced portion of \$5 million was cancelled and was no longer available.

The facility charged a standby fee of 5% on the unadvanced portion of \$5 million and a closing fee of 0.75% on the advanced portion of \$10 million. The Corporation also issued 5 million warrants to the creditor, with each warrant to purchase one common share, at prices between \$1.20 and \$1.60. These warrants were valued at \$2,307,000 (Note 11). These amounts were fully amortized when the facility was repaid in full early in 2005. The facility was secured by a floating charge debenture on the Corporation's assets, subordinated to the Corporation's existing security issued in relation to the Long-Term Financing (Note 7).

9. ASSET RETIREMENT OBLIGATION

The undiscounted amount of expected cash flows required to settle the asset retirement obligations is estimated at \$15,328,566 (2005 - \$9,204,000). The liability for the expected cash flows, as reflected in the consolidated financial statements, has been discounted at 9% (2005 - 9%) and the inflation rate used is 2% (2005 - 2%).

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

	2006	2005
Opening balance, beginning of year	\$ 4,577,373	\$ 4,021,143
Liabilities disposed	(138,675)	(923,126)
Revisions to estimates	(81,180)	(810,062)
Liabilities settled	(84,219)	-
Liabilities incurred	344,982	1,911,470
Accretion expenses	415,645	377,948
Ending balance, end of year	\$ 5,033,926	\$ 4,577,373

The majority of costs attributable to these commitments and contingencies are expected to be incurred between 2007 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.

Years Ended December 31, 2006 and 2005

10. PREFERRED SHARES

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, the board of directors approved the repurchase of the preferred shares at face value. The preferred shares which were all held by a senior officer of the Corporation have been repurchased for cancellation. Liability in the amount of \$nil (2005 - \$1,148,641) has been reflected in the Corporation's consolidated financial statements. The holder of the preferred shares had waived the right to redeem these shares prior to January, 2007. As a result, the liability had been classified as long-term debt. During the current year, dividends of \$79,402 (2005 - \$91,891) were paid. These amounts have been recorded as long-term debt interest.

Years Ended December 31, 2006 and 2005

11. SHARE CAPITAL

- a) Authorized
 - i) Unlimited number of common voting shares
 - ii) Unlimited number of preferred shares
- b) Issued and outstanding

	2006		2005	
	Number of Shares	Amounts	Number of Shares	Amounts
Common shares				
Balance, beginning of year	68,093,883	\$ 57,375,841	42,008,611	\$ 20,780,818
Issued on exercise of warrants (Note 11(d))	2,286,650	3,269,485	3,223,417	4,084,502
Issued on exercise of options	2,102,000	2,484,245	560,936	625,556
	72,482,533	63,129,571	45,792,964	25,490,876
Flow-through shares issued:				
January 25, 2005 at \$1.40	-	-	3,366,366	4,712,905
July 27, 2005 at \$2.00	-	-	3,900,000	7,800,000
November 21, 2006 at \$1.90	8,270,000	15,713,000	-	-
	8,270,000	15,713,000	7,266,366	12,512,905
Private placements:				
January 25, 2005 at \$1.25, net of deemed warrant value	-	-	6,561,200	6,898,926
July 27, 2005 at \$1.70, net of deemed warrant value	-	-	9,117,353	13,153,208
	-	-	15,678,553	20,052,134
Tax effect of flow-through share renouncement	-	(4,254,388)	-	-
Transfer from contributed surplus (Note 12)	-	1,014,501	-	1,602,805
Carrying value of warrants exercised	-	873,757	-	40,495
Shares repurchased for cancellation	(3,851,700)	(3,233,222)	(644,000)	(480,132)
Cash share issue costs, net of tax of \$329,857 (2005 - \$881,617)	-	(672,762)	-	(1,567,318)
Non-cash share issue costs	-	-	-	(275,924)
	(3,851,700)	(6,272,114)	(644,000)	(680,074)
Balance, end of year	76,900,833	\$ 72,570,457	68,093,883	\$ 57,375,841
Share purchase warrants				
Balance, beginning of year	7,752,277	\$ 3,608,371	-	\$ -
Issued	-	-	7,839,277	3,648,866
Expired	(4,469,427)	(2,300,356)	-	-
Exercised 2005 warrants (Note 11(d))	(2,189,150)	(873,757)	(87,000)	(40,495)
Balance, end of year	1,093,700	\$ 434,258	7,752,277	\$ 3,608,371
Total common shares and warrants	77,994,533	\$ 73,004,715	75,846,160	\$ 60,984,212

Years Ended December 31, 2006 and 2005

11. SHARE CAPITAL (continued)

During 2004, the Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 250,000 common shares to April 22, 2005. In 2005, the Corporation purchased for total proceeds of \$289,864, 249,400 common shares, at an average price of \$1.16 per common share. \$74,072 was recorded as a reduction of share capital and the excess of \$215,792 was charged to deficit.

During 2005, the Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 2,500,000 common shares to April 24, 2006. During the period ended April 24, 2006, 1,213,500 shares were repurchased for \$2,343,564 at an average price of \$1.93 per common share. The Corporation recorded \$959,551 as a reduction of share capital and the excess of \$1,384,013 was charged to deficit.

In May 2006, the Corporation obtained permission from the TSX Venture Exchange for a Normal Course Issuer Bid to repurchase for cancellation up to 5,000,000 common shares to May 17, 2007. During the period ended December 31, 2006, the Corporation repurchased 3,282,200 shares for \$5,201,305 at an average price of \$1.58 per common share and recorded \$2,753,803 as a reduction of share capital and the excess of \$2,447,502 was charged to deficit.

Of the repurchased shares 1,978,200 are being held for cancellation.

Pursuant to an escrow agreement and the policies of the TSX Venture Exchange, 19,731,522 common shares of the Corporation were deposited in escrow at the amalgamation date to form Terra Energy Corp. The shares have all been released. (2005 - 236,844 were remaining to be released).

Years Ended December 31, 2006 and 2005

11. SHARE CAPITAL (continued)

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.

Details of all options outstanding are as follows:

	2006		2005	
	Number of Options	Weighted average exercise price	Number of Options	Weighted average exercise price
Employee Stock Options				
Balance, beginning of year	4,201,000	1.24	2,483,000	\$0.98
Granted	3,365,500	1.80	2,243,000	1.24
Exercised	(1,610,500)	(1.11)	(195,000)	(1.01)
Expired	(154,000)	(1.89)	(330,000)	(1.27)
Balance, end of year	5,802,000	1.58	4,201,000	1.24
Agent Options				
Balance, beginning of year	1,383,209	1.40	1,054,216	1.32
Granted	-	-	694,929	1.40
Exercised	(491,500)	(1.40)	(365,936)	(1.17)
Expired	(236,780)	(1.40)	-	-
Balance, end of year	654,929	1.40	1,383,209	1.40
Other Options				
Balance, beginning of year	329,730	1.21	329,730	1.21
Expired	(329,730)	1.21	-	-
Balance, end of year	-	-	329,730	1.21
Total Options, balance, end of year	6,456,929	1.56	5,913,939	\$ 1.27

Years Ended December 31, 2006 and 2005

11. SHARE CAPITAL (continued)

c) Stock Options (continued)

During 2006, the Corporation granted options to officers, directors, employees, and consultants to purchase 3,365,500 (2005 - 2,243,000) common shares ranging at prices between \$1.66 and \$2.27. Of these options 91,400 have since expired.

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

The weighted average price of outstanding stock options at December 31, 2006 was \$1.56 (2005 - \$1.27). The weighted average price for exercisable options was \$1.60 (2005 - \$1.27), and term for exercisable options was 2.55 years (2005 - 2.27 years).

Years Ended December 31, 2006 and 2005

11. SHARE CAPITAL (continued)

c) Stock Options (continued)

Options outstanding as at December 31, 2005:

<i>Options Exercise Price \$</i>	<i>Weighted Average Remaining Contract Life</i>	<i>Outstanding December 31, 2005</i>	<i>Exercisable December 31, 2005</i>
\$0.75	3.13 years	187,000	187,000
\$1.00	3.13 years	1,558,000	617,000
\$1.00	3.52 years	358,000	118,000
\$1.15	4.07 years	400,000	80,000
\$1.21	1.00 years	329,730	329,730
\$1.40	0.66 years	241,500	241,500
\$1.40	1.00 years	486,780	486,780
\$1.40	1.08 years	654,929	654,929
\$1.51	4.47 years	1,353,000	477,100
\$1.60	4.48 years	60,000	12,000
\$1.70	4.96 years	18,000	3,600
\$1.89	4.76 years	222,000	44,400
\$2.02	4.88 years	10,000	2,000
\$2.10	4.90 years	35,000	7,000
	2.27 years	5,913,939	3,261,039

Years Ended December 31, 2006 and 2005

11. SHARE CAPITAL (continued)

d) Warrants

	2006			Balance, December 31, 2006
	Balance, December 31, 2005	Exercised	Expired	
The Corporation issued in exchange for warrants previously granted by Rhodes Resources Corp., the following warrants:				
Rhodes Series C warrants				
These warrants are exercisable at \$1.10 per common share until January 29, 2005 and at \$1.20 per share until January 29, 2006 at which time these warrants expire.	43,000	33,000	10,000	-
Total Rhodes	43,000	33,000	10,000	-
During 2004, the Corporation issued the following warrants:				
2004 Terra Series B				
These warrants were issued in conjunction with the Subordinated Debt issued on December 30, 2004 and are exercisable at \$1.40 per common share until June 30, 2007 at which time these warrants will expire.	1,250,000	-	-	1,250,000
2004 Terra Series C				
These warrants were issued in conjunction with the Subordinated Debt issued on December 30, 2004 and are exercisable at \$1.40 per common share until December 31, 2006 and at \$1.60 per common share until December 31, 2007 at which time these warrants will expire.	2,500,000	-	-	2,500,000
2004 Terra Series D				
One warrant is required for exercise to purchase one common share at \$1.40 until December 30, 2005 and one common share at \$1.60 until December 30, 2006 at which time these warrants will expire 2005 Terra Series E.	535,250	64,500	470,750	-
Subtotal 2004 warrants	4,285,250	64,500	470,750	3,750,000
During 2005, the Corporation issued the following warrants:				
2005 Terra Series E				
These warrants are exercisable at \$1.40 to purchase one common share until January 26, 2006 and at \$1.60 per one common share until January 26, 2007 at which time these warrants will expire.	3,193,600	2,099,900		1,093,700
2005 Terra Series F				
One warrant is required for exercise to purchase one common share at \$2.10 until July 27, 2007 at which time these warrants will expire.	4,558,677	89,250	4,469,427	-
Subtotal 2005 warrants	7,752,277	2,189,150	4,469,427	1,093,700
Total Terra Energy warrants	12,037,527	2,253,650	4,940,177	4,843,700
Total warrants	12,080,527	2,286,650	4,950,177	4,843,700

Years Ended December 31, 2006 and 2005

11. SHARE CAPITAL (continued)

d) Warrants (continued)

	2005				Balance, December 31, 2005
	Balance, December 31, 2004	Issued	Exercised	Expired	
The Corporation issued in exchange for warrants previously granted by Rhodes Resources Corp., the following warrants:					
Rhodes Series A warrants These warrants are exercisable at \$1.00 per common share until October 28, 2005 when these warrants expire	530,667	-	524,667	6,000	-
Rhodes Series B warrants These warrants are exercisable at \$1.10 per common share until December 31, 2004 and at \$1.20 per share until December 31, 2005 at which time these warrants expire.	373,500	-	370,000	3,500	-
Rhodes Series C warrants These warrants are exercisable at \$1.10 per common share until January 29, 2005 and at \$1.20 per share until January 29, 2006 at which time these warrants expire.	70,000	-	27,000	-	43,000
Total Rhodes warrants	974,167	-	921,667	9,500	43,000
During 2004, the Corporation issued the following warrants:					
2004 Terra Series A These warrants were issued in conjunction with the Subordinated Debt issued on December 30, 2004 and are exercisable at \$1.20 per common share until December 31, 2006 at which time these warrants will expire.	1,250,000	-	1,250,000	-	-
2004 Terra Series B These warrants were issued in conjunction with the Subordinated Debt issued on December 30, 2004 and are exercisable at \$1.40 per common share until June 30, 2007 at which time these warrants will expire.	1,250,000	-	-	-	1,250,000
2004 Terra Series C These warrants were issued in conjunction with the Subordinated Debt issued on December 30, 2004 and are exercisable at \$1.40 per common share until December 31, 2006 and at \$1.60 per common share until December 31, 2007 at which time these warrants will expire.	2,500,000	-	-	-	2,500,000
2004 Terra Series D One warrant is required for exercise to purchase one common share at \$1.40 until December 30, 2005 and one common share at \$1.60 until December 30, 2006 at which time these warrants will expire 2005 Terra Series E.	1,500,000	-	964,750	-	535,250
During 2005, the Corporation issued the following warrants:					
Subtotal 2004 warrants	6,500,000	-	2,214,750	-	4,285,250
2005 Terra Series E These warrants are exercisable at \$1.40 to purchase one common share until January 26, 2006 and at \$1.60 per one common share until January 26, 2007 at which time these warrants will expire.	-	3,280,600	87,000	-	3,193,600
2005 Terra Series F One warrant is required for exercise to purchase one common share at \$2.10 until July 27, 2007 at which time these warrants will expire.	-	4,558,677	-	-	4,558,677
Subtotal 2005 warrants	-	7,839,277	87,000	-	7,752,277
Total Terra Energy warrants	6,500,000	7,839,277	2,301,750	-	12,037,527
Total warrants	7,474,167	7,839,277	3,223,417	9,500	12,080,527

Years Ended December 31, 2006 and 2005

11. SHARE CAPITAL (continued)

e) Stock-Based Compensation

For stock options granted to employees compensation expense of \$2,743,436 has been recorded for the year ended December 31, 2006 (2005 - \$940,000) with the offsetting credit to contributed surplus. The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yield nil (2005 - Nil); expected volatility at 66% (2005 - 50% to 70%); risk-free interest rate of 4.0-6.0% (2005 - 3.5% to 4.25%); weighted average life of 2.96 years (2005 - 5 years) .

For the options granted during 2006, the estimated fair value expected to be recognized over the option life is approximately \$2,838,901 (2005 - \$1,322,014) or \$0.82 per option issued (2005 - \$0.59).

f) Per Share Amounts

The income per share figures has been calculated using the weighted average number of common shares outstanding during the periods. The following table summarizes the calculation of basic net income and diluted net income per share.

	2006	2005
Net income available to common shareholders	\$ 887,652	\$ 1,177,532
Weighted-average number of common shares outstanding - basic	71,515,707	57,772,818
Dilutive effect of stock options	560,464	1,916,565
Dilutive effect of warrants	934,996	1,931,618
Weighted-average number of commons shares outstanding - diluted	73,011,167	61,621,001
Net income per share (\$/share)		
Basic	\$0.01	\$0.02
Diluted	\$0.01	\$0.02

For 2006, 1,591,900 stock options (2005 - 267,000) and nil warrants (2005 - 4,558,677) are anti-dilutive and have been excluded from the calculation of diluted earnings per share.

12. CONTRIBUTED SURPLUS

Contributed surplus consists of the fair value of both share warrants issued for various financing agreements and for the stock-based compensation on stock options.

The details of contributed surplus are as follows:

	2006	2005
Balance, beginning of year	\$ 3,809,311	\$ 4,196,192
Stock-based compensation	2,743,436	940,000
Agent's options granted	-	275,924
Warrants expired	2,300,356	-
Exercise of options and warrants to common shares	(1,014,501)	(1,602,805)
Balance, end of year	\$ 7,838,602	\$ 3,809,311

Years Ended December 31, 2006 and 2005

13. INCOME TAXES

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

	2006	2005
Oil and gas properties	\$ 7,323,104	\$ 3,209,587
Valuation allowance	1,222,941	1,260,000
Deferred partnership income	7,809,953	6,085,389
Attributed crown royalty income benefit	(450,678)	(194,147)
Non-capital loss carryforwards	(4,610,380)	(5,367,753)
Share issuance costs	(1,049,215)	(1,058,386)
Future income tax liability	<u>\$ 10,245,725</u>	<u>\$ 3,934,690</u>

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.

- 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% (2005 - 34%) to the earnings for the following years as follows:

	2006	2005
Expected income tax expense	\$ 1,091,146	\$ 436,494
Crown royalties, net of ARTC	1,384,851	56,349
Large corporations tax	13,542	98,285
Resource allowance	(707,598)	(351,347)
Stock-based compensation	905,334	319,600
Financing fee	-	1,009,630
Effect of changing tax rate	(240,850)	-
Adjustment to opening tax pool balances	-	(434,831)
Recognition of previously unrecognized income tax benefit	-	(872,234)
Other	(27,575)	(155,672)
Actual income tax expense	<u>\$ 2,418,850</u>	<u>\$ 106,274</u>

- 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:

	2006	2005
Canadian oil and natural gas property expenses (COGPE)	\$ 43,845,400	\$ 38,436,100
Canadian development expenses (CDE)	21,630,800	8,133,600
Canadian exploration expenses (CEE)	17,258,700	11,759,800
Foreign development expenses (FDE)	2,078,017	2,308,817
Foreign development expenses successored (FDE)	3,705,883	3,705,883
Undepreciated capital costs	30,160,000	25,178,300
Loss carryforwards	13,970,800	15,780,900
Share issue costs	3,179,400	3,112,900
Alberta royalty deduction	4,097,100	1,765,000
	<u>\$139,926,100</u>	<u>\$110,181,300</u>

Years Ended December 31, 2006 and 2005

14. STATEMENT OF CASH FLOWS

Changes in non-cash working capital

	2006	2005
Accounts receivable	\$ 2,219,612	\$ (5,575,038)
Taxes receivable	-	28,801
Prepaid expenses	(451,373)	49,518
Accounts payable and accrued liabilities	(12,166,833)	11,787,943
	(10,398,594)	6,291,224
Changes in non-cash working capital from investing	(10,667,637)	3,771,056
Changes in non-cash working capital from operations	269,043	2,520,168
	\$ (10,398,594)	\$ 6,291,224

Other information

	2006	2005
Interest paid	\$ 2,288,280	\$ 758,360
Taxes received	\$ -	\$ 28,568
Taxes paid	\$ 32,346	\$ 134,842
	\$ 32,346	\$ 134,842

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. LEASE COMMITMENTS

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:

Year	Amount
2007	\$ 116,500
2008	164,900
2009	213,200
2010	221,400
	221,400

Years Ended December 31, 2006 and 2005

17. 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 of 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 \$395,000 (2005 - \$561,155) which expire at various dates during 2007.
- c) The Corporation is required to incur exploration and development activities by December 31, 2007 of approximately \$15,713,000 as a result of flow-through shares issued in November 2006. At December 31, 2006, the Corporation has incurred qualifying expenditures of approximately \$1,829,099 towards this obligation.
- d) At December 31, 2006, the Corporation has incurred all of its required exploration and development expenditure obligations arising from the flow-through shares issued in 2005.
- e) The Corporation has firm transportation and processing contracts expiring between October 31, 2007 and 2009. The monthly transportation and processing fees pursuant to the contacts are \$230,000.
- f) 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.

Years Ended December 31, 2006 and 2005

18. SUBSEQUENT EVENT

a) Subsequent to December 31, 2006, the Corporation entered into the following financial commodity contracts:

Contract Type	Floor Price	Ceiling Price	Volumes Per Day	Contract Term
Financial	Sell \$7.40 per GJ	N/A	2,000 GJ	March 1, 2007 to July 31, 2007
Financial	Sell \$6.53 per GJ	N/A	1,000 GJ	April 1, 2007 to October 31, 2007
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 October 31, 2008
Financial	Sell \$8.00 per GJ	\$8.60 per GJ	1,000 GJ	November 1, 2007 to March 31, 2008
Financial	Sell \$7.10 per GJ	N/A	1,000 GJ	April 1, 2007 to October 31, 2007
Financial	Sell \$8.00 per GJ	N/A	2,000 GJ	November 1, 2007 to December 31, 2007
Financial	Sell \$7.95 per GJ	N/A	1,000 GJ	April 1, 2007 to March 31, 2008
Financial	Sell \$8.05 per GJ	N/A	1,000 GJ	December 1, 2007 to December 31, 2007
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

b) Subsequent to the year end, the Corporation re-priced certain stock options. 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. The difference between fair value of the new options issued as compared to the outstanding options will be expensed as at the repricing date.

<i>Old Options Exercise Price \$</i>	<i>New options Exercise price \$</i>	<i>Number of Shares Re-priced</i>	<i>Weighted Average Remaining Contract Life</i>
\$1.15	\$1.08	161,500	3.08 years
\$1.51	\$1.08	693,000	3.47 years
\$1.66	\$1.08	48,000	2.12 years
\$1.66	\$1.08	32,000	3.08 years
\$1.70	\$1.08	248,600	4.53 years
\$1.80	\$1.08	260,000	4.18 years
\$1.82	\$1.08	25,000	2.17 years
\$1.85	\$1.08	40,000	3.05 years
\$1.89	\$1.08	144,400	3.75 years
\$1.89	\$1.08	210,000	4.11 years
\$1.94	\$1.08	40,000	3.45 years
\$2.02	\$1.08	10,000	3.88 years
\$2.10	\$1.08	160,000	4.29 years
\$2.19	\$1.08	26,500	3.05 years
\$2.27	\$1.08	8,000	3.48 years
		2,107,000	