

Unaudited Interim Consolidated Financial Statements of

ARSENAL ENERGY INC.

For the Three Months ended March 31, 2010 and 2009

ARSENAL ENERGY INC.

Interim Consolidated Balance Sheets
(unaudited)

As at	March 31, 2010	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 2,411,775	\$ 1,325,915
Accounts receivable	6,947,393	6,470,045
Prepaid expenses and deposits	496,692	532,808
Risk management contracts (note 8)	468,034	126,749
	10,323,894	8,455,517
Reclamation deposit	152,370	157,650
Property, plant and equipment (note 2)	108,610,834	108,267,249
	\$119,087,098	\$116,880,416
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 16,016,753	\$ 14,778,189
Bank loan (note 3)	14,158,000	22,290,000
Future income tax	135,730	36,757
	30,310,483	37,104,946
Risk management contracts (note 8)	112,519	123,371
Asset retirement obligations (note 5)	13,861,470	14,044,639
Future income taxes	8,249,190	7,860,589
	52,533,662	59,133,545
Shareholders' Equity:		
Common shares (note 7(b))	111,549,449	100,955,986
Contributed surplus (note 7(g))	6,106,719	5,980,601
Accumulated other comprehensive loss	(660,506)	(507,506)
Deficit	(50,442,226)	(48,682,210)
	66,553,436	57,746,871
	\$ 119,087,098	\$ 116,880,416

Segmented information (note 11)
Commitments and contingencies (note 12)
Subsequent event (note 3)

See accompanying notes to interim consolidated financial statements.

ARSENAL ENERGY INC.

Interim Consolidated Statements of Operations and Deficit
(unaudited)

Three months ended March 31

	2010	2009
Revenue		
Oil and gas	\$ 11,586,513	\$ 7,969,913
Realized gain on risk management contract (note 8(a))	318,345	39,341
Unrealized gain on risk management contracts (note 8(a))	352,137	255,846
Royalties	(1,703,210)	(1,799,398)
	10,553,785	6,465,702
Other income	3,809	820
	10,557,594	6,466,522
Expenses		
Operating	3,688,396	3,655,564
Transportation	238,752	211,374
General and administrative	804,142	953,766
Finance charges and fees	258,655	237,299
Interest on convertible debentures	-	34,323
Foreign exchange gain	(170,326)	(204,069)
Convertible debenture accretion	-	16,911
Depletion, depreciation and accretion	7,863,002	6,583,248
Stock-based compensation (note 7(f))	116,419	264,925
	12,799,040	11,753,341
Loss before income taxes	(2,241,446)	(5,286,819)
Income taxes :		
Future income tax (reduction)	(481,430)	(2,215,108)
Net loss for the period	(1,760,016)	(3,071,711)
Deficit, beginning of period	(48,682,210)	(37,631,694)
Deficit, end of period	\$ (50,442,226)	\$ (40,703,405)
Loss per share, basic and diluted (note 7(d))	\$ (0.01)	\$ (0.03)

Interim Consolidated Statement of Comprehensive Loss
(unaudited)

	2010	2009
Net loss for the period	\$ (1,760,016)	\$ (3,071,711)
Translation losses on foreign operations	(153,000)	-
Comprehensive loss	\$ (1,913,016)	\$ (3,071,711)

See accompanying notes to interim consolidated financial statements.

ARSENAL ENERGY INC.

Interim Consolidated Statements of Cash Flows
(unaudited)

Three months ended March 31

	2010	2009
Cash provided by (used in):		
Operations:		
Net loss for the period	\$(1,760,016)	\$ (3,071,711)
Items not affecting cash:		
Unrealized gain on risk management contracts	(352,137)	(295,187)
Depletion, depreciation and accretion	7,863,002	6,583,248
Future income tax reduction	(481,430)	(2,215,108)
Convertible debenture accretion	-	16,911
Stock-based compensation	116,419	264,925
Unrealized foreign exchange gain	(107,081)	(52,952)
Settlement of risk management contracts (note 8)	-	9,085,144
Asset retirement obligations settled	(233,612)	(253,142)
	5,045,145	10,062,128
Net change in non-cash working capital (note 10)	379,565	(3,084,143)
	5,424,710	6,977,985
Financing:		
Bank loan (repayment)	(7,876,900)	(1,399,472)
Repayment of convertible debentures	-	(3,480,000)
Issue of shares for cash	12,604,170	-
Share issue expenses	(1,033,909)	-
Net change in non-cash working capital items (note 10)	26,017	(52,638)
	3,719,378	(4,932,110)
Investing:		
Additions to property, plant and equipment	(8,633,950)	(2,575,061)
Disposition of property, plant and equipment	214,831	839,375
Net change in non-cash working capital items (note 10)	397,030	(583,312)
	(8,022,089)	(2,318,998)
Foreign exchange loss on cash held in foreign currency	(36,139)	24,670
Change in cash and cash equivalents during the period	1,085,860	(248,453)
Cash and cash equivalents, beginning of period	1,325,915	825,223
Cash and cash equivalents, end of period	\$ 2,411,775	\$ 576,770

Supplemental information (note 10)

See accompanying notes to interim consolidated financial statements.

ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements
(Unaudited)
Three Months ended March 31, 2010 and 2009

1. Significant accounting policies:

These interim consolidated financial statements of Arsenal Energy Inc. ("Arsenal" or the "Company") have been prepared by management in accordance with accounting principles generally accepted in Canada, the same accounting principles and methods as used in the financial statements for the year ended December 31, 2009. The interim consolidated financial statement note disclosures do not include all disclosures applicable for annual financial statements. Accordingly, the interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto for the year ended December 31, 2009. These interim consolidated financial statements include the accounts of Arsenal and its wholly owned subsidiaries.

2. Property, plant and equipment:

	March 31, 2010	December 31, 2009
Petroleum and natural gas properties	\$ 165,281,737	\$ 159,328,416
Production equipment	31,827,506	30,002,163
	197,109,243	189,330,579
Office furniture, equipment and other	443,312	443,343
	197,552,555	189,773,922
Accumulated depletion and depreciation	(88,941,721)	(81,506,673)
	\$ 108,610,834	\$ 108,267,249

In Canada and the United States, the costs of acquisition and evaluation of unproved properties have been capitalized but excluded from depletion. The costs of unproved properties excluded in Canada from depletion were \$3,639,561 (2009 - nil). Future development costs totaling \$2,552,700 (December 31, 2009 - \$2,552,700) in Canada and \$26,623,813 (December 31, 2009 - \$27,546,395) in the United States were included in the depletion calculation.

For the period ended March 31, 2010, Arsenal capitalized direct general and administrative expenses of \$105,000 (2009 - \$87,900) and \$21,075 (2009 - \$79,366) of stock based compensation and \$7,482 (2009 - \$23,281) of future tax related thereto.

In the three months ending March 31, 2010, the Company disposed of a non-core minor property for proceeds of \$214,483. In addition, the Company disposed of asset retirement obligations relating to the property sold of \$210,282.

3. Bank loan:

At March 31, 2010, the Company had a \$31,000,000 credit facility consisting of a demand revolving operating loan facility of which \$14,158,000 had been drawn. The facility can be utilized in either Canadian or U.S. dollars.

At December 31, 2009, the Company had a non-revolving reducing term loan facility in the amount of \$4.08 million requiring reductions of \$820,000 per month. On January 29, 2010, the Company repaid its non-revolving reducing term loan.

Debt under the facility, that includes bank debt and working capital deficiency but excludes the risk management contracts and future income tax, amounted to \$20,318,893 at March 31, 2010 (December 31, 2009 - \$28,739,421). Included in debt under the facility at March 31, 2010, is a U.S. \$10,000,000 (CAD - \$10,158,000) Libor based loan.

The credit facility at March 31, 2010 was secured by a fixed and floating charge debenture providing a fixed charge over all present and after acquired petroleum and natural gas interests and a floating charge over all lands, a continuing guarantee from the Company's US subsidiary in the form of a Mortgage Security Agreement and Letter of Undertaking limited to \$13,000,000.

3. Bank loan (continued):

Interest on the Company's demand revolving operating loan facility is at rates ranging from Canadian or US prime plus 1.25% to 2.25% on prime based loans, from the base rate plus 2.75% to 3.75% on guaranteed notes and from the Libor base rate plus 2.75% to 3.75% on Libor based loans. Interest on the Company's non-revolving reducing term loan facility was at Canadian or US prime plus 3.00% on prime based loans and from the base rate plus 4.50% on guaranteed notes and Libor based loans. Borrowings of guaranteed notes and Libor loans were limited under the non-revolving reducing term loan facility to 60% of the outstanding balance. The non-revolving reducing term loan was repaid on January 29, 2010

The interest rate is set based on the net debt to trailing funds flow ratio, as defined in the agreement, (funds flow for the last quarter annualized).

Pursuant to the loan agreement, the Company cannot permit:

- The working capital ratio (as defined in the agreement to include the unutilized portion of the facility) to fall to below 1 : 1.

The Company is in compliance with its bank covenants at March 31, 2010.

In April, based on the bank's review of the Company's December 31, 2009 engineering report, the Company's credit facility was increased from \$31,00,000 to \$40,000,000. The credit facility is secured by a fixed and floating charge debenture providing a fixed charge over all present and after acquired petroleum and natural gas interests and a floating charge over all lands, a limited liability guarantee from the Company's US subsidiary in the form of a Mortgage Security Agreement and Letter of Undertaking in the amount of \$20,400,000. The amount of the facility is subject to a borrowing base test performed on a periodic basis, primarily based on reserves, using commodity prices estimated by the lender, as well as other factors. During the first three months of 2010, the Company incurred interest on its credit facilities in the amount of \$214,566 (2009 - \$288,402).

4. Related party transactions:.

An officer of the Company is a partner in a law firm that provides legal services to the Company. During the first three months of 2010, the Company recorded a total of \$128,639 (March 31, 2009 - \$44,407) for legal fees and disbursements. As at March 31, 2010 accounts payable and accrued liabilities include \$114,689 (December 31, 2009 - \$42,232) relating to these payments.

5. Asset retirement obligations:

The Company's asset retirement obligations result from the net ownership interest in petroleum and natural gas assets including well sites, gathering systems and processing facilities.

The following table presents the reconciliation of the beginning and ending aggregate carrying amount of the obligations associated with the retirement of oil and gas properties:

	Three months ended March 31, 2010	Year ended December 31, 2009
Asset retirement obligations, beginning of period	\$ 14,044,639	\$ 14,498,062
Liabilities settled	(233,612)	(558,798)
Liabilities acquired	-	208,769
Liabilities disposed	(210,282)	(2,541,950)
Liabilities incurred	68,202	134,476
Change in estimate	-	1,619,119
Foreign currency translation	(87,833)	(343,818)
Accretion expense	280,356	1,028,779
Asset retirement obligations, end of period	\$ 13,861,470	\$ 14,044,639

The total undiscounted amount of estimated cash flows required to settle the obligation is \$34.9 million (March 31, 2009 - \$32.7 million), which has been discounted using a credit-adjusted risk free rate of 8.0% (2009 – 8.0%) and an inflation factor of 1.5% (2009 – 1.5%). The majority of these

5. Asset retirement obligations (continued):

obligations will be incurred between 2017 and 2022; however approximately \$9.0 million in obligations are not anticipated to be incurred until after 2030.

6. Convertible debentures:

Arsenal completed a corporate acquisition on March 14, 2006, and assumed obligations under unsecured convertible debentures totaling \$3,480,000. The convertible debentures were a debt security with an embedded conversion option and were segregated into a debt and equity component based on the respective fair value of each at the date of acquisition. The equity component of \$370,000 represented the holder's conversion right and was included in Shareholders' Equity. The remaining balance was classified as debt and was being accreted over the remaining period to maturity to the face value of the debenture. The interest accrued on the debentures at 8%, payable semi-annually on June 30th and December 31st of each year. The debentures matured and were repaid on February 15, 2009 and the holders conversion rights were reclassified to contributed surplus.

7. Shareholder's equity:

a) Authorized:

Unlimited number of common shares

Unlimited number of non-voting preferred shares, issuable in series.

b) Issued:

	Three Months Ended March 31, 2010		Year Ended December 31, 2009	
	Number	Amount	Number	Amount
Common shares:				
Balance, beginning of period	120,461,890	\$ 100,955,986	101,249,646	\$ 93,515,925
Issued on exercise of options	28,500	13,620	-	-
Common shares issued	11,283,000	9,590,550	8,000,000	4,000,000
Flow-through common shares issued	3,000,000	3,000,000	11,250,000	5,000,000
Tax effect of flow-through shares	-	(1,250,000)	-	(1,040,000)
Share issue costs	-	(1,033,910)	-	(665,580)
Tax effect of share issue costs	-	261,827	-	180,125
Unclaimed shares returned to treasury	-	-	(37,756)	(34,484)
Allocated from contributed surplus	-	11,376	-	-
Balance, end of period	134,773,390	\$ 111,549,449	120,461,890	\$ 100,955,986

Common Shares

On February 26, 2010, the Company issued 11,283,000 common shares at \$0.85 per share for gross proceeds of \$9,590,550.

c) Flow-through shares:

As part of the common share issuance on February 26, 2010, the Company issued 3,000,000 flow-through common shares at \$1.00 per share for gross proceeds of \$3,000,000, for which directors and officers of the Company subscribed for 59,000 flow-through common shares for gross proceeds of \$59,000. The terms of the share issue require the Company to incur Canadian

Exploration Expenses in the amount of \$3,000,000 by December 31, 2011. As at March 31, 2010, no exploration costs had been incurred on this issuance.

7. Shareholder's equity (continued):

On December 17, 2009, the Company issued 2,500,000 flow-through common shares at \$0.60 per share for gross proceeds of \$1,500,000. The terms of the share issue requires the Company to incur Canadian Exploration Expenses in the amount of \$1,500,000 by December 31, 2010. As at March 31, 2010, approximately \$500,000 has been incurred on exploratuion expenditures requiring approximately \$1,000,000 to be incurred by December 31, 2010.

In September 2009, the Company issued 8,750,000 flow-through common shares at \$0.40 per share for gross proceeds of \$3,500,000, for which directors and officers of the Company subscribed for 612,500 flow-through common shares for gross proceeds of \$245,000. The terms of the share issue require the Company incur Canadian Exploration Expenses in the amount of \$3,500,000 by December 31, 2010. As at March 31, 2010, all expenditures had been incurred.

d) Per share amounts:

The following table shows the weighted average number of common and diluted shares.

	Three Months Ended March 31, 2010	Three Months Ended March 31 2009
Basic and diluted:		
Loss per share basic and diluted	\$ (0.01)	\$ (0.03)
Shares outstanding:		
Basic	125,869,090	101,249,646
Diluted	125,869,090	101,249,646

In calculating the per share amounts for the three months ended March 31, 2010, 9,733,500 (2009 – 9,049,000) options were excluded from the dilution calculation, as they were anti-dilutive.

e) Stock options:

The Company has a stock option plan in which the Company may grant options to its directors, officers, employees and consultants for up to 10% of its outstanding common shares. Under the plan, the exercise price of each option granted shall not be less than the market price of the Company's common shares on the date the option is granted and the contractual term of each option is not to exceed five years. All options vest over a period as determined by the Board of Directors. Stock options are granted periodically throughout the year.

7. Shareholder's equity (continued):

The following table summarizes the status of the Company's stock option plan as at March 31, 2010 and December 31, 2009 and the changes during those periods:

	Three Months Ended March 31, 2010		Year Ended December 31, 2009	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Balance, beginning of period	9,322,000	\$ 0.55	7,361,000	\$ 0.70
Granted	440,000	0.88	3,133,000	0.31
Exercised	(28,500)	0.48	-	-
Expirations	-	-	(150,000)	0.59
Forfeited	-	-	(1,022,000)	0.94
Balance, end of period	9,733,500	\$ 0.56	9,322,000	\$ 0.55
Exercisable, end of period	5,613,832	\$ 0.68	4,991,999	\$ 0.73

The following table summarizes information about the stock options outstanding and exercisable at March 31, 2010:

Range	Options outstanding			Options exercisable	
	Number of options	Weighted average exercise price	Weighted average remaining life (years)	Number of options	Weighted average exercise price
\$0.20 to \$0.35	1,674,000	\$ 0.21	3.75	556,666	\$ 0.21
\$0.36 to \$0.50	3,801,500	0.40	3.72	1,239,166	0.39
\$0.51 to \$0.70	1,488,000	0.60	2.90	1,488,000	0.60
\$0.71 to \$1.00	1,590,000	0.82	3.60	1,150,000	0.80
\$1.01 to \$1.50	1,180,000	1.18	0.67	1,180,000	1.18
Total	9,733,500	\$ 0.56	3.22	5,613,832	\$ 0.68

f) Stock-based compensation:

Options granted to employees are accounted for using the fair value method. The fair value of stock options granted during the first three months of 2010 was \$267,564 (\$0.61 per option) (2009 - \$389,025 (\$0.23 per option)) as estimated at the date of grant using the Black-Scholes option-pricing model with weighted average assumptions for grants as follows:

Three Months Ended March 31,	2010	2009
Risk free rate	2.90%	1.46%
Expected life	5 years	5 years
Expected volatility	87%	152%
Expected dividend	nil	nil
Expected forfeitures	nil	nil

7. Shareholder's equity (continued):

g) Contributed surplus:

The estimated fair value of the options, at the time of grant, is amortized and recorded to contributed surplus over the vesting period of the options on a straight line basis. The change in the contributed surplus account is reconciled in the table below:

	Three Months Ended March 31, 2010	Year Ended December 31, 2009
Balance, beginning of period:	\$ 5,980,601	\$ 4,451,743
Stock-based compensation expensed	116,419	912,571
Stock-based compensation capitalized	21,075	211,803
Transferred to share capital	(11,376)	-
Reclassification of equity component of debenture (note 6)	-	370,000
Unclaimed shares returned to treasury	-	34,484
Balance, end of period	\$ 6,106,719	\$ 5,980,601

8. Risk management and financial instruments:

a) Commodity price risk management:

Commodity price risk is the risk that future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by the relationship between the Canadian and United States dollar as well as global economic events that dictate the levels of supply and demand. The Company has attempted to mitigate a portion of the commodity price risk through the use of commodity price contracts.

As at March 31, 2010, the Company has five crude oil swaps and one natural gas swaps in-place fixing the price of future production. All risk management contracts are denominated in Canadian dollars. For the three months ended March 31, 2010, the Company recorded a realized commodity contract gain of \$318,345 (2009 - \$39,341) and an unrealized commodity contract gain of \$352,137 (2009 - \$255,846). The Company assigned three crude oil risk management contracts to its U.S. subsidiary's production. The remaining two crude oil contracts and the natural gas contract relate to Canadian production. As at March 31, 2010 the Company has recorded a current future income tax liability in the amount of \$135,730 based on the current unrealized gain of \$468,034.

The following table details the year end mark-to-market risk management contract presentation in the financial statements at the dates indicated:

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Total fair value consists of the following:		
Fair value, end of period - current portion	\$ 468,034	\$ 78,524
Fair value, end of period - long-term portion	(112,519)	177,323
Total fair value, end of period	\$ 355,515	\$ 255,847

8. Risk management and financial instruments (continued):

The following table reconciles the changes in the fair value of risk management contracts outstanding at the dates indicated:

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Fair value, beginning of period	\$ 3,378	\$ 9,045,804
Changes in fair value	670,482	295,187
Settlement paid (received)	(318,345)	(9,085,144)
Fair value, end of period	\$ 355,515	\$ 255,847

The Company had the following risk management contract outstanding as at March 31, 2010.

Commodity	Volume	Remaining Term	Price	Fair
Natural	1,000 GJ per	April 1, 2010 - Dec 31,	6.78 per	\$ 806,163
Oi	100 bbl per	April 1, 2010 - Apr 30,	72.60 per	(39,022)
Oi	100 bbl per	May 1, 2010 - Apr 30,	70.50 per	(282,392)
Oi	200 bbl per	April 1, 2010 - Dec 31,	69.05 per	(95,422)
Oi	300 bbl per	April 1, 2010 - Dec 31,	67.70 per	74,71
Oi	100 bbl per	Jan 1, 2011 - Dec 31,	69.50 per	(108,527)
			bbl	\$ 355,515

Commodity price sensitivity:

Commodity	201
Natural gas production sold under fixed commodity contract	275,00
Price Change (per GJ)	\$ 0.1
Sensitivity - net loss before	\$ 27,50
<hr/>	
Commodity	
Oil production sold under fixed commodity contract	213,50
Price Change (per bbl)	\$ 1.0
Sensitivity - net loss before	\$ 213,50

b) Fair value of financial instruments:

The Company's exposure under its financial instruments is limited to financial assets and liabilities, all of which are included in these financial statements. Financial instruments include cash and cash equivalents, reclamation deposit, accounts receivable, accounts payable and accrued liabilities, risk management contracts and bank debt. The fair values of financial assets and liabilities that are included in the balance sheet approximate their carrying amounts. Certain of these financial instruments including risk management contracts are measured in the financial statements at fair value. These financial instruments require disclosure about how fair value was determined based on significant levels of inputs described in the following hierarchy:

- Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and value to provide pricing information on an ongoing basis.

8. Risk management and financial instruments (continued):

- Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices in Level 2 are either directly or indirectly observable as of the reporting date. Level 2 valuations

are based on inputs including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace.

- Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

The fair value of risk management contracts as presented on the balance sheet is determined by discounting the difference between the contracted price and published forward price curves as at the balance sheet date, using the remaining contracted oil and natural gas volumes and are considered Level 2.

c) Credit risk:

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint interest partners and petroleum and natural gas marketers.

A substantial portion of the Company's accounts receivable are with customers and joint interest partners in the oil and gas industry and are subject to normal market and industry credit risks.

As at March 31, 2010 the Company's receivables consisted of \$1,320,960 (December 31, 2009 - \$2,636,881) from joint interest partners the majority of which has either been collected or is

expected to be collected within the next 60 days, \$4,253,341 (December 31, 2009 - \$2,922,179) of receivables from petroleum and natural gas marketers, which have been collected and \$1,373,092 (December 31, 2009 - \$910,986) of other receivables. At March 31, 2010, Arsenal had approximately \$940,496 (December 31, 2009 - \$948,160) of receivables that are considered past due and collection efforts, including the taking of production and consideration of legal action have commenced.

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint interest receivables are typically collected within one to three months of the joint interest bill being issued to the partner. The Company attempts to mitigate the risk from joint interest receivables by obtaining partner approval of significant capital expenditures and payment of cash advances prior to expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances are dependent on industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition further risk exists with joint interest partners as disagreements occasionally arise that increase the potential for non-collection. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint interest partners; however the Company does have the ability to request deposits and to withhold production from joint interest partners in the event of non-payment.

The carrying amount of cash and cash equivalents and accounts receivable represents the maximum credit exposure. The Company did not have an allowance for doubtful accounts as at March 31, 2010 (December 31, 2009 - nil).

8. Risk management and financial instruments (continued):

As at March 31, 2010 the Company considers its receivables to be aged as follows:

Aging	December 31, 2009
Not past due	\$ 6,006,897
Past due by more than 90 days	940,496
Total	\$ 6,947,393

d) Foreign currency exchange risk:

The Company is exposed to foreign currency fluctuations as crude oil and natural gas prices received are referenced to United States dollar denominated prices, and revenues earned and costs incurred in the United States are denominated in United States dollars. The Company has mitigated a portion of this exchange risk by entering into fixed Canadian dollar crude oil price swaps as outlined in the commodity price risk section above. At March 31, 2010, the Company had outstanding U.S. \$10,000,000 (CAD - \$10,158,000) of Libor based loans. A \$0.01 increase or decrease in the Canadian / United States foreign exchange rate would increase or decrease, as the case may be, net loss before future income taxes by approximately \$100,000.

e) Interest rate risk:

The Company is exposed to interest rate risk to the extent that the revolving demand loan is at a floating rate of interest. Based on \$19.0 million average bank debt outstanding over the three months ending March 31, 2010, a 100 basis point (1%) change in the interest rate would increase or decrease interest expense for the three month period by \$46,875.

All debt is denominated in Canadian dollars, except for U.S. \$10,000,000 (CAD - \$10,158,000) of Libor based loans.

f) Liquidity risk:

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as much as possible, that it will always have sufficient liquidity to meet its liabilities when due, under normal and stressed conditions. Management closely monitors cash flow requirements to ensure that it has sufficient cash on demand or borrowing capacity to meet operational and financial obligations. At March 31, 2010, the Company had a \$31.0 million credit facility (see note 3).

In April 2010, the facility was increased to \$40.0 million

9. Capital management:

In order to continue the Company's ongoing exploration and development program, the Company must maintain a strong capital base. A strong capital base results in increased market confidence, an essential factor in maintaining existing shareholders and in attracting new investors. The Company is committed to establishing and maintaining a strong capital base to ensure the Company has access to the equity and debt markets when deemed advisable. In order to maintain a strong capital base, the Company continually monitors the risk reward profile of its exploration and development projects and the economic indicators in the market including commodity prices, interest rates and foreign exchange rates. It then determines increases or decreases to its capital budget.

The Company considers shareholders equity, bank debt and working capital as components of its capital base. The Company can access or increase its capital base through the issuance of shares and through bank borrowings that are based on reserves. The Company can safeguard its capital base by stabilizing its funds from operations, by fixing commodity prices on a portion of the Company's production and by closely monitoring expenses and by closely monitoring and scrutinizing the results of its capital expenditure program and adjusting expenditures as required based on economic conditions and drilling results.

9. Capital management (continued):

The Company monitors its capital base based primarily on its net debt to annualized funds flow ratio and its debt to equity ratios. Debt includes bank debt, plus or minus working capital. Annualized funds flow is calculated as cash flow from operations before changes in non-cash working capital and asset retirement expenditures from the Company's most recent quarter multiplied by four adjusted, if required, by increasing or decreasing commodity price expectations and future production profiles. The Company's goal is to target this ratio at 1 : 1 but it can and will fluctuate based on the timing of property transactions, commodity prices and on the mix of exploratory and development drilling. During periods of extreme commodity price declines, high drilling activity or after large property or corporate acquisitions, it is expected that the ratio would increase and during periods of high commodity prices and low activity levels, the ratio would decrease. The Company's focus in these instances is to concentrate on bringing the ratio back into line. The Company prepares an annual operating and capital expenditure budget. The budget is updated when critical factors change and actual results are realized. Critical factors include economic factors such as the state of equity markets, changes to commodity prices, interest rates and foreign exchange rates and non economic factors such as drilling results and production profiles. The Company's board of directors approves the budget and reviews changes thereto.

At March 31, 2010, the Company's debt to annualized funds flow ratio was 0.96 : 1 and its debt to equity ratio was 0.31 : 1. An equity issue with gross proceeds of \$12.6 million during the quarter helped with debt reduction thereby improving the debt to annualized funds flow ratio. The debt to forward funds from operations ratio at March 31, 2010 is higher than the corporate goal of 1 : 1 as established in the Company's strategy goals and guidelines due primarily to reduced commodity prices and therefore lower funds from operations and due to the acquisition of GEOCAN in mid 2008 using primarily debt followed by a significant decline in commodity prices and thus cash flow from operations.

The Company cannot permit the working capital ratio (as defined in the bank loan agreement to include the unutilized portion of the facility) to fall below 1 : 1. At March 31, 2010, the Company has complied with this external financial covenant.

The Company's share capital is not subject to external restrictions, however the credit facilities are petroleum and natural gas reserves based. The Company has not paid or declared any dividends since the date of incorporation and does not foresee doing so in the foreseeable future.

There were no changes in the Company's approach to capital management during the period.

	March 31, 2010
Bank loan	\$ 14,158,000
Working capital (excluding risk management contracts and future income taxes)	6,160,893
Total debt	\$ 20,318,893
Annualized funds flow	\$ 21,115,028
Net debt to annualized funds flow ratio	0.96

10. Supplemental cash flow information:

Three Months ended March 31	2010	2009
Change in non-cash working capital items:		
Accounts receivable	\$ (477,348)	\$ (755,408)
Prepaid expenses and deposits	41,396	(1,180,142)
Accounts payable and accrued liabilities	1,238,564	(1,784,542)
	802,612	(3,720,093)
Amounts relating to operating activities	379,565	(3,084,143)
Amounts relating to financing activities	26,017	(52,638)
Amounts relating to investing activities	397,030	(583,312)
	802,612	(3,720,093)
Interest paid	\$ 227,848	\$ 197,314

11. Segmented information:

A portion of the Company's assets and revenues are earned in the United States and Canada, and are monitored as an identifiable reporting segment by management. Business risks and economic indicators are similar across all geographical regions.

March 31, 2010 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	8,423,684	3,162,829	11,586,513
Income (loss) before income taxes	(2,895,768)	654,322	(2,241,446)
Operating income ¹	4,356,453	1,599,702	5,956,155
Property, plant and equipment	97,339,376	11,271,458	108,610,834
Property dispositions	(214,831)	-	(214,831)
Capital expenditures	7,105,806	1,528,144	8,633,950

March 31, 2009 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	6,348,461	1,621,452	7,969,913
Income (loss) before income taxes	(4,832,937)	(453,882)	(5,286,819)
Operating income ¹	1,819,461	484,116	2,303,577
Property, plant and equipment	114,318,906	7,762,217	122,081,123
Property dispositions	(839,375)	-	(839,375)
Capital expenditures	1,543,590	1,031,471	2,575,061

¹ Defined as oil and gas revenues less royalties, operating costs and transportation.

12. Commitments and contingencies:**a) Flow-through shares:**

In connection with the issuance of flow-through common shares in 2010 and 2009, the Company has a commitment to incur \$1,000,000 of eligible expenditures by December 31, 2010 and a further \$3,000,000 of eligible expenditures by December 31, 2011.

12. Commitments and contingencies (continued):

b) Office premises and equipment leases:

The Company leases its office premises and computer equipment through an operating lease for accounting purposes. The estimated operating lease commitments relating to leased office premises and computer equipment are as follows:

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Office premises and equipment leases	
2010	\$ 384,944
2011	494,752
2012	288,605
2013	-
Total commitment	<hr/>
	\$ 1,168,301

c) Outstanding lawsuits:

Various lawsuits have been filed against the Company for incidents which arose in the ordinary course of business. In the opinion of management, the outcome of the lawsuits, now pending, is not determinable or not material to the Company's operation. Should any loss result from the resolution of these claims, such loss will be charged to operations in the year of resolution.