

# **WAVEFORM ENERGY LTD.**

**MAY 30, 2007**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

The following Management's Discussion and Analysis ("MD&A") for WaveForm Energy Ltd. ("WaveForm" or the "Company") should be read in conjunction with the interim unaudited financial statements and notes of the Company for the three months ended March 31, 2007 and the audited financial statements of the Company for the year ended December 31, 2006. This MD&A incorporates information up to and including May 30, 2007. The financial statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). All of the amounts reported in this MD&A are in Canadian dollars, unless otherwise indicated. Certain other information with respect to the Company is available on SEDAR, at [www.sedar.com](http://www.sedar.com) and at the Company's website at [www.waveformenergy.com](http://www.waveformenergy.com). Additional information can also be obtained by contacting the Company at WaveForm Energy Ltd, Suite 1700, 520, 5<sup>th</sup> Ave. S.W., Calgary, Alberta, T2P 3R7.

### **NON-GAAP FINANCIAL MEASUREMENTS**

The Company has used certain measures of financial reporting that are commonly used benchmarks within the oil and gas industry in this MD&A that are considered non-GAAP measures. The measures used in this document include "cash flow from operations" and "cash flow from operations per share". The term cash flow from operations contained within the MD&A should not be considered as an alternative to, or more meaningful than, cash flow from operating activities as determined in accordance with GAAP. The Company believes that cash flow from operations is a useful supplementary measure as investors may use this information to analyze operating performance, leverage and liquidity. Cash flow from operations, as disclosed within this MD&A, represents funds from operations before changes in non-cash working capital. The Company presents cash flow from operations per share whereby per share amounts are calculated consistent with the calculation of earnings per share. These non-GAAP measures may not necessarily be comparable to similarly titled measures used by other entities and readers of this MD&A are cautioned in attempting to make such comparisons.

## **OTHER MEASUREMENTS**

For the purposes of calculating unit costs, natural gas has been converted to a barrel of oil equivalent ("BOE") using 6,000 cubic feet (6 Mcf) of natural gas equal to one barrel of oil (6:1), unless otherwise stated. The BOE conversion ratio of 6 Mcf to 1 barrel is based on an energy equivalency conversion method and does not represent a value equivalency. Therefore BOEs may be misleading if used in isolation. References to natural gas liquids ("NGLs") in this MD&A include condensate, propane, butane and ethane and one barrel of NGLs is considered to be equivalent to one barrel of crude oil equivalent (BOE).

## **ADVISORY REGARDING FORWARD LOOKING STATEMENTS**

Certain statements included or incorporated by reference in the MD&A constitute forward-looking statements or forward-looking information under applicable securities legislation. Forward-looking statements or information typically contain statements with words such as "anticipate", "expect", "plan", "intend", "estimate", "propose", or similar words suggesting future outcomes or statements regarding an outlook. Forward-looking statements in this MD&A include, but are not limited to, statements with respect to reserves, crude oil and natural gas prices, well productivity, operating costs, general and administrative costs, taxation rates, interest rates, and capital expenditure plans for 2007 and beyond. Existing or potential investors should not to place undue reliance on forward-looking statements as there can be no assurance that the plans, intentions or expectations they are based on will occur. By their nature, forward-looking statements involve numerous assumptions, known and unknown, risks and uncertainties, both general and specific that contributes to the possibility that although the predictions, forecasts, projections and other forward-looking statements are reasonable, there can be no assurance that such expectations will prove to be correct. Some of the risks and other factors which could cause results to differ materially from those expressed in the forward-looking statements contained in the presentation include general economics, business and market conditions; volatility of energy prices; fluctuations in interest rates; energy supply and demand; competition, access to future funding , timing and amount of capital expenditures, imprecision in estimation future productive capacity, well productivity, operating cost adjustments; cost overruns; and such other risks and uncertainties described from time to time. Existing or potential investors are cautioned that the foregoing list of important factors is not exhaustive. Furthermore, the forward-looking statement contained in this document are made as of the date this report, effective May 30, 2007, and the Company does not take any obligations to update publicly or to revise any of the included forward-looking statements, whether as a result of new information, future events or otherwise, unless so required by applicable securities laws. The forward-looking statements contained herein are expressly qualified by this cautionary statement.

## **THE COMPANY**

WaveForm is a junior oil and gas company whose shares have publicly traded on the TSX Venture Exchange since January, 2005 under the trading symbols “WE.A” and “WE.B” for the Class A and Class B shares respectively. The Company is focused on the acquisition, exploration and development of oil and natural gas production in western Canada. Its principal properties are in the Tableland area of southeast Saskatchewan and Rowley and Ferrier areas of Alberta.

## **PRINCIPAL PROPERTIES**

### ***Tableland***

WaveForm currently owns 52,776 acres in the Tableland area of southeast Saskatchewan, consisting of 24,993 of crown lands and 27,784 acres of freehold lands. The Company’s share of production is 38 API oil from 10 wells in the Ratcliff zone. Average production was 88 BOED net (125 BOED gross) for the three months ended March 31, 2007. WaveForm has a 65% working interest in this field. In early May 2007, the Company acquired all of the issued and outstanding shares of another company and as a result, its interest in the Tableland production will be increased to 100%, before royalties.

On March 23, 2007, WaveForm announced that it has entered into a Letter Agreement with a private U. S. based oil and gas company (“Farmee”) whereby the Farmee shall have the right to earn a 70% working interest in the Company’s non-producing land holdings in the Tableland area. The Farmee has committed to commence drilling operations for a Bakken horizontal well on or before August 31, 2007, and upon fulfilling its obligations, the Farmee shall earn a 70% working interest (after payout) in the section comprising the Bakken well. Thereafter, the Farmee may earn a 70% working interest in the remainder of WaveForm’s Tableland non-producing holdings by drilling either a second Bakken horizontal well or by drilling a vertical well to a depth that would test the Winnipegosis Formation. Each well is expected to cost approximately \$3.5 million.

### ***Rowley***

Waveform has 2,720 gross (2,528 net) acres in the Rowley area of Alberta. The Company produces natural gas from two wells. The Company owns 100% working interest in one well which produces from the Mannville and Pekisko zones. The Company has a 70% working interest in a second well with production coming from the Mannville. Average net production from the two wells amounted to 75 boed during the three months ended March 31, 2007. One well was shut in for part of February and most of the month of March for testing undertaken to assist in defining future drilling prospects on the 3D seismic shot during the fourth quarter of 2006. Current daily production from Rowley is approximately 85 BOED. During 2006, the Company shot a 8 square mile 3D seismic in the Rowley field and is currently evaluating these lands for possible drilling locations.

### ***Ferrier***

Waveform has 1,920 (640 net) acres and 12 square miles of 3D seismic in the Ferrier area of Alberta. The Company produces natural gas from two wells producing from the Shunda and Ellerslie zones. WaveForm has a 37.5% non operated working interest in one well. WaveForm has a 25% non operated working interest (with a 15% gross overriding royalty on 25% of production) in a second well which will be converted to a 37.5% working interest after payout expected to occur in the second quarter of 2007. Production at March 31, 2007 was 64 boed net from the two wells. Average net production from the two wells amounted to 64 boed for the three months ended March 31, 2007. After payout, production is expected to increase to approximately 100 boed net to WaveForm. The Company had identified one potential location for drilling in the Shunda zone and one potential target in Rock Creek.

### **ACQUISITION OF STONE CASTLE EXPLORATION LTD. (“Stone Castle”)**

On May 8, 2007, the Company acquired all of the issued and outstanding share capital of Stone Castle Exploration Ltd. (“Stone Castle”), a private oil and gas company with properties jointly held with the Company in Saskatchewan. Shareholders in Stone Castle received units comprised of 0.5 Class A share of the Company and 0.5 warrant to acquire Class A share. Each warrant is exercisable at \$0.20 per share until June 30, 2007, \$0.30 per share until December 31, 2007 and \$0.40 per share until expiry on December 31, 2008. On closing, the Company issued 6,167,500 common shares and 6,167,500 warrants from treasury. The Company also advanced funds to Stone Castle of \$1.6 million which were used to pay third party indebtedness of Stone Castle. The Company increased its loan to its secured lender by an additional \$1 million to \$9 million to partially fund the repayment of indebtedness of Stone Castle.

The acquisition provided the Company with approximately 37 boed of oil production and an additional 13,358 net acres, comprising of 7,444 of crown and 5,914 acres of freehold lands in Tableland, Saskatchewan.

## SUMMARY FINANCIAL RESULTS

	Three Months Ended March 31,	
	2007	2006
Revenues, net of royalties	\$883,260	\$1,138,547
Cash flow (deficiency) from operations (before changes in non cash working capital)	\$(273,051)	\$602,070
Cash flow (deficiency) from operations (before changes in non cash working capital) per share	(\$0.005)	\$0.02
Net income and comprehensive income (loss)	\$395,334	(520,957)
Net income and comprehensive income (loss) per share	\$0.01	(\$0.02)
Total assets at end of period	\$17,203,919	\$26,203,686

## PETROLEUM SALES AND PRODUCTION

	Three Months Ended March 31,	
	2007	2006
Daily average crude oil sales (bbls/d)	84	238
Daily average natural gas sales (mcf/d)	681	-
Daily average natural gas liquid sales (bbls/d)	23	-
Total daily average sales (boe/d)	220	238
Average price received – petroleum sales (per barrel)	\$60.88	\$56.91
Average price received – natural gas sales (per mcf)	\$7.42	-
Average price received – natural gas liquid sales	\$49.02	-
Total operating revenue, net of royalties	\$880,478	\$1,131,812

The Company's average crude oil sales has declined significantly from 238 barrels per day realized during the three months ended March 31, 2006 to 84 barrels per day for the current period principally reflecting the decline in the Company's Tableland production. Natural gas and natural gas liquids sales reflect production from Ferrier and Rowley that was acquired in April 2006. Following the acquisition of Stone Castle, and after payout of the Ferrier well which is expected in June, the Company's current production base is in the region of 300 boe per day. Average price received from crude oil sales increased by 7% during the three months ended March 31, 2007 compared to the same period in 2006.

## ROYALTIES

	Three Months Ended March 31,	
	2007	2006
Crown royalties	\$ 142,981	\$ 41,299
Freehold royalties	4,925	7,868
Gross overriding royalties	16,816	45,846
Total royalty expense	164,722	95,013
Average royalty rate	16.24%	7.74%

Total royalty expense increased significantly from \$95,013 during the three months ended March 31, 2006 to \$164,722 for the same period in 2007. Average royalty rate also increased from 7.74% in 2006 to 16.24% in 2007. Production revenues from Tableland in Saskatchewan has benefited from crown royalty holidays resulting from deep horizontal well incentives. The increase in average royalty rate principally results from royalties paid on production acquired during 2006.

## OPERATING EXPENSES

	Three Months Ended March 31,	
	2007	2006
Operating costs	\$293,139	\$256,770
Operating costs per boe	\$14.90	\$11.91

Operating costs per barrel of oil equivalent has increased from \$11.91 during the three months ended March 31, 2006 to \$14.90 per boe during the same period in 2007. The increase in operating costs results from lower production volumes in the Tableland area.

## DEPLETION AND DEPRECIATION EXPENSE

	Three Months Ended March 31,	
	2007	2006
Depreciation of office equipment	\$ 3,993	\$ 3,546
Accretion of asset retirement obligation	9,072	9,411
Depletion and depreciation of petroleum and natural gas properties	429,092	1,270,109
Total depletion, depreciation, and accretion	\$442,157	\$1,283,066

Total depletion, depreciation and accretion expense declined significantly during the three months ended March 31, 2007 compared to the same period in 2006. The reduction results from lower production volumes coupled with a provision for impairment that was recorded in 2006 against the Company's carrying value of oil and gas properties.

## GENERAL AND ADMINISTRATIVE EXPENSE

Gross general and administrative expenses amounted to \$527,748 for the three months ended March 31, 2007 compared to \$279,707 for the same period in 2006. The increase principally results from higher manpower and consulting costs, and office costs offset in part by the lack of any overhead recovery during 2007 when no wells were drilled by the Company.

## INCOME TAXES

The Company has recorded a loss before income taxes of \$1,059,666 during the three months ended March 31, 2007 compared with a loss of \$787,957 for the same period in 2006. During the period ended March 31, 2007, the Company filed flow through renunciation of expenditures with taxation authorities, resulting in future income tax liability from such flow through renunciations. A valuation allowance recorded at December 31, 2006 of \$1,227,000 was reversed as a result of future income tax liability as at March 31, 2007. As a result, the Company has recorded recovery of future income taxes of \$1,455,000 during the three months ended March 31, 2007.

## NET INCOME AND COMPREHENSIVE INCOME

Although the Company has recorded a pre tax loss of \$1,059,665 for the three months ended March 31, 2007, as a result of the recording of future income tax recoveries of \$1,455,000, the Company has recorded net income and comprehensive income, after taxation, of \$395,334.

## CASH FLOW FROM OPERATIONS

	Three Months Ended March 31,	
	2007	2006
Revenues, net of royalties	\$883,260	\$1,138,547
Operating costs	(293,139)	(256,770)
General and administrative costs	(527,748)	(279,707)
Interest cost	(335,424)	-
Cash flow (deficiency) from operations, before changes in non cash working capital	(273,051)	602,070
Change in non-cash working capital	56,185	(57,348)
Cash flow from (used in) operating activities	(\$216,866)	\$544,722

During the three months ended March 31, 2007, the Company suffered a cash deficiency from operations, before non cash working capital changes, of \$273,051 compared to a cash flow from operations, before non cash working capital changes, of \$602,070 for the same period last year. The cash flow deficiency arises as a result of lower production volumes, higher overhead and impact of interest expense on debt that resulted from the acquisition of additional properties in April 2006.

## CAPITAL EXPENDITURES

Set out below is the summary of capital expenditures incurred on property and equipment during the years ended December 31, 2006 and 2005.

	Three Months Ended March 31,	
	2007	2006
Land acquisition	\$58,491	\$1,670,581
Geological and geophysical	1,523	71,642
Drilling and completion	172,103	5,508,370
Equipment and facilities	163,768	467,333
Other	-	20,000
	\$ 395,885	\$7,737,926

During the three months ended March 31, 2007, the Company did not drill any wells. Capital equipment was purchased to replace rental equipment in the Tableland area to help reduce operating costs and provide for long term economic production. During the first quarter of 2006, the Company drilled a total of 12 (6.5 net) wells.

## FINANCING ACTIVITIES

On January 15, 2007, the Company completed an equity financing, comprising of 32 million Class A Shares, and 32 million warrants to acquire Class A Shares, raising gross proceeds of \$4 million. In addition, the Company raised an additional \$76,625 on the exercise of warrants. Of the equity proceeds, the Company utilized \$2 million to reduce its senior debt from \$10 million to \$8 million. Balance of the proceeds was added to the Company's treasury.

In March 2006, the Company issued 2,916,700 Class A "flow through" shares at \$2.40 per share for gross proceeds of \$7 million. Effective December 31, 2006, The Company has renounced \$7 million to investors for income tax purposes. The Company is committed to spend 100% of the proceeds raised on qualifying exploration and development expenditures. At March 31, 2007, the Company is committed to incur expenditures of \$4,632,366 in expenditures during 2007 to meet its flow through obligations.

In March 2006, the Company issued 1,630,500 Class A shares at \$1.84 per share for gross proceeds of \$3,000,120. With proceeds on exercise of options, the Company raised gross proceeds of \$10,023,467 by way of equity during the three months ended March 31, 2006. Total share issuance costs amounted to \$784,706 during 2006.

With respect to debt, at December 31, 2006, the Company had \$10 million of loan that remained outstanding. On January 15, 2007, the Company repaid \$2 million of the loan reducing the principal amount to \$8 million. In early May, 2007, the loan was increased to \$9 million and the expiry date of the loan was extended to December 31, 2007. The Company was breach of certain financial covenants under the loan facility. The lender has waived compliance with such covenants to date.

## **LIQUIDITY AND CAPITAL RESOURCES**

At December 31, 2006, the Company had \$142,052 in cash and cash equivalents. Net financing activities during the first quarter of 2007 resulted into cash inflow of \$1,668,531 principally from the issue of equity, offset by repayment of a portion of debt facilities. The Company's investment activities consumed \$1,065,184 of cash resources, principally on capital expenditures on the Company's properties and repayment of accounts payable. As a result, the Company's cash resources were increased by \$528,533 during the three months ended March 31, 2007.

On January 15, 2007, the Company closed a private placement of 32 million units at \$0.125 per unit, comprising of 32 million Class A shares and 32 million of warrants to purchase Class A shares until December 31, 2008 at prices varying from \$0.125 per share to \$0.40 per share. This private placement raised gross proceeds of \$4 million on closing. In addition, during 2007, to date, the Company issued 11,933,000 Class A shares on the exercise of warrants raising an additional equity of \$1,491,625 in the form of cash which was added to treasury. In aggregate, the Company has raised \$5,491,625 in additional cash by way of equity during 2007 to date.

The Company presently has a loan outstanding of \$9 million repayable on December 31, 2007. The Company continues to be in a working capital deficit and will need to secure additional equity, debt or a combination thereof in order to be able to pay off the loan in full on due date.

As of May 30, 2007, the Company had limited cash resources of approximately \$1.5 million. The Company remains undercapitalized to exploit all available opportunities that are available to it. The Company has executed a farm out which provides for the drilling of up to two wells on Company lands at no cash cost to the Company. As at March 31, 2007, the Company was committed to incur additional exploration and development expenditures of \$4,632,366 in order to meet its flow through obligations before the end

of 2007. The Company continues to examine all strategic options that are available to it to maximize shareholder value.

## **EQUITY**

Set out below is the Company's equity capital structure as at the dates indicated:

	<b>May 30, 2007</b>	<b>March 31, 2007</b>	<b>December 31, 2006</b>
Class A shares	82,219,131	64,731,631	32,118,631
Class B shares	935,616	935,616	935,616
Warrants to purchase Class A shares	36,334,500	36,487,000	-
Stock options	6,725,000	6,425,000	1,645,333

The authorized share capital consists of an unlimited number of Class A and B voting shares. The Class B shares are convertible into Class A shares based on a formula equal to \$10 divided by the greater of \$1 and the then market price of the Class A shares. The Class B shares are convertible at the option of the Company at any time after January 21, 2008 and before January 31, 2010. The Class B shares are convertible at the option of the shareholder, at any time after February 1, 2010 and before March 1, 2010. Any Class B shares not previously converted will automatically convert to Class A shares on March 1, 2010.

## **CONTRACTUAL OBLIGATIONS**

The Company has entered into a lease for office space which expires on April 30, 2011. The annual commitments for the next five years are as follows:

<b>Annual Commitments</b>	
2007 (nine months)	\$146,812
2008	195,750
2009	195,750
2010	195,750
2011	65,250

During 2006, the Company incurred \$7 million through the issuance of flow through shares and has renounced \$7 million of exploration expenditures to investors. At March 31, 2007, the Company had incurred \$2,367,714 in eligible expenditures and was committed to incur the remaining \$4,632,366 of expenditures during 2007 to meet its flow through commitments.

## **RELATED PARTY TRANSACTIONS**

During the three months ended March 31, 2007, the Corporation incurred an expenditure of \$116,574 (three months ended March 31, 2006 - \$13,056) for general corporate legal services payable to a legal firm of which a director is counsel. These fees are included in general and administrative expense, share issuance costs and acquisition costs. The Corporation incurred \$218,400 (three months ended March 31, 2006 - \$Nil) for financing advisory fees payable to a Company of which a director of the Corporation is an officer, prior to his appointment as a director of the Corporation. The Corporation paid \$4,770 (three months ended March 31, 2006 - \$Nil) for services rendered (in connection with due diligence with respect to a corporate acquisition) to a company controlled by a director of the Corporation. All transactions were completed on the basis of fair market value and general market terms and conditions.

## **NEW ACCOUNTING POLICIES**

The Company follows generally accepted accounting principles in Canada. Effective January 1, 2007, the Company has adopted the new Canadian accounting standards for financial instruments – recognition and measurement, presentation and disclosures, hedging and comprehensive income. There is no material impact as a result of the adoption of the new accounting standards on the Company's financial statements for the current period or prior period.

## **DISCLOSURE CONTROLS AND PROCEDURES**

The Company has established disclosure controls and procedures for the preparation of financial and other reports. The Chief Executive Officer and the Acting Chief Financial Officer have concluded, based upon their evaluation, that the design and operation of these disclosure controls and procedures are adequate and effective in providing reasonable assurance that material information related to the Company, is made known to them by employees or third party consultants working for the Company. It should be noted that while the Company's Chief Executive Officer and Acting Chief Financial Officer believe that the disclosure controls and procedures will provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute assurance that the objectives of the control system are met.

## **INTERNAL CONTROL OVER FINANCIAL REPORTING**

The Chief Executive Officer and Acting Chief Financial Officer of the Company are responsible for designing internal controls over financial reporting or causing them to be designed under their supervision in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

The design of the internal control over financial reporting was assessed as of December 31, 2006. During this process, management identified certain material weaknesses in internal controls over financial reporting which are as follows:

- a) Due to the limited number of staff of WaveForm , it is not possible to achieve a proper segregation of duties; and
- b) Due to the limited number of staff, WaveForm does not have technical accounting expertise and knowledge to address all complex and non-routine financial transactions that may arise.

These weaknesses in WaveForm's internal controls over financial reporting result in a more than remote likelihood that a material misstatement would not be prevented or detected. Management and the board of directors work to mitigate the risk of a material misstatement in financial reporting by segregating duties as much as possible under the circumstances. In addition, outside third party consulting expertise is utilized to assist in dealing with complex accounting and technical issues that arise during preparation of quarterly and annual financial statements. In spite of management's best efforts, there can be no assurance that this risk can be reduced to less than a remote likelihood of a material misstatement. No further material weaknesses other than those described above have been identified.

## SELECTED QUARTERLY INFORMATION

	Three Months Ended			
	March 31, 2007	December 31, 2006	September 30, 2006	June 30, 2006
Revenue (net of royalties)	\$883,260	\$1,091,363	\$1,278,057	\$1,530,342
Net income and comprehensive income (loss)	395,334	(3,640,410)	(14,508,892)	(492,643)
Net income and comprehensive income (loss) per share	\$0.01	\$(0.13)	\$(0.44)	\$(0.01)

	Three Months Ended			
	March 31, 2006	December 31, 2005	September 30, 2005	June 30, 2005
Revenue	\$1,138,547	\$978,595	\$600,261	\$94,529
Net income and comprehensive income (loss)	(520,957)	(9,544,583)	(155,725)	(269,406)
Net income and comprehensive income (loss) per share	\$(0.02)	\$(0.34)	\$(0.01)	\$(0.01)

The Company has been steadily increasing its revenues until the second quarter of 2006 and thereafter the revenues have declined principally as a result of lower production levels. Substantial losses in the fourth quarter of 2005 and the third and fourth quarter of 2006 result from providing for impairment allowance against the carrying value of the petroleum and natural gas properties.

## OUTLOOK

The Company's existing financial position provides the Company with limited flexibility with respect to exploiting its asset base. Further equity infusion will be required to finance the ongoing capital program. The Company has announced the farm out of the Bakken play in Saskatchewan where at least one deep well is expected to commence drilling prior to the end of August 2007. The Company is continuing to evaluate the inventory of its drilling locations. The acquisition of Stone Castle will add to the operating cash flow of the Company. The Company continues to examine strategic alternatives to maximize shareholder value.

## **RISKS AND UNCERTAINTIES**

The Company's business is subject to risks encountered in the oil and gas industry. The risks and uncertainties below are not the only issues facing the Company. Additional risks and uncertainties not presently known to WaveForm or that the Company currently considers immaterial may also impair the business and operations of WaveForm. If any of the following risks actually occur, the Company's business may be harmed and the financial condition and results of operations may suffer significantly.

### ***Limited Operating History***

WaveForm has a limited operating history upon which a prospective investor can evaluate the business. The Company is subject to the risks, expenses and uncertainties encountered by companies in the resource sector.

### ***Exploration, Development and Production Risks***

Oil and natural gas exploration involves a high degree of risk and there is no assurance that expenditures made on future exploration by the Company will result in new discoveries of oil or natural gas in commercial quantities. It is difficult to project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions such as over pressured zones and tools lost in the hole, and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof.

The Company currently has a limited number of specific identified drilling prospects. The long-term commercial success of the Company depends on its ability to find, acquire, and develop and commercial produce oil and natural gas reserves. No assurance can be given that the Company will be able to locate additional drilling prospects. Substantial amounts may be expended on properties where reserves have yet to be proven.

Future oil and gas exploration may involve unprofitable efforts, not only from dry wells, but from wells that are productive but do not produce sufficient net revenues to return a profit after drilling, operating and other costs. Completion of a well does not assure a profit on the investment or recovery of drilling, completion and operating costs. In addition, drilling hazards or environmental damage could greatly increase the cost of operations and various field operating conditions may adversely affect the production from successful wells. These conditions include delays in obtaining governmental approvals or consents, shut-ins of connected wells resulting from extreme weather conditions, insufficient storage or transportation capacity or other geological or mechanical conditions. While close well supervision and effective maintenance operations can contribute to maximizing production rates over time, production delays and declines from normal field operating conditions cannot be eliminated and can be expected to adversely affect revenue and cash flow levels to varying degrees.

In addition, oil and gas operations are subject to the risks of exploration, development and production of oil and natural gas properties, including encountering unexpected formations or pressures, premature declines or reservoirs, blow-outs, sour gas releases, fires and spills. Losses resulting from the occurrence of any of these risks could have a materially adverse effect on future results of operations, liquidity and financial condition.

### ***Insurance***

The Company's involvement in the exploration for and development of oil and gas properties may result in the Company becoming subject to liability for pollution, blow-outs, property damage, personal injury or other hazards. Although the Company has obtained insurance in accordance with industry standards to address such risks, such insurance has limitations on liability that may not be sufficient to cover the full extent of such liabilities. In addition, such risks may not, in all circumstances be insurable or, in certain circumstances, the Company may elect not to obtain insurance to deal with specific risks due to the high premiums associated with such insurance or other reasons. The payment of such uninsured liabilities would reduce the funds available to the Company. The occurrence of a significant event that the Company is not fully insured against, or the insolvency of the insurer of such event, could have a material adverse effect on the Company's financial position, results of operations or prospects.

### ***Prices, Markets and Marketing of Crude Oil and Natural Gas***

Oil and natural gas are commodities whose prices are determined based on world demand, supply and other factors, all of which are beyond the control of the Company. World prices for oil and natural gas have fluctuated widely in recent years. Any material decline in prices could result in a reduction of net production revenue. Certain wells or other projects may become uneconomic as a result of a decline in world oil prices and natural gas prices, leading to a reduction in the volume of the Company's oil and gas reserves. The Company might also elect not to produce from certain wells at lower prices. All of these factors could result in a material decrease in the Company's future net production revenue, causing a reduction in its oil and gas acquisition and development activities. In addition, bank borrowings available to the Company are in part determined by the borrowing base of the Company. A sustained material decline in prices from historical average process could limit or reduce the Company's borrowing base therefore reducing the bank credit available to the Company, and could require that a portion of any existing bank debt of the Company be repaid.

In addition to establishing markets for its oil and natural gas, the Company must also successfully market its oil and natural gas to prospective buyers. The marketability and price of oil and natural gas which may be acquired or discovered by the Company will be affected by numerous factors beyond its control. The Company will be affected by the difference between the price paid by refiners for light quality oil and the grades of oil produced by the Company. The ability of the Company to market its natural gas may depend upon its ability to acquire space on pipelines which deliver natural gas to commercial markets.

The Company will also likely be affected by deliverability uncertainties related to the proximity of its reserves to pipelines and processing facilities and related to operational problems with such pipelines and facilities and extensive government regulation relating to price, taxes, royalties, land tenure, allowable production, the export of oil and natural gas and many other aspects of the oil and natural gas business. The Company has a limited direct experience in the marketing of oil and natural gas.

### ***Substantial Capital Requirements; Liquidity***

The Company anticipates that it will make substantial capital expenditures for the acquisition, exploration, development and production of oil and natural gas reserves in the future. If the Company's revenues or reserves decline, the Company may have limited ability to expend the capital necessary to undertake or complete future drilling programs. There can be no assurance that debt or equity financing, or cash generated by operation will be available or sufficient to meet these requirements or for other corporate purposes or, if debt or equity financing is available, that it will be on terms acceptable to the Company. Moreover, future activities may require the Company to alter its capitalization significantly. The inability of the Company to access sufficient capital for its operations could have a material adverse effect on the Company's financial condition, results of operations or prospects.

### ***Competition***

The oil and gas industry is highly competitive. The Company's competitors for the acquisition, exploration, production and development of oil and natural gas properties, and for capital to finance such activities, include companies that have greater financial and personnel resources available to them than the Company.

The Company's ability to successfully bid on and acquire additional property rights, to discover reserves, to participate in drilling opportunities and to identify and enter into commercial arrangements with customers will be dependent upon developing and maintaining close working relationships with its future industry partners and joint operators and its ability to select and evaluate suitable properties and to consummate transactions in a highly competitive environment.

### ***Environmental Risks***

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of international conventions and state and municipal laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil and gas operations. The legislation also requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating costs. The discharge of oil, natural gas or other pollutants into the air, soil

or water may give rise to liabilities to government and third parties and may require the Company to incur costs to remedy such discharge. No assurance can be given that environmental laws will not result in a curtailment of production or a material increase in the costs of production, development or exploration activities or otherwise adversely affect to Company's financial condition, results or operations or prospects.

### ***Reserve Replacement***

The Company's future oil and natural gas reserves, production, and cash flows to be derived there from are highly dependent on the Company successfully acquiring or discovering new reserves. Without the continual addition of new reserves, any existing reserves the Company may have at any particular time and the production there from will decline over time as such existing reserves are exploited. A future increase in the Company's reserves will depend not only on the Company's ability to select and acquire suitable producing properties or prospects. There can be no assurance that the Company's future exploration and development efforts will result in the discovery and development of additional commercial accumulations of oil and natural gas.

### ***Reliance on Operators***

The Company may not be the operator of certain oil and gas properties in which it acquires an interest. To the extent the Company is not the operator of its oil and gas properties, the Company will be dependent on such operators for the timing of activities related to such properties and will largely be unable to direct or control the activities of the operators.

### ***Corporate Matters***

Certain of the directors and officers of the Company may also be directors and officers of other oil and gas companies involved in natural resource exploration and development, and conflicts of interest may arise between their duties as officers and directors of the Company and as officers and directors of such other companies. Such conflicts must be disclosed in accordance with, and are subject to such other procedures and remedies as apply under the ABCA.

### ***Permits and Licenses***

The operations of the Company may require licenses and permits from various governmental authorities. There can be no assurance that the Company will be able to obtain all necessary licenses and permits which may be required to carry out exploration and development at its projects.

### ***Additional Funding Requirements***

The Company's cash flow from its reserves may not be sufficient to fund its ongoing activities at all times. From time to time, the Company may require additional financing in order to carry out its oil and gas acquisition, exploration and development activities. Failure to obtain such financing on a timely basis could cause the Company to forfeit its interest in certain acquisition opportunities and reduce or terminate its operations. If the Company's revenues from its reserves decreases as a result of lower oil and natural gas prices or otherwise, it will affect the Company's ability to expend the necessary capital to replace its reserves or to maintain its production. If the Company's cash flow from operations is not sufficient to satisfy its capital expenditure requirements, there can be no assurance that additional debt or equity financing will be available on favorable terms.

### ***Issuance of Debt***

From time to time, the Company may enter into transactions to acquire assets or the shares of other Companies. These transactions may be financed partially or wholly with debt, which may increase the Company's debt levels above industry standards. Neither the Company's articles nor its by-laws limit the amount of indebtedness that the Company may incur. The level of the Company's indebtedness from time to time could impair the Company's ability to obtain additional financing in the future on a timely basis to take advantage of business opportunities that may arise.

### ***Availability of Drilling Equipment and Access Restrictions***

Oil and natural gas exploration and development activities are dependant on the availability of drilling and related equipment in the particular areas where such activities will be conducted. Demand for such limited equipment or access restrictions may affect the availability of such equipment to the Company and may delay exploration and development activities.

### ***Kyoto Protocol***

Canada is a signatory to the United Nations Framework Convention on Climate Change and has ratified the Kyoto Protocol established hereunder to set legally binding targets to reduce nationwide emissions of carbon dioxide, methane, nitrous oxide and other so-called "greenhouse gases". The Company's exploration and production facilities and other operations and activities will emit a small amount of greenhouse gases which may subject the Company to legislation regulating emissions of greenhouse gases. The Government of Canada has put forward a Climate Change Plan for Canada which suggests further legislation will set greenhouse gases emission reduction requirements for the various industrial activities, including oil and gas exploration and production.

Future federal legislation, together with provincial emission reduction requirements, such as those proposed in Alberta's Bill 32: Climate Change and Emissions Management may require the reduction of emissions or emissions intensity with the Company's operations and facilities. The direct or indirect costs of these regulations may adversely affect the business of the Company.

### ***Tax Treatment of Flow-Through Shares***

The tax treatment applicable with respect to oil and gas activities and Flow-Through shares constitutes a major factor when considering an investment in the Flow-Through shares. There is no guarantee that the taxation laws and regulations and the current administrative practices of both the federal and provincial tax authorities will not be amended or constructed in such a way that the tax consideration for a subscriber holding Class A Shares or Class B Shares will not be altered, and moreover there is no guarantee that there will not be any difference of opinion between the federal and provincial tax authorities with respect to the tax treatment of the Class A Shares or Class B Shares, the status of the Class A Shares or Class B Shares and the activities contemplated by the Company's exploration and development programs.

The Class A Shares and Class B Shares are designed for investors whose income is subject to high marginal tax rates. The right to deduct CEE accrued to the initial purchaser of Units and is not transferable. No guarantee can be given that Canadian tax laws will not be amended, that the amendments announced with respect to such laws will be adopted or that the current administrative practices of the tax authorities will not be modified. In addition, there is no guarantee that the projected tax deductions will be accepted by the Canada Revenue Agency. Consequently, the tax considerations for subscribers holding or selling Class A Shares or Class B Shares may be fundamentally altered.

There is no guarantee that an amount equal to the total proceeds or the sale of the Class A Shares and Class B Shares forming part of the Units will be expended on or prior to December 31, 2007 as Qualifying Expenditures. If the Company does not expend an amount equal to the proceeds from the sales of the Class A Shares and Class B Shares comprising of the Units so as to incur Qualifying Expenditures prior to December 31, 2007, the Company shall restate the amount of expenses that it has renounced in favor of the investors and the investors will be reassessed and will be requested to remit the tax benefits from which they would have benefited.

# Financial Statements

WaveForm Energy Ltd.

Three Months Ended March 31, 2007

WAVEFORM ENERGY LTD.

**BALANCE SHEETS**

As at March 31, 2007 and December 31, 2006  
(Unaudited)

	March 31, 2007	December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 528,533	\$ 142,052
Accounts receivable	1,168,340	1,241,300
Prepaid expenses	65,422	87,553
	<u>1,762,295</u>	<u>1,470,905</u>
Property and equipment (note 4)	15,441,624	15,478,823
	<u>\$ 17,203,919</u>	<u>\$ 16,949,728</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 919,517	\$ 1,804,347
Loan payable (note 5)	8,000,000	10,000,000
	<u>8,919,517</u>	<u>11,804,347</u>
Asset retirement obligation	531,838	522,765
Future income taxes (note 9)	745,000	-
Shareholders' equity		
Share capital (note 6)	34,334,685	33,379,327
Warrants (note 6)	797,843	-
Contributed surplus (note 6)	936,291	699,878
Deficit	(29,061,255)	(29,456,589)
	<u>7,007,564</u>	<u>4,622,616</u>
Nature of business and future operations (note 1)		
Commitments (note 7)		
Subsequent events (note 12)		
	<u>\$ 17,203,919</u>	<u>\$ 16,949,728</u>

See accompanying notes to financial statements.

WAVEFORM ENERGY LTD.

STATEMENTS OF OPERATIONS AND COMPREHENSIVE  
INCOME (LOSS) AND DEFICIT

For three months ended March 31, 2007 and 2006  
(Unaudited)

	March 31, 2007	March 31, 2006
<b>REVENUE</b>		
Crude oil, natural gas, and natural gas liquids sales	\$ 1,045,200	\$ 1,226,825
Royalties	(164,722)	(95,013)
Interest and other income	2,782	6,735
	<b>883,260</b>	<b>1,138,547</b>
<b>EXPENSES</b>		
Operating	293,139	256,770
General and administrative	527,748	279,707
Depletion, depreciation and accretion	442,157	1,283,066
Stock based compensation	236,413	106,961
Financing (note 8)	443,469	-
	<b>1,942,926</b>	<b>1,926,504</b>
<b>LOSS BEFORE INCOME TAXES</b>	<b>(1,059,666)</b>	<b>(787,957)</b>
<b>TAXATION</b>		
Future income tax reduction (note 9)	(1,455,000)	(267,000)
<b>NET INCOME AND COMPREHENSIVE INCOME (LOSS)</b>	<b>395,334</b>	<b>(520,957)</b>
<b>DEFICIT, BEGINNING OF PERIOD</b>	<b>(29,456,589)</b>	<b>(10,293,687)</b>
<b>DEFICIT, END OF PERIOD</b>	<b>\$ (29,061,255)</b>	<b>\$ (10,814,644)</b>
Net income and comprehensive income (loss) per share - basic and diluted (note 6e)	<b>\$ 0.01</b>	<b>\$ (0.02)</b>

See accompanying notes to financial statements.

WAVEFORM ENERGY LTD.  
**STATEMENTS OF CASH FLOW**

For three months ended March 31, 2007 and 2006  
(unaudited)

	March 31, 2007	March 31, 2006
<b>CASH PROVIDED BY (USED IN):</b>		
<b>OPERATIONS:</b>		
Net income and comprehensive income (loss)	\$ 395,334	\$ (520,957)
Add (deduct) items not involving cash:		
Depletion, depreciation and accretion	442,157	1,283,066
Stock based compensation	236,413	106,961
Financing (note 8)	108,045	-
Future income tax reduction (note 9)	(1,455,000)	(267,000)
	(273,051)	602,070
Change in non-cash working capital (note 11)	56,185	(57,348)
	(216,866)	544,722
<b>FINANCING:</b>		
Issue of shares and warrants	4,076,625	9,222,327
Share and warrant issuance costs	(231,469)	-
Loan repayment	(2,000,000)	-
Change in non-cash working capital (note 11)	(176,625)	(2,247)
	1,668,531	9,219,980
<b>INVESTMENTS:</b>		
Property and equipment expenditures	(395,885)	(7,737,926)
Change in non-cash working capital (note 11)	(669,299)	3,842,472
	(1,065,184)	(11,580,398)
<b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>386,481</b>	<b>(1,815,686)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>142,052</b>	<b>4,653,548</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 528,533</b>	<b>\$ 2,837,852</b>

See accompanying notes to financial statements.

**SUPPLEMENTAL CASH FLOW INFORMATION**

	March 31, 2007	March 31, 2006
Interest received	\$ 2,782	\$ 6,735
Interest paid	335,425	-

## NOTES TO THE FINANCIAL STATEMENTS

For three months ended March 31, 2007 and 2006

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### 1. Nature of business and future operations

WaveForm Energy Ltd. (the "Corporation") is incorporated under the laws of the province of Alberta. The Corporation is engaged in the acquisition, development and exploration of petroleum and natural gas in Western Canada.

These financial statements have been prepared on the basis that the Corporation will continue its operations as a going concern. At March 31, 2007, the Corporation had a working capital deficiency of over \$7 million, and had incurred recurring losses. At March 31, 2007, the Company had a loan of \$8 million, which has subsequently increased to \$9 million. The loan has been extended to December 31, 2007. Continuing operations are dependant upon the ability of the Company to access adequate capital to continue its exploration and development program, meet flow through expenditure obligations, achieve profitable operations and its ability to extend its loan facilities. The financial statements do not reflect adjustments to assets, liabilities and operations that would be necessary should the going concern assumption be inappropriate.

### 2. Basis of presentation and changes in accounting policies

The unaudited interim financial statements have been prepared in accordance with Canadian generally accepted accounting principles, and following the same accounting policies as disclosed in the audited financial statements for the year ended December 31, 2006 except as disclosed in note 3. The disclosures provided herein are incremental to those included with the annual financial statements and do not include all of the disclosures required in the annual financial statements. These interim financial statements should be read in conjunction with the annual financial statements as at and for the year ended December 31, 2006.

### 3. Changes in accounting policies

Effective January 1, 2007, the Corporation has adopted the new Canadian accounting standards for financial instruments – recognition and measurement, presentation and disclosures, hedging and comprehensive income. There is no impact as a result of the adoption of the new Canadian accounting standards.

## NOTES TO THE FINANCIAL STATEMENTS

For three months ended March 31, 2007 and 2006

**4. Property and equipment**

	March 31, 2007		
	Cost	Accumulated Depletion, Depreciation and amortization	Net Book Value
Petroleum and natural gas properties	\$52,487,684	\$37,106,094	\$15,381,590
Office equipment	103,987	43,953	60,034
	<b>\$52,591,671</b>	<b>\$37,150,047</b>	<b>\$15,441,624</b>

	December 31, 2006		
	Cost	Accumulated Depletion, Depreciation and amortization	Net Book Value
Petroleum and natural gas properties	\$52,091,798	\$36,677,002	\$15,414,796
Office equipment	103,988	39,961	64,027
	<b>\$52,195,786</b>	<b>\$36,716,963</b>	<b>\$15,478,823</b>

At March 31, 2007, undeveloped land and seismic costs amounting to \$869,320 (December 31, 2006 - \$868,796) have been excluded from the depletion calculation. Future development costs of \$1,080,000 (December 31, 2006 - \$1,080,000) were added to the depletion calculation. In 2007, no general and administrative costs (December 31, 2006 - \$58,125) have been capitalized.

**5. Loan Payable**

On March 31, 2007, the Corporation had a senior secured debt facility (the "Facility"), that has a first charge on all assets of the Corporation for \$8 million, which was fully drawn. The Facility bears interest at bank prime rate plus 3% per annum. In May 2007, the Corporation increased the facility to \$9 million and drew down \$1 million to partially pay the loan of Stone Castle Exploration Ltd to its lender on the closing of its acquisition by the Corporation. The loan has been extended to December 31, 2007. At March 31, 2007 the Corporation was not in compliance with certain covenants under the Facility and the lender has waived compliance to with such covenants.

## NOTES TO THE FINANCIAL STATEMENTS

For three months ended March 31, 2007 and 2006

### 6. Share capital

(a) Authorized:

The authorized share capital consists of an unlimited number of Class A and B voting shares. The Class B shares are convertible into Class A shares based on a formula equal to \$10 divided by the greater of \$1 and the then market price of the Class A shares. The Class B shares are convertible at the option of the Corporation at any time after January 21, 2008 and before January 31, 2010. The Class B shares are convertible at the option of the shareholder, at any time after February 1, 2010 and before March 1, 2010. Any Class B shares not previously converted will automatically convert to Class A shares on March 1, 2010.

(b) Issued and outstanding:

Class A Shares	Three months ended March 31, 2007		Year ended December 31, 2006	
	Number of Shares	Value	Number of Shares	Value
Beginning of period	32,118,631	\$ 28,261,895	27,461,264	\$ 20,578,468
Issued for cash (note 6c)	32,000,000	3,298,240	1,630,500	3,000,120
Flow through shares issued for cash (note 6d)	-	-	2,916,700	7,000,080
Stock options exercised (note 6i)	-	-	110,167	73,933
Warrants exercised	613,000	76,625	-	-
Transfer of carrying value on exercise of warrants		13,443		
Future tax effect of flow-through shares		(2,275,000)		(1,873,000)
Share issue costs (net of future income taxes of \$61,842 (2006 - \$267,000))		(157,950)		(517,706)
<b>End of period</b>	<b>64,731,631</b>	<b>\$ 29,217,253</b>	<b>32,118,631</b>	<b>\$ 28,261,895</b>

## NOTES TO THE FINANCIAL STATEMENTS

For three months ended March 31, 2007 and 2006

### 6. Share capital (continued)

Class B Shares	Three months ended March 31, 2007		Year ended December 31, 2006	
	Number of Shares	Value	Number of Shares	Value
<b>Beginning and end of period</b>	935,616	\$ 5,117,432	935,616	\$ 5,117,432
<b>End of period – Class A and Class B shares</b>	<b>65,915,247</b>	<b>\$ 34,334,685</b>	<b>33,054,247</b>	<b>\$ 33,379,327</b>

(c) Issued for cash:

In January 2007, the Corporation issued 32,000,000 Units at \$0.125 per unit for gross proceeds of \$4,000,000. The Units consisted of one Class A share and one warrant. The Black-Scholes Model methodology was used to determine the allocation of values between Class A shares and warrants. In March 2006, the Corporation issued 1,630,500 Class A shares at \$1.84 per share for gross proceeds of \$3,000,120

(d) Flow-through shares:

In March 2006, the Corporation issued 2,916,700 Class A “flow through” shares at \$2.40 per share for gross proceeds of \$7,000,080. The Corporation is committed to spend 100% of the funds on qualifying exploration and development expenditures. Effective December 31, 2006 in accordance with the terms of the share subscription agreements, the Corporation renounced for income tax purposes, \$7,000,080 to holders of Class A shares. At March 31, 2007 the Corporation had incurred \$2,367,714 in eligible expenditures. At March 31, 2007, the Corporation is committed to incur the remaining \$4,632,366 of expenditures during the balance of 2007.

(e) Net income and comprehensive income (loss) per share:

The basic weighted average number of Class A and Class B shares outstanding as at March 31, 2007 were 59,889,414 (three months ended March 31, 2006 – 29,577,527).

Diluted weighted average number of Class A and Class B shares outstanding as at March 31, 2007 were 75,764,059. The dilutive effect of outstanding options and warrants is calculated using the treasury stock method. During the three months ended March 31, 2006, all warrants and options would have an anti-dilutive effect on the loss per share as the Corporation was in a loss position

## NOTES TO THE FINANCIAL STATEMENTS

For three months ended March 31, 2007 and 2006

### 6. Share capital (continued)

(f) Stock option plan:

The Corporation has a stock option plan for directors, officers, employees and consultants. The Corporation may grant up to 10% of the aggregate number of Class A and Class B shares outstanding and no one optionee is permitted to hold more than 5% of the total Class A and B shares outstanding. The options vest one third immediately and one third on the first and second anniversary dates of the grant and expire in five years from the date of grant.

	Three months ended March 31, 2007		Year ended December 31, 2006	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Beginning of period	1,645,333	\$ 0.60	1,871,400	\$ 0.88
Granted	5,500,000	0.20	400,000	1.00
Forfeited	(720,333)	0.90	(515,900)	1.17
Exercised	-	-	(110,167)	0.50
Outstanding end of period	6,425,000	\$ 0.29	1,645,333	\$ 0.60
Exercisable – end of period	2,466,661	\$ 0.32	1,203,662	\$ 0.61

Exercise Price	Options outstanding at March 31, 2007		Options exercisable at March 31, 2007	
	Number	Weighted Average Remaining Life (years)	Number	Weighted Average Remaining Life (years)
\$0.20	5,500,000	4.8	1,833,330	4.8
\$0.40	450,000	2.8	450,000	2.8
\$1.00	400,000	4.3	133,333	4.3
\$2.04	75,000	3.4	49,998	3.4
	6,425,000		2,466,661	

The weighted average fair value of all options granted during the three months ended March 31, 2007 was \$0.20 (year ended December 31, 2006 - \$0.40).

The fair value of options granted during the three months ended March 31, 2007 of \$623,559 (year ended December 31, 2006 - \$158,483) was calculated using a risk free rate of 4%, dividend yield of 0%, volatility factor of 75%, and an expected life of 5 years. The value of the options was recorded as stock based compensation expense, with an offsetting amount to contributed surplus based upon the vesting period.

## NOTES TO THE FINANCIAL STATEMENTS

For three months ended March 31, 2007 and 2006

### 6. Share capital (continued)

(g) Warrants

	Three months ended March 31, 2007		Year ended December 31, 2006	
	Number of warrants	Value	Number of warrants	Value
Beginning of period	-	-	-	-
Granted	37,100,000	\$ 844,893	-	-
Exercised	(613,000)	-	-	-
Transfer of carrying value on exercise of warrants		(13,443)		
Warrant issue costs (net of future income taxes of \$13,158 (2006 - \$nil)		(33,607)		-
End of period	36,487,000	\$ 797,843	-	-

In January 2007, the Corporation issued 32,000,000 Units at \$0.125 per unit for gross proceeds of \$4,000,000. The Units consisted of one Class A share and one Warrant. The Black-Scholes model methodology was used to determine the allocation of value between Class A shares and warrants. Each warrant is exercisable into one Class A Share at a price of \$0.125 per share until March 31, 2007 (extended to April 3, 2007), thereafter at \$0.20 per share until June 30, 2007, thereafter at \$0.30 per share until December 31, 2007, and thereafter at \$0.40 per share until expiry on December 31, 2008.

In January 2007, the Corporation issued 1,600,000 warrants to its financing agent. Each warrant is exercisable into one Class A Share at a price of \$0.125 per share until March 31, 2007 (extended to April 3, 2007), thereafter at \$0.20 per share until June 30, 2007, thereafter at \$0.30 per share until December 31, 2007, and thereafter at \$0.40 per share until expiry on December 31, 2008.

In January 2007, the Corporation issued 3,500,000 warrants to its lender as consideration for the loan extension. Each warrant is exercisable into one Class A Share at a price of \$0.15 per share, before the Facility is fully paid, \$0.175 upon full repayment of the Facility, until expiry on December 31, 2008.

(h) Escrowed shares

Pursuant to an Escrow Agreement dated October 28, 2004 a total of 6,178,867 Class A shares of certain officers, directors, employees, and principal shareholders are being held in escrow. On January 7, 2005 when the shares of the Corporation were listed on the TSX Venture exchange, 10% of the escrowed shares were released. The remaining 90% is being released in 15% increments during consecutive 6 month periods following the listing.

## NOTES TO THE FINANCIAL STATEMENTS

For three months ended March 31, 2007 and 2006

### 6. Share capital (continued)

(i) Contributed surplus

A summary of change in the Corporation's contributed surplus balance for the year ended December 31, 2006 and three months ended March 31, 2007 is as follows:

Balance – January 1, 2006	\$ 221,674
Stock based compensation related to fair value of options granted	497,136
Options and warrants exercised	(18,932)
Balance – January 1, 2007	699,877
Stock based compensation related to fair value of options granted	236,413
Balance – March 31, 2007	\$ 936,291

### 7. Commitments

The Corporation has the following office rental commitments, which expires April 30, 2011, on March 31, 2007:

2007 (9 months)	\$ 146,812
2008	195,750
2009	195,750
2010	195,750
2011	65,250

### 8. Financing cost

	Three months ended March 31, 2007		Three months ended March 31, 2006	
Interest	\$	335,424	\$	-
Extension fee – grant of warrants		108,045		-
	\$	443,469	\$	-

## NOTES TO THE FINANCIAL STATEMENTS

For three months ended March 31, 2007 and 2006

### 9. Future income taxes

The provision for income taxes in the financial statements differs from the result which would be obtained by applying the federal and provincial tax rate to the Corporation's earnings before income taxes. This difference results from the following items:

	Three months ended March 31, 2007	Three months ended March 31, 2006
Net loss before income taxes	\$ (1,059,566)	\$ (787,957)
Combined federal and provincial tax rate	32.5%	36.55%
Computed "expected" income tax expense	(344,000)	(288,000)
Increase resulting from:		
Non-deductible items	116,000	40,000
Resource allowance	-	(19,000)
Valuation allowance	(1,227,000)	-
<b>Future income tax reduction</b>	<b>\$ (1,455,000)</b>	<b>\$ (267,000)</b>

The components of the Corporation's net future income tax asset are as follows:

Property, and equipment	\$ (1,700,000)	\$ 272,000
Share issuance costs	715,000	642,000
Non capital losses	240,000	353,000
<b>Net future income tax asset (liability)</b>	<b>\$ (745,000)</b>	<b>\$ 1,267,000</b>

The Corporation has accumulated non-capital losses for income tax purposes of approximately \$740,000 which are available against future taxable income. Unless sufficient taxable income is earned, these losses will expire by 2016.

### 10. Related party transactions

During the three months ended March 31, 2007, the Corporation incurred an expenditure of \$116,574 (three months ended March 31, 2006 - \$13,056) for general corporate legal services payable to a legal firm of which a director is counsel. These fees are included in general and administrative expense, share issuance costs and acquisition costs. The Corporation incurred \$218,400 (three months ended March 31, 2006 - \$Nil) for financing advisory fees payable to a Company of which a director of the Corporation is an officer, prior to his appointment as a director of the Corporation. The Corporation paid \$4,770 (three months ended March 31, 2006 - \$Nil) for services rendered (in connection with due diligence with respect to a corporate acquisition) to a company controlled by a director of the Corporation. All transactions were completed on the basis of fair market value and general market terms and conditions.

## NOTES TO THE FINANCIAL STATEMENTS

For three months ended March 31, 2007 and 2006

## 11. Changes in non-cash working capital

	Three months ended March 31, 2007	Three months ended March 31, 2006
Decrease (increase) in non-cash working capital		
Accounts receivable	\$ 72,960	\$ 1,821,450
Prepaid expenses	22,131	(72,223)
Accounts payable and accrued liabilities	(884,830)	(5,651,394)
Net change in non-cash working capital	\$ (789,739)	\$ (3,902,167)
Relating to:		
Operations	\$ 56,185	\$ (57,348)
Financing	(176,625)	(2,347)
Investments	(669,299)	(3,842,472)
	\$ (789,739)	\$ (3,902,167)

## 12. Subsequent events

- (a) On February 20, 2007, the Corporation announced that it had executed a formal agreement with Stone Castle Exploration Ltd. ("Stone Castle") to acquire all of the issued and outstanding shares of Stone Castle. Stone Castle is a private oil and gas company with properties that are jointly held with the Company in Saskatchewan. Shareholders in Stone Castle will receive units comprised of 0.5 Class A share of the Corporation and 0.5 warrant to acquire Class A share. Each warrant will be exercisable at \$0.20 per share until June 30, 2007, \$0.30 per share until December 31, 2007 and \$0.40 per share until expiry on December 31, 2008. Stone Castle has approximately 12,335,000 common shares that are issued and outstanding. The acquisition closed on May 8<sup>th</sup>, 2007. As of March 31, 2007 Stone Castle was indebted to the Corporation in the amount of \$469,592.
- (b) As at March 31, 2007, the Corporation has a secured loan outstanding in the amount of \$8,000,000. In early May 2007, the loan was increased to \$9,000,000. The term of the loan has been extended to December 31, 2007.
- (c) Effective March 31, 2007, 11,320,000 warrants were exercised to acquire Class A Shares at \$0.125 per share. On April 2 and 3, 2007, the Corporation issued 11,320,000 Class A Shares. Proceeds realized amounted to \$1,415,000.