

IVANHOE ENERGY INC
Form 10-Q
August 09, 2005

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended June 30, 2005**

or

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the transition period from ___ to ___**

Commission file number 000-30586

IVANHOE ENERGY INC.

(Exact name of registrant as specified in its charter)

Yukon, Canada
*(State or other jurisdiction of
incorporation or organization)*

98-0372413
*(I.R.S. Employer
Identification No.)*

**Suite 654 999 Canada Place
Vancouver, British Columbia, Canada
V6C 3E1**

(Address of principal executive office)

(604) 688-8323

(registrant's telephone number, including area code)

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report:

Not Applicable

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act)

Yes No

The number of shares of the registrant's capital stock outstanding as of June 30, 2005 was 201,432,299 Common Shares, no par value.

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Part I Financial Information**Item 1 Financial Statements****IVANHOE ENERGY INC.****Unaudited Condensed Consolidated Balance Sheets**

(stated in thousands of U.S. Dollars except share amounts)

	June 30, 2005	December 31, 2004
Assets		
Current Assets		
Cash and cash equivalents	\$ 3,728	\$ 9,322
Notes and accounts receivable	5,998	5,377
Prepaid and other current assets	512	812
	10,238	15,511
Long term assets		
Oil and gas properties and investments, net	1,392	6,424
Intangible asset	121,238	96,551
	89,932	
	\$ 222,800	\$ 118,486
Liabilities and Shareholders Equity		
Current Liabilities		
Accounts payable and accrued liabilities	\$ 18,611	\$ 9,845
Note payable - current portion	1,667	1,667
Convertible loans	8,000	
	28,278	11,512
Long term debt		
	1,806	2,639
Asset retirement obligations		
	1,688	749
Commitments and contingencies		
	1,900	
Shareholders Equity		
Share capital, issued 201,432,299 common shares; December 31, 2004		
169,664,911 common shares	260,709	183,617
Warrants	10,153	
Contributed surplus	2,559	1,748
Accumulated deficit	(84,293)	(81,779)
	189,128	103,586

\$ **222,800** \$ 118,486

(See accompanying notes)

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IVANHOE ENERGY INC.**Unaudited Condensed Consolidated Statements of Loss and Accumulated Deficit**

(stated in thousands of U.S. Dollars except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Revenue				
Oil and gas revenue	\$ 6,617	\$ 3,472	\$ 12,310	\$ 6,764
Interest income	28	49	71	89
	6,645	3,521	12,381	6,853
Expenses				
Operating costs	1,771	1,157	3,533	2,431
General and administrative	1,506	1,462	3,917	3,066
Business development	1,178	422	1,897	699
Depletion and depreciation	2,567	1,503	4,774	2,949
Interest expense	375	25	495	48
Write down of GTL investments	279	250	279	250
	7,676	4,819	14,895	9,443
Net Loss	1,031	1,298	2,514	2,590
Accumulated Deficit, beginning of period	83,262	62,346	81,779	61,054
Accumulated Deficit, end of period	\$ 84,293	\$ 63,644	\$ 84,293	\$ 63,644
Net Loss per share Basic and Diluted	\$ 0.01	\$ 0.01	\$ 0.01	\$ 0.02
Weighted Average Number of Shares (in thousands)	195,200	169,116	183,621	165,622

(See accompanying notes)

IVANHOE ENERGY INC.**Unaudited Condensed Consolidated Statements of Cash Flow**

(stated in thousands of U.S. Dollars)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Operating Activities				
Net loss	\$ (1,031)	\$ (1,298)	\$ (2,514)	\$ (2,590)
Items not requiring use of cash				
Depletion and depreciation	2,567	1,503	4,774	2,949
Write down of GTL investments	279	250	279	250
Stock based compensation	534	242	830	481
Changes in non-cash working capital items	(499)	602	(744)	244
	1,850	1,299	2,625	1,334
Investing Activities				
Capital investments	(12,057)	(14,821)	(24,337)	(25,176)
Merger, net of cash acquired	(9,979)		(9,979)	
Equity investment and Merger related costs	(957)	(2,000)	(1,687)	(2,500)
Proceeds from sale of assets		13,458		13,458
Other	(63)	(112)	(54)	(180)
Changes in non-cash working capital items	2,429	5,614	9,312	5,131
	(20,627)	2,139	(26,745)	(9,267)
Financing Activities				
Proceeds from private placements, net of share issue costs	10,153		10,153	20,428
Proceeds from exercise of options and warrants	1,690	1,236	1,725	1,375
Share issue costs on shares issued for Merger	(93)		(93)	
Proceeds from debt obligations	2,000	2,000	8,000	12,000
Repayments of debt obligations	(417)	(10,000)	(833)	(10,000)
Other	(163)		(426)	
	13,170	(6,764)	18,526	23,803
Increase (decrease) in cash and cash equivalents, for the period	(5,607)	(3,326)	(5,594)	15,870
Cash and cash equivalents, beginning of period	9,335	33,687	9,322	14,491
Cash and cash equivalents, end of period	\$ 3,728	\$ 30,361	\$ 3,728	\$ 30,361
Supplementary Information Regarding Non-Cash Transactions				
Financing activities, non-cash:				
Shares issued for Merger	\$ (75,000)	\$	\$ (75,000)	\$

Included in the above are the following:

Taxes paid	\$ 2	\$	\$ 4	\$ 3
Interest paid	\$ 265	\$ 14	\$ 14	\$ 28

Changes in non-cash working capital items**Operating Activities:**

Notes and accounts receivable	\$ (275)	\$ (266)	\$ (314)	\$ (856)
Prepaid and other current assets	85	3	(45)	31
Accounts payable and accrued liabilities	(309)	865	(385)	1,069
	(499)	602	(744)	244

Investing Activities

Notes and accounts receivable	432	(831)	(405)	(1,153)
Prepaid and other current assets	127		350	
Accounts payable and accrued liabilities	1,870	6,445	9,367	6,284
	2,429	5,614	9,312	5,131
	\$ 1,930	\$ 6,216	\$ 8,568	\$ 5,375

(See accompanying notes)

Notes to the Condensed Consolidated Financial Statements
June 30, 2005

(all tabular amounts are expressed in thousands of U.S. dollars except per share amounts)

(Unaudited)

1. BASIS OF PRESENTATION AND LIQUIDITY

The Company's accounting policies are in accordance with accounting principles generally accepted in Canada. These policies are consistent with accounting principles generally accepted in the U.S., except as outlined in Note 15. The unaudited condensed consolidated financial statements have been prepared on a basis consistent with the accounting principles and policies reflected in the December 31, 2004 consolidated financial statements. These interim condensed consolidated financial statements do not include all disclosures normally provided in annual consolidated financial statements and should be read in conjunction with the most recent annual consolidated financial statements. The December 31, 2004 consolidated balance sheet was derived from the audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles (**GAAP**) in Canada and the U.S. In the opinion of management, all adjustments (which included normal recurring adjustments) necessary for the fair presentation for the interim periods have been made. The results of operations and cash flows are not necessarily indicative of the results for a full year.

The Company's financial statements as at and for the three-month and six-month periods ended June 30, 2005 have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. The Company incurred a net loss of \$2.5 million for the six-month period ended June 30, 2005, and, as at June 30, 2005, had an accumulated deficit of \$84.3 million and negative working capital of \$18.0 million. The Company expects to incur substantial expenditures to further its capital investment programs and the Company's cash flow from operating activities will not be sufficient to satisfy its current obligations and meet its capital investment objectives. Management's plans include sale of additional equity securities, alliances or other partnership agreements with entities with the resources to support the Company's projects as well as convertible loan, debt and mezzanine financing in order to generate sufficient resources to assure continuation of the Company's operations and achieve its capital investment objectives. The Company is presently in active negotiation with a third party for the formation of a joint venture for the deployment, in a specific region of the world, of the GTL and RTP technologies it licenses or owns. The transaction that is being discussed would, if consummated, include a potentially significant equity investment in the Company by the third party. No assurances can be given that the Company and the third party with whom it is presently negotiating will successfully conclude this potential transaction nor that the Company will be able to raise additional capital or enter into one or more alternative business alliances with other parties if this potential transaction is not successfully concluded. If the Company is unable to obtain adequate additional financing or enter into such business alliances, management will be required to sharply curtail the Company's operations, which may include the sale of assets.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts and other disclosures in these condensed consolidated financial statements. Actual results may differ from those estimates.

Certain items in the 2004 financial statements have been reclassified for comparison to the 2005 presentation.

2. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

As more fully described in Note 11, on April 15, 2005 the Company acquired all the issued and outstanding common shares of Ensyn Group, Inc. (**Ensyn**) pursuant to a merger between Ensyn and a wholly owned subsidiary of the Company (**Merger**) in accordance with an Agreement and Plan of Merger dated December 11, 2004 (**Merger Agreement**). This acquisition was accounted for using the purchase method. These consolidated financial statements include the accounts of Ivanhoe Energy Inc. and its subsidiaries, including those acquired in the Merger, all of which are wholly owned.

The Company conducts most exploration, development and production activities in its oil and gas business jointly with others. As part of the Merger, the Company acquired a 50% interest in a joint venture, which owns a rapid thermal processing (**RTPTM**) commercial demonstration facility (**RTP CDF**) located in California's San Joaquin Basin as well as certain rights to manufacture RTPTM facilities (See Note 12). Our accounts reflect only the Company's proportionate interest in the assets and liabilities of these joint ventures.

All inter-company transactions and balances have been eliminated for the purposes of these condensed consolidated financial statements.

Intangible Assets

Intangible assets are initially recognized and measured at cost. Intangible assets with finite lives are amortized over their useful lives whereas intangible assets with indefinite useful lives are not amortized unless it is subsequently determined to have a finite useful life. Intangible assets are reviewed annually for impairment, or when events or changes in circumstances indicate that the carrying value of an intangible asset may not be recoverable. If the carrying value of an intangible asset exceeds its fair value or expected future discounted cash flows, the excess is written down to the results of operations with a corresponding reduction in the carrying value of the intangible asset.

In the Merger, the Company acquired an intangible asset in the form of an exclusive, irrevocable license to employ rapid thermal processing technology (**RTPTM Technology**) for petroleum applications. The Company will assign the carrying value of the RTPTM Technology to the number of RTPTM facilities it expects to develop that will use the RTPTM Technology. The amount of the carrying value of the RTPTM Technology assigned to each RTPTM facility will be amortized to earnings on a basis related to the operations of the RTPTM facility from the date on which the facility is placed into service. The carrying value of the RTPTM Technology will be evaluated for impairment annually, or as changes in circumstances indicate the intangible asset might be impaired, based on an assessment of its fair market value.

Development Costs

The Company incurs various costs in the pursuit of gas-to-liquids (**GTL**) and enhanced oil recovery (**EOR**), including RTPTM Technology for heavy oil processing, projects throughout the world. Such costs incurred prior to signing a memorandum of understanding (**MOU**), or similar agreements, are considered to be business development and are expensed as incurred. Upon executing an MOU to determine the technical and commercial feasibility of a project, including studies for the marketability for the projects products, the Company assumes the feasibility and related costs incurred have potential future value, are probable of leading to a definitive agreement for the exploitation of proved reserves and should be capitalized as development costs. If a definitive agreement is not subsequently reached, then the project's capitalized development costs, which are deemed to have no future value, are written down to the results of operations with a corresponding reduction in the investments in GTL and EOR assets.

Additionally, the Company incurs costs to develop, enhance and identify improvements in the application of the GTL and RTPTM technologies it licenses or owns. The cost of equipment and facilities acquired or constructed for such purposes are capitalized development costs and amortized over the expected economic life of the equipment or facilities commencing with the start up of commercial operations for which the equipment or facilities are intended. The Company reviews the recoverability of such capitalized development costs annually, or as changes in circumstances indicate the development costs might be impaired, through an evaluation of the expected future discounted cash flows from the associated projects. If the carrying value of such capitalized development costs exceeds the expected future discounted cash flows, the excess is written down to the results of operations with a corresponding reduction in the investments in GTL and EOR assets.

Costs incurred in the operation of equipment and facilities used to develop or enhance GTL and RTPTM technologies prior to commencing commercial operations are business development expenses and are charged to the results of operations in the period incurred.

3. OIL AND GAS PROPERTIES AND INVESTMENTS

Capital assets categorized by geographical location and business segment are as follows:

	As at June 30, 2005				
	Oil and Gas		GTL	EOR	Total
	U.S.	China			
Oil and Gas Properties:					
Proved	\$ 83,733	\$ 51,029	\$	\$	\$ 134,762
Unproved	21,670	13,576			35,246
	105,403	64,605			170,008
Accumulated depletion	(13,398)	(8,934)			(22,332)
Accumulated provision for impairment	(50,350)				(50,350)
	41,655	55,671			97,326
GTL and EOR Investments:					
GTL master license			10,000		10,000
Commercial demonstration facility				4,572	4,572
Feasibility studies and other deferred costs			4,245	4,923	9,168
			14,245	9,495	23,740
Furniture and equipment	438	95		15	548
Accumulated depreciation	(343)	(29)		(4)	(376)
	95	66		11	172
	\$ 41,750	\$ 55,737	\$ 14,245	\$ 9,506	\$ 121,238

	As at December 31, 2004				
	Oil and Gas		GTL	EOR	Total
	U.S.	China			
Oil and Gas Properties:					
Proved	\$ 81,648	\$ 35,771	\$	\$	\$ 117,419
Unproved	20,447	10,581			31,028
	102,095	46,352			148,447
Accumulated depletion	(10,956)	(6,663)			(17,619)
Accumulated provision for impairment	(50,350)				(50,350)
	40,789	39,689			80,478
GTL and EOR Investments:					
GTL master license			10,000		10,000

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Feasibility studies and other deferred costs			3,793	2,091	5,884
			13,793	2,091	15,884
Furniture and equipment	417	84		11	512
Accumulated depreciation	(300)	(22)		(1)	(323)
	117	62		10	189
	\$ 40,906	\$ 39,751	\$ 13,793	\$ 2,101	\$ 96,551

For the three-month period ended June 30, 2005, the Company capitalized \$0.9 million of costs associated with future asset retirement and abandonment of the Northwest Lost Hills #1-22, which was temporarily abandoned in 2003.

Costs as at June 30, 2005 and December 31, 2004 of \$35.2 million and \$31.0 million, respectively, related to unproved oil and gas properties were excluded from the depletion and ceiling test calculations.

For the three-month and six-month periods ended June 30, 2005, general and administrative expenses related directly to oil and gas acquisition, exploration and development activities, and investments in GTL and EOR projects of \$1.0 million and \$1.9 million, respectively, were capitalized. For the same periods ended June 30, 2004 \$0.9 million and \$1.6 million, respectively, were capitalized.

As at June 30, 2005, the GTL and EOR Investments include \$4.6 million of costs associated with the fair value

of the RTP™ CDF acquired in the Merger. The RTP™ CDF is being used to develop and identify improvements in the application of the RTP™ Technology by processing and testing heavy crude feedstock of prospective customers until such time as the RTP™ CDF is sold or dismantled and redeployed (See Note 12).

As a result of the Company's on-going evaluation of its GTL investments, \$0.3 million of its investments were written down for the three-month period ended June 30, 2005 related to its GTL project in Bolivia due to the impact that political and fiscal uncertainty in Bolivia could have on the viability of a GTL plant. For the three-month period ended June 30, 2004, GTL investments of \$0.3 million were written down as the opportunity to build a 45,000 bpd GTL fuels plant in Oman failed to materialize due to a lack of sufficient uncommitted gas volumes to support a plant of that size.

4. LONG TERM ASSETS

During 2004, prior to entering into the Merger Agreement, the Company acquired from Ensyn a 15% equity interest in Ensyn Petroleum International Ltd. (**EPIL**) and exclusive rights to use the RTP™ Technology for petroleum applications in key international markets. Ensyn, the parent company of EPIL, retained the remaining 85% of EPIL. The \$3 million cost to acquire the 15% equity interest in EPIL plus \$2.5 million of costs incurred by the Company in connection with the Merger, including \$1.0 million to acquire an option to purchase an additional 5% of EPIL (which expired, unexercised, in January 2005) are included in long-term assets as at December 31, 2004. The Merger was completed on April 15, 2005 and the 15% equity interest in EPIL was eliminated upon consolidating the accounts of the Company and its subsidiaries as at June 30, 2005 (See Note 11).

5. INTANGIBLE ASSET

The Company's intangible asset consists of the underlying value of an exclusive, irrevocable license acquired in the Merger with Ensyn to deploy, worldwide, the RTP™ Technology for petroleum applications as well as exclusive right to deploy RTP™ Technology in all applications other than bio-mass (See Note 11). This intangible asset is not currently being amortized and its carrying value was not impaired for the three-month and six-month periods ended June 30, 2005.

6. SEGMENT INFORMATION

The following tables present the Company's interim segment information for the three-month and six-month periods ended June 30, 2005 and 2004 and identifiable assets as at June 30, 2005 and December 31, 2004:

	Three-Month Period Ended June 30, 2005					
	Oil and Gas		GTL	EOR	Corporate	Total
	U.S.	China				
Oil and gas revenue	\$ 3,294	\$ 3,323	\$	\$	\$	\$ 6,617
Interest income	4	1			23	28
	3,298	3,324			23	6,645
Operating costs	1,152	619				1,771
General and administrative	258	137			1,111	1,506
Business development			319	859		1,178
Depletion and depreciation	1,315	1,237	3	9	3	2,567
Interest expense	84				291	375
Write-downs and provision for impairment			279			279
	2,809	1,993	601	868	1,405	7,676
Net (Income) Loss	\$ (489)	\$ (1,331)	\$ 601	\$ 868	\$ 1,382	\$ 1,031

Capital Investments	\$ 1,711	\$ 8,700	\$ 516	\$ 1,130	\$	\$ 12,057
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Six-Month Period Ended June 30, 2005

	Oil and Gas					Total
	U.S.	China	GTL	EOR	Corporate	
Oil and gas revenue	\$ 6,163	\$ 6,147	\$	\$	\$	\$ 12,310
Interest income	10	3			58	71
	6,173	6,150			58	12,381
Operating costs	2,269	1,264				3,533
General and administrative	414	362			3,141	3,917
Business development			723	1,174		1,897
Depletion and depreciation	2,483	2,271	6	11	3	4,774
Interest expense	154				341	495
Write-downs and provision for impairment			279			279
	5,320	3,897	1,008	1,185	3,485	14,895
Net (Income) Loss	\$ (853)	\$ (2,253)	\$ 1,008	\$ 1,185	\$ 3,427	\$ 2,514
Capital Investments	\$ 2,511	\$ 18,251	\$ 731	\$ 2,844	\$	\$ 24,337
Identifiable Assets (As at June 30, 2005)	\$ 45,854	\$ 59,856	\$ 14,289	\$ 99,657	\$ 3,144	\$ 222,800
Identifiable Assets (As at December 31, 2004)	\$ 49,465	\$ 44,960	\$ 13,867	\$ 2,441	\$ 7,753	\$ 118,486

Three-Month Period Ended June 30, 2004

	Oil and Gas					Total
	U.S.	China	GTL	EOR	Corporate	
Oil and gas revenue	\$ 2,006	\$ 1,466	\$	\$	\$	\$ 3,472
Interest income	1	3			45	49
	2,007	1,469			45	3,521
Operating costs	677	480				1,157
General and administrative	302	174			986	1,462
Business development			422			422
Depletion and depreciation	994	501	7		1	1,503
Interest expense	23				2	25
			250			250

Write-downs and provision for
impairment

	1,996	1,155	679		989	4,819
Net (Income) Loss	\$ (11)	\$ (314)	\$ 679	\$	\$ 944	\$ 1,298
Capital Investments	\$ 6,793	\$ 7,277	\$	\$ 751	\$	\$ 14,821

Six-Month Period Ended June 30, 2004

	Oil and Gas					Total
	U.S.	China	GTL	EOR	Corporate	
Oil and gas revenue	\$ 3,800	\$ 2,964	\$	\$	\$	\$ 6,764
Interest income	3	6			80	89
	3,803	2,970			80	6,853
Operating costs	1,431	1,000				2,431
General and administrative	409	430			2,227	3,066
Business development			699			699
Depletion and depreciation	1,859	1,077	11		2	2,949
Interest expense	45				3	48
Write-downs and provision for impairment			250			250
	3,744	2,507	960		2,232	9,443
Net (Income) Loss	\$ (59)	\$ (463)	\$ 960	\$	\$ 2,152	\$ 2,590
Capital Investments	\$ 9,843	\$ 14,152	\$ 67	\$ 1,114	\$	\$ 25,176

6. SHARE CAPITAL

Following is a summary of the changes in share capital and stock options outstanding for the three-month period ended June 30, 2005:

	Common Shares			Stock Options	
	Number (thousands)	Amount	Contributed Surplus	Number (thousands)	Weighted Average Exercise Price Cdn.\$
Balance December 31, 2004	169,665	\$ 183,617	\$ 1,748	8,246	\$ 2.65
Shares issued for Merger	30,000	74,907			
Shares issued for exercise of warrants	1,500	1,650			
Shares issued for services	192	441			
Shares issued on exercise of options	75	94	(19)	(75)	\$ 1.42
Options granted				2,364	\$ 3.03
Options expired				(943)	\$ 6.17
Stock based compensation			830		\$
Balance June 30, 2005	201,432	\$ 260,709	\$ 2,559	9,592	\$ 2.40

On April 15, 2005, the Company closed a Cdn.\$12.7 million (U.S.\$10.2 million, net of U.S.\$0.1 million in share issue costs), special warrant financing by way of a private placement, with six institutional and individual investors.

Proceeds from the financing were used to complete the Merger and for general corporate purposes. The financing consisted of 4,100,000 special warrants at Cdn.\$3.10 per special warrant. Each special warrant entitled the holder to receive, at no additional cost, one common share and one common share purchase warrant. Each common share purchase warrant entitles the holder to purchase one common share at a price of Cdn.\$3.50 until April 15, 2007. Common shares and share purchase warrants were issued for the exercise of the 4,100,000 special warrants on July 4, 2005.

In June 2005, 3,000,000 share purchase warrants, issued on July 3, 2003, were exercised for the purchase of 1,500,000 common shares at U.S.\$1.10 per share. As at June 30, 2005, the following purchase warrants were exercisable to purchase additional common shares until the expiry date at the price per share as indicated:

Year of Special Warrant Financing	Price per Special Warrant	Number of Purchase Warrants Issued	Remaining Number of Purchase Warrants (thousands)	Number of Common Shares	Expiry Date	Exercise Price per Share
2003	U.S.\$1.00	3,000	3,000	1,500	September 8, 2005	U.S.\$1.10
2003	U.S.\$1.70	3,529	3,029	1,515	September 8, 2005	U.S.\$1.87
2003	U.S.\$4.00	1,250	1,250	1,250	October 31, 2005	U.S.\$4.30
2004	U.S.\$2.90	5,449	5,449	2,725	February 18, 2006	U.S.\$3.20
2004	U.S.\$2.90	1,724	1,724	862	March 5, 2006	U.S.\$3.20
2005	Cdn.\$3.10	4,100	4,100	4,100	April 15, 2007	Cdn.\$3.50
		19,052	18,552	11,952		

7. STOCK BASED COMPENSATION

The Company accounts for all stock options granted using the fair value based method of accounting. This method was adopted effective January 1, 2004 for stock options granted to employees and directors after January 1, 2002. Under this method, compensation costs are recognized in the financial statements over the stock options vesting period using an option-pricing model for determining the fair value of the stock options at the grant date. For the three-month and six-month periods ended June 30, 2005, the Company expensed \$0.5 million and \$0.8 million, respectively, in stock based compensation, which is included in general and administrative expense. For the same periods ended June 30, 2004, \$0.2 million and \$0.5 million, respectively, was expensed.

8. NOTE AND ADVANCE PAYABLE

In February 2003, the Company obtained a bank facility for up to \$5.0 million to develop the southern expansion of its South Midway field. The note is repayable over three years starting August 2004 with interest at 0.5% above the bank's prime rate or 3.0% over the London Inter-Bank Offered Rate (**LIBOR**), at the option of the Company. The note is secured by all the Company's rights and interests in its South Midway properties. The note balance, as at June 30, 2005 and December 31, 2004, was \$3.5 million and \$4.3 million, respectively, with a six-month fixed LIBOR rate of 6.5% per annum as at June 30, 2005.

The scheduled maturities of the bank note payable as at June 30, 2005 were as follows:

2005	\$ 834
2006	1,667
2007	972
	3,473
Less: current portion	1,667
	\$ 1,806

In March 2004, the Company received a \$10.0 million advance as part of a \$20.0 million up-front payment due to a farm-in to the Company's Dagang oil project. Upon finalization of the farm-in agreement in June 2004, the Company's

farm-in partner elected to apply \$10.0 million of the up-front payment due to the Company against the advance.

9. CONVERTIBLE LOANS

The Company has two unsecured convertible loans, of \$6.0 million and \$2.0 million, which bear interest at 8.0% per annum and are due upon the earliest of i.) five days following receipt of proceeds from a private placement or public offering of Company common shares ii.) ninety days following written demand for repayment from lender or iii.) August 23, 2005. During the term of the loans the lender may convert at its option unpaid principal and interest, in whole or in part, to the Company's common shares at \$2.25 per share as to the \$6.0 million loan and \$2.15 per share as to the \$2.0 million loan. The fair value of the convertible loans approximate their carrying values due to the short-term maturity. No value was assigned to the equity component of the loans. The lender

waived its right to have the loans repaid from the proceeds of the April 15, 2005 and July 7, 2005 special warrant financings described in Notes 6 and 14.

10. ASSET RETIREMENT OBLIGATIONS

The undiscounted amount of expected cash flows required to settle the Company's asset retirement obligations as at June 30, 2005 was estimated at \$3.0 million, which includes \$0.1 million for dismantlement and site restoration of the RTP™ CDF and \$1.5 million to permanently abandon the Northwest Lost Hills # 1-22 well. The liability for the expected cash flows, as reflected in the financial statements, has been discounted at 5% to 7% and is estimated to be settled over a twelve-year period starting in 2010.

11. MERGER

On April 15, 2005, the Company and Ensyn completed the Merger (as more fully described in the Company's 2004 Annual Report filed on Form 10-K) in which the Company paid \$10.0 million in cash and issued 30 million Ivanhoe common shares (**Merger Shares**) in exchange for all of the issued and outstanding Ensyn common shares. Ten million of the Merger Shares issued were deposited in an escrow fund and are being held to secure certain obligations on the part of the former Ensyn stockholders to indemnify the Company for damages arising from any breaches of warranties and covenants in the Merger Agreement and certain liabilities.

The Company's consolidated results of operations for the three-month period ended June 30, 2005 included a net loss of \$0.6 million, or nil per share, associated with the operations acquired from Ensyn after the completion of the Merger on April 15, 2005. Had the Merger been completed on January 1, 2005 or 2004, the pro forma revenue, net loss and net loss per share of the merged entity for the three-month and six-month periods ended June 30, 2005 and 2004 would have been as follows:

	Three-Month Periods Ended June 30,					
	2005			2004		
	Revenue	Net Loss	Net Loss Per Share	Revenue	Net Loss	Net Loss Per Share
As reported	\$ 6,645	\$ 1,031	\$ 0.01	\$ 3,521	\$ 1,298	\$ 0.01
Pro forma adjustments	6	550		36	330	
	\$ 6,651	\$ 1,581	\$ 0.01	\$ 3,557	\$ 1,628	\$ 0.01
Weighted Average Number of Shares (in thousands)			200,145			199,116

	Six-Month Periods Ended June 30,					
	2005			2004		
	Revenue	Net Loss	Net Loss Per Share	Revenue	Net Loss	Net Loss Per Share
As reported	\$ 12,381	\$ 2,514	\$ 0.01	\$ 6,853	\$ 2,590	\$ 0.02
Pro forma adjustments	736	730		174	605	
	\$ 13,117	\$ 3,244	\$ 0.01	\$ 7,027	\$ 3,195	\$ 0.02
Weighted Average Number of Shares (in thousands)			200,527			195,621

As at June 30, 2005, the Company incurred \$4.0 million of costs associated with the Merger, including \$1.0 million to acquire an option to purchase an additional 5% of EPIL, which expired, unexercised, in January 2005. The total purchase consideration and cost of the Merger was \$89.0 million and has been allocated to the net assets acquired from Ensyn as follows:

Purchase Consideration

29,999,886 shares of Ivanhoe at \$2.50 per share	\$ 75,000
Cash	10,000
	85,000
Merger related costs	4,000
Total purchase consideration and cost of the Merger	\$ 89,000

Net Assets Acquired

Cash	\$ 21
Non-cash working capital, net	(117)
Oil and gas properties and investments	4,561
Intangible asset	89,531
Asset retirement obligation	(96)
Contingent obligation	(1,900)
Less : previous investment in EPIL	(3,000)
	\$ 89,000

The allocation of the purchase consideration and cost of the Merger is preliminary and subject to change.

12. ENSYN AGREEMENTS***RTP™ Joint Venture***

In the Merger, the Company acquired a 50% interest in a joint venture (**RTP™ Joint Venture**), which owns the RTP™ CDF and exclusive right to use the RTP™ Technology to manufacture RTP™ facilities, at cost plus 25%, or be paid a fixed fee if the RTP™ facilities are manufactured by any party other than the RTP™ Joint Venture. The fixed fee is a one-time fee for each RTP™ facility installed determined based on factors including the capacity and application of the RTP™ facility. The RTP™ Joint Venture must include in the purchase price for RTP™ facilities a royalty of \$500/barrel of capacity of each installed RTP™ facility payable in a lump sum and pay such royalty to the Company or alternately, at the Company's option, the royalty may be paid to the Company by the purchaser of the RTP™ facility. The Company has a 50% interest in the profits and losses of the RTP™ Joint Venture.

In 2003, Ensyn (which changed its name following the Merger to Ivanhoe Energy HTL Inc. (**IE HTL**)) entered into an agreement with Aera Energy LLC (**Aera**) providing for the construction of an RTP™ CDF on Aera's property in California's San Joaquin Basin to demonstrate the commercial viability of the RTP™ Technology. The RTP™ Joint Venture partners agreed to fund the construction of an RTP™ CDF to be owned and operated by the RTP™ Joint Venture up until its redeployment to another site or sale to a third party. Within six months after completing the RTP™ CDF's testing and demonstration period, the Company is responsible for dismantling the facility and restoring the Aera site to its original condition.

No royalties were paid by the RTP™ Joint Venture to the Company for the construction of the RTP™ CDF.

Other than the RTP™ CDF and exclusive right to use the RTP™ Technology to manufacture RTP™ facilities, the RTP™ Joint Venture had no assets, liabilities, revenues or net income for the three-month and six-month periods ended June 30, 2005. The Company has included its 50% interest in the RTP™ CDF in its balance sheet as at June 30, 2005.

ConocoPhillips Canada Resources Limited

Under a pre-existing agreement between IE HTL and ConocoPhillips Canada Resources Corp. (**ConocoPhillips Canada**), certain non-exclusive rights to use the RTP™ Technology for petroleum applications in Canada were granted. ConocoPhillips Canada has the right, through August 2010, to place orders for RTP™ facilities with input capacity of up

to 250,000 barrels-per-day. Should ConocoPhillips Canada install RTP facilities, IE HTL is entitled to receive royalties per barrel after the first 50,000 barrels-per day of feedstock input capacity.

13. COMMITMENTS AND CONTINGENCIES

Zitong Exploration Commitment

With the signing of the production-sharing contract in September 2002 for the Zitong block, the Company is obligated to conduct a minimum exploration program during the first three years, which includes acquiring seismic data, reprocessing existing seismic and drilling two exploration wells. At the end of the three-year period, if the Company does not complete the minimum exploration program, and elects not to continue, it will be obligated to pay, to PetroChina within 30 days, a cash equivalent of the deficiency in the work program. The remaining cost of the minimum exploration program is estimated to be \$6.7 million as at June 30, 2005.

Contingent Obligations

As part of the Merger, the Company assumed a contingent obligation to pay \$1.9 million in the event, and at such time that, the sale of units incorporating the RTP™ Technology for petroleum applications reach a total of \$100 million. This contingent obligation was recorded in the Company's balance sheet as at June 30, 2005 as part of the net assets acquired in the Merger. Additionally, the Company assumed a contingent obligation to advance to a subsidiary of Ensyn Corporation, formed from the spin-off of Ensyn's Renewables Business immediately prior to the Merger, up to approximately \$0.4 million if this subsidiary cannot meet certain debt servicing ratios required under a Canadian municipal government loan agreement. The loan principal is repayable in nine equal annual installments commencing April 1, 2006 and ending April 1, 2014. Ensyn Corporation has agreed to indemnify the Company for any amounts advanced to the subsidiary under the loan agreement.

14. SUBSEQUENT EVENT

Private Placement

On July 7, 2005, the Company closed a Cdn.\$3.1 million (U.S.\$ 2.4 million) special warrant financing, by way of a private placement, with an institutional investor. Proceeds from the financing will be used to pursue opportunities for the commercial deployment of the Company's RTP Technology as well as funding the ongoing development of its oil and gas projects in China and for general corporate purposes. The financing consisted of 1,000,000 special warrants at Cdn.\$3.10 per special warrant. Each special warrant entitles the holder to receive, at no additional cost, one common share and one common share purchase warrant immediately following the filing and regulatory acceptance of a Canadian prospectus, or four months after the closing date, whichever ever occurs first. One common share purchase warrant will entitle the holder to purchase one common share at a price of Cdn.\$3.50 exercisable until the second anniversary date of the closing.

15. ADDITIONAL DISCLOSURE REQUIRED UNDER U.S. GAAP

The consolidated financial statements have been prepared in accordance with Canadian GAAP, which conforms to U.S. GAAP except as described below:

Condensed Consolidated Balance Sheets

Shareholders' Equity and Oil and Gas Properties and Investments

As at June 30, 2005

	Oil and Gas Properties and Investments	Share Capital and Warrants	Shareholders' Equity		Total
			Contributed	Accumulated	
			Surplus	Deficit	
Canadian GAAP	\$ 121,238	\$ 270,862	\$ 2,559	\$ (84,293)	\$ 189,128
Adjustment for reduction in stated capital		74,455		(74,455)	
Adjustment to ascribed value of shares issued for U.S. royalty interests, net	1,358	1,358			1,358
Provision for impairment	(8,650)			(8,650)	(8,650)
Depletion adjustments due to differences in provision for impairment	910			910	910
GTL and EOR development costs expensed	(9,168)			(9,168)	(9,168)
Adjustment for change in accounting for stock based compensation		(300)	(2,458)	2,758	
U.S. GAAP	\$ 105,688	\$ 346,375	\$ 101	\$ (172,898)	\$ 173,578

As at December 31, 2004

	Oil and Gas Properties and Investments	Share Capital	Shareholders' Equity		Total
			Contributed	Accumulated	
			Surplus	Deficit	
Canadian GAAP	\$ 96,551	\$ 183,617	\$ 1,748	\$ (81,779)	\$ 103,586
Adjustment for reduction in stated capital		74,455		(74,455)	
Adjustment to ascribed value of shares issued for U.S. royalty interests, net	1,358	1,358			1,358
Provision for impairment	(8,650)			(8,650)	(8,650)
Depletion adjustments due to differences in provision for impairment	482			482	482
GTL and EOR development costs expensed	(5,884)			(5,884)	(5,884)
Adjustment for change in accounting for stock based compensation		(300)	(1,660)	1,960	
U.S. GAAP	\$ 83,857	\$ 259,130	\$ 88	\$ (168,326)	\$ 90,892

Share Capital and Accumulated Deficit

In June 1999, the shareholders approved a reduction of stated capital in respect of the common shares by an amount of \$74.4 million being equal to the accumulated deficit as at December 31, 1998. Under U.S. GAAP, a reduction of the accumulated deficit such as this is not recognized except in the case of a quasi reorganization. The effect of this is that under U.S. GAAP, share capital and accumulated deficit are increased by \$74.4 million as at June 30, 2005 and December 31, 2004.

Oil and Gas Properties and Investments

As more fully described in our financial statements in Item 8 of our 2004 Annual Report filed on Form 10-K, there are differences between the full cost method of accounting for oil and gas properties as applied in Canada and as applied in the U.S. The principal difference is in the method of performing ceiling test evaluations under the full cost method of accounting rules. The Company performed the ceiling test in accordance with U.S. GAAP and determined that for 2004 an impairment provision of \$15.0 million was required on its U.S. oil and gas properties compared to a \$16.3 million impairment provision under Canadian GAAP. For 2001, a \$10.0 million provision for impairment was required, for U.S. GAAP purposes, in connection with the Company's China oil and gas properties. These differences result in accumulated net additional impairment provisions of \$8.7 million for U.S. GAAP purposes as at June 30, 2005 and December 31, 2004.

The differences in the amount of impairment provisions between Canadian and U.S. GAAP resulted in a reduction in accumulated depletion of \$0.9 million and \$0.5 million as at June 30, 2005 and December 31, 2004, respectively.

As more fully described in Note 2 to these consolidated financial statements, for Canadian GAAP, the Company capitalizes certain costs incurred for GTL and EOR projects subsequent to executing a memorandum of understanding to determine the technical and commercial feasibility of a project, including studies for the marketability for the projects' products. If no definitive agreement is reached, then the project's capitalized costs, which are deemed to have no future value, are written down and charged to operations with a corresponding reduction in the investments in GTL and EOR assets. For U.S. GAAP, feasibility, marketing and related costs are considered to be research and development and are expensed as incurred. As at June 30, 2005 and December 31, 2004, the Company capitalized \$9.2 million and \$5.9 million, respectively, for Canadian GAAP, which was expensed for U.S. GAAP purposes. For U.S. GAAP purposes, the aggregate value attributed to the acquisition of U.S. royalty rights during 1999 and 2000 was \$1.4 million higher, due to the difference between Canadian and U.S. GAAP in the value ascribed to the shares issued to acquire the royalty rights, primarily resulting from differences in the recognition of effective dates of the transactions. For the year ended December 31, 2004, a ceiling test impairment of \$1.0 million of the U.S. GAAP difference related to royalty rights was recognized in the results of operations.

Condensed Consolidated Statements of Loss

The application of U.S. GAAP had the following effects on net loss and net loss per share as reported under Canadian GAAP:

	Three-Month Periods Ended June 30,			
	2005		2004	
	Net Loss	Net Loss Per Share	Net Loss	Net Loss Per Share
Canadian GAAP	\$ 1,031	\$ 0.01	\$ 1,298	\$ 0.01
Stock based compensation expense	(566)		(232)	
Depletion adjustments due to differences in provision for impairment	(256)		(57)	
GTL and EOR development costs expensed, net	1,355		501	
U.S. GAAP	\$ 1,564	\$ 0.01	\$ 1,510	\$ 0.01
Weighted Average Number of Shares under U.S. GAAP (in thousands)		195,200		169,116

	Six-Month Periods Ended June 30,			
	2005		2004	
	Net Loss	Net Loss Per Share	Net Loss	Net Loss Per Share
Canadian GAAP	\$ 2,514	\$ 0.01	\$ 2,590	\$ 0.02
Stock based compensation expense	(798)		(461)	
Depletion adjustments due to differences in provision for impairment	(428)		(80)	
GTL and EOR development costs expensed, net	3,284	0.02	931	
U.S. GAAP	\$ 4,572	0.03	\$ 2,980	\$ 0.02
Weighted Average Number of Shares under U.S. GAAP (in thousands)		183,621		165,622

As discussed under "Oil and Gas Properties and Investments" in this note, there is a difference in performing the ceiling test evaluation under the full cost method of accounting between U.S. and Canadian GAAP. Application of the ceiling test evaluation under U.S. GAAP resulted in accumulated net additional impairment provisions of \$8.7 million for U.S. GAAP purposes as at June 30, 2005 and December 31, 2004. The net increase in impairment provisions resulted in lower depletion rates for U.S. GAAP purposes and a reduction of \$0.3 million and \$0.4 million in the net losses for the three-month and six-month periods ended June 30, 2005, respectively, and reductions of \$0.1 million each in the net losses for the three-month and six-month periods ended June 30, 2004.

For Canadian GAAP, the Company accounts for all stock options granted to employees and directors since January 1, 2002 using the fair value based method of accounting. Under this method, compensation costs are recognized in the financial statements over the stock options vesting period using an option-pricing model for determining the fair value of the stock options at the grant date. For U.S. GAAP, the Company continues to apply APB Opinion No. 25, as interpreted by FASB Interpretation No. 44, in accounting for its stock option plan and does not recognize compensation costs in its financial statements for stock options issued to employees and directors. For U.S. GAAP purposes, this resulted in a reduction of \$0.6 million and \$0.8 million in the net losses for the three-month and six-month periods ended June 30, 2005, respectively, and a reduction of \$0.2 million and \$0.5 million in the net losses for the three-month and six-month periods ended June 30, 2004, respectively.

As described under Oil and Gas Properties and Investments in this note, for Canadian GAAP, feasibility, marketing and related costs incurred prior to executing a GTL or EOR definitive agreement are capitalized and are subsequently written down upon determination that a project's future value has been impaired. For U.S. GAAP, such costs are considered to be research and development and are expensed as incurred. For the three-month and six-month periods ended June 30, 2005, the Company expensed \$1.4 million and \$3.3 million, respectively, of GTL and EOR development costs for U.S. GAAP purposes and \$0.5 million and \$0.9 million for the three-month and six-month periods ended June 30, 2004, respectively.

Stock Based Compensation

Had stock based compensation expense been determined based on fair value at the stock option grant date, consistent with the method of SFAS No. 123, Accounting for Stock Based Compensation, the Company's net loss and net loss per share would have been increased to the pro forma amounts indicated below:

	Three-Month Periods Ended June 30,		Six-Month Periods Ended June 30,	
	2005	2004	2005	2004
Net loss under U.S. GAAP	\$ 1,564	\$ 1,510	\$ 4,572	\$ 2,980
Stock-based compensation expense determined under the fair value based method for employee and director awards	597	498	860	992
Pro forma net loss under U.S. GAAP	\$ 2,161	\$ 2,008	\$ 5,432	\$ 3,972
Basic loss per common share under U.S. GAAP:				
As reported	\$ 0.01	\$ 0.01	\$ 0.03	\$ 0.02
Pro forma	\$ 0.01	\$ 0.01	\$ 0.03	\$ 0.02
Weighted Average Number of Shares under U.S. GAAP (in thousands)	195,200	169,116	183,621	165,622

Stock based compensation for U.S. GAAP was calculated in accordance with the Black Scholes option-pricing model using the same assumptions as used for Canadian GAAP.

Pro Forma Effect of Merger

The Company's U.S. GAAP consolidated results of operations for the three-month period ended June 30, 2005 included a net loss of \$0.6 million, or nil per share, associated with the operations acquired from Ensyn after the completion of the Merger on April 15, 2005. Had the Merger been completed on January 1, 2005 or 2004, the U.S. GAAP pro forma revenue, net loss and net loss per share of the merged entity for the three-month and six-month periods ended June 30, 2005 and 2004 would have been as follows:

	Three-Month Periods Ended June 30,					
	2005			2004		
	Revenue	Net Loss	Net Loss Per Share	Revenue	Net Loss	Net Loss Per Share
As reported	\$ 6,645	\$ 1,564	\$ 0.01	\$ 3,521	\$ 1,510	\$ 0.01
Pro forma adjustments	6	550		36	330	
	\$ 6,651	\$ 2,114	\$ 0.01	\$ 3,557	\$ 1,840	\$ 0.01
Weighted Average Number of Shares (in thousands)			200,145			199,116

	Six-Month Periods Ended June 30,					
	2005			2004		
	Revenue	Net Loss	Net Loss Per Share	Revenue	Net Loss	Net Loss Per Share
As reported	\$ 12,381	\$ 4,572	\$ 0.03	\$ 6,853	\$ 2,980	\$ 0.02
Pro forma adjustments	736	730		174	605	
	\$ 13,117	\$ 5,302	\$ 0.03	\$ 7,027	\$ 3,585	\$ 0.02
Weighted Average Number of Shares (in thousands)			200,527			195,621

Condensed Consolidated Statements of Cash Flow

As a result of the write-down of GTL and EOR development costs required under U.S. GAAP, the statements of cash flow, as reported, would result in cash provided by operating activities of \$1.0 million for the three-month period ended June 30, 2005 and a cash deficiency from operating activities of \$0.9 million for the six-month period ended June 30, 2005. Cash provided by operating activities would be \$0.5 million and \$0.2 million for the three-month and six-month periods ended June 30, 2004, respectively. Additionally, capital investments reported under investing activities would be \$10.2 million and \$20.8 million for the three-month and six-month periods ended June 30, 2005, respectively, and \$14.2 million and \$24.2 million for the three-month and six-month periods ended June 30, 2004, respectively.

Impact of New and Pending Canadian GAAP Accounting Standards

In January 2005, the Canadian Institute of Chartered Accountants (CICA) approved Section 1530 Comprehensive Income (S.1530), Section 3855 Financial Instruments Recognition and Measurement (S.3855) and Section 3865 Hedges (S.3865) to harmonize financial instrument and hedge accounting with U.S. GAAP and introduce the concept of comprehensive income. S.1530 requires presentation of certain gains and losses outside of net income, such as unrealized gains and losses related to hedges or other derivative instruments. S.3855 establishes standards for recognizing and measuring financial assets and financial liabilities and non-financial derivatives as required to be disclosed under Section 3861 Financial Instruments Disclosure and Presentation . S.3865 establishes standards for how and when hedge accounting may be applied. We apply SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities for U.S. GAAP purposes and will implement S.3865 for Canadian GAAP for hedging activities. These sections apply to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006 and are not expected to have a material impact on our financial statements.

In January 2005, the CICA approved Section 3251 Equity which establishes standards for the presentation of equity and changes in equity during a reporting period. This section applies to interim and annual financial statements

relating to fiscal years beginning on or after October 1, 2006 and is not expected to have a material impact on our financial statements.

Effective January 1, 2005, the Company adopted revised CICA Accounting Guideline 15 (**AcG 15**), Consolidation of Variable Interest Entities . AcG 15 is harmonized in all material respects with U.S. GAAP and provides guidance for applying consolidation principles to certain entities (defined as VIEs) that are subject to control on a basis other than ownership of voting interests. An entity is a VIE when, by design, one or both of the

following conditions exist: (a) total equity investment at risk is insufficient to permit that entity to finance its activities without additional subordinated support from other parties; (b) as a group, the holders of the equity investment at risk lack certain essential characteristics of a controlling financial interest. AcG 15 requires consolidation by a business of VIEs in which it is the primary beneficiary. The primary beneficiary is defined as the party that has exposure to the majority of the expected losses and/or expected residual returns of the VIE. AcG 15 does not impact us at this time.

Impact of New and Pending U.S. GAAP Accounting Standards

In June 2004, the Financial Accounting Standards Board (**FASB**) issued an exposure draft of a proposed statement, **Fair Value Measurements** to provide guidance on how to measure the fair value of financial and non-financial assets and liabilities when required by other authoritative accounting pronouncements. The proposed statement attempts to address concerns about the ability to develop reliable estimates of fair value and inconsistencies in fair value guidance provided by current U.S. GAAP, by creating a framework that clarifies the fair value objective and its application in GAAP. In addition, the proposal expands disclosures required about the use of fair value to re-measure assets and liabilities. The standard would be effective for financial statements issued for fiscal years beginning after June 15, 2005.

In December 2004, the FASB issued a revision to SFAS No. 123, **Accounting for Stock Based Compensation** which supersedes APB No. 25, **Accounting for Stock Issued to Employees** . This statement (**SFAS No. 123(R)**) requires measurement of the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award on the date of the grant and recognition of the cost in the results of operations over the period during which an employee is required to provide service in exchange for the award. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. The Company applies APB Opinion No. 25, as interpreted by FASB Interpretation No. 44, in accounting for awards issued from its stock option plan and does not recognize compensation costs in its U.S. GAAP financial statements for stock options issued to its employees and directors. This statement is effective for the first fiscal year that begins after June 15, 2005 and may be implemented on a modified prospective or retrospective basis. The Company has elected to implement this statement on a modified prospective basis starting in the first quarter of 2006. Under the modified prospective basis the Company would recognize stock based compensation in its U.S. GAAP results of operations for the unvested portion of awards outstanding as at January 1, 2006 and for all awards granted after January 1, 2006.

To assist in the implementation of SFAS No. 123(R), the SEC issued SAB No. 107, **Share-Based Payment** . While SAB No. 107 addresses a wide range of issues, the largest area of focus is valuation methodologies and the selection of assumptions. Notably, SAB No. 107 lays out simplified methods for developing certain assumptions. In addition to providing the SEC staff's interpretive guidance on SFAS No. 123(R), SAB No. 107 addresses the interaction of SFAS No. 123(R) with existing SEC guidance (e.g., the interaction with the SEC's guidance dealing with non-GAAP disclosures). Its intent is to clarify, not change, any of SFAS No. 123(R)'s guidance.

In March 2005, the FASB issued Interpretation No. 47 (**FIN 47**) **Accounting for Conditional Asset Retirement Obligations** an interpretation of FASB Statement No. 143 . A conditional asset retirement obligation refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Thus, the timing and (or) method of settlement may be conditional on a future event. FIN 47 requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. FIN 47 is effective no later than the end of fiscal years ending after December 15, 2005 (December 31, 2005, for calendar-year enterprises). Retrospective application for interim financial information is permitted but is not required. The conditional event with respect to the abandonment of the Northwest Lost Hills # 1-22 well materialized during the three-month period ended June 30, 2005 and the Company recorded \$0.9 million in asset retirement costs and asset retirement obligations.

In May 2005, the FASB issued SFAS No. 154 (**SFAS 154**) **Accounting Changes and Error Corrections** a replacement of APB Opinion No. 20 and FASB Statement No. 3 . SFAS 154 changes the requirements for the

accounting for and reporting of a change in accounting principle. APB Opinion No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS 154 carries forward without change the guidance contained in APB Opinion No. 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS 154 also carries forward the guidance in APB Opinion No. 20 requiring justification of a change in accounting principle on the basis of preferability. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In June 2005, the FASB published an Exposure Draft containing proposals to change the accounting for business combinations. The proposed standards would replace the existing requirements of the FASB's Statement No. 141,

Business Combinations. The proposals would result in fewer exceptions to the principle of measuring assets acquired and liabilities assumed in a business combination at fair value. Additionally, the proposals would result in payments to third parties for consulting, legal, audit, and similar services associated with an acquisition being recognized generally as expenses when incurred rather than capitalized as part of the business combination. The FASB also published an Exposure Draft that proposes, among other changes, that non-controlling interests be classified as equity within the consolidated financial statements. The FASB's proposed standard would replace Accounting Research Bulletin No. 51,

Consolidated Financial Statements.

The following standards issued by the FASB do not impact the Company at this time:

SFAS No. 151, Inventory Costs' an amendment of ARB No. 43, Chapter 4' effective for inventory costs incurred during fiscal years beginning after June 15, 2005.

SFAS No. 153, Exchanges of Nonmonetary Assets' an amendment of APB Opinion No. 29' effective for nonmonetary asset exchanges occurring in fiscal years beginning after June 15, 2005.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

With the exception of historical information, certain matters discussed in this Form 10-Q are forward looking statements that involve risks and uncertainties. Certain statements contained in this Form 10-Q, including statements which may contain words such as 'could', 'should', 'expect', 'believe', 'will' and similar expressions and statements related to matters that are not historical facts are forward-looking statements. Such statements involve known and unknown risks and uncertainties which may cause our actual results, performances or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Although we believe that our expectations are based on reasonable assumptions, we can give no assurance that our goals will be achieved. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include, but are not limited to, our ability to raise capital as and when required, the timing and extent of changes in prices for oil and gas, competition, environmental risks, drilling and operating risks, uncertainties about the estimates of reserves and the potential success of heavy oil and gas-to-liquids development technologies, the prices of goods and services, the availability of drilling rigs and other support services, legislative and government regulations, political and economic factors in countries in which we operate and implementation of our capital investment program.

The following should be read in conjunction with the Company's consolidated financial statements contained herein and in the Form 10-K for the year ended December 31, 2004, along with Management's Discussion and Analysis of Financial Condition and Results of Operations contained in such Form 10-K. Any terms used but not defined in the following discussion have the same meaning given to them in the Form 10-K. The unaudited

condensed consolidated financial statements in this Quarterly Report filed on Form 10-Q have been prepared in accordance with generally accepted accounting principles in Canada. The impact of significant differences between Canadian and U.S. accounting principles on the unaudited condensed consolidated financial statements is disclosed in Note 15. The date of this discussion is July 29, 2005.

Executive Overview of 2005 Results

Despite significant increases in our revenues for the first two quarters of 2005, we continue to generate net losses at approximately the same levels as the comparable periods in 2004 primarily as a result of increases in non-cash expenses such as depletion and stock based compensation and from cash items such as general and administrative and business development expenses. Our net operating revenues and cash flow from operating activities have almost doubled for the three-month and six-month periods ended June 30, 2005, respectively, compared to the same periods for 2004 due mainly to increases in oil and gas prices but also due to increased volumes generated from our field development programs at Dagang, Citrus and Knights Landing.

The following table sets forth certain selected consolidated data for the three-month and six-month periods ended June 30, 2005 and 2004:

	Three-Month Periods Ended June 30,		Six-Month Periods Ended June 30,	
	2005	2004	2005	2004
(stated in thousands of U.S. dollars, except per share and production amounts)				
Oil and gas revenue	\$ 6,617	\$ 3,472	\$ 12,310	\$ 6,764
Net loss	\$ 1,031	\$ 1,298	\$ 2,514	\$ 2,590
Net loss per share	\$ 0.01	\$ 0.01	\$ 0.01	\$ 0.02