



**MANAGEMENT'S DISCUSSION & ANALYSIS**

**December 31, 2009**

## MANAGEMENT'S DISCUSSION AND ANALYSIS

March 9, 2010

This management's discussion and analysis ("MD&A") for Sure Energy Inc. ("Sure Energy" or the "Company") should be read in conjunction with the audited financial statements of the Company as at December 31, 2009 and 2008 together with the accompanying notes. Additional information relating to the Company can be viewed or downloaded at [www.sureenergyinc.com](http://www.sureenergyinc.com) or [www.sedar.com](http://www.sedar.com). Readers should also read the "Forward Looking Information" legal advisory contained at the end of this document.

The financial information presented has been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). Readers can find the definitions of non-GAAP measures located at the end of this document.

Throughout the report BOE, or barrel of oil equivalent, is defined as 6 Mcf to 1 bbl. BOEs may be misleading particularly if used in isolation. A BOE conversion ratio of 6 Mcf:1 bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

## BUSINESS AND FINANCIAL STRATEGY

Sure Energy is a junior oil and gas company engaged in the exploration for, and the acquisition, development and production of oil and natural gas reserves primarily in Alberta and Saskatchewan. Sure Energy's main objective is value creation by providing a shareholder exposure to emerging development plays with large volumes of oil and gas in place, such as the conventional Viking light oil development at Redwater, and exposure to higher impact natural gas targets. Sure Energy achieves its objective through a combination of exploration activities, drilling and assessing strategic acquisitions. On August 14, 2009, Sure Energy closed the acquisition of Conifer Exploration Ltd. ("Conifer"), which provided the company increased exposure to the Viking development at Redwater.

The global recession has created uncertainty resulting in a period of low commodity prices, volatile financial markets and restricted access to capital markets. Sure Energy's financial strategy has been to maintain a strong balance sheet and a conservative capital structure. As at December 31, 2009, the Company had net debt of \$4.5 million and an unused credit facility of \$8.5 million. The Company has planned a conservative capital expenditure program for 2010. Production increases during 2010 will provide sufficient cash flow for the Company to operate in 2010.

## OVERVIEW

### Selected Annual and Quarterly Information

	2009	Q4 09	Q3 09	Q2 09	Q1 09	2008	Q4 08	Q3 08	Q2 08	Q1 08	2007
<b>Production</b>											
Natural gas (Mcf/d)	<b>3,532</b>	3,614	3,453	3,626	3,435	<b>2,044</b>	2,568	2,088	1,744	1,771	<b>1,666</b>
Oil (bbls/d)	<b>42</b>	66	53	21	29	<b>13</b>	15	12	14	12	<b>3</b>
NGLs (bbls/d)	<b>31</b>	39	28	27	27	<b>19</b>	21	22	15	20	<b>-</b>
BOE/d	<b>662</b>	708	657	653	628	<b>373</b>	463	382	319	327	<b>281</b>
<b>Average Selling Price</b>											
Natural gas (\$/Mcf)	<b>4.07</b>	4.69	3.07	3.56	4.99	<b>8.09</b>	6.85	8.08	10.29	7.74	<b>6.36</b>
Oil (\$/bbl)	<b>65.87</b>	73.73	70.11	67.40	38.04	<b>100.11</b>	61.52	126.01	128.42	89.22	<b>79.35</b>
NGLs (\$/bbl)	<b>44.66</b>	50.98	47.34	38.56	38.64	<b>53.03</b>	41.72	61.68	63.39	47.44	<b>-</b>
\$/BOE	<b>28.02</b>	33.66	23.83	23.54	30.68	<b>50.57</b>	41.78	51.58	64.77	48.09	<b>38.63</b>
<b>Netback (\$/BOE)</b>											
Operating	<b>12.89</b>	16.61	11.29	11.03	12.27	<b>29.28</b>	23.04	29.46	39.10	28.41	<b>20.98</b>
Funds Flow	<b>7.31</b>	10.33	6.73	6.25	5.58	<b>20.06</b>	15.57	23.84	26.78	15.46	<b>11.26</b>

**Financial****(\$000s except share and per share amounts)**

Revenue	<b>6,765</b>	2,193	1,439	1,398	1,735	<b>6,909</b>	1,781	1,813	1,883	1,432	<b>3,958</b>
Funds Flow	<b>1,766</b>	672	408	372	314	<b>2,740</b>	662	839	779	460	<b>1,153</b>
Per share, basic	<b>0.04</b>	0.01	0.01	0.01	0.01	<b>0.08</b>	0.02	0.02	0.03	0.02	<b>0.04</b>
Loss	<b>(3,760)</b>	(828)	(1,284)	(1,140)	(508)	<b>(1,234)</b>	(561)	(176)	(98)	(399)	<b>(2,981)</b>
Per share, basic	<b>(0.09)</b>	(0.02)	(0.03)	(0.03)	(0.01)	<b>(0.04)</b>	(0.01)	(0.00)	(0.00)	(0.01)	<b>(0.10)</b>
Capital Expenditures	<b>11,398</b>	1,631	8,600	307	860	<b>13,654</b>	3,486	3,125	1,433	5,610	<b>6,043</b>
Total Assets		37,908	36,959	32,154	33,602		37,068	35,761	27,174	26,247	
Net Debt		(4,537)	(3,664)	1,678	1,671		2,239	4,963	(592)	47	
Shareholder's Equity		30,054	30,824	29,254	30,298		31,287	31,692	23,880	23,817	
Common Shares (000's)		46,874	46,874	37,659	37,659		37,659	37,659	30,767	30,767	

**Q4 2009**

Revenue increased during the quarter mainly due to a recovery in the price of natural gas. Capital expenditures included a well that was drilled, completed and tied-in on the Peace River Arch. The well commenced production on January 1, 2010.

**Q3 2009**

On August 14, 2009 Sure Energy closed a purchase and sale agreement to acquire all issued and outstanding shares of Conifer for a total consideration of \$8.9 million.

Production remained consistent from quarter to quarter. Production increases from the acquisition of Conifer were offset by a voluntary shut in at Chinook. Royalty expense decreased due to low gas prices and the receipt of gas cost allowance credits in the period. Operating expenses increased due to gas processing equalizations.

**Q2 2009**

Production increased during the quarter from 628 BOE/d to 653 BOE/d due to a full quarter of production on new wells that commenced production in 2009. However, revenue decreased because commodity prices decreased significantly. The Company received a gas cost allowance credit of \$230,000 during the quarter which reduced royalty expense. The credit was received on the basis of capital spent by Argent Energy Inc. and Sure Energy in prior periods.

**Q1 2009**

Revenue decreased during the quarter compared to the fourth quarter of 2008 as an increase in production was offset by weak commodity prices. Production increased by 36 percent over the fourth quarter of 2008 to 628 BOE/d. New wells that commenced production had high royalty rates under the Alberta New Royalty Framework.

**Q4 2008**

Revenue decreased during the quarter due to significant decreases in commodity prices offset by a 21 percent increase in production from the new wells at Boundary and Chinook.

**Q3 2008**

Revenue decreased marginally in the quarter due to a decrease in commodity prices, partially offset by an increase in production from two new wells at Boundary and Chinook. During the quarter, Sure Energy completed a private placement of common and flow-through shares.

**Q2 2008**

Revenue increased during the quarter due to increases in oil and gas prices. Operating costs increased during the current quarter mainly due to a 13 month processing fee adjustment in the Tweedie area.

**Q1 2008**

On January 15, 2008, the Company acquired all of the outstanding common shares of Argent Energy Inc. ("Argent"), a private oil and gas company. The total consideration included the issuance of 1,861,847 common shares of the Company issued in exchange for all of the outstanding Argent common shares and the assumption of debt of \$2.0 million and a working capital deficiency of \$1.1 million. The exchange ratio was 0.1075 Sure Energy share for every outstanding common share of Argent.

The business combination has been accounted for as a purchase. Argent was amalgamated with Sure Energy on January 15, 2008.

A total of 360,215 shares of Sure Energy were also issued in connection with the closing as settlement of severance to former Argent employees.

Production increased during the quarter due to the acquisition of Argent which more than offset the reduction in volumes due to natural decline. Revenue also increased during the quarter due to increases in benchmark oil and gas prices. Working capital decreased during the quarter as cash was used to finance the Argent acquisition.

#### ACQUISITION OF CONIFER EXPLORATION LTD.

On August 14, 2009, Sure Energy closed a purchase and sale agreement to acquire all issued and outstanding shares of Conifer for a total consideration of \$8.9 million. Under the terms of the agreement, Sure Energy paid \$6.0 million in cash and issued 9,214,754 common shares for the issued and outstanding common shares of Conifer. The cash portion of the deal was financed from Sure Energy's existing working capital surplus and bank line. Concurrent with the closing, Sure Energy's credit facility was increased to \$11.5 million consisting of a \$10 million revolving operating demand loan and a \$1.5 million non-revolving acquisition/development demand loan.

#### RESULTS OF OPERATIONS

Revenues Petroleum and Natural Gas Revenue (\$000s)	Three Months Ended December 31,		Year ended December 31,	
	2009	2008	2009	2008
Natural gas	1,558	1,619	5,250	6,051
Oil	450	82	1,017	480
NGLs	185	80	498	378
	2,193	1,781	6,765	6,909

Production	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Natural gas (Mcf/d)	3,614	2,568	3,532	2,044
Oil (bbls/d)	66	15	42	13
NGLs (bbls/d)	39	21	31	19
BOE/d	708	463	662	373

Average Selling Price	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Natural gas (\$/Mcf)	4.69	6.85	4.07	8.09
Oil (\$/bbl)	73.73	61.52	65.87	100.11
NGLs (\$/bbl)	50.98	41.72	44.66	53.03
\$/BOE	33.66	41.78	28.02	50.57

Average Benchmark Prices	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
AECO (daily) natural gas (\$/Mcf)	4.26	6.34	3.75	7.71
WTI Crude oil (US\$/bbl)	76.19	58.79	61.80	99.66
Edmonton par price (Cdn \$/bbl)	76.60	63.21	65.93	102.13
Exchange rate (US\$/Cdn\$)	1.0563	1.2113	1.1415	1.0668

Revenue for the quarter was \$2.2 million versus \$1.8 million for the comparative quarter. Production for the quarter averaged 708 BOE/d, representing an increase of 53 percent over the comparative quarter. Production increased as a result of new gas wells at Chinook and Boundary that commenced production in late 2008. Production also increased from the acquisition of Conifer which closed on August 14, 2009. The Company's realized price for its natural gas was \$4.69/Mcf for the quarter, 32 percent less than the \$6.85/Mcf received in the prior quarter.

Revenue for the year was \$6.8 million versus \$6.9 million for the comparative year. Production for the year averaged 662 BOE/d, representing an increase of 77 percent over the prior year. Production increased as a result of new gas wells at Chinook and Boundary that commenced production in late 2008. Production also increased from the acquisition of Conifer. The Company's realized price for its natural gas was \$4.07/Mcf, 50 percent less than the \$8.09/Mcf received in the comparative period.

The Company has not hedged or entered into any fixed price arrangements during 2009 or for any subsequent period.

### Royalties

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Royalties	312	343	940	1,283
Average royalty as a percent of revenue	14.2	19.3	13.9	18.6

Royalties as a percentage of revenue decreased to 14.2 percent for the current quarter versus 19.3 percent for the comparative quarter. For the year ended December 31, 2009, royalties as a percent of revenue were 13.9 percent versus 18.6 percent for the prior year. The Company received gas cost allowance credits based on capital spent by Argent and Sure Energy in prior periods. Overall, gas royalty rates are lower due to low gas prices.

### Alberta Royalty Changes

On December 2, 2008, the Mines and Minerals (New Royalty Framework) Amendment Act 2008, Bill 47, was given Royal Assent by the Lieutenant Governor of Alberta and became law on January 1, 2009. This Act revised the calculation of Alberta provincial royalties effective the production month of January 2009.

On November 19, 2008, the Government of Alberta introduced a program where certain wells drilled after November 19, 2008 are eligible for Transitional royalties, for the period ending January 1, 2014.

These changes to Alberta royalties have been included in the reserves and value assessment by the independent qualified reserves evaluators.

On March 3, 2009, the Alberta government announced short term incentives to stimulate economic activity. The program is designed to be of more benefit to smaller producers such as Sure Energy. The program includes a royalty credit of \$200 per meter for new conventional oil and gas wells drilled between April 1, 2009 and March 31, 2010. Under this incentive, Sure Energy's maximum benefit is 50% of Crown royalties owed in fiscal years 2009 and 2010. An additional incentive is a maximum five percent royalty on the first year of production for certain new oil and gas wells that begin production between April 1, 2009 and March 31, 2010. On June 25, 2009, the Alberta government extended these incentive programs for an additional year.

The majority of Sure Energy's Alberta drilling prospects are on Crown lands and will be eligible under these incentives.

### Operating expenses

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Operating expenses	698	396	2,363	1,433

Operating costs were \$698,000 or \$10.72 per BOE for the current quarter versus \$396,000 or \$9.29 per BOE for the comparative period. Current quarter operating costs per BOE increased compared to the comparative quarter due to the higher operating costs on the oil wells acquired from Conifer.

Operating costs were \$2.4 million or \$9.79 per BOE for the current year versus \$1.4 million or \$10.49 per BOE for the comparative period. Operating costs per BOE decreased slightly due to the lower operating costs on the new gas wells that were drilled in late 2008.

## Transportation

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Transportation	99	60	348	192

Transportation costs were \$1.53 per BOE in the current quarter and \$1.41 for the comparative period. Transportation costs were \$1.44 per BOE for 2009 (2008 - \$1.41 per BOE). Transportation costs are fairly consistent on a BOE basis and relate to the costs of transporting Sure Energy's natural gas production on major pipelines and trucking Sure Energy's oil to the point of transfer.

## General and Administrative

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Gross general and administrative	486	506	1,756	1,766
Capitalized overhead	(98)	(154)	(426)	(427)
	388	352	1,330	1,339

General and administrative ("G&A") costs were \$5.96 per BOE for the current quarter and \$8.24 per BOE for the comparative period. G&A costs were \$1.3 million or 5.51 per BOE for the current year and \$1.3 million or 9.80 per BOE for the prior year. G&A costs will decrease on a per BOE basis as the Company grows its production. As activity increases, the Company will apply overhead charges, which are charged to specific well operations, and reduce G&A as is customary in the industry.

## Interest

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Interest income	-	32	15	78
Interest expense	24	-	33	-

During the quarter, Sure Energy utilized its debt facility to finance a portion of the acquisition of Conifer. The interest rate on the debt facility was 3.5 percent.

## Stock Compensation (non-cash)

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Stock compensation	58	146	513	625

Stock compensation (non-cash) expense was \$58,000 in the current quarter and \$146,000 for the comparative period. Stock compensation expense was \$513,000 for the current year (2008 - \$625,000). This amount is made up of the amortization of the expense relating to the options granted to employees, officers and directors, and the performance incentive rights ("PIRs") granted to Sure Energy employees, directors and consultants. The remaining 1,752,500 unvested PIRs vest when the 21 day weighted average trading price of Sure Energy common shares exceeds \$1.50.

## Depletion, Depreciation and Accretion

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Depletion and depreciation	1,424	1,057	5,690	3,282
Accretion	18	20	73	67
	1,442	1,077	5,763	3,349

The Company's depletion, depreciation and accretion ("DD&A") provision for the current quarter was \$1.4 million, or \$22.15 per BOE and \$1.1 million or \$25.29 per BOE for the comparative period. The Company's depletion, depreciation and accretion ("DD&A") provision for the year was \$5.8 million, or \$23.87 per BOE and \$3.3 million or \$24.51 per BOE for the comparative period. DDA per BOE decreased for the quarter and for the year due to the successful well drilled at Gordondale and increase in

reserves in Redwater. \$5.0 million in costs related to the Company's undeveloped land base were excluded from the depletion calculation.

Accretion of the asset retirement obligations is calculated at the Company's credit-adjusted, risk-free rate of 8 percent. The Company has estimated the net present value of the asset retirement obligations to be \$1.0 million.

### Income and future taxes

The Company does not expect to pay current income tax in 2010 or 2011. Estimated income tax pools at December 31, 2009 are as follows:

(\$000s)	
Canadian oil and gas property expenses	10,496
Canadian development expenses	2,778
Canadian exploration expenses	4,069
Undepreciated capital costs	5,550
Non-capital losses	21,905
Financing costs	103
Successored pools (restricted)	18,852
	63,753

As a result of the Company issuing flow-through shares in 2008, Canadian exploration expenses of \$2.5 million were renounced to investors in February, 2009. The flow through commitment was fully met at December 31, 2009.

Share capital was reduced and a future income tax liability was recorded to recognize the foregone tax benefit of the renouncement. The Company recorded a future income tax recovery in the statement of operations to the extent that there was an unrecognized future income tax asset to offset the future income tax liability as a result of the renouncement.

### Netbacks

Components of the Company's operating, funds flow and loss netbacks are as follows:

(\$/BOE)	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Price	33.66	41.78	28.02	50.57
Royalties	(4.80)	(8.04)	(3.90)	(9.39)
Operating costs	(10.72)	(9.29)	(9.79)	(10.49)
Transportation	(1.53)	(1.41)	(1.44)	(1.41)
Operating Netback	16.61	23.04	12.89	29.28
General and administrative	(5.96)	(8.24)	(5.51)	(9.80)
Interest income (expense)	(0.32)	0.77	(0.07)	0.58
Funds Flow Netback	10.33	15.57	7.31	20.06
Stock compensation	(0.90)	(3.42)	(2.13)	(4.57)
Depletion, depreciation and accretion	(22.15)	(25.29)	(23.87)	(24.51)
Future income taxes	-	-	3.11	-
Loss Netback	(12.72)	(13.14)	(15.58)	(9.02)

## CAPITAL EXPENDITURES

Cash expenditures for the period were as follows:

<b>Capital Program Summary</b>	<b>Three Months Ended December 31,</b>		<b>Year Ended December 31,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
(\$000s)				
Land	7	187	444	738
Geological and geophysical	145	150	1,014	785
Drilling	683	1,814	821	2,977
Completions	575	191	616	747
Recompletions and workovers	19	15	632	177
Production equipment and facilities	460	935	649	2,890
Capitalized exploration G&A	98	154	426	427
Drilling credits	(357)	-	(357)	-
	1,630	3,446	4,245	8,741
Asset disposition	(149)	-	(149)	(158)
Corporate acquisitions	21	-	7,173	4,993
Asset retirement obligation	129	43	129	73
Other assets	-	(3)	-	5
	1,631	3,486	11,398	13,654

The acquisition of Conifer was the most significant event in the current year. The Company drilled, completed and equipped a well on the Peace River Arch in the current quarter. The well commenced production on January 1, 2010. The well was in Alberta and qualified to earn approximately \$357,000 of drilling credits which were recorded as a reduction in capital.

## SHARE CAPITAL

The following common shares, options and PIR's were outstanding:

<b>Outstanding at:</b>	<b>December 31, 2009</b>	<b>December 31, 2008</b>	<b>March 9, 2010</b>
Common shares	46,873,962	37,659,208	46,849,464
Options	3,239,000	3,239,000	3,147,000
PIR's	3,505,000	3,780,000	3,505,000
	53,617,962	44,678,208	53,501,464

On January 15, 2008, Sure Energy issued 1,861,847 common shares at a price of \$0.93 per share in exchange for all the outstanding Argent common shares. In addition, 360,215 common shares were issued at a price of \$0.93 per share as settlement of severance to former Argent employees.

On July 18, 2008 Sure Energy completed a private placement of approximately 5.0 million common shares at a subscription price of \$1.10 per common share and approximately 1.9 million flow-through common shares at a subscription price of \$1.32 per flow-through common share.

On November 7, 2008, the Company issued 899,000 options at an exercise price of \$0.39. Concurrently, 375,000 options with an exercise price of \$1.28 were forfeited and not reissued.

On August, 14, 2009, Sure Energy issued 9,214,754 common shares at a price of \$0.30 per share and cash of \$6.0 million to acquire all the issued and outstanding common shares of Conifer.

## CAPITALIZATION, FINANCIAL RESOURCES AND LIQUIDITY

The Company's policy is to maintain a strong capital base for the objectives of maintaining financial flexibility, creditor and market confidence, and to sustain future investing in oil and gas activities which may or may not be successful. The objective is to balance the proportion of debt and equity in its capital structure. The Company defines its capital structure to include

shareholders' equity, bank debt and working capital. The key measures that the Company utilizes in evaluating its capital structure are net debt to funds flow from operations, net debt as a percent of total capitalization and the current credit available from its creditors in relation to the Company's budgeted capital program. Net debt and funds flow from operations are non-GAAP measures and are used by the Company to analyze operating performance, leverage and liquidity. The Company's capitalization and calculation of funds flow from operations is as follows:

	December 31, 2009	December 31, 2008
Net debt		
Working capital		
Accounts receivable	(1,829)	(870)
Prepaid expenses	(457)	(241)
Accounts payable and accrued liabilities	3,777	4,915
	1,491	3,804
Cash and cash equivalents	-	(6,043)
Bank debt	3,046	-
Total net debt	4,537	(2,239)
Market capitalization		
Common shares outstanding	46,873,962	37,659,208
Closing price, TSX	0.61	0.23
Total market capitalization	28,593	8,662
Total net debt and market capitalization	33,130	6,423
Net debt as a percent of total capitalization	14%	(35)%

	Three Months Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Funds flow from operations				
Loss	(828)	(561)	(3,760)	(1,234)
Add items not affecting cash:				
Depletion, depreciation and accretion	1,442	1,077	5,763	3,349
Stock compensation	58	146	513	625
Future income tax recovery	-	-	(750)	-
Total funds flow from operations	672	662	1,766	2,740
Net debt to funds flow from operations ratio			2.57	(0.82)

The Company also assesses its capital structure by forecasting cash flows and estimated debt levels. There are several strategies to maintain or adjust capital structure including increasing bank credit as a result of reserve growth, decreasing capital spending and new equity issues.

The Company is subject to a covenant on its credit facility to maintain its ratio of current assets (including the undrawn portion of the demand credit facility) to current liabilities (not including current bank debt) at a 1.0:1.0 level. As at December 31, 2009 the current ratio was 2.45 (December 31, 2008 - 2.88).

#### RELATED PARTY TRANSACTIONS

The Corporate Secretary is a partner of a law firm that is paid for legal services. The transactions are arms-length and measured at the exchange amount.

#### CONTRACTUAL OBLIGATIONS AND FINANCIAL INSTRUMENTS

The Company is committed to pay minimum rent for leased premises. A portion of the minimum rent is recovered under sublease. Sure Energy has not entered into any financial contracts.

As a result of the Company issuing flow-through shares in 2008, the Company was committed to incurring qualifying expenditures of approximately \$2.5 million before December 31, 2009. The commitment was fully met at December 31, 2009.

## **CRITICAL ACCOUNTING ESTIMATES**

As an oil and gas producer, a number of critical estimates are applied in the preparation of the financial statements within the accounting policies defined in Note 1 of the financial statements. These critical estimates are defined below.

### **Oil and Gas Accounting**

Sure Energy follows the full cost method of accounting for exploration and development activities. In accordance with this method of accounting, all costs associated with exploration and development are capitalized whether successful or not. The aggregate of net capitalized costs and estimated future development costs less estimated salvage values is amortized using the unit-of-production method based on estimated proved oil and gas reserves.

### **Proved Reserves**

Full cost accounting relies on the estimated proved reserves believed to be recoverable from our oil and gas properties. Determination of reserves is a complex process involving judgments, estimates and decisions based on available geological, engineering/production and any other relevant economic data. These estimates are subject to material change as economic conditions change and ongoing production and development activities provide new information. The Company's reserves were evaluated by an independent firm, Sproule Associates Limited. Reserve estimates are critical to the following accounting estimates:

- Calculation of unit of production depletion. Proved reserve estimates were used to determine the DD&A rate applied to each unit of production.
- Ceiling test calculation, measurement of impairment of oil and gas assets. Estimated future undiscounted cash flows are determined using the estimate of proved reserves.

An increase in estimated proved oil and gas reserves would result in a corresponding reduction in depletion expense. A decrease in estimated future development costs would result in a corresponding reduction in depletion expense.

The calculation of proved reserves are affected by the following events:

- Changes to commodity prices
- Production performance of wells
- Changes to reservoir performance/pressures
- New geological and geophysical data
- Competitor production practices
- Changes to government regulations
- As circumstances change and additional data becomes available, revisions are made to these estimates.

### **Unproved properties**

Certain costs related to unproved properties may be excluded from costs subject to depletion until proved reserves have been determined or their value is impaired. These properties are reviewed quarterly and any impairment is transferred to the costs being depleted. The costs related to unproved properties are also excluded from the book value subject to the ceiling test measurement.

### **Full Cost Accounting Ceiling Test**

The Company is required to review the carrying value of all property, plant and equipment, including the carrying value of oil and gas assets, for potential impairment. Impairment is indicated if the carrying value of the long-lived asset or oil and gas cost centre is not recoverable by the future undiscounted cash flows. If impairment is indicated, the amount by which the carrying value exceeds the estimated fair value of the long-lived asset is charged to earnings.

The ceiling test is based on estimates of reserves, production rate, petroleum and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements could be material.

### **Asset Retirement Obligations**

The Company is required to provide for future removal and site restoration costs. The Company must estimate these costs in accordance with existing laws, contracts or other policies. These estimated costs are charged to property, plant and equipment and the appropriate liability account over the expected service life of the asset. The estimate of future removal and site restoration costs involves a number of estimates related to timing of abandonment, determination of economic life of the asset, costs associated with abandonment and site restoration, review of potential abandonment methods and salvage/usage of tangible equipment.

### **Income Tax Accounting**

The determination of the Company's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment subsequent to the financial statement reporting period. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded by management.

### **Stock-Based Compensation Plan**

The Company has a stock-based compensation plan that is described in note 7 to the financial statements as at and for the year ended December 31, 2009. The Company accounts for stock options and PIRs issued to consultants, employees and directors of Sure Energy based on the fair value method. The compensation expense related to the stock options granted is recognized over the vesting period of the awards. The compensation expense related to the PIRs is recognized over the life of the awards due to the contingent nature of their vesting. When the PIRs vest, additional compensation expense is recognized to the extent of the fair value of the vested portion of the PIRs. The fair value of the stock options and PIRs was determined at the respective grant dates using the Black-Scholes model. The fair value of the PIRs issued to consultants, employees and directors will be recalculated at each period end.

### **Other Estimates**

The accrual method of accounting requires management to incorporate certain estimates including estimates of revenues, royalties and production costs as at a specific reporting date but for which actual revenues and costs have not yet been received; and estimates on capital projects which are in progress or recently completed where actual costs have not been received at a specific reporting date. The Company ensures that the individuals with the most knowledge of the activity are responsible for the estimate. These estimates are then reviewed for reasonableness and past estimates are compared to actual results in order to make informed decisions on future estimates.

## **DISCLOSURE CONTROLS AND INTERNAL CONTROLS OVER FINANCIAL REPORTING**

Disclosure controls and procedures are designed to provide reasonable assurance that material information is gathered and reported to senior management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to permit timely decisions regarding public disclosure.

Management is responsible for establishing and maintaining adequate internal control over financial reporting ("ICFR"). ICFR means a process designed by or under the supervision of the Chief Executive Officer and Chief Financial Officer, and effected by the Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

Management completed an assessment of the design of ICFR. The Company used the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework and guidance for smaller public companies for the design of the Company's ICFR. All internal control systems have inherent limitations and therefore our ICFR can only provide reasonable assurance and may not prevent or detect misstatements due to error or fraud.

The Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation of the design and operating effectiveness of the Company's disclosure controls and ICFR as of the date of this MD&A, that disclosure controls and ICFR are not effective due to the material weakness in ICFR as described below. The material weakness identified did not result in any adjustments to the Company's financial statements for the three months and year ended December 31, 2009 or any prior period.

During the process of management's assessment, it was determined that a deficiency existed in the ICFR. Segregation of duties was identified as an area where a deficiency exists. Specifically, certain duties within the accounting department were not segregated due to the limited number of individuals employed in this area. The risk of a material misstatement is mitigated by

direct involvement of senior management in the day to day operations of the Company and review of the financial statements and disclosures by senior management and the Board of Directors. However, these mitigating procedures are not considered sufficient to reduce the likelihood that a material misstatement would not be prevented or detected. This weakness and its related risks is not uncommon in an entity of the size of the Company. As the Company grows, it plans to expand the number of individuals involved in the accounting function.

There have been no significant changes in the Company's ICFR that occurred during the year ended December 31, 2009 that has materially affected, or is reasonably likely to materially affect, the Company's ICFR.

## **CHANGES IN ACCOUNTING POLICIES**

### **Current Year Changes**

Effective December 31, 2009, Sure Energy adopted CICA issued amendments to Handbook Section 3862, "Financial Instruments – Disclosures". The amendments include enhanced disclosures relating to the fair value of financial instruments and the liquidity risk associated with financial instruments. Section 3862 now requires that all financial instruments measured at fair value be categorized into one of three hierarchy levels. The amendments are consistent with recent amendments to financial instrument disclosure standards in IFRS.

### **Not Yet Adopted**

In February 2008, the CICA announced that Canadian GAAP for publicly accountable enterprises will be replaced by International Financial Reporting Standards ("IFRS") for fiscal years beginning on or after January 1, 2011. Companies will be required to provide IFRS comparative information for the previous fiscal year. Accordingly, the conversion from Canadian GAAP to IFRS will be applicable to reporting for the first quarter of 2010, for which the current and comparative information will be prepared under IFRS.

Management has commenced the process to transition from Canadian GAAP to IFRS. The Chief Financial Officer has attended several external IFRS oil and gas training workshops and reports the transition progress to the Audit Committee on a regular basis.

The process consists of the following phases:

- Scoping – Management has completed a comprehensive analysis of its financial statements to identify areas that may be impacted by transitioning to IFRS.
- Impact Analysis – Management is in the process of developing IFRS policies and assessing the impact of these policies on Sure Energy. The Audit Committee will review and approve all IFRS policies proposed by management.
- Implementation - Once the IFRS Policies are finalized, the policies will be implemented and changes made to the financial statements, the accounting process and any other business processes that may be affected.

The transition from Canadian GAAP to IFRS is expected to have a significant impact on Sure Energy. At this time, management has identified key differences that will impact the financial statements, but is unable to quantify the impact of adopting IFRS as management has not finalized its policy choices. The key differences are as follows:

- Exploration and Evaluation ("E&E") Expenditures – Under IFRS, E&E expenditures, such as the cost of undeveloped land, will be segregated from and accounted for separate from property plant and equipment.
- Depletion of Property Plant and Equipment – Under IFRS, depletion may be calculated using a reserve base of proved or proved plus probable reserves. Canadian GAAP only allows use of proved reserves as your reserve base.
- Impairment of PP&E – Under IFRS, Impairment calculations are performed at Cash Generating Unit level using proved or proved plus probable reserves which is at a more granular level than Canadian GAAP.
- First Time Adoption of IFRS – IFRS allows optional exemptions for full retrospective application of IFRS over certain areas. IFRS provides the option for Sure Energy to value their opening property, plant and equipment at Canadian GAAP net book value.

## **BUSINESS RISKS**

As an exploration and production company in the oil and gas industry, Sure Energy is exposed to a number of business risks, which are beyond the control of management.

### **Operational**

Operational risks include exploring for and developing natural gas and oil reserves on an economic basis, drilling risks, reservoir performance, access to contract services, availability of skilled labour and weather conditions affecting the timing of capital program completion. Sure Energy maintains an insurance policy consistent with industry standards to protect against well blowouts and other drilling problems, destruction and damage to tangible assets, pollution and third-party liability coverage. In addition, the Company employs highly qualified staff and experienced contract services and provides a compensation environment that rewards above average performance, develops long-term relationships and provides measurement objectives consistent with shareholder value enhancement.

### **Financial**

Financial risks include fluctuations in commodity price, interest rates and the Canadian/US dollar exchange rate. The Company is currently unhedged due to the fact that it commenced operations during a period of low gas prices, and gas is its main commodity. Available commodity, interest rate and exchange rate hedges will be continually assessed by management as part of ongoing operations. The Company manages its liquidity risk by maintaining a healthy balance sheet and will only take on prudent levels of debt measured by debt to cash flow and debt coverage ratios. This allows for strong financial capacity to maintain exploration and development activities in any downturn in commodity prices. An additional financial risk is credit risk for failure of performance by counter-parties. This risk is controlled by an evaluation of the credit risk before contract initiation and ensuring product sales and delivery contracts are made with well-known and financially strong crude oil and natural gas marketers.

### **Regulatory**

The oil and gas industry is a heavily regulated industry with respect to environmental and safety practices. However, production and drilling practices of competitors may challenge the regulations creating production disruptions for the Company, such as the current EUB production restrictions. With respect to environmental and safety issues, Sure Energy maintains an environmental and safety policy with a well-defined reporting process to the Board of Directors. Other regulatory risks include changes to royalty and tax legislation over which the Company has no control.

## **OUTLOOK**

Sure Energy has a solid asset base of oil and natural gas reserves and production to build on, while at the same time providing its shareholders with an extensive inventory of over 160 prospects to grow from.

The proved plus probable reserve base has grown to over 3.25 million BOE's with approximately 50% oil and liquids weighting, while production has increased to 950 BOE/d.

Redwater has emerged through the acquisition of Conifer and consolidation of the area to be the significant growth driver with over 115 light oil locations on 8,741 acres of undeveloped land.

The Company continues to remain in a strong financial position and has approved a \$10 million capital budget to be financed with cash flow and our balance sheet. Prospects to be drilled in 2010 include wells at Sedalia (gas), Hatton (heavy oil), Peace River Arch (gas), and Queensdale, Sask. (oil) along with a minimum of five light oil horizontal wells at Redwater.

In addition to this, the market is now starting to recognize the true value and growth potential of our business.

### **Non-GAAP Measures**

Sure Energy management uses and reports certain non-GAAP measures in the evaluation of operating and financial performance. These measures do not have any standardized meanings prescribed by Canadian GAAP and therefore may not be comparable with the calculation of similar measures for other companies. Funds flow from operations, operating and cash flow netbacks, net debt and working capital are metrics used to compare Sure Energy with its peers.

Funds flow from operations is used by the Company to analyze operating performance, leverage and liquidity. Readers should refer to the "CAPITALIZATION, FINANCIAL RESOURCES AND LIQUIDITY" section of the MD&A for a reconciliation of funds flow from operations.

We use the terms Operating Netbacks and Cash Flow Netbacks to evaluate operational performance of the Company. Operating netback, which is calculated as average unit sales price less royalties, transportation costs and operating expenses and cash flow netback, which further deducts administrative and interest expense and current income tax represents the cash

margin for every barrel of oil equivalent sold. Readers should refer to the “Netbacks” section of the MD&A for the calculations of operating and cash flow netbacks.

Net debt and working capital, which is current assets less debt and current liabilities, is used to assess efficiency and financial strength. Readers should refer to the “LIQUIDITY AND CAPITAL RESOURCES” section of the MD&A for a reconciliation of net debt and working capital.

### Forward-looking Information

Certain statements contained in this management's discussion and analysis constitute forward-looking information. These statements relate to future events or Sure Energy's future performance. The use of any of the words "could", "expect", "believe", "will", "projected", "estimated" and similar expressions and statements relating to matters that are not historical facts are intended to identify forward-looking information and are based on Sure Energy's current belief or assumptions as to the outcome and timing of such future events. Actual future results may differ materially. In particular, the statements related to business strategy, the timing for the payment of current income tax and in the section “Outlook” are forward looking information. Sure Energy's Annual Information Form and other documents filed with securities regulatory authorities (accessible through the SEDAR website [www.sedar.com](http://www.sedar.com)) describe the risks, material assumptions and other factors that could influence actual results and which are incorporated herein by reference. Sure disclaims any intention or obligation to publicly update or revise any forward-looking information, whether as a result of new information, future events or otherwise, except as may be expressly required by applicable securities laws.

### GLOSSARY OF ABBREVIATIONS

\$000s	Thousands of dollars	Mbbls	Thousands of barrels
AECO	Alberta Energy Co.	MBOE	Thousand barrels of oil equivalent
AEUB	Alberta Energy Utilities Board	Mcf	Thousand cubic feet
bbls	Barrels	Mcf/d	Thousand cubic feet per day
bbls/d	Barrels per day	MMcf	Million cubic feet
Bcf	Billion cubic feet	MMcf/d	Million cubic feet per day
BOE	Barrel of oil equivalent (6 Mcf = 1 bbl)	MMbtu	Millions of British thermal units
BOE/d	Barrels of oil equivalent per day	NGLs	Natural gas liquids
GJ	Gigajoules	NPV	Net present value
G&A	General and administrative	TSX	Toronto Stock Exchange
		WTI	West Texas Intermediate