



**MANAGEMENT'S DISCUSSION & ANALYSIS**

**December 31, 2010**

## MANAGEMENT'S DISCUSSION AND ANALYSIS

March 8, 2011

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, 2010 and 2009 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 MD&A.

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 MD&A.

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.

### OVERVIEW

#### Selected Annual and Quarterly Information

	2010	Q4 10	Q3 10	Q2 10	Q1 10	2009	Q4 09	Q3 09	Q2 09	Q1 09
<b>Production</b>										
Natural gas (Mcf/d)	4,248	4,071	3,972	3,982	4,978	3,532	3,614	3,453	3,626	3,435
Oil (bbls/d)	196	578	64	68	72	42	66	53	21	29
NGLs (bbls/d)	40	41	36	39	44	31	39	28	27	27
BOE/d	944	1,297	762	771	945	662	708	657	653	628
<b>Average Selling Price</b>										
Natural gas (\$/Mcf)	4.26	3.82	3.73	4.11	5.17	4.07	4.69	3.07	3.56	4.99
Oil (\$/bbl)	78.11	78.34	80.05	74.47	77.92	65.87	73.73	70.11	67.40	38.04
NGLs (\$/bbl)	59.01	57.38	53.33	60.67	63.89	44.66	50.98	47.34	38.56	38.64
\$/BOE	37.90	48.70	28.68	30.88	36.11	28.02	33.66	23.83	23.54	30.68
<b>Netback (\$/BOE)</b>										
Operating	22.86	34.36	13.05	18.17	18.65	12.89	16.61	11.29	11.03	12.27
Funds Flow	18.28	30.12	7.93	13.24	14.33	7.31	10.33	6.73	6.25	5.58

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

	2010	Q4 10	Q3 10	Q2 10	Q1 10	2009	Q4 09	Q3 09	Q2 09	Q1 09
Revenue	13,063	5,813	2,012	2,165	3,073	6,765	2,193	1,439	1,398	1,735
Funds Flow	6,229	3,594	558	929	1,218	1,766	672	408	372	314
Per share, basic	0.13	0.08	0.01	0.02	0.03	0.04	0.01	0.01	0.01	0.01
Income (loss)	(2,603)	344	(1,277)	(951)	(719)	(3,760)	(828)	(1,284)	(1,140)	(508)
Per share, basic	(0.06)	0.01	(0.03)	(0.02)	(0.02)	(0.09)	(0.02)	(0.03)	(0.03)	(0.01)
Capital Expenditures	17,827	9,366	4,026	2,132	2,303	11,398	1,631	8,600	307	860
Total Assets		51,517	41,036	38,513	38,620		37,908	36,959	32,154	34,352
Net Debt		(14,700)	(10,228)	6,797	5,594		(4,537)	(3,664)	1,678	1,671
Shareholder's Equity		31,578	27,503	28,615	29,394		30,054	30,824	29,254	31,048
Common Shares (000's)		48,431	46,849	46,849	46,849		46,874	46,874	37,659	37,659

**Q4 2010**

Revenue increased significantly during the quarter due to new oil production at Redwater and Saskatchewan. Capital expenditures reflected 5 gross (5.0 net) wells drilled at Redwater in the quarter. Sure Energy entered into a \$20 million term loan facility. \$10 million was drawn during the quarter.

**Q3 2010**

Revenue decreased slightly during the quarter as a result of a decrease in commodity prices and production declines. Capital expenditures included successful oil wells drilled in Redwater and Saskatchewan. These wells commenced production in the fourth quarter of 2010.

**Q2 2010**

Revenue decreased during the quarter as a result of a decrease in commodity prices and reduced gas production. Production from the Peace River Arch and in Chinook was temporarily restricted due to voluntary gas plant turnarounds by the operator. The Company received a gas cost allowance credit of \$183,000 during the quarter which reduced royalty expense.

**Q1 2010**

Revenue increased during the quarter from increases in oil and gas prices and increased gas production from the Peace River Arch well that commenced production in January 2010. Capital expenditures included 4 gross (2.8 net) wells that were drilled in the quarter.

**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 Exploration Ltd. ("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.

## RESULTS OF OPERATIONS

Revenues Petroleum and Natural Gas Revenue (\$000s)	Three Months Ended December 31,		Year ended December 31,	
	2010	2009	2010	2009
Natural gas	1,431	1,558	6,600	5,250
Oil	4,166	450	5,601	1,017
NGLs	216	185	862	498
	5,813	2,193	13,063	6,765

Production	Three Months Ended December 31,		Year Ended December 31,	
	2010	2009	2010	2009
Natural gas (Mcf/d)	4,071	3,614	4,248	3,532
Oil (bbls/d)	578	66	196	42
NGLs (bbls/d)	41	39	40	31
BOE/d	1,297	708	944	662

Average Selling Price	Three Months Ended December 31,		Year Ended December 31,	
	2010	2009	2010	2009
Natural gas (\$/Mcf)	3.82	4.69	4.26	4.07
Oil (\$/bbl)	78.34	73.73	78.11	65.87
NGLs (\$/bbl)	57.38	50.98	59.01	44.66
\$/BOE	48.70	33.66	37.90	28.02

Average Benchmark Prices	Three Months Ended December 31,		Year Ended December 31,	
	2010	2009	2010	2009
AECO (daily) natural gas (\$/Mcf)	3.43	4.26	3.79	3.75
WTI Crude oil (US\$/bbl)	85.17	76.19	79.53	61.80
Edmonton par price (Cdn \$/bbl)	80.38	76.60	77.54	65.93
Exchange rate (US\$/Cdn\$)	1.0128	1.0563	1.0301	1.1415

Revenue for the quarter was \$5.8 million versus \$2.2 million for the comparative quarter. Production for the quarter averaged 1,297 BOE/d, representing an increase of 83 percent over the comparative quarter. Revenue for the year ended December 31, 2010 was \$13.1 million versus \$6.8 million for the comparative period. Production for the year averaged 944 BOE/d representing an increase of 43 percent. The Company's realized price for its natural gas was \$3.82/Mcf for the quarter, 19 percent less than the \$4.69/Mcf received in the prior quarter. The Company's realized price for its natural gas for the year ended December 31, 2010 was \$4.26/Mcf, 5 percent more than the \$4.07/Mcf received in the comparative period. The Company received an average price for its oil sales for the quarter of \$78.34 per barrel (Q4 2009 - \$73.73/bbl) and \$78.11 per barrel (2009 - \$65.87) for the year. Production commenced in the quarter for horizontal oil wells drilled at Redwater and Saskatchewan which increased production and average selling price per BOE.

The Company has not hedged or entered into any fixed price arrangements during 2010 or for any subsequent period.

## Royalties

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2010	2009	2010	2009
Royalties	350	312	1,108	940
Average royalty as a percent of revenue	6.0	14.2	8.5	13.9

Royalties as a percentage of revenue decreased to 6.0 percent for the fourth quarter versus 14.2 percent for the comparative quarter. For the year ended December 31, 2010, royalties as a percent of revenue were 8.5 percent versus 13.9 percent for the prior period. The Company received gas cost allowance credits based on capital spent by Sure Energy in prior periods. Overall, gas royalty rates are lower due to low gas prices and incentives received by Sure Energy on new production. New production at Redwater qualifies for a royalty of five percent for the first 24 months and new production in Saskatchewan qualifies for a royalty of 2.5 percent for the first 6,000 cubic metres.

### Alberta Royalty Changes

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,	
	2010	2009	2010	2009
Operating expenses	1,102	698	3,432	2,363

Operating costs were \$1.1 million or \$9.23 per BOE for the fourth quarter versus \$698,000 or \$10.72 per BOE for the comparative period. Current quarter operating costs per BOE decreased compared to the comparative quarter due to the lower operating costs on the new oil wells in Redwater and Saskatchewan.

Operating costs for the year ended December 31, 2010 were \$3.4 million or \$9.96 per BOE for the current year versus \$2.4 million or \$9.79 per BOE for the comparative period.

### Transportation

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2010	2009	2010	2009
Transportation	260	99	645	348

Transportation costs were \$2.18 per BOE in the fourth quarter and \$1.53 for the comparative period. Transportation costs were \$1.87 per BOE for the year ended December 31, 2010 (2009 - \$1.44 per BOE). Transportation costs 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. Transportation costs increased in the current period due to the higher trucking costs on the increased oil production.

### General and Administrative

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2010	2009	2010	2009
Gross general and administrative	471	486	1,670	1,756
Capitalized overhead	(67)	(98)	(342)	(426)
	404	388	1,328	1,330

General and administrative ("G&A") costs were \$3.38 per BOE for the fourth quarter and \$5.96 per BOE for the comparative period. G&A costs will decrease on a per BOE basis as the Company grows its production. G&A costs were \$3.85 per BOE for the year ended December 31, 2010 and \$5.51 per BOE for the comparative period. 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,	
	2010	2009	2010	2009
Interest income	-	-	-	15
Interest expense	133	24	281	33

The interest rate on the debt facility was 4.00 percent.

On December 20, 2010, Sure Energy entered into an agreement for a \$20 million secured subordinated term loan facility (the "Note Facility") from Deans Knight Capital Management Ltd. ("Deans Knight") on behalf of certain investors (the "Note Holders"). Deans Knight currently has control over 6.4 million common shares and 2.5 million warrants or 18.08 percent of the outstanding shares of the Company assuming the exercise of the warrants at December 31, 2010. The drawn portion of the Note Facility bears interest at 6.25 percent per annum. The undrawn portion bears a standby fee of 0.25 percent. Warrants to purchase 2.5 million common shares at a price of \$1.80 per share were issued as additional consideration to the Note Holders. The Company has the ability to force the Note Holders to exercise the warrants if the weighted average price per share of Sure Energy equals or exceeds \$2.80 per share for 20 consecutive trading days. The notes mature and the warrants expire 37 months from the date of closing. Draws on the Note Facility may be made at the Company's discretion in minimum tranches of \$2.5 million. The fair value of the warrants issued was estimated using the Black-Scholes option pricing. The fair value of the warrants was recorded as shareholders' equity and deferred financing costs on the balance sheet. The deferred financing costs are amortized over the life of the Note Facility.

## Stock Compensation (non-cash)

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2010	2009	2010	2009
Stock compensation	317	58	710	513

Stock compensation (non-cash) expense was \$317,000 in the fourth quarter and \$58,000 for the comparative period. Stock compensation expense was \$710,000 for the year ended December 31, 2010 (2009 - \$513,000). The increase was due to the vesting of the remaining Performance Incentive Rights ("PIR").

## Depletion, Depreciation and Accretion

(\$000s)	Three Months Ended December 31,		Year Ended December 31,	
	2010	2009	2010	2009
Depletion and depreciation	2,878	1,424	8,074	5,690
Accretion	25	18	88	73
	2,903	1,442	8,162	5,763

The Company's depletion, depreciation and accretion ("DD&A") provision for the fourth quarter was \$2.9 million, or \$24.57 per BOE and \$1.4 million or \$22.15 per BOE for the comparative period. The Company's depletion, depreciation and accretion ("DD&A") provision for the current year to date was \$8.2 million, or \$23.76 per BOE and \$5.8 million or \$23.87 per BOE for the comparative period.

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 \$1.3 million.

## Income and future taxes

The Company does not expect to pay current income tax in 2011 or 2012. Estimated income tax pools at December 31, 2010 are as follows:

(\$000s)	
Canadian oil and gas property expenses	10,367
Canadian development expenses	10,801
Canadian exploration expenses	4,720
Undepreciated capital costs	6,543
Non-capital losses	25,369
Financing costs	183
Successored pools (restricted)	17,287
	75,270

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,	
	2010	2009	2010	2009
Price	48.70	33.66	37.90	28.02
Royalties	(2.93)	(4.80)	(3.21)	(3.90)
Operating costs	(9.23)	(10.72)	(9.96)	(9.79)
Transportation	(2.18)	(1.53)	(1.87)	(1.44)
Operating Netback	34.36	16.61	22.86	12.89
General and administrative	(3.38)	(5.96)	(3.85)	(5.51)
Interest income (expense)	(0.86)	(0.32)	(0.73)	(0.07)
Funds Flow Netback	30.12	10.33	18.28	7.31
Stock compensation	(2.66)	(0.90)	(2.06)	(2.13)
Depletion, depreciation and accretion	(24.57)	(22.15)	(23.76)	(23.87)
Future income taxes	-	-	-	3.11
Loss Netback	2.89	(12.72)	(7.54)	(15.58)

## CAPITAL EXPENDITURES

Cash expenditures for the period were as follows:

Capital Program Summary	Three Months Ended December 31,		Year Ended December 31,	
(\$000s)	2010	2009	2010	2009
Land	108	7	837	444
Geological and geophysical	148	145	651	1,014
Drilling	6,851	683	11,063	821
Completions	1,151	575	2,007	616
Recompletions and workovers	(440)	19	376	632
Production equipment and facilities	1,377	460	2,681	649
Capitalized exploration G&A	67	98	342	426
Drilling credits	-	(357)	(451)	(357)
	9,262	1,630	17,506	4,245

Asset acquisition (disposition)	-	(149)	155	(149)
Corporate acquisition	-	21	-	7,173
Asset retirement obligation	95	129	157	129
Other assets	9	-	9	-
	9,366	1,631	17,827	11,398

Drilling activity for the three months and year is summarized as follows:

#### Three Months Ended December 31, 2010

	Gas		Oil		Dry and Abandoned		Total	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Exploration	-	-	-	-	-	-	-	-
Development	-	-	5	5.0	-	-	5	5.0
Total	-	-	5	5.0	-	-	5	5.0

#### Year Ended December 31, 2010

	Gas		Oil		Dry and Abandoned		Total	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Exploration	1	1.0	-	-	2	2.0	3	3.0
Development	1	1.0	9	7.8	-	-	10	8.8
Total	2	2.0	9	7.8	2	2.0	13	11.8

#### SHARE CAPITAL

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

Outstanding at:	December 31, 2010	December 31, 2009	March 8, 2011
Common shares	48,431,130	46,873,962	48,528,630
Options	3,793,334	3,239,000	3,730,834
PIR's	2,880,000	3,625,000	2,850,000
Warrants	2,500,000	-	2,500,000
	57,604,464	53,737,262	57,609,464

During the year, 1.5 million options to acquire shares at a weighted average exercise price of \$1.15 per share were granted to employees and directors. Proceeds of \$1.4 million were received and 1.6 million shares were issued as a result of options and PIR's exercised.

2.5 million warrants to purchase shares at a price of \$1.80 per share were issued as consideration to the Note Holders of the Note Facility.

#### 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, the note facility 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. Funds flow from operations is a non-GAAP measure and it is 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, 2010	December 31, 2009
Net debt		
Working capital		
Accounts receivable	(3,110)	(1,829)
Prepaid expenses	(853)	(457)
Accounts payable and accrued liabilities	8,223	3,777
	4,260	1,491
Note facility	10,000	-
Bank debt	440	3,046
Total net debt	14,700	4,537
Market capitalization		
Common shares outstanding	48,431,130	46,873,962
Closing price, TSX	1.75	0.61
Total market capitalization	84,754	28,593
Total net debt and market capitalization	99,454	33,130
Net debt as a percent of total capitalization	15%	14%

	Three months ended December 31,		Year ended December 31,	
	2010	2009	2010	2009
Funds flow from operations:				
Income (loss)	344	(828)	(2,603)	(3,760)
Add items not affecting cash:				
Depletion, depreciation and accretion	2,903	1,442	8,162	5,763
Non-cash interest expense	30	-	30	-
Stock compensation	317	58	710	513
Future income tax recovery	-	-	-	(750)
Total funds flow from operations	3,594	672	6,299	1,766
Net debt to funds flow from operations ratio			2.33	2.57

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.

At December 31, 2010, Sure Energy had total credit facilities of \$35.0 million, consisting of a \$15 million bank credit facility and a \$20 million Secured Note Facility. At December 31, 2010, \$10.4 million was drawn on the credit facilities.

The Company is subject to a covenant on its bank 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, 2010, the ratio was 2.25 (December 31, 2009 - 2.45).

## RELATED PARTY TRANSACTIONS

The Note Facility was provided by Deans Knight on behalf of the Note Holders. Deans Knight currently has control over 18.08 percent of the outstanding shares and warrants of the Company.

## 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.

The Note Facility bears fixed rate interest of 6.25 percent and matures in 37 months.

## **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, 2010. 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.

### **INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)**

In February 2008, the CICA announced that Canadian GAAP for publicly accountable enterprises will be replaced by 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.

The transition process to IFRS 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.

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 Audit Committee has been presented with the Company's accounting policy selections as disclosed herein.

The transition from Canadian GAAP to IFRS is expected to have a significant impact on Sure Energy. Most adjustments on the transition to IFRS will be made retrospectively against opening retained earnings as of the date of the first comparative balance sheet presented. IFRS 1 provides for certain exemptions to full retrospective application of IFRS. Management has evaluated the various policy choices under IFRS and will implement the choices that are most appropriate for Sure Energy. The following

is a listing of key differences between Canadian GAAP and IFRS, policy choices under IFRS, and IFRS 1 exemptions applicable to Sure Energy:

- Exploration and Evaluation (“E&E”) expenditures – All E&E expenditures that are currently recognized as Property, Plant and Equipment (“PP&E”) under Canadian GAAP, will be reclassified as an E&E asset under IFRS. E&E assets consist of the carrying value of undeveloped land for exploration properties. E&E assets will not be amortized and will be assessed for impairment upon transition and when indicators suggest the possibility of impairment. Management estimates that E&E expenditures of \$1.9 million will be reclassified as an E&E asset in the opening balance sheet on January 1, 2010.
- PP&E transition – IFRS 1 provides an exemption whereby PP&E is valued at deemed cost upon transition to IFRS. Deemed cost is equivalent to the carrying value of PP&E under Canadian GAAP and is allocated to six cash generating units (“CGUs”) under IFRS. The allocation to CGUs is made based on proved plus probable reserve values. CGUs are aligned with the geographic regions in which Sure Energy operates.
- Depletion of PP&E – Under IFRS, the Company will calculate depletion using a reserve base of proved plus probable reserves. Canadian GAAP only allows use of proved reserves as a reserve base. Depletion will be calculated by CGU under IFRS, whereas Canadian GAAP depletion was calculated for just one cost centre. Sure Energy expects that its depletion expense for the year ended December 31, 2010 will be reduced by approximately \$3.6 million as compared to depletion calculated under Canadian GAAP.
- Impairment of PP&E – Under Canadian GAAP, Sure Energy includes all PP&E in one impairment test. Impairment testing is done at the CGU level under IFRS. As at January 1, 2010, impairment tests were performed in accordance with IFRS and no impairment was identified.
- Asset retirement obligation (“ARO”) – Under IFRS, Sure Energy is required to revalue its entire ARO liability at each balance sheet date using the current risk-free rate of interest. Under Canadian GAAP, the ARO liability is discounted using a credit-adjusted risk-free rate of interest and the liability is not adjusted for changes in the rate. As a result of the changes, Sure Energy’s opening ARO liability will be higher by approximately \$420,000 under IFRS than Canadian GAAP as at January 1, 2010.
- Flow-through shares – For Canadian GAAP, equity is reduced for the value of the tax pools renounced to flow-through shareholders. Under IFRS, equity is reduced by the premium paid for the flow through share versus a normal share. The company issued 1.9 million flow-through shares in 2008. Share capital is approximately \$334,000 less under IFRS than Canadian GAAP for this difference.
- Business combinations - Sure Energy has elected under IFRS 1 to not retrospectively restate any business combinations that have been previously recorded under Canadian GAAP.

The following table summarizes Sure Energy’s January 1, 2010 balance sheet under Canadian GAAP and the transitional entries required to present the opening balance sheet under IFRS based upon our policy choices (subject to vary). Sure Energy has not prepared a full set of annual financial statements under IFRS, therefore, amounts are unaudited:

(\$000’s)	Canadian GAAP	IFRS Adjustments	IFRS
Current assets	2,286	-	2,286
E&E assets	-	1,899	1,899
PP&E	35,622	(1,899)	33,723
<b>Total assets</b>	<b>37,908</b>	<b>-</b>	<b>37,908</b>
Current liabilities	6,823	-	6,823
ARO liability	1,031	420	1,451
Shareholders’ equity	30,054	(420)	29,634
<b>Total liabilities and shareholders’ equity</b>	<b>37,908</b>	<b>-</b>	<b>37,908</b>

## 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 is 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 has 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, 2010 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 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, 2010 that has materially affected, or is reasonably likely to materially affect, the Company's ICFR.

## **CHANGES IN ACCOUNTING POLICIES**

### **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**

The fourth quarter of 2010 saw Sure Energy increase its production to 1,297 BOE/d and its oil weighting to 48%. The Company is positioned to continue this transition from predominantly a gas producer to primarily an oil producer with its inventory of at least 32 low risk drilling locations at Redwater and three to four at Queensdale. Successful evaluation of more peripheral lands in both areas would add to this inventory. Although wells in both areas experience the initial high decline rates typical of horizontal wells, after the first year the declines stabilize to 10 – 18% per year. These wells will therefore create a stable platform on which to build the production base. The current inventory should allow for steady growth over the next three years by drilling 11 to 12 wells per year.

The Company has a \$20 million base budget approved for 2011 which will be financed with cash flow and bank lines. This budget includes three 100 percent wells in North Redwater, 5 gross (3.2 net) wells in South Redwater, two 100 percent wells in Queensdale and one 100 percent exploration well and is scheduled to be spent by the end of August. At that time Sure Energy will evaluate the drilling results and general market conditions with a view to expanding the budget in the final four months of the year. Only three wells, one in Redwater and two in Queensdale are planned to be drilled in the first quarter of 2011. However, the Company is actively seeking a new project area to augment and diversify its portfolio and which it hopes will provide the base for the next step growth of the production base. With no improvement in gas prices in sight for the immediate future the Company will continue to focus its efforts and its capital on oil projects.

### **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 and financial strategy, expectations with respect to general and administrative costs, the timing for the payment of current income tax, the Company's policy to maintain a strong capital base, 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