



**Candax Energy Inc.**  
**Management's Discussion and Analysis**  
**For the year ended December 31, 2006**

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

The following is a discussion of the consolidated financial condition and results from operations of Candax Energy Inc. ("Candax" or the "Company") for the periods indicated. All references to "year" refer to the year ended December 31, 2006. The following should be read in conjunction with the audited consolidated financial statements and notes. Additional information relevant to the Company's activities, including the Company's Annual Information Form, can be found on SEDAR at [www.sedar.com](http://www.sedar.com). This information is presented as of March 22, 2007.

### **Company Overview**

Candax is a Toronto-based oil and natural gas company engaged in the exploration for, and the acquisition, development and production of, natural gas and crude oil, with emphasis on the Middle East and North Africa. Candax targets mainly oil and natural gas, but also has natural gas liquids in its portfolio. Candax also owns a 50% interest in Société d'Electricité d'El Bibane ("SEEB"), a Tunisian power generation company. At present, all of the operating assets of the Company are located in Tunisia.

### **Commodity Prices**

Crude oil prices and volatility remained relatively high during 2006. A combination of supply factors, transportation limitations, geopolitical concerns and market speculation have combined to support Brent oil prices averaging US \$65 per barrel during 2006 while averaging approximately US \$59 per barrel during the fourth quarter of 2006. Brent is currently trading in the US \$60 per barrel range.

### **Foreign Exchange Fluctuations**

Candax operates primarily in a US dollar-based environment. The majority of the Company's revenues and expenses (both capital and operating) are paid in US dollars, although Candax is also exposed to Canadian dollar, Pounds Sterling and Tunisian Dinar expenses. However, being a Canadian company trading on the TSX, Candax has elected to report its financial results in Canadian dollars. Accordingly, all foreign currency amounts presented in Candax's consolidated statements of operations and deficit and cash flows are converted to Canadian funds for reporting purposes based on the average Canadian to US dollar exchange rate prevailing during the reporting period. During the reporting period, the Canadian dollar has been strong against the US dollar, with a reduced difference between the two currencies compared to historical rates. The US to Canadian dollar closing exchange rate on December 31, 2006 was \$1.1654 and averaged \$1.1341 during the year.

### **Capital Structure and Dilution**

Since incorporation in June 2004, Candax has participated in multiple share and securities offerings. The funds raised through these capital offerings financed initial development activities and Candax's April 2005 acquisition of Centurion's operations in Tunisia and additional working capital requirements. These funds will also be used to fund development drilling and exploration programs in Tunisia in the coming months and development activities elsewhere. As at December 31, 2004, there were 4,680,000 common shares outstanding. In the second quarter, in connection with the conversion of special warrants and settlement costs, 43,497,000 common shares were issued, bringing the number of common shares outstanding on June 30, 2005 to 48,177,000. On August 23, 2005 Candax received a receipt from the applicable securities regulatory authorities in Canada for a prospectus dated August 22, 2005 which, among other things, qualified the distribution of the common shares and warrants of Candax issuable upon the exchange of certain subscription receipts of Candax. The common shares and warrants of Candax commenced trading on the TSX at the opening on Monday, August 29, 2005, under the symbols CAX and CAX.W respectively. This increased the number of shares outstanding as at December 31, 2005 to 130,677,000. Each of the 41,250,000 warrants entitled the holder thereof to acquire one common share of Candax at a price of \$1.20 on April 14, 2006, subject to adjustment.



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During the first quarter of 2006, 1,252,500 broker warrants were exercised at \$0.80 and during April 2006, a further 1,447,500 broker warrants were exercised for \$0.80. On April 18, 2006 35,497,106 warrants were exercised at \$1.20 and combined, increased the common shares outstanding to 168,874,106 which is the amount outstanding as at March 22, 2007.

In addition, on April 7, 2005 and May 24, 2005, the Board approved the grant, pursuant to the stock option plan, of a total of 11,250,000 stock options to various directors, officers, employees, and consultants. Each stock option entitles the holder to purchase one Common Share of the Company at a price of \$0.80 per share. One-third of the granted options vested immediately, one-third vested on the first anniversary of the grant date, and the remaining one-third will vest on the second anniversary of the grant date. The stock options expire on April 1, 2010 or May 24, 2010, at which time they will be of no further force or effect. During the year, a further 400,000 options were granted under the stock option plan at an average exercise price of \$0.94. On February 6, 2007, 1,000,000 options were granted under the stock option plan at an exercise price of \$0.58 and on March 19, 2007, 75,000 options were granted under the stock option plan at an exercise price of \$0.50 bringing the total number of options currently issued to 12,725,000 as at March 22, 2007.

On November 1, 2005, Candax signed an agreement with Pro-Edge Consultants Inc. (Pro-Edge) to act as its Investor Relations firm. Pursuant to the commencement of the engagement of Pro-Edge by Candax, Candax has issued 50,000 options at \$0.49 to Pro-Edge in accordance with Candax's share incentive plan. The options, each of which is exercisable to acquire one common share of Candax, expire on October 27, 2007. As per the engagement contract, an additional 30,000 options were issued to Pro-Edge at the end of every full three-month period for which Pro-Edge was engaged. During 2006 an additional 100,000 options at an average exercise price of \$1.03 were issued to Pro-Edge. Such options were subject to approval by the Toronto Stock Exchange, will have an expiry date of two years and will vest over a 12 month period, with one-quarter of the options vesting at the end of each three-month period. In November 2006, a new investor relations agreement was entered into with Pro-Edge which increased their monthly retainer fee and capped their options at the current level of 150,000.

**Acquisition of Tunisian Producing Assets from Centurion Energy International**

On April 26, 2005, Candax completed the purchase from Centurion Energy International Inc. of its Tunisian operations for a total cost of \$44.1 million including working capital adjustments and costs related to the purchase. Specifically, Candax purchased Centurion's wholly-owned subsidiaries: Ecumed Petroleum Grombalia, Ltd., Ecumed Petroleum Zarzis, Ltd., Ecumed Petroleum Tunisia, Ltd. and Centurion's 50% interest in the SEEB power plant, which represented all of Centurion's production from the Ezzaouia (31.4% working interest), El Bibane (73.8% working interest), Robbana (80% working interest) and Al Manzah (75% working interest) fields approximating 1,200 barrels of oil per day of oil and 4.8 MMscf per day of natural gas. Centurion has retained the right to participate for up to 50% of Candax's resultant working interest in any Deep Triassic exploration well at either or both of Ezzaouia and El Bibane. Centurion's interest in the Mellita permit and the accompanying PetroCanada farm-out agreement were not included in the purchase and sale transaction.

The initial purchase price of \$41.2 million was adjusted upward by \$2.9 million for working capital adjustments for the period from January 1, 2005 to the April 26, 2005 closing date. The effective date of the transaction was January 1, 2005 and all economic benefits accrued to Candax from that date forward. However as title to the assets did not pass until April 26, 2005, all revenues and costs were treated as an adjustment to the purchase price and reflected in the allocation of the purchase price to the acquired assets. Consequently, Candax began consolidating the Tunisian operations on May 1, 2005.

**Chaal Licence**

The area comprising the Chaal Permit is located in central Tunisia approximately 50 kilometres west of the city of Sfax. The Chaal Permit covers an area measuring 1,200 square kilometres. At December 31, 2005, Candax held an 80% working interest in the Chaal Permit with its partner SMIP holding 20%. The Company was formally granted its interest in the Chaal Permit on March 17, 2005 and a production



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sharing agreement and a petroleum prospecting permit with Entreprise Tunisienne d'activites Pétrolières ("ETAP") was signed on April 2, 2005. The Chaal Permit is valid for a period of two years from the date of the publication of its decree in the Journal Officiel de la Republique Tunisienne, which publication was issued on June 14, 2005.

In December 2005, Candax received approval to convert the original prospecting permit into an exploration permit by agreeing with its joint venture partners to drill the Chaal-1 well, avoiding the requirement for seismic testing. The new exploration permit has a period of two years, which expires May 25, 2008 and a financial obligation to spend a minimum of US \$3 million in the drilling of an exploration well. The minimum expenditure requirement has been met. Additionally, as part of the farm-out agreement dated November 30, 2005, Mitsubishi Corporation ("Mitsubishi") agreed to pay 100% of Candax's net costs for the Chaal-1 well, up to a maximum of US \$8 million, in return for earning a 20% interest in the Chaal Permit. Mitsubishi has an option to acquire, subject to certain conditions, a further 5% interest from Candax in the Chaal Permit prior to the drilling of a second well. In addition, Mitsubishi has agreed to pay Candax certain other cash payments dependent upon receiving government consent to undertake the development of the Chaal project and achieving certain other gas sales-based thresholds.

The Chaal-1 exploration well was spudded on February 5, 2006. During April 2006, the drilling operations were completed and the well was drilled to a total depth of 4,600 metres. The results of logging indicated that a total gas bearing section of some 450 metres was penetrated by the well in the Middle/Lower Nara, comprising limestone, argillaceous limestone and shale/claystone. A gross limestone section of approximately 200 metres was evaluated within this gas bearing section, with a net reservoir interval estimated to be approximately 90 metres. An analysis of the produced gas confirms that there is good quality gas in Chaal, with over 99% hydrocarbon content, little evidence of CO<sub>2</sub>, N<sub>2</sub> at 0.82% and H<sub>2</sub>S of 0.04%. Due to high mud weights used during drilling as a result of the high pressure, the lack of suitable equipment in Tunisia and mechanical difficulties, a flow test could not be successfully completed. In August, a rig-less program was undertaken utilizing a coiled-tubing unit to displace the remaining heavy mud in the well which had adversely affected the initial tests, and then to re-perforate and perform an acid squeeze on prospective zones. Candax planned to re-perforate the zone that was first perforated in the original drill stem test DST-2, and then to also perforate across an untested higher interval, originally planned as DST-3. This program was suspended on August 28, 2006 due to mechanical difficulties. While the well was being flowed back after an acid injectivity test on part of the DST-2 zone, a sudden loss of annulus pressure was observed, which on examination was clearly due to the development of a leak between the annulus and the tubing. In order to resolve the communication problem, the completion would have needed to be pulled, and this operation would have required a rig. As no rig was immediately available, the completion of the perforating, acidizing and testing operations on the well could not be safely undertaken, and the decision to suspend operations on the well was made. Going forward, Candax and its partners are reviewing all technical options and are developing a forward program and budget for 2007 for the appraisal of the Chaal discovery.

As a result of Mitsubishi meeting its required funding commitments under the above-mentioned farm-out agreement, it acquired a 20% interest in the Permit, reducing Candax's equity interest to 60%.

### **Review of Operations**

Candax was incorporated on June 4, 2004 and did not, until the April 26, 2005 purchase of its Tunisian operations, have any revenue generating producing assets. As a result, comparison to previous quarters has no analytical value for some of the reported results. Discussion is limited to the quarters in the current year with comparative analysis provided only when meaningful.

### **Revenue**

Sales, net of royalties for the year and three months ended December 31, 2006, were \$13.2 million and \$0.9 million, respectively (not comparable to 2005 which only included eight months of revenue). During the fourth quarter of 2006, the Company sold 14,103 barrels of oil at an average price of US \$60.41 down



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significantly from the fourth quarter of 2005 where 24,245 barrels were sold at an average price of US \$46.04. The decrease in barrels sold was due to the timing of the liftings. On a year-to-date basis, the Company sold 191,722 barrels of oil at an average price of US \$61.23 down significantly from 2005 where 316,000 barrels were sold at an average price of US \$49.53. The decrease in barrels sold was due to the shut-in of the El Bibane field during 2006. There was no revenue earned during the year from gas or electricity sales as the El Bibane field was shut-in and as a result, electricity generating activities continued to be suspended as described below.

**Production**

The following table summarizes the production for 2006 and 2005:

BCLS	Q1		Q2		Q3		Q4		Total	
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005
Oil (bbls/day)	654	1,194	578	1,062	519	809	489	470	559	881
Gas (mmcf/day)	-	4.4	-	4.4	-	2.6	-	-	-	2.8
BOEs/day	654	1,933	578	1,792	519	1,237	489	470	559	1,354

Where amounts are expressed on a barrel of oil equivalent (boe) basis, natural gas volumes have been converted to barrels of oil equivalent at 6,000 cubic feet to one barrel of oil equivalent (6 mcf = 1 boe). This conversion ratio is the convention used in the oil and natural gas industry and is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. The use of boe may be misleading, particularly if used in isolation.

As described above, the economic benefit of this production belongs to Candax although under Canadian generally accepted accounting principles is not included in the results of operations until after the acquisition closing date.

The BOEs/day in Q1, Q2 and Q3 in 2005 are significantly higher than the respective amounts in 2006 as the El Bibane field was shut-in effective the end of August 2005. The BOEs/day are consistent in Q4 for 2005 and 2006 reflecting the production from the remaining fields.

**Company Share of Proved Plus Probable Reserves for the period ended December 31, 2006**

*(Escalated Prices and Costs)*

Reserves Category	Boe		Oil		Natural Gas	
	Gross (Mboe)	Net (Mboe)	Gross (Mbbbl)	Net (Mbbbl)	Gross (MMcf)	Net (MMcf)
Total Proved – All Categories	8,486	4,027	5,769	2,541	16,302	8,913
Probable – All Categories	8,009	3,017	5,789	2,135	13,322	5,290
Total Proved Plus Probable	16,496	7,044	11,559	4,677	29,624	14,203

Candax announced on September 1, 2005, that during routine maintenance some unexpected corrosion of the El Bibane 3 wellhead was discovered. In the interests of safety and good environmental practice it was decided to shut-in the well. Efforts to restart the well were unsuccessful and it was announced on September 26, 2005 that restart operations were suspended and the resumption of production would await the previously announced redevelopment program for El Bibane.

A full-field development program had already been planned by Candax to optimize production and recovery of the reserves at El Bibane, and this program will now include reinstating production from El Bibane 3. The plan comprises the drilling of a further development well and a gas re-injection well. The implementation of this development program was expected to be initiated late in the fourth quarter of 2005 but was delayed due to engineering and certification delays related to the fabrication and construction of the jack-up barge system.



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In March 2007, the Company terminated the off-shore drilling contract. This decision followed a year of successive delays and missed deadlines despite repeated assurances to the contrary by the contractor and thus their failure to perform the operations contemplated by the contract. After serving the contractor with several Notices of Default, and in light of its continued inability to provide the necessary rig certifications, Candax is of the opinion that the drilling equipment was not in compliance with essential health, safety and environmental standards. As a result, formal notice to terminate the contract was served upon the contractor. Candax did not incur any costs with or make any payments to the contractor relating to the re-development drilling contract.

Candax is focused on obtaining an alternate drilling option. The water depth at El Bibane (6 to 8 metres) has always severely limited the number of jack-up rigs capable of undertaking the program. Candax is now negotiating with a number of contractors, but the market for suitable jack-up drill rigs remains tight, although somewhat better than a year ago and the nearest term availability is unlikely to be before mid-year 2007. When completed, it is expected to lead to higher levels of oil production, more efficient recovery of reserves and also enable remote restart of production in the event of a temporary future shut-in of a well.

Total investment as at February 2007 on the re-development project has been approximately US \$14 million (on a net basis), which includes the project engineering for the onshore and offshore facilities upgrades and pipeline and platform installation contracts which are 50% completed and on budget. All outstanding work on these related contracts will be phased in and completed in time for immediate hook up to the wells at El Bibane as they are drilled and completed.

The shut-in has also suspended operations at the SEEB power plant. The plant has been placed on care and maintenance mode and all excess staff has been released reducing the carrying costs to an absolute minimum. The Company's share of the operating and maintenance costs for the fourth quarter was \$0.2 million; year-to-date, \$0.6 million. The plant will restart as soon as gas is produced from El Bibane. Due to the lack of production from the El Bibane field, the SEEB power plant has not generated revenues during 2006 and as a result was unable to meet its current obligations under the credit facility. Interest payments were made during February, May, August and November of 2006 through proceeds from business interruption insurance as well as from the debt service reserve and capital contributions from the partners but principal amounts of \$2.4 million (Candax's share \$1.2 million) were deferred.

On February 1, 2007 an amount of \$0.4 million representing Candax's interest owing, was deducted from the debt service reserve account held by the lender. Principal payments of \$0.5 million were deferred. The balance in the debt service reserve account after this payment was \$1.4 million which will be used to fund future interest payments in 2007 until the SEEB plant resumes normal operations, expected to be in the second half of 2007.

Negotiations with the lenders are on-going as there is no commitment from the lenders to continue to defer principal payments. In the event of a declaration of default by the lenders, the lenders would take control of the SEEB plant and Candax would owe a default payment of US \$0.8 million but would not be liable for the balance of the loans outstanding nor for the deferred principal amounts.

#### **Operating Costs**

Operating costs for the year ended December 31, 2006 were \$4.5 million (not comparable to 2005 which only included eight months of operating costs). For the three months ended December 31, 2006, operating costs of \$1.0 million increased by \$0.8 million over the same period in 2005 due to reduced operating expenses charged to inventory.

#### **General and Administrative Costs**

General and administrative costs for the year and the three months ended December 31, 2006 were \$3.6 million and \$0.6 million respectively, consistent with the same respective period costs in 2005 of \$3.7 million and \$0.9 million.



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Candax is developing and evaluating a range of international opportunities as it seeks to develop its international portfolio and thus is incurring proportionately higher general and administrative expenses than might be expected from an equivalent domestic Canadian oil company.

**Interest expense**

Interest expense increased to \$1.4 million for the year ended December 31, 2006, compared to \$0.9 million for the year ended December 31, 2005. The increase was due to the fact the limited recourse loans were in default commencing in May 2006 resulting in a 2% increase in the interest rate charged.

**Depletion, Depreciation and Amortization expense**

Depletion, depreciation and amortization expense for the year and the three months ended December 31, 2006 was \$4.7 million and \$0.5 million respectively, comparable to the respective period costs in 2005 of \$4.0 million and \$0.5 million. This amount is calculated using the purchase price of the acquired assets and the proved reserves information as at December 31, 2006.

**Selected Quarterly Financial Data (unaudited)**

<i>in thousands of Canadian dollars except per share amounts</i>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>	<b>Year</b>
<b>2006</b>					
Sales, net of royalties	9,193	1,139	1,923	897	13,152
Net income (loss)	1,638	(460)	(2,159)	970	(11)
Net income (loss) per share - basic and diluted	0.01	(0.00)	(0.01)	(0.00)	(0.00)
Total assets	101,894	140,932	137,984	143,896	143,896
Long-term financial liabilities	11,773	11,174	10,455	3,056	3,056
<b>2005</b>					
Sales, net of royalties	-	2,233	9,202	1,447	12,882
Net income (loss)	(520)	(186)	2,966	(3,762)	(1,502)
Net income (loss) per share - basic and diluted	(0.11)	-	0.04	-	(0.02)
Total assets	3,716	89,305	91,051	91,737	91,737
Long-term financial liabilities	-	13,524	11,807	12,225	12,225
<b>2004</b>					
Sales, net of royalties	-	-	-	-	-
Loss	-	(9)	(181)	(259)	(449)
Loss per share - basic and diluted	-	(0.09)	(1,806)	(2,590)	(4,490)
Total assets	-	-	483	3,974	3,974

As described earlier, the Company was incorporated on June 4, 2004 but no revenues were earned until the second quarter of 2005 when the Company completed its acquisition. During 2004, general and administrative expenses were incurred with respect to the initial start-up costs. Since the acquisition was not completed until the end of April 2005, the second quarter of 2005 only represented two months of revenue and is proportionately less than the third quarter due to the timing of liftings. The revenue in the fourth quarter of 2005 was significantly less than the third quarter of 2005 because of timing of liftings and the suspension of the operations of El Bibane and SEEB as discussed earlier. Revenue for the first quarter of 2006 is similar to that earned in the third quarter of 2005 due to the similar contractual nature of the Company's sales agreements. Revenue for the second, third and fourth quarters of 2006 are significantly lower than that earned in the first quarter of 2006 due to the timing of the liftings. The long-term financial liabilities as at the end of the fourth quarter 2006 are significantly lower than the other quarters in 2006 and 2005 as the limited recourse loans were reclassified from long-term to current.



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**Liquidity, Capital Resources and Capital Expenditures**

Candax, through the subscription receipts described under Capital Structure and Dilution on page 1 above, raised net proceeds of \$63.1 million in 2005. The acquisition of the Tunisian assets from Centurion required \$43.7 million and the remaining cash was held to fund working capital requirements and petroleum development activities and/or acquisitions.

On April 17, 2006, a total of 35,497,106 warrants were exercised into common shares for total proceeds to the Company of \$42.6 million. These warrants were issued on April 14, 2005 in connection with the Company's private placement of 82,500,000 subscription receipts. In addition, 2,700,000 broker warrants, which were issued as part of their commission as underwriters of the financing, were exercised at \$0.80 for proceeds to the Company of \$2.2 million.

On April 13, 2006, the Company signed a bank credit facility with the Bank of Scotland. The initial facility size was for US \$10 million although the assets in Tunisia could support a significantly higher facility if required. The primary purpose of the facility is to fund the Company's new venture activities and it also provides operational flexibility for the redevelopment of the El Bibane field and potentially the fast-track of new project development activities. The facility bears interest at London Interbank Overnight Rate ("LIBOR") plus 2% and there are no fixed repayment terms. No funds have been drawn on this facility to date.

As at December 31, 2006, the Company had \$51.4 million in cash and cash equivalents. Of this amount, \$45.0 million was invested in highly liquid investments.

**Commitments**

Under the terms of an agreement with the Tunisian government, 20% of the Company's oil production must be dedicated to the domestic market. The production sold under this domestic market obligation receives a price equal to 90% of the U.S. dollar price for the Brent-based export sales. Oil production is accumulated in a storage facility until a marketable cargo is achieved. Under this agreement, the state-owned company, ETAP, with respect to its 55% rights on the Ezzaouia field production and on behalf of the Government with respect to the domestic market obligation and the Company's Tunisian entities have agreed to optimize tanker lifting volumes. As a result of this reciprocal practice, a short-term volumetric imbalance may arise through an "under/over" lift position. This short-term situation is corrected from future production allocations.

**Critical Accounting Estimates**

A discussion of the Company's significant accounting policies is contained in Note 2 to the 2006 audited consolidated financial statements. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. These estimates relate primarily to the future development costs associated with proved undeveloped reserves, reserve volumes, future production and revenues, and future costs associated with asset retirement obligations. The Company has its oil and gas reserves, future development costs and future cash flows from those reserves evaluated and reported on by Ryder-Scott Company Petroleum Consultants, independent petroleum reserve engineering consultants. The estimation of these amounts is a subjective process, based on engineering data, forecasted prices and production levels and the timing of expenditures. All of these estimates are subject to numerous uncertainties and various interpretations, and consequently will change over time to reflect updated information as it is received.

**Business Risks**

A comprehensive assessment of the Company's business risks is set out in the 2006 Annual Information Form. There are a number of inherent risks associated with oil and gas operations and development. Many of these risks are beyond the control of the Company. The following outlines some of the principal risks and their potential impact on the Company:



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

A portion of the current working capital of Candax will be expended on petroleum and natural gas exploration, exploitation and development activities, which are high-risk ventures with uncertain prospects for success. Oil and gas exploration involves a high degree of risk and there is no assurance that expenditures made on future exploration activities by the Company will result in new discoveries of oil, condensate or natural gas that are commercially viable or economically producible. Holders of securities of the Company must rely on the ability, expertise, judgment, discretion, integrity and good faith of management of the Company. It is difficult to project the costs of implementing any exploratory or developmental drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions such as over-pressured zones and tools lost in the hole and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof. Few properties that are explored are ultimately developed into new reserves. In certain instances, the Company may be precluded from pursuing an exploration program or decide not to continue with an exploration program and such an occurrence may have a negative effect on the value of the securities of the Company.

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

***Petroleum and Natural Gas Reserves***

All evaluations of future net revenues are before consideration of indirect costs such as administrative overhead, other miscellaneous expenses and income taxes. The future net revenues may not be representative of the fair market value of the reserves. There is no assurance that the forecast price and cost assumptions contained in the year end 2006 Ryder Scott Report will be attained and variances may be material. There are numerous uncertainties inherent in estimating quantities of proved and probable reserves, including many factors beyond the control of the Company. The reserves data and net present value of future cash flows set forth represent estimates only.

In general, estimates of economically recoverable petroleum and natural gas reserves and the future net revenues therefrom are based upon a number of variable factors and assumptions, such as historical production from the properties, commodity prices, the assumed effects of regulation by governmental agencies and future operating costs, each of which may vary considerably from actual results. Estimates of the economically recoverable petroleum and natural gas reserves attributable to any particular group of properties, classification of such reserves based on risk of recovery and estimates of future net revenues expected therefrom, prepared by different engineers or by the same engineers at different times, may vary substantially. The reserve estimates included in this prospectus may be materially different from the quantities and values ultimately realized.

***Fluctuation of Commodity Prices***

Oil and natural gas are commodities whose prices are determined based on world demand, supply and other factors all of which are beyond the control of the Company. Crude oil is influenced by the world economy and OPEC's ability to adjust supply to world demand. Recently crude oil prices have been kept high by political events causing disruptions in the supply of oil, and concern over potential supply disruptions triggered by unrest in the Middle East. Political events trigger large fluctuations in oil price levels. Natural gas prices are influenced by factors within North America. The continued tight supply



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demand balance for natural gas is causing significant elasticity in pricing. Despite record drilling activity, a strong economy, weather, fuel switching and demand for electrical generation there still exists a tight supply causing prices to remain high.

World prices for oil and natural gas have fluctuated widely in recent years. Future price fluctuations in world prices may continue and may have a significant impact upon the projected revenue of the Company, the projected return from its existing and future reserves and the general financial viability of the Company.

The oil and natural gas prices realized by the Company are affected by factors such as supply and demand, oil quality and transportation adjustments. The Company expects to market its oil and natural gas production in a manner consistent with past practices. In the case of natural gas, the Company has fixed rate sales contracts. The Company's current natural gas production is subject to the provisions of the Petroleum Law, which provides for sales into the Tunisian domestic market at rates less than those which would be realized in the international market. While the Company sells the majority of its Tunisian oil to arms-length purchasers priced on a sale by sale basis at prevailing market conditions, a portion of the oil produced by the Company is required to be sold domestically in Tunisia at rates less than those which would be realized in the international market. There is no assurance that the price paid for the oil produced by the Company will remain at current levels. A decrease in the price obtained for its oil may have a material adverse effect on the financial condition of the Company and its future results of operations.

***Foreign Currency Exchange Rates***

The Company sells its oil production pursuant to marketing agreements that are denominated in US dollars. Many of the operational and other expenses incurred by the Company are paid in US dollars or in local currency of the country where operations are performed. The assets and liabilities of the Company (including reserve information) are recorded in Canadian dollars. As a result, fluctuations in the US dollar against the Canadian dollar and each of these currencies against local currencies in jurisdictions where properties of the Company are located could result in unanticipated and material fluctuations in the financial results of the Company.

***Competition***

A number of other oil and gas companies operate and are allowed to bid for exploration and production licenses and other services in countries in North Africa and the Middle East which are the focus of the business and operations of the Company, thereby providing competition to the Company. Larger companies may have access to greater resources than the Company, may be more successful in the recruitment and retention of qualified employees and may conduct their own refining and petroleum marketing operations, which may give such companies a competitive advantage over the Company. Some of these companies have been conducting operations in Tunisia for considerably longer periods of time than has the Company and thus these companies may be more familiar with the political and business landscape in Tunisia than the Company. In addition, actual or potential competitors may be strengthened through the acquisition of additional assets and interests.

***Environmental Regulation***

The current and future operations of the Company that are conducted in Tunisia are subject to environmental regulations promulgated by the Government of Tunisia. Should the Company initiate operations in other countries, such operations will be subject to environmental legislation in such jurisdictions. Current environmental legislation in Tunisia provides for restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil, condensate and natural gas operations. In addition, certain types of operations may require the submission and approval of environmental impact assessments. The existing operations of the Company are subject to such environmental policies and legislation. Environmental legislation and policy is periodically amended. Such amendments may result in stricter standards and enforcement and in more stringent fines and penalties for non-compliance. Environmental assessments of existing and proposed projects carry a heightened



**Candax Energy Inc.**  
**Management's Discussion and Analysis**  
**For the year ended December 31, 2006**

degree of responsibility for companies and their directors, officers and employees. The costs of compliance associated with changes in environmental regulations could require significant expenditures, and breaches of such regulations may result in the imposition of material fines and penalties. In an extreme case, such regulations may result in temporary or permanent suspension of production operations. There can be no assurance that these environmental costs or effects will not have a material adverse effect on the future financial condition or results of the operations of the Company.

***Political Risks***

Tunisia has experienced relative prosperity and stability under the leadership of President Ben Ali over the past two decades. Notwithstanding this relative stability, in the past, Tunisia has been affected by extremist Islamic militant activity. Tunisian authorities have implemented anti-terrorism policies and security precautions. By law, parties organized on the basis of religion, region, race or language are forbidden. Despite this, there are groups in Tunisia dedicated to turning the country into an Islamic republic. The Tunisian government has taken steps to prevent the Islamic militant struggle in neighbouring Algeria from affecting Tunisia by increasing its military presence along the Tunisia/Algeria border, imposing visa restrictions and imposing strict controls on local militants. Tunisia is bordered by both Algeria and Libya. Both countries have experienced periods of civil, political and militant unrest and Libya has been the subject of international sanctions; future unrest in any of the neighbouring countries could affect Tunisia.

In addition to the political risks, the Company is also subject to the laws of the various levels of government in the countries in which it conducts business. Such legislation may be changed from time to time in response to economic or political conditions, and the implementation of new legislation or modification of existing legislation affecting the oil and gas industry could change the Company's revenues and/or costs and have a material adverse impact on the business, results of operations, financial condition and liquidity.

***Internal Control over Financial Reporting***

Internal controls over financial reporting are procedures designed to provide reasonable assurance that transactions are properly authorized, assets are safeguarded against unauthorized or improper use, and transactions are properly recorded and reported. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance with respect to the reliability of financial reporting and financial statement preparation.

**Evaluation of Disclosure Controls and Procedures and Internal Control over Financial Reporting**

***Disclosure Controls and Procedures***

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the Company's President and Chief Executive Officer and Chief Financial Officer, on a timely basis so that appropriate decisions can be made regarding public disclosure. As at the end of the period covered by this management's discussion and analysis, management of the Company, with the participation of the President and Chief Executive Officer and the Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures as required by Canadian securities laws. Based on that evaluation, the President and Chief Executive Officer and the Chief Financial Officer have concluded that, as of the end of the year covered by this management's discussion and analysis, the disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in the Company's annual filings and interim filings (as such terms are defined under Multilateral Instrument 52-109 – *Certification of Disclosure in Issuers' Annual and Interim Filings*) and other reports filed or submitted under Canadian securities laws is recorded, processed, summarized and reported within the time periods specified by those laws and that material information is accumulated and communicated to management of the Company, including the President and Chief Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.



**Candax Energy Inc.**  
**Management's Discussion and Analysis**  
**For the year ended December 31, 2006**

***Internal Control over Financial Reporting***

Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian generally accepted accounting principles. The Company's CEO and CFO have ensured the design of internal control over financial reporting.

During the most recent year end there were no changes in the Company's internal control over financial reporting that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Recent Accounting Changes and Effective Dates**

In January 2005, the CICA issued new guidance relating to comprehensive income, equity, financial instruments and hedges. Under the new standards:

- (i) a new location for recognizing certain gains and losses – other comprehensive income – has been introduced, providing for certain gains and losses arising from changes in fair value to be temporarily recorded outside the income statement, but in a transparent manner;
- (ii) existing requirements for hedge accounting are extended; and
- (iii) all financial instruments, including derivatives, are to be included on a company's balance sheet and measured (in most cases) at fair value.

The guidance will be effective for the first quarter of 2007. The Company is reviewing the guidance to determine the potential impact on the consolidated financial statements.

In July 2006, the CICA revised Section 1506, "Accounting Changes", which requires that:

- (i) voluntary changes in accounting policy are made only if they result in the financial statements providing reliable and more relevant information;
- (ii) changes in accounting policy are generally applied retrospectively; and
- (iii) prior period errors are corrected retrospectively.

Section 1506 is effective for fiscal years beginning on or after January 1, 2007 with early adoption permitted. The implementation of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

**Forward-Looking Statements**

This Management's Discussion and Analysis includes "forward-looking statements", within the meaning of applicable securities legislation, which are based on the opinions and estimates of Management and are subject to a variety of risks and uncertainties and other factors that could cause actual events or results to differ materially from those projected in the forward looking statements. Forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "budget", "plan", "continue", "estimate", "expect", "forecast", "may", "will", "project", "predict", "potential", "targeting", "intend", "could", "might", "should", "believe" and similar words suggesting future outcomes or statements regarding an outlook. Such risks and uncertainties include, but are not limited to, risks associated with the oil and gas industry (including operational risks in exploration development and production; delays or changes in plans with respect to exploration or development projects or capital expenditures; the uncertainty of reserve estimates; the uncertainty of estimates and projections in relation to production, costs and expenses; the uncertainty surrounding the ability of Candax to obtain all permits, consents or authorizations required for its operations and activities; and health safety and environmental risks), the risk of commodity price and foreign exchange rate fluctuations, the ability of Candax to fund the capital and operating expenses necessary to achieve the business objectives of Candax, the uncertainty associated with commercial negotiations and negotiating with foreign governments and risks associated with international business activities, as well as those risks described in public disclosure documents filed by Candax. Due to the risks, uncertainties and assumptions inherent in forward-looking statements,



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prospective investors in securities of Candax should not place undue reliance on these forward-looking statements. Statements in relation to "reserves" are deemed to be forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions, that the reserves described can be profitably produced in the future.

Readers are cautioned that the foregoing lists of risks, uncertainties and other factors are not exhaustive. The forward-looking statements contained in this press release are made as of the date hereof and the Company undertakes no obligation to update publicly or revise any forward-looking statements contained in this press release or in any other documents filed with Canadian securities regulatory authorities, whether as a result of new information, future events or otherwise, except in accordance with applicable securities laws. The forward-looking statements contained in this press release are expressly qualified by this cautionary statement.



**Candax Energy Inc.**

Consolidated Financial Statements

For the year ended December 31, 2006

## **MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING**

The consolidated financial statements and other financial information included in the Annual Report are the responsibility of, and have been prepared by, the management of Candax Energy Inc. within reasonable limits of materiality. To fulfill this responsibility, the Company maintains appropriate systems of internal control, policies and procedures. These systems of internal control, policies and procedures help ensure that the Company's reporting practices and accounting and administrative procedures provide reasonable assurance that the financial information is relevant, reliable, and accurate, and that assets are safeguarded and transactions are executed in accordance with proper authorization. These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. When alternative methods exist, the Company has chosen those that it deems most appropriate in the circumstances, in order to ensure that the consolidated financial statements are presented fairly in all respects. Where appropriate, these consolidated financial statements reflect estimates based on judgments of the management. Financial information presented elsewhere in the Annual Report is consistent, where applicable, with that shown in the accompanying consolidated financial statements.

PricewaterhouseCoopers LLP, the independent auditors, have examined the consolidated financial statements of the Company. The independent auditors' responsibility is to express a professional opinion on the fairness of the consolidated financial statements. The auditors' report outlines the auditors' opinion and the scope of their examination and their report follows.

The consolidated financial statements have also been reviewed by the Directors of Candax Energy Inc. and by its Audit Committee. The Audit Committee is comprised of independent directors, and meets periodically during the year with the independent auditors and the management. The independent auditors have full and unrestricted access to the Audit Committee.

*"Signed"*

Michael I.T. Wood  
President and Chief Executive Officer

March 22, 2007

*"Signed"*

Christopher J. Hopkins  
Chief Financial Officer

## **AUDITORS' REPORT**

To the Shareholders of Candax Energy Inc.

We have audited the consolidated balance sheets of Candax Energy Inc. as at December 31, 2006 and 2005 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

*"Signed"*

PricewaterhouseCoopers, LLP  
Chartered Accountants  
Toronto, Ontario

March 22, 2007

**Candax Energy Inc.**  
**Consolidated Balance Sheets**

**As at December 31 (in thousands of Canadian dollars)** 2006 2005

**ASSETS**

**Current**

Cash and cash equivalents	\$	51,433	\$	22,584
Restricted investments (Note 5)		1,637		2,326
Accounts receivable		6,486		1,736
Inventory (Note 4)		1,745		2,452
Deposits and prepaids		984		1,587
		62,285		30,685
Restricted investments (Note 5)		-		1,808
Deferred financing fees		831		-
Petroleum and natural gas properties (Note 6)		66,151		42,891
Property, plant and equipment (Note 6)		14,512		16,353
Long-term receivable (Note 7)		117		-
	\$	143,896	\$	91,737

**LIABILITIES**

**Current**

Accounts payable and accrued liabilities	\$	14,023	\$	5,933
Current portion of limited recourse long-term debt (Note 8)		10,948		1,157
		24,971		7,090
Limited recourse long-term debt (Note 8)		3,056		12,225
Asset retirement obligation (Note 9)		1,733		2,282
Future income tax liability (Note 10)		4,435		5,645
		34,195		27,242

**SHAREHOLDERS' EQUITY**

Capital stock (Note 11)		111,434		64,699
Warrants		-		2,299
Contributed surplus		1,991		1,136
Cumulative translation adjustment		(1,762)		(1,688)
Deficit		(1,962)		(1,951)
		109,701		64,495
	\$	143,896	\$	91,737

**Commitments (Note 13)**

*The accompanying notes to the consolidated financial statements are an integral part of these statements.*

Approved on behalf of the Board of Directors

“Signed”

John R. Cullen, Director

“Signed”

John A. Clarke, Director

**Candax Energy Inc.**  
**Consolidated Statements of Operations and Deficit**

<b>For the years ended December 31</b>	<b>2006</b>	<b>2005</b>
<b>(in thousands of Canadian dollars except for per share amounts)</b>		<small>(see Note 3)</small>
<b>Revenues</b>		
Sales, net of royalties	\$ 13,152	\$ 12,882
Interest and other income	3,111	1,048
	<u>16,263</u>	<u>13,930</u>
<b>Expenses</b>		
Operating costs	4,477	2,681
Depletion, depreciation and amortization	4,686	3,995
General and administrative	3,566	3,726
Interest	1,360	926
Foreign exchange	(979)	595
Stock-based compensation	534	1,136
Accretion on asset retirement obligation	201	156
	<u>13,845</u>	<u>13,215</u>
<b>Income for the year before current and future income taxes</b>	<u>2,418</u>	<u>715</u>
Current income tax expense	2,979	786
Future income tax (recovery) expense (Note 10)	(550)	1,431
	<u>2,429</u>	<u>2,217</u>
<b>Loss for the year</b>	<u>\$ (11)</u>	<u>\$ (1,502)</u>
Deficit, beginning of year	(1,951)	(449)
<b>Deficit, end of year</b>	<u>\$ (1,962)</u>	<u>\$ (1,951)</u>
<b>Loss per share - basic and diluted</b>	<u>(0.00)</u>	<u>(0.02)</u>
<b>Weighted average number of shares outstanding - basic and diluted</b>	<u>166,872,809</u>	<u>83,220,077</u>

*The accompanying notes to the consolidated financial statements are an integral part of these statements.*

**Candax Energy Inc.**  
**Consolidated Statements of Cash Flows**

<b>For the years ended (in thousands of Canadian dollars)</b>	<b>2006</b>	<b>2005</b>
<b>OPERATING ACTIVITIES</b>		
Loss	\$ (11)	\$ (1,502)
Items not affecting cash		
Settlement costs	-	100
Stock-based compensation	534	1,136
Depletion, depreciation and amortization	4,686	3,995
Future income tax (recovery) expense	(550)	1,431
Accretion on asset retirement obligation	201	156
	<u>4,860</u>	<u>5,316</u>
Net change in non-cash working capital (Note 15)	4,650	45
	<u>9,510</u>	<u>5,361</u>
<b>INVESTING ACTIVITIES</b>		
Acquisition of subsidiaries (Note 3)	-	(44,068)
Decrease (increase) in restricted investments	2,497	(1,808)
Investment in long-term receivable	(117)	
Additions to petroleum and natural gas properties	(26,374)	(1,107)
	<u>(23,994)</u>	<u>(46,983)</u>
<b>FINANCING ACTIVITIES</b>		
Repayment of long-term debt	-	(895)
Issuance of common shares and warrants	46,735	68,250
Conversion of warrants	(2,299)	(4,273)
Issuance of warrants	-	2,299
Deferred financing fees	(831)	
Costs of share issuance	-	(3,551)
	<u>43,605</u>	<u>61,830</u>
Foreign currency translation	(272)	(1,433)
<b>Net increase in cash and cash equivalents</b>	<u>28,849</u>	<u>18,775</u>
Cash and cash equivalents, beginning of year	22,584	3,809
<b>Cash and cash equivalents, end of year</b>	<u>\$ 51,433</u>	<u>\$ 22,584</u>
<b>Cash and cash equivalents are comprised of:</b>		
Cash	\$ 6,445	\$ 1,712
Short-term investments	44,988	20,872
	<u>\$ 51,433</u>	<u>\$ 22,584</u>
Interest paid during the year	\$ 1,222	\$ 634
Income taxes paid during the year	\$ 706	\$ 137

*The accompanying notes to the consolidated financial statements are an integral part of these statements.*

## **1. Description of the Business**

Candax Energy Inc. (“Candax” or the “Company”) was incorporated as Addax Energy Inc. on June 4, 2004 under the laws of the Province of Ontario. On June 25, 2004, the Company filed Articles of Amendment changing its name to Candax Energy Inc.

Candax is a Toronto-based oil and natural gas company engaged in the exploration for, and the acquisition, development and production of, natural gas and crude oil, with emphasis on the Middle East and North Africa. Candax targets mainly oil and natural gas, but also has natural gas liquids in its portfolio. Candax also has a 50% interest in Société d'Electricité d'El Bibane (“SEEB”), a Tunisian power generation company. At present, all of the operating assets of the Company are located in Tunisia.

Candax is in the process of acquiring various petroleum and natural gas properties. The recovery of both the costs of acquiring the petroleum and natural gas properties and the related deferred exploration and development expenses depends on the existence of economically recoverable reserves, the ability of the Company to obtain the financing necessary to complete exploration and the development of the properties, and the future profitable production, or alternatively, on the sufficiency of proceeds from disposition.

## **2. Summary of Significant Accounting Policies**

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”). The significant accounting policies are summarized below:

### **Consolidation**

The consolidated financial statements include the accounts of Candax together with its wholly owned subsidiaries, Ecumed Petroleum Grombalia, Ltd., Ecumed Petroleum Tunisia, Ltd., Ecumed Petroleum Zarzis, Ltd. and Falcan Chaal Petroleum, Ltd. (known collectively as the “Tunisian properties”), Candax Energy Limited (“CEL”), Candax Energy Services Limited (“CESL”) and the proportionate share of its 50% investment in SEEB. All significant intercompany balances and transactions have been eliminated.

### **Joint ventures**

Substantially all of the Company's exploration and operating activities, including electricity generation, are conducted jointly with others. These consolidated financial statements reflect only the Company's proportionate interest in such activities.

### **Measurement uncertainty**

Management has made estimates and assumptions regarding certain assets, liabilities, revenues and expenses in the preparation of the consolidated financial statements. Such estimates primarily relate to unsettled transactions and events as of the date of the consolidated financial statements. Accordingly, actual results may differ from estimated amounts.

Depletion and amortization, and amounts used for ceiling test calculations are based on estimates of oil and natural gas reserves and commodity prices, production expenses and capital costs required to develop and produce those reserves. The majority of the Company's reserve estimates are evaluated annually by Ryder-Scott Company Petroleum Consultants, independent petroleum reserve engineering consultants. By their nature, estimates of reserves and the related future cash flows are subject to measurement uncertainty, and the impact of differences between actual and estimated amounts on the consolidated financial statements of future periods could be material.

The calculation of the asset retirement obligation includes estimates of the future costs to settle the asset retirement obligation, the timing of the cash flows to settle the obligation, and the future inflation rates. The impact of differences between actual and estimated costs, timing and inflation on the consolidated financial statements of future periods could be material.

**Cash and cash equivalents**

Cash and cash equivalents comprise cash and short-term market investments with maturities of three months or less at the date of acquisition.

**Restricted investments**

Restricted investments represent amounts which have been pledged as security for transactions entered into by the Company. The investments are held by third parties and as such are not available for the Company's own use. (See Note 5)

**Petroleum and natural gas properties and related depletion and amortization**

Candax follows the full cost method of accounting, whereby all costs incurred in exploring for and developing oil and gas reserves are capitalized. Such expenditures include geological and geophysical expenses, carrying charges for unproved properties, costs of drilling both productive and non-productive wells, gathering and production facilities and general and administrative costs directly related to exploration and development activities. Capitalized costs are accumulated on a country-by-country basis and are amortized and depleted using the unit-of-production method based upon estimated proved reserves. For those properties that are still in the development stage, related costs are capitalized until either commercial production commences or it is determined that the invested amounts will never be recovered.

Natural gas reserves are converted to equivalent barrels of oil on the basis of their relative energy content (6 mcf equals 1 barrel). Costs directly associated with the acquisition and evaluation of unproved properties are initially excluded from the computation of depletion. These unproved properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered impaired, the cost of the property or the amount of the impairment is added to all other capitalized costs subject to amortization and depletion.

The Company calculates a ceiling test whereby the net capitalized costs of properties cannot exceed the sum of the undiscounted cash flows expected to result from the properties using proved reserves. Cash flows are calculated based on third-party quoted forward prices and adjusted for the Company's contracted prices and quality differentials. If there is impairment, the magnitude of it would be calculated by comparing the carrying amount of property, plant and equipment to the estimated net present value of future cash flows from proved plus risked probable reserves. A risk-free interest rate is used to arrive at the net present value of the future cash flows. Any excess carrying value above the net present value of future cash flows would be recorded as a permanent impairment and charged as additional depletion expense in the consolidated statements of operations and deficit.

Sales of oil and gas properties are accounted for as adjustments to capitalized costs, with no gain or loss recognized unless such adjustments would alter the rate of depletion and amortization by more than 20%.

**Foreign currency translation**

The Tunisian subsidiaries are considered self-sustaining operations and exist in a business environment where the US dollar is their functional currency. The financial statements of self-sustaining operations are translated into Canadian dollars from their functional currency using the current rate method. Under this method, assets and liabilities are translated into Canadian dollars using the exchange rate in effect at the consolidated balance sheet date. Revenues and expenses are translated into Canadian dollars at the average exchange rate for the period. All resulting exchange gains and losses are recorded in shareholders' equity in the cumulative translation adjustment account.

CEL and CESL are considered integrated foreign operations and as such, their financial statements are translated using the temporal method. Under this method, monetary assets and liabilities denominated in foreign currency are translated into Canadian dollars at the exchange rate in effect at the consolidated balance sheet date and non-monetary assets and liabilities are translated into Canadian dollars at the exchange rate in effect on the transaction date. Revenues and expenses denominated in foreign currencies are translated into Canadian dollars at the average exchange rate for the period. All resulting exchange gains and losses are recorded in the consolidated statements of operations and deficit.

#### **Inventory valuation**

The crude oil inventory value is calculated using the related production and depletion costs per barrel and the spare parts are carried at the lower of cost and market.

#### **Asset retirement obligation**

The Company recognizes the fair value of an asset retirement obligation ("ARO") in the period in which it is incurred when a reasonable estimate of fair value can be made. The fair value of the estimated ARO is recorded as a long-term liability, with a corresponding increase in the carrying amount of the related asset. The capitalized amount is amortized to expense through depletion over the life of the asset. The liability amount is increased each reporting period due to the passage of time and the amount of this accretion is charged to earnings in the period. Revisions, if any, to the estimated timing of cash flows or to the original estimated undiscounted cost, if any, also result in an increase or decrease to the ARO and the related asset. Actual costs incurred upon settlement of the ARO are charged against the ARO to the extent of the liability recorded. Any difference between the actual costs incurred upon settlement of the ARO and the recorded liability is recognized as a gain or loss in the Company's earnings in the period in which the settlement occurs.

Asset retirement assets for natural gas and crude oil are amortized using the unit-of-production method.

#### **Stock-based compensation plan**

The Company has an incentive stock option plan which is described in Note 11. The Company accounts for its stock-based compensation plan using the fair value method. The fair value of stock options is determined on their grant date and recorded as compensation expense over the period that the stock options vest, with a corresponding increase in contributed surplus. When stock options are exercised, the proceeds, together with the amount recorded in contributed surplus, are recorded in capital stock. The calculation of this expense is described in Note 11.

#### **Financial instruments**

Canadian accounting standards require the disclosure of the fair value of financial assets and liabilities. The fair value of the Company's current financial assets and liabilities is considered to approximate book value due to their current nature, as does the long-term debt, which is at floating rates.

#### **Revenue recognition**

Revenues from the sale of oil, gas and electricity are recorded when title passes to the customer.

#### **Income taxes**

The Company follows the liability method of accounting for income taxes. Under this method future tax liabilities and assets are recognized for the estimated tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax bases. Future tax liabilities and assets are measured using enacted tax rates. The effect on future tax liabilities and assets of a change in tax rates is recognized in the period that the change occurs.

#### **Net income (loss) per common share**

Net income (loss) per common share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. For the purposes of the weighted average number of common shares calculation, common shares are determined to be outstanding from the date they are issued. Diluted income (loss) per common share is calculated using the treasury stock method, which assumes that all outstanding stock option grants are exercised, if dilutive, and the assumed proceeds are used to purchase the Company's common shares at the average market price during the year.

### **3. Acquisition**

On April 26, 2005, Candax completed the purchase of the Tunisian operations of Centurion Energy International Inc. ("Centurion") for a purchase price of \$44.1 million satisfied with cash, inclusive of a \$2.9 million working capital adjustment. The effective date of the purchase was January 1, 2005 and the economic benefits from January 1, 2005 to April 26, 2005 have been recorded as an adjustment to the purchase price. The results from the Tunisian operations have been included in these financial

**Candax Energy Inc.**  
**Notes to the Consolidated Financial Statements**  
*(in thousands of Canadian dollars unless otherwise stated)*

statements for 2005 for the eight month period from April 26, 2005 to December 31, 2005, and for 2006, for the twelve month period January 1, 2006 to December 31, 2006.

Specifically, Candax purchased Centurion's wholly-owned subsidiaries: Ecumed Petroleum Grombalia, Ltd., Ecumed Petroleum Zarzis, Ltd., Ecumed Petroleum Tunisia, Ltd. and Centurion's 50% interest in the Société d'Electricité d'El Bibane ("SEEB") power plant, which represented all of Centurion's production from the Ezzaouia (31.3846% working interest), El Bibane (73.7729% working interest), Robbana (80% working interest) and Al Manzah (75% working interest). Centurion has retained the right to participate for up to 50% in Candax's resultant working interest in any Deep Triassic exploration well at either or both of Ezzaouia and El Bibane.

The acquisition was accounted for using the purchase method and accordingly the purchase price was allocated to the assets acquired and liabilities assumed based on their fair values on April 26, 2005 as follows:

Current assets, including cash of \$584	\$	4,468
Restricted investments		1,946
Petroleum and natural gas properties		45,153
Property, plant and equipment		17,659
Current liabilities		(3,707)
Long-term debt		(14,924)
Asset retirement obligation		(2,317)
Future income tax liability		(4,210)
<b>Purchase price</b>	<b>\$</b>	<b>44,068</b>

**4. Inventory**

	<b>2006</b>		<b>2005</b>	
Crude oil	\$	1,015	\$	1,693
Spare production equipment and parts		730		759
	<b>\$</b>	<b>1,745</b>	<b>\$</b>	<b>2,452</b>

**5. Restricted Investments**

Restricted investments represent a \$1.6 million (2005 – \$1.8 million) debt service reserve held by the Arab Banking Corporation as security for principal and interest payments to be made by SEEB under its limited recourse long-term debt (see Note 8).

In 2005, the restricted investment of \$2.3 million related to a letter of credit in favour of our joint venture partner, Mitsubishi.

**Candax Energy Inc.**  
**Notes to the Consolidated Financial Statements**  
*(in thousands of Canadian dollars unless otherwise stated)*

**6. Capital Assets**

<b>2006</b>	Cost	Accumulated Amortization	Net book Value
Petroleum and natural gas properties	69,429	(3,278)	66,151
Property, plant and equipment	17,659	(3,147)	14,512
	<u>87,088</u>	<u>(6,425)</u>	<u>80,663</u>
<b>2005</b>			
Petroleum and natural gas properties	45,381	(2,490)	42,891
Property, plant and equipment	17,659	(1,306)	16,353
	<u>63,040</u>	<u>(3,796)</u>	<u>59,244</u>

As at December 31, 2006:

- included in the cost of properties is \$0.6 million (2005 - \$0.4 million) of capitalized head office general and administrative costs
- petroleum and natural gas properties include \$20.0 million (2005 - \$13.4 million) in respect of unproved properties in Tunisia which have been excluded from depletion calculations.
- the prices used in the ceiling test evaluation of the Company's crude oil and natural gas reserves were:

2007	0.39	56.09
2008	0.40	55.85
2009	0.40	54.77
2010	0.41	52.65
2011	0.42	51.52
Average thereafter	0.55	54.17

**Chaal Permit**

On September 30, 2004, Candax signed a memorandum of understanding ("MOU") with a Tunisian company to apply as joint venture partners ("JVP") for the Chaal Permit in Tunisia. The MOU indicated the Company as operator with an 80% working interest in the property. Candax reimbursed its partner for past costs incurred by the partner on the permit to a gross amount of US \$0.2 million. Candax also agreed to assign a 2% net profits interest to its partner after all costs have been recovered.

On November 30, 2005, Candax signed an agreement with Mitsubishi Corporation ("Mitsubishi") for the farm-out of a 20% working interest in the Chaal Permit. Candax retained a 60% working interest in the Chaal Permit and is the Licence operator. The terms of the farm-out were that Mitsubishi would pay 100% of Candax's net costs for the Chaal-1 well, up to a maximum of US \$8 million, in return for earning a 20% interest in the Chaal Permit. Mitsubishi has an option to acquire, subject to certain conditions, a further 5% interest from Candax in the Chaal Permit prior to the drilling of a second well. Mitsubishi has agreed to pay Candax certain other cash bonuses dependent upon receiving government consent to undertake the development of the Chaal project and achieving certain other gas sales-based thresholds.

During 2006, Mitsubishi met its required funding commitments under the above-mentioned farm-out agreement, and as a result acquired a 20% interest in the Permit, reducing Candax's equity interest to 60%.

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**7. Long-term Receivable**

Effective March 31, 2006, the Company entered into an agreement with Caterpillar Power Ventures International Ltd. ("Caterpillar") to purchase, over time, 50% of Caterpillar's US \$5 million loan to SEEB, a Tunisian power generation company in which the Company and Caterpillar each have a 50% interest. Under the terms of the agreement, the Company will increase its participation in Caterpillar's loan to SEEB from zero to US \$2.5 million through payments made to Caterpillar. The Company is required to pay Caterpillar US \$0.2 million annually on or before March 31 of each year. In addition, any amount collected by the Company from SEEB on account of the gas receivables which were outstanding on March 31, 2006, in the amount of US \$0.7 million will be used to offset the loan to Caterpillar.

**8. Limited Recourse Long-Term Debt**

	Rate	(\$000s)	
		2006	2005
Limited recourse SEEB debt			
Project financing (US\$ based)	LIBOR +1.5% +2% default margin*	\$ 4,113	\$ 4,139
Project financing (Euro based)	ADB** +2% +2% default margin*	6,835	6,168
Due to Caterpillar Power Ventures Inc.	13%	3,056	3,075
		<u>14,004</u>	<u>13,382</u>
Amounts due within one year			
Project financing (US\$ based)		(4,113)	(633)
Project financing (Euro based)		(6,835)	(524)
		<u>(10,948)</u>	<u>(1,157)</u>
		<u>\$ 3,056</u>	<u>\$ 12,225</u>

\* the 2% default margin commenced May 2006 as principal payments were deferred and the loans were technically in default

\*\* African Development Bank Base Rate

On March 18, 2002, SEEB and its joint venture partner closed a US\$22.2 million limited-recourse project financing, 50% of which was subsequently converted into Euros. Security for the financing is limited to the project assets and a corporate non-performance guarantee of US \$0.8 million. Candax's share of the project financing at December 31, 2006 is \$10.9 million (2005 - \$10.3 million). All required interest and principal payments are expected to be repaid through operating cash flows of the SEEB power plant. The proceeds of this project financing were used to fund construction costs of the SEEB plant which commenced operations May 9, 2003. As disclosed in Note 16, the required principal payments have not been made due to a lack of cash resources at SEEB and as a result the loan is in default. Since the loan is in default it may be called by the lenders at anytime and therefore the entire amount of the non-recourse loan is considered current.

Also included in the limited recourse SEEB debt is an amount of \$3.1 million (2005 - \$3.1 million) in respect of Candax's share of additional project financing provided by Caterpillar Power Ventures Inc. to complete the SEEB project. There are no fixed repayment terms nor will the lender demand repayment in 2007. The venture plans to repay this debt with SEEB operating cash flows, however this is not anticipated to occur until the second half of 2007. Accordingly, this additional financing has been classified as a long-term obligation.

For the year ended December 31, 2006, interest expense in the amount of \$1.4 million (2005 - \$1.0 million) has been recorded in the consolidated statements of operations and deficit.

**9. Asset Retirement Obligation**

	<u>2006</u>	<u>2005</u>
Balance at January 1	\$ 2,282	\$ -
Increase resulting from acquisition	-	2,317
Accretion expense	201	156
Foreign exchange	(14)	(82)
Revision in estimate	(736)	(109)
Balance at December 31	<u>\$ 1,733</u>	<u>\$ 2,282</u>

The total undiscounted amount of estimated cash flows required to settle the obligation is \$5.7 million at December 31, 2006, which has been discounted using a credit-adjusted risk-free rate of 9%. Most of these obligations are not expected to be paid until 2021.

**10. Income taxes**

The future tax liability of \$4.4 million at December 31, 2006 (2005 - \$5.6 million) relates to the difference in the unclaimed tax deductible costs of capital assets in Tunisia and the related carrying value. The carrying value is based on the fair value of net assets acquired in the acquisition (see Note 3). When the assets are amortized there will be an associated tax benefit for accounting purposes. The liability is based on consolidated accounting values and any cash liability for income tax purposes is not triggered unless the underlying assets are sold. The approximate value of tax pools available in Tunisia are \$34.4 million (2005 - \$33.7 million).

	<u>2006</u>	<u>2005</u>
Profit before income taxes	\$ 2,418	\$ 715
Canadian corporate tax rate	36.12%	39.10%
Calculated income tax provisions	873	280
Effect on taxes from foreign tax rate differential	336	78
Expenses incurred with no recognized tax benefit	1,220	1,859
	<u>\$ 2,429</u>	<u>\$ 2,217</u>

Future income taxes have been provided for on the following temporary differences:

Future tax (assets) liabilities

	<u>2006</u>	<u>2005</u>
Capital assets	\$ 4,435	\$ 5,645
Non-capital loss carryforwards	(1,156)	(1,173)
Valuation allowance	1,156	1,173
Net future tax liability	<u>\$ 4,435</u>	<u>\$ 5,645</u>

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At December 31, 2006, the Company had non-capital tax losses available to offset future income for tax purposes in Canada. The losses expire in the years as noted:

2011	400
2012	2,000
2013	<u>870</u>
	<u><b>3,200</b></u>

The Company has not recognized a future tax asset for Canadian non-capital losses carried forward, since it is not, more likely than not, that such an asset will be utilized in the foreseeable future.

**11. Capital Stock**

**Common shares**

Candax is authorized to issue an unlimited number of common shares without par value. The Company's issued and outstanding common shares consist of the following:

	Number	Amount
<b>Balance at December 31, 2004</b>	<b>4,680,000</b>	<b>100</b>
Conversion of special warrants	43,372,000	4,448,900
Settlement costs	125,000	100,000
Conversion of subscription receipts	82,500,000	66,000,000
Value attributed to warrants		(2,298,955)
Share issuance costs		(3,550,977)
<b>Balance at December 31, 2005</b>	<b>130,677,000</b>	<b>64,699,068</b>
Conversion of broker warrants	2,700,000	2,160,000
Conversion of share purchase warrants	35,497,106	42,596,528
Transfer from warrants		1,978,250
<b>Balance at December 31, 2006</b>	<b>168,874,106</b>	<b>\$ 111,433,846</b>

On April 14, 2005, Candax completed a private placement of 82,500,000 subscription receipts at a price of \$0.80 per subscription receipt for total proceeds of \$66 million. Each subscription receipt entitled the holder to acquire, for no additional consideration, one common share and one-half of one common share purchase warrant, each whole warrant being exercisable to acquire one common share at \$1.20 for one year. On August 23, 2005 Candax received a receipt from the applicable securities regulatory authorities in Canada for a prospectus dated August 22, 2005 which qualified the distribution of the common shares and warrants of Candax issued upon the exchange of these subscription receipts.

The value attributed to the warrants was \$2.3 million using the following assumptions under the Black-Scholes model:

Expected volatility	60%
Risk-free interest rate	3.043%
Term	0.65 year
Exercise price	\$1.20

The agents in respect of the sale of 45,000,000 of the subscription receipts received a cash commission of \$2.2 million, being equal to 6% of the gross proceeds from the sale of the subscription receipts, as well as broker warrants entitling them to acquire 2,700,000 common shares, being equal to 6% of the subscription receipts sold through the agents. Each broker warrant entitled the holder to acquire one common share at a price of \$0.80 for a period of one year from the closing date.

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During the year ended December 31, 2006, 2,700,000 broker warrants were exercised at \$0.80 and on April 18, 2006 35,497,106 share purchase warrants were exercised at \$1.20. During the year 5,752,894 share purchase warrants expired and an amount of \$0.3 million was transferred from warrants to contributed surplus.

**Stock Options**

In April 2005, the Board of Directors established a share incentive plan to provide additional incentive to its directors, officers, employees and consultants for their efforts on behalf of the Company in the conduct of its affairs. The maximum number of common shares reserved for issuance under the share option plan comprising part of the share incentive plan may not exceed 10% of the number of common shares outstanding. Under the terms of the plan, all options vest immediately, unless otherwise specified. All options granted under the plan expire no later than the tenth anniversary of the grant date.

For the year ended December 31, 2006, the Company granted 400,000 options at market price to employees and consultants. These share options have an average exercise price of \$0.94, a vesting period of three years and expire in 2011.

Using the fair value method, the compensation expense is amortized over the three-year vesting period of the options. For the year ended December 31, 2006, the Company recorded a stock-based compensation expense of \$0.5 million (2005 - \$1.1 million) relating to share options. The portion of the fair value charge to be recognized in future periods is \$0.1 million.

The fair value was estimated on the date of the grant using the Black-Scholes fair value option-pricing model and the following assumptions:

	2006	2005
Expected volatility	60%	0% *
Risk-free interest rate	4.23%	3.96%
Term	5 years	5 years
Dividend yield	nil	nil

\* Since the Company's shares were not publicly traded at the time of the granting, the Company is eligible to use the "minimum value" under Section 3870 of the Canadian Institute of Chartered Accountant's Handbook, which assumes a volatility of 0%.

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The following tables summarize the options outstanding in accordance with the Company's share incentive plan:

<b>Outstanding share options</b>	<b>2006</b>		<b>2005</b>	
	<b>Weighted Average Exercise Price</b>	<b>Number of Options</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Options</b>
<b>Outstanding - beginning of year</b>	\$ <b>0.80</b>	<b>11,250,000</b>	-	-
<b>Transactions during the year:</b>				
Granted	0.94	400,000	0.80	11,250,000
Exercised	-	-	-	-
Expired	-	-	-	-
<b>Outstanding - end of year</b>	<b>\$ 0.80</b>	<b>11,650,000</b>	<b>\$ 0.80</b>	<b>11,250,000</b>

**Information relating to share options outstanding at December 31, 2006**

<b>Price range</b>	<b>Options outstanding</b>	<b>Weighted average remaining life on outstanding options in months</b>	<b>Options exercisable</b>
\$0.80 - \$1.19	11,650,000	39	7,661,666

As the average market price of the common shares during the period was less than the exercise price of the options the dilutive effect of the outstanding options have not been included in computing earnings per share.

**12. Related Party Transactions**

As described in Note 1, the Company has a 50% interest in SEEB. During the year the Company had no gas sales to SEEB (2005 - \$0.7 million) and as at December 31, 2006 the Company had a receivable from SEEB in the amount of \$0.8 million (2005 - \$0.4 million).

**13. Commitments**

(a) Under the terms of an agreement with the Tunisian government, 20% of the Company's oil production must be dedicated to the domestic market. The production sold under this domestic market obligation receives a price equal to 90% of the US dollar price for the Brent-based export sales. Oil production is accumulated in a storage facility until a marketable cargo is achieved. Under this agreement, the state-owned oil company, ETAP, with respect to its 55% rights on the Ezzaouia field production and on behalf of the Government with respect to the domestic market obligation and the Company's Tunisian entities have agreed to optimize tanker lifting volumes. As a result of this reciprocal practice, a short-term volumetric imbalance may arise through an "under/over" lift position. This short-term situation is corrected from future production allocations.

(b) On April 13, 2006, the Company signed a US \$10 million credit facility with the Bank of Scotland. The primary purpose of the facility will be the Company's new venture activities although it also provides operational flexibility for the redevelopment of the El Bibane field and potentially the fast-track of new project development activities. The facility bears interest at the London Interbank Overnight Rate plus 2% and there are no fixed repayment terms. No funds have been drawn on this facility to date.

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**14. Segmented Information**

(a) By generation source

	Oil and gas operations		Electricity generation operations		Total	
	2006	2005	2006	2005	2006	2005
<b>For the year ended December 31</b>						
Sales (net of royalties)	\$ 13,152	\$ 11,286	\$ -	\$ 1,596	\$ 13,152	\$ 12,882
Depletion, depreciation and amortization	2,845	2,690	1,841	1,305	4,686	3,995
Interest expense	-	-	1,360	926	1,360	926
Net income (loss)	2,871	(473)	(2,882)	(1,029)	(11)	(1,502)
<b>As at December 31</b>						
Capital assets	66,151	42,891	14,512	16,353	80,663	59,244

(b) All capital assets and revenues are located in Tunisia with the exception of interest earned on the US dollar-denominated term deposit located in Guernsey and interest earned on Canadian and US dollar-denominated bonds located in Canada.

**15. Changes in Non-cash Working Capital**

	2006	2005
Accounts receivable	\$ (4,750)	\$ (1,699)
Inventory	707	(2,452)
Deposits and prepaids	603	(1,587)
Accounts payable and accrued liabilities	8,090	5,783
	<b>\$ 4,650</b>	<b>\$ 45</b>

**16. Subsequent Event**

Limited recourse long-term debt default.

As described in Note 3, the Company has a 50% joint venture interest in the SEEB power plant and as a result, has limited recourse long-term debt in the amount of \$11.6 million. Due to the lack of production from the El Bibane field, the SEEB power plant has not generated revenues during 2006 and as a result was unable to meet its current obligations under the credit facility. Interest payments were made during February, May, August and November of 2006 through proceeds from business interruption insurance as well as from the debt service reserve and capital contributions from the partners but principal amounts of \$2.4 million (Candax's share \$1.2 million) were deferred.

On February 1, 2007 an amount of \$0.4 million representing Candax's interest owing, was deducted from the debt service reserve account held by the lender. Principal payments of \$0.5 million were deferred. The balance in the debt service reserve account after this payment was \$1.4 million which will be used to fund future interest payments in 2007 until the SEEB plant resumes normal operations, expected to be in the second half of 2007.

Negotiations with the lenders are on-going as there is no commitment from the lenders to continue to defer principal payments. In the event of a declaration of default by the lenders, the lenders would take control of the SEEB plant and Candax would owe a default payment of US \$0.8 million but would not be liable for the balance of the loans outstanding nor for the deferred principal amounts.