# MANAGEMENT'S Discussion & Analysis

## Basis of Presentation

The following Management's Discussion and Analysis (the "MD&A") dated April 3, 2012 is a review of results of operations and the liquidity and capital resources of Sea Dragon Energy Inc. (the "Company" or "Sea Dragon") for the three and twelve months ended December 31, 2011. This MD&A should be read in conjunction with the accompanying audited consolidated financial statements for the years ended December 31, 2011 and 2010, and the unaudited MD&A for the year ended December 31, 2010.

As of January 1, 2011, Sea Dragon adopted International Financial Reporting Standards ("IFRS"), and the following disclosures, as well as the associated unaudited consolidated interim financial statements have been prepared in accordance with IFRS. The Company's effective transition date is January 1, 2010, to accommodate 2010 IFRS comparative figures. The Company has provided information throughout this document to assist users in understanding the transition from Canadian Generally Accepted Accounting Principles ("CGAAP"). A summary of all of the significant changes including the various reconciliation of GAAP financial statements to those prepared under IFRS is included in Note 27 in the Company's audited consolidated financial statements for the year ended December 31, 2011. The reporting and the functional currency of the Company is the United States dollar ("US$").

Certain information contained herein is forward-looking and based upon assumptions and anticipated results that are subject to risks, uncertainties and other factors. Should one or more of these uncertainties materialize or should the underlying assumptions prove incorrect, actual results may vary materially from those expected. See "Forward Looking Statements", below.

## Change in reporting currency and accumulated other comprehensive income

Effective July 1, 2010, the Company changed its presentation and functional currency from Canadian dollars (CDN$) to US$, as significant portions of the Company's revenues, expenses and cash flows are denominated in US$. The change in presentation currency is to better reflect the Company's business activities and to improve investors' ability to compare the Company's financial results with other publicly traded businesses in the international oil and gas industry. Prior to July 1, 2010, the Company reported its annual and quarterly consolidated balance sheets and the related consolidated statements of operations and cash flows in CDN$. The change in functional currency on July 1, 2010 is appropriate based on the fact that both subsidiaries did not have an available external financing up until June 30, 2010 and both subsidiaries did not have positive cash inflows up until June 30, 2010 and therefore were reliant upon the head office funding for their operation. In addition, the acquisition of the Kom Ombo concession occurred during Q2 2010 which significantly contributed to the cash flows. In making this change in presentation currency, the Company followed the recommendations set out in IAS 21, The Effects of Change in Foreign Exchange Rates. In accordance with IAS 21, the financial statements for all years and periods presented have been translated into the new presentation currency using the current rate method. Under this method, the statement of loss and cash flow statement items for each year and period have been translated into the presentation currency using the average exchange rates prevailing during each reporting period. All assets and liabilities have been translated using the exchange rate prevailing at the consolidated balance sheets dates. Shareholders' equity transactions have been translated using the rates of exchange in effect as of the dates of the various capital transactions, while shareholders' equity balances from the translation are included as a separate component of other comprehensive income. All resulting exchange differences arising from the translation are included as a separate component of other comprehensive income. All comparative financial information has been restated to reflect the Company's results as if they had been historically reported in US$ and the effect on the consolidated financial statements resulted in an accumulated and other comprehensive income adjustment of $8.3 million, of which $5.8 million was adjusted for on transition to IFRS (refer to note 27 in the Company's audited financial statements for the year ended December 31, 2011) resulting in a balance of $2.5 million as at July 1, 2010.

All financial references in this MD&A are in thousands of United States Dollars unless otherwise noted.

Additional information related to the Company can be found on SEDAR at *www.sedar.com.*

## Forward-Looking Statements

*Certain statements included or incorporated by reference in this MD&A constitute forward-looking statements or forward-looking information under applicable securities legislation. Such forward-looking statements or information are for the purpose of providing information about Management's current expectations and plans relating to the future. Readers are cautioned that reliance on such information may not be appropriate for other purposes, such as making investment decisions. Forward-looking statements or information typically contain statements with words such as "anticipate", "believe", "expect", "plan", "intend", "estimate", "propose", "project" or similar words suggesting future outcomes or statements regarding an outlook. Forward-looking statements or information in this MD&A include, but are not limited to, statements or information with respect to: business strategy and objectives; development plans; exploration plans; acquisition and disposition plans and the timing thereof; reserve quantities and the discounted present value of future net cash flows from such reserves; future production levels; capital expenditures; net revenue; operating and other costs; royalty rates and taxes.*

*Forward-looking statements or information are based on a number of factors and assumptions that have been used to develop such statements and information but may prove to be incorrect. Although the Company believes that the expectations reflected in such forward-looking statements or information are reasonable, undue reliance should not be placed on forward-looking statements because the Company can give no assurance that such expectations will prove to be correct. In addition to other factors and assumptions that may be identified in this MD&A, assumptions have been made regarding, among other things: the impact of increasing competition; the general stability of the economic and political environment in which the Company operates; the timely receipt of any required regulatory approvals; the ability of the Company to obtain qualified staff, equipment and services in a timely and cost-efficient manner; the ability of the operator of the projects which the Company has an interest in to operate the field in a safe, efficient and effective manner; the ability of the Company to obtain financing on acceptable terms; field production rates and decline rates; the ability to replace and expand oil and natural gas reserves through acquisition, development or exploration; the timing and costs of pipeline, storage and facility construction and expansion and the ability of the Company to secure adequate product transportation; future oil and natural gas prices; currency, exchange and interest rates; the regulatory framework regarding royalties, taxes and environmental matters in the countries in which the Company operates; and the ability of the Company to successfully market its oil and natural gas products. Readers are cautioned that the foregoing list is not exhaustive of all factors and assumptions that may have been used.*

*Forward-looking statements or information are based on current expectations, estimates and projections that involve a number of risks and uncertainties that could cause actual results to differ materially from those anticipated by the Company and described in the forward-looking statements or information. The risks and uncertainties that may cause actual results to differ materially from the forward-looking statements or information include, among other things: the ability of Management to execute its business plan; general economic and business conditions; the risk of war or instability affecting countries or states in which the Company operates; the risks of the oil and natural gas industry, such as operational risks in exploring for, developing and producing crude oil and natural gas; market demand; the possibility that government policies or laws may change or governmental approvals may be delayed or withheld; risks and uncertainties involving geology of oil and natural gas deposits; the uncertainty of reserves estimates and reserves life; the ability of the Company to add production and reserves through acquisition, development and exploration activities; the Company's ability to enter into or renew production sharing concession; potential delays or changes in plans with respect to exploration or development projects or capital expenditures; the uncertainty of estimates and projections relating to production (including decline rates), costs and expenses; fluctuations in oil and natural gas prices, foreign currency, exchange, and interest rates; risks inherent in the Company's marketing operations, including credit risk; uncertainty in amounts and timing of oil revenue payments; health, safety and environmental risks; risks associated with existing and potential future law suits and regulatory actions against the Company; uncertainties as to the availability and cost of financing; and financial risks affecting the value of the Company's investments. Readers are cautioned that the foregoing list is not exhaustive of all possible risks and uncertainties.*

## Use of Estimates

The preparation of consolidated financial statements in conformity with IFRS requires management to make estimates and assumptions based on information available at the time. These estimates and assumptions affect the reported amounts of assets, particularly the recoverability of accounts receivable and acquisition costs of property and equipment. Estimates and assumptions also affect the recording of liabilities and contingent liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Due to various factors affecting future costs and operations, actual results could differ from management's best estimates.

## Non-IFRS Measures

The MD&A contains the terms "funds from operations", and "netbacks" which are not recognized measures under IFRS. The Company uses these measures to help evaluate its performance.

## Funds from operations

Funds from operations are a non-IFRS measure that represents funds generated from operating activities before changes in non-cash working capital. Funds from operations should not be considered an alternative to, or more meaningful than, cash flow from operating activities. Management uses funds from operations to analyze performance and considers it an indication of the Company's ability to generate the cash necessary to fund future capital investments and to repay debt. Sea Dragon's determination of funds from operations may not be comparable to that reported by other companies nor should it be viewed as an alternative to cash flow from operating activities, net earnings or other measures of financial performance calculated in accordance with IFRS.

Reconciliation of cash flow from operations and funds flow from operations

| | THREE MONTHS ENDED DECEMBER 31 | | TWELVE MONTHS ENDED DECEMBER 31 | |
|---|---|---|---|---|
| *$000's* | **2011** | 2010 | **2011** | 2010 |
| Cash from/(used in) operating activities | **(793)** | 1,273 | **(1,900)** | 2,017 |
| Less: changes in non-cash working capital | **(1,302)** | 1,147 | **(7,525)** | 410 |
| Funds from operations | **509** | 126 | **5,625** | 1,607 |

## Netback

Netback is a non-IFRS measure that represents sales net of all operating expenses and government royalties. Management believes that netback is a useful supplemental measure to analyze operating performance and provide an indication of the results generated by the Company's principal business activities prior to the consideration of other income and expenses. Management considers netbacks an important measure as it demonstrates the Company's profitability relative to current commodity prices. Netback may not be comparable to similar measures used by other companies. See netback reconciliation schedule under the outlook section below.

# SEA DRAGON'S BUSINESS, STRATEGY AND OUTLOOK

## Sea Dragon's Business

Sea Dragon is engaged in exploring, developing and operating oil and gas properties, focusing primarily on North Africa, West Africa and the Middle-East. Currently the Company's activities are historically concentrated in Egypt, where the Company has interests in two concessions with short and long-term potential. The Company's strategy calls for gaining entry into other countries that offer significant potential and opportunities that would enhance the Company's growth within a reasonable timeframe. The Company intends to create shareholder value through significant and rapid growth in production volumes, cash flow and earnings.

As a result of large demonstrations in Egypt beginning in January 2011, the country's President resigned on February 11, 2011 and turned over all power to a transitional government to introduce the necessary political reforms towards democracy and civilian government with transparent elections. In addition, the prime minister of Egypt who was previously appointed by the President resigned on March 3, 2011. The demonstrations had a minimal effect on the operations of the Company with the exception of minor delays in materials and permitting. In late 2011 and early 2012 Egypt successfully held parliamentary and senate elections. The presidential elections are expected to occur in June 2012.

Sea Dragon believes Egypt has a long history of creating an environment to attract and retain foreign investment and is currently engaged in a transaction that will expand its asset base in Egypt. Sea Dragon will also seek to expand in other countries.

## Strategy

**Increase shareholder value through growth in production, reserves and cash flow.** In addition, the Company's two current concessions offer long-term exploration opportunities with significant oil-in-place resource potential. Sea Dragon is also continuing to search for, identify and evaluate new and economically attractive investments.

**Acquire interests with significant upside potential in discovered, but undeveloped oil and natural gas assets.** The Company's growth strategy is based on working with established companies and identifying and negotiating the acquisition of assets with high growth potential. To date, Sea Dragon has acquired interests in two development concessions in Egypt: the NW Gemsa Concession ("NW Gemsa") and the Kom Ombo Concession ("Kom Ombo"). Each concession offers current production, development drilling, and longer-term exploration opportunities creating upside for significant reserves growth.

## Outlook

The Company's expected capital expenditure program for 2012 is approximately $12.2 million.

The Company's capital expenditure program for Kom Ombo includes, but is not limited to, the drilling of two exploration wells, three development wells, several workovers and a fracturing program.

The Company's capital expenditure program for NW Gemsa includes, but is not limited to the drilling of four development wells, three additional water injector wells, two workovers, and expanding the production facilities.

## OPERATIONAL AND FINANCIAL HIGHLIGHTS:

In accordance with Canadian industry practice, production volumes and revenues are reported on a Company interest basis, before deduction of royalties.

| | | THREE MONTHS ENDED DECEMBER 31 | | TWELVE MONTHS ENDED DECEMBER 31 | |
|---|---|---|---|---|---|
| *$000's except per unit amounts* | PRIOR QUARTER[1] | 2011 | 2010 | 2011 | 2010 |
| **OPERATIONAL** | | | | | |
| Oil revenue, net of royalties | 5,131 | **4,814** | 3,851 | **20,494** | 12,529 |
| Direct operating costs | 159 | **(1,100)** | (1,268) | **(3,007)** | (3,424) |
| Netback | 5,290 | **3,714** | 2,583 | **17,487** | 9,105 |
| Oil sales *(bbl/d)* | 1,066 | **991** | 995 | **1,082** | 1,001 |
| Brent oil price *(US$/bbl)* | 113.35 | **109.38** | 87.34 | **111.28** | 80.33 |
| Realized oil price *(US$/bbl)* | 108.44 | **104.54** | 82.34 | **106.15** | 75.02 |
| Royalties *(US$/bbl)* | 56.13 | **51.72** | 40.23 | **54.23** | 40.70 |
| Operating costs *(US$/bbl)* | (1.62) | **12.07** | 13.85 | **7.62** | 9.37 |
| Netback *(US$/bbl)* | 53.93 | **40.75** | 28.26 | **44.30** | 24.95 |
| Capital expenditures | 1,592 | **1,892** | 5,545 | **8,024** | 12,132 |
| Capital acquisitions | – | **–** | – | **–** | **44,501** |

[1] *Three months ended September 30, 2011*

## Production

Production for the three and twelve months ended December 31, 2011 and 2010 averaged 991 bbl/d and 1,082 bbl/d compared to 995 bbl/d and 1,001 bbl/d for the comparative periods in the prior year. During 2011 the Company drilled three wells (1.5 net) in Kom Ombo and six wells (0.6 net) in NW Gemsa. During the three months ended December 31, 2011 (the "Quarter"), the Company drilled two wells (0.2 net) in NW Gemsa, with one completed as a water injector well and the other coming onto production in late February 2012.

## Pricing

The Company is exposed to the volatility in commodity price markets for all of its production volumes and changes in foreign exchange rate between the Canadian and US dollar for certain general and administrative expenses. The above table outlines the changes in the various benchmark commodity prices and economic parameters which affect the prices received for the Company's production.

For the three and twelve months ended December 31, 2011 the Company received an average price of $104.54 per barrel and $106.15 per barrel compared to the average Brent Oil price ("Brent") of $109.38 per barrel and $111.28 per barrel. The Company receives a discount to Brent due to the quality of the oil produced and a contracted discounted price levied by the refineries.

After relatively flat prices for the majority of 2010, prices began to increase in the fourth quarter of 2010 with increases throughout 2011. Oil prices exited the year at $108.09, which is $12.27 higher than where they started the year at. Brent ranged from a low of US$93.52 per barrel in January to a high of US$126.64 per barrel in April 2011. Due to strong economic growth in both developed and more importantly emerging markets, oil demand has increased providing price support for oil prices. In addition, turmoil in the Middle East and North Africa has further increased oil prices. At this time, Sea Dragon does not hedge any of its production.

## Crude Oil Sales

Crude oil sales for the three and twelve months ended December 31, 2011 was $9.5 million and $41.9 million, compared to $7.5 million and $27.4 million for the three and twelve months ended December 31, 2010. For the three months ended December 31, 2011 the increase in revenue is attributable to a 27 percent increase in realized sales price from the prior period ending December 31, 2010.

| CRUDE OIL SALES | PRIOR | THREE MONTHS ENDED DECEMBER 31 | | TWELVE MONTHS ENDED DECEMBER 31 | |
|---|---|---|---|---|---|
| *$000's except per unit amounts* | QUARTER | **2011** | 2010 | **2011** | 2010 |
| Crude oil sales | 10,638 | **9,527** | 7,535 | **41,901** | 27,400 |
| Per bbl | 108.44 | **104.54** | 82.34 | **106.15** | 75.02 |

For the twelve months ended December 31, 2011 the increase in revenue is due to a 41 percent increase in realized sales price and an 8 percent increase in sales volumes from prior period ending December 31, 2010.

| *$000's* | |
|---|---|
| Three months ended December 31, 2010 | 7,535 |
| Price variance | 2,025 |
| Production variance | (33) |
| **Three months ended December 31, 2011** | **9,527** |

| *$000's* | |
|---|---|
| Twelve months ended December 31, 2010 | 27,400 |
| Price variance | 12,292 |
| Production variance | 2,209 |
| **Twelve months ended December 31, 2011** | **41,901** |

## Royalties

| $000's except per unit amounts | PRIOR QUARTER | THREE MONTHS ENDED DECEMBER 31 | | TWELVE MONTHS ENDED DECEMBER 31 | |
|---|---|---|---|---|---|
| | | **2011** | 2010 | **2011** | 2010 |
| Royalties | 5,507 | **4,713** | 3,683 | **21,407** | 14,871 |
| Per bbl | 56.13 | **51.72** | 40.23 | **54.23** | 40.70 |
| Royalties as a percent of revenue (%) | 52 | **49** | 49 | **51** | 54 |

Royalties fluctuate in Egypt due to changes in the cost oil, whereby the Concession agreements allow for recovery of operating costs and capital costs through a change in government take as highlighted below:

| Concession | Sea Dragons WI [1] | Cost oil to Contractor [2] | Capital cost recovered [2] | Operating cost recovered [2] | Excess oil to Contractor [3] | Profit oil to Contractor [4] |
|---|---|---|---|---|---|---|
| NW Gemsa | 10% | 30% | 5 years | Immediate | Nil | 16.1% |
| Kom Ombo | 50% | 40% | 4 years | Immediate | 21% | 21% |

*(1) WI denotes the Company's Working interest*

*(2) Cost oil is the amount of oil revenue that is attributable to Sea Dragon and their joint venture partners (the "Contractor") subject to the limitation of the cost recovery pool. Oil revenue, up to a specified percentage is available for recovery by the Contractor for costs incurred in exploring and developing the concession. Operating costs and capital costs are added to a cost recovery pool (the "Cost Pool"). Capital costs for exploration and development expenditures are amortized into the Cost Pool over a specified number of years with operating costs being added to the Cost Pool as incurred.*

*(3) If the costs in the Cost Pool are less than the cost oil attributable to the Contractor, the shortfall, referred to as excess cost oil ("Excess Oil"), reverts 100% to the State in NW Gemsa and 21 percent to the Contractor in Kom Ombo.*

*(4) Profit oil is the amount of oil revenue that is attributable to Contractor*

## Direct operating costs

| $000's except per unit amounts | PRIOR QUARTER | THREE MONTHS ENDED DECEMBER 31 | | TWELVE MONTHS ENDED DECEMBER 31 | |
|---|---|---|---|---|---|
| | | **2011** | 2010 | **2011** | 2010 |
| Direct operating costs | (159) | **1,100** | 1,268 | **3,007** | 3,424 |
| Per bbl | (1.62) | **12.07** | 13.85 | **7.62** | 9.37 |

Operating costs for the three and twelve months ended December 31, 2011 were $1.1 million ($12.07 per bbl) and $3.0 million ($7.62 per bbl) respectively, compared to $1.3 million ($13.85 per bbl) and $3.4 million ($9.37 per bbl) in the comparative periods in the prior year. During the prior quarter the Company reclassified certain amounts from operating expenses to capital assets and accounts receivables. This reclassification was due to new information obtained from the operator of NW Gemsa during the prior quarter.

## Current taxes

| $000's except per unit amounts | PRIOR QUARTER | THREE MONTHS ENDED DECEMBER 31 | | TWELVE MONTHS ENDED DECEMBER 31 | |
|---|---|---|---|---|---|
| | | **2011** | 2010 | **2011** | 2010 |
| Current taxes | 1,274 | **1,139** | 896 | **5,043** | 3,175 |

Pursuant to the terms of the Company's concession agreements, the corporate tax liability of the joint venture partners is paid by the government of Egypt controlled corporations ("Corporations") out of the profit oil attributable to the Corporations, and not by the Company. For accounting purposes the corporate taxes paid by the Corporations are treated as a benefit earned by the Company; the amount is included in net oil revenues and deducted as an income tax expense.

## Capital expenditures

| $000's | PRIOR QUARTER | THREE MONTHS ENDED DECEMBER 31 2011 | 2010 | TWELVE MONTHS ENDED DECEMBER 31 2011 | 2010 |
|---|---|---|---|---|---|
| Property, plant and equipment expenditures | (1,572) | **(1,946)** | (5,545) | **(7,956)** | (12,132) |
| Exploration and evaluation expenditures | (20) | **54** | – | **(68)** | – |
| | (1,592) | **(1,892)** | (5,545) | **(8,024)** | (12,132) |

During the three months ended December 31, 2011, the Company spent $1.9 million on capital expenditures which included the drilling of two wells (0.2 net) in NW Gemsa. During 2011 the Company drilled three wells (1.5 net) in Kom Ombo and six wells (0.6 net) in NW Gemsa. During the three months ended December 31, 2011 the exploration and evaluation expenditures were credited due to new information obtained from the operator.

The following table is the cumulative costs for property and equipment on all of the Company's oil and gas properties:

| $000's | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Oil and gas properties, at cost | **54,949** | 47,014 |
| Accumulated depletion | **(7,893)** | (4,115) |
| Accumulated Impairment | **(13,660)** | – |
| | **33,396** | 42,899 |
| Furniture and fixtures, at cost | **390** | 369 |
| Accumulated depreciation | **(177)** | (96) |
| | **213** | 273 |
| | **33,609** | 43,172 |

During the twelve months ended December 31, 2011, the Company capitalized $ 2.0 million of general and administrative costs related to development and production activities in Egypt (December 31, 2010 - $0.7 million).

At December 31, 2011, future development costs totaling $28.6 million (2010 - $6.6 million) have been included in costs subject to depletion.

## Impairment Test

At the reporting date, an impairment test was triggered due to reserve revisions in the fourth quarter of 2011. The impairment test was carried out on both the Kom Ombo and NW Gemsa fields in accordance with the accounting policy stated in note 3. The recoverable amounts of the fields have been determined based on value-in-use calculations. These calculations require the use of estimates. The present value of future cash flows was computed by applying forecast prices of oil and gas reserves to estimated future production of proved and probable oil and gas reserves, less estimated future expenditures to be incurred in developing and producing the proved and probable reserves. The present value of estimated future net revenues is computed using a discount factor of 15%. The discount rate used reflects the specific risks relating the underlying cash generating unit. Based on this calculation, there is an impairment recorded for the Kom Ombo field due to both reserve revisions as well as a change in the discount factor applied, and there is no impairment recorded for the NW Gemsa fields.

The value in use calculation assumes Brent oil sales prices in US$/bbl as follows:

| 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|
| $105.61 | $101.36 | $97.23 | $97.41 | $101.42 | $103.37 | $105.43 | $107.54 |
| **2020** | **2021** | **2022** | **2023** | **2024** | **2025** | **2026** | **2027** |
| $109.69 | $111.89 | $114.13 | $116.41 | $118.74 | $121.11 | $123.53 | $126.00 |

The current discount factor applied to the Kom Ombo impairment test results in an impairment of the Kom Ombo cash generating unit of $13.7 million. The current discount factor applied to the NW Gemsa impairment test results in an excess of recoverable amount over the carrying value of the NW Gemsa cash generating unit of $23.8 million.

If the discount factor applied to the impairment test were to increase by 5% above the current factor of 15%, the impairment of the carrying value of the Kom Ombo field would be $18.2 million and the excess of recoverable amount over the carrying value of the NW Gemsa field would be $16.8 million.

If the discount factor applied to the impairment test were to decrease by 5% below the current factor of 15%, the impairment of the carrying value of the Kom Ombo field would be $7.3 million and the excess of recoverable amount over the carrying value of the NW Gemsa field would be $33.4 million.

### INTANGIBLE EXPLORATION AND EVALUATION ASSETS

| *$000's* | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Exploration and evaluation assets, beginning of period | **22,165** | – |
| Acquisitions | **–** | 35,867 |
| Additions | **68** | 2,067 |
| Transfers to property, plant and equipment | **–** | (15,769) |
| Exploration and evaluation expense | **(294)** | – |
| Exploration and evaluation assets, end of period | **21,939** | 22,165 |

Intangible exploration and evaluation assets consist of the Company's exploration projects which are pending the determination of proven or probable reserves. As at December 31, 2011 an amount of $21.9 million (December 31, 2010 - $22.2 million) remains in intangible E&E assets in respect of the Kom Ombo Concession. During the year ended December 31, 2011, the Company determined certain exploration and evaluation costs to be unsuccessful and not recoverable. Accordingly, $0.4 million in capitalized costs were recognized as exploration and evaluation expense for the year ended December 31, 2011. In addition, during the year ended December 31, 2011 the Company incurred $0.6 million in pre-license costs (2010-nil) which were expensed.

## General and administrative costs

| | | THREE MONTHS ENDED DECEMBER 31 | | TWELVE MONTHS ENDED DECEMBER 31 | |
|---|---|---|---|---|---|
| *$000's* | PRIOR QUARTER | 2011 | 2010 | 2011 | 2010 |
| Wages and employee costs | 454 | **410** | 640 | **1,860** | 2,083 |
| Consultants | 408 | **819** | 312 | **1,713** | 1,304 |
| Travel | 133 | **76** | 69 | **387** | 664 |
| Office expense | 119 | **172** | 573 | **807** | 828 |
| Foreign offices | 270 | **303** | 34 | **1,179** | 479 |
| Finance/banking | 1 | **11** | (58) | **15** | (335) |
| Total | 1,385 | **1,791** | 1,570 | **5,961** | 5,023 |

General and administrative ("G&A") costs for the three and twelve months ended December 31, 2011 were $1.8 million and $5.9 million compared to $1.6 million and $5.0 million in the comparative periods in the prior year. Overall, G&A costs increased from prior year due to additional employees and the opening of Cairo and Paris offices. The cost increases are commensurate with increased activity and the hiring of additional personnel. The increase in G&A costs during the Quarter from Prior Quarter are due to increased consultant costs as a result of the proposed acquisition of National Petroleum Company Egypt Limited. See note 26 in the accompanying Financial Statements.

## Stock based compensation

Stock-based compensation expense is the amortization over the vesting period of the fair value of stock options granted to employees, directors and key consultants of the Company. The fair value of all options granted is estimated using the Black-Scholes option pricing model. The non-cash compensation expense for the three and twelve months ended December 31, 2011, was $0.2 million and $0.7 million, compared to $0.3 million and $1.3 million in the comparative periods in the prior year.

On July 12, 2011 Sea Dragon Energy granted 8,060,000 options to purchase common shares under Sea Dragon's stock option plan, of which 5,950,000 were granted to officers and directors. Each option has an exercise price of $0.13 CDN, vests annually over the next three years and expires on July 8, 2016.

The following table summarizes the assumptions used in the Black-Scholes option pricing model for options granted during 2010 and 2011:

| | 2011 | 2010 |
|---|---|---|
| Fair value at grant date *(CDN)* | **$0.10** | $0.26 |
| Share price *(CDN)* | **$0.13** | $0.31 |
| Exercise price *(CDN)* | **$0.13** | $0.30 |
| Volatility *(%)* | **108** | 125 |
| Forfeiture *(%)* | **0.67** | 0.67 |
| Option life | **5 years** | 5 years |
| Dividends | **0%** | 0% |
| Risk-free interest rate | **2.10%** | 2.23% |

## Depletion, depreciation and amortization ("DD&A")

| | | THREE MONTHS ENDED DECEMBER 31 | | TWELVE MONTHS ENDED DECEMBER 31 | |
|---|---|---|---|---|---|
| *$000's* | PRIOR QUARTER | 2011 | 2010 | 2011 | 2010 |
| Depletion, depreciation and amortization | 890 | **1,172** | 673 | **3,859** | 4,047 |
| Per bbl | 9.07 | **12.86** | 7.35 | **9.78** | 11.08 |

For the three and twelve months ended December 31, 2011, depletion, depreciation and amortization ("DD&A") was $1.2 million and $3.9 million compared to $0.7 million and $4.0 million for the comparative periods in the prior year. The decrease in DD&A on an absolute basis is due to a lower depletable base and higher reserves value in NW Gemsa.

## Net Earnings

For the three and twelve months ended December 31, 2011, the Company recorded a net loss of $14.4 million and $12.8 million, compared to a net loss of $0.7 million and $3.0 million in the comparative periods in the prior year.

## LIQUIDITY AND CAPITAL RESOURCES

### Share capital

The Company's authorized share capital consists of an unlimited number of common shares and an unlimited number of preferred shares, issuable in one or more series. The common shares of Sea Dragon trade on the TSX Venture Exchange under the symbol SDX.

| Trading statistics | Prior Quarter | THREE MONTHS ENDED DECEMBER 31 2011 | THREE MONTHS ENDED DECEMBER 31 2010 | TWELVE MONTHS ENDED DECEMBER 31 2011 | TWELVE MONTHS ENDED DECEMBER 31 2010 |
|---|---|---|---|---|---|
| High (CDN) | $0.14 | **$0.11** | $0.34 | **$0.33** | $0.66 |
| Low (CDN) | $0.08 | **$0.07** | $0.23 | **$0.07** | $0.23 |
| Average Volume | 1,041,659 | **700,837** | 1,179,394 | **1,285,316** | 1,207,256 |

The following table summarizes the outstanding common shares, warrants and options as at April 3, 2012, December 31, 2011, and December 31, 2010.

| Outstanding as at: | April 3, 2012 | December 31, 2011 | December 31, 2010 |
|---|---|---|---|
| Common shares | 376,459,358 | 376,459,358 | 376,459,358 |
| Warrants | 30,000,000 | 30,000,000 | 30,000,000 |
| Options | 20,010,000 | 20,010,000 | 13,250,000 |

As at December 31, 2011 the Company had 30.0 million warrants with exercise price of $0.50 CDN per warrant. The warrants expire on November 6, 2012.

The following table summarizes the outstanding options as at December 31, 2011:

| | OUTSTANDING OPTIONS | | VESTED OPTIONS | |
|---|---|---|---|---|
| Exercise price range | Number of options *(000's)* | Remaining contractual life | Number of options *(000's)* | Remaining contractual life |
| $0.01 to $0.18 | **11,060** | **4.0 years** | **2,000** | **2.6 years** |
| $0.19 to $0.39 | **3,500** | **3.6 years** | **1,833** | **3.6 years** |
| $0.40 to $0.59 | **1,450** | **2.9 years** | **1,000** | **2.9 years** |
| $0.60 to $0.79 | **4,000** | **1.6 years** | **4,000** | **1.6 years** |
| | **20,010** | **3.4 years** | **8,833** | **2.4 years** |

### Capital Resources

As at December 31, 2011 the Company had working capital of approximately $11.9 million including cash on hand of $ 6.1 million. The Company expects to fund its 2012 capital program from funds from operations and cash on hand. The credit facility may also be utilized to finance other opportunities to expand the Company's asset base.

As at December 31, 2011, the Company had $12.2 million in accounts receivable outstanding compared to $6.2 million as at December 31, 2010. Approximately $11.2 million is due from the government of Egypt controlled corporations for oil sales and is expected to be received in the normal course of operations. As of the date of the MD&A the Company has collected $4.0 million.

The following table outlines the Company's sources and uses of cash for the three and twelve months ended December 31, 2011 and 2010.

| $000's | PRIOR QUARTER | THREE MONTHS ENDED DECEMBER 31 2011 | 2010 | TWELVE MONTHS ENDED DECEMBER 31 2011 | 2010 |
|---|---|---|---|---|---|
| **Sources:** | | | | | |
| Funds from operations | 2,158 | **509** | 126 | **5,625** | 1,607 |
| Proceeds from issuance of shares | – | – | 87 | – | 64,638 |
| Convertible debenture | – | – | – | – | 287 |
| Deposit and restricted cash | – | – | – | – | 2,168 |
| Issuance of Debt | – | **3,000** | – | **3,000** | – |
| Exploration and evaluation expenditures | – | **54** | – | **–** | – |
| Effect of foreign exchange on cash and cash equivalents | 125 | **33** | 177 | **58** | 275 |
| Changes in non-cash working capital | | | 1,147 | | 410 |
| | 2,283 | **3,596** | 1,537 | **8,683** | 69,385 |
| **Uses:** | | | | | |
| Property, plant and equipment expenditures | (1,572) | **(1,946)** | (5,545) | **(7,956)** | (56,633) |
| Exploration and evaluation expenditures | (20) | **–** | – | **(68)** | – |
| Effect of foreign exchange on cash and cash equivalents | (486) | **(1,274)** | – | **(1,760)** | – |
| Changes in non-cash working capital | (3,181) | **(1,302)** | | **(7,525)** | – |
| | (5,259) | **(4,522)** | (5,545) | **(17,309)** | (56,633) |
| Increase/(decrease) in cash | (2,976) | **(926)** | (4,008) | **(8,626)** | 12,752 |
| Cash and cash equivalents at beginning of period | 10,027 | **7,051** | 18,759 | **14,751** | 1,999 |
| Cash and cash equivalents at end of period | 7,051 | **6,125** | 14,751 | **6,125** | 14,751 |

## Financial Instruments

The Company is exposed to financial risks due to the nature of its business and the financial assets and liabilities that it holds. The following discussion reviews material financial risks, quantifies the associated exposures, and explains how these risks, and the Company's capital are managed.

### Market risk

Market risk is the risk that changes in market prices, such as commodity prices, foreign exchange rates and interest rates will affect the Company's income or the value of the financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return.

### Commodity price risk

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for oil and natural gas are impacted by not only the relationship between the United States dollar and other currencies but also world economic events that impact the perceived levels of supply and demand. The Company may hedge some oil and natural gas sales through the use of various financial derivative forward sales contracts and physical sales contracts. The Company's production is sold on the daily average price. The Company, however, may give consideration in certain circumstances to the appropriateness of entering into long term, fixed price marketing contracts. The Company will not enter into commodity contracts other than to meet the Company's expected sale requirements.

At December 31, 2011 the Company did not have any outstanding hedges in place.

**Foreign currency risk**

Currency risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in foreign exchange rates. The reporting and functional currency of the Company is United States dollars (US$). Substantially all of the Company's operations are in foreign jurisdictions and as a result, the Company is exposed to foreign currency exchange rate risk on some of its activities primarily on exchange fluctuations between the Canadian dollar (CDN$) and the US$. The majority of capital expenditures are incurred in US$ and oil revenues are received in US$ therefore reducing the Company's exposure to foreign exchange.

The table below shows the Company's exposure to foreign currencies for its financial instruments:

| | | US$ | EGP | EUR | CAD |
|---|---|---|---|---|---|
| As at December 31, 2011 | *Total per FS* [1] | *US$ Equivalent* | | | |
| Cash and cash equivalents | 6,125 | 5,777 | 11 | 92 | 245 |
| Trade and other receivables | 12,230 | 12,146 | – | 13 | 71 |
| Bank indebtedness | (3,000) | (3,000) | – | – | – |
| Trade and other payables | (3,786) | (3,007) | | (66) | (713) |
| Balance sheet exposure | **11,569** | **11,916** | **11** | **39** | **(397)** |

[1] *denotes Financial Statements*

The average exchange rate during the twelve months ended December 31, 2011 was 1 US$ equals $1.0117 CDN$ (2010 – 1 US$: $0.9713 CDN$) and the exchange rate at December 31, 2011 was 1 US$ equals $0.9833 Canadian dollar (2010 – 1 US$: $1.0054 CDN$).

## Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint venture partners, oil and natural gas marketers, and cash held with banks. The maximum exposure to credit risk at the end of the period is as follows:

| | CARRYING AMOUNT | | |
|---|---|---|---|
| | **December 30, 2011** | December 31, 2010 | January 1, 2010 |
| Cash and cash equivalents | **6,125** | 14,751 | 1,999 |
| Trade and other receivables | **12,230** | 6,194 | 2,282 |
| Total | **18,355** | 20,945 | 4,281 |

## Trade and other receivables:

All of the Company's operations are conducted in Egypt. The Company's exposure to credit risk is influenced mainly by the individual characteristics of each counter party. Receivables relating to oil and gas sales are due from Ganope and EGPC, two Government of Egypt controlled corporations and are normally collected in six to eight months following production. The Company expects to collect the outstanding receivables in the normal course of operations.

The maximum exposure to credit risk for loans and receivables at the reporting date by type of customer was:

| | CARRYING AMOUNT | | |
|---|---|---|---|
| | **December 31, 2011** | December 31, 2010 | January 1, 2010 |
| Government of Egypt controlled corporations | **11,215** | 5,586 | 2,572 |
| Joint venture partners | **677** | 282 | (353) |
| Other | **338** | 326 | 63 |
| Total trade and other receivables | **12,230** | 6,194 | 2,282 |

The Company's most significant customer, a government controlled corporation in Egypt, accounts for $7.6 million of the trade receivables at December 31, 2011 (December 31, 2010: $4.3 million).

As at December 31, 2011 and 2010, the Company's trade and other receivables is aged as follows:

| | 2011 | 2010 |
|---|---|---|
| Current (less than 90 days) | **7,646** | 4,144 |
| Past due (more than 90 days) | **4,584** | 2,050 |
| Total | **12,230** | 6,194 |

Subsequent to December 31, 2011 the Company collected $4.0 million from government of Egypt controlled corporations.

### Cash and cash equivalents:

The Company limits its exposure to credit risk by only investing in liquid securities and only with highly rated counterparties. The Companies cash and cash equivalents are currently held by banks with AA or equivalent credit ratings or better. Given these credit ratings, management does not expect any counterparty to fail to meet its obligations.

The Company defines and computes its capital as follows:

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Equity | **68,877** | 81,007 |
| Working capital (1) | **(11,939)** | (15,670) |
| Total capital | **56,938** | 65,337 |

The Company's objective when managing its capital is to ensure it has sufficient capital to maintain its ongoing operations, pursue the acquisition of interests in producing or near to production oil and gas properties and to maintain a flexible capital structure which optimizes the cost of capital at an acceptable risk. The Company manages its capital structure and makes adjustments to it, based on the funds available to the Company, in order to support the exploration and development of its interests in its existing properties and to pursue other opportunities.

## SUMMARY OF QUARTERLY RESULTS

| FISCAL YEAR | 2011 | | | | 2010 | | | |
|---|---|---|---|---|---|---|---|---|
| *Financial $000's* | **Q4** | Q3 | Q2 | Q1 | Q4 | Q3 | Q2 | Q1 |
| Cash, beginning of period | **7,051** | 10,027 | 11,534 | 14,751 | 18,449 | 21,107 | 5,202 | 1,999 |
| Cash, end of period | **6,125** | 7,051 | 10,027 | 11,534 | 14,751 | 18,449 | 21,107 | 5,202 |
| Working capital | **11,939** | 14,290 | 13,988 | 14,670 | 15,670 | 20,825 | 23,311 | 4,388 |
| Funds from operations | **509** | 2,158 | 948 | 2,010 | 127 | 766 | 690 | 29 |
| per share | **–** | – | – | 0.01 | – | – | – | – |
| Net Income/(Loss) | **(14,839)** | 1,143 | (78) | 487 | (711) | (803) | (708) | (822) |
| per share | **(0.04)** | – | – | – | – | – | – | – |
| Capital expenditures | **1,892** | 1,592 | 1,626 | 2,914 | 5,545 | 3,982 | 45,702 | 1,404 |
| Total assets | **75,663** | 88,310 | 86,098 | 87,234 | 86,282 | 85,393 | 84,204 | 35,602 |
| Shareholders' equity | **68,877** | 83,082 | 81,698 | 81,669 | 81,007 | 81,290 | 81,540 | 32,026 |
| Common shares outstanding *(000's)* | **376,459** | 376,459 | 376,459 | 376,459 | 376,459 | 375,959 | 375,704 | 208,430 |
| Warrants outstanding *(000's)* | **30,000** | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,255 | 32,185 |
| Operational | | | | | | | | |
| Oil sales *(bbl/d)* | **991** | 1,066 | 1,094 | 1,178 | 995 | 1,190 | 1,032 | 786 |
| Brent oil price *($/bbl)* | **109.38** | 113.35 | 116.84 | 105.87 | 87.34 | 76.92 | 79.41 | 77.37 |
| Realized oil price *($/bbl)* | **104.54** | 108.44 | 111.77 | 100.12 | 82.34 | 72.01 | 75.90 | 68.68 |
| Royalties *($/bbl)* | **51.72** | 56.13 | 62.46 | 46.90 | 40.23 | 38.47 | 40.87 | 44.38 |
| Operating costs *($/bbl)* | **12.07** | (1.62) | 10.63 | 9.51 | 13.85 | 7.56 | 10.36 | 5.02 |
| Netback *($/bbl)* | **40.75** | 53.93 | 38.68 | 43.71 | 28.26 | 25.98 | 24.67 | 19.28 |

The increase in oil sales from 2010 is due to the purchase of Kom Ombo in late April 2010. In addition to increased volumes, the realized oil price has increased due to the rising Brent oil price beginning in the third quarter of 2010 through to late April 2011. Prices decreased slightly after that but exited the year 13 percent higher than when the year started. There was a decrease in production volumes during Q4 due to water injector wells drilled in NW Gemsa which are not yet on production. In Q3 there was a decrease in operating expenses due to an adjustment owing to new information which resulted in increased net income, funds flow from operations and netback. The decrease in net income for Q4 is primarily due to the impairment which was recorded on Kom Ombo Concession for $13.6 million. The Company funded the purchase of both assets from cash on hand and the issuance of equity in the fourth quarter of 2009 and second quarter of 2010.

## CONTRACTUAL OBLIGATIONS, COMMITMENTS AND CONTINGENCIES

### Contractual obligation and commitments

Pursuant to concession agreements in Egypt, the Company is required to perform certain minimum exploration activities that include the drilling of exploration wells. These obligations have not been provided for in the financial statements.

The following are the anticipated payments under the contracts:

| | 2011 | 2010 |
|---|---|---|
| Less than one year | **750** | 1,000 |
| Between one and five years | **–** | – |
| More than five years | **–** | – |
| | **750** | 1,000 |

### Operating leases

The Company has office lease commitments in Calgary, Paris and Cairo. Non-cancellable operating lease rentals are payable as follows:

| | 2011 | 2010 |
|---|---|---|
| Less than one year | **465** | 397 |
| Between one and five years | **1,429** | 1,429 |
| More than five years | **731** | 744 |
| | **2,625** | 2,570 |

### Contingencies

On April 16, 2010, a statement of claim (the "Claim") was filed in the province of Alberta against the Company in which the plaintiffs allege, among other things, that the actions of the Company contributed to the plaintiffs not being recognized for a 25% interest in the EWA Concession Agreement. The plaintiffs seek injunctions and damages of $32.0 million as compensation. On February 3, 2011, the Alberta Court of Queen's Bench granted an application by the Company to stay the Court proceedings in respect of this Claim, on the grounds that the Claim is subject to an arbitration agreement and an arbitration tribunal has previously been appointed to adjudicate the same subject matter as the Claim. The arbitration has itself been stayed since April 2009, due to the failure by the plaintiffs to pay a deposit required by the arbitration tribunal for the arbitrator's fees and expenses.

The Company believes this Claim to be without merit and it is not likely that a loss will be incurred, therefore no provision has been made in the financial statements for this claim. Any such loss will be recognized in the period it becomes likely to occur.

## ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

The Company has prepared its December 31, 2011 Audited Consolidated Financial Statements in accordance with IFRS 1, First-time Adoption of International Financial Reporting Standards, and with IAS-34, Interim Financial Reporting, as issued by the IASB.

The Company's IFRS accounting policies are provided in Note 3 of the Consolidated Financial Statements. In addition, Note 27 to the Consolidated Financial Statements presents reconciliations between the Company's 2010 Canadian GAAP results and the 2010 IFRS results.

The following discussion explains the significant differences between Sea Dragon's previous GAAP accounting policies and those applied by the Company under IFRS.

## ACCOUNTING POLICY CHANGES

IFRS policies have been retrospectively and consistently applied except where specific IFRS 1 optional and mandatory exemptions permitted an alternative treatment upon transition to IFRS for first-time adopters.

The most significant changes to the Company's accounting policies relate to the accounting for Property, Plant and Equipment ("PP&E"). Under Canadian GAAP, Sea Dragon followed the Canadian Institute of Chartered Accountants ("CICA") guideline on full cost accounting in which all costs directly associated with the acquisition of, the exploration for, and the development of oil assets were capitalized. Costs accumulated were depleted using the unit-of-production method based on proved reserves determined using estimated future prices and costs. Upon transition to IFRS, the Company was required to adopt new accounting policies for PP&E, including exploration and evaluation costs and development costs.

Under IFRS, exploration and evaluation costs are those expenditures for an area where technical feasibility and commercial viability has not yet been determined. Development costs include those expenditures for areas where technical feasibility and commercial viability has been determined. Sea Dragon adopted the IFRS 1 exemption whereby the Company deemed its January 1, 2010 IFRS PP&E costs to be equal to its previous GAAP historical PP&E net book value. Accordingly, exploration and evaluation costs were deemed equal to the unproved properties balance and the development costs were deemed equal to the PP&E cost pool balance. Under IFRS, exploration and evaluation costs are presented as exploration and evaluation assets and development costs are presented within property, plant and equipment on the balance sheet.

### Exploration and Evaluation

Exploration and evaluation assets at January 1, 2010 were deemed to be $nil, representing the unproved properties balance under Canadian GAAP. This did result in a reclassification of $22.2 million from property, plant and equipment to exploration and evaluation assets on Sea Dragon's Balance Sheet as at December 31, 2010. As at December 31, 2010 the Company's exploration and evaluation assets were $22.2 million. The remaining full cost pool was allocated to the development assets pro rata using the estimated proved plus probable reserve values.

Under previous CGAAP, exploration and evaluation costs were capitalized as property, plant and equipment in accordance with the CICA's full cost accounting guidelines. Under IFRS, Sea Dragon capitalizes these costs initially as exploration and evaluation assets. Once technical feasibility and commercial viability of the area has been determined, the capitalized costs are transferred from exploration and evaluation assets to property, plant and equipment. Under IFRS, unrecoverable exploration and evaluation costs associated with an area and costs incurred prior to obtaining the legal rights to explore are expensed. During the twelve months ended December 31, 2010, Sea Dragon expensed $0.3 million of unsuccessful exploration and evaluation assets.

### Depreciation, Depletion and Amortization

Development costs at January 1, 2010 were deemed to be $14.4 million, representing the full cost pool balance under previous GAAP. Consistent with previous GAAP, these costs are capitalized as property, plant and equipment under IFRS. Under previous GAAP, development costs were depleted using the unit-of production method based on estimated proved reserves and calculated for the full cost pool. Under IFRS, development costs are depleted using the unit-of-production method based on estimated proved plus probable reserves and calculated at the established area level. Depleting at an area level under IFRS resulted in a $2.6 million decrease to Sea Dragon's DD&A expense for the twelve months ended December 31, 2010.

### Impairments

Under previous GAAP, impairment was recognized if the carrying amount exceeded the undiscounted cash flows from proved reserves. Impairment was measured as the amount by which the carrying value exceeded the sum of the fair value of the proved and probable reserves and the costs of unproved properties. Impairments recognized under previous GAAP were not reversed. Under IFRS, impairment is recognized if the carrying value exceeds the recoverable amount for a cash-generating unit. Operations are aggregated into cash-generating units based on their ability to generate largely independent cash flows. If the carrying value of the cash-generating unit exceeds the recoverable amount, the cash-generating unit is written down with an impairment recognized in net earnings. Impairments recognized under IFRS are reversed when there has been a subsequent increase in the recoverable amount. Impairment reversals are recognized in net earnings and the carrying amount of the cash-generating unit is increased to its revised recoverable amount as if no impairment had been recognized for the prior periods.

### Share-based payments

Under previous GAAP, Sea Dragon accounted for certain stock-based compensation plans using the Black Scholes option pricing model, whereby the compensation costs were amortized over the vesting period of the fair value of stock options.

For the stock-based compensation plan, IFRS requires the liability for share-based payments be fair valued using an option pricing model, such as the Black-Scholes-Merton model, at each reporting date. Accordingly, upon transition to IFRS, the Company recorded a fair value adjustment of $0.4 million as at January 1, 2010 to increase the share-based compensation liability with a corresponding charge to retained earnings. Sea Dragon elected to use the IFRS 1 exemption whereby the liabilities for share-based payments that had vested or settled prior to January 1, 2010 were not required to be retrospectively restated. Subsequent IFRS fair value adjustments are recorded through administrative expenses with an offsetting adjustment to the contributed surplus.

**Foreign Currency**

As permitted by IFRS 1, the Company elected to apply the exemption to set the cumulative foreign currency translation adjustment to zero upon transition to IFRS. Accordingly, $5.8 million was recognized as an adjustment to retained earnings on January 1, 2010.

**Income Tax**

The determination of the Company's income and other tax assets or liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax asset or liability may differ significantly from that estimated and recorded.

**Other Exemptions**

Other significant IFRS 1 exemptions taken by Sea Dragon at January 1, 2010 include the following:

- Business combinations and joint ventures entered into prior to January 1, 2010 were not retrospectively restated under IFRS.

## RECENT ACCOUNTING PRONOUNCEMENTS

All accounting standards effective for periods beginning on or after January 1, 2011 have been adopted as part of the transition to IFRS. The following new IFRS pronouncements have been issued but are not effective and may have an impact on the Company:

As of January 1, 2013, Sea Dragon will be required to adopt IFRS 9, Financial Instruments, which is the result of the first phase of the IASB's project to replace IAS 39, Financial Instruments: Recognition and Measurement. The new standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only two classification categories: amortized cost and fair value. The adoption of this standard should not have a material impact on Sea Dragon's Consolidated Financial Statements.

In May 2011, the IASB issued the following standards which have not yet been adopted by the Company: IFRS 10, Consolidated Financial Statements (IFRS 10), IFRS 11, Joint Arrangements (IFRS 11), IFRS 12, Disclosure of Interests in Other Entities (IFRS 12), IAS 27, Separate Financial Statements (IAS 27), IFRS 13, Fair Value Measurement (IFRS 13) and amended IAS 28, Investments in Associates and Joint Ventures (IAS 28). Each of the new standards is effective for annual periods beginning on or after January 1, 2013 with early adoption permitted. The Company has not yet begun the process of assessing the impact that the new and amended standards will have on its financial statements or whether to early adopt any of the new requirements.

The following is a brief summary of the new standards:

**IFRS 10 – Consolidation**

IFRS 10 requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC-12 Consolidation—Special Purpose Entities and parts of IAS 27 Consolidated and Separate Financial Statements.

**IFRS 11 - Joint Arrangements**

IFRS 11 requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity account for interests in joint ventures. IFRS 11 supersedes IAS 31, Interests in Joint Ventures, and SIC-13, Jointly Controlled Entities—Non-monetary Contributions by Venturers.

**IFRS 12 – Disclosure of Interests in Other Entities**

IFRS 12 establishes disclosure requirements for interests in other entities, such as joint arrangements, associates, special purpose vehicles and off balance sheet vehicles. The standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities.

**IFRS 13 - Fair Value Measurement**

IFRS 13 is a comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and in many cases does not reflect a clear measurement basis or consistent disclosures.

**Amendments to Other Standards**

In addition, there have been amendments to existing standards, including IAS 27, Separate Financial Statements (IAS 27), and IAS 28, Investments in Associates and Joint Ventures (IAS 28). IAS 27 addresses accounting for subsidiaries, jointly controlled entities and associates in non-consolidated financial statements. IAS 28 has been amended to include joint ventures in its scope and to address the changes in IFRS 10 – 13.

## BUSINESS RISK ASSESSMENT

There are a number of inherent business risks associated with oil and gas operations and development. Many of these risks are beyond the control of management. The following outlines some of the principal risks and their potential impact to the Company.

### Political Risk

Sea Dragon operates in Egypt which has different political, economic and social systems than in North America and which subject the Company to a number of risks not within the control of the Company. Exploration or development activities in such countries may require protracted negotiations with host governments, national oil companies and third parties and are frequently subject to economic and political considerations such as taxation, nationalization, expropriation, inflation, currency fluctuations, increased regulation and approval requirements, corruption and the risk of actions by terrorist or insurgent groups, changes in laws and policies governing operations of foreign-based companies, economic and legal sanctions and other uncertainties arising from foreign governments, any of which could adversely affect the economics of exploration or development projects.

### Financial Resources

The Company's cash flow from operations may not be sufficient to fund its ongoing activities and implement its business plans. From time to time the Company may enter into transactions to acquire assets or the shares of other companies. Depending on the future exploration and development plans, the Company may require additional financing, which may not be available or, if available, may not be available on favorable terms. Failure to obtain such financing on a timely basis could cause the Company to forfeit its interest in certain properties, miss certain acquisition opportunities and reduce or terminate operations. If the revenues from the Company's reserves decrease as a result of lower oil prices or otherwise, it will impact its ability to expend the necessary capital to replace its reserves or to maintain its production. If cash flow from operations are not sufficient to satisfy capital expenditure requirements, there can be no assurance that additional debt, equity, or asset dispositions will be available to meet these requirements or available on acceptable terms. In addition, cash flow is influenced by factors which the Company cannot control, such as commodity prices, exchange rates, interest rates and changes to existing government regulations and tax and royalty policies.

## Exploration, Development and Production

The long-term success of Sea Dragon will depend on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. These risks are mitigated by Sea Dragon through the use of skilled staff, focusing exploration efforts in areas in which the Company has existing knowledge and expertise or access to such expertise, using up-to-date technology to enhance methods, and controlling costs to maximize returns. Despite these efforts, oil and natural gas exploration involves a high degree of risk, which even a combination of experience, knowledge and careful evaluation may not be able to overcome. There is no assurance that Sea Dragon will be able to locate satisfactory properties for acquisition or participation or that the Company's expenditures on future exploration will result in new discoveries of oil or natural gas in commercial quantities. It is difficult to accurately project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions such as over-pressured zones, 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.

Future oil and gas exploration may involve unprofitable efforts, not only from dry wells, but from wells that are productive but do not produce sufficient net revenues to return a profit after drilling, operating and other costs. Completion of a well does not assure a profit on the investment or recovery of drilling, completion, infrastructure and operating costs. In addition, drilling hazards and/or environmental damage could greatly increase the costs 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-in of wells resulting from extreme weather conditions or natural disasters, insufficient transportation capacity or other geological and mechanical conditions. As well, approved activities may be subject to limited access windows or deadlines which may cause delays or additional costs. 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.

The nature of oil and gas operations exposes Sea Dragon to risks normally incident to the operation and development of oil and natural gas properties, including encountering unexpected formations or pressures, blow-outs, and fires, all of which could result in personal injuries, loss of life and damage to the property of the Company and others. The Company has both safety and environmental policies in place to protect its operators and employees, as well as to meet the regulatory requirements in those areas where it operates. In addition, the Company has liability insurance policies in place, in such amounts as it considers adequate. The Company will not be fully insured against all of these risks, nor are all such risks insurable.

## Oil and Natural Gas Prices

The price of oil and natural gas will fluctuate based on factors beyond the Company's control. These factors include demand for oil and natural gas, market fluctuations, the stability of regional state-owned monopolies to control gas prices, the proximity and capacity of oil and natural gas pipelines and processing equipment and government regulations, including regulations relating to environmental protection, royalties, allowable production, pricing, importing and exporting of oil and natural gas. Fluctuations in price will have a positive or negative effect on the revenue to be received by the Company.

## Reserve Estimates

There are numerous uncertainties inherent in estimating quantities of oil, natural gas and natural gas liquids, reserves and cash flows to be derived there from, including many factors beyond the Company's control. In general, estimates of economically recoverable oil and natural gas reserves and the future net cash flows there from are based upon a number of variable factors and assumptions, such as historical production from the properties, production rates, ultimate reserve recovery, timing and amount of capital expenditures, marketability of oil and natural gas, royalty rates, the assumed effects of regulation by governmental agencies and future operating costs, all of which may vary from actual results. All such estimates are to some degree speculative, and classifications of reserves are only attempts to define the degree of speculation involved. For those reasons, estimates of the economically recoverable oil 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 there from prepared by different engineers, or by the same engineers at different times, may vary. The Company's actual production, revenues and development and operating expenditures with respect to its reserves will vary from estimates thereof and such variations could be material.

Estimates of proved reserves that may be developed and produced in the future are often based upon volumetric calculations and upon analogy to similar types of reserves rather than actual production history. Estimates based on these methods are generally less reliable than those based on actual production history. Subsequent evaluation of the same reserves based upon production history and production practices will result in variations in the estimated reserves and such variations could be material.

The Company's actual future net cash flows as estimated by independent reserve engineers will be affected by many factors which include, but are not limited to: actual production levels; supply and demand for oil and natural gas; curtailments or increases in consumption by oil and natural gas purchasers; changes in governmental regulation; taxation changes; the value of the Canadian dollar and US$; and the impact of inflation on costs.

Actual production and cash flows derived there from will vary from the estimates contained in the applicable engineering reports. The reserve reports are based in part on the assumed success of activities the Company intends to undertake in future years. The reserves and estimated cash flows to be derived there from contained in the engineering reports will be reduced to the extent that such activities do not achieve the level of success assumed in the calculations.

### Reliance on Operators and Key Employees

To the extent the Company is not the operator of its oil and natural gas properties, the Company will be dependent on such operators for the timing of activities related to such properties and will largely is unable to direct or control the activities of the operators. In addition, the success of the Company will be largely dependent upon the performance of its management and key employees. The Company has no key-man insurance policies, and therefore there is a risk that the death or departure of any member of management or any key employee could have a material adverse effect on the Company.

### Government Regulations

The Company may be subject to various laws, regulations, regulatory actions and court decisions that can have negative effects on the Company. Changes in the regulatory environment imposed upon Sea Dragon could adversely affect the ability of the Company to attain its corporate objectives. The current exploration, development and production activities of the Company require certain permits and licenses from governmental agencies and such operations are, and will be, governed by laws and regulations governing exploration, development and production, labor laws, waste disposal, land use, safety, and other matters. There can be no assurance that all licenses and permits that the Company may require to carry out exploration and development of its projects will be obtainable on reasonable terms or on a timely basis, or that such laws and regulation would not have an adverse effect on any project that the Company may undertake.

### Environmental Factors

All phases of the Company's operations are subject to environmental regulation in Egypt. Environmental legislation is evolving in a manner which requires stricter standards and enforcement, increased fines, and penalties for non-compliance, more stringent environmental assessments of proposed projects and a heightened degree of responsibility for companies and their officers, directors and employees.

### Insurance

The Company's involvement in the exploration for and development of oil and natural gas properties may result in the Company or its subsidiaries, as the case may be, becoming subject to liability for pollution, blow-outs, property damage, personal injury or other hazards. Prior to drilling, the Company or the operator will obtain insurance in accordance with industry standards to address certain of these risks. However, such insurance has limitations on liability that may not be sufficient to cover the full extent of such liabilities. In addition, such risks may not in all circumstances be insurable or, in certain circumstances, the Company or its subsidiaries, as the case may be, may elect not to obtain insurance to deal with specific risks due to the high premiums associated with such insurance or other reasons. The occurrence of a significant event that the Company may not be fully insured against, or the insolvency of the insurer of such event, could have a material adverse effect on the Company's financial position.

### Regulatory Matters

The Company's operations will be subject to a variety of federal and provincial or state laws and regulations, including income tax laws and laws and regulations relating to the protection of the environment. The Company's operations may require licenses from various governmental authorities and there can be no assurance that the Company will be able to obtain all necessary licenses and permits that may be required to carry out planned exploration and development projects.

## Operating Hazards and Risks

Exploration for natural resources involves many risks, which even a combination of experience, knowledge and careful evaluation may not be able to overcome. Operations in which the Company has a direct or indirect interest will be subject to all the hazards and risks normally incidental to exploration, development and production of resources, any of which could result in work stoppages, damages to persons or property and possible environmental damage.

Although the Company has obtained liability insurance in an amount it considers adequate, the nature of these risks is such that liabilities might exceed policy limits, the liabilities and hazards might not be insurable, or the Company might not elect to insure itself against such liabilities due to high premium costs or other reasons, in which event the Company could incur significant costs that could have a material adverse effect upon its financial condition.

## Repatriation of earnings

Currently there are no restrictions on the repatriation from Egypt of earnings to foreign entities. However, there can be no assurance those restrictions on repatriation of earnings from Egypt will not be imposed in the future.

## Disruptions in Production

Other factors affecting the production and sale of oil and gas that could result in decreases in profitability include: (i) expiration or termination of permits or licenses, or sales price redeterminations or suspension of deliveries; (ii) future litigation; (iii) the timing and amount of insurance recoveries; (iv) work stoppages or other labor difficulties; (v) changes in the market and general economic conditions, equipment replacement or repair, fires, civil unrest or other unexpected geological conditions that can have a significant impact on operating results.

## Foreign Investments

All of the Company's oil investments are located outside of Canada. These investments are subject to the risks associated with foreign investment including tax increases, royalty increases, re-negotiation of contracts, currency exchange fluctuations and political uncertainty. The jurisdiction in which the Company operates, Egypt, has a well established fiscal regime and there are some improved fiscal terms to encourage investments. Sea Dragon will be paid in US dollars on its oil and gas sales.

As operations are primarily carried out in US dollars, the main exposure to currency exchange fluctuations is the conversion to equivalent Canadian funds for reporting purposes.

## Competition

The Company operates in the highly competitive areas of oil and gas exploration, development and acquisition with a substantial number of other companies, including U.S.-based and foreign companies doing business in Egypt. The Company faces intense competition from independent, technology-driven companies as well as from both major and other independent oil and gas companies in seeking oil and gas exploration licences and production licences in Egypt; and acquiring desirable producing properties or new leases for future exploration.

The Company believes it has significant in-country relationships within the business community and government authorities needed to obtain cooperation to execute projects.

## Disclosure Controls and Procedures

As the Company is classified as a Venture Issuer under applicable Canadian securities legislation, it is required to file basic Chief Executive Officer and Chief Financial Officer Certificates, which it has done for the year ended December 31, 2011. The Company makes no assessment relating to establishment and maintenance of disclosure controls and procedures and internal controls over financial reporting as defined under Multilateral Instrument 52-109 as at December 31, 2011.