



Audited Financial Statements  
As at December 31, 2008 and 2007 and for the years then ended

## **Management's Report**

The accompanying financial statements of MGM Energy Corp. (the "Company") are the responsibility of Management and have been approved by the Board of Directors. The financial statements have been prepared by Management in Canadian dollars and in accordance with Canadian Generally Accepted Accounting Principles and include certain estimates that reflect Management's best judgments. When alternative accounting methods exist, Management has chosen those it considers most appropriate in the circumstances. These financial statements have been prepared on a carve-out basis from Paramount Resources Ltd. as described in Note 2 to the financial statements.

Management is also responsible for establishing and maintaining adequate internal control over the Company's financial reporting. The Company's internal control system was designed to provide reasonable assurance that all transactions are accurately recorded to permit preparation of financial statements in accordance with Generally Accepted Accounting Principles, and that the Company's assets are safeguarded.

The Board of Directors is responsible for ensuring that Management fulfills its responsibilities for financial reporting and internal control. The Board of Directors exercises this responsibility through the Audit Committee. The Audit Committee meets regularly with Management and the independent auditors to ensure that Management's responsibilities are properly discharged and to review the financial statements. The Audit Committee reports its findings to the Board of Directors for consideration when approving the financial statements for issuance to the shareholders. The Audit Committee also considers, for review by the Board of Directors and approval by the shareholders, the engagement or re-appointment of the external auditors. The Audit Committee of the Board of Directors is comprised entirely of independent directors.

Ernst & Young LLP, independent auditors appointed by the shareholders of the Company, conducts an examination of the financial statements in accordance with Canadian generally accepted auditing standards. Ernst & Young LLP has full and free access to the Audit Committee and Management.

/s/ Clayton H. Riddell  
**Clayton H. Riddell**  
**Chief Executive Officer**

/s/ Richard N. Miller  
**Richard N. Miller**  
**Chief Financial Officer**

March 5, 2009

## **Auditors' Report**

To the Shareholders of **MGM Energy Corp.**

We have audited the balance sheets of **MGM Energy Corp.** (the "Company") as at December 31, 2008 and 2007 and the statements of loss and other comprehensive loss, statements of deficit and statements of 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 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 financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

As discussed in note 2, prior to January 12, 2007, the Spinout Assets and Ancillary Asset were properties of Paramount Resources Ltd. and had no separate legal status.

Calgary, Canada  
March 5, 2009

/s/ Ernst & Young LLP  
Chartered Accountants

**MGM Energy Corp.**  
**Balance Sheets**  
(\$000s)

As at December 31	2008	2007
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 82,001	\$ 111,301
Accounts receivable and other current assets	1,850	730
	<b>83,851</b>	112,031
<b>Property, plant and equipment</b> (Note 4)	<b>220,725</b>	237,320
<b>Future income taxes</b> (Note 9)	<b>9,014</b>	13,302
	<b>\$ 313,590</b>	\$ 362,653
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	\$ 12,628	\$ 15,799
Due to related parties (Note 12)	108	81
	<b>12,736</b>	15,880
<b>Asset retirement obligations</b> (Note 6)	<b>1,996</b>	1,172
	<b>14,732</b>	17,052
<b>Contingencies and Commitments</b> (Notes 5, 7 and 13)		
<b>Shareholders' Equity</b>		
Share capital (Note 7)	455,336	404,275
Contributed surplus (Note 8)	4,664	2,307
Deficit	(161,142)	(60,981)
	<b>298,858</b>	345,601
	<b>\$ 313,590</b>	\$ 362,653

See the accompanying notes to the financial statements.

On behalf of the Board of Directors

/s/ H. W. Sykes  
**H. W. Sykes**  
**Director**

/s/ R. B. Hodgins  
**R. B. Hodgins**  
**Director**

**MGM Energy Corp.**  
**Statements of Loss and Other Comprehensive Loss**

(\$000s, except as noted)

For the period prior to January 12, 2007, the results of operations and cash flows of MGM Energy Corp. have been prepared on a carve-out basis from Paramount Resources Ltd. as is described in Note 2. These financial statements may not be indicative of the results that would have been attained if MGM Energy Corp. had operated as a stand-alone entity for this period.

Years Ended December 31	2008	2007
		(Note 2)
<b>Revenue</b>		
Interest income	\$ 2,763	\$ 3,116
<b>Expenses</b>		
General and administrative (Note 12)	5,513	5,881
Stock-based compensation (Note 8)	2,357	2,561
Pipeline regulatory and access	55	598
Exploration	28,827	11,591
Lease rental and land costs	3,273	1,051
Dry hole (Note 4)	73,942	66,423
Write-down of petroleum and natural gas properties (Note 4)	10,000	-
Interest and financing charges	336	236
Accretion of asset retirement obligations (Note 6)	128	199
Depreciation	382	132
	<b>124,813</b>	<b>88,672</b>
<b>Loss before income tax</b>	<b>(122,050)</b>	<b>(85,556)</b>
Future income tax recovery (Note 9)	(21,889)	(23,225)
<b>Net loss and other comprehensive loss</b>	<b>\$ (100,161)</b>	<b>\$ (62,331)</b>
<b>Net loss per Common Share (\$/share)</b>		
Basic	\$ (0.52)	\$ (0.79)
Diluted	\$ (0.52)	\$ (0.79)
<b>Weighted average Common Shares outstanding (000s)</b> (Note 7)		
Basic	190,935	79,088
Diluted	190,935	79,088

**Statements of Deficit**

(\$000s)

Years Ended December 31	2008	2007
Deficit, beginning of year	\$ (60,981)	\$ -
Net loss	(100,161)	(62,331)
Allocation to net investment by Paramount Resources Ltd.	-	1,350
<b>Deficit, end of year</b>	<b>\$ (161,142)</b>	<b>\$ (60,981)</b>

See the accompanying notes to the Financial Statements.

**MGM Energy Corp.**  
**Statements of Cash Flows**

(\$000s)

For the period prior to January 12, 2007, the results of operations and cash flows of MGM Energy Corp. have been prepared on a carve-out basis from Paramount Resources Ltd. as is described in Note 2. These financial statements may not be indicative of the results that would have been attained if MGM Energy Corp. had operated as a stand-alone entity for this period.

Years Ended December 31	2008	2007
		(Note 2)
<b>Operating activities</b>		
Net loss and other comprehensive loss	\$ (100,161)	\$ (62,331)
Add (deduct):		
Stock-based compensation	2,357	2,561
Exploration	28,827	11,591
Dry hole	73,942	66,423
Accretion of asset retirement obligations (Note 6)	128	199
Asset retirement obligation expenditures	-	(405)
Write-down of petroleum and natural gas properties	10,000	-
Depreciation	382	132
Future income tax recovery	(21,889)	(23,225)
	(6,414)	(5,055)
Change in non-cash working capital (Note 11)	2,792	1,555
	(3,622)	(3,500)
<b>Financing activities</b>		
Repayment of note to Paramount Resources Ltd. resulting from Spinout transaction	-	(12,000)
Proceeds on settlement of note	-	163
Common shares issued, net of issuance costs	77,237	355,106
Net investment by Paramount Resources Ltd. for period prior to Spinout	-	3,195
	77,237	346,464
<b>Investing activities</b>		
Capital expenditures (Note 4)	(95,859)	(244,258)
Reorganization costs	-	(1,000)
Change in non-cash working capital (Note 11)	(7,056)	13,595
	(102,915)	(231,663)
(Decrease) increase in cash and cash equivalents	(29,300)	111,301
Cash and cash equivalents, beginning of year	111,301	-
<b>Cash and cash equivalents, end of year</b>	<b>\$ 82,001</b>	<b>\$ 111,301</b>
<b>Supplemental cash flow information</b> (Note 11)		

See the accompanying notes to the Financial Statements.

# NOTES TO FINANCIAL STATEMENTS

*(\$000s, except as noted)*

## 1. Structure and Formation of the Company

**MGM Energy Corp.** (“MGM Energy” or the “Company”) is an independent Canadian public company, the principal business of which is to acquire, develop, optimize, exploit and produce oil and natural gas in Northern Canada. The Company was incorporated under the *Business Corporations Act* (Alberta) (the “ABCA”) as 1278517 Alberta Ltd. on October 31, 2006. On December 4, 2006, the Company’s articles were amended to change its name to “MGM Energy Corporation” and subsequently on January 9, 2007 the articles were further amended to change its name to “MGM Energy Corp.”

### *MGM Spinout*

On January 12, 2007, Paramount Resources Ltd. (“Paramount”) completed a reorganization pursuant to a plan of arrangement under the ABCA involving Paramount, its shareholders and MGM Energy (the “MGM Spinout”).

Through the MGM Spinout:

- MGM Energy became the owner of (i) rights and obligations under a Farm-in agreement (the “Farm-in Agreement”) respecting Mackenzie Delta, Northwest Territories Exploration Licence #394, Exploration Licence #427 and Inuvik Concession Blocks 1 and 2 (the “Farm-in Properties”); (ii) oil and gas properties in the Colville Lake / Sahtu area of the Central Mackenzie Valley, Northwest Territories (the “Colville Properties”); and (iii) an interest in one well in the Cameron Hills area of the southern portion of the Northwest Territories (the “Ancillary Asset”), all of such property formerly being owned by Paramount (collectively referred to as the “Spinout Assets”);
- MGM Energy issued Paramount a demand promissory note in the principal amount of \$12.0 million, bearing interest at 10% per annum, and 18.2 million voting Class A Preferred Shares, which note was subsequently repaid by MGM Energy and which shares were subsequently converted into voting common shares of MGM Energy (“Common Shares”) on a share-for-share basis; and
- MGM Energy issued Paramount’s shareholders an aggregate of approximately 2.8 million Common Shares and approximately 14.2 million warrant units, with each warrant unit consisting of one MGM Energy short term warrant (each, a “Short Term Warrant”) and one MGM Energy longer term warrant (each, a “Longer Term Warrant”).

Each warrant entitled the holder to purchase one Common Share or one flow-through Common Share. Each Longer Term Warrant was not exercisable, and was not separable from the corresponding Short Term Warrant included in the warrant unit, unless the corresponding Short Term Warrant was exercised.

Paramount has the option, subject to certain conditions, to reacquire the Ancillary Asset from MGM Energy for \$5 million, the same price that it sold such asset to MGM Energy through the MGM Spinout (the “Repurchase Option”). Because of the nature of the Repurchase Option, for accounting purposes the Ancillary Asset is deemed to be retained by Paramount and is not reflected in the balance sheet of MGM Energy.

## NOTES TO FINANCIAL STATEMENTS

(\$000s, except as noted)

The transfer of the Spinout Assets from Paramount to MGM Energy did not result in a substantive change in ownership of the Spinout Assets and therefore the transaction was accounted for using the carrying value of the property transferred, with the exception of the amount recorded in property, plant and equipment in respect of the Ancillary Asset, which was not recorded. The carrying values of assets and related liabilities transferred to MGM Energy on January 12, 2007 were as follows:

Property, plant and equipment	\$	71,859
Asset retirement obligations		(439)
Note receivable		163
Accounts payable		(1,000)
Future income taxes		(13,369)
Net carrying value	\$	57,214

The amounts recorded in MGM Energy's financial statements in respect of consideration for the Spinout Assets on January 12, 2007 were as follows:

Note payable	\$	12,000
Common Shares		3,508
Class A Preferred Shares		41,706
Total	\$	57,214

No amounts were attributed to the Short Term Warrants or the Longer Term Warrants.

MGM Energy shared 50 percent of the costs of the MGM Spinout with Paramount. Included in the net carrying value above is \$1.0 million in respect of MGM Energy's share of such costs. The carrying value of Class A Preferred Shares was reduced by an equivalent amount.

## 2. Basis of Presentation

MGM Energy is considered to be a development stage enterprise, as it has yet to generate revenue from its planned principal operations. Similar to other development stage enterprises, the recoverability of amounts shown for property, plant and equipment are dependent upon the ability of the Company to obtain necessary financing for its planned exploration and development activities and to discover, develop, transport and market economically recoverable quantities of petroleum and natural gas. There can be no assurance, however, that the Company's efforts to obtain additional financing will ultimately be successful. As at the date of these financial statements, management is uncertain whether MGM Energy will have access to equity in 2009, whether through a marketed or bought deal financing or a rights offering, or other sources of funding such as asset sales, given the condition of the equity markets and the Company's significant decline in share price over the past year.

These financial statements are stated in Canadian dollars and have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). As described in Note 1, MGM Energy acquired the Spinout Assets from Paramount effective January 12, 2007 at which point the results of operations and cash flows accrue to the Company. These financial statements present results of operations and cash flows of the Farm-in Properties, the Colville Properties and the Ancillary Asset on a carve-out basis from Paramount as if MGM Energy had operated as a stand-alone entity subject to Paramount's control prior to January 12, 2007. Because of the nature of the

## NOTES TO FINANCIAL STATEMENTS

*(\$000s, except as noted)*

Repurchase Option, the Ancillary Asset is deemed to be retained by Paramount and has not been recorded by MGM Energy, but applicable asset retirement obligations, operating results and cash flows of the Ancillary Asset are reflected in these financial statements. The book value of the Ancillary Asset as at December 31, 2006 was \$1.6 million.

Each of Paramount's core areas has distinct operating staff, capital budgets and targets. Paramount also has shared services such as drilling, facilities and construction, accounting, land administration and corporate compliance. Historically, Paramount has maintained accounting records necessary to support its consolidated financial statements and for other internal and tax reporting purposes. Certain expenses, assets and liabilities applicable to the Spinout Assets for periods prior to January 12, 2007 were derived directly from the accounting records of Paramount, and it was necessary to allocate certain items in the manner described below.

For the period prior to January 12, 2007, the amounts for operating costs, geological and geophysical costs, dry hole costs, lease rental costs, accretion of asset retirement obligations and write-down of petroleum and natural gas properties were derived directly from the accounting records of Paramount. As the Spinout Assets have never produced, except for limited periods of testing, there were no revenue, royalties, transportation costs, or depletion and depreciation in respect of such properties. Similarly, no gains or losses associated with financial instruments related to revenue were allocated to the Spinout Assets because of their non-producing nature.

General and administrative costs incurred by Paramount for the period prior to January 12, 2007 were allocated on a pro rata basis using the estimated percentage of time spent by individual employees on the Spinout Assets during the period.

For purposes of presentation of the statement of cash flows prior to January 12, 2007, cash receipts and disbursements were deemed to be transferred to and from Paramount's corporate account concurrent with the respective inflow or outflow of cash and are presented as "Net investment by Paramount Resources Ltd."

**As a result of the basis of presentation described above, these financial statements which include the period prior to January 12, 2007 may not be indicative of the results that would have been attained if MGM Energy had operated as a stand-alone entity prior to January 12, 2007.**

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

#### **(a) *Joint Operations***

A portion of MGM Energy's activities are conducted jointly with others and accordingly, these financial statements reflect only the Company's proportionate share of any revenues, expenses, assets and liabilities.

#### **(b) *Measurement Uncertainty and Use of Estimates***

The timely preparation of these financial statements in conformity with Canadian GAAP requires that management make estimates and assumptions and use judgment that affects: (i) the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements; and (ii) the reported amounts of expenses during the reported periods. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Actual results could differ materially from these estimates.

## NOTES TO FINANCIAL STATEMENTS

*(\$000s, except as noted)*

The amounts recorded for accretion and asset retirement obligations are based on estimates of future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact of changes in these estimates and assumptions on the financial statements of future periods could be material.

### **(c) *Cash and Cash Equivalents***

Cash and cash equivalents consist of cash and short-term investments with original maturities of three months or less. The short-term investments are classified as held-to-maturity and measured at amortized cost using the effective interest method. As at December 31, 2008, cash equivalents included \$80 million (2007 - \$110 million) of investments in various short-term instruments with maturities of three months or less and which bore interest at rates between 1.46% and 2.19%.

### **(d) *Property, Plant and Equipment***

Property, plant and equipment are recorded at cost. MGM Energy follows the successful efforts method of accounting for petroleum and natural gas operations. Under this method, acquisition costs of oil and gas properties and costs of drilling and equipping development wells are capitalized. Costs of drilling exploratory wells are initially capitalized. If economically recoverable reserves are not found, such costs are charged to earnings as dry hole expense. Exploration wells are assessed annually, or more frequently as economic conditions dictate, for determination of reserves and, as such, success. Costs of drilling exploratory wells remain capitalized when a well has found a sufficient quantity of reserves to justify completion as a producing well and sufficient progress is being made to assess the reserves and the economic and operating viability of the well. All other exploration costs, including geological and geophysical costs and annual lease rentals, are charged to earnings when incurred. Producing areas and significant unproved properties are assessed annually, or more frequently as economic events dictate, for potential impairment. Any impairment loss is the difference between the carrying value of the asset and its fair value.

### **(e) *Depletion and Depreciation***

Capitalized costs of proved oil and gas properties are depleted using the unit of production method. For purposes of these calculations, natural gas volumes are converted to barrels on an energy equivalent basis.

The costs of successful exploratory wells and development wells are depleted over proved developed reserves while acquired resource properties with proved reserves are depleted over proved reserves. Acquisition costs of probable reserves are not depleted or amortized while under active evaluation for commercial reserves. Costs become subject to depletion as proved reserves are recognized. Other property, plant and equipment are depreciated over their estimated useful lives.

Costs associated with significant development projects are not depleted until commercial production commences.

### **(f) *Asset Retirement Obligations***

MGM Energy recognizes the fair value of an asset retirement obligation in the period in which it is incurred and when a reasonable estimate of the fair value can be made. The fair values of asset retirement obligations are capitalized as part of the cost of the related long-lived asset and depreciated on the same basis as the underlying asset. The accumulated asset retirement obligation is adjusted for the passage of time, which is recognized as accretion expense in the statements of loss and other comprehensive loss, and for revisions in either the timing or the amount of the original estimated cash flows associated with the liability. Actual costs incurred upon settlement of

## NOTES TO FINANCIAL STATEMENTS

*(\$000s, except as noted)*

the asset retirement obligation reduce the asset retirement obligation to the extent of the liability recorded. Differences between the actual costs incurred upon settlement of the asset retirement obligation and the liability recorded are recognized in the period in which the settlement occurs.

### **(g) Future Income Taxes**

MGM Energy follows the liability method of accounting for income taxes. Under this method, future income taxes are recognized for the effect of any difference between the carrying amount of an asset or liability reported in the financial statements and its respective tax basis, using substantively enacted income tax rates. Accumulated future income tax balances are adjusted to reflect changes in substantively enacted income tax rates, with adjustments being recognized in the results of operations in the period in which the change occurs.

### **(h) Flow-Through Shares**

MGM Energy has financed a portion of its exploration activities through the issue of flow-through shares. As permitted under the *Income Tax Act* (Canada), the tax attributes of eligible expenditures incurred with the proceeds of flow-through share issuances are renounced to subscribers. On the date that MGM Energy files the renouncement documents with the tax authorities, a future income tax liability is recognized and shareholders' equity is reduced, for the tax effect of expenditures renounced to subscribers.

### **(i) Stock-Based Compensation**

MGM Energy has granted stock options to employees and directors, the details of which are described in Note 8 (Stock-Based Compensation).

MGM Energy uses the fair value method to recognize compensation expense associated with the MGM Energy options and non-reciprocal awards of stock options previously made by Paramount to certain MGM Energy employees and officers. Fair values are determined using the Black-Scholes-Merton option pricing model and relevant assumptions on the date options are granted. Compensation costs are recognized over the vesting period of the stock options.

### **(j) Other Comprehensive Income, Financial Instruments and Hedging**

MGM Energy classifies all financial instruments into one of the following categories: loans and receivables, assets held-to-maturity, assets available-for-sale, other financial liabilities, and held-for-trading assets and liabilities.

Financial instruments that are classified as held-for-trading or available-for-sale are re-measured each reporting period at fair value with the resulting gain or loss recognized immediately in net income and other comprehensive income, respectively. All other financial instruments are initially accounted for at fair value and subsequently at amortized cost using the effective interest method with foreign exchange gains and losses recognized immediately in net income.

MGM Energy currently does not utilize hedges or other derivative financial instruments in its operations.

## NOTES TO FINANCIAL STATEMENTS

(\$000s, except as noted)

### (k) Recent Accounting Pronouncements

#### *International Financial Reporting Standards (“IFRS”)*

In February 2008, the Accounting Standards Board (“AcSB”) of the Canadian Institute of Chartered Accountants (“CICA”) confirmed that the use of IFRS will be required in 2011 for publicly accountable enterprises. In April 2008, the AcSB issued an IFRS Omnibus Exposure Draft proposing that publicly accountable enterprises be required to apply IFRS, in full and without modification, on January 1, 2011. The transition date of January 1, 2011 will require the restatement, for comparative purposes, of amounts reported by the Company for its year ended December 31, 2010, and of the opening balance sheet as at January 1, 2010. The AcSB proposes that CICA Handbook Section - Accounting Changes, paragraph 1506.30 (which would require an entity to disclose information relating to a new primary source of GAAP that has been issued but is not yet effective and that the entity has not applied) not be applied with respect to this Exposure Draft. The Company is continuing to assess the financial reporting impacts of the adoption of IFRS and, at this time, the impact on future financial position and results of operations is not reasonably determinable or estimable. Further, the Company anticipates a significant increase in disclosure resulting from the adoption of IFRS and is continuing to assess the level of this disclosure required and any necessary systems changes to gather and process the information.

#### *Capital Disclosures and Financial Instruments – Disclosure and Presentation*

Beginning in 2008, MGM Energy adopted new accounting standards for *Capital Disclosures and Financial Instruments – Disclosure and Presentation*. The new standards require companies to disclose their objectives, policies and processes for managing capital, as well as whether externally imposed capital requirements have been complied with and to provide enhanced disclosure of risks associated with financial instruments, including how these risks are managed.

### (l) Comparative Figures

Certain comparative figures have been reclassified to conform to the current period’s financial statement presentation.

## 4. Property, Plant and Equipment

	December 31, 2008			December 31, 2007
	Cost	Accumulated Depletion and Depreciation	Net Book Value	Net Book Value
Petroleum and natural gas properties	\$ 219,627	\$ -	\$ 219,627	\$ 236,719
Other	1,612	514	1,098	601
	<u>\$ 221,239</u>	<u>\$ 514</u>	<u>\$ 220,725</u>	<u>\$ 237,320</u>

As the Company is in the development stage and has no production, all capitalized costs associated with non-producing petroleum and natural gas properties are currently not subject to depletion.

## NOTES TO FINANCIAL STATEMENTS

(\$000s, except as noted)

### *Continuity of Suspended Exploratory Well Costs*

	Year Ended December 31	
	2008	2007
Balance, beginning of year	\$ 52,778	\$ 70,268
Additions pending the determination of proved reserves	15,197	7,691
Well costs charged to dry hole expense	(25,036)	(25,181)
Balance, end of year	\$ 42,939	\$ 52,778

### *Aging of Capitalized Exploratory Well Costs*

	Year Ended December 31	
	2008	2007
Exploratory well costs capitalized for a period of one year or less	\$ 15,197	\$ 7,691
Exploratory well costs capitalized for a period of greater than one year	27,742	45,087
Balance, end of year	\$ 42,939	\$ 52,778
Number of projects that have exploratory well costs that have been capitalized for a period of greater than one year	3	6

At December 31, 2008, \$42.9 million of capitalized exploratory well costs relate to the Colville Properties and the Farm-in Properties. The commerciality of the gas related to such properties is being evaluated in conjunction with the planned drilling program and anticipated timing for construction of the Mackenzie Valley Pipeline.

The dry hole expense of \$73.9 million for the year ended December 31, 2008 relates to one well drilled in the 2008/2009 winter program, three wells drilled in the 2007/08 winter program, and three wells drilled in 2004 and 2005. The dry hole expense results from the determination by MGM Energy that there are no economically recoverable reserves related to these wells.

As at December 31, 2008, MGM Energy wrote down the book value of a \$10 million land deposit, previously capitalized to property, plant and equipment, to zero.

## **5. Demand Facility**

In October 2007, MGM Energy entered into a \$30 million senior secured revolving demand facility bearing interest at the lender's prime rate or banker's acceptance rate, at the discretion of MGM Energy, plus an applicable margin. The facility is secured by a first floating debenture over all of the Company's assets. Of the \$30 million facility, up to \$10 million is available for borrowings and the entire amount is available for letters of credit. The amount available to MGM Energy under the facility is reduced dollar for dollar by any outstanding letters of credit. MGM Energy is required to repay the facility or to have funds available in cash or short-term investments at least equal to the borrowings under the facility, excluding letters of credit, for a period of three consecutive business days each quarter. In October 2008, MGM Energy obtained a temporary increase in the amount of its bank facility from \$30 million to \$40 million until April 30, 2009. The increase in the facility provides additional capacity for MGM Energy to issue letters of credit for its 2008/2009 drilling program, such letters of credit to be released at the end of the drilling season. Any usage of the facility in excess of \$30 million will be available only to the extent that MGM Energy maintains cash or cash equivalents equal to the amount of usage in excess of \$30 million. The amount available to MGM Energy on the \$10 million increase in the facility is reduced dollar for dollar by any outstanding

## NOTES TO FINANCIAL STATEMENTS

(\$000s, except as noted)

letters of credit. At December 31, 2008, there was no debt outstanding on the facility; however, there were undrawn letters of credit outstanding of \$33.0 million. All letters of credit have a term of one year or less but are automatically renewable on an annual basis for an additional year if the letter of credit is not cancelled prior to its expiry date.

### 6. Asset Retirement Obligations

	Year Ended December 31	
	2008	2007
Asset retirement obligations, beginning of year	\$ 1,172	\$ 439
Liabilities incurred	523	926
Liabilities assumed on acquisition of properties	-	1,422
Revisions in estimated cost of abandonment	173	(1,409)
Liabilities settled	-	(405)
Accretion expense	128	199
Asset retirement obligations, end of year	\$ 1,996	\$ 1,172

The total future asset retirement obligations were estimated by management based on MGM Energy's net ownership in all wells, estimated work to reclaim and abandon the wells, and the estimated timing of the costs to be incurred in future periods. The undiscounted cash flows estimated to settle the asset retirement obligations associated with MGM Energy's oil and gas properties at December 31, 2008 are \$16.1 million (2007 - \$11.3 million). The majority of these obligations are not expected to be settled for several years, or decades, and have been discounted using credit-adjusted risk-free rates between 7 7/8 percent and 10 percent, and assuming an inflation rate of 3 percent.

### 7. Share Capital

#### *Authorized*

MGM Energy's authorized capital is comprised of an unlimited number of Common Shares, 18.2 million voting Class A Preferred Shares convertible to Common Shares on a one-for-one basis without any further consideration and an unlimited number of preferred shares, issuable in series ("Preferred Shares"). All Class A Preferred Shares were converted into Common Shares on a one-for-one basis on February 16, 2007. There were no Class A Preferred Shares or Preferred Shares outstanding at December 31, 2008.

## NOTES TO FINANCIAL STATEMENTS

(\$000s, except as noted)

### Issued and Outstanding

<b>Common Shares</b>	<b>Shares</b>	<b>Amount</b>
Balance, December 31, 2006	1	\$ -
Issued on MGM Spinout	2,832,673	3,508
Cancelled on MGM Spinout	(1)	-
Issued on exercise of Short Term and Longer Term Warrants	13,824,021	76,504
Conversion of Class A Preferred Shares	18,200,000	41,706
Issued for cash	94,088,150	292,120
Share issuance costs, net of tax benefit	-	(9,563)
Balance, December 31, 2007	128,944,844	\$ 404,275
Tax adjustment on flow-through share renunciations	-	(26,982)
Issued for cash	134,250,000	80,108
Share issuance costs, net of tax benefit	-	(2,065)
<b>Balance, December 31, 2008</b>	<b>263,194,844</b>	<b>\$ 455,336</b>

In February 2007, MGM Energy completed a private placement of 210,000 Common Shares at \$5.00 per share and 160,000 Common Shares issued on a flow-through basis at \$6.25 per share, with each Common Share accompanied by one Longer Term Warrant. The gross proceeds of this issue were \$2.1 million.

In May 2007, MGM Energy issued 42,726,193 Common Shares at \$3.10 per share and 11,991,957 Common Shares issued on a flow-through basis at \$3.85 per share, for gross proceeds of \$178.6 million.

In August 2007, MGM Energy issued 33,000,000 Common Shares at \$2.75 per share and 6,000,000 Common Shares issued on a flow-through basis at \$3.45 per share, for gross proceeds of \$111.5 million.

In July 2008, MGM Energy issued 82,000,000 Common Shares at \$0.55 per share and 52,250,000 Common Shares issued on a flow-through basis at \$0.67 per share, for gross proceeds of \$80.1 million.

### Flow-Through Shares

In July 2008, MGM Energy issued a total of \$35.0 million of Common Shares on a “flow-through” basis. As a result, the Company must incur an equivalent amount of qualifying resource expenditures. At December 31, 2008, MGM Energy estimates it has incurred approximately \$19 million of qualifying expenditures relative to the flow through shares issued in July 2008. All commitments with respect to the 2007 flow-through share offerings were met by March 2008.

### Capital Disclosure

MGM Energy manages shareholders’ equity as capital. Shareholders’ equity had a book value of \$299 million as December 31, 2008. MGM Energy does not manage its revolving demand facility as capital as it is not the intent of MGM Energy at this time to use the facility to finance operations. MGM Energy’s near-term objectives regarding capital are to ensure that it has sufficient cash resources to fund its ongoing operations for at least a year and to fund any planned winter drilling and seismic programs prior to making financial commitments relating to the programs. As all of MGM Energy’s operations are located in the Northwest Territories, almost all capital expenditures will be incurred during the winter months, although the capital expenditures have to be committed to during the preceding

## NOTES TO FINANCIAL STATEMENTS

(\$000s, except as noted)

summer to ensure that equipment and services will be available. Given MGM Energy's stage of development and that there is currently no certainty regarding the completion of the Mackenzie Valley Pipeline, debt financing is not an option for MGM Energy at this time. Therefore, it is likely that all capital requirements for at least the next year will be funded from issuance of equity. On an annual basis, MGM Energy will determine the potential winter drilling and seismic programs and will proceed with those programs only to the extent that equity capital is available at a share price that is acceptable to MGM Energy. MGM Energy is not subject to any externally imposed capital requirements.

### 8. Stock-Based Compensation

#### MGM Energy Options

MGM Energy has a stock option plan (the "Plan") that enables the Board of Directors or its Compensation Committee to grant to MGM Energy employees and directors options to acquire Common Shares of the Company. The exercise price of an option is no lower than the closing market price of the Common Shares on the day preceding the date of grant. Upon exercise of options under the Plan, optionholders receive either (i) a share certificate for the Common Shares; or (ii) a cash payment in an amount equal to the positive difference, if any, between the market price and the exercise price of the number of Common Shares in respect of which the option is exercised (a "Cash Surrender"). MGM Energy, however, can refuse to accept a Cash Surrender and therefore require that the holder exercise their vested options for cash and acquire Common Shares.

MGM Energy Options	2008		2007	
	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options
	(\$ / share)		(\$ / share)	
Balance, beginning of year	3.50	3,146,000	-	-
Granted	0.46	8,651,000	3.50	3,146,000
Forfeited	1.56	(564,000)	-	-
Balance, end of year	1.30	11,233,000	3.50	3,146,000
Options exercisable, end of year	3.99	1,040,000	5.00	312,000

## NOTES TO FINANCIAL STATEMENTS

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Additional information about MGM Energy's stock options outstanding at December 31, 2008 is as follows:

Range of Exercise Prices	Number	Outstanding		Exercisable		
		Weighted Average Contractual Life	Weighted Average Exercise Price	Number	Weighted Average Contractual Life	Weighted Average Exercise Price
(\$ / share)		(years)	(\$ / share)		(years)	(\$ / share)
0.16 – 1.00	8,233,000	9.62	0.48	-	-	-
1.01 – 2.00	-	-	-	-	-	-
2.01 – 3.00	1,600,000	8.21	2.45	390,000	8.21	2.45
3.01 – 4.00	100,000	2.83	3.17	25,000	2.83	3.17
4.01 – 5.00	1,300,000	2.33	4.98	625,000	2.33	4.98
<b>Total</b>	<b>11,233,000</b>	<b>8.51</b>	<b>1.30</b>	<b>1,040,000</b>	<b>4.50</b>	<b>3.99</b>

Up to July 2007, options granted by MGM Energy had a term of approximately 4.5 years. The term of options granted subsequent to July 2007 is 10 years.

The fair value of each option granted is estimated on the grant date using the Black-Scholes-Merton option pricing model with weighted average assumptions for grants as follows:

	Year Ended December 31	
	2008	2007
Weighted average fair value of options granted (\$/option)	\$ 0.46	\$ 1.72
Risk-free interest rate	3.15%	4.22%
Expected lives (years)	7	5.63
Expected volatility	0.70	0.50
Annual dividend per share (\$/Common Share)	\$ -	\$ -

### Contributed Surplus

A reconciliation of contributed surplus is provided below.

	Year Ended December 31	
	2008	2007
Balance, beginning of year	\$ 2,307	\$ -
Stock-based compensation expense	2,357	2,561
Portion of stock-based compensation related to period prior to Spinout	-	(254)
<b>Balance, end of year</b>	<b>\$ 4,664</b>	<b>\$ 2,307</b>

## NOTES TO FINANCIAL STATEMENTS

(\$000s, except as noted)

### 9. Income Taxes

The following table reconciles income taxes calculated at the Canadian statutory rate to MGM Energy's recorded future tax recovery:

	Year Ended December 31	
	2008	2007
Loss before income tax	\$ (122,050)	\$ (85,556)
Effective Canadian statutory income tax rate	29.5%	31.0%
Expected tax recovery	\$ (36,005)	\$ (26,523)
Increase in income tax resulting from:		
Statutory and other rate differences	4,537	2,499
Net investment by Paramount Resources Ltd.	-	68
Stock-based compensation	695	715
Valuation allowance	8,559	-
Other	325	16
Future tax recovery	\$ (21,889)	\$ (23,225)

#### *Components of Future Income Tax Asset:*

	Year Ended December 31	
	2008	2007
Property, plant and equipment—carrying value deficit (excess) over tax basis	\$ (922)	\$ 2,111
Asset retirement obligations	514	302
Loss carryforwards	14,429	7,744
Share issuance costs and other	3,552	3,145
Valuation allowance	(8,559)	-
Future income tax asset	\$ 9,014	\$ 13,302

The future income tax asset at December 31, 2008 is anticipated to be reduced to nil by March 31, 2009 as a result of the renunciation of flow-through share expenditures in the first quarter of 2009.

### 10. Financial Instruments

#### *Interest rate risk*

MGM Energy is exposed to interest rate risk to the extent that changes in market interest rates impact MGM Energy's short term deposits that have floating interest rates and to the extent borrowings are made under the debt facility.

Based on the average cash and cash equivalents balance for the year ended December 31, 2008, had interest rates during the year been 100 basis points higher, assuming all other variables remained constant, the net loss before income tax for the year would have been \$0.8 million lower. An equal and offsetting impact would have occurred had interest rates been 100 basis points lower, assuming all other variables remained constant.

## NOTES TO FINANCIAL STATEMENTS

(\$000s, except as noted)

### 11. Changes in Non-Cash Working Capital

	Year Ended December 31	
	2008	2007
Accounts receivable and other current assets	\$ (1,120)	\$ (730)
Accounts payable and accrued liabilities	(3,171)	15,799
Due to related parties	27	81
	<b>\$ (4,264)</b>	<b>\$ 15,150</b>
Operating activities	\$ 2,792	\$ 1,555
Investing activities	(7,056)	13,595
	<b>\$ (4,264)</b>	<b>\$ 15,150</b>

#### *Supplemental cash flow information*

	Year Ended December 31	
	2008	2007
Interest paid	\$ -	\$ 20
Taxes paid	\$ -	\$ -

### 12. Related Party Transactions

#### *Paramount Resources Ltd.*

At December 31, 2008, Paramount held 43.9 million common shares of MGM Energy, representing 16.7 percent of the issued and outstanding common shares of MGM Energy at such time.

In addition to the common shares of MGM Energy held by Paramount, MGM Energy and Paramount have certain common members of management and directors. The following provides a summary of the related party transactions between MGM Energy and Paramount:

- For the year ended December 31, 2008, amounts billed by Paramount under a services agreement totaled \$0.2 million (2007 - \$1.1 million), including a 10 percent charge of approximately \$0.02 million (2007 - \$0.1 million), representing charges primarily for accounting, human resources and regulatory consulting services. Under the services agreement, MGM Energy pays Paramount its reasonable costs incurred in providing services to MGM Energy plus 10 percent of such costs.
- Paramount participated in the July 15, 2008 Common Share issuance, purchasing 22,363,636 Common Shares for gross proceeds of \$12.3 million.

#### *Other*

Certain directors and officers of MGM Energy participated in the July 15, 2008 Common Share issuance, purchasing 110,000 Common Shares and 30,379,850 Common Shares issued on a flow-through basis for aggregate gross proceeds to MGM Energy of \$20.4 million. In 2007, certain directors and officers of MGM Energy purchased 7,562,000 Common Shares and 4,264,935 Common Shares issued on a flow-through basis for aggregate gross proceeds to MGM Energy of \$34.6 million.

## NOTES TO FINANCIAL STATEMENTS

(\$000s, except as noted)

MGM Energy reimbursed a director and officer of MGM Energy a total of \$0.04 million for costs incurred by the director and officer for transportation services. This amount was owed at December 31, 2008. In 2007, MGM Energy purchased, at fair market value, office furniture from Trilogy Energy Trust for \$0.4 million. Trilogy Energy Trust is a related party to MGM Energy due to Paramount's ownership interest in both parties.

### 13. Contingencies and Commitments

During 2006, Paramount entered into an area-wide Farm-in Agreement respecting the Farm-in Properties. On January 12, 2007, Paramount assigned all of its rights and obligations under the Farm-in Agreement to MGM Energy through the MGM Spinout.

Under the Farm-in Agreement:

- MGM Energy can earn a staged 50 percent interest in the Farm-in Properties by drilling 11 wells within a four-year period and making certain lease continuation payments. The aggregate of such lease continuation payments will be between \$11 million and \$21 million (of which \$11 million has been paid to December 31, 2008 and up to \$10 million is to be paid in 2010);
- Approximately \$50 million of seismic must be acquired, of which approximately \$25 million has been spent to date.
- If all of the drilling commitments under the Farm-in Agreement are satisfied, MGM Energy will also earn a 50 percent interest in three discoveries previously made in the Mackenzie Delta by the counterparties to the Farm-in Agreement; and
- Of the 11 wells, MGM Energy was required to drill at least five exploratory wells; two were drilled during the 2006/2007 drilling season, and three were drilled in the 2007/2008 drilling season. As the five exploratory wells have been drilled, MGM Energy may elect to stop further drilling and earn a reduced interest in the Farm-in Properties and no interest in the three discoveries. In that event, MGM Energy would remain responsible for the continuation payments and seismic commitment referenced above.

Paramount continued to be jointly and severally liable for the obligations of MGM Energy under the Farm-in Agreement to the extent that such obligations were not satisfied by MGM Energy as long as MGM Energy was an "affiliate" of Paramount as referred to in the Farm-in Agreement. As a result of equity issuances by MGM Energy during 2007 and 2008, MGM Energy and Paramount are no longer "affiliates" as defined in the Farm-in Agreement.

At December 31, 2008, MGM Energy has the following commitments:

	2009	2010	2011	2012	2013	After 2013
Capital spending commitments	\$ 33,400	\$ 40,900	\$ 500	\$ 29,300	\$ 500	\$ -
Obligation under lease	\$ 811	\$ 936	\$ 936	\$ 936	\$ 936	\$ 468

MGM Energy is obligated under certain Northwest Territories Exploration Licences to fulfill minimum work commitments totaling \$38 million over the next five years, which are included in the above table. As a condition of the Exploration Licences, the Company was required to post security of 25 percent of these work commitments,

## **NOTES TO FINANCIAL STATEMENTS**

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equal to \$9 million in letters of credit. The posted security is released in proportion to the actual work expenditures over the life of the Exploration Licence.

### **14. Subsequent Events**

On January 20, 2009, MGM Energy announced that the first well of the 2008/09 winter drilling program, Ellice J-27, was a successful gas well.

On February 18, 2009, MGM Energy announced that the second well of the 2008/09 winter drilling program, North Ellice J-17, did not encounter any hydrocarbons. Expenditures of \$4.4 million related to this well made in 2008 are included in dry hole expense for the year ended December 31, 2008.