

# MANAGEMENT'S DISCUSSION AND ANALYSIS

For the three months and years ended  
December 31, 2010 and 2009

## FINANCIAL AND OPERATING SUMMARY

(\$000s except per share amounts)

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
<b>Financials highlights</b>						
Oil and NGL sales	15,014	9,999	50%	47,685	30,697	55%
Natural gas sales	3,322	2,934	13%	10,029	12,156	(17%)
Other revenue	208	-	nm	213	-	nm
Total oil, natural gas, and NGL revenue	18,544	12,933	43%	57,927	42,853	35%
Funds from Operations <sup>1</sup>	7,907	5,320	49%	25,688	17,492	47%
Per share basic (\$)	0.15	0.32	(53%)	0.70	1.05	(33%)
Per share diluted (\$)	0.15	0.32	(53%)	0.70	1.05	(33%)
Net loss excluding non-recurring charges relating to the recapitalization <sup>2</sup>	(4,147)	(21)	nm	(1,307)	(2,112)	(38%)
Net earning (loss)	(4,147)	(21)	nm	(10,326)	(2,112)	389%
Per share basic (\$)	(0.08)	-	nm	(0.28)	(0.13)	115%
Per share diluted (\$)	(0.08)	-	nm	(0.28)	(0.13)	115%
Corporate & asset acquisitions (cash & share consideration) <sup>3</sup>	66,239	-	nm	188,812	-	nm
Capital expenditures	26,465	5,154	414%	41,996	17,888	135%
Net debt at end of period <sup>4</sup>	46,240	46,902	(1%)	46,240	46,902	(1%)
<b>Operating highlights</b>						
Production:						
Oil and NGL (bbls per day)	2,308	1,614	43%	1,871	1,477	27%
Natural gas (mcf per day)	10,182	6,887	48%	6,930	6,995	(1%)
Total (boe per day) (6:1)	4,005	2,762	45%	3,026	2,643	14%
Average realized price (excluding hedges):						
Oil and NGL (\$per bbl)	70.70	67.35	5%	69.83	56.93	23%
Natural gas (\$ per mcf)	3.55	4.63	(23%)	3.96	4.76	(17%)
Realized gain (loss) on commodity contracts (\$ per boe)	1.92	0.54	256%	2.53	0.90	181%
Net back (excluding hedges) (\$ per boe)						
Oil, natural gas and NGL sales	50.33	50.90	(1%)	52.45	44.42	18%
Royalties	(6.43)	(5.77)	11%	(7.35)	(5.23)	41%
Operating expenses	(14.87)	(15.60)	(5%)	(15.25)	(13.52)	13%
Transportation expenses	(1.72)	(1.84)	(7%)	(2.20)	(2.03)	8%
Operating netback	27.31	27.69	(1%)	27.65	23.64	17%
G&A expenses	(5.96)	(4.32)	38%	(5.60)	(4.03)	39%
Interest expense	(0.80)	(2.37)	(66%)	(0.90)	(2.11)	(57%)
Corporate netback	20.55	21.00	(2%)	21.15	17.50	21%
<b>Common shares (000s)</b>						
Common shares outstanding, end of period	56,095	17,836	215%	56,095	17,836	215%
Weighted average basic shares outstanding	53,065	16,667	218%	36,468	16,700	118%
Stock option dilution (treasury m)	-	(69)	nm	-	-	nm
Weighted average diluted shares outstanding	53,065	16,736	217%	36,468	16,700	118%

- 1 Management uses funds from operations (before changes in non-cash working capital and non-recurring recapitalization costs) to analyze operating performance and leverage. Funds from operations as presented does not have any standardized meaning prescribed by Canadian GAAP and, therefore, may not be comparable with the calculation of similar measures for other entities.
- 2 Excluding the non-recurring recapitalization costs, as well as the increase in stock-based compensation that resulted from the recapitalization. Please see Net Income (Loss) note.
- 3 Please see capital expenditures note.
- 4 The Corporation defines net debt as outstanding bank debt plus or minus cash-based working capital.

## OVERVIEW AND HIGHLIGHTS

Surge is pleased with the transformation it has achieved since recapitalizing Zapata Energy Corporation on April 13, 2010. The Corporation is now well positioned in three exciting light oil resource plays and has commenced drilling in these key light oil resource plays late in 2010. Upon the closing of the recently announced North Dakota acquisitions expected on May 12, 2011, Surge will have: a significant undeveloped land base of more than 500,000 net acres, internally estimated DPIIP<sup>1</sup> of more than 460 million barrels (gross) and more than 460 gross (350 net) oil drilling locations.

A timeline of some of the major events in 2010 is as follows:

- March 25, 2010: Announced the recapitalization of Zapata Energy Corporation.
- April 13, 2010: Entered into a reorganization and investment agreement, completed a \$17 million non-brokered private placement in conjunction with the recapitalization of Zapata and named the new Board of Directors and management team.
- May 5, 2010: Completed a bought deal financing for total proceeds of \$50 million.
- June 25, 2010: Re-named the Corporation Surge Energy Inc. and changed the stock ticker symbol to SGY.
- July 12, 2010: Completed the acquisition of Corinthian Energy Corporation for 16.0 million common shares and the assumption of approximately \$15 million of net debt which added two high impact light oil resource plays, 125 gross (100 net) light oil horizontal drilling locations, and 80,000 acres of net undeveloped land and more than 160 million barrels (gross) of DPIIP.
- July 12, 2010: Acquired an additional 25 percent Unit Interest at Waskada in southwest Manitoba.
- July 20, 2010: Increased bank line from \$50 million to \$80 million and completed the acquisition of Crystal Lake Resources Ltd. for 0.3 million common shares.
- October 20, 2010: Completed a subscription receipt bought deal financing for gross proceeds of \$42 million.
- November 1, 2010: Completed the acquisition of a low decline light oil resource play asset with all season access at Valhalla South for \$75 million, which added 24 gross (15.3 net) light oil horizontal drilling locations and more than 100 million barrels (gross) of DPIIP and increased the bank line from \$80 million to \$90 million.
- Subsequent to the year ended December 31, 2010, Surge increased its bank line from \$90 million to \$105 million. The Corporation forecasts that its bank line will increase to \$120 million in May of 2011.
- Established a non-core dispositions package which has successfully resulted in approximately \$6.5 million of proceeds for Surge to date.

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<sup>1</sup> Discovered Petroleum Initially In Place (DPIIP) is defined as quantity of hydrocarbons that are estimated to be in place within a known accumulation, plus those estimated quantities in accumulations yet to be discovered. There is no certainty that it will be economically viable or technically feasible to produce any portion of this DPIIP except for those identified as proved or probable reserves. There is no certainty that it will be commercially viable to produce any portion of the resources.

- Executed preparation for 2011 drilling program targeting light oil, which is projected to increase operating netbacks to approximately \$47.00<sup>2</sup> by the fourth quarter of 2011 and increase light/medium oil weighting to greater than 70 percent.
- Surge had greater than 245 gross (more than 220 net) oil drilling locations in inventory at December 31, 2010, currently has more than 350 gross (more than 265 net) oil drilling locations and forecasts having more than 460 gross (more than 350 net) oil drilling locations in inventory after the closing of the previously announced acquisitions in North Dakota expected for May 12, 2011.

### ACHIEVEMENTS AND FORECAST:

- Increased production by 125 percent from approximately 2,000 boe per day shortly after the recapitalization in April 2010 to a 2010 exit production rate of more than 4,500 boe per day with a forecast to exit 2011 at 7,500 boe per day, with oil and NGL weighting increasing from 60 percent to more than 70 percent.
- Realized an average production rate of 4,005 boe per day in the fourth quarter 2010, a 45 percent increase as compared to 2009 production rate of 2,762 boe per day with a forecast to grow exit production by 67 percent to 7,500 boe/d in 2011.
- Realized an average production rate of 3,026 boe per day for the year ended December 31, 2010, a 14 percent increase as compared to the 2009 production rate of 2,643 boe per day; with a forecast to grow production by 98 percent to an average of 6,000 boe/d in 2011.
- More than 80 percent of Surge's revenue in 2010 resulted from oil and natural gas liquids production, with less than 20 percent derived from natural gas production.
- Increased Proved plus Probable reserves by 114 percent from 9.9 million boe at December 31 2009 to 21.2 million boe at December 31, 2010.
- Increased the NPV10 BT of Proved plus Probable reserves by 90 percent from \$217 million as at December 31, 2009 to \$412 million<sup>3</sup> as at December 31, 2010.
- Achieved Proved plus Probable Finding and Development ("F&D") costs of \$13.26 per boe, including a \$24.0 million change in Future Development Capital ("FDC").
- Achieved a F&D recycle ratio for 2010 of 2.1 times.
- Attained a Proved plus Probable Reserve Life Index of 12.9 years based on the Corporation's estimated 2010 exit production rate of approximately 4,500 boe per day.
- Achieved a Proved plus Probable reserves replacement ratio of 11.2 based on the Corporation's estimated 2010 average production for the year of 3,026 boe per day.
- Achieved a 100 percent success rate drilling ten gross (ten net) wells in the fourth quarter 2010; realized a gross success rate of 91 percent drilling by 22 gross (21.5 net) wells in 2010.
- Reduced operating expenses per boe by five percent and transportation expenses per boe by seven percent in the fourth quarter of 2010 as compared to the fourth quarter of 2009, with a forecast to reduce

<sup>2</sup> Based on April 18, 2011 forward strip for the fourth quarter: CDN \$103.95 Edmonton Par (US \$111.17 WTI) and CDN \$4.00/mcf AECO using a CAD/USD of \$1.0346.

<sup>3</sup> The estimated values disclosed do not represent fair market value.

combined operating and transportation costs by 21 percent to \$13.00 per boe in the fourth quarter of 2011.

- Increased Surge's operating netback by 17 percent for the year ended December 31, 2010 as compared to the year ended December 31, 2009 from \$23.64 per boe to \$27.65 per boe. Surge's fourth quarter 2011 netback is forecast to be approximately \$47.00<sup>2</sup> per boe based on recent 2011 strip oil and gas prices and as a result of the Corporation's increasing light oil weighting and decreasing costs in 2011.
- Increased funds from operations by 49 percent to \$8.0 million in the fourth quarter of 2010 from \$5.3 million in the fourth quarter of 2009. Increased funds from operations by 47 percent to \$25.7 million in 2010 from \$17.5 million in 2009 with a forecast to grow funds from operations by 189 percent to \$75 million<sup>2</sup> in 2011.

## Netback Comparison

	Q4 2010	Q3 2010	% Change
Average production (boe per day)	4,005	3,138	28%
Revenue	\$ 50.33	\$ 49.41	2%
Royalties	(6.43)	(6.07)	6%
Operating costs	(14.87)	(14.98)	(1%)
Transportation costs	(1.72)	(1.86)	(8%)
<b>Operating netback</b>	<b>\$ 27.31</b>	<b>\$ 26.50</b>	<b>3%</b>

The Corporation continued to achieve reductions in both operating costs and transportation expenses on a per boe basis in the fourth quarter of 2010 as compared to the third quarter of 2010. Surge's operating netback increased by three percent from \$26.50 in the third quarter of 2010 to \$27.31 in the fourth quarter of 2010. The management team continues to focus on finding efficiencies within existing operations and expects operating netbacks to continue to grow through 2011. Surge exited 2010 with a low decline (approximately 15 percent) oil-weighted production base of more than 4,500 boe per day and maintains a significant undeveloped land base of more than 400,000 net acres. Surge maintained approximately \$59 million of borrowing capacity at year-end on the Corporation's \$105 million bank line, with \$46 million of net debt at year-end (defined as outstanding bank debt plus or minus cash-based working capital).

## OUTLOOK

Surge has built a low decline, oil-weighted production base and positioned itself in several high impact, emerging light oil resource plays. Upon the closing of the recently announced North Dakota acquisitions expected on May 12, 2011, Surge will have: a significant undeveloped land base of more than 500,000 net acres, internally estimated DPIIP of more than 460 million barrels (gross) and more than 460 gross (350 net) oil drilling locations, comprised of 85 percent light oil, with the remainder of the inventory being medium gravity.

During 2010, since the recapitalization of Zapata on April 13, 2010, Surge has positioned itself in three high impact light oil resource plays at Valhalla South (Doig), Windfall (Bluesky) and southwest Manitoba (Spearfish), adding more than 190 gross (175 net) light oil horizontal drilling locations, 80,000 acres of net undeveloped land

<sup>2</sup> Based on April 18, 2011 forward strip: CDN \$99.06 Edmonton Par (US\$106.12 WTI) and CDN \$3.90/mcf AECO using a CAD/USD of 1.0307.

and more than 245 million barrels (gross) of DPIP. Surge has had an excellent start to 2011 and continues to implement its business plan of targeting per share growth by positioning the Corporation in high impact oil resource plays with significant oil in place and applying its proven expertise and experience to build core areas. Surge continues to demonstrate this ability with the recent announcement of its expansion into North Dakota, where the Corporation significantly strengthened its position in the Spearfish light oil resource play by adding 205 gross (120 net) light oil horizontal drilling locations on 6,000 net acres of highly prospective lands. Management estimates DPIP to be approximately 125 million barrels (gross) within these lands.

Complimenting Surge's high impact light oil resource plays at Valhalla South (Doig), Windfall (Bluesky) and southwest Manitoba/North Dakota (Spearfish) are the low cost, low decline, high rate of return oil resource assets in south east Alberta that have considerable secondary recovery potential. The infill drilling and secondary recovery programs that have been implemented to date provide significant internally generated cash flow and enable Surge to execute its capital program in each of its core areas.

In 2011, Surge will continue to grow the Corporation organically through drilling in each of its core areas, continuing the development of secondary recovery programs in southeast Alberta and by evaluating plans for secondary recovery pilot programs on its new light oil resource plays. Additionally, the Corporation will continue to make accretive acquisitions that fit its business plan of positioning Surge in high impact, emerging crude oil resource plays. Surge is committed to delivering top quartile corporate performance and creating value for shareholders by growing reserves, cash flow and production on a per share basis. Surge looks forward to applying for listing of its common shares on the TSX in the fourth quarter of 2011.

By the end of May 2011, Surge anticipates finalizing its syndicated bank facility, increasing its line of credit to \$120 million. Surge's 2010 year end net debt was \$46 million (defined as outstanding bank debt plus or minus cash-based working capital) representing 0.6 times forecast 2011 funds flow based on April 18, 2011 forward strip pricing and Surge forecasts 2011 year end net debt of \$91 million representing 0.8 times forecast annualized fourth quarter 2011 funds flow based on April 18, 2011 forward strip pricing.

Surge forecasts a 2011 capital program of \$120 million with guidance to achieve 2011 exit production of 7,500 boe per day (greater than 70 percent light/medium oil & NGLs), a 67 percent increase over 2010, with 2011 annual production of 6,000 boe per day (greater than 65 percent light/medium oil and NGLs), a 98 percent increase over 2010. Based this 2011 production guidance, Surge is forecasting an increase in funds from operations of approximately 189 percent as compared to 2010 to approximately \$75 million in 2011 (based on April 18, 2011 forward strip pricing).

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**MANAGEMENT'S DISCUSSION AND ANALYSIS**

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This Management's Discussion and Analysis (MD&A) of the consolidated financial position and results of operations of Surge Energy Inc. ("Surge" or the "Corporation"), formerly Zapata Energy Corporation, which includes its subsidiaries and partnership arrangements, is for the three months and years ended December 31, 2010 and 2009. For a full understanding of the financial position and results of operations of the Corporation, the MD&A should be read in conjunction with the documents filed on SEDAR, including historical financial statements, press releases and the Annual Information Form (AIF). These documents are available at [www.sedar.com](http://www.sedar.com).

**FORWARD-LOOKING STATEMENTS**

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This MD&A contains forward-looking statements.

More particularly, this MD&A contains statements concerning anticipated: (i) production weighting for 2011, (ii) exploration and development activities, (iii) changes to the Alberta royalty regime regulations in force, (iv) effect on Surge of anticipated changes to the Alberta royalty regime, (v) capital expenditures for 2011, (vi) sources of funding for future capital requirements, (vii) outcome and effect on Surge of outstanding legal proceedings and claims, (viii) amounts received or paid to settle financial instruments currently entered into upon maturity, and (ix) changes to accounting policies. The forward-looking statements are based on certain key expectations and assumptions made by Surge, including expectations and assumptions concerning the performance of existing wells and success obtained in drilling new wells, anticipated expenses, cash flow and capital expenditures and the application of regulatory and royalty regimes.

Although Surge believes that the expectations and assumptions on which the forward-looking statements are based are reasonable, undue reliance should not be placed on the forward-looking statements because Surge can give no assurance that they will prove to be correct. Since forward-looking statements address future events and conditions, by their very nature they involve inherent risks and uncertainties. Actual results could differ materially from those currently anticipated due to a number of factors and risks. These include, but are not limited to, risks associated with the oil and gas industry in general (e.g., operational risks in development, exploration and production; delays or changes in plans with respect to exploration or development projects or capital expenditures; the uncertainty of reserve estimates; the uncertainty of estimates and projections relating to production, costs and expenses, and health, safety and environmental risks), commodity price and exchange rate fluctuations and uncertainties resulting from potential delays or changes in plans with respect to exploration or development projects or capital expenditures. Certain of these risks are set out in more detail in this MD&A and in Surge's AIF which has been filed on SEDAR and can be accessed at [www.sedar.com](http://www.sedar.com).

The forward-looking statements contained in this MD&A are made as of the date hereof and Surge undertakes no obligation to update publicly or revise any forward-looking statements or information, whether as a result of new information, future events or otherwise, unless so required by applicable securities laws.

All amounts are expressed in Canadian dollars unless otherwise noted. Oil, natural gas and natural gas liquids reserves and volumes are converted to a common unit of measure, referred to as a barrel of oil equivalent (boe), on the basis of 6,000 cubic feet of natural gas being equal to one barrel of oil. This conversion ratio is based on an energy equivalency conversion method, primarily applicable at the burner tip and does not necessarily represent a value equivalency at the wellhead. It should be noted that the use of boe might be misleading, particularly if used in isolation.

The terms "funds from operations", "funds from operations per share", and "netback" used in this discussion are not recognized measures under Canadian generally accepted accounting principles (GAAP). Management believes that in addition to net income, funds from operations and netback are useful supplemental measures as they provide an indication of the results generated by the Corporation's principal business activities before the consideration of how those activities are financed or how the results are taxed. Investors are cautioned, however, that these measures should not be construed as alternatives to net income determined in accordance with GAAP, as an indication of Surge's performance.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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Surge's method of calculating funds from operations may differ from that of other companies, and, accordingly, may not be comparable to measures used by other companies. Surge determines funds from operations as cash flow from operating activities before changes in non-cash working capital and non-recurring recapitalization costs as follows:

(\$000s)	3 Months Ended December 31		Years Ended December 31,	
	2010	2009	2010	2009
Cash flow from operating activities (per GAAP)	594	5,732	17,137	16,341
Change in non-cash working capital	7,313	(412)	3,142	1,151
Non-recurring recapitalization costs	-	-	5,409	-
<b>Funds from operations</b>	<b>7,907</b>	<b>5,320</b>	<b>25,688</b>	<b>17,492</b>

Funds from operations per share is calculated using the weighted average basic and diluted shares used in calculating earnings per share. Operating and corporate netbacks are also presented. Operating netbacks represent Surge's revenue, excluding realized and unrealized gains or losses on commodity contracts, less royalties and operating and transportation expenses. Corporate netbacks represent Surge's operating netback, less general and administrative and interest expenses, in order to determine the amount of funds generated by production. Operating and corporate netbacks have been presented on a per barrels of oil equivalent ("boe") basis.

The term "net income (loss) before and after tax, excluding non-recurring charges relating to the recapitalization" used in this discussion is not a recognized measure under Canadian generally accepted accounting principles (GAAP). Management believes that in addition to net income, net income (loss) before and after tax, excluding non-recurring charges relating to the recapitalization is a useful supplemental measure, as it provides an indication of the results generated by the Corporation's principal business activities before the consideration of non-recurring recapitalization costs. Investors are cautioned, however, that these measures should not be construed as alternatives to net income determined in accordance with GAAP, as an indication of Surge's performance.

Excluding the non-recurring recapitalization costs, as well as the increase in stock-based compensation that resulted from the recapitalization, the Corporation's approximate net loss would have been \$4.1 million for the three months ended December 31, 2010 and \$1.3 million for the year ended December 31, 2010.

(\$000s)	3 Months Ended December 31,		Years Ended December 31,	
	2010	2009	2010	2009
Loss before taxes (per GAAP)	(3,899)	(506)	(11,147)	(3,716)
Add back:				
Recapitalization costs	-	-	5,409	-
Stock-based compensation expense relating to the recapitalization	-	-	3,610	-
Net income(loss) before tax excluding non-recurring charges relating to the recapitalization	(3,899)	(506)	(2,128)	(3,716)
Future income tax(reduction)	248	(485)	(821)	(1,604)
recurring charges relating to the recapitalization	(4,147)	(21)	(1,307)	(2,112)

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Surge's management is responsible for the integrity of the information contained in this report and for the consistency between the MD&A and financial statements. In the preparation of these statements, estimates are necessary to make a determination of future values for certain assets and liabilities. Management believes these estimates have been based on careful judgments and have been properly presented. The financial statements have been prepared using policies and procedures established by management and fairly reflect Surge's financial position, results of operations and funds from operations.

Surge's Board of Directors and Audit Committee have reviewed and approved the financial statements and MD&A. This MD&A is dated April 27, 2011.

### OPERATIONS

#### Drilling

	Drilling		Success rate (%) gross	Working interest (%)
	Gross	Net		
Q1 2010	1	0.5	100%	50%
Q2 2010	6	6	83%	100%
Q3 2010	5	5	80%	100%
Q4 2010	10	10	100%	100%
<b>Total</b>	<b>22</b>	<b>21.5</b>	<b>91%</b>	<b>98%</b>

Surge achieved a 100 percent success rate in the fourth quarter of 2010, drilling 10 gross (10 net) wells, resulting in 10 gross (10 net) oil wells. During 2010, Surge achieved a 91 percent success rate drilling 22 gross (21.5 net) wells.

#### Production

	Q4 2010	Q3 2010	Q2 2010	Q1 2010	Q4 2009	Q3 2009	Q2 2009	Q1 2009
Oil and NGL (bbls per day)	2,308	1,841	1,621	1,707	1,614	1,428	1,374	1,492
Natural gas (mcf per day)	10,182	7,783	3,823	5,874	6,887	6,294	7,586	7,223
Total (boe per day) (6:1)	4,005	3,138	2,258	2,686	2,762	2,477	2,638	2,696
% Oil and NGL	58%	59%	72%	64%	58%	58%	52%	55%

Surge achieved production of 4,005 boe per day in the fourth quarter of 2010, a 45 percent increase from the fourth quarter of 2009 production rate of 2,762 boe per day. Average production during 2010 was 3,026 boe per day as compared to 2,643 boe per day during 2009. The increase in the quarterly and year to date production volumes compared to the 2009 rates was primarily due to increased production from acquisitions and new drills and partially offset by approximately 3,000 mcf a day of gas that was shut in over the course of 2010.

Surge realized a 58 percent oil and natural gas liquids production weighting in the fourth quarter of 2010. The Corporation realized average oil and natural gas liquids production of 2,308 bbls per day for the fourth quarter of 2010.

**OIL, NATURAL GAS AND NGL, COMMODITY CONTRACTS AND OTHER REVENUES**

A one percent decrease in average revenue per boe, combined with a 45 percent increase in production, resulted in revenues of \$18.5 million in the fourth quarter of 2010, up 43 percent from \$12.9 million in the fourth quarter of 2009. During 2010, an 18 percent increase in average revenue per boe, coupled with a 14 percent increase in volume, resulted in revenues of \$57.9 million, up 35 percent from \$42.9 million during 2009.

Surge had certain oil and gas commodity contracts in place as of December 31, 2010. The Corporation recognized an unrealized loss of \$2.6 million and a realized gain of \$0.7 million on its commodity contracts in the fourth quarter of 2010. This compares to an unrealized loss of \$1.1 million and a realized gain of \$0.1 million on its commodity contracts in the fourth quarter of 2009.

Realized commodity contract gains resulted in an increase of \$1.92 per boe to the average revenue, including commodity contracts, for the fourth quarter of 2010. Realized commodity contract gains resulted in an increase of \$0.54 per boe to average revenue, including commodity contracts, for the fourth quarter of 2009.

The Corporation recognized an unrealized loss of \$2.3 million and a realized gain of \$2.8 million on its commodity contracts during 2010. This compares to an unrealized loss of \$1.2 million and a realized gain of \$0.9 million on its commodity contracts during 2009.

Please refer to the "Financial Instruments" section of this MD&A for further details on these oil and natural gas commodity contracts, and interest rate swaps.

**PRICES**

In the fourth quarter of 2010, Surge realized average revenue of \$50.33 per boe, before realized commodity contract gains, a decrease of one percent from the \$50.90 per boe recorded in the fourth quarter of 2009. During 2010, Surge realized average revenue of \$52.45 per boe, before realized commodity contract gains, an increase of 18 percent from the \$44.42 per boe recorded during 2009.

Surge realized an average of \$70.70 per bbl of oil and natural gas liquids in the fourth quarter of 2010, an increase of five percent per barrel from the \$67.35 per bbl realized in the fourth quarter of 2009. This compares to an average Edmonton Light Sweet price of \$80.33 per bbl in the fourth quarter of 2010, which increased five percent per barrel from the \$76.56 per bbl in the fourth quarter of 2009. The increase in oil and natural gas liquids prices is consistent with the increase in benchmark prices.

Surge realized an average of \$69.83 per bbl of oil and natural gas liquids during 2010, an increase of 23 percent per barrel from the \$56.93 per bbl realized during 2009. This compares to an average Edmonton Light Sweet price of \$77.48 per bbl during 2010, which increased 17 percent per barrel from the \$65.98 per bbl during 2009. The increase in oil and natural gas liquids prices is relatively consistent with the increase in benchmark prices as well as an improvement in differentials due to increased light oil production.

The Corporation realized an average natural gas price of \$3.55 per mcf in the fourth quarter of 2010, a 23 percent decrease from the \$4.63 per mcf averaged in the fourth quarter of 2009. This compares to an average Alberta Plant Gate reference price of \$3.43 per mcf in the fourth quarter of 2010 and \$4.26 per mcf in the fourth quarter of

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2009 reflecting a 19 percent decrease. The decrease in natural gas prices is relatively consistent with the decrease in benchmark prices.

The Corporation realized an average natural gas price of \$3.96 per mcf during 2010, a 17 percent decrease from the \$4.76 per mcf averaged during 2009. This compares to an average Alberta Plant Gate reference price of \$3.79 per mcf during 2010 and \$3.74 per mcf during 2009 reflecting a one percent increase. The difference in the average realized natural gas price is due to physical natural gas hedge gains included in the year ended December 31, 2009 natural gas revenue, amounting to approximately \$0.80 per mcf.

More than 80 percent of Surge's revenue resulted from oil and natural gas liquids production, with less than 20 percent derived from natural gas production.

Realized commodity contract gains resulted in an increase of \$2.53 per boe to the average revenue including commodity contracts during 2010. Realized commodity contract gains resulted in an increase of \$0.90 per boe to average revenue including commodity contracts during 2009.

### Revenue and Realized Prices

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Oil and NGL (\$000s)	15,014	9,999	50%	47,685	30,697	55%
Natural gas (\$000s)	3,322	2,934	13%	10,029	12,156	(17%)
Processing and other (\$000s)	208	-	nm	213	-	nm
Total oil, natural gas and NGL revenue (\$000s)	18,544	12,933	43%	57,927	42,853	35%
Oil and NGL (\$ per bbl)	70.70	67.35	5%	69.83	56.93	23%
Natural gas (\$ per mcf)	3.55	4.63	(23%)	3.96	4.76	(17%)
Total oil, natural gas and NGL revenue (\$ per boe)	50.33	50.90	(1%)	52.45	44.42	18%
Unrealized gain(loss) on commodity contracts (\$ per boe)	(7.19)	(4.39)	64%	(2.13)	(1.27)	68%
Realized gain(loss) on commodity contracts (\$ per boe)	1.92	0.54	256%	2.53	0.90	181%
Total oil, natural gas, and NGL revenue after commodity contracts (\$ per boe)	45.06	47.05	(4%)	52.85	44.05	20%
Reference Prices						
Edmonton par - light oil (\$ per bbl)	80.33	76.56	5%	77.48	65.98	17%
Alberta reference price (\$ per mcf)	3.43	4.26	(19%)	3.79	3.74	1%

### ROYALTIES

Surge realized royalty expense of \$2.4 million or 13 percent of revenue in the fourth quarter of 2010, compared to \$1.5 million or 11 percent of revenue in the fourth quarter of 2009. During 2010, Surge realized royalty expense of \$8.1 million or 14 percent of revenue, compared to \$5.0 million or 12 percent of revenue during 2009.

The increase in royalties as a percentage of revenue during 2010 compared to the same periods in 2009 is primarily due to \$0.5 million of prior period royalty adjustments recorded in the second quarter of 2010. Excluding these prior period adjustments, royalties would have been approximately 13 percent of revenue.

On January 1, 2009 the Alberta government's Alberta Royalty Framework (ARF) took effect. Under the ARF, royalty rates on conventional and non-conventional oil and natural gas production in Alberta may increase to a maximum of 50 percent. The sliding scale royalty calculations are based on a broader range of commodity prices and production rates.

In response to the drop in commodity prices experienced during the second half of 2008, on November 19, 2008, the Government of Alberta announced the introduction of a five year program of transitional royalty rates with the intent of promoting new drilling. Under this new program, companies drilling new natural gas or conventional oil wells (deeper than 1,000 metres and no deeper than 3,500 metres) will be given a one-time option, on a producing zone per well basis, to adopt either the new transitional royalty rates or those outlined in the ARF. In order to qualify for this program, wells must be drilled during the period starting on November 19, 2008 and ending on December 31, 2013. Following this period all new wells drilled will automatically be subject to the ARF.

On March 3, 2009, an incentive program designed to encourage the execution of new drilling projects in Alberta was announced in response to the global economic crisis and slowdown in drilling activity throughout the province of Alberta. The incentive program provides for a drilling royalty credit for new conventional oil and natural gas wells that initiate drilling on or after April 1, 2009 and that complete drilling by March 31, 2010. The incentive program also provides a reduced royalty rate on new wells for the first year of production or up to an established total production volume of 50,000 boe (boe cap is calculated at 10:1).

In 2010, the Government of Alberta announced that this program will be permanently implemented. This incentive program is expected to positively impact the Corporation.

In April 2010, the Government of Alberta announced an additional royalty incentive program relating to horizontal oil well drilling projects. Horizontal oil wells drilled on or after May 1, 2010 qualify for the Horizontal Oil New Well Royalty Rate program. This incentive program provides a reduced royalty rate on new horizontal oil wells for the first 18 to 48 months of production, based on drilling depth, up to an established total production volume of 50,000 to 100,000 boe (boe cap is calculated at 10:1).

During 2010, Surge recorded \$2.6 million of drilling royalty credits as a reduction to capital costs.

As royalties under the ARF are sensitive to both commodity prices and production levels, the estimated ARF and corporate royalty rates will fluctuate with commodity prices, well production rates, production decline of existing wells, and performance and location of new wells drilled.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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### Royalties

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Total (\$000s)	2,371	1,466	62%	8,122	5,046	61%
% of Revenue	13%	11%	2%	14%	12%	2%
\$ per boe	6.43	5.77	11%	7.35	5.23	41%

### OPERATING EXPENSE

Operating expense per boe decreased five percent in the fourth quarter of 2010 to \$14.87 per boe as compared to \$15.60 per boe in the same period of 2009. Total operating expenses in the fourth quarter of 2010 were \$5.5 million, up 38 percent from \$4.0 million in the fourth quarter of 2009. During 2010, operating expense per boe increased 13 percent to \$15.25 per boe as compared to \$13.52 per boe in the same period of 2009. Total operating expenses were \$16.8 million, up 29 percent from \$13.0 million during 2009.

The increase in operating expenses per boe in 2010 compared to the same periods in 2009 was mainly due to increased workover and maintenance expenditures relating to optimization projects. This increase was also attributable to increased government and regulatory costs, coupled with higher operating costs per boe on the acquired Corinthian assets.

Operating expenses per boe fell from \$14.98 per boe in the third quarter of 2010 to \$14.87 per boe in the fourth quarter of 2010, a less than one percent reduction. The management team continues to focus on finding efficiencies within existing operations and expects combined operating and transportation expenses per boe to continue decline into 2011.

### Operating Expenses

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Total (\$000s)	5,481	3,962	38%	16,841	13,042	29%
\$ per boe	14.87	15.60	(5%)	15.25	13.52	13%

### TRANSPORTATION EXPENSES

Transportation expenses in the fourth quarter of 2010 were \$0.6 million or \$1.72 per boe as compared to \$0.5 million or \$1.84 per boe recorded in the same period of 2009. The seven percent decrease in transportation costs per boe in the fourth quarter of 2010 compared to the same period in 2009 was primarily the result of a pipeline being constructed, connecting oil production from the Silver Battery. The pipeline tie in was completed during August of 2010. During 2010, transportation expenses totalled \$2.4 million, a 24 percent increase over 2009 expense of \$2.0 million. The eight percent increase in transportation costs per boe during 2010 compared to the same period in 2009 was primarily due to increased tariffs related to a three year transportation agreement recorded in the first quarter of 2010.

The management team continues to focus on finding efficiencies within existing operations and expects combined operating and transportation expenses per boe to continue decline.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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### Transportation Expenses

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Total (\$000s)	634	468	35%	2,426	1,961	24%
% of Revenue	3%	4%	(1%)	4%	5%	(1%)
\$ per boe	1.72	1.84	(7%)	2.20	2.03	8%

### GENERAL AND ADMINISTRATIVE EXPENSES (G&A)

Net G&A expenses for the fourth quarter of 2010 increased 38 percent to \$5.96 per boe as compared to \$4.32 per boe in the fourth quarter of 2009. Total G&A expenses for the fourth quarter of 2010, net of recoveries and capitalized amounts of \$1.7 million, was \$2.2 million, compared to \$1.1 million in the fourth quarter of 2009, after recoveries and capitalized amounts of \$0.06 million.

Net G&A expenses during 2010 increased to \$5.60 per boe as compared to \$4.03 per boe for the same period of 2009. Total G&A expenses during 2010, net of recoveries and capitalized amounts of \$3.1 million, was \$6.2 million, compared to \$3.9 million in the same period of 2009, after recoveries and capitalized amounts of \$0.3 million. The increase in net G&A expenses per boe in the fourth quarter and for the year is due primarily to additional rent on newly acquired office space, increased consulting and legal expenditures and increased staffing levels in 2010, in order to position the Corporation for future growth.

The increase in recoveries was a result of the management group capitalizing more administrative costs directly attributable to capital activities, due to an increased focus on these types of activities.

The management team expects G&A expenses per boe to decline throughout 2011.

### G&A Expenses

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Total (\$000s)	3,878	1,155	236%	9,281	4,209	121%
Recoveries and capitalized amounts	(1,682)	(57)	2,851%	(3,096)	(323)	859%
Net G&A expenses	2,196	1,098	100%	6,185	3,886	59%
Net G&A expenses per boe	5.96	4.32	38%	5.60	4.03	39%

**RECAPITALIZATION COSTS**

On April 13, 2010, the Corporation was recapitalized by a new management group and Board of Directors. During the course of the recapitalization, certain non-recurring recapitalization costs were incurred. These costs do not reflect the ongoing cost of business incurred by Surge and are comprised primarily of legal fees, financial adviser fees, severance and transaction due diligence costs.

**Recapitalization costs**

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Recapitalization costs (\$000s)	-	-	-	<b>5,409</b>	-	nm

**INTEREST EXPENSE**

Surge incurred interest expense of \$0.3 million or \$0.80 per boe in the fourth quarter of 2010 as compared to \$0.6 million or \$2.37 per boe in the fourth quarter of 2009, a decrease of 66 percent per boe. During 2010, the Corporation incurred interest expense of \$1.0 million or \$0.90 per boe as compared to \$2.0 million or \$2.11 per boe during 2009, a decrease of 57 percent. The decrease is due to the repayment of Surge's outstanding debt during the second quarter of 2010 and the reduced outstanding balance throughout the remainder of 2010.

**Interest Expense**

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Interest expense (\$000s)	<b>295</b>	601	(51%)	<b>998</b>	2,036	(51%)
\$ per boe	<b>0.80</b>	2.37	(66%)	<b>0.90</b>	2.11	(57%)

**NETBACKS**

During 2010, the operating netback per boe (defined as revenue excluding realized and unrealized gains or losses on commodity contracts per boe less royalties, operating and transportation expenses on a per boe basis) of the Corporation was \$27.65, a 17 percent increase over the \$23.64 recorded during 2009. The increase in operating netback was largely due to an 18 percent increase in revenue per boe, partially offset by a 41 percent increase in royalty expenses per boe, a 13 percent increase in operating costs per boe and an eight percent increase in transportation expenses per boe during 2010 as compared to the same period in 2009.

Surge's operating netback per boe was \$27.31 in the fourth quarter of 2010, a one percent decrease from \$27.69 recorded in the fourth quarter of 2009. The decrease in operating netback was largely due to an 11 percent increase in royalty expenses per boe partially offset by a five percent decrease in operating costs per boe and a seven percent decrease in transportation expense per boe in the fourth quarter of 2010, compared to the same period in 2009.

During 2010, the corporate netback per boe (defined as operating netback per boe less G&A and interest expense per boe) of the Corporation was \$21.15, a 21 percent increase over the \$17.50 recorded during 2009. The increase in corporate netback was impacted by the increase in G&A expense per boe in 2010 and offset by a decrease in interest expense per boe, as compared to the same period in 2009.

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Surge's corporate netback per boe was \$20.55 in the fourth quarter of 2010, a two percent decrease as compared to \$21.00 in the fourth quarter of 2009. The decrease in corporate netback was impacted by the increase in G&A expense per boe in 2010 and offset by a decrease in interest expense per boe, as compared to the same period in 2009.

The management team continues to focus on finding efficiencies within existing operations and expects both operating and corporate netbacks to continue to grow throughout 2011.

### Corporate Average Netbacks

(\$ per boe, except production)	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Average production (boe per day)	<b>4,005</b>	2,762	45%	<b>3,026</b>	2,643	14%
Revenue	<b>50.33</b>	50.90	(1%)	<b>52.45</b>	44.42	18%
Royalties	<b>(6.43)</b>	(5.77)	11%	<b>(7.35)</b>	(5.23)	41%
Operating costs	<b>(14.87)</b>	(15.60)	(5%)	<b>(15.25)</b>	(13.52)	13%
Transportation costs	<b>(1.72)</b>	(1.84)	(7%)	<b>(2.20)</b>	(2.03)	8%
<b>Operating netback</b>	<b>27.31</b>	27.69	(1%)	<b>27.65</b>	23.64	17%
G&A expense	<b>(5.96)</b>	(4.32)	38%	<b>(5.60)</b>	(4.03)	39%
Interest expense	<b>(0.80)</b>	(2.37)	(66%)	<b>(0.90)</b>	(2.11)	(57%)
<b>Corporate netback</b>	<b>20.55</b>	21.00	(2%)	<b>21.15</b>	17.50	21%

### FUNDS FROM OPERATIONS AND CASH FLOW FROM OPERATIONS

For the fourth quarter of 2010 funds from operations increased by 49 percent to \$7.9 million compared to \$5.3 million in the fourth quarter of 2009. On a per share basis, funds from operations decreased by 53 percent to \$0.15 per basic share in the fourth quarter 2010 from \$0.32 per basic share in the same period of 2009 due to equity issuances in the past year. Funds from operations increased by two percent on a per boe basis to \$21.46 in the fourth quarter of 2010 from \$20.94 in the fourth quarter of 2009.

During the past year, funds from operations increased by 47 percent to \$25.7 million compared to \$17.5 million during 2009. On a per share basis, funds from operations decreased by 33 percent to \$0.70 per basic share during 2010 from \$1.05 per basic share in the same period of 2009 due to equity issuances. Funds from operations increased by 28 percent on a per boe basis to \$23.26 during 2010 from \$18.13 during 2009.

Cash flow from operations differs from funds from operations due to the inclusion of changes in non-cash working capital, as well as non-recurring recapitalization costs. Cash flow from operations for the fourth quarter of 2010 was \$0.6 million as compared to \$5.7 million in the fourth quarter of 2009. Included in cash flow from operations is a decrease in non-cash working capital of \$7.4 million for the fourth quarter of 2010 and an increase of \$0.4 million for the same period of 2009. Cash flow from operations during the past year was \$17.1 million as compared to \$16.3 million during 2009. Included in cash flow from operations is a decrease in non-cash working capital of \$3.1 million during the past year, as well as a decrease due to recapitalization costs of \$5.4 million, and a decrease of \$1.2 million for the same period of 2009.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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### Funds from Operations

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Funds from operations (\$000s)	<b>7,907</b>	5,320	49%	<b>25,688</b>	17,492	47%
Per share - basic	<b>0.15</b>	0.32	(53%)	<b>0.70</b>	1.05	(33%)
Per share - diluted	<b>0.15</b>	0.32	(53%)	<b>0.70</b>	1.05	(33%)
Per boe	<b>21.46</b>	20.94	3%	<b>23.26</b>	18.13	28%
Cash flow from operations (\$000s)	<b>594</b>	5,732	(90%)	<b>17,137</b>	16,341	5%

### STOCK-BASED COMPENSATION

Surge recorded stock-based compensation expense of \$0.7 million in the fourth quarter of 2010 compared to \$0.2 million for the same period of 2009, calculated using the Black-Scholes option-pricing model. During 2010, Surge recorded stock-based compensation expense of \$5.4 million compared to \$0.4 million for the same period of 2009.

During 2010, 2,636,000 options were issued at a weighted average exercise price of \$6.38 per option and 295,000 options were forfeited at a weighted average price of \$6.61 per option. In addition, as a result of the recapitalization transaction, all options held on April 13, 2010 vested in full and the remaining stock-based compensation on these options was recognized in the second quarter of 2010.

Included in stock-based compensation expense during 2010 is \$3.6 million of stock based compensation expense related to the fair value of flow-through share premiums and performance warrants issued on April 13, 2010 as part of the recapitalization transaction. This amount was recorded in the second quarter of 2010.

The following assumptions were used to calculate stock-based compensation during 2010: zero dividend yield; expected volatility of 69 percent; risk free rate of two percent; and expected life of five years.

### Stock-based Compensation Expense

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Stock-based compensation expense (\$000):	<b>680</b>	211	222%	<b>5,351</b>	381	nm
Per boe	<b>1.85</b>	0.83	123%	<b>4.85</b>	0.39	nm

### DEPLETION, DEPRECIATION AND ACCRETION (DD&A)

Depletion and depreciation are calculated based upon capital expenditures, production rates and reserves. Surge uses the asset retirement obligation method to record the present value of estimated clean-up and restoration costs for all of its facilities, including well sites and pipelines. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is charged to earnings in the period. Excluded from the Corporation's depletion and depreciation calculation are costs associated with salvage values, unproven properties and seismic of \$107.1 million. Future development costs for proved reserves of \$63.8 million have been included in the depletion calculation.

Surge recorded \$8.5 million or \$22.94 per boe in DD&A expense in the fourth quarter of 2010, a 25 percent increase as compared to \$18.32 per boe in DD&A expense in the fourth quarter of 2009.

During 2010, \$23.7 million or \$21.44 per boe in DD&A expense were recorded, a nine percent increase as compared to \$19.72 per boe in DD&A expense during 2009.

The DD&A calculation is based on production volumes of 368,460 boe for the quarter and 1,104,490 boe for the year ended December 31, 2010. This increase in the DD&A rate per boe is due to the corporate acquisitions completed during the three months and year ended December 31, 2010.

**Depletion, Depreciation and Accretion (DD&A) Expense**

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
(DD&A) (\$000s)	<b>8,454</b>	4,654	82%	<b>23,681</b>	19,022	24%
Per boe	<b>22.94</b>	18.32	25%	<b>21.44</b>	19.72	9%

**INCOME AND OTHER TAXES**

Surge recognized a combined net future tax liability of approximately \$34.6 million as at December 31, 2010, an increase of \$16.9 million from the year-end 2009 future tax liability of \$17.6 million. The future tax liability increased by \$0.7 million related to the \$2.6 million of flow-through shares issued in 2009 and renounced in 2010. The future tax liability also increased by \$17.5 million related to Corinthian acquisition and decreased by \$0.1 million due to the Crystal Lake acquisition. The future tax liability also decreased by the future tax reduction of \$0.8 million for the year ended December 31, 2010.

As at December 31, 2010, the Corporation had incurred the entire \$2.6 million towards this flow-through share obligation and has satisfied the terms of this flow-through share offering.

The provision for income taxes differs from the amount obtained by applying the combined federal and provincial income tax rate for 2010, which was 28 percent and is calculated on earnings before income taxes. The difference is mainly due to future tax rate differences.

**Tax Expenses (Reduction)**

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Tax expenses (reduction) (\$000s)	<b>248</b>	(485)	(151%)	<b>(821)</b>	(1,604)	(49%)
Per boe	<b>0.67</b>	1.91	(65%)	<b>(0.74)</b>	(1.66)	(55%)

**NET INCOME (LOSS)**

The Corporation recorded net losses for the three months ended December 31, 2010 of \$4.1 million or \$0.08 per basic share, a decrease of 100 percent from the \$0.00 per basic share recorded for the comparable three months of 2009. During 2010, the Corporation recorded net losses of \$10.3 million or \$0.28 per basic share, a decrease of 115 percent from the \$0.13 per basic share recorded during 2009. The non-recurring recapitalization costs, combined with the increased stock-based compensation that resulted from the recapitalization and prior period royalty adjustments recorded in the second quarter of 2010, were large contributors to the net loss.

**Net Income (Loss)**

	3 Months Ended December 31,			Years Ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Total (\$000s)	(4,147)	(21)	nm	(10,326)	(2,112)	389%
Per share - basic	(0.08)	-	nm	(0.28)	(0.13)	115%
Per share - diluted	(0.08)	-	nm	(0.28)	(0.13)	115%

**Net income(loss) before tax excluding non-recurring charges relating to the recapitalization**

(\$000s)	3 Months Ended December 31,		Years Ended December 31,	
	2010	2009	2010	2009
Net loss (per GAAP)	(4,147)	(21)	(10,326)	(2,112)
Add back:				
Recapitalization costs	-	-	5,409	-
Stock-based compensation expense relating to the recapitalization	-	-	3,610	-
Net income(loss) before tax excluding non-recurring charges relating to the recapitalization	(4,147)	(21)	(1,307)	(2,112)

**CAPITAL EXPENDITURES**

Cash-based capital expenditures, net of any applicable Alberta drilling royalty credits, for the fourth quarter of 2010 were \$92.7 million, an \$87.6 million increase from the \$5.2 million spent in the fourth quarter of 2009.

During 2010, Surge invested \$31.5 million (\$28.9 million net of \$2.6 million in Alberta drilling royalty credits) to drill 22 gross (21.5 net) wells, \$5.9 million on seismic and land acquisitions, \$4.9 million on facilities and equipment, \$76.8 million on property acquisitions (\$75.3 million net of \$1.4 million in disposition), \$113.5 million on corporate acquisitions and \$2.4 million on other capital items.

Non-cash corporate and property acquisition costs consist primarily of future income taxes and asset retirement obligations.

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## Capital Expenditure Summary

(\$000s)	3 months ended December 31,			Years ended December 31,		
	2010	2009	% Change	2010	2009	% Change
Land and seismic	1,441	585	146%	5,877	2,382	147%
Drilling and intangibles	22,204	3,202	593%	31,495	11,042	185%
Alberta drilling royalty credits	(1,388)	(1,193)	16%	(2,615)	(1,543)	69%
Facilities and equipment	3,116	2,558	22%	4,882	5,812	(16%)
Other	1,092	1	100%	2,357	20	nm
	26,465	5,154	414%	41,996	17,713	137%
Corporate acquisitions	-	-	- %	113,469	-	100%
Property acquisitions	67,670	-	100%	76,774	-	100%
Property dispositions	(1,431)	-	100%	(1,431)	-	100%
<b>Total cash &amp; share based acquisitions / dispositions</b>	<b>66,239</b>	-	nm	<b>188,812</b>	-	nm
<b>Total cash &amp; share based capital</b>	<b>92,704</b>	5,154	nm	<b>230,808</b>	17,713	nm
Non-cash corporate acquisition costs	-	-	- %	21,318	-	100%
Non-cash property acquisition costs	1,228	-	100%	1,228	-	100%
Non-cash ARO Asset Additions	109	-	100%	286	175	63%
Capitalized SBC including future taxes	794	-	100%	4,007	-	100%
<b>Total non-cash-based capital</b>	<b>2,131</b>	-	100%	<b>26,839</b>	175	nm
<b>Total capital additions</b>	<b>94,835</b>	5,154	nm	<b>257,647</b>	17,888	nm

# MANAGEMENT'S DISCUSSION AND ANALYSIS

For the three months and years ended  
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## Quarterly and Annual Financial Information

	Year end 2010	Q4 2010	Q3 2010	Q2 2010	Q1 2010	Year end 2009	Q4 2009	Q3 2009	Q2 2009	Q1 2009	Year end 2008
Oil, Natural gas & NGL sales	57,927	18,544	14,264	11,141	13,978	42,853	12,932	10,788	9,829	9,304	71,160
gain(loss) on financial derivatives)	(2,349)	(2,648)	(1,110)	23	1,386	(1,222)	(1,116)	1,026	(22)	(1,110)	1,852
Provision for bad debt	506	391	-	-	115	840	-	-	840	-	3,053
Net earnings (loss)	(10,326)	(4,147)	(832)	(7,515)	2,168	(2,112)	(21)	844	(1,294)	(1,641)	7,698
Net earnings (loss) per share (\$)											
Basic	(0.28)	(0.08)	(0.02)	(0.27)	0.12	(0.13)	-	0.05	(0.08)	(0.10)	0.45
Diluted	(0.28)	(0.08)	(0.02)	(0.27)	0.11	(0.13)	-	0.05	(0.08)	(0.10)	0.45
Total assets	377,577	-	-	-	-	132,360	-	-	-	-	#####
Total long-term financial liabilities	30,000	-	-	-	-	41,650	-	-	-	-	39,650
Average daily sales											
Oil & NGL (bbls/d)	1,871	2,308	1,841	1,621	1,707	1,477	1,614	1,428	1,374	1,492	1,365
Natural gas (mcf/c)	6,930	10,182	7,783	3,823	5,874	6,995	6,887	6,295	7,586	7,223	9,056
Barrels of oil equivalent (boe per day) (6:1)	3,026	4,005	3,138	2,258	2,686	2,643	2,762	2,478	2,638	2,695	2,875
Average sales price											
Natural gas (\$/mcf)	3.96	3.55	3.71	3.74	5.20	4.85	4.63	4.28	3.59	5.41	8.38
Oil & NGL (\$/bbl)	69.83	70.70	69.33	66.57	72.35	58.84	69.52	62.39	58.48	42.18	82.77
Barrels of oil equivalent (\$/boe)	52.45	50.33	49.41	54.22	57.83	45.32	51.44	47.34	39.88	37.82	65.96

## Share Capital and Option Activity

	Q4 2010	Q3 2010	Q2 2010	Q1 2010	Q4 2009	Q3 2009	Q2 2009	Q1 2009
Weighted Common Shares	53,065,155	30,874,642	27,589,374	18,576,487	16,669,721	16,666,811	16,668,503	16,695,117
Stock option dilution (treasury method) <sup>1</sup>	-	-	-	457,033	-	69,353	-	-
average dilution shares outstanding <sup>1</sup>	53,065,155	30,874,642	27,589,374	19,033,520	16,669,721	16,736,164	16,668,503	16,695,117

<sup>1</sup> In computing the net loss per diluted share, nil shares were added to the weighted average number of shares outstanding because they were anti-dilutive.

On January 19, 2010, the Corporation issued 848,600 units at a price of \$3.00 per unit, with each unit consisting of one common share and one-half of a common share purchase warrant (with each whole warrant exercisable into one common share at a price of \$4.00 per share until December 23, 2010), for total gross proceeds of \$2,545,800. Certain former officers and directors purchased 20,000 units for total gross proceeds of \$60,000.

On January 29, 2010, the Corporation issued 78,333 units at a price of \$3.00 per unit, with each unit consisting of one common share and one-half of a common share purchase warrant (with each whole warrant exercisable into one common share at a price of \$4.00 per share until December 23, 2010), for total gross proceeds of \$235,000.

On April 13, 2010, pursuant to a private placement, the new management group, together with certain additional subscribers identified by the new management group, subscribed for 1,394,317 common units of the Corporation at a price of \$4.40 per common unit, 1,787,500 common shares of the Corporation at a price of \$4.40 per common share and 681,819 flow-through units at a price of \$4.40 per flow-through unit, for total proceeds to the Corporation of approximately \$17,000,000. Each common unit is comprised of one common share and one common share performance warrant, entitling the holder to purchase one common share at a price of \$5.17 for a period of five years. Each flow-through unit is comprised of one common share issued on a flow-through basis pursuant to the Income Tax Act of Canada and one common share performance warrant, also entitling the holder to purchase one common share at a price of \$5.17 for a period of five years. The common and flow-through shares issued as part of the common and flow-through units were ascribed a value of \$3.30 per share or \$6,851,000 due to the escrow restrictions described below. For further details on the vesting conditions and valuation of the common share performance warrants, please refer to note 8(d). The Corporation also recorded \$331,000 of stock-based compensation on the flow-through units.

All of the units issued were acquired by contractors, employees, officers or directors of the Corporation ("deemed service providers"). For deemed service providers, units acquired through the private placement are held under an escrow agreement in which one-third of the units are to be released equally every six months following the date of issuance. No securities will be released from escrow after the date the deemed service provider ceases to be a service provider, unless directed by a resolution of the Board of Directors. Upon the deemed service provider ceasing to be a service provider, Surge will repurchase for cancellation or provide for a transfer to another deemed service provider all of the securities of the deemed service provider then held in escrow at a price equal to the lesser of \$4.40 per unit and the market price of the common shares of Surge on the last day of trading immediately prior to the deemed service provider ceasing to be a service provider.

On May 5, 2010, the Corporation issued 6,945,000 common shares at a price of \$7.20 per share for gross proceeds of \$50,004,000, pursuant to a short form prospectus.

On July 9, 2010, the Corporation issued 16,025,529 common shares at an ascribed price of \$5.90 per share in connection with the acquisition of Corinthian Energy Corp.

On July 19, 2010, the Corporation issued 288,639 common shares at an ascribed price of \$5.90 per share in connection with the acquisition Crystal Lake Resources Ltd.

On November 1, 2010, the Corporation issued 8,001,000 common shares at a price of \$5.25 per share for gross proceeds of \$42.0 million.

During 2010, 672,199 warrants were exercised. As a result, the Corporation issued 672,199 common shares at a price of \$4.00 for gross proceeds of \$2.7 million.

During 2010, two share purchase loans aggregating \$360,000 due from two former officers of the Corporation were repaid. The loans bore interest at a rate of 4.75 percent and were due on June 30, 2010. The entire amount of the principal and interest outstanding has been repaid and the related common shares totaling 160,000 were issued. The 160,000 shares attributable to the share purchase loans had been included in stock options.

On April 26, 2011 Surge had 56,096,547 common shares, 2,076,136 performance warrants and 3,081,666 options outstanding.

## **LIQUIDITY AND CAPITAL RESOURCES**

On December 31, 2010, Surge had a net working capital deficit of \$48.1 million including unrealized hedging losses of \$2.6 million, as well as bank debt of \$30 million.

Surge anticipates that future capital requirements will be funded through a combination of internal cash flow, divestitures, debt and/or equity financing. There is no assurance that debt and equity financing will be available on terms acceptable to the Corporation to meet its capital requirements.

The Corporation has a \$105.0 million extendible, revolving term credit facility with a Canadian bank bearing interest at bank rates. The facility is available on a revolving basis until July 13, 2011. On July 13, 2011, at the Corporation's discretion, the facilities are available on a non-revolving basis for a one-year period, at the end of which time the facility would be due and payable. Alternatively, the facilities may be extended for a further 364-day period at the request of the Corporation and subject to the approval of the bank. As the available lending limits of the facilities are based on the bank's interpretation of the Corporation's reserves and future commodity prices, there can be no assurance that the amount of the available facilities will not decrease at the next scheduled review. Interest rates vary depending on the ratio of net debt to cash flow. Under the terms of the agreement, the Corporation is required to meet certain financial and engineering reporting requirements.

The Corporation defines net debt as outstanding bank debt plus or minus cash-based working capital:

<b>Net Debt</b>	
(\$000s)	
Bank debt	\$ (30,000)
Cash	1,437
Accounts receivable	12,404
prepaid expenses and deposits	1,657
Accounts payable	(31,738)
<b>Total</b>	<b>\$ (46,240)</b>

The facility is secured by a general assignment of book debts, debentures of \$200.0 million with a floating charge over all assets of the Corporation with a negative pledge and undertaking to provide fixed charges on the major producing petroleum and natural gas properties at the request of the bank.

**RELATED-PARTY AND OFF-BALANCE-SHEET TRANSACTIONS**

Certain former officers and directors of the Corporation purchased 20,000 units for total gross proceeds of \$60,000 as part of the January 19, 2010 equity offering.

Certain officers and directors of the Corporation purchased 1,099,413 common units, 661,951 flow-through units and 9,088 common shares as part of the April 13, 2010 private placement.

At December 31, 2009, two share purchase loans aggregating \$360,000 were due from two former officers of the Corporation and had been deducted from share capital. The loans bore interest at a rate of 4.75 percent and were due on June 30, 2010. On April 13, 2010, the entire amount of the principal and interest outstanding has been repaid and the related common shares totaling 160,000 have been issued.

Surge was not involved in any off-balance-sheet transactions during the three months or year ended December 31, 2010 other than those mentioned under contracted obligations below.

**CONTRACTUAL OBLIGATIONS AND CONTINGENCIES**

The Corporation has entered into farm-in agreements in the normal course of its business. The Corporation is also contractually obligated under its debt agreements as outlined under liquidity and capital resources.

Surge has future minimum payments relating to its operating leases and firm transportation service agreements totalling \$9.5 million, as summarized below:

**Commitments**

(\$000s)

2011	\$ 1,599
2012	2,245
2013	1,611
2014	1,109
2015	960
2016+	2,019
<b>Total</b>	<b>\$ 9,543</b>

In 2009, the Corporation issued a total of 757,000 flow-through common shares at \$3.40 per share for gross proceeds of \$2.6 million. The Corporation renounced these qualifying petroleum and natural gas expenditures on December 31, 2009. As at December 31, 2010, the Corporation had incurred the entire \$2.6 million towards this flow-through share obligation and has satisfied the terms of this flow-through share offering.

In 2010, the Corporation issued a total of 681,819 flow-through common shares at \$4.40 per share as part of a flow-through unit for gross proceeds of \$3.0 million. The Corporation renounced these qualifying petroleum and natural gas expenditures effective December 31, 2010. As at December 31, 2010 Corporation had incurred \$0.8 million towards this flow-through share obligation and has until December 31, 2011 to incur the \$2.2 million of remaining expenditures.

### FINANCIAL INSTRUMENTS

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Derivative contracts are recorded at fair value based on an estimate of the amounts that would have been received or paid to settle these instruments prior to maturity given future market prices and other relevant factors. The actual amounts received or paid to settle these instruments at maturity could differ significantly from those estimated.

The following table outlines the realized and unrealized gains (losses) on oil and gas commodity contracts for the year ended December 31, 2010:

# MANAGEMENT'S DISCUSSION AND ANALYSIS

For the three months and years ended  
December 31, 2010 and 2009

## Financial Instruments

					Year ended Dec 31, 2010	Year ended Dec 31, 2010
Term	Type (floating to fixed)	Volume	Swap Price (Surge receives) (C\$)	Index (Surge pays) (C\$)	Unrealized gains (losses) (C\$000s)	Realized gains (losses) (C\$000s)
Jan 1 – Dec 31, 2010	Swap	2,000 GJs/d	\$5.80	AECO Monthly Average	-	1,459
Apr 1 – Oct 31, 2010	Swap	1,000 GJs/d	\$5.32	AECO Monthly Average	-	377
Nov 1, 2009 - Mar 31, 2010	Swap	500 GJs/d	\$6.00	AECO Monthly Average	-	42
Jan 1 to Dec 31, 2011	Call	500 GJs/d	\$6.55	AECO Monthly Average	(2)	-
Jan 1 to Dec 31, 2011	Put	500 GJs/d	\$5.00	AECO Monthly Average	454	-
Mar 1, 2009 - Dec 31, 2010	Swap	750 GJs/d	\$5.64	AECO Monthly Average	-	261
Jan 1 to Dec 31, 2010	Swap	100 bbls/d	\$86.00	WTI - NYMEX	-	151
Jan 1 to Dec 31, 2010	Swap	100 bbls/d	\$84.00	WTI - NYMEX	-	78
Jan 1 to Dec 31, 2010	Swap	100 bbls/d	\$86.00	WTI - NYMEX	-	151
Jan 1 to Dec 31, 2010	Swap	200 bbls/d	\$81.00	WTI - NYMEX	-	(63)
Feb 1 to Dec 31, 2010	Swap	100 bbls/d	\$87.75	WTI - NYMEX	-	197
Feb 1 to Dec 31, 2010	Swap	100 bbls/d	\$87.90	WTI - NYMEX	-	201
Jan 1 to Dec 31, 2011	Swap	250 bbls/d	\$80.00	WTI - NYMEX	(1,247)	-
Jan 1 to Dec 31, 2011	Call	250 bbls/d	\$96.55	WTI - NYMEX	415	-
Jan 1 to Dec 31, 2011	Swap	250 bbls/d	\$80.00	WTI - NYMEX	(1,247)	-
Jan 1 to Dec 31, 2011	Call	250 bbls/d	\$91.00	WTI - NYMEX	661	-
Jan 1 to Dec 31, 2011	Call	125 bbls/d	\$78.40	WTI - NYMEX	(757)	-
Jan 1 to Dec 31, 2011	Swap	250 bbls/d	\$85.50	WTI - NYMEX	(749)	-
Jan 1 to Dec 31, 2011	Put	250 bbls/d	\$78.40	WTI - NYMEX	123	-
<b>Total</b>					<b>(2,349)</b>	<b>2,854</b>

## MANAGEMENT'S DISCUSSION AND ANALYSIS

For the three months and years ended  
December 31, 2010 and 2009

The following table outlines the unrealized and realized loss on an interest rate swap contract for the year ended December 31, 2010:

Term	Type (floating to fixed)	Amount (C\$)	Company fixed interest rate (%)	Counter party floating rate index	Year ended Dec 31, 2010	Year ended Dec 31, 2010
					Unrealized gains (losses) (C\$)	Realized losses (C\$)
Feb 24 – Apr 15, 2010	Swap	35,000,000	4.42 to 4.44	CAD-BA-CDOR	0	(60)

## SUBSEQUENT EVENTS

Subsequent to December 31, 2010, the Corporation entered into seven financial oil contracts:

Term	Volume	Floor Price (C\$)	Other Terms
Apr 1 to Dec 31, 2011	250 bbls/day	\$80.00	Participation in 100% of the upside above \$84.35 CDN per barrel.
Jul 1 to Dec 31, 2011	250 bbls/day	\$90.00	Participation in upside above \$90.00 CDN per barrel at a rate of 74%.
Jan 1 to Dec 31, 2012	250 bbls/day	\$97.00	N/A
Jan 1 to Dec 31, 2012	250 bbls/day	\$80.00	Participation in upside above \$80.00 CDN per barrel at a rate of 75%.
Jan 1 to Dec 31, 2012	250 bbls/day	\$90.00	Participation in upside above \$90.00 CDN per barrel at a rate of 63%.
Jan 1 to Dec 31, 2012	250 bbls/day	\$80.00	Participation in 100% of the upside above \$89.95 CDN per barrel.
Jan 1 to Dec 31, 2012	500 bbls/day	\$90.00	Participation in 68.5% of the upside above \$90.00 CDN per barrel.

**NEW ACCOUNTING PRONOUNCEMENTS****International Financial Reporting Standards**

Effective January 1, 2011, Canadian public companies are required to adopt International Financial Reporting Standards ("IFRS") which will include comparatives for 2010. Surge's financial statements up to and including December 31, 2010 have been reported in accordance with Canadian GAAP as it existed on each reporting date. Financial statements for the quarter ended March 31, 2011, including comparative amounts, will be prepared on an IFRS basis.

A transition plan has been developed to convert the financial statements to IFRS. External advisors have been retained and will continue to assist management with the project on an as needed basis. Training has been provided to key employees and staff training programs will continue as needed. The Corporation continues to assess the effect of the transition on information systems, internal controls over financial reporting and disclosure controls and procedures.

Systems and controls are being updated as IFRS accounting processes are implemented. Significant system and control changes are not anticipated. The project team continues to provide updates to senior management and the Audit Committee. Calculations of the impact of changes in accounting policy have been prepared by management and have not been approved by the Corporation's Board of Directors or reviewed by the Corporation's auditors.

The Corporation's auditors have been involved throughout the process to ensure the Corporation's policies are in accordance with the new standards.

There are significant accounting policy changes anticipated on adoption of IFRS which are described in more detail below. Most adjustments required on transition to IFRS will be made retrospectively against opening retained earnings as of the date of the first comparative balance sheet being January 1, 2010. In July 2009, the International Accounting Standards Board ("IASB") issued amendments to IFRS 1 "First time adoption of IFRS" allowing additional exemptions for first-time adopters. Under these amendments, full cost oil and gas companies can elect to use the recorded amount under a previous GAAP as the deemed cost for oil and gas assets on the transition date to IFRS. Surge is planning to adopt this exemption. Management has analyzed the various other accounting policy choices available under IFRS 1 and has determined the following to be most appropriate for Surge:

- Oil and gas properties formerly classified as Property, Plant and Equipment ("PP&E") will be classified under IFRS as either Development and Production assets ("D&P") or Exploration and Evaluation assets ("E&E"). Upon transition to IFRS, Surge will reclassify all E&E expenditures included in the PP&E balance under Canadian GAAP, as a separate item under IFRS. These assets will be measured at cost and will not be depleted but will be assessed for impairment when indicators suggest the possibility of impairment. Once these E&E assets have reached technical feasibility and commercial viability, they will be transferred to D&P. At the time of transfer, they will be subjected to an impairment test. Surge's E&E assets will primarily consist of undeveloped exploration lands and at January 1, 2010 are estimated at \$0.3 million.

- Under IFRS, D&P assets are grouped into areas designated as cash generating units ("CGU") for the purposes of impairment testing and further broken down into components within the CGU for purposes of depletion and depreciation. IFRS 1 provides for the allocation of the Canadian GAAP net book value of PP&E assets excluding E&E assets, to IFRS CGUs and components on a pro rata basis using the reserve volumes or values as at December 31, 2009. Surge has elected to allocate the D&P balance using reserve values and at January 1, 2010, the value allocated to the PP&E assets is approximately \$126.5 million.

- Under IFRS, divestitures of an oil and gas property will generally result in a gain or loss recognized in earnings. Under Canadian GAAP, proceeds of divestitures are deducted from the full cost pool without recognition of a gain or loss unless such a deduction resulted in a change to the depletion rate of 20 percent or greater.
- Under Canadian GAAP, impairment testing on oil and gas properties is performed at a cost centre level. Under IFRS, impairment testing will be performed at the CGU level. This will result in a greater number of impairment tests. At January 1, 2010, Surge did not have any impairment on its D&P assets under IFRS.
- Depletion and depreciation of D&P will be calculated at a component level. Depletion of resource properties within D&P will be calculated using the unit-of-production method under IFRS with the option to base the calculation on proved reserves or proved plus probable reserves. Surge will use proved plus probable reserves to calculate the depletion of resource properties. Surge expects that depletion expense for the year ended December 31, 2010 will be lower than currently reported under Canadian GAAP. Depreciation of office equipment will continue to be calculated using a declining balance method.
- IFRS 1 allows Surge to use the IFRS rules for business combinations on a prospective basis rather than restating all business combinations prior to transition on January 1, 2010. Surge will elect to use this exemption; therefore, Surge will not be recording any adjustments to retrospectively restate any of its business combinations that have occurred prior to January 1, 2010. Under IFRS reporting, Surge will restate two business combinations that occurred in each of the third and fourth quarters of 2010. Transaction costs capitalized under Canadian GAAP to PP&E are expensed under IFRS.
- Under Canadian GAAP, Surge's Asset Retirement Obligation is discounted over its life based on a credit adjusted risk free rate which was 7.7 percent at December 31, 2009. Under IFRS, Surge is required to revalue its liability for asset retirement costs at each balance sheet date using a risk-free discount rate. As a result, the Corporation's Asset Retirement Obligation will increase upon transition to IFRS as the liability will be re-valued using a discount rate of 4.00 percent to reflect the Corporation's estimated risk-free rate of interest. The revalued Asset Retirement Obligation at the transition date is estimated at \$13.0 million, with a corresponding decrease in future tax of \$2.0 million, the offsetting net increase in the liability of \$5.0 million charged to retained earnings.
- Under IFRS, share-based payments are expensed based on a graded vesting schedule, which was also permitted under GAAP. Surge has historically recorded stock-based compensation using the graded method, which results in front loading of the expense. IFRS differs from GAAP in that the Corporation will also be required to incorporate a forfeiture multiplier rather than account for forfeitures as they occur as currently practiced under Canadian GAAP. The Corporation's historical forfeiture rate is close to zero percent, and therefore no opening balance sheet adjustment is anticipated.
- Under IFRS, risk-sharing agreements in which the Corporation cedes a portion of its working interest to a third-party are generally considered to be disposals of property, plant and equipment, potentially resulting in a gain or loss on disposition. Under the Corporation's existing Canadian GAAP, no gain or loss is recorded on these or other dispositions where the change in consolidated depletion is less than 20 percent. There is no equivalent exemption in IFRS. As a result, it is expected that the Corporation will record gains or losses on risk-sharing arrangements and other disposition transactions under IFRS. There is no impact on transition to IFRS as result of this requirement. Subsequent to transition, the significance of these gains or losses will be dependent on the details of specific transactions.
- Under Canadian GAAP, the future tax liability associated with the renouncement of tax deductions from the issuance of flow through shares was recorded as a reduction in share capital at the time of renouncement. Under IFRS, the difference between the future tax liability associated with the renouncement of the tax deductions and the premium price received on the issuance of flow through shares over the market value of the Corporation's common shares at the time of issue is recorded as a future tax expense as the expenditures are incurred. This future tax expense effectively represents the net loss on the distribution of the tax deductions to investors. The

transitional adjustment results in an increase of \$2.5 million, before the associated tax impact, to share capital with a resulting offset being charged to retained earnings.

In the first quarter of 2011, the Corporation plans to prepare its 2010 IFRS comparative quarterly financial statements and will assess and continue to review the impact of the IFRS changes on disclosure controls and internal controls, including identification of instances where controls may require amendments or additions in order to address the accounting policy changes required under IFRS. No material changes in control procedures are anticipated.

## **CRITICAL ACCOUNTING ESTIMATES**

### **Oil and Natural Gas Reserves**

Under National Instrument 51-101 (N.I. 51-101), "proved" reserves are those reserves that can be estimated with a high degree of certainty to be recoverable, i.e., that it is likely that the actual remaining quantities recovered will exceed the estimated proved reserves. In accordance with this definition, the level of certainty targeted by the reporting corporation should result in at least a 90 percent probability that the quantities actually recovered will equal or exceed the estimated reserves. In the case of "probable" reserves, which are obviously less certain to be recovered than proved reserves, N.I. 51-101 states that it must be equally likely that the actual remaining quantities recovered will be greater or less than the sum of the estimated proved plus probable reserves. With respect to the consideration of certainty, in order to report reserves as proved plus probable, the reporting corporation must believe that there is at least a 50 percent probability that the quantities actually recovered will equal or exceed the sum of the estimated proved plus probable reserves. The implementation of N.I. 51-101 has resulted in a more rigorous and uniform standard of reserve evaluation.

The oil and natural gas reserve estimates are made using all available geological and reservoir data as well as historical production data. Estimates are reviewed and revised as appropriate. Revisions occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Corporation's plans. The effect of changes in proved oil and natural gas reserves on the financial results and position of the Corporation is described next under depletion expense and impairment of petroleum and natural gas properties.

### **Depletion Expense**

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

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

### **Withheld Costs**

Certain costs related to unproved properties may be excluded from costs subject to depletion until proved reserves have been determined or their value is impaired. These properties are reviewed quarterly and any

impairment is transferred to the costs being depleted, which would increase depletion expense for the given period.

### **Impairment of Petroleum and Natural Gas Assets**

The Corporation is required to review the carrying value of all petroleum and natural gas assets for potential impairment. Impairment is indicated if the carrying value of the petroleum and natural gas assets is not recoverable by the future undiscounted funds from operations. If impairment is indicated, the amount by which the carrying value exceeds the estimated fair value of the property, plant and equipment is charged to earnings. The assessment of impairment is dependent on estimates of reserves, production rates, prices, future costs and other relevant assumptions.

### **Asset Retirement Obligations**

The Corporation is required to provide for future removal and site restoration costs. The Corporation must estimate these costs in accordance with existing laws, contracts, or other policies. The fair value of the liability for the Corporation's asset retirement obligation is recorded in the period in which it is expected to be incurred, discounted to its present value using the Corporation's eight percent credit adjusted risk-free rate and two percent inflation rate. The offset to the liability is recorded in the carrying amount of petroleum and natural gas properties. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is charged to earnings in the period. Revisions to the estimated timing of funds from operations or to the original estimated undiscounted cost could also result in an increase or decrease in the obligation. Actual costs incurred upon settlement of the retirement obligation are charged against the obligation to the extent of the liability recorded.

### **Stock-based Compensation**

The Corporation uses the fair value method for valuing the stock option grants. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model. A zero dividend yield is used as the Corporation does not issue dividends; the volatility is a calculation based on past trading history and the risk-free rate is from the Bank of Canada. An increase in dividends would decrease the option exercise and an increase in the volatility or the risk-free rate would increase the calculated expense.

### **Legal, Environmental Remediation and Other Contingent Matters**

The Corporation is required to determine whether a loss is probable based on judgment and interpretation of laws and regulations and whether the loss can reasonably be estimated. When the loss is determined, it is charged to earnings.

The Corporation's management must continually monitor known and potential contingent matters and make appropriate provisions by charges to earnings when warranted by circumstance.

### **Income Tax Accounting**

The determination of the Corporation's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded by management. In addition, the Corporation calculates future taxes based on rates substantively enacted at each reporting period and expected to apply when temporary differences reverse. Any

changes in the anticipated reversals may impact future tax rates and the increase or decrease will be recorded through earnings.

### **Financial Instruments**

The Corporation recognizes the fair value for the unrealized portion of derivative contracts at each reporting date on the financial statements. The fair value is based on an estimate of the amounts that would have been paid to or received from counterparties to settle these instruments given future market prices and other relevant factors. As the fair value is based on a number of subjective estimates such as future prices and volatility in commodity markets, estimates could differ from actual results realized.

### **RISK FACTORS**

Additional risk factors can be found under "Risk Factors" in the Corporation's 2010 Annual Information Form, which can be found on [www.sedar.com](http://www.sedar.com). Many risks are discussed below and in the 2010 Annual Information Form, but these risk factors should not be construed as exhaustive. There are numerous factors, both known and unknown, that could cause actual results or events to differ materially from forecast results.

On October 25, 2007, the Alberta Government announced the New Royalty Framework (NRF) which took after January 1, 2009. On March 3, 2009, the Alberta Government announced a drilling royalty credit and new well incentive program that will be in effect from April 1, 2009 to March 31, 2010. On November 29, 2008, the Alberta Government announced that in response to the global economic crisis and a slowdown in oil and natural gas drilling in Alberta, companies drilling certain new wells after November 19, 2008 have a one-time option of selecting a transitional rate or the NRF rate. All wells drilled between 2009 and 2013 that adopt the transitional rate will be required to shift to the NRF on January 1, 2014. All wells drilled prior to November 19, 2008 will move to the NRF on January 1, 2009.

Oil and natural gas operations involve many risks that even a combination of experience, knowledge and careful evaluation may not be able to overcome. The long-term commercial success of Surge depends on its ability to find, acquire, develop, and commercially produce oil and natural gas reserves. Without the continual addition of new reserves, any existing reserves Surge may have at any particular time and the production therefrom will decline over time as such existing reserves are exploited. A future increase in Surge's reserves will depend not only on the Corporation's ability to explore and develop any properties it may have from time to time, but also on its ability to select and acquire suitable producing properties or prospects. No assurance can be given that further commercial quantities of oil and natural gas will be discovered or acquired by Surge.

Surge's principal risks include finding and developing economic hydrocarbon reserves efficiently and being able to fund the capital program. The Corporation's need for capital is both short-term and long-term in nature. Short-term working capital will be required to finance accounts receivable, drilling deposits and other similar short-term assets, while the acquisition and development of oil and natural gas properties requires large amounts of long-term capital. Surge anticipates that future capital requirements will be funded through a combination of internal funds from operations, debt and/or equity financing. There is no assurance that debt and equity financing will be available on terms acceptable to the Corporation to meet its capital requirements. If any components of the Corporation's business plan are missing, the Corporation may not be able to execute the entire business plan.

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of federal, provincial, and local laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil and natural gas operations. The legislation also

requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating costs. The discharge of oil, natural gas or other pollutants into the air, soil, or water may give rise to liabilities to governments and third parties and may require Surge's operating entities to incur costs to remedy such discharge. Although Surge believes that it is in material compliance with current applicable environmental regulations, no assurance can be given that environment laws will not result in a curtailment of production or a material increase in the costs of production, development or exploration activities or otherwise adversely affect Surge's financial condition, results of operations or prospects.

Surge's involvement in the exploration for and development of oil and natural gas properties may result in Surge becoming subject to liability for pollution, blowouts, property damage, personal injury or other hazards. Although, prior to drilling, Surge will obtain insurance in accordance with industry standards to address certain of these risks, such insurance has limitations on liability that may not be sufficient to cover the full extent of such liability. In addition, such risks may not, in all circumstances, be insurable or, in certain circumstances, Surge may elect not to obtain insurance to deal with specific risks due to the high premiums associated with such insurance or other reasons. The payment of such uninsured liabilities would reduce the funds available to Surge. The occurrence of a significant event that was not fully insured against, or the insolvency of the insurer of such event, could have a material adverse effect on Surge's financial position, results of operations or prospects and will reduce income otherwise used to fund operations.

The Corporation utilizes financial derivatives contracts to manage market risk. All such transactions are conducted in accordance with the risk management policy that has been approved by the Board of Directors.