Petsec Energy

# PETSEC ENERGY ANNUAL REPORT 2010

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**2010 was a pivotal year for Petsec Energy Ltd. Operationally it was a difficult year as the combined effect of low gas prices, regulatory changes in the Gulf of Mexico following the Macondo oil spill, and the shut-in of the Company's Main Pass 270 field due to third party pipeline problems, impacted revenues. Notwithstanding this, the Company made substantial progress in advancing its business strategy and activity in the USA and, in addition, reached a new milestone with its Beibu Gulf project in China. Petsec Energy's new strategy to drill larger targets in the deeper geologic section of the Gulf Coast and Gulf of Mexico was successful. The second well drilled in the year, which tested the Marathon Prospect, resulted in a significant discovery and was consistent with pre-drill reserve estimates. Further, in order to rebalance its operations more towards oil the Company entered into a joint venture focussed on**

# 2010

### JANUARY

- 2009 Production of 7.1 Bcfe, revenues of US$52 million, and cashflow (EBITDAX) of US$31.3 million.

### APRIL

- Main Pass 20 #4 "Jenny Lake" well spud in Gulf of Mexico, USA, targeting gross reserves of 20 to 45 Bcfe.
- The Macondo well blew out releasing oil to surface. Consequently, the U.S. Federal Government announced a moratorium on drilling in greater than 500 feet of water.

### MAY/JUNE

- Awarded eight leases from the Central Gulf of Mexico lease sale. Prospects within the leases contain mapped target reserves ranging in size from 20 to >100 Bcfe. Total potential reserves for the Company's prospects increased to 400-750 Bcfe.
- The Jenny Lake well was drilled to 12,800 feet and intersected 100 feet of hydrocarbon filled sands, but was insufficient to be completed for commercial production. The well was plugged and abandoned.

### AUGUST

- The drilling moratorium and regulation changes in the Federal waters of the Gulf of Mexico prompted the Company to focus more of its future drilling on onshore prospects and prospects in the State waters of Louisiana and Texas.
- The Company acquired a 10% working interest ("WI") in the Marathon prospect leases, Atchafalaya Bay, State waters Louisiana. The Marathon #1 well spud in August 2010.

### OCTOBER

- Marathon #1 well drilled to 18,800 feet and made a significant gas and condensate discovery. The Company booked net 2P reserves of 3.3 Bcfe (8% WI) after transfer of a 2% WI as part of the PEI term debt settlement. The prospect has further exploration potential that will be tested in 2011.

### DECEMBER

- Marathon well connected to production facilities and commenced initial production at a gross production rate of 14.7 MMcf/day. The production rate has since been increased to in excess of 20 MMcf of gas and 100 barrels of condensate per day.
- Company established a relationship with an experienced shale oil group.

shale oil opportunities in onshore regions of the USA. In March 2011, the Company's financial position improved significantly with an agreement to fully settle the Petsec Energy Inc. ("PEI") US$29.2 million term loan which was due for repayment in 2011. On the Beibu Gulf Project, significant progress has been made towards the commencement of development of the 6.12, 6.12 South and 12.8 West oil fields, with the approval of the Overall Development Plan ("ODP") by China National Offshore Oil Corporation ("CNOOC") in late January 2011. This was followed by the announcement in February 2011 of a Final Investment Decision ("FID") by the joint venture partners to proceed with the development, and the lodgement of the ODP for formal Chinese Government approval.

# 2011

## JANUARY

- 2010 Production of 3.9 Bcfe, revenues of US$27.1 million, and cashflow (EBITDAX) of US$12.6 million.
- CNOOC approved Project Investment and ODP for development of the Wei 6.12, 6.12 South and 12.8 West oil fields in Block 22/12 Beibu Gulf, China. CNOOC backed-in for 51% of the project and became operator.

## FEBRUARY

- The Company and its joint venture partners announce FID for the development of the Wei 6.12, 6.12 South and 12.8 West oil fields; first production is anticipated by the end of 2012.
- CNOOC approved ODP for the three oil fields was lodged with the Chinese Government for formal approval.

## MARCH

- Term debt of US$29.2 million owed by PEI is fully settled.

## APRIL

- Second exploration/development well on the Marathon gas/condensate discovery is commenced to target additional reserves.

## ANNUAL GENERAL MEETING TO BE HELD AT:

10.00 am (AEST) on Wednesday, 18 May 2011, at the Museum of Sydney, corner of Bridge and Phillip Streets, Sydney

## PETSEC ENERGY LTD ABN 92 000 602 700

The Company is listed on the Australian Stock Exchange (symbol: PSA) and traded over the counter in the USA in the form of ADRs (symbol: PSJEY). Its corporate office is in Sydney, Australia, and its USA operations offices are in Lafayette, Louisiana and Houston, Texas.

## FINANCIAL

- Oil & gas sales (net of royalties): US$27.1 million (US$6.98/Mcfe) – down 48% on 2009;
- EBITDAX: US$12.6 million (US$3.26/Mcfe) – down 60% on 2009;
- Net underlying loss (before exploration write-offs, provisions and tax): US$2.2 million;
- Dry hole, impairment and abandonment expense of US$19.5 million, and impairment of deferred tax assets: US$13.6 million;
- Net loss after tax: US$35.2 million;
- Acquisition, development & exploration expenditure: US$10.6 million;
- Cash on hand: US$23.1 million;
- Term Debt: US$29.2 million as at 31 December 2010 – fully extinguished in March 2011.

# Year in brief 2010

Photographer George Payne

## OPERATIONS USA

- Production: 3.9 Bcfe – down 45% on 2009; due in part to a pipeline shut-in at the Main Pass 270 field.
- As at 1 January 2011 the independently (Ryder Scott) estimated proved and probable (2P) oil and gas reserves following the PEI term debt settlement are 15.5 Bcfe.
- Main Pass 270 shut-in from April to September 2010 due to third-party pipeline issues.
- Eight leases awarded following the March 2010 Central Gulf of Mexico lease sale. Ten large prospects identified with total reserve potential of 400-750 Bcfe in the deeper geologic section.
- Significant gas and condensate discovery made in October 2010 at the Marathon Prospect confirming pre-drill reserve estimates of 20 to 78 Bcfe; Company books 3.3 Bcfe of 2P reserves after transfer of 2% as part of term debt settlement.
- Established shale oil joint venture ("JV") to explore for oil in Texas/Louisiana.

## DEVELOPMENT CHINA

- Total China oil resources net to Company: 5-15 million barrels in five oil fields. Commercial negotiations concluded in June 2010 with signing of a Commercial Negotiation Memorandum ("CNM"), which specifies the terms and conditions for the joint development of 6.12, 6.12 South & 12.8 West oil fields.
- Supplemental Development Agreement ("SDA") signed by the JV in conjunction with CNOOC in August 2010. The SDA incorporates the terms of the CNM and attaches to the Block 22/12 Petroleum Contract ("PC").
- CNOOC approves Overall Development Plan ("ODP") in late January 2011 for the development of the 6.12, 6.12 South & 12.8 West oil fields.
- CNOOC elects to back-in for its full 51% share of the project and becomes operator of the development. Petsec Energy interest in the ODP reduces from 25% to 12.25%.
- Final Investment Decisions made by the Block 22/12 JV in February 2011, ODP lodged for Chinese Government approval.
- Independently confirmed 2P oil reserves for the three fields: 24 MMbbl. Petsec Energy interest: 2.94 million barrels of oil, net of CNOOC 51% back-in.
- Feasibility studies for the development of the 12.8 East and 12.3.1 oil fields (15 to 72 million barrels, P50-P10) progressed during the year. Subject to satisfactory economics, development anticipated to commence 2011/2012 and will connect to the infrastructure built for the 6.12-12.8 West project.

DRILLING OF FIRST WELL
ON THE MARATHON PROSPECT

Photographer George Payne

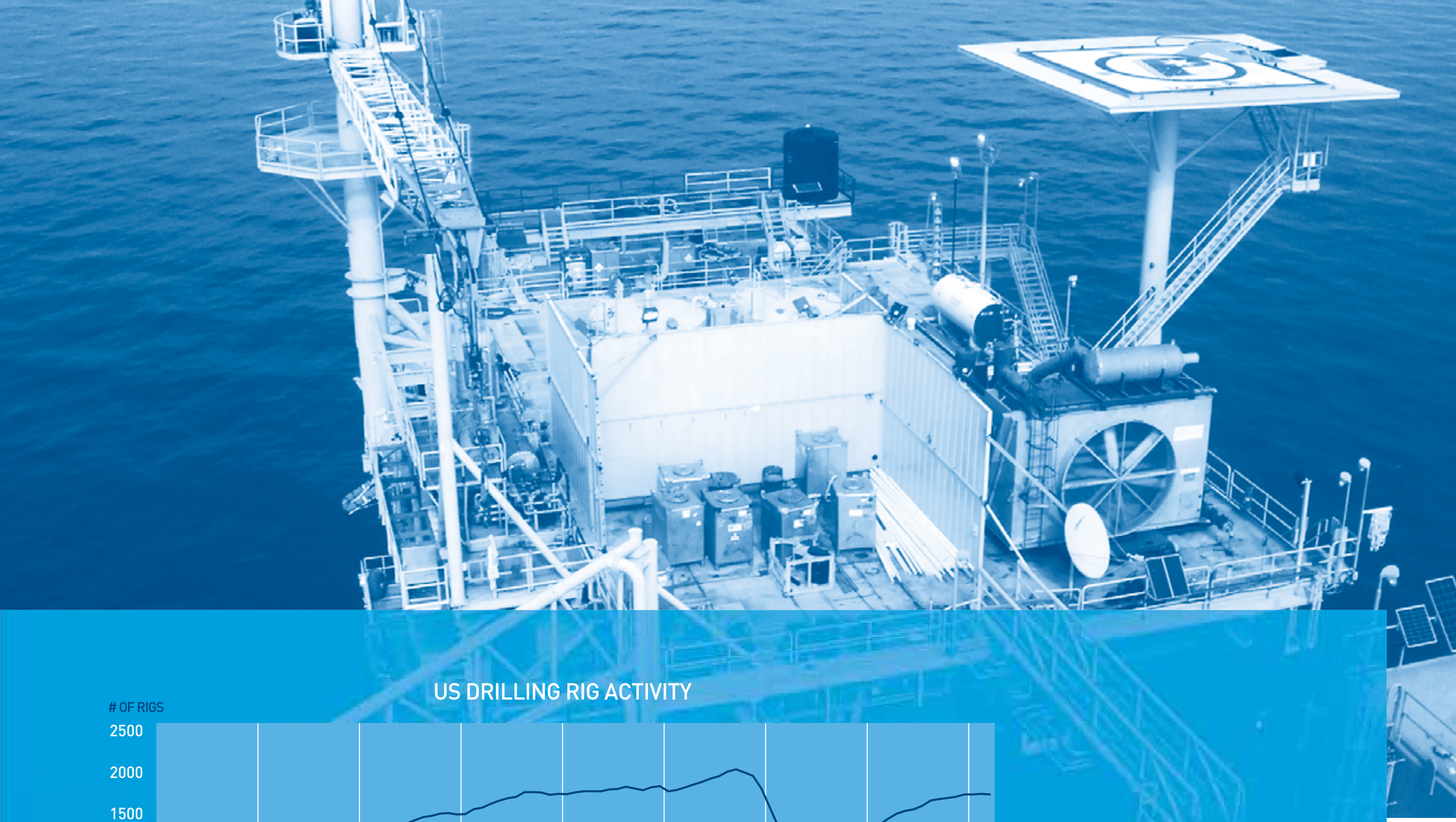
# Chairman's Report

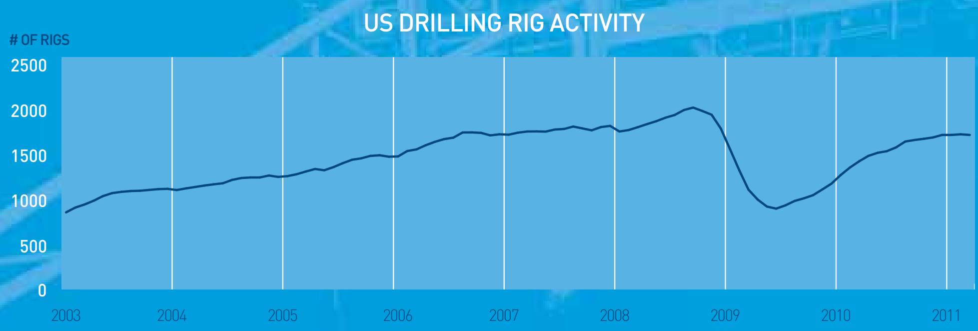
## Activity in the Gulf of Mexico during 2010 was disrupted as a result of the catastrophic Macondo well blowout in April 2010 that resulted in the area being effectively closed for drilling operations, and activity continues to be impacted into 2011. Consequently, Petsec was able to drill only one of the proposed three to five wells to test our new suite of large, deep geologic section targets in the Gulf of Mexico.

**TN FERN**
Chairman and
Managing Director

The effects of the global financial crisis continued to be felt during 2010 with the drilling moratorium further impacting the availability of bank credit. As a result the Company had to set aside cash to support letters of credit to meet BOEMRE (formerly MMS) bonding obligations. Oil prices continued to strengthen, a promising sign for development of the 6.12/12.8W oil fields in the Beibu Gulf, China. On the other hand, natural gas prices were negatively impacted by a slow US economy and an oversupply of natural gas, mainly due to the success of onshore horizontal drilling for shale gas. Main Pass 270, the Company's largest producing field, was shut-in from early April to mid September due to leaks in an onshore gas transmission pipeline, further impacting revenues.

As a consequence of the suspension of operations in the Gulf of Mexico, the Company decided to focus its exploration efforts onshore and in the adjacent, shallow State waters not subject to federal regulations.
This led to Petsec's participation in the drilling of the significant gas/condensate discovery on the Marathon prospect, in the Atchafalaya Bay Louisiana, and also to the establishment of an onshore shale oil joint venture.






Source: Baker Hughes

Following extensive negotiations that commenced in the second half of 2010, the Company agreed to a settlement of the US subsidiary's US$29.2 million term loan in March 2011 that resulted in the extinguishment of the entire debt amount. Following this settlement the Company has approximately US$10.5 million in cash, 2P reserves in the USA of 15.5 Bcfe with a net present value ("NPV10") of US$46.4 million at five year oil and gas strip prices, and ten non-producing leases in the Gulf of Mexico that hold prospects with 400 – 750 Bcfe of gross reserve potential. In addition the Company has 2P reserves of 2.94 million barrels of oil in three oil fields in Beibu Gulf, China, where development has begun and first production is expected in late 2012.

## ACHIEVING GROWTH

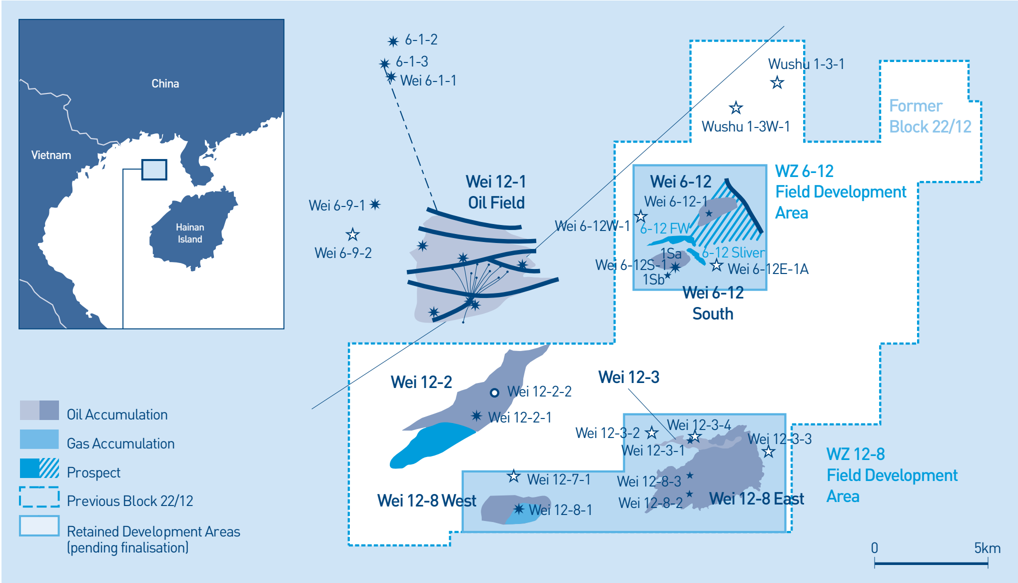
Petsec Energy has a proud record of achieving growth through successful exploration, as demonstrated during the period 2002 to 2007 and the Company is determined to repeat this success with a renewed focus, particularly in the USA, that it believes will deliver value and reward for shareholders.

The Company has broadened the focus of its USA operations from the Federal waters of the Gulf of Mexico to include the shallow State waters of the Gulf Coast, and onshore regions of Louisiana and Texas. While continuing to pursue conventional larger, deep section gas condensate and oil targets, Petsec Energy will also pursue unconventional shale oil opportunities. The Company has ten mapped prospects in the Federal waters of the Gulf of Mexico that are ready to drill with each prospect holding significant reserve potential. Current plans are to commence drilling on at least one of these high impact prospects during the fourth quarter of 2011.

The Company has spent a considerable part of the last two to three years high grading its previous lease inventory of over 60 leases to the current 18. In addition, Petsec has generated new trend opportunities such as subsalt plays along the Gulf Coast and in the shallow waters of the Gulf of Mexico. The subsalt prospect generation effort is progressing well and has potential to expose the Company to significant new oil reserves in older fields.

US$29.2M

TERM LOAN SETTLED IN MARCH 2011




**2.94MMbbl**

**NET 2P RESERVES TO PETSEC ENERGY FOR THE 6.12/12.8 WEST OIL FIELDS DEVELOPMENT**

The value of the Company's interest in the Block 22/12 Beibu Gulf, China joint venture is closer to being realised following the decision by CNOOC to participate in the Project development, and submission of the Overall Development Plan (ODP) for the 6.12, 6.12 South and 12.8 West oil fields for Chinese Government approval. In accordance with the Block 22/12 Petroleum Contract CNOOC has elected to assume its maximum allowable interest of 51% in the development thereby reducing the Company's interest to 12.25% in those three oil fields. CNOOC has also become the operator for the development and operation of the ODP.

The ODP was lodged by CNOOC for formal Chinese Government approval in February 2011 and may take several months to be ratified. CNOOC has commenced engineering design work, bidding for long lead equipment has begun, and first oil production is expected before year end 2012.

Independently confirmed 2P reserves for the ODP are 24 MMbbl gross (2.94 MMbbl net to Petsec Energy) and development capital expenditure is estimated at US$300 million gross (US$37 million net to Petsec Energy).

The Company retains a 25% interest in the remaining two oil fields 12.8 East and 12.3.1 and in the remaining exploration potential. CNOOC has the right to back-in and participate for a 51% interest in any future development in these areas. The fields have been estimated to contain recoverable reserves ranging from 15-72 MMbbl (P50 – P10) and feasibility studies are currently underway. Subject to satisfactory economics, development of these two oil fields could commence in 2011/2012, and their production will connect to infrastructure built for the 6.12/12.8 West project.


## CAPITAL STRUCTURE – AS AT 15 MARCH 2011

| | |
|---|---|
| **Australia** | |
| Exchange | ASX |
| Ticker | PSA |
| Shares on issue | 231.3 million |
| Options on issue | 5.0 million |
| Share price | A$0.18 |
| Market capitalisation | A$41.6 million |
| **USA** | |
| Exchange | OTC Pink Sheets |
| Ticker | PSJEY |

Source: ASX

## 2011 BUDGET

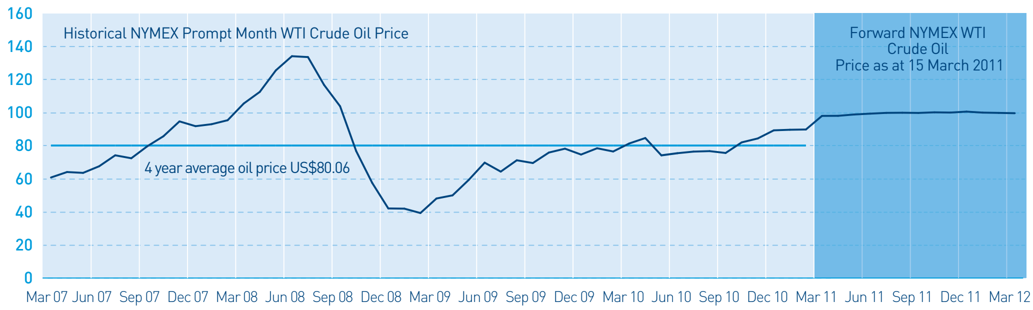
| | |
|---|---|
| Drilling planned | 3-5 wells in USA |
| Exploration and Development – USA | US$10-21 million |
| Development – China | US$10 million |
| Estimated production – USA | 3.0 Bcfe |
| Estimated revenues net of royalties – USA | US$15 million |
| Total cash deposits (at 1 Jan 11) | *US$23.1 million |

* Includes US$5.7m of restricted cash deposits used to support letters of credit and to fund certain abandonment obligations

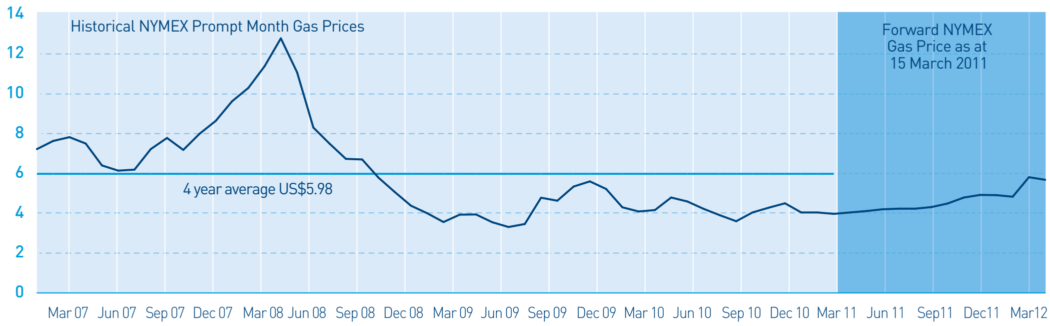
| | | Wells | Net Reserves | 2010 | | | | 2011 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **USA** | | | | | | | | | | | |
| Gulf Coast and Gulf of Mexico | 2010 Drilling | | | | | | | | | | |
| Gulf Coast | Development/Production | | | | | | | | | | |
| Gulf Coast and Gulf of Mexico | 2011 Drilling | 3-5 | 10-30 Bcfe | | | | | | | | |
| Shale Oil JV | 2011 Activity | | 15-150 MMbbl | | | | | | | | |
| **China** | | | | | | | | | | | |
| 6.12/6.12 South/12.8 West | FID/Development | | 2.94 MMbbl | | | | | | | | |
| 12.8 East/12.3.1 | Feasibility/FID | | 1.25 MMbbl | | | | | | | | |
| | | | | 1st Qtr | 2nd Qtr | 3rd Qtr | 4th Qtr | 1st Qtr | 2nd Qtr | 3rd Qtr | 4th Qtr |

Feasibility/FID
Drilling
Development
Production

### WTI CRUDE OIL PRICES




### HENRY HUB NATURAL GAS PRICE




## FUNDING OUR GROWTH PLANS

The Company expects to fund its USA exploration programme for 2011 through a combination of current cash, operating cash flows, the sale of certain assets and the recovery of restricted cash amounts currently securing bonding obligations.

The Company believes it can fund its share of the development cost of the 6.12, 6.12 South and 12.8 West oil fields, which is currently estimated at US$37 million over a two and a half year period, predominantly through project debt financing. The Company has also received a number of proposals from various interested parties seeking to acquire its interest in the entire Block 22/12 Beibu Gulf joint venture. These offers are currently being assessed to evaluate whether selling the Company's interest provides an opportunity to extract greater value for shareholders than the option of retaining, funding and developing the asset.

The last three years have been particularly challenging, with the global financial crisis, credit restrictions, halving of the US gas price, Hurricane Ike, the Macondo oil spill and temporary closure and slowdown of activity in the Gulf of Mexico. Nevertheless, we have eliminated US$100 million of debt, developed a new prospect portfolio of large, deep prospects to accommodate the changed operating conditions in the Gulf of Mexico, established ourselves onshore Louisiana and Texas with a substantial discovery at Marathon and entered into a new shale oil joint venture.

With all debt eliminated, reasonable cashflow, a strong prospect inventory, and the value of our China asset, the Company is well positioned to achieve significant growth over the next few years. All of the team at Petsec Energy are working hard to achieve that growth.

**TN Fern**
Chairman and Managing Director

Petsec Energy

# DIRECTORS' REPORT AND FINANCIAL REPORTS

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# Directors' Report

For the year ended 31 December 2010

The directors present their report together with the Financial Report of Petsec Energy Ltd ("the Company") and of the consolidated entity, being the Company and its subsidiaries, for the financial year ended 31 December 2010 and the independent auditor's report thereon.

## 1. Directors

The names and particulars of the qualifications and experience of each director during or since the end of the financial year are:

### Terrence N Fern

***Chairman and Chief Executive Officer***

Mr Fern has been a director since 1987 and has over 35 years of extensive international experience in petroleum and minerals exploration, development and financing. He holds a Bachelor of Science degree from the University of Sydney and has followed careers in both exploration geophysics and natural resource investment. Mr Fern is also a director of Oceana Gold Corporation.

### David A Mortimer AO

***Non-executive Director***
***Chairman of the Audit Committee and the Nomination and Remuneration Committee***

Mr Mortimer was appointed to the Board in 1985 and has over 35 years of corporate finance experience. He was a senior executive of TNT Limited Group from 1973, serving as Finance Director and then as Chief Executive Officer until his resignation in October 1997. He is Chairman of Australia Post, Crescent Capital Partners and Leighton Holdings Limited. Mr Mortimer holds a Bachelor of Economics degree (First Class Honours) from the University of Sydney. Mr Mortimer is a Fellow of the University of Sydney, Governor of the Australia Israel Chamber of Commerce and President of the Sydney University Football Club.

Mr Mortimer was formerly a director of ASX listed company Intoll Management Limited (formally MIG) from 2000 until December 2010.

### Michael L Harvey

***Non-executive Director***
***Member of the Audit Committee and the Nomination and Remuneration Committee***

Mr Harvey was appointed to the Board in 2008 and is a third generation Texan oil man who brings a wealth of experience of establishment and successful growth of exploration and production (E&P) companies in South-East Asia and the Gulf of Mexico, USA. After receiving his degree from Texas A&M University in 1970, Mr Harvey served as an officer in the US Army in Vietnam.

Subsequently, he began his career in the oil industry with Shell Oil Company in their Corporate Planning and Economics department. Since 1987 to date, he has founded and been the CEO of four private US E&P companies operating in the Gulf of Mexico and the Gulf Coast of the USA. Between 1987 and 1998 he established, grew and sold Gulfstar Petroleum Corporation and Gulfstar Energy Inc. In 2000 he founded Gryphon Exploration Inc., which was acquired by Woodside Petroleum Ltd for US$285 million in 2005. In 2007 he founded Stonegate Production Company, where he is Chairman and CEO. Mr Harvey was formerly a non-executive director of the listed Norwegian company Scorpion Offshore from 2006 until May 2010.

### Peter E Power – Retired from the Board and its Committees on 21 May 2010

***Non-executive Director***
***Member of the Audit Committee and the Nomination and Remuneration Committee***

Dr Power served as a director of the Company from 1999 until his retirement from the Board and its Committees on 21 May 2010.

## 2. Executive Officers

### Ross A Keogh

*President of Petsec Energy Inc. ("PEI")*

Mr Keogh joined the Company in 1989 and has over 30 years experience in the oil and gas industry. Between 1979 and 1989, Mr Keogh worked in the financial accounting and budgeting divisions of Total Oil Company and as Joint Venture Administrator for Bridge Oil Limited in Australia. Mr Keogh holds a Bachelor of Economics degree, with a major in Accounting, from Macquarie University in Sydney. Mr Keogh was appointed Chief Financial Officer in November 1998 until April 2002, and appointed President of PEI in April 2002.

### Ron Krenzke

*Executive Vice President of Exploration of PEI*

Mr Krenzke joined the Company in November 2009 as the Executive Vice President of Exploration of Petsec Energy Inc. Mr Krenzke has 37 years of experience in the oil and gas exploration and production company management and growth, exploration program development, prospect generation and acquisition, joint ventures, and corporate divestiture. In his early career he worked for major and large independent oil companies including: Mobil Oil, Texas Eastern, Monsanto Oil and Amerada Hess. Since 1990 Mr Krenzke has founded and co-founded three private E&P companies operating in the Gulf Coast region of the USA. One company that he co-founded was Gryphon Exploration Company which was formed in 2000 and was ultimately sold in 2005 for US$285 million. From 2006 through 2008, Mr Krenzke worked as a consultant in business development and evaluation of exploration and producing properties in the Gulf Coast, Gulf of Mexico and North Sea regions. In 2008 he joined Saxet Petroleum as Executive Vice President of Exploration, leaving in 2009 to join Petsec. Mr Krenzke holds a Bachelor of Science degree in Geophysics from Texas A&M University.

### Denis Swords

*General Counsel and Corporate Secretary of PEI*

Mr Swords joined the Company in 2005 as the General Counsel and Corporate Secretary of Petsec Energy Inc. Mr Swords has over 25 years of experience working in and with the oil and gas industry. He earned a Master of Science degree in Geology from the University of New Orleans and worked as an exploration geologist from 1982 until he enrolled in the Louisiana State University Law School in 1989. After receiving his Juris Doctor Degree in 1992, Mr Swords became a partner in a mid-sized law firm where he counselled numerous oil and gas clients.

### Fiona A Robertson

*Chief Financial Officer*

Ms Robertson joined the Company in 2002 as the Chief Financial Officer of the Petsec Energy Ltd group. Ms Robertson has over 30 years of corporate finance experience including more than 20 in the resources industry. She spent 14 years working for The Chase Manhattan Bank in London, New York and Sydney, and eight years with Delta Gold Ltd as General Manager, Finance/Chief Financial Officer. In October 2009, Ms Robertson became a Non-Executive Director of Drillsearch Energy Limited. Ms Robertson holds a Master of Arts degree in Geology from Oxford University, is a Fellow of the Australian Institute of Company Directors and a Member of the Australasian Institute of Mining and Metallurgy.

### Paul Gahdmar

*Company Secretary and Group Financial Controller*

Mr Gahdmar joined the Company in 1999 as the Financial Accountant of the Petsec Energy group and has since held a number of management positions within the Company. Mr Gahdmar was appointed as the Company Secretary of Petsec Energy Ltd in 2008 and has over 15 years experience in corporate accounting and finance in listed companies within the resources industry. Mr Gahdmar holds a Master of Business and Technology degree from The University of New South Wales and a Diploma in Investor Relations from the Australasian Investor Relations Association, and is a Fellow of the National Institute of Accountants.

# Directors' Report continued

For the year ended 31 December 2010

## 3. Directors' meetings

The Board has a formally constituted Audit Committee and a Nomination and Remuneration Committee, of which each director is a member. A non-executive director chairs both committees.

The number of directors' meetings (including meetings of committees of directors) and number of meetings attended by each of the directors of the Company during the financial year are:

| | Regular Board Meetings | Additional Board Meetings | Audit Committee Meetings | Nomination & Remuneration Committee Meetings |
|---|---|---|---|---|
| **Total number held during the year** | **10** | **1** | **6** | **2** |
| T N Fern | 10 | 1 | 6** | 2** |
| D A Mortimer | 10 | 1 | 6 | 2 |
| M L Harvey | 9 | 1 | 6 | 2 |
| P E Power* | 5 | – | 2 | 1 |

* Dr Power retired from the board on 21 May 2010.
** Mr Fern attended as an invitee.

## 4. Remuneration report

The Remuneration Report is set out on pages 18 to 24 and forms part of the Directors' Report for the financial year ended 31 December 2010.

## 5. Principal activities

The principal activities of the consolidated entity during the course of the financial year were oil and gas exploration and production in the shallow waters of the Gulf of Mexico and onshore Louisiana Gulf Coast region of the USA, and oil exploration in the shallow waters of the Beibu Gulf off the south coast of China.

## 6. Financial review

### Highlights

The consolidated entity generated net revenues after royalties from its U.S. Gulf of Mexico and onshore Louisiana operations of US$27.1 million for the full year, from production of 3.9 Bcfe at an average gas equivalent sales price of US$6.98/Mcfe. This represents a 48% decrease on net revenues after royalties for the previous corresponding period of US$52.0 million (2009: Production of 7.1 Bcfe; and average gas equivalent sales price of US$7.36/Mcfe), mainly due to natural decline in field production in combination with a lower average net gas equivalent sales price received for the current period.

Earnings before interest, income tax, DD&A and exploration expense ("EBITDAX") for the twelve months to 31 December 2010 of US$12.6 million (2009: US$31.3 million) reflected the reduced level of production and the lower average net gas equivalent sales price received.

The consolidated entity recorded an EBITDAX (cash operating) margin of US$3.26/Mcfe (2009: US$4.43/Mcfe) for the current period, representing a 47% gross operating margin.

Depreciation, depletion, amortisation and rehabilitation (DD&A) expense for the current period was US$12.5 million, 40% lower than the previous corresponding period charge of US$21.0 million due to the combined effect of lower production and prior period impairments recognised against the carrying values of the U.S. oil and gas properties.

The underlying net loss (i.e. Earnings/(loss) before dry hole, impairment and abandonment expense, derivative gains and income tax) for the year was US$2.2 million, a reduction on the previous corresponding period underlying net profit of US$3.3 million. Lease operating, GG&A, DD&A and financial expense was lower than in the previous corresponding period, reflecting a reduction in the size of the consolidated entity's U.S. operations, further cost cutting and a reduced level of borrowings following the repayment of the principal loan balance in December 2009 of the Company's U.S. subsidiary's revolving credit facility.

The Company periodically reviews the carrying values (i.e. book value) of its oil and gas properties and, in accordance with accounting standards and the consolidated entity's policy, is required to demonstrate the carrying value of its properties are no less than, the estimated future discounted cash flow to be generated from the expected production from these properties.

During the current period, the consolidated entity recognised dry hole, impairment and abandonment expense of US$19.5 million (2009: US$10.3 million). This comprised US$2.9 million in relation to Petsec Energy's share of dry hole costs of the Main Pass Block 20 #4 exploration well;

## 6. Financial review continued

### Highlights continued

US$16.5 million in impairment provisions against producing properties and undrilled leases due to reserve revisions, lower gas prices, and the current difficult Gulf of Mexico investment climate; and US$0.1 million increase in rehabilitation provisions (see note 7 – "Profit/(loss) for the period" of the notes to the consolidated financial statements for further details).

Under Australian Accounting Standards, the consolidated entity is also required to assess at each reporting period, the extent to which deferred tax assets in respect of the carry-forward of unused tax losses and temporary differences qualify for recognition on the balance sheet based on current facts and circumstances, including projected future taxable profits.

With the reduction in the group's U.S. reserve base the capacity to utilise tax losses depends on exploration success. Consequently, the consolidated entity has also recognised impairment of its deferred tax assets of US$13.6 million reflecting the uncertainty over the Company's capacity to utilise these losses.

The net loss after tax of US$35.2 million for the twelve months to 31 December 2010 compares to the previous corresponding period net loss after tax of US$14.9 million, due to the abovementioned factors.

### Financial position

At 31 December 2010, the consolidated entity held total cash deposits of US$23.1 million (31 December 2009: US$25.4 million). The cash deposits included US$5.7 million of restricted cash deposits used to guarantee certain of the Company's U.S. operations future rehabilitation obligations.

Total outstanding debt at 31 December 2010 amounted to US$29.2 million (31 December 2009: US$29.4 million) and is comprised of a subordinated term loan held by Petsec Energy Inc. (PEI). The loan is secured by the assets of PEI and matures on 8 November 2011. Petsec Energy Ltd has not provided any guarantee or security in respect of these borrowings.

As at 31 December 2010, PEI obtained a waiver from the lender in respect of compliance with the asset coverage ratio covenant under this loan.

In December 2010, PEI and the lender entered into a memorandum of understanding in relation to the settlement and extinguishment of the loan amount. As part of this memorandum the scheduled 31 December 2010 quarter payment of US$75,000 was deferred.

Under the terms of the memorandum of understanding, the US$29.2 million liability will be fully extinguished in return for a payment of US$12 million in cash, conveyances of certain minority working interests in 2 producing fields, and 25% of PEI's working interest in its non producing leases as at 31 December 2010. The working interest conveyances are effective 1 January 2011. Petsec Energy Ltd will fund US$11 million of the cash settlement amount. (See Note 17 – Loans and borrowings in the notes to the consolidated financial statements for further details).

As at the date of this report, PEI is in ongoing discussions with the lender to finalise the documentation and extinguish the loan under the terms of the memorandum of understanding.

## 7. Operations review

### USA, Gulf of Mexico/Onshore Louisiana

*Gulf of Mexico*

The deep water (5,000 feet) BP-operated Macondo well blew out on 20 April 2010, causing an explosion and fire which killed 11 people and sank the drillship, releasing oil to surface until the well was capped in mid July 2010. Consequently the U.S. Federal Government announced a moratorium on further deep water drilling (greater than 500 feet of water), and caused all operators to suspend all 33 deep water wells being drilled at the time. The moratorium effectively stopped operations in all US Federal waters including the Gulf of Mexico shelf where Petsec Energy operates. The Texas Offshore Lease Sale scheduled for August 2010, and the offshore Louisiana sales due in March 2011, were both cancelled. The drilling moratorium was lifted on 12 October 2010, following the capping of the Macondo well in July.

The former regulatory body responsible for Gulf of Mexico drilling (Minerals Management Service "MMS") has been substantially changed and is now called the Bureau of Ocean Energy Management, Regulation and Enforcement (BOEMRE), and new rules and regulations have been established. Permitting for drilling in the shallow waters of the Gulf of Mexico has recommenced, however the permitting process is much slower than was the case prior to the moratorium. Petsec Energy expects to recommence drilling in the Federal waters of the Gulf of Mexico in the second half of 2011, probably in the fourth quarter.

The drilling moratorium and changes to the regulatory system in the Federal waters of the Gulf of Mexico caused Petsec Energy to focus future drilling onshore and in the State waters of Louisiana and Texas. The Marathon gas/condensate discovery made in October 2010 was a result of this new focus.

# Directors' Report continued

For the year ended 31 December 2010

## 7. Operations review continued

### USA, Gulf of Mexico/Onshore Louisiana

*Production*

Petsec Energy currently produces oil and gas only in the USA, in the offshore shallow waters the Gulf of Mexico and onshore Gulf Coast of Louisiana. It holds interests in 10 producing leases of which Marathon, Main Pass Blocks 18/19, Main Pass Block 270, and Chandeleur Block 31/32 are the main fields.

The Main Pass Block 270 field (the Company's largest in 2010) was shut-in in early April 2010 due to damage to an onshore oil pipeline which is owned and operated by a third-party. Regulatory uncertainties consequent to the Macondo oil spill delayed restoration of production, which recommenced on 15 September 2010.

*Acquisitions*

During the year, Petsec Energy was awarded eight lease blocks successfully bid at the Central Gulf of Mexico Lease Sale 213 held in New Orleans, Louisiana USA on 17 March 2010. Petsec Energy submitted four sole bids (100% working interest) and four joint bids with another company for a net total amount to the Company of US$1,602,980.

The lease blocks contain prospects mapped by the Company ranging in size from 20 to in excess of 100 Bcfe.

*Exploration and development*

Petsec Energy's proposed 2010 drilling programme of three to five wells in 2010 was designed to test the new suite of prospects generated by the Company, located on the Gulf of Mexico shelf (in less than 300 feet of water) in the geologic section of 12,000 to 18,000 feet, with estimated potential reserves of 20 to in excess of 100 Bcfe each. The first well of the drill programme was spud in mid April 2010 targeting potential reserves of 20 – 45 Bcfe. The well was drilled to a total depth of 3,900 metres (12,800 feet) in early June 2010, intersecting a thick channelised reservoir sequence confirming the targets predicted by the Company's 3D seismic analysis. Log analysis indicated the presence of 100 feet of gas-charged, fine grained sand reservoir which correlated to the strong seismic amplitude response. Further petrophysical analyses, however, indicated that the reservoir had very low permeability and was incapable of producing hydrocarbons at commercial rates. Consequently, the well was plugged and abandoned at a cost to the Company of US$2.9 million. Whilst the low permeability was disappointing, the geologic model and seismic interpretation were confirmed. Further drilling in the Gulf of Mexico was stopped due to the moratorium, and focus was directed onshore Louisiana.

In the second half of 2010, the Company participated with a 10% working interest in the drilling of the Marathon Prospect in Louisiana State Lease 20221. No. 1 exploratory well in the shallow waters along the Louisiana Gulf Coast, with Phoenix Exploration as operator. The Marathon well is located in the Atchafalaya Bay in south Louisiana in approximately 8 feet (2.4 metre) of water. The well targeted mapped reserve potential, ranging from 20 to 78 billion cubic feet of gas equivalent ("Bcfe"). It was spud on 8 August 2010 and reached target depth of 5,730 metres (18,800 feet) on 18 October 2010 discovering gas and condensate, confirming the pre-drill 3D seismic mapping and reserve potential. The well was brought into production on 30 December 2010 at an initial gross production rate of 14.7 MMcf/day with 12,800 psi flowing tubing pressure, increasing to over 20 MMcf and 100 barrels of condensate, per day.

A second well is planned in the second quarter of 2011 to further develop and expand the extent of the field.

The Company has directed its focus onshore and in State waters as a result of the Gulf of Mexico drilling moratorium in 2010 and the consequent uncertain regulatory environment. In response to the current US oversupply of gas due to the extraordinary success of horizontal drilling for shale gas, the Company's bias will be towards oil operations. Consequently, Petsec Energy has established a relationship with an experienced shale oil group and has jointly undertaken regional and local investigations to determine areas of interest. It is anticipated that meaningful lease holdings on which exploratory drilling can commence may be established within the next six months.

*Plug and abandonment*

During the year, the Mobile Bay Area fields were permanently shut-in earlier than expected because of lower gas prices. They are expected to be plugged and abandoned during the first half of 2011 at an estimated cost of US$4.8 million, US$2.5 million of which will be met with restricted cash that has been set aside for this purpose. The Main Pass 20 field which ceased production during 2009 is expected to be plugged and abandoned late in the second half of 2011 at an estimated cost of US$3.5 million.

# 7. Operations review continued

## China, Block 22/12 Beibu Gulf (South China Sea)

The Block 22/12 Joint Venture announced a Final Investment Decision ("FID") on 14 February 2011 to proceed with the development of the Weizhou 6.12 North, 6.12 South and 12.8 West oilfields, following approval of the Overall Development Plan ("ODP") by China National Offshore Oil Corporation ("CNOOC") in late January. The ODP has been lodged with the relevant Chinese Government authorities for formal approval. Basic engineering and design and ordering of long lead items have commenced. CNOOC has assumed operatorship of the development and production operations having elected to back-in to the maximum interest of 51% allowable under the Block 22/12 Petroleum Contract. As a consequence Petsec Energy's interest in the three oil fields comprising the development has reduced to 12.25%. Independently confirmed 2P reserves for this ODP are 24 MMbbl of oil (Petsec 12.25% share: 2.94 MMbbl). The remaining two fields, 12.8 East and 12.3.1, are being reviewed and may be developed in 2012/13, connecting to the production infrastructure to be built for the 6.12/12.8 West oil fields.

The development encompasses the drilling of eleven development wells and potentially three to four exploration wells targeting potential reserves of 20 to 40 million barrels from two unmanned well head platforms to be built at the 6.12 South and 12.8 West oil fields.

These platforms will be connected by pipelines to a new CNOOC processing platform, adjacent to CNOOC's 12.1.1 platform. The project will have access to 20,000 barrels of oil per day processing capacity from which oil will be transported through CNOOC's 16" pipeline 32 km to storage and export terminal at Weizhou Island.

First oil production is expected before year end 2012.

Development capital expenditure is estimated at US$300 million. Petsec Energy's share is US$37 million of which about US$10 million may be required in 2011. Operating costs are anticipated to be similar to CNOOC operating costs in the 12.1.1 area.

### *Development of the Wei 12.8 East and 12.3.1 oil fields*

Feasibility studies for the development of the 12.8 East and 12.3.1 oil fields, which have been estimated to contain recoverable reserves ranging from 15 to 72 MMbbl (P50 – P10), have commenced. Subject to satisfactory economics, development of these two oil fields is anticipated to commence in 2011/2012, and will connect to the infrastructure built for the 6.12/12.8W project.

Eight undrilled prospects in Block 22/12 have been estimated to hold an additional 100 MMbbl gross potential.

## Oil and gas reserves – USA and China

Independently estimated proved and probable ("2P") reserves at 31 December 2010 for the USA were 16.9 Bcfe and estimated 2P reserves for Petsec's 12.25% working interest in 6.12/6.12 South and 12.8 West oil fields development of Block 22/12, Beibu Gulf China are 2.94 MMbbl.

## USA

Independently estimated 2P USA oil and gas reserves at 31 December 2010 were 16.9 Bcfe, after additions of 4.1 Bcfe from exploration, net revisions of 1.3 Bcfe (Main Pass 18/19 and 270 fields), and production for the year of 3.9 Bcfe.

| | Independent Assessment[1] | | | Petsec Energy |
|---|---|---|---|---|
| Gas Equivalent (Bcfe*) | Proved Reserves | Probable Reserves | Proved and Probable Reserves | Estimated Recoverable Proved and Probable Reserves |
| **USA Reserves**<br>Reserves at 1 January 2010 | 14.0 | 4.0 | **18.0** | **18.9** |
| Net additions | 2.5 | 1.6 | **4.1** | **4.1** |
| Net revisions | 0.5 | (1.8) | **(1.3)** | **(2.4)** |
| Production | (3.9) | – | **(3.9)** | **(3.9)** |
| **USA Reserves at 31 December 2010** | **13.1** | **3.8** | **16.9** | **16.7** |

*Billion cubic feet of gas equivalent using ratio of six thousand cubic feet of natural gas to one barrel of oil.

[1]The independent reserve assessments at 31 December 2010 were estimated by independent petroleum engineers Ryder Scott Company.

# Directors' Report continued

For the year ended 31 December 2010

## 7. Operations review continued

### China

The Overall Development Plan ("ODP") for the development of the 6.12, 6.12 South and 12.8 West oil fields was approved by China National Offshore Oil Company ("CNOOC") in late January 2011, and a Final Investment Decision to proceed with the development made by the joint venture in February. CNOOC backed into the project for 51% as permitted under the Block 22/12 Petroleum Contract and was awarded operatorship, reducing the Company's share from 25% to 12.25%. The 2P reserves for this project are 24 MMbbl of oil which have been independently confirmed by RISC Pty Ltd, independent petroleum engineers, (Petsec's 12.25% working interest: 2.94 MMbbl). The remaining two fields, 12.8 East and 12.3.1, are subject to current feasibility studies and reserves are yet to be booked.

### Competent Person Statement

The USA and China reserves have been assessed by independent petroleum engineers – Ryder Scott Company for the USA reserves and RISC Pty Ltd for the China reserves. In accordance with ASX Listing Rules, the Petsec Energy USA internal reserve estimates information in this report is based upon information compiled, reviewed and signed off by Mr Ron Krenzke, Executive Vice President Exploration, a full time employee of Petsec Energy. The Beibu Gulf reserve estimates in this report are based on information provided by Roc Oil Company Limited in its capacity as Joint Venture Operator, and reviewed and signed off by Mr Krenzke. Mr Krenzke has at least five years' relevant experience within the sector and consents to the disclosure of this information in the form and context in which it appears.

## 8. Objectives, strategy and future performance

It is the consolidated entity's objective to increase shareholder value through successful oil and gas exploration, development, and production and through acquisitions. The consolidated entity intends to produce its current reserves, continue oil and gas exploration drilling activities in the Gulf of Mexico shelf and onshore Louisiana, USA, develop shale oil potential in Louisiana and Texas, USA, develop the Wei 6.12, 6.12 South and 12.8 West oil fields and progress the development of the Wei 12.8 East and 12.3.1 oil fields in the Beibu Gulf in China.

## 9. Dividends

Directors do not recommend the payment of a dividend for the financial year ended 31 December 2010. No dividends were paid during the financial year.

## 10. Significant changes in state of affairs

There were no significant changes to the state of affairs of Petsec Energy during the financial year, other than those detailed in the "Financial review" and "Operations review" sections of this report.

## 11. Environmental regulation

The consolidated entity's oil and gas exploration and production activities are subject to significant environmental regulation under U.S. Federal and State legislation and laws and decrees of the People's Republic of China.

The consolidated entity is committed to achieving a high standard of environmental performance and compliance with all lease conditions. Directors are not aware of any breach of environmental compliance requirements relating to the consolidated entity's activities during the year.

## 12. Likely developments

### China

*Beibu Gulf, Block 22/12 Joint Venture*

The consolidated entity anticipates formal Chinese Government approval of the ODP for the development of the Wei 6.12, 6.12 South and 12.8 West oil fields during second quarter 2011. First production from the fields is anticipated for fourth quarter 2012.

### USA

The consolidated entity anticipates drilling one to two wells in the Federal waters of the Gulf of Mexico, and two to three wells onshore and in the State waters of Louisiana and Texas during 2011.

## 13. Directors' interests

The relevant interest of each director in the shares or options over such instruments issued by the Company, as notified by the directors to the Australian Securities Exchange in accordance with S205G (1) of the Corporations Act 2001, at the date of this report is as follows:

| Director | Ordinary Shares | Options over Ordinary Shares |
|---|---|---|
| T N Fern | 28,826,876 | 2,000,000 |
| D A Mortimer | 9,326,550 | Nil |
| M L Harvey | Nil | Nil |

## 14. Share options

### Options granted to directors and officers of the Company

During or since the end of the financial year, grants of 600,000 options were made to directors or the five most highly remunerated officers of the Company as part of their remuneration.

As at 31 December 2010, there were 5,272,000 options over ordinary shares in Petsec Energy Ltd on issue, all of which are employee options exercisable at prices ranging from A$0.20 to A$3.11 per share expiring at various dates between 12 April 2011 and 31 December 2014 with exercise dependent on completion of vesting period and satisfaction of share price hurdles ranging from A$0.30 to A$6.84 being achieved on the Australian Securities Exchange. During the year 2,146,000 were granted, 2,573,500 options were forfeited and no options were exercised.

Subsequent to 31 December 2010 through the date of this report, no employee options have been exercised.

### Unissued shares under option

At the date of this report, unissued ordinary shares of the Company under option are:

| Expiry date | Exercise price | Number of shares |
|---|---|---|
| 12 April 2011 | A$2.38 | 15,000 |
| 24 July 2011 | A$2.90 | 200,000 |
| 4 December 2011 | A$2.46 | 25,000 |
| 23 January 2012 | A$2.27 | 35,000 |
| 30 January 2012 | A$2.38 | 380,000 |
| 13 April 2012 | A$1.91 | 25,000 |
| 14 June 2012 | A$2.40 | 1,500,000 |
| 14 June 2012 | A$3.11 | 500,000 |
| 17 July 2012 | A$1.48 | 30,000 |
| 12 February 2013 | A$1.19 | 75,000 |
| 31 December 2013 | A$0.20 | 604,500 |
| 31 December 2014 | A$0.23 | 1,657,500 |
| | | **5,047,000** |

### Shares issued on exercise of options

During the financial year, there were no ordinary shares issued by the Company as result of the exercise of options.

## 15. Indemnification and insurance of officers

During the year ended 31 December 2010, the Company maintained policies of insurance in respect of directors and officers liability. The policies insure persons who are directors or officers of the Company and its controlled entities against certain costs and expenses which may be incurred by them in defending proceedings and against other liabilities which may arise from their positions. The insured directors and officers are the directors, executive officers and secretaries of the Company and the directors, executive officers and secretaries of controlled entities.

The insurance contracts prohibit the disclosure of particulars of the premiums and the nature of the liabilities insurance.

The Company has entered into Deeds of Indemnity and Access with directors on the terms approved by shareholders. The agreements stipulate that the Company will meet the full amount of any liabilities to another person that might arise from their position (except where the liability arises out of conduct involving a lack of good faith).

The Company has made during or since the end of the financial year no payments in relation to indemnification. The Company provides the normal indemnities to directors and officers in relation to the work carried out on behalf of or at the request of the Company.

## 16. Non-audit services

During the year KPMG, the Company's auditor, has performed certain other services in addition to their statutory duties.

The Board has considered the non-audit services provided during the year by the auditor and in accordance with advice provided by resolution of the audit committee, is satisfied that the provision of those non-audit services during the year by the auditor is compatible with, and did not compromise, the auditor independence requirements of the Corporation Act 2001 for the following reasons:

- All non-audit services were subject to the corporate governance procedures adopted by the Company and have been reviewed by the audit committee to ensure they do not impact the integrity and objectivity of the auditor; and
- The non-audit services provided do not undermine the general principles relating to auditor independence as set out in APES 110 *Code of Ethics for Professional Accountants*, as they did not involve reviewing or auditing the auditor's own work, acting in a management or decision-making capacity for the Company, acting as an advocate for the Company or jointly sharing risks and rewards.

Details of the amounts paid to the auditor of the Company, KPMG, and its related practices for audit and non-audit services provided during the year are set out in Note 8 of the accompanying Financial Statements.

# Directors' Report continued

For the year ended 31 December 2010

## 17. Lead auditor's independence declaration

The Lead Auditor's Independence Declaration is set out on page 25 and forms part of the Directors' Report for the financial year ended 31 December 2010.

## 18. Rounding off

The Company is of a kind referred to in ASIC Class Order 98/100 dated 10 July 1998 and in accordance with that Class Order, amounts in the Financial Report and Directors' Report have been rounded off to the nearest one thousand dollars, unless otherwise stated.

## 19. Events subsequent to balance date

Other than any matter disclosed, there has not arisen in the interval between the end of the financial year and the date of this report any item, transaction or event of a material and unusual nature likely, in the opinion of the directors of the Company, to affect significantly the operations of the consolidated entity, the results of those operations, or the state of affairs of the consolidated entity, in future years.

This report is made with a resolution of the directors:

**T N Fern**
Director

Sydney, 28 February 2011

## 20. Remuneration Report – Audited

### 20.1 Nomination and Remuneration Committee

The Nomination Committee oversees the appointment and induction process for directors and committee members, and the selection, appointment and succession planning process of the Company's Managing Director. The Committee makes recommendations to the Board on the appropriate skill mix, personal qualities, expertise and diversity of each position. When a vacancy exists or there is a need for particular skills, the Committee in consultation with the board determines the selection criteria based on the skills deemed necessary.

The Remuneration Committee reviews and makes recommendations to the Board on compensation packages and policies applicable to the executive officers and directors themselves of the Company and of other group executives for the consolidated entity. It is also responsible for oversight of diversity, share option schemes, incentive performance packages, superannuation entitlements, retirement and termination entitlements, fringe benefits policies and professional indemnity and liability insurance policies.

Executive compensation and other terms of employment are reviewed annually by the Nomination and Remuneration Committee having regard to performance against goals set at the start of the year, relevant corporate information and where appropriate independent expert advice.

The Nomination and Remuneration Committee comprised the following members during the year:

- D A Mortimer (Chairman) – Independent Non-Executive
- M L Harvey – Independent Non-Executive
- P E Power – Independent Non-Executive (retired from the Board and its Committees on 21 May 2010)

The Board policy is that the Nomination and Remuneration Committee will comprise a majority of non-executive directors and a non-executive chairman.

The Nomination and Remuneration Committee meets at least twice a year and as required. The Committee met two times during the year and Committee members' attendance record is disclosed in the table of directors' meetings.

The Nomination and Remuneration Committee's charter is available on the Company's website.

### 20.2 Principles of compensation

Key management personnel have authority and responsibility for planning, directing and controlling the activities of the Company and the consolidated entity, including other executives. Key management personnel comprise the directors of the Company and executives for the Company and the consolidated entity including the five most highly remunerated S300A executives.

Compensation levels for key management personnel and secretaries of the Company and key management personnel of the consolidated entity are competitively set to attract and retain appropriately qualified and experienced directors and senior executives. The Remuneration Committee obtains peer comparisons and/or independent advice on the appropriateness of compensation packages of both the Company and the consolidated entity, given trends in comparative companies both locally and internationally and the objectives of the Company's compensation strategy.

The compensation structures explained below are designed to attract suitably qualified candidates, reward the achievement of the Company's objectives, and achieve the broader outcome of creation of value for shareholders. The compensation structures take into account:

- the capability and experience of the key management personnel
- the key management personnel's ability to control the relevant performance of their segment of operation.

## 20. Remuneration Report – Audited continued

### 20.2 Principles of compensation continued

Compensation packages include a mix of fixed compensation and performance-based including equity-based incentives.

In addition to their salaries, the consolidated entity also provides non-cash benefits to its key management personnel, and contributes to several post-employment defined contribution superannuation plans in Australia and also matches contributions made by U.S.-based key management personnel to a voluntary savings plan under Section 401(k) of the U.S. tax code.

#### Fixed compensation

Fixed compensation consists of base compensation (which is calculated on a total cost basis and includes any FBT charges related to employee benefits), as well as employer contributions to superannuation funds.

The Nomination and Remuneration Committee review compensation levels and other terms of employment annually through a process that considers individual, segment and overall performance of the consolidated entity against goals set at the start of the year. In addition, where necessary, external consultants provide analysis and advice to ensure the directors' and senior executives' compensation is competitive in the market place.

#### Performance-linked compensation

Performance-linked compensation includes both short-term and long-term incentives and is designed to reward key management personnel for meeting or exceeding the Company's financial objectives and agreed individual objectives. The short-term incentive (STI) is an "at risk" bonus provided in the form of cash, while the long-term incentive (LTI) is provided as options over ordinary shares of the Company under the rules of the Employee Option Plan (see note 18(c) to financial statements).

#### Short-term incentive bonus

Performance-linked cash bonuses are payable to eligible employees under the Company's Incentive Plan. Eligible employees may be entitled to a bonus based on the company's performance in the year relative to a number of pre-determined performance targets and based on an annual evaluation of individual performance. The target bonus is set as a percentage of an employee's base salary and will vary above or below the target level based on the extent to which agreed targets are exceeded or underachieved. In addition to the Company's Incentive Plan the Nomination and Remuneration Committee has the right to grant discretionary bonuses. Factors considered by the Committee when granting discretionary bonuses include achievement of strategic objectives, retention and motivation of employees. No bonuses will be paid under the above incentive plan in respect of the 2010 year (2009: Nil).

#### Long-term incentive

Eligible employees are also provided with long-term incentives through participation in the Company's Employee Option Plan, subject to the approval of the Remuneration Committee. Employees are typically offered options on an annual basis comprising three tranches which vest annually with the first tranche becoming exercisable up to one year from the date of issue subject to the share price (at the time options are exercised) being not less than a hurdle price of the higher of 30 cents per share or 25% above the exercise price. The exercise price of options is based on the weighted average market price of the Company's ordinary shares for the five trading days preceding the date of issue, subject to a minimum exercise price of 20 cents.

#### Service Agreements

Remuneration and other terms of engagement of executive employees are formalised in service agreements that are unlimited in term but capable of termination by varying periods of notice or by payment of an amount in lieu of notice. The service agreements generally outline the components of compensation paid, but do not prescribe how compensation levels are modified year-to-year. Compensation levels are reviewed each year to consider factors such as cost-of-living changes, performance of and changes in the scope of the role performed by the executive and changes required to meet the principles of the compensation policy.

The Managing Director, Mr Fern, is engaged via a company of which Mr Fern is a director. The Company may terminate this agreement without cause by giving not less than twelve months' notice or pay an amount equal to the fees for twelve months in lieu of notice. Mr Fern may terminate the agreement with not less than six months' notice. With cause, Mr Fern may terminate the agreement by giving one month's notice and would be entitled to a payment equal to fees for a twelve-month period.

The President of Petsec Energy Inc., Mr Keogh has an employment agreement, which is capable of termination without cause by the company by a lump sum payment equal to one and one-half times his annual Base Salary. Mr Keogh may terminate the agreement without cause by giving the company at least thirty days notice in writing. Mr Keogh may terminate the agreement for cause and in this event is entitled to receive a lump sum payment equal to one and one-half times his annual base salary at that time.

# Directors' Report continued

For the year ended 31 December 2010

## 20. Remuneration Report – Audited continued

### Service Agreements continued

Other executives have service agreements which are capable of termination by the Company without cause by the payment of between one and three months' notice, or are "at-will" employment contracts entered into in the USA where either party may terminate the employment relationship at any time and for any reason without any further liability, except as required by law.

### Non-executive directors

Directors' fees are set having regard to periodic advice from external remuneration consultants, market surveys and the level of fees paid relative to that of other comparable companies. Directors' fees for the 2010 year were unchanged from the 2009 year and comprise base fees, plus statutory superannuation for Australian directors. Directors are also entitled to reasonable travel, accommodation and other expenses incurred in attending meetings or while engaged on Company business.

Non-executive directors do not receive performance-related compensation. Directors' fees cover all main Board activities and membership of committees and are subject to the aggregate limit of A$300,000 approved by shareholders at the 1996 Annual General Meeting.

Non-executive directors appointed prior to 2003 are entitled to receive a retirement benefit that is equivalent to the remuneration received in the three years prior to retirement. Incoming non-executive directors are not entitled to retirement benefits.

### 20.3 Directors' and Executive Officers' Remuneration Report

Details of the nature and amount of remuneration for the key management personnel consisting of each director and executive officer of the Company and the consolidated entity are:

| | | Short-term benefits | | | | Post-employment benefits | | Share-based payment | Total US$ | Proportion of remuneration performance related % | Value of options as proportion of remuneration % |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Key management personnel – Directors[1]** | | Salary & fees US$ | Short-term incentive cash bonus US$ | Other benefits US$ | Service agreements US$ | Superannuation benefits US$ | Retirement benefits US$ | Accounting fair value of options US$ | | | |
| **Executive** | | | | | | | | | | | |
| T N Fern[1] (Note 1) Chairman, Managing Director | **2010** | **–** | **–** | **23,355** | **606,012** | **–** | **–** | **63,843** | **693,210** | **–** | **9.2** |
| | 2009 | – | – | 22,320 | 521,400 | – | – | 92,508 | 636,228 | – | 14.5 |
| **Non-executive** | | | | | | | | | | | |
| D A Mortimer[1] Director | **2010** | **59,683** | **–** | **–** | **–** | **5,371** | **–** | **–** | **65,054** | **–** | **–** |
| | 2009 | 51,350 | – | – | – | 4,622 | 11,850 | – | 67,822 | – | – |
| P E Power[1] (Note 2) Director | **2010** | **23,283** | **–** | **–** | **–** | **–** | **179,049** | **–** | **202,332** | **–** | **–** |
| | 2009 | 51,350 | – | – | – | 2,311 | 11,850 | – | 65,511 | – | – |
| M L Harvey Director | **2010** | **50,000** | **–** | **–** | **–** | **–** | **–** | **–** | **50,000** | **–** | **–** |
| | 2009 | 50,000 | – | – | – | – | – | – | 50,000 | – | – |
| **Total directors** | **2010** | **132,966** | **–** | **23,355** | **606,012** | **5,371** | **179,049** | **63,843** | **1,010,596** | | **6.3** |
| | 2009 | 152,700 | – | 22,320 | 521,400 | 6,933 | 23,700 | 92,508 | 819,561 | – | 11.3 |

[1]Directors' remuneration amounts except for Mr Harvey are actually paid in Australian dollars and presented in US dollars at the following FX rates i) 2010 – 0.9182 ii) 2009 – .7900

## 20. Remuneration Report – Audited continued

### 20.3 Directors' and Executive Officers' Remuneration Report

Details of the nature and amount of remuneration for the key management personnel consisting of each director of the Company and executive officer of the Company and the consolidated entity are:

| Key management personnel – Executive officers | | Short-term benefits: Salary & fees US$ (Note 6) | Short-term benefits: Short-term incentive cash bonus US$ | Short-term benefits: Other benefits US$ (Note 7) | Short-term benefits: Service agreement US$ | Post-employment benefits: Superannuation/401K benefits US$ | Post-employment benefits: Retirement benefits US$ | Share-based payment: Accounting fair value of options US$ (Note 8) | Total US$ | Proportion of remuneration performance related % | Value of options as proportion of remuneration % |
|---|---|---|---|---|---|---|---|---|---|---|---|
| R A Keogh, President, Petsec Energy Inc. (PEI) | **2010** | **234,000** | **–** | **27,917** | **–** | **33,212** | **–** | **55,222** | **350,351** | **–** | **15.8** |
| | 2009 | 259,776 | – | 22,482 | – | 17,200 | – | 84,062 | 383,520 | – | 21.9 |
| R Krenzke Executive Vice President Exploration, PEI | **2010** | **234,000** | **–** | **27,917** | **–** | **24,300** | **–** | **–** | **286,217** | **–** | **–** |
| | 2009 | 26,361 | – | 1,605 | – | – | – | – | 27,966 | – | – |
| F Steele (Note 3) Vice President Land, PEI | **2010** | **109,320** | **–** | **16,285** | **–** | **10,932** | **–** | **839** | **137,376** | **–** | **0.6** |
| | 2009 | 194,716 | – | 22,482 | – | 9,350 | – | 17,369 | 243,917 | – | 7.1 |
| D Swords General Counsel/ Corporate Secretary, PEI | **2010** | **177,000** | **–** | **27,884** | **–** | **17,700** | **–** | **10,221** | **232,805** | | **4.4** |
| | 2009 | 189,456 | – | 22,449 | – | 8,850 | – | 8,727 | 229,482 | – | 3.8 |
| F Robertson[1] (Note 4) Chief Financial Officer | **2010** | **–** | **–** | **7,374** | **217,687** | **–** | **–** | **25,602** | **250,663** | **–** | **10.2** |
| | 2009 | – | – | 4,781 | 116,000 | – | – | 12,525 | 133,306 | – | 9.4 |
| C Jones[1] (Note 5) General Manager Corporate, Company Secretary | **2010** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** |
| | 2009 | – | – | 1,706 | 16,488 | – | – | – | 18,194 | – | – |
| P Gahdmar[1] Company Secretary, Group Financial Controller | **2010** | **147,417** | **–** | **2,230** | **–** | **13,268** | **–** | **8,945** | **171,860** | **–** | **5.2** |
| | 2009 | 131,671 | – | 1,083 | – | 11,850 | – | 7,116 | 151,720 | – | 4.7 |
| **Total executive officers** | **2010** | **901,737** | **–** | **109,607** | **217,687** | **99,412** | **–** | **100,829** | **1,429,272** | **–** | **7.1** |
| | 2009 | 801,980 | – | 76,588 | 132,488 | 47,250 | – | 129,799 | 1,188,105 | – | 10.9 |
| **Total compensation: key management personnel (Consolidated)** | **2010** | **1,034,703** | **–** | **132,962** | **823,699** | **104,783** | **179,049** | **164,672** | **2,439,868** | **–** | **6.7** |
| | 2009 | 954,680 | – | 98,908 | 653,888 | 54,183 | 23,700 | 222,307 | 2,007,666 | – | 11.1 |
| **Total compensation: key management personnel (Company)** | **2010** | **230,383** | **–** | **32,959** | **823,699** | **18,639** | **179,049** | **98,390** | **1,383,119** | **–** | **7.1** |
| | 2009 | 234,371 | – | 29,890 | 653,888 | 18,783 | 23,700 | 112,149 | 1,072,781 | – | 10.5 |

[1] Australian-based executive officers' remuneration amounts are actually paid in Australian dollars and presented in US dollars at the following FX rates i) 2010 – 0.9182 ii) 2009 – 0.7900.

# Directors' Report continued

For the year ended 31 December 2010

## 20. Remuneration Report – Audited continued

### 20.3 Directors' and Executive Officers' Remuneration Report continued

*Notes*

1. Included in service agreements above is an amount of US$606,012 (2009: US$521,400) which was paid or is payable to, a company of which Mr Fern is a director.

   During the year, a company of which Mr Fern is a director provided management services to the Company and its controlled entities. The dealings were in the ordinary course of business and on normal terms and conditions.

2. Dr Power retired from the Board on 21 May 2010 and was paid a retirement benefit of US$179,049 in accordance with the Company's principles of compensation (see note 20.2 "Non-executive directors" on page 20 of the Directors Report). This benefit was recognised as an expense during the period of Dr Power's service.

3. Mr Steele resigned from his position of Vice President Land, PEI on 26 July 2010.

4. Included in service agreements above is an amount of US$217,687 (2009: US$116,000), which was paid, or is payable to the above company (of which Mr Fern is a director) and through which Ms Robertson provided services.

5. Mr Jones resigned from his position of General Manager Corporate, Company Secretary on 5 March 2009.

6. Salary and fees for certain specified executives includes the movement during the reporting period of accruals for annual leave and long service leave.

7. Other benefits represent amounts paid on behalf of the Managing Director and Executive Officers in respect of insurance and car parking benefits.

8. The fair value of options is calculated at the date of the grant using the Black-Scholes model and allocated to each reporting period over the period from grant date to vesting date.

No termination benefits or other long-term benefits were paid to key management personnel for the years ended 31 December 2010 and 2009.

The following table sets out the factors and assumptions used in determining the fair value of the options issued to the above individuals.

| Grant date | Expiry date | Average fair value per option | Exercise price | Price of shares on grant date | Estimated volatility | Risk-free interest rate | Dividend yield |
|---|---|---|---|---|---|---|---|
| 1/03/06 | 24/02/11 | A$0.725 | A$2.13 | A$2.10 | 48.1% | 5.11% | – |
| 2/03/07 | 30/01/12 | A$0.509 | A$2.38 | A$1.95 | 46.5% | 5.91% | – |
| 2/03/07 | 12/02/12 | A$0.497 | A$2.40 | A$1.95 | 46.5% | 5.91% | – |
| 2/03/07 | 12/02/12 | A$0.373 | A$3.11 | A$1.95 | 46.5% | 5.91% | – |
| 1/06/07 | 14/06/12 | A$0.214 | A$2.40 | A$1.49 | 40.5% | 6.23% | – |
| 1/06/07 | 14/06/12 | A$0.141 | A$3.11 | A$1.49 | 40.5% | 6.23% | – |
| 14/1/09 | 31/12/13 | A$0.044 | A$0.20 | A$1.15 | 101.9% | 2.90% | – |
| 25/2/09 | 31/12/13 | A$0.030 | A$0.20 | A$0.15 | 88.1% | 3.27% | – |
| 29/1/10 | 31/12/14 | A$0.087 | A$0.23 | A$0.22 | 62.8% | 4.66% | – |

## 20. Remuneration Report – Audited continued

### 20.4 Analysis of short-term incentive cash bonuses included in remuneration

Amounts included in remuneration for the financial year, within the table included in note 20.3 of this Directors' Report, represent the amount that vested in the financial year based on achievement of personal goals and satisfaction of specified performance criteria.

No amounts vest in future financial years in respect of the bonus schemes for the 2010 year.

No amounts were forfeited due to the performance or service criteria not being met in relation to the current financial year.

### 20.5 Equity instruments

All options refer to options over ordinary shares of Petsec Energy Ltd, which are exercisable on a one-for-one basis under the Employee Option Plan.

*Options over equity instruments granted as compensation*

600,000 options over ordinary shares in the Company were granted as compensation to key management persons during the reporting period (2009: 235,000). Details on options over ordinary shares that were granted as compensation to key management persons during the reporting period and details on options that vested during the reporting period are as follows:

| | Number of options granted during 2010 | Grant date | Fair value per option at grant date | Exercise price per option | Expiry date | Number of vested during 2010 |
|---|---|---|---|---|---|---|
| **Executives** | | | | | | |
| R Keogh | – | – | – | – | – | 50,000 |
| F Steele | 200,000 | 29/01/10 | A$0.087 | A$0.23 | 31/12/14 | – |
| D Swords | 200,000 | 29/01/10 | A$0.087 | A$0.23 | 31/12/14 | 20,000 |
| P Gahdmar | 200,000 | 29/01/10 | A$0.087 | A$0.23 | 31/12/14 | 8,333 |

Details on options over ordinary shares that were granted as compensation to key management persons during the previous corresponding period and details on options that vested during the previous corresponding period are as follows:

| | Number of options granted during 2009 | Grant date | Fair value per option at grant date | Exercise price per option | Expiry date | Number of vested during 2009 |
|---|---|---|---|---|---|---|
| **Executives** | | | | | | |
| D Swords | 60,000 | 14/01/09 | A$0.044 | A$0.20 | 31/12/13 | – |
| R Keogh | 150,000 | 25/02/09 | A$0.030 | A$0.20 | 31/12/13 | – |
| P Gahdmar | 25,000 | 25/02/09 | A$0.030 | A$0.20 | 31/12/13 | – |

No options have been granted or cancelled since the end of the financial year through the date of this report.

For options granted during the year ended 31 December 2010, the earliest exercise date is 1 January 2011.

*Modification of terms of equity-settled share-based payment transactions*

No terms of equity-settled share-based payment transactions (including options granted as compensation to a key management person) have been altered or modified by the issuing entity during the reporting period or the prior period.

*Exercise of options granted as compensation*

No shares were issued, during the reporting period, on the exercise of options previously granted as compensation to key management personnel (previous corresponding period: Nil).

# Directors' Report continued

For the year ended 31 December 2010

## 20. Remuneration Report – Audited continued

### 20.5 Equity instruments continued

*Analysis of Movement in Options*

During the reporting period, 2,146,000 options were granted, 2,573,500 options were cancelled and no options were exercised.

The movement during the previous corresponding period, by value, of options over ordinary shares in the Company held by each director and each of the five named Company executives and relevant group executives is detailed below.

| | Value of Options | | |
|---|---|---|---|
| 2010 | Granted in year[A] A$ | Exercised in year[B] A$ | Total option value in year A$ |
| **Executives** | | | |
| F Steele | A$17,492 | – | A$17,492 |
| D Swords | A$17,492 | – | A$17,492 |
| P Gahdmar | A$17,492 | – | A$17,492 |

| | Value of Options | | |
|---|---|---|---|
| 2009 | Granted in year[A] A$ | Exercised in year[B] A$ | Total option value in year A$ |
| **Executives** | | | |
| R Keogh | A$8,773 | – | A$8,773 |
| D Swords | A$4,711 | – | A$4,711 |
| P Gahdmar | A$1,462 | – | A$1,462 |

[A] The value of options granted in the year is the fair value of the options calculated at grant date using the Black-Scholes model. This amount is allocated to remuneration over the vesting period.

[B] The value of options exercised during the year is calculated as the market price of shares of the Company on the ASX as at the close of trading on the date the options were exercised after deducting the price paid to exercise the option.

# Lead Auditor's Independence Declaration

under Section 307C of the Corporations Act 2001

To: the directors of Petsec Energy Ltd

I declare that, to the best of my knowledge and belief, in relation to the audit for the financial year ended 31 December 2010 there have been:

(i) no contraventions of the auditor independence requirements as set out in the Corporations Act 2001 in relation to the audit; and

(ii) no contraventions of any applicable code of professional conduct in relation to the audit.

KPMG

**KPMG**

Paul Zammit

**Paul Zammit**

Partner

Sydney, 28 February 2011

# Statements of comprehensive income

For the year ended 31 December 2010

| | Note | Consolidated | | The Company | |
|---|---|---|---|---|---|
| | | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| Revenues from sale of oil & gas and royalties | 5 | **31,061** | 57,124 | **–** | – |
| Royalties paid | | **(3,981)** | (5,088) | **–** | – |
| **Net revenues after royalties** | | **27,080** | 52,036 | **–** | – |
| Other income and expenses | 5 | **1,062** | – | **1,899** | 2,526 |
| Lease operating expenses | | **(6,915)** | (10,862) | **–** | – |
| Geological, geophysical and administrative expenses | | **(8,583)** | (9,882) | **(2,181)** | (1,901) |
| EBITDAX[1] | | **12,644** | 31,292 | **(282)** | 625 |
| Depreciation, depletion, amortisation and rehabilitation | | **(12,496)** | (20,982) | **(13)** | (12) |
| EBITX[2] | | **148** | 10,310 | **(295)** | 613 |
| Seismic and repair expense | | **(533)** | (1,561) | **–** | – |
| Dry hole, impairment and abandonment expense | 7 | **(19,450)** | (10,311) | **–** | – |
| Net movement in provisions against loans to and investments in controlled entities | 7 | **–** | – | **(52,086)** | (56,332) |
| EBIT[3] | | **(19,835)** | (1,562) | **(52,381)** | (55,719) |
| Derivative gains on 2011 collars[4] | | **1,178** | – | **–** | – |
| Financial income | 9 | **531** | 176 | **525** | 133 |
| Financial expenses | 9 | **(3,522)** | (5,671) | **–** | – |
| Net financial income/(expense) | 9 | **(2,991)** | (5,495) | **525** | 133 |
| **Profit/(loss) before income tax** | | **(21,648)** | (7,057) | **(51,856)** | (55,586) |
| Income tax benefit/(expense) | 10 | **(13,589)** | (7,842) | **–** | – |
| **Profit/(loss) for the period** | | **(35,237)** | (14,899) | **(51,856)** | (55,586) |
| **Other comprehensive income/(loss)** Foreign exchange translation differences | | **679** | 974 | **12,178** | 30,273 |
| Cash flow hedges, net of tax | | **(2,744)** | (5,600) | **–** | – |
| **Total comprehensive income/(loss) for the period** | | **(37,302)** | (19,525) | **(39,678)** | (25,313) |

| | Note | US Cents | US Cents |
|---|---|---|---|
| **Earnings/(loss) per share** Basic and diluted earnings/(loss) per share | 11 | **(15.2)** | (9.5) |

[1] Earnings before interest (financial income and expense), income tax, depreciation, depletion, amortisation, rehabilitation and exploration (including dry hole, impairment and abandonment expense; seismic and repair expense).

[2] Earnings before interest (financial income and expense), income tax and exploration (including dry hole, impairment and abandonment expense; seismic and repair expense).

[3] Earnings before interest (financial income and expense) and income tax.

[4] Derivative gains relate to 2011 gas collar hedge contracts that are not hedge accounted.

The statement of comprehensive income is to be read in conjunction with the notes to the consolidated financial statements set out on pages 31 to 70.

# Statements of changes in equity

For the year ended 31 December 2010

| Consolidated | Share capital US$'000 | Translation reserve US$'000 | Cashflow hedge reserve US$'000 | Share-based compensation US$'000 | Accumulated losses US$'000 | Total equity US$'000 |
|---|---|---|---|---|---|---|
| | In thousands of USD | | | | | |
| Balance at 1 January 2009 | 170,276 | 1,658 | 8,344 | 951 | (95,341) | 85,888 |
| **Total comprehensive income/(loss) for the period** | | | | | | |
| Profit or loss | – | – | – | – | (14,899) | (14,899) |
| **Other comprehensive income/(loss)** | | | | | | |
| Foreign exchange translation differences | – | 974 | – | – | – | 974 |
| Cash flow hedges, net of tax | – | – | (5,600) | – | – | (5,600) |
| Total other comprehensive income/(loss) | – | 974 | (5,600) | – | – | (4,626) |
| Total comprehensive income/(loss) for the period | – | 974 | (5,600) | – | (14,899) | (19,525) |
| **Transactions with owners, recorded directly in equity** | | | | | | |
| ***Contributions by and distributions to owners*** | | | | | | |
| Shares issued | 13,223 | – | – | – | – | 13,223 |
| Vesting of share options | 528 | – | – | (528) | – | – |
| Share-based payments expense | – | – | – | 366 | – | 366 |
| Total transactions with owners | 13,751 | – | – | (162) | – | 13,589 |
| Balance at 31 December 2009 | 184,027 | 2,632 | 2,744 | 789 | (110,240) | 79,952 |
| | | | | | | |
| Balance at 1 January 2010 | **184,027** | **2,632** | **2,744** | **789** | **(110,240)** | **79,952** |
| **Total comprehensive income/(loss) for the period** | | | | | | |
| Profit or loss | **–** | **–** | **–** | **–** | **(35,237)** | **(35,237)** |
| **Other comprehensive income/(loss)** | | | | | | |
| Foreign exchange translation differences | **–** | **679** | **–** | **–** | **–** | **679** |
| Cash flow hedges, net of tax | **–** | **–** | **(2,744)** | **–** | **–** | **(2,744)** |
| Total other comprehensive income/(loss) | **–** | **679** | **(2,744)** | **–** | **–** | **(2,065)** |
| Total comprehensive income/(loss) for the period | **–** | **679** | **(2,744)** | **–** | **(35,237)** | **(37,302)** |
| **Transactions with owners, recorded directly in equity** | | | | | | |
| ***Contributions by and distributions to owners*** | | | | | | |
| Vesting of share options | **756** | **–** | **–** | **(756)** | **–** | **–** |
| Share-based payments expense | **–** | **–** | **–** | **191** | **–** | **191** |
| Total transactions with owners | **756** | **–** | **–** | **(565)** | **–** | **191** |
| Balance at 31 December 2010 | **184,783** | **3,311** | **–** | **224** | **(145,477)** | **42,841** |

The statement of changes in equity is to be read in conjunction with the notes to the consolidated financial statements set out on pages 31 to 70.

# Statements of changes in equity continued

For the year ended 31 December 2010

| | In thousands of USD | | | | | |
|---|---|---|---|---|---|---|
| **The Company** | Share capital US$'000 | Translation reserve US$'000 | Cashflow hedge reserve US$'000 | Share-based compensation US$'000 | Accumulated losses US$'000 | Total equity US$'000 |
| Balance at 1 January 2009 | 170,276 | (5,956) | – | 951 | (23,424) | 141,847 |
| **Total comprehensive income/(loss) for the period** | | | | | | |
| Profit or loss | – | – | – | – | (55,586) | (55,586) |
| **Other comprehensive income/(loss)** | | | | | | |
| Foreign exchange translation differences | – | 30,273 | – | – | – | 30,273 |
| Total other comprehensive income/(loss) | – | 30,273 | – | – | – | 30,273 |
| Total comprehensive income/(loss) for the period | – | 30,273 | – | – | (55,586) | (25,313) |
| **Transactions with owners, recorded directly in equity** | | | | | | |
| ***Contributions by and distributions to owners*** | | | | | | |
| Shares issued | 13,223 | – | – | – | – | 13,223 |
| Vesting of share options | 528 | – | – | (528) | – | – |
| Share-based payments expense | – | – | – | 366 | – | 366 |
| Total transactions with owners | 13,751 | – | – | (162) | – | 13,589 |
| Balance at 31 December 2009 | 184,027 | 24,317 | – | 789 | (79,010) | 130,123 |
| Balance at 1 January 2010 | **184,027** | **24,317** | **–** | **789** | **(79,010)** | **130,123** |
| **Total comprehensive income/(loss) for the period** | | | | | | |
| Profit or loss | **–** | **–** | **–** | **–** | **(51,856)** | **(51,856)** |
| **Other comprehensive income/(loss)** | | | | | | |
| Foreign exchange translation differences | **–** | **12,178** | **–** | **–** | **–** | **12,178** |
| Total other comprehensive income/(loss) | **–** | **12,178** | **–** | **–** | **–** | **12,178** |
| Total comprehensive income/(loss) for the period | **–** | **12,178** | **–** | **–** | **(51,856)** | **(39,678)** |
| **Transactions with owners, recorded directly in equity** | | | | | | |
| ***Contributions by and distributions to owners*** | | | | | | |
| Vesting of share options | **756** | **–** | **–** | **(756)** | **–** | **–** |
| Share-based payments expense | **–** | **–** | **–** | **191** | **–** | **191** |
| Total transactions with owners | **756** | **–** | **–** | **(565)** | **–** | **191** |
| Balance at 31 December 2010 | **184,783** | **36,495** | **–** | **224** | **(130,866)** | **90,636** |

The statement of changes in equity is to be read in conjunction with the notes to the consolidated financial statements set out on pages 31 to 70.

# Balance Sheets

For the year ended 31 December 2010

| | Note | Consolidated 2010 US$'000 | Consolidated 2009 US$'000 | The Company 2010 US$'000 | The Company 2009 US$'000 |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current assets** | | | | | |
| Cash and cash equivalents | | **17,373** | 25,356 | **12,817** | 17,182 |
| Restricted cash deposits[1] | | **4,487** | – | **–** | – |
| Trade and other receivables | 12 | **2,816** | 4,302 | **3,969** | 1,325 |
| Fair value of derivative financial instruments | 21 | **1,247** | 4,222 | **–** | – |
| Prepayments | | **993** | 1,630 | **116** | 79 |
| Total current assets | | **26,916** | 35,510 | **16,902** | 18,586 |
| **Non-current assets** | | | | | |
| Restricted cash deposits[1] | | **1,213** | – | **–** | – |
| Receivables from controlled entities | 12 | **–** | – | **38,054** | 30,068 |
| Investments | 13 | **–** | – | **44,405** | 89,825 |
| Property, plant and equipment | | **209** | 328 | **38** | 41 |
| Exploration, evaluation and development expenditure – Tangible | 14(a) | **54,384** | 75,272 | **–** | – |
| Exploration and evaluation expenditure – Intangible | 14(b) | **7,344** | 6,917 | **–** | – |
| Intangible assets – Software | | **13** | 48 | **–** | – |
| Deferred tax assets | 15 | **–** | 12,513 | **–** | – |
| Fair value of derivative financial instruments | 21 | **–** | 69 | **–** | – |
| Total non-current assets | | **63,163** | 95,147 | **82,497** | 119,934 |
| **Total assets** | | **90,079** | 130,657 | **99,399** | 138,520 |
| **LIABILITIES** | | | | | |
| **Current liabilities** | | | | | |
| Trade and other payables | 16 | **4,157** | 6,278 | **321** | 788 |
| Loans and borrowings | 17 | **28,919** | 300 | **–** | – |
| Rehabilitation provisions | 19 | **8,571** | 3,624 | **–** | – |
| Employee benefits provisions | | **176** | 184 | **35** | 37 |
| Total current liabilities | | **41,823** | 10,386 | **356** | 825 |
| **Non-current liabilities** | | | | | |
| Trade and other payables | 16 | **–** | – | **8,174** | 7,195 |
| Loans and borrowings | 17 | **–** | 28,134 | **–** | – |
| Rehabilitation provisions | 19 | **5,182** | 11,808 | **–** | – |
| Employee benefits provisions | | **233** | 377 | **233** | 377 |
| Total non-current liabilities | | **5,415** | 40,319 | **8,407** | 7,572 |
| **Total liabilities** | | **47,238** | 50,705 | **8,763** | 8,397 |
| **Net assets** | | **42,841** | 79,952 | **90,636** | 130,123 |
| **EQUITY** | | | | | |
| Issued capital | | **184,783** | 184,027 | **184,783** | 184,027 |
| Reserves | | **3,535** | 6,165 | **36,719** | 25,106 |
| Accumulated losses | | **(145,477)** | (110,240) | **(130,866)** | (79,010) |
| **Total equity** | | **42,841** | 79,952 | **90,636** | 130,123 |

[1] Relates to restricted cash amounts used to collateralise letter of credit amounts in excess of the Company's bank borrowing base facility and restricted cash amounts held in escrow to fund certain abandonment obligations (see note 17 – Loans and borrowings for further details).

The balance sheet is to be read in conjunction with the notes to the consolidated financial statements set out on pages 31 to 70.

# Statements of cashflow

For the year ended 31 December 2010

| | Note | Consolidated | | The Company | |
|---|---|---|---|---|---|
| | | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| **Cashflows from operating activities** | | | | | |
| Cash receipts from customers | | **33,163** | 58,911 | **–** | – |
| Cash payments for royalties | | **(3,958)** | (5,629) | **–** | – |
| Cash payments to suppliers and employees | | **(20,091)** | (21,122) | **(2,232)** | (1,699) |
| Interest received | | **531** | 180 | **525** | 133 |
| Management fees received – related parties | | **–** | – | **978** | 1,109 |
| Taxes refunded | | **480** | – | **–** | – |
| Interest paid | | **(2,584)** | (4,297) | **–** | – |
| Restricted deposits[1] | | **(5,700)** | – | **–** | – |
| **Net cash from operating activities** | | **1,841** | 28,043 | **(729)** | (457) |
| **Cashflows from investing activities** | | | | | |
| Payments for property, plant and equipment | | **(124)** | (215) | **(10)** | (6) |
| Payments for exploration, evaluation and development expenditure | | **(11,815)** | (10,348) | **–** | – |
| Loans to controlled entities | | **–** | – | **(5,954)** | (1,931) |
| Proceeds from sale of assets | | **12** | 391 | **–** | 1 |
| **Net cash from investing activities** | | **(11,927)** | (10,172) | **(5,964)** | (1,936) |
| **Cashflows from financing activities** | | | | | |
| Debt facility repayments | | **(225)** | (21,100) | **–** | – |
| Proceeds from shares issued – net of transaction costs | | **–** | 13,655 | **–** | 13,655 |
| **Net cash from financing activities** | | **(225)** | (7,445) | **–** | 13,655 |
| Net increase/(decrease) in cash and cash equivalents | | **(10,311)** | 10,426 | **(6,693)** | 11,262 |
| Cash and cash equivalents at 1 January | | **25,356** | 13,735 | **17,182** | 4,725 |
| Effects of exchange rate changes on cash held | | **2,328** | 1,195 | **2,328** | 1,195 |
| **Cash and cash equivalents at 31 December** | | **17,373** | 25,356 | **12,817** | 17,182 |

[1] Relates to restricted cash amounts used to collateralise letter of credit amounts in excess of the Company's bank borrowing base facility and restricted cash amounts held in escrow to fund certain abandonment obligations (see note 17 – Loans and borrowings for further details).

The statement of cashflows is to be read in conjunction with the notes to the consolidated financial statements set out on pages 31 to 70.

# Notes to the consolidated financial statements

For the year ended 31 December 2010

## 1. Reporting entity

Petsec Energy Ltd (the "Company") is a company domiciled in Australia. The registered office of the Company is Level 13, 1 Alfred Street Sydney NSW 2000. The consolidated financial statements of the Company as at and for the year ended 31 December 2010 comprise the Company and its subsidiaries (together referred to as the "consolidated entity").

The financial report is presented in United States dollars, which is the consolidated entity's choice of presentation currency.

## 2. Basis of preparation

### (a) Statement of compliance

The financial report is a general purpose financial report which has been prepared in accordance with Australian Accounting Standards ("AASBs") (including Australian Interpretations) adopted by the Australian Accounting Standards Board ("AASB") and the *Corporations Act 2001*. The consolidated financial report of the consolidated entity and the financial report of the Company comply with International Financial Reporting Standards ("IFRSs") and interpretations adopted by the International Accounting Standards Board (IASB).

The Board of Directors approved the financial statements on 28 February 2011.

### (b) Basis of measurement

The consolidated financial statements have been prepared on the historical cost basis except for the following:

- Derivative financial instruments are measured at fair value; and

The methods used to measure fair values are discussed further in Note 4.

The consolidated entity is of a kind referred to in ASIC Class Order 98/100 dated 10 July 1998 (updated by CO 05/641 effective 28 July 2005 and CO 06/51 effective 31 January 2006) and in accordance with that Class Order, all financial information presented in US dollars has been rounded to the nearest thousand unless otherwise stated.

### (c) Use of estimates and judgements

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

In particular, information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the financial statements are described in Note 3(d) – Exploration, evaluation and development expenditure – Intangible and tangible, Note 3(m) Rehabilitation provision and Note 3(r) – Income tax.

### (d) Going concern basis of preparation

The financial statements of the consolidated entity have been prepared on the basis of a going concern. The going concern basis of preparation assumes that an entity will realise its assets and discharge its liabilities in the normal course of business.

Petsec Energy Inc. ("PEI") a wholly owned subsidiary of Petsec Energy Ltd is in ongoing negotiations with the lender in relation to the repayment of its subordinated term loan (see note 17 – Loans and borrowings for further details). As detailed in Note 17, whilst a memorandum of understanding has been agreed with the lender, final documentation has not been executed. In contemplation of finalising these discussions, the lender has also provided a waiver of the asset coverage ratio covenant that was applicable at 31 December 2010.

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 3. Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements, and have been applied consistently by the Company and consolidated entity.

### (a) Basis of consolidation

***(i) Subsidiaries***

Subsidiaries are entities controlled by the Company. Control exists when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable or convertible are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. The accounting policies of subsidiaries have been changed when necessary to align them with the policies adopted by the consolidated entity.

In the Company's financial statements, investments in subsidiaries are carried at the lower of cost or recoverable amount.

***(ii) Joint operating arrangements***

Joint operating arrangements are those entities over whose activities the consolidated entity has joint control, established by contractual agreement. The interest of the consolidated entity in unincorporated joint operating arrangements and jointly operated assets are brought to account by recognising in its financial statements the assets it controls, the liabilities and the expenses it incurs and its share of income that it earns from the sale of goods or services by the joint operations.

***(iii) Transactions eliminated on consolidation***

Intra-group balances and any unrealised gains and losses or income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

### (b) Foreign currency

***(i) Functional and presentation currency***

Items included in the financial statements of each of the consolidated entity's subsidiaries are measured using the currency of the primary economic environment in which the subsidiary operates ("the functional currency"). The functional currency of the Company and its Australian subsidiaries is Australian dollars (A$) and the functional currency of the Company's overseas subsidiaries is United States dollars (US$).

The financial statements are presented in United States dollars. The consolidated entity believes the US dollar is the best measure of performance for Petsec Energy Ltd because oil and gas, the consolidated entity's dominant sources of revenue, are priced in US dollars and the consolidated entity's main operations are based in the USA and China with most of the costs incurred in US dollars.

Prior to consolidation, the results and financial position of each entity within the group are translated from the functional currency into the group's presentation currency as follows:

- Assets and liabilities for each balance sheet are translated at the closing rate at the date of that balance sheet;
- Income and expenses for each income statement are translated at average exchange rates (unless this is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions);
- Components of equity are translated at the historical rates; and
- All resulting exchange differences are recognised as a separate component of equity.

## 3. Significant accounting policies continued

### (b) Foreign currency continued

#### *(ii) Foreign currency transactions and balances*

Foreign currency transactions are translated into the functional currency at the exchange rates prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated to the respective functional currency at the foreign exchange rate ruling at that date. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction.

Foreign exchange gains and losses arising from a monetary item receivable from or payable to a foreign operation, the settlement of which is neither planned nor likely in the foreseeable future, are considered to form part of a net investment in a foreign operation and are recognised directly in equity in the foreign currency translation reserve (FCTR).

### (c) Derivative financial instruments and hedging activities

The consolidated entity's revenues are exposed to changes in commodity prices. From time to time, the consolidated entity enters into derivative financial instruments to manage a portion of its oil and gas sales price risks.

The consolidated entity's interest expense is exposed to changes in short-term interest rates. From time to time, the consolidated entity enters into derivative financial instruments to manage a portion of its interest rate risks.

The consolidated entity does not hold derivative financial instruments for speculative purposes.

Derivative financial instruments are initially recognised at fair value on the date a derivative contract is entered into and are subsequently remeasured to their fair value each reporting date. The method of recognising the resulting gain or loss depends on whether the derivative is designated as hedging instrument, and if so, the nature of the item being hedged. The consolidated entity designates certain derivatives as hedges of highly probable forecast transactions (cash flow hedges).

The consolidated entity documents at the inception of the transaction the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The consolidated entity also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions have been and will continue to be highly effective in offsetting changes in fair values or cash flows of hedged items.

#### *(i) Cash flow hedge*

Changes in the fair value of the derivative-hedging instrument designated as a cash flow hedge are recognised directly in equity to the extent that the hedge is effective. To the extent that the hedge is ineffective, changes in fair value are recognised in the income statement.

If the hedging instrument no longer meets the criteria for hedge accounting, expires or is sold, terminated or exercised, then hedge accounting is discontinued prospectively. The cumulative gain or loss previously recognised in equity remains there until the forecast transaction occurs. When the hedged item is a non-financial asset, the amount recognised in equity is transferred to the carrying amount of the asset when it is recognised. In other cases the amount recognised in equity is transferred to the income statement in the same period that the hedged item affects profit or loss.

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 3. Significant accounting policies continued

### (c) Derivative financial instruments and hedging activities continued

*(ii) Derivative financial instruments that do not qualify for hedge accounting*

Certain derivative financial instruments do not qualify for hedge accounting. Changes in the fair value of any derivative financial instrument that does not qualify for hedge accounting are recognised immediately in the income statement.

### (d) Exploration, evaluation and development expenditure – Intangible and tangible

Exploration, evaluation and development costs are accumulated in respect of each separate area of interest. The consolidated entity's capitalisation policy for its natural gas and crude oil exploration and development activities is to capitalise costs of productive exploratory wells, development drilling and productive wells, and costs to acquire mineral interests. Exploration costs, including personnel costs, certain geological and geophysical expenses including seismic costs where exploration rights have not been obtained for oil and natural gas leases, are charged to expense as incurred. Exploratory drilling costs are initially capitalised, but charged to expense if and when the well is determined not to have found reserves in commercial quantities.

Exploration and evaluation expenditures relating to an area of interest are capitalised as intangible deferred costs where exploration rights have been obtained. These intangible deferred costs are carried forward only to the extent that they are expected to be recouped through successful development and exploitation, or sale of the area, or where exploration and evaluation activities have not yet reached a stage which permits a reasonable assessment of the existence of economically recoverable reserves, and active and significant exploration operations are continuing. These intangible deferred costs are not subject to amortisation. Once management has determined the existence of economically recoverable reserves for an area of interest, deferred costs are reclassified from intangible to tangible assets on the balance sheet. Tangible deferred costs are amortised using a units-of-production method, as further discussed in Note 3(e).

Development expenditures relating to an area of interest are capitalised as tangible deferred costs, and are carried forward to the extent that, they are expected to be recouped either through the sale or successful exploitation of the area of interest.

Exploration, evaluation and development assets are assessed for impairment when facts and circumstances suggest that the carrying amount of the asset may exceed its recoverable amount. In the event that indicators of impairment are present, an impairment loss is recorded based on the higher of an asset's fair value less costs to sell and value in use (see Note 3(h)(ii)). When an area of interest is abandoned or the directors decide that it is not commercial, any accumulated costs in respect of that area are written off in the financial period the decision is made.

### (e) Amortisation of exploration, evaluation and development expenditure

Exploration, evaluation and development expenditure in the production phase is amortised on a units-of-production method based on the ratio of actual production to remaining proved and probable reserves (2P). Remaining 2P reserves are at the lower of 2P reserves estimated by external independent petroleum engineers and internal estimates.

Amortisation is not charged on costs carried forward in respect of areas of interest in the development phase until commercial production commences.

### (f) Intangible assets – Software

Software acquired by the consolidated entity, which have finite useful lives, is measured at cost less accumulated amortisation.

## 3. Significant accounting policies continued

### (g) Property, plant and equipment

#### *(i) Recognition and measurement*

Items of property, plant and equipment are measured at cost less accumulated depreciation and impairment losses.

Cost includes expenditures that are directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials and direct labour, any other costs directly attributable to bringing the asset to a working condition for its intended use, and the costs of dismantling and removing the items and restoring the site on which they are located. Purchased software that is integral to the functionality of the related equipment is capitalised as part of the equipment. Borrowing costs related to the acquisition or construction of qualifying assets are recognised in profit and loss as incurred.

When parts of an item of property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of property, plant and equipment.

Gains and losses on disposal of an item of property, plant and equipment are determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment and are recognised net within "other income" in profit and loss.

#### *(ii) Leased assets*

Leases in terms of which the consolidated entity assumes substantially all the risks and rewards of ownership are classified as finance leases. Lease payments are accounted for as described in accounting policy 3(o).

#### *(iii) Subsequent costs*

The cost of replacing part of an item of property, plant and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the consolidated entity and its costs can be measured reliably. The costs of the day-to-day servicing of property, plant and equipment are recognised in the income statement as incurred.

#### *(iv) Depreciation and amortisation*

Depreciation of property, plant and equipment is recognised in the income statement on a straight-line basis over the estimated useful lives of each part of an item. Leased assets are depreciated over the shorter of the lease term and their useful lives. Assets are depreciated or amortised from the date of acquisition or, in respect of internally constructed assets, from the time an asset is completed and held ready for use.

Depreciation methods, useful lives and residual values are reassessed at the reporting date. When changes are made, adjustments are reflected prospectively in current and future periods only.

The estimated useful lives or the amortisation method used for each class of asset in the current and comparative periods are as follows:

| | 2010 | 2009 |
|---|---|---|
| **Property, plant and equipment** | | |
| Furniture and fittings | **5 – 8 years** | 5 – 8 years |
| Office equipment | **3 – 4 years** | 3 – 4 years |
| Leasehold improvements | **5 – 7 years** | 5 – 7 years |

### (h) Impairment – Non-financial assets

The carrying amounts of the consolidated entity's and the Company's non-financial assets, other than deferred tax assets (see Note 3(r)), are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. For intangible assets that have indefinite lives or that are not yet available for use, recoverable amount is estimated at each reporting date.

An impairment loss is recognised if the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. A cash-generating unit is the smallest identifiable asset group that generates cash flows that largely are independent from other assets or groups. Impairment losses are recognised in the income statement. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amount of the other assets in the unit (group of units) on a *pro rata* basis.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessment of the time value of money and the risks specific to the asset.

The measurement of recoverable amount for the consolidated entity's exploration, evaluation and development expenditure requires significant estimation and judgement. Note 14 provides further details of the key assumptions adopted by the consolidated entity in measuring the recoverable amount of exploration, evaluation and development expenditure.

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 3. Significant accounting policies continued

### (h) Impairment – Non-financial assets continued

Impairment losses recognised in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

### (i) Trade and other receivables

Trade receivables, which generally have 30-60 day terms, are recognised and carried at original invoice amount less an allowance for any uncollectible amounts.

An estimate for doubtful debts is made when collection of the full amount is no longer probable. Bad debts are written off when identified.

### (j) Cash and cash equivalents

Cash and cash equivalents in the balance sheet comprise cash at bank and on hand and short-term deposits with an original maturity of three months or less.

For the purposes of the Statement of Cash Flows, cash and cash equivalents consist of cash and cash equivalents as defined above, net of outstanding bank overdrafts.

### (k) Interest-bearing loans and borrowings

All loans and borrowings are initially recognised at cost, being the fair value of the consideration received net of debt issue costs associated with the borrowing.

After initial recognition, interest-bearing loans and borrowings are subsequently measured at amortised cost using the effective interest method. Amortised cost is calculated by taking into account any issue costs, and any discount or premium on settlement.

### (l) Borrowing costs

Borrowing costs comprise interest payable on borrowings calculated using the effective interest rate method, lease finance charges and amortisation of discounts or premiums relating to borrowings. Borrowing costs are expensed as incurred unless they relate to qualifying assets.

### (m) Provisions

A provision is recognised if, as a result of a past event, the consolidated entity has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability.

Where discounting is used, the increase in the provision due to the passage of time is recognised as a finance cost.

*Rehabilitation*

The consolidated entity recognises a provision for the legal obligation associated with the retirement of long-lived assets that results from the acquisition, construction, development, and (or) the normal operation of oil and natural gas properties. The initial recognition of a liability for rehabilitation, which is discounted using a credit-adjusted risk-free interest rate, increases the carrying amount of the related long-lived asset by the same amount as the liability. In periods subsequent to initial measurement, period-to-period changes in the liability are recognised for the passage of time (unwinding of discount) as financial expense. Additionally, the capitalised asset retirement cost is subsequently allocated to expense on a units-of-production basis over its estimated useful life.

Changes in the estimate of the liability arising from revised timing or estimated cost-to-complete the rehabilitation are recognised with a corresponding adjustment to the relevant long-lived asset.

The rehabilitation provision requires significant estimation and judgement. These estimates include:

- Expected method of remediation;
- Forecast costs-to-complete the future remediation; and
- Anticipated timing of the remediation work.

The consolidated entity monitors the estimates and judgements involved in measuring this provision. Changes in estimated rehabilitation provisions are accounted for on a prospective basis and affect provisions.

### (n) Employee benefits and director benefits

*(i) Short-term employee benefits*

Liabilities for employee benefits for wages, salaries, annual leave and sick leave represent present obligations resulting from employees' services provided to reporting date and are calculated at undiscounted amounts based on remuneration wage and salary rates that the consolidated entity expects to pay as at reporting date including related on-costs, such as workers' compensation insurance and payroll tax.

*(ii) Long-term employee benefits*

The provision for employee benefits for long service leave represents the present value of the estimated future cash outflows to be made resulting from employees' services provided to reporting date.

## 3. Significant accounting policies continued

### (n) Employee benefits and director benefits continued

*(ii) Long-term employee benefits continued*

The provision is calculated using expected future increases in wage and salary rates including related on-costs and expected settlement dates based on turnover history and is discounted using the rates attaching to national government bonds at reporting date which most closely match the terms of maturity of the related liabilities.

*(iii) Defined contribution pension plans*

The Company and other controlled entities contribute to several defined contribution pension plans. Obligations for contributions to defined contribution pension plans are recognised as an expense in the income statement when they are due.

*(iv) Employee incentive plans*

Under the employee incentive plan, a liability may be recognised for bonuses for eligible employees based on the consolidated entity's performance for the year based on a number of pre-determined performance criteria.

*(v) Share-based compensation transactions*

Share-based compensation benefits are provided to employees of the consolidated entity, including directors, via the Company's Employee Option Plan and Employee Share Plan.

The grant date fair value of options granted to employees is recognised as an employee expense, with a corresponding increase in equity, over the period in which the employees become unconditionally entitled to the options.

### (o) Leases

Leases in terms of which the consolidated entity assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income.

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognised as an expense in the income statement on a straight-line basis over the lease term. Lease incentives received are recognised as an integral part of the total lease expense, over the term of the lease.

### (p) Revenue and other income recognition

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the consolidated entity and the revenue can be reliably measured. The following specific recognition criteria must also be met before revenue is recognised:

*Sale of oil and gas*

Revenues are recognised when the product is in the form in which it is to be delivered and an actual physical quantity has been provided or allocated to a purchaser pursuant to a contract. Revenue from oil and gas sales is measured at the fair value of the consideration receivable.

Revenue from oil and gas royalties is recognised on an accrual basis in accordance with the terms of underlying royalty agreements. Revenue from oil and gas royalties is measured at the fair value of the consideration receivable.

*Sale of non-current assets*

Gains or losses on sale of non-current assets are recognised as other income at the date control of the asset passes to the buyer, usually when an unconditional contract of sale is signed.

*Dividend income*

Dividend income is recognised by the Company when controlled subsidiaries declare dividends.

*Interest income*

Interest income is recognised as the interest accrues (using the effective interest method, which is the rate that discounts estimated future cash receipts through the expected life of the financial instrument).

### (q) Earnings per share

The consolidated entity presents basic and diluted earnings per share (EPS) data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the period. Diluted EPS is determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, which comprise share options granted to employees.

### (r) Income tax

Income tax expense comprises current and deferred tax. Income tax expense is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 3. Significant accounting policies continued

### (r) Income tax continued

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognised using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognised for the following temporary differences: the initial recognition of assets or liabilities that affect neither accounting nor taxable profit nor differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

A deferred tax asset is recognised to the extent that it is probable that future taxable profits will be available against which the temporary difference or tax losses can be utilised. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

*Tax consolidation*

The Company and its wholly owned Australian resident entities have formed a tax-consolidated group with effect from 1 July 2002 and are therefore taxed as a single entity from that date. The head entity within the tax-consolidated group is Petsec Energy Ltd.

Current tax expense/income, deferred tax liabilities and deferred tax assets arising from temporary differences of the members of the tax-consolidated group are recognised in the separate financial statements of the members of the tax-consolidated group using the 'separate taxpayer within group' approach by reference to the carrying amount of assets and liabilities in the separate financial statements of each entity and the tax values applying under tax consolidation.

Any current tax liabilities (or assets) and deferred tax assets arising from unused Australian tax losses of the subsidiaries are assumed by the head entity in the tax-consolidated group and are recognised by the Company as amounts payable (receivable) to/(from) other entities in the tax-consolidated group in conjunction with any tax funding arrangement amounts (refer below). Any difference between these amounts is recognised by the Company as an equity contribution or distribution.

The Company recognises deferred tax assets arising from unused tax losses of the tax-consolidated group to the extent that it is probable that future taxable profits of the tax-consolidated group will be available against which the asset can be utilised.

Any subsequent period adjustments to deferred tax assets arising from unused tax losses as a result of revised assessments of the probability of recoverability are recognised by the head entity only.

*Nature of tax funding arrangements and tax sharing arrangements*

The head entity, in conjunction with other members of the Australian tax-consolidated group, has entered into a tax funding arrangement, which sets out the funding obligations of members of the tax-consolidated group in respect of tax amounts. The tax funding arrangements require payments to/from the head entity equal to the current tax liability/(asset) assumed by the head entity and any tax-loss deferred tax asset assumed by the head entity, resulting in the head entity recognising an inter-entity receivable/(payable) equal in amount to the tax liability/(asset) assumed. The inter-entity receivable/(payable) is at call.

The head entity in conjunction with other members of the Australian tax-consolidated group has also entered into a tax sharing agreement. The tax sharing agreement provides for the determination of the allocation of income tax liabilities between the entities should the head entity default on its tax payment obligations. No amounts have been recognised in the financial statements in respect of this agreement, as payment of any amounts under the tax sharing agreement is considered remote.

### (s) Goods and services tax

Revenues, expenses and assets are recognised net of the amount of goods and services tax (GST), except where the amount of GST incurred is not recoverable from the taxation authority. In these circumstances, the GST is recognised as part of the cost of acquisition of the asset or as part of the expense.

Receivables and payables are stated with the amount of GST included. The net amount of GST recoverable from, or payable to, the taxation authority is included as a current asset or liability in the balance sheet.

Cash flows are included in the Statement of Cash Flows on a gross basis. The GST components of cash flows arising from investing and financing activities, which are recoverable from or payable to the taxation authority, are classified as operating cash flows.

## 3. Significant accounting policies continued

*(t) Segment reporting*

An operating segment is a distinguishable component of the consolidated entity whose information is reviewed regularly by the CEO, the Group's chief decision making officer who is engaged in providing related products or services which are subject to risk and rewards that are different to other segments.

## 4. Determination of fair values

A number of the consolidated entity's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. Where applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

### Commodity and interest rate derivatives

The fair value of commodity and interest rate derivative hedging instruments are based on the relationship between the agreed contracted fixed and floor prices and quoted market prices at period end.

## 5. Revenue and other income and expenses

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| **Revenue** | | | | |
| Revenues from sale of oil and gas | **24,311** | 35,545 | **–** | – |
| Derivative hedging gains/(losses) | **6,750** | 21,579 | **–** | – |
| | **31,061** | 57,124 | **–** | – |
| **Other income and expenses** | | | | |
| Drilling, production and prospect overhead income | **699** | 137 | **–** | – |
| Management fee income | **–** | – | **857** | 905 |
| Dividend income | **–** | – | **2,787** | 3,075 |
| Net foreign exchange gains/(losses) | **368** | (101) | **(1,741)** | (1,454) |
| Net loss on disposal of property, plant and equipment | **(5)** | (36) | **(4)** | – |
| | **1,062** | – | **1,899** | 2,526 |

## 6. Personnel expenses

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| Wages and salaries | **2,536** | 2,596 | **232** | 195 |
| Service agreements for executives | **824** | 654 | **824** | 654 |
| Contract labour | **670** | 1,475 | **–** | – |
| Superannuation & 401(k) plans | **121** | 132 | **23** | 22 |
| Retirement benefits | **–** | 24 | **–** | 24 |
| Share-based payment compensation | **173** | 323 | **76** | 84 |
| Other employee-related expenses | **9** | – | **9** | – |
| | **4,333** | 5,204 | **1,164** | 979 |

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 7. Profit/(loss) for the period

| Profit/(loss) for the period includes the following items that are significant because of their nature, size or incidence: | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| **Expenses** | | | | |
| Dry hole, impairment and abandonment expense | **(19,450)** | (10,311) | **–** | – |
| Net movements in provisions against loans to and investments in controlled entities | **–** | – | **(52,086)** | (56,332) |

### Dry hole, impairment and abandonment expense

The estimated recoverable amount of all oil and gas assets is based on discounted cash flow projections that are based on a range of estimates and assumptions that are subject to change.

For the year ended 31 December 2010, the consolidated entity recognised US$19,450,000 in dry hole, impairment and abandonment expense, comprising:

- US$2,873,000 dry hole costs primarily in relation to the Main Pass Block 20 #4 exploration well drilled in April 2010;
- US$16,462,000 impairments recognised against certain producing properties and exploration leases due to various factors that have impacted upon the Company's estimate of recoverable value, including downward reserve revisions, lower commodity prices and lease relinquishment;
- US$115,000 increase in rehabilitation provisions of certain properties due to the reassessment of future estimates of plug & abandonment costs;

In 2009, the consolidated entity recognised dry hole, impairment and abandonment expense of US$10,311,000 comprising US$8,001,000 of net impairment provisions against certain oil & gas properties and US$2,310,000 increase in the Company's rehabilitation provision due to the reassessment of future plug and abandonment cost estimates.

### Net movement in provisions against loans to and investments in controlled entities

During the year ended 31 December 2010, the company recognised a further provision of US$52,086,000 in provision against the carrying amount of its investments in controlled entities (2009: US$56,332,000). This additional provisioning reflects the cumulative effect of reserve depletion and revisions and the impact of lower commodity prices on estimates of recoverable amounts of US oil and gas properties. Refer to Note 14 for further discussion of the factors that influence the estimation uncertainty associated with the underlying US oil and gas properties.

## 8. Auditors' remuneration

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$ | 2009 US$ | 2010 US$ | 2009 US$ |
| **Audit services:** | | | | |
| ***Auditors of the Company*** | | | | |
| KPMG Australia | | | | |
| Audit and review of financial reports | **105,000** | 80,000 | **105,000** | 80,000 |
| Overseas KPMG Firms | | | | |
| Audit and review of financial reports | **20,000** | 46,000 | **20,000** | – |
| **Other services:** | | | | |
| ***Auditors of the Company*** | | | | |
| KPMG Australia | | | | |
| Corporate, tax and compliance services | **–** | 13,000 | **–** | 13,000 |
| Overseas KPMG Firms | | | | |
| Corporate, tax and compliance services | **15,800** | 33,000 | **–** | – |
| | **140,800** | 172,000 | **125,000** | 93,000 |

## 9. Finance income and expense

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| Interest income – Related parties | **531** | 176 | **525** | 133 |
| Financial income | **531** | 176 | **525** | 133 |
| Interest expense | **(2,583)** | (4,247) | **–** | – |
| Unwinding of discount | **(939)** | (1,424) | **–** | – |
| Financial expense | **(3,522)** | (5,671) | **–** | – |
| Net financial income | **(2,991)** | (5,495) | **525** | 133 |

## 10. Income tax expense

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| **Recognised in the income statement** | | | | |
| ***Current tax expense*** | **–** | – | **–** | – |
| ***Deferred tax expense*** | | | | |
| Origination and reversal of temporary differences | **13,589** | 7,842 | **–** | – |
| Total income tax benefit/(expense) in income statement | **13,589** | 7,842 | **–** | – |

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 10. Income tax expense continued

### Numerical reconciliation between tax expense and pre-tax net profit /(loss)

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| Profit/(loss) before tax | **(21,648)** | (7,057) | **(51,856)** | (55,586) |
| Income tax expense/(benefit) using the Australian corporation tax rate of 30% (2008: 30%) | **(6,494)** | (2,117) | **(15,557)** | (16,676) |
| Increase/(decrease) in income tax expense due to: Non-assessable income | **–** | – | **(911)** | (922) |
| Non-deductible expenses | **216** | 290 | **15,652** | 16,929 |
| U.S. income taxes at different rate | **(1,043)** | (275) | **–** | – |
| Australian tax losses utilised | **–** | – | **–** | – |
| Deferred tax movements not brought to account in current year | **8,798** | 2,102 | **816** | 669 |
| Provisions against deferred tax assets recognised in prior years | **12,513** | 7,842 | **–** | – |
| Under/(over) provided in prior years | **(401)** | – | **–** | – |
| Income tax expense/(benefit) on pre-tax net profit | **13,589** | 7,842 | **–** | – |

### Deferred tax recognised directly in equity

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| Relating to cash flow hedges | **–** | 3,015 | **–** | – |
| | **–** | 3,015 | **–** | – |

The consolidated entity's tax expense for the year ended 31 December 2010 includes a provision of US$12,513,000 (2009: US$7,842,000) to reduce the carrying value of the recognised deferred tax asset. This provision reflects the impact of revised estimates of probable future US taxable income. Refer to Note 14 for further discussion of the factors that influence the estimation uncertainty associated with the recoverability of oil and gas properties, and consequently the probability of generation of probable US taxable income.

## 11. Earnings per share

The Company has only one type of security, being ordinary shares, included in the basic earnings per share calculation.

In addition to the ordinary shares, the Company has 5,272,000 (2009: 5,699,500) options outstanding under the Employee Option Plan. In determining potential ordinary shares, 4,667,500 (2009: 4,872,000) are not dilutive.

During the year, 2,146,000 options were granted, 2,573,500 options were forfeited and no options were exercised and converted to ordinary shares.

## 11. Earnings per share continued

### Basic earnings/(loss) per share

The calculation of basic earnings/(loss) per share at 31 December 2010 was based on the loss attributable to ordinary shareholders of US$35,237,000 (2009: Loss of US$14,899,000) and a weighted average number of ordinary shares outstanding during the year ended 31 December 2010 of 231,283,622 (2009: 156,512,245), calculated as follows:

### Profit/(loss) attributable to ordinary shareholders

| | Consolidated | |
|---|---|---|
| | 2010 US$'000 | 2009 US$'000 |
| Profit/(loss) for the period | **(35,237)** | (14,899) |

### Weighted average number of shares (basic)

| | Consolidated | |
|---|---|---|
| **In thousands of shares** | 2010 | 2009 |
| Issued ordinary shares at 1 January | **231,284** | 154,189 |
| Effect of shares issued in 2010 and 2009, respectively | **–** | 2,323 |
| Weighted average number of ordinary shares at 31 December | **231,284** | 156,512 |

### Earnings/(loss) per share

| | Consolidated | |
|---|---|---|
| **In USD cents** | 2010 | 2009 |
| Basic and diluted earnings/(loss) per share | **(15.2)** | (9.5) |

## 12. Trade and other receivables

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| **Current** | | | | |
| Trade receivables | **2,792** | 4,271 | **–** | – |
| Other receivables | **24** | 30 | **23** | 30 |
| Loans receivable from controlled entities | **–** | – | **3,946** | 1,295 |
| | **2,816** | 4,302 | **3,969** | 1,325 |
| **Non-current** | | | | |
| Dividends receivable from controlled entities | **–** | – | **8,178** | 6,468 |
| Loans receivable from controlled entities | **–** | – | **29,876** | 23,600 |
| | **–** | – | **38,054** | 30,068 |

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 13. Other investments

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| **Non-current** | | | | |
| Investment in controlled entities – at recoverable amount | **–** | – | **44,405** | 89,825 |
| | **–** | – | **44,405** | 89,825 |

The Company reassesses its estimate of recoverable amount in its investment in controlled entities annually.

## 14. Exploration, evaluation and development expenditure

| | Consolidated | |
|---|---|---|
| **(a) Tangible** | 2010 US$'000 | 2009 US$'000 |
| **Costs carried forward in respect of areas of interest in the following phases:** | | |
| ***Production phase – at WDV*** | | |
| Balance at 1 January | **63,121** | 83,571 |
| Additions | **1,625** | 4,379 |
| Reclassification from development phase | **281** | 3,396 |
| Reclassification from tangible exploration phase | **2,071** | – |
| Reclassification from intangible exploration phase | **71** | – |
| Impairment and abandonment expense | **(13,121)** | (7,538) |
| Current year amortisation expense | **(12,232)** | (20,687) |
| Balance at 31 December | **41,816** | 63,121 |
| ***Development phase – at cost*** | | |
| Balance at 1 January | **–** | 3,072 |
| Additions | **281** | 324 |
| Reclassification to production phase | **(281)** | (3,396) |
| Balance at 31 December | **–** | – |
| ***Exploration and/or evaluation phase – at cost*** | | |
| Balance at 1 January | **12,151** | 11,421 |
| Additions | **5,664** | 1,329 |
| Reclassification to production phase | **(2,071)** | – |
| Disposals | **(7)** | – |
| Dry hole and impairment expense | **(3,169)** | (599) |
| Balance at 31 December | **12,568** | 12,151 |
| **Total costs carried forward** | **54,384** | 75,272 |

## 14. Exploration, evaluation and development expenditure continued

| (b) Intangible | Consolidated 2010 US$'000 | 2009 US$'000 |
|---|---|---|
| **Costs carried forward in respect of areas of interest in the following phase:** | | |
| ***Exploration and/or evaluation phase – at cost*** | | |
| Balance at 1 January | **6,917** | 8,636 |
| Additions | **3,420** | 455 |
| Disposals/lease relinquishments | **(314)** | – |
| Reclassification to tangible production phase | **(71)** | – |
| Impairment expense | **(2,608)** | (2,174) |
| Balance at 31 December | **7,344** | 6,917 |

### Recoverable amount

The ultimate recoupment of costs carried forward for exploration and evaluation phases is dependent on the successful development and commercial exploitation or sale of the respective areas.

The estimated recoverable amount of all cash generating units in the development and production phases is determined by discounting the estimated future cash flows to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the assets. The consolidated entity utilises discounted future cash flows as estimated by independent petroleum engineers for this assessment. The key assumptions used include:

- Estimated proved and probable reserves (2P reserves);
- For wells now in production – initial production rates based on current producing rates for those wells;
- For wells not currently in production – initial production rates based on test data and other related information;
- Estimated rates of production decline based on current trends;
- Hydrocarbon prices that the consolidated entity estimates to be reasonable taking into account historical prices, current prices, and prices used in making its exploration and development decisions;
- Operating costs directly applicable to the leases or wells;
- Development costs based on authorisations for expenditure for the proposed work or actual costs for similar projects;
- Pre-tax discount rate of 10%.

### Risk of future impairments

The determination of the estimated recoverable amount of Petsec's producing oil and gas properties is highly sensitive to a change in estimated recoverable reserves and oil and gas prices.

As a result of historical impairments, certain properties are carried at recoverable amounts. Consequently any reduction in recoverable reserves or a reduction in the oil or gas price may trigger the need for further impairment on these specific properties.

### Development of Block 22/12 Beibu Gulf

In late January 2011 the China National Offshore Oil Corporation ("CNOOC") approved the overall development plan for the Weizhou 6.12 North, 6.12 South and 12.8 West oilfields. On 14 February 2011, the Block 22/12 Joint Venture announced a final investment decision to proceed with development of these fields. This development will require significant capital expenditure, which is currently estimated to be US$37 million in total (net to the Company's interest) of which US$10 million may be incurred in the next 12 months. Petsec Energy is in discussions with potential financiers to provide funding alternatives. In addition, Petsec has also received a number of offers from various parties seeking to acquire the Company's interest in the joint venture. The Board is currently evaluating these offers.

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 15. Deferred tax assets

### Recognised deferred tax assets and liabilities

| Consolidated | Assets 2010 US$'000 | Assets 2009 US$'000 | Liabilities 2010 US$'000 | Liabilities 2009 US$'000 | Net 2010 US$'000 | Net 2009 US$'000 |
|---|---|---|---|---|---|---|
| Exploration, evaluation and development expenditure | **7,366** | 5,415 | **–** | – | **7,366** | 5,415 |
| Cash flow hedges | **–** | – | **–** | (1,478) | **–** | (1,478) |
| Other items | **–** | 600 | **(162)** | – | **(162)** | 600 |
| Tax value of loss carry-forwards recognised | **–** | 7,976 | **–** | – | **–** | 7,976 |
| Deferred tax balances not brought to account | **(7,366)** | – | **162** | – | **(7204)** | – |
| Deferred tax assets/(liabilities) | **–** | 13,991 | **–** | (1,478) | **–** | 12,513 |

| The Company | Assets 2010 US$'000 | Assets 2009 US$'000 | Liabilities 2010 US$'000 | Liabilities 2009 US$'000 | Net 2010 US$'000 | Net 2009 US$'000 |
|---|---|---|---|---|---|---|
| Provisions | **154** | 169 | **–** | – | **154** | 169 |
| Equity issue costs | **161** | 145 | **–** | – | **161** | 145 |
| Deferred tax balances not brought to account | **(315)** | (314) | **–** | – | **(315)** | (314) |
| Deferred tax assets/(liabilities) | **–** | **–** | **–** | – | **–** | – |

### Unrecognised deferred tax assets

Deferred tax assets have not been recognised in respect of the following items:

| | Consolidated 2010 US$'000 | Consolidated 2009 US$'000 | The Company 2010 US$'000 | The Company 2009 US$'000 |
|---|---|---|---|---|
| Deductible temporary differences in USA (net) | **7,204** | – | **–** | – |
| Tax operating loss carry-forwards in USA (net) | **23,193** | – | **–** | – |
| Deductible temporary differences in Australia (net) | **315** | 314 | **315** | 314 |
| Tax operating loss carry-forwards in Australia (net) | **2,718** | 1,929 | **2,718** | 1,929 |
| | **33,430** | 2,243 | **3,033** | 2,243 |

During the current period, the consolidated entity determined in accordance with the deferred tax recognition criteria under Australian Accounting Standards that deferred tax assets in respect of its USA operations no longer qualified for recognition on the balance sheet based on current facts and circumstances, including projected future taxable profits. Accordingly, the consolidated entity recognised a provision of US$12,513,000 against the remaining deferred tax balance previously brought to account until such time as the USA operations can regain sustained profitability sufficient to make it probable that the tax losses can be utilised.

No deferred tax has been recognised to-date in relation to either the Australia or China operations as they do not qualify for recognition until such time that it is probable that future taxable profits will be available against which unused tax operating losses and temporary differences in the relevant tax jurisdictions can be utilised.

The deductible temporary differences and tax losses in Australia do not expire under current tax legislation though these losses are subject to testing under loss recoupment rules, in order for them to be utilised. USA loss carry forwards expire in 2021 and later.

## 15. Deferred tax assets continued

### Movement in temporary differences during the year

| | Consolidated | | | | |
|---|---|---|---|---|---|
| | Balance 1 Jan 09 US$'000 | Recognised in income US$'000 | Recognised in equity US$000 | Reclassified to other balance sheet account US$000 | Balance 31 Dec 09 US$'000 |
| Exploration, evaluation and development expenditure | 7,923 | (2,508) | – | – | 5,415 |
| Cash flow hedges | (4,493) | – | 3,015 | – | (1,478) |
| Other items | 574 | 11 | – | 15 | 600 |
| U.S. operating loss carry-forwards | 13,321 | (5,345) | – | – | 7,976 |
| | 17,325 | (7,842) | 3,015 | 15 | 12,513 |

| | Consolidated | | | | |
|---|---|---|---|---|---|
| | Balance 1 Jan 10 US$'000 | Recognised in income US$'000 | Recognised in equity US$000 | Reclassified to other balance sheet account US$000 | Balance 31 Dec 10 US$'000 |
| Exploration, evaluation and development expenditure | **5,415** | **1,951** | **–** | **–** | **7,366** |
| Cash flow hedges | **(1,478)** | **1,478** | **–** | **–** | **–** |
| Other items | **600** | **(360)** | **–** | **(402)** | **(162)** |
| U.S. operating loss carry-forwards | **7,976** | **(7,976)** | **–** | **–** | **–** |
| Deferred tax balances in USA not brought to account | **–** | **(7,204)** | **–** | **–** | **(7,204)** |
| | **12,513** | **(12,111)** | **–** | **(402)** | **–** |

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 15. Deferred tax assets continued

### Movement in temporary differences during the year continued

| | The Company | | | | |
|---|---|---|---|---|---|
| | Balance 1 Jan 09 US$'000 | Recognised in income US$'000 | Recognised in equity US$000 | Reclassified to other balance sheet account US$000 | Balance 31 Dec 09 US$'000 |
| Provisions | 174 | (5) | – | – | 169 |
| Equity issue costs | | | 145 | | 145 |
| Deferred tax balances in Australia not brought to account | (174) | 5 | (145) | – | (314) |
| | – | – | – | – | – |

| | The Company | | | | |
|---|---|---|---|---|---|
| | Balance 1 Jan 10 US$'000 | Recognised in income US$'000 | Recognised in equity US$000 | Reclassified to other balance sheet account US$000 | Balance 31 Dec 10 US$'000 |
| Provisions | **169** | **(15)** | **–** | **–** | **154** |
| Equity issue costs | **145** | **16** | **–** | **–** | **161** |
| Deferred tax balances in Australia not brought to account | **(314)** | **(1)** | **–** | **–** | **(315)** |
| | **–** | **–** | **–** | **–** | **–** |

## 16. Trade and other payables

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| **Trade and other payables, stated at cost** | | | | |
| Trade payables | **746** | 2,675 | **62** | 616 |
| Exploration and development accruals | **633** | 1,235 | **–** | – |
| Joint operating arrangement advances | **–** | 157 | **–** | – |
| Operational and administration accruals | **2,727** | 2,175 | **208** | 136 |
| Related party payables | **51** | 36 | **51** | 36 |
| | **4,157** | 6,278 | **321** | 788 |
| **Non-current liabilities** | | | | |
| Loans payable to controlled entities | **–** | – | **8,174** | 7,195 |
| | **–** | – | **8,174** | 7,195 |

## 17. Loans and borrowings

This note provides information about the contractual terms of the consolidated entity's interest-bearing loans and borrowings. For more information about the consolidated entity's exposure to interest rate risk see Note 21.

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| **Current liabilities** | | | | |
| Secured bank loans | **29,175** | 300 | **–** | – |
| Transaction costs | **(256)** | – | **–** | – |
| | **28,919** | 300 | **–** | – |
| **Non-current liabilities** | | | | |
| Secured bank loans | **–** | 29,100 | **–** | – |
| Original issue discount | **–** | (124) | **–** | – |
| Transaction costs | **–** | (842) | **–** | – |
| | **–** | 28,134 | **–** | – |
| | **28,919** | 28,434 | **–** | – |

### Terms and debt repayment schedule

Terms and conditions of outstanding loans and letters of credit of the consolidated entity were as follows:

| | | | | 31 December 2010 | | 31 December 2009 | |
|---|---|---|---|---|---|---|---|
| | Currency | Average nominal interest rate at period end | Year of maturity | Face value US$000 | Carrying amount US$000 | Face value US$000 | Carrying amount US$000 |
| Revolving credit facility Letters of credit | USD | – | 2011 | **6,625** | **–** | 8,260 | – |
| Subordinated term loan | USD | 6.54 | 2011 | **29,175** | **28,919** | 29,400 | 28,434 |
| Total outstanding loans and letters of credit | | | | **35,800** | **28,919** | 37,660 | 28,434 |

### Financing arrangements

All of the consolidated entity's borrowings have been incurred by PEI, a wholly owned subsidiary. These borrowings are secured by the assets of PEI. Petsec Energy Ltd has not provided any guarantee or security in respect of these borrowings.

At 31 December 2010, PEI had a US$6.6 million revolving facility supporting outstanding letters of credit and a US$29.2 subordinated term loan outstanding.

The revolving credit facility and subordinated term loan are secured by the assets of PEI, including oil and gas and cash assets, with a carrying amount of US$60,044,000 (2009: US$86,300,000).

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 17. Loans and borrowings continued

### Financing arrangements continued

Both the revolving facility and the subordinated term loan include financial covenants and other restrictions. The financial covenants include the requirement that PEI:

- Maintain a prescribed ratio of current assets to current liabilities; and
- Restrict the level of bank debt and interest by reference to earnings;

The subordinated term loan agreement also restricts the level of net funded bank debt by reference to discounted cash flow estimates from production of PEI's proved reserves. The lender has waived this requirement as of 31 December 2010. Subsequent to 31 December 2010, this waiver has been extended as negotiations have continued in respect of the memorandum of understanding – see below for further details. The current waiver is scheduled to expire on 28 February 2011. To allow negotiations to be completed and the transaction settled, PEI expects to obtain a further extension of this waiver.

The revolving credit facility and the subordinated term loan both limit the ability of PEI to return cash to Petsec Energy Ltd.

*(i) Revolving facility*

The revolving facility agreement, as amended, is available to support US$6.6 million of outstanding letters of credit (2009: US$8.3 million). The letters of credit secure BOEMRE bonding, potential plug and abandonment, and contingent environmental liabilities in connection with PEI's oil and natural gas operations. No borrowings or new letters of credit are available under the facility. In November 2010, the maturity date of the facility was extended to 15 August 2011.

Under the extension, PEI is also required to deposit US$0.5 million per month into a restricted cash account until outstanding letters of credit issued by Compass Bank are fully cash collateralised. At 31 December 2010, US$6.6 million of letters of credit are on issue of which US$3.4 million are secured by the borrowing based under the credit facility and US$3.2 million are secured by restricted cash. A further US$2.5 million in restricted cash deposits is held in escrow to fund certain abandonment obligations.

*(ii) Subordinated term loan*

The Second Lien agreement involves a 2007 subordinated term loan of US$30 million with a maturity of 8 November 2011. The facility was issued at an original issue discount of 1%. Proceeds received at drawdown in 2007 were US$29.7 million. PEI originally entered into the loan to partially fund a US$103 million acquisition of producing oil & gas properties.

The loan balance at 31 December 2010 was US$29.2 million.

This loan had scheduled repayments of US$0.3 million per annum (US$0.075 million per quarter) during 2010, with the balance payable in equal quarterly instalments during 2011.

Interest on the term loan is floating, based on LIBOR plus a margin of 6.25% per annum. The current interest rate at 31 December 2010 is 6.55% (2009: 6.50%) and is paid monthly.

During 2009, PEI held an interest rate swap that effectively fixed the interest rate (base rate and margin) on the term loan at 10.4% until 31 December 2009. See "Interest rate risk" within this note for further information.

In December 2010, PEI and the lender entered into a memorandum of understanding in relation to the settlement and extinguishment of amounts outstanding under this facility. As part of this memorandum the scheduled 31 December 2010 quarter payment of US$75,000 was deferred.

Under the terms of the memorandum of understanding, the US$29.2 million liability will be fully extinguished in return for a cash payment of US$12 million, conveyances of certain minority working interests in 2 producing fields, and 25% of PEI's working interest in its non producing leases as at 31 December 2010. The working interest conveyances are effective 1 January 2011. Petsec Energy Ltd will fund US$11 million of the cash settlement.

PEI continues to work with the lender in finalising the legal documentation to complete the settlement of the obligation in accordance with the terms of the memorandum of understanding.

In the event that the parties are unable to complete the necessary documentation, and settlement and extinguishment of the amount outstanding under this facility does not eventuate, then PEI as borrower under this facility, is unlikely to have sufficient cashflow to extinguish the liability in full under this facility in accordance with the current repayment schedule. Whilst the carrying value of PEI's oil and gas properties are supported by projections of future cash flows from operations, and exceed the liability, any forced disposal of such assets may be at amounts that are significantly less that their respective carrying values as at 31 December 2010. A forced liquidation of PEI's assets, or filing by PEI for US Chapter 11 bankruptcy protection, would represent a fundamental change in the consolidated entity's balance sheet. This would also require further significant write downs against certain of the Company's receivables and the Company's investment in subsidiaries.

## 18. Employee benefits

### (a) Defined contribution plans

The consolidated entity contributes to several defined contribution employee superannuation plans in Australia. Employer contributions are based on various percentages of their gross salaries. The consolidated entity is under no legal obligation to make contributions in excess of those specified in Superannuation Industry (Supervision) legislation. The amount recognised, as expense was US$23,000 for the year ended 31 December 2010 (2009: US$22,000).

U.S. based employees are eligible to participate in a voluntary savings plan under Section 401(k) of the US tax code ("401(k) plan"). The employer matching contributions recognised as an expense was US$98,000 for the year ended 31 December 2010 (2009: US$110,000).

### (b) Employee incentive plans

The Company has an employee incentive plan, under which a liability may be recognised for bonuses for eligible employees based on the consolidated entity's performance for the year based on a number of pre-determined performance criteria. No bonus is payable in respect of the 2010 year (2009: Nil).

### (c) Share-based payments

The following sets forth the share-based compensation transactions under the Company's Employee Option Plan.

The number and weighted average exercise prices of share options, is as follows:

| In thousands of options | Weighted average exercise price 2010 | Number of options 2010 | Weighted average exercise price 2009 | Number of options 2009 |
|---|---|---|---|---|
| Outstanding at the beginning of the period | **A$2.10** | **5,700** | A$2.40 | 5,240 |
| Granted during the period | **A$0.23** | **2,146** | A$0.20 | 837 |
| Exercised during the period | **–** | **–** | – | – |
| Forfeited during the period | **A$1.75** | **(2,574)** | A$2.02 | (377) |
| Outstanding at the end of the period | **A$1.51** | **5,272** | A$2.10 | 5,700 |
| Exercisable at the end of the period | **A$2.31** | **2,531** | A$2.36 | 2,669 |

The options outstanding at 31 December 2010 have an exercise price in the range of A$0.20 to A$3.11 and a weighted average contractual life of 2.32 years.

During the year, no share options were exercised (2009: Nil).

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 18. Employee benefits continued

### (c) Share-based payments continued

The Employee option plan provides for employees, executives and directors to be granted options over ordinary shares at the discretion of the Nomination and Remuneration Committee.

Each option is convertible to one ordinary share. The exercise prices of the options, determined in accordance with the Rules of the plan, are based on the ruling market prices when the options are issued.

All options expire on the earlier of their expiry date or when the holder's employment ceases unless otherwise approved by the Remuneration Committee. Options may not be exercised until they are vested and thereafter exercise is conditional on satisfaction of share price hurdles and the terms of issue. The vesting periods range from six months to four years after granting. The plan does not represent remuneration for past services.

The terms and conditions of the grants are as follows, whereby all options are settled by physical delivery of shares:

| Grant date/employees entitled | Number of instruments | Contractual life of options |
|---|---|---|
| Option grant to key management personnel at 1 March 2006 | **450,000** | 4.49 years |
| Option grant to other personnel at 28 April 2006 | **192,000** | 4.46 years |
| Option grant to other personnel at 24 July 2006 | **200,000** | 4.50 years |
| Option grant to other personnel at 20 December 2006 | **25,000** | 4.46 years |
| Option grant to other personnel at 2 March 2007 | **80,000** | 4.40 years |
| Option grant to other personnel at 2 March 2007 | **655,000** | 4.42 years |
| Option grant to other personnel at 30 May 2007 | **65,000** | 4.37 years |
| Option grant to key management personnel at 1 June 2007 | **1,500,000** | 4.54 years |
| Option grant to key management personnel at 1 June 2007 | **500,000** | 4.54 years |
| Option grant to other personnel at 10 September 2007 | **30,000** | 4.35 years |
| Option grant to other personnel at 27 February 2008 | **90,000** | 4.46 years |
| Option grant to key management personnel at 14 January 2009 | **60,000** | 3.52 years |
| Option grant to other personnel at 14 January 2009 | **395,500** | 3.52 years |
| Option grant to key management personnel at 25 February 2009 | **175,000** | 3.35 years |
| Option grant to other personnel at 25 February 2009 | **206,000** | 3.35 years |
| Option grant to key management personnel at 29 January 2010 | **600,000** | 3.54 years |
| Option grant to other personnel at 29 January 2010 | **1,546,000** | 3.54 years |
| **Total share option schemes with all or a portion of options outstanding at 31 December 2010** | **6,769,500** | |

## 18. Employee benefits continued

### (c) Share-based payments continued

The fair value of services received in return for share options granted are measured by reference to the fair value of share options granted. The estimate of the fair value of the services received is measured based on a Black-Scholes model. The contractual life of the option is used as an input into this model. During the year ended 31 December 2010, grants of 600,000 options were made to key management personnel (2009: 235,000).

The following table summarises the fair value assumptions of share options granted to key management personnel during the years ended 31 December 2010 and 2009.

| | Key management personnel 2010 | Key management personnel 2009 |
|---|---|---|
| Weighted average fair value at measurement date | **A$0.09** | A$0.06 |
| Weighted average share price | **A$0.22** | A$0.14 |
| Weighted average exercise price | **A$0.23** | A$0.20 |
| Expected volatility (expressed as weighted average used in the modelling under Black-Scholes model) | **62.83%** | 91.59% |
| Expected option life (expressed as weighted average used in the modelling under Black-Scholes model) | **3.5 years** | 3.4 years |
| Expected dividends | **–** | – |
| Risk-free interest rate (based on national government bonds) | **4.66%** | 2.90% – 3.27% |

The expected volatility is based on historic volatility (calculated based on the weighted average remaining life of the share options), adjusted for any expected changes to future volatility due to publicly available information.

Share options are granted under a service condition and minimum share price hurdles. Such conditions are not taken into account in the grant date fair value measurement of the services received, however, are considered in assumptions about the number of options that are expected to become exercisable.

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 19. Rehabilitation provisions

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| **Current** | | | | |
| Balance at 1 January | **3,624** | 674 | **–** | – |
| Provisions made during the year | **156** | – | **–** | – |
| Provisions reclassed from non-current classification | **8,186** | 2,589 | **–** | – |
| Provisions used during the year | **(3,630)** | (1,464) | **–** | – |
| Provisions revised during the year | **(51)** | 1,415 | **–** | – |
| Unwind of discount | **286** | 410 | **–** | – |
| Balance at 31 December | **8,571** | 3,624 | **–** | – |
| **Non-current** | | | **–** | |
| Balance at 1 January | **11,808** | 12,126 | | – |
| Provisions made during the year | **11** | – | **–** | – |
| Provisions reclassed to current classification | **(8,186)** | (2,589) | **–** | – |
| Provisions used during the year | **(4)** | – | **–** | – |
| Provisions revised during the year | **900** | 1,282 | **–** | – |
| Unwind of discount | **653** | 989 | **–** | – |
| Balance at 31 December | **5,182** | 11,808 | **–** | – |
| | **13,753** | 15,432 | **–** | – |

## 20. Capital and reserves

### Share capital

*Ordinary shares*

| | The Company | |
|---|---|---|
| **In thousands of shares** | 2010 | 2009 |
| On issue at 1 January | **231,284** | 154,189 |
| Shares issued for cash | **–** | 77,095 |
| On issue at 31 December – fully paid | **231,284** | 231,284 |

## 20. Capital and reserves continued

The Company does not have authorised capital or par value in respect of its issued shares.

The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the Company.

### Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of operations where their functional currency is different to the presentation currency of the reporting entity.

### Cash flow hedge reserve

The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet transpired.

### Share-based compensation

The share-based compensation represents the value of unvested options issued under the Company's Employee Option Plan.

### Capital management

The Board's policy is to maintain an appropriate capital base to sustain future development of the consolidated entity. This capital base comprises equity and borrowings.

There was no change in the consolidated entity's approach to capital management during the year.

Neither the Company nor any of its subsidiaries are subject to externally imposed capital requirements.

## 21. Additional financial instruments disclosures

### Foreign exchange exposures

During 2009 and 2010, operating costs were incurred in both Australian and US dollars.

Throughout 2009 and 2010, the consolidated entity held the majority of its liquid funds in US dollars.

Fluctuations in the Australian dollar/US dollar exchange rate have impacted the underlying performance of the consolidated entity. The consolidated entity's policy is not to hedge the Australian dollar/US dollar exchange rate risk as income (cash inflows) and expenses (cash outflows), are predominantly denominated in US dollars, with the exception of Australian dollar denominated equity funding, consequently surplus funds are primarily held in US dollars.

### Commodity price exposures

The revenue and income of the consolidated entity are affected by changes in natural gas and crude oil prices, and various financial transactions have been undertaken (purchased put options and swaps involving commodity prices for natural gas) to reduce the effect of these changes. The consolidated entity has proved reserves of these commodities sufficient to cover all these transactions and it only enters into such derivatives to match its anticipated underlying physical production and reserves. The consolidated entity has limited the term of the transactions and the percentage of the Company's expected aggregate oil and natural gas production that may be hedged at any time.

#### *Swaps*

In a natural gas swap agreement the consolidated entity receives from the counterparty the difference between the agreed contracted fixed price and the quoted or published reference settlement price if the latter is lower than the fixed price. If the reference settlement price is higher than the agreed fixed price, the consolidated entity will pay the difference to the counterparty. The consolidated entity had no outstanding swaps at 31 December 2010.

#### *Collars*

In a collar agreement, a floor price and a ceiling price are established. If there is no cash outlay upon entering a collar arrangement, it is called a "costless" or "cashless" collar. If quoted reference prices at the specified date (expiration date) are lower than the floor price, then the counterparty pays the price difference multiplied by the notional quantity to the consolidated entity. If the quoted reference prices at the specified date are higher than the ceiling price, then the consolidated entity pays the price difference multiplied by the notional quantity to the counterparty.

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 21. Additional financial instruments disclosures continued

### Commodity price exposures continued

At 31 December 2010, the consolidated entity had the following outstanding natural gas hedges in place:

| Production period | Hedge type | Average daily volume | Weighted average USD price* |
|---|---|---|---|
| 2011 | Collars | 2,162 MMBtu | 6.00 – 7.56 |

* Floor and ceiling prices for collars.

At 31 December 2009, the consolidated entity had the following outstanding natural gas hedges in place:

| Production period | Hedge type | Average daily volume | Weighted average USD price* |
|---|---|---|---|
| 2010 | Swaps | 6,656 MMBtu | 7.43 |
| 2011 | Collars | 2,162 MMBtu | 6.00 – 7.56 |

* Fixed price for swaps and floor and ceiling prices for collars.

The consolidated entity does not use hedge accounting treatment for its collars. Accordingly, changes in the fair value of the collars are recognised in income immediately.

At 31 December 2010, the consolidated entity had recorded derivative assets of US$1.2 million and derivative liabilities of nil, representing the fair value of the commodity hedge instruments at that date of which US$1.2 million of associated net unrealised gains were recognized in income in 2010. At 31 December 2009, the consolidated entity recorded derivative assets of US$4.3 million and derivative liabilities of nil representing the fair value of the commodity hedge instruments at that date of which US$4.2 million of associated net gains were deferred in equity, net of taxes of US$1.5 million. Refer to accounting policy Note 3(c).

The fair values for commodity hedge agreements will vary with movements in market prices until the contracts settle.

### Credit risk exposures

Credit risk represents the loss that would be recognised if counterparties failed to perform as contracted. The credit risk on financial assets of the consolidated entity that have been recognised is the carrying amount, net of any provision for doubtful debts. The consolidated entity has assessed that the counterparties credit ratings determined by a recognised ratings agency remains acceptable.

### Interest rate risk

The consolidated entity's variable-rate borrowings are exposed to a risk of change in cash flows due to changes in interest rates. Investments in equity securities and short-term receivables and payables are not exposed to interest rate risk.

During 2009, the consolidated entity held an interest rate swap; effectively converting the variable rate interest on the second lien term loan to a fixed rate of 10.4% per annum through 31 December 2009. The interest rate swap had a notional amount matching the outstanding balance of the subordinated term loan. Under the swap agreement, the consolidated entity received a floating interest rate based on the three-month LIBOR rate and paid a fixed rate of 4.15%. There were no interest rate swaps in place during 2010 or in respect of future years.

The consolidated entity determined that interest rate swap agreements outstanding at 31 December 2009 were highly effective and thus qualified for hedge accounting treatment. Accordingly, in 2009, gains or losses on the swaps were included in interest expense upon each monthly settlement.

### Sensitivity analysis

In managing commodity price and interest rate risks the consolidated entity aims to reduce the impact of short-term fluctuations on the consolidated entity's earnings. However, credit considerations limit the amount of hedging with derivative instruments that the consolidated entity can enter into. The consolidated entity and the Company do not use derivative instruments to manage foreign exchange rate risk. Over the longer-term, permanent changes in commodity prices, interest rates and exchange rates will have an impact on profit.

The estimated impact of a 10 per cent change in the average commodity price for the year ended 31 December 2010 would have increased or decreased the consolidated entity's profit or loss by US$800,000 (2009: US$692,000) excluding potential impact of impairments. The estimated impact of a change of 100 basis points in interest rates would have increased or decreased the consolidated entity's profit or loss by US$145,000 (2009: US$39,000). The estimated impact of a 10 per cent change in the USD/AUD exchange rates would have increased or decreased the consolidated entity's and the Company's profit or loss by US$223,000 (2009: US$215,000).

## 21. Additional financial instruments disclosures continued

### Fair values of financial assets and liabilities

The fair values of financial assets and liabilities, together with the carrying amounts shown in the balance sheet, are as follows

| | | 2010 | | 2009 | |
|---|---|---|---|---|---|
| **Consolidated** | **Note** | Carrying amount US$'000 | Fair value US$'000 | Carrying amount US$'000 | Fair value US$'000 |
| Trade and other receivables | | **2,816** | **2,816** | 4,302 | 4,302 |
| Cash and restricted cash deposits | | **23,073** | **23,073** | 25,356 | 25,356 |
| Natural gas hedge contracts: | | | | | |
| Assets | | **1,247** | **1,247** | 4,291 | 4,291 |
| Secured bank loans | | **(28,919)** | **(29,175)** | (28,434) | (29,400) |
| Trade and other payables | | **(4,157)** | **(4,157)** | (6,278) | (6,278) |
| | | **(5,940)** | **(6,196)** | (763) | (1,729) |
| Unrecognised loss | | | **(256)** | | (966) |

The carrying values of all other financial assets and liabilities are estimated to approximate fair value because of their short maturity.

The carrying amounts shown in the balance sheet of the Company are equal to fair value.

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 22. Operating leases

### Leases as lessee

Non-cancellable operating lease rentals are payable as follows:

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| Less than one year | **418** | 524 | **172** | 144 |
| Between one and five years | **329** | 917 | **177** | 300 |
| | **747** | 1,441 | **349** | 444 |

The consolidated entity leases office space in Australia and the USA under operating leases. The leases typically run for a period of 3 to 5 years. Lease payments are subject to review every year to reflect market rentals. None of the leases includes contingent rentals.

One of the leased properties has been sublet by the consolidated entity. The lease and subleases expire in 2012. Sub-lease payments of A$27,000 are expected to be received during the following financial year.

During the year ended 31 December 2010, US$1,197,000 was recognised as an expense in the income statement in respect of operating leases (2009: US$1,538,000). US$25,000 (2009: US$28,000) was recognised as income in the income statement in respect of sub-leases.

## 23. Capital and other commitments

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| **Capital expenditure commitments** | | | | |
| **Exploration, evaluation and development expenditure** | | | | |
| *Contracted but not provided for and payable:* | | | | |
| Within one year | **1,216** | 2,205 | **–** | – |
| One year or later and no later than five years | **624** | 348 | **–** | – |
| | **1,840** | 2,553 | **–** | – |
| **Joint operating arrangements commitments** | | | | |
| *Share of capital commitments of the joint operating arrangements:* | | | | |
| Within one year | **1,356** | 396 | **–** | – |

## 24. Contingencies and legal matters

The consolidated entity is a defendant from time to time in legal proceedings. Where appropriate the consolidated entity engages legal counsel.

The production, handling, storage, transportation and disposal of oil and natural gas, by-products thereof and other substances and materials produced or used in connection with oil and natural gas operations were subject to regulation under U.S. federal, state and local laws and regulations primarily relating to protection of human health and environment. To date, expenditure related to complying with these laws and for remediation of existing environmental contamination has not been significant in relation to the results of operations of the Company.

The Company's U.S. subsidiary, Petsec Energy Inc. ("PEI") is required to provide bonding or security for the benefit of U.S. regulatory authorities and lease owners in relation to its obligations to pay lease rentals and royalties, the plugging and abandonment of oil and natural gas wells, and the removal of related facilities. As of 31 December 2010, the consolidated entity was contingently liable for US$10,075,000 of surety and supplemental bonds (2009: US$10,575,000) issued through a surety company to secure those obligations. US$6,625,000 of these bonds were collateralised by letters of credit.

In the corresponding period, US$6,625,000 of these bonds were collateralised by letters of credit and a further US$1,635,000 in letters of credit collateralised PEI's obligations to a joint venture partner.

## 25. Deed of cross guarantee

Pursuant to an ASIC Class Order 98/1418 dated 13 August 1998, relief is granted to certain wholly owned Australian subsidiaries of the Company from the Corporations Act requirements for preparation, audit, and publication of Financial Reports and Directors' Reports.

It is a condition of the Class Order that the Company and each of its subsidiaries enter into a Deed of Cross Guarantee Indemnity. The effect of the deed is that the Company guarantees to each creditor payment in full of any debt in the event of winding up of any of the subsidiaries under certain provisions of the Corporations Act. If a winding-up occurs under other provisions of the Act, the Company will only be liable in the event that after six months any creditor has not been paid in full. The subsidiaries have also given similar guarantees in the event that the Company is wound up.

The subsidiaries subject to the Deed are:

- Petsec Investments Pty. Limited
- Petroleum Securities Pty. Limited
- Najedo Pty. Ltd
- Petroleum Securities Share Plan Pty Limited
- Laurel Bay Petroleum Limited
- Ginida Pty. Limited
- Western Medical Products Pty. Limited

A consolidated income statement and consolidated balance sheet, comprising the Company and subsidiaries which are a party to the Deed, after eliminating all transactions between parties to the Deed of Cross Guarantee, as at 31 December 2010 and 2009, is set out as follows:

### Summarised income statement and retained earnings/(accumulated losses)

| | Consolidated | |
|---|---|---|
| | 2010 US$'000 | 2009 US$'000 |
| Retained earnings/ (accumulated losses) at beginning of year | **(79,044)** | (23,455) |
| Profit/(loss) after related income tax expense | **(51,858)** | (55,589) |
| Retained earnings/ (accumulated losses) at end of year | **(130,902)** | (79,044) |

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 25. Deed of cross guarantee continued

### Balance sheet

| | Consolidated | |
|---|---|---|
| | 2010 US$000 | 2009 US$000 |
| **ASSETS** | | |
| **Current Assets** | | |
| Cash and cash equivalents | **12,817** | 17,182 |
| Other receivables | **3,969** | 1,325 |
| Prepayments | **116** | 79 |
| **Total current assets** | **16,902** | 18,586 |
| **Non-current assets** | | |
| Loan receivable from controlled entities | **26,592** | 20,710 |
| Other financial assets | **8,178** | 6,468 |
| Other investments | **39,509** | 85,516 |
| Property, plant and equipment | **38** | 41 |
| **Total non-current assets** | **74,317** | 112,735 |
| **Total assets** | **91,219** | 131,321 |
| **LIABILITIES** | | |
| **Current liabilities** | | |
| Trade and other payables | **322** | 788 |
| Employee benefits provision | **35** | 37 |
| **Total current liabilities** | **357** | 825 |
| **Non-current liabilities** | | |
| Employee benefits provision | **233** | 377 |
| **Total non-current liabilities** | **233** | 377 |
| **Total liabilities** | **590** | 1,202 |
| **Net assets** | **90,629** | 130,119 |
| **EQUITY** | | |
| Issued capital | **184,783** | 184,027 |
| Reserves | **36,748** | 25,136 |
| Retained earnings/(accumulated losses) | **(130,902)** | (79,044) |
| **Total equity** | **90,629** | 130,119 |

## 26. Consolidated entities

| | Country of Incorporation | Ownership interest 2010 % | 2009 % |
|---|---|---|---|
| **Parent entity** | | | |
| Petsec Energy Ltd | | | |
| **Significant subsidiaries** | | | |
| Petsec Investments Pty. Limited | Australia | **100** | 100 |
| Petroleum Securities Pty. Limited | Australia | **100** | 100 |
| Najedo Pty. Limited | Australia | **100** | 100 |
| Petroleum Securities Share Plan Pty. Limited | Australia | **100** | 100 |
| Petsec America Pty. Limited | Australia | **100** | 100 |
| Petsec (U.S.A.) Inc. | USA | **100** | 100 |
| Petsec Petroleum LLC | USA | **100** | 100 |
| Petsec Energy Inc. | USA | **100** | 100 |
| Petsec Exploration and Production LLC[1] | USA | **100** | – |
| Laurel Bay Petroleum Limited | Australia | **100** | 100 |
| Ginida Pty. Limited | Australia | **100** | 100 |
| Western Medical Products Pty. Limited | Australia | **100** | 100 |

[1] Holds the consolidated entity's interests in the Marathon Prospect.

All entities carry on business in the country where they were incorporated with the exception of Petsec Petroleum LLC, which holds the consolidated entity's interests in the Beibu Gulf, China.

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 27. Segment reporting

The consolidated entity operates in the oil and gas industry.

Segment information is presented in the consolidated financial statements in respect of the consolidated entity's geographic segments, which reflects the presentation of information to the chief operating decision maker.

Segment results include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. Segment acquisition of property, plant and equipment, intangibles and exploration, evaluation and development assets is the total cost incurred during the period to acquire segment assets that are expected to be utilised for more than one period.

In presenting information on the basis of geographical segments, segment revenue and assets are based on the geographical location of operations.

| | Australia | | USA | | China | | Consolidated | |
|---|---|---|---|---|---|---|---|---|
| | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 | 2010 US$'000 | 2009 US$'000 |
| Oil and gas sales and royalties | **–** | – | **31,061** | 57,124 | **–** | | **31,061** | 57,124 |
| Royalties paid | **–** | – | **(3,981)** | (5,088) | **–** | | **(3,981)** | (5,088) |
| **Net revenues after royalties*** | **–** | – | **27,080** | 52,036 | **–** | | **27,080** | 52,036 |
| Segment result from continuing operations | **(1,342)** | (2,098) | **(19,902)** | (4,495) | **(404)** | (464) | **(21,648)** | (7,057) |
| Income tax benefit | | | | | | | **(13,589)** | (7,842) |
| **Profit after tax** | | | | | | | **(35,237)** | (14,899) |
| Depreciation, depletion, amortisation and rehabilitation | **13** | 12 | **12,483** | 20,970 | **–** | – | **12,496** | 20,982 |
| Dry hole, impairment and abandonment expense | – | – | 19,456 | 10,316 | (6) | (5) | 19,450 | 10,311 |
| Seismic and repair expense | – | – | 533 | 1,561 | – | – | 533 | 1,561 |
| Segment assets | **12,993** | 17,331 | **63,424** | 100,393 | **13,662** | 12,933 | **90,079** | 130,657 |
| Acquisition of property, plant and equipment and exploration, evaluation and development assets | **10** | 6 | **11,323** | 9,266 | **606** | 1,291 | **11,939** | 10,563 |
| Segment liabilities | **589** | 1,203 | **45,963** | 48,760 | **686** | 742 | **47,238** | 50,705 |
| Cash flows from operating activities | **(1,707)** | (1,566) | **3,942** | 30,060 | **(394)** | (451) | **1,841** | 28,043 |
| Cash flows from investing activities | **(10)** | (5) | **(11,198)** | (8,876) | **(719)** | (1,291) | **(11,927)** | (10,172) |
| Cash flows from financing activities | **–** | 13,655 | **(225)** | (21,100) | **–** | – | **(225)** | (7,445) |

* There are no inter-segment sales

## 28. Interests in unincorporated joint operating arrangements

Included in the assets of the consolidated entity are the following items which represent the consolidated entity's interest in the assets and liabilities in joint operating arrangements:

| Assets | Consolidated 2010 US$'000 | Consolidated 2009 US$'000 |
|---|---|---|
| **Exploration, evaluation and development expenditure – Tangible:** | | |
| ***Leases now in production*** | | |
| Producing leases – at cost | **138,230** | 141,307 |
| Less: accumulated amortisation and impairment | **(102,391)** | (91,389) |
| | **35,839** | 49,918 |
| Represented by the following lease carrying values: | | |
| – Main Pass 270 | **24,691** | 34,359 |
| – Main Pass 19 | **8,724** | 15,205 |
| – Mobile Bay Area | **–** | 354 |
| – Onshore Louisiana | **2,424** | – |
| | **35,839** | 49,918 |
| ***Leases not yet in production*** | | |
| – Block 22/12 Beibu Gulf, China | **12,315** | 11,630 |
| – Other Gulf of Mexico leases | **110** | – |
| | **12,425** | 11,630 |
| Total exploration, evaluation and development expenditure – Tangible | **48,264** | 61,548 |
| **Exploration and evaluation expenditure – Intangible:** | | |
| ***Not in production*** | | |
| – Block 22/12 Beibu Gulf, China | **1,338** | 1,301 |
| – Onshore Louisiana | **2,814** | 2,814 |
| – Other Gulf of Mexico leases | **2,640** | 314 |
| Total exploration, evaluation and development expenditure – Intangible | **6,792** | 4,429 |

| Liabilities | Consolidated 2010 US$'000 | Consolidated 2009 US$'000 |
|---|---|---|
| **Rehabilitation provision:** | | |
| – Main Pass 19 | **1,340** | 1,217 |
| – Mobile Bay Area | **4,836** | 3,463 |
| – Main Pass 270 | **336** | 300 |
| – Onshore Louisiana | **711** | 588 |
| – Other Gulf of Mexico leases | **–** | 57 |
| | **7,223** | 5,625 |

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 28. Interests in unincorporated joint operating arrangements continued

| The contribution of the consolidated entity's joint operating arrangements to EBIT (including exploration write-offs and impairments; and excluding the effects of hedging): | Consolidated 2010 US$'000 | Consolidated 2009 US$'000 |
|---|---|---|
| – Main Pass 19 | **(5,215)** | 979 |
| – Mobile Bay Area | **(1,317)** | (4,981) |
| – Main Pass 270 | **(6,882)** | 2,391 |
| – Main Pass 20 Deep #4 well | **(2,860)** | – |
| – Block 22/12 Beibu Gulf, China | **(404)** | (485) |
| – Onshore Louisiana | **1,357** | (3,566) |
| – Other Gulf of Mexico leases | **230** | 297 |
| | **(15,091)** | (5,365) |

The principal activity of all the joint operating arrangements is oil & gas exploration. Listed below is the name of each of the joint operating arrangements and the percentage working interest held in the joint operating arrangement by the consolidated entity as at and during the year ended 31 December:

| | Interest held 2010 | Interest held 2009 |
|---|---|---|
| – Main Pass 19 | **55.00%** | 55.00% |
| – Mobile Bay Area | **40.00% to 50.00%** | 40.00% to 50.00% |
| – Main Pass 270 | **25.00%** | 25.00% |
| – Block 22/12 Beibu Gulf, China | **12.25% to 25.00%** | 25.00% |
| – Onshore Louisiana | **10.00% to 80.00%** | 46.00% to 80.00% |
| – Other Gulf of Mexico leases | **25.00% to 50.00%** | 25.00% to 54.00% |

## 29. Wholly owned areas of interest

Included in the assets and liabilities of the consolidated entity are the following items which represent the consolidated entity's wholly owned areas of interest:

| | Consolidated | |
|---|---|---|
| **Assets** | **2010 US$'000** | **2009 US$'000** |
| **Exploration, evaluation and development expenditure – Tangible:** | | |
| ***Leases now in production*** | | |
| Producing leases – at cost | **47,778** | 107,379 |
| Less: accumulated amortisation and impairments | **(41,801)** | (94,175) |
| | **5,977** | 13,204 |
| Represented by the following lease carrying values: | | |
| – Main Pass 18 | **5,348** | 9,826 |
| – Chandeleur 31/32 | **629** | 3,378 |
| | **5,977** | 13,204 |
| ***Not in production*** | | |
| – Spare equipment | **143** | 503 |
| – Other Gulf of Mexico leases | **–** | 17 |
| | **143** | 520 |
| Total exploration, evaluation and development expenditure – Tangible | **6,120** | 13,724 |
| **Exploration and evaluation expenditure – Intangible:** | | |
| ***Not in production*** | | |
| – Main Pass 91 | **–** | 1,247 |
| – North Padre Island 929/934 | **–** | 1,241 |
| – Other Gulf of Mexico leases | **552** | – |
| Total exploration and evaluation expenditure – Intangible | **552** | 2,488 |
| **Non-current liabilities** | | |
| **Rehabilitation provision:** | | |
| – Vermilion 258 | **–** | 3,081 |
| – Main Pass 18 | **134** | 126 |
| – Main Pass 20 | **3,516** | 3,996 |
| – Chandeleur 31/32 | **2,880** | 2,604 |
| | **6,530** | 9,807 |

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 29. Wholly owned areas of interest continued

| The contribution of the consolidated entity's areas of interest to EBIT (including exploration write-offs and impairments; and excluding the effects of hedging): | Consolidated 2010 US$'000 | Consolidated 2009 US$'000 |
|---|---|---|
| – Chandeleur 31/32 | **786** | 2,399 |
| – Main Pass 18 | **(965)** | (1,355) |
| – Main Pass 20 | **(245)** | (1,227) |
| – Other Gulf of Mexico leases | **(2,745)** | (3,388) |
| – Spare equipment | **(359)** | – |
| | **(3,528)** | (3,571) |

## 30. Reconciliation of cash flows from operating activities

| Cash flows from operating activities | Consolidated 2010 US$'000 | Consolidated 2009 US$'000 | The Company 2010 US$'000 | The Company 2009 US$'000 |
|---|---|---|---|---|
| Profit/(loss) for the period | **(35,237)** | (14,899) | **(51,856)** | (55,586) |
| *Adjustments for:* | | | | |
| Depreciation, depletion & amortisation and rehabilitation | **12,496** | 20,982 | **13** | 12 |
| Dry-hole, impairment and abandonment expense | **19,450** | 10,311 | **–** | – |
| Repair expense | **142** | 458 | **–** | – |
| Net movement in provisions against investments and loans to controlled entities | **–** | – | **52,086** | 56,332 |
| Management fee income | **–** | – | **(857)** | (905) |
| Dividend income | **–** | – | **(2,787)** | (3,075) |
| Net foreign exchange losses/(gains) | **(368)** | 101 | **1,741** | 1,454 |
| Net loss/(gain) on property, plant and equipment | **5** | 36 | **4** | – |
| Share-based payment expenses | **173** | 323 | **76** | 84 |
| **Operating profit before changes in working capital and provisions** | **(3,339)** | 17,312 | **(1,580)** | (1,684) |
| Decrease/(Increase) in restricted cash deposits | **(5,700)** | – | **–** | – |
| Decrease/(Increase) in receivables, prepayments | **2,123** | 3,084 | **(2,681)** | (210) |
| Decrease/(Increase) in deferred tax assets | **12,513** | 4,812 | **–** | – |
| (Decrease)/Increase in payables and provisions | **(3,756)** | 2,835 | **3,532** | 1,437 |
| **Net cash from operating activities** | **1,841** | 28,043 | **(729)** | (457) |

## 31. Related parties

The following were key management personnel of the consolidated entity at any time during the reporting period and unless otherwise indicated were key management personnel for the entire period:

| | |
|---|---|
| Executive director | T N Fern (Chairman and Managing Director) |
| Non-executive directors | D A Mortimer AO |
| | M L Harvey |
| | P E Power – Retired from Board on 21 May 2010 |
| Executives | R A Keogh (President, Petsec Energy Inc.) |
| | R Krenzke (Executive Vice President Exploration, Petsec Energy Inc.) |
| | D Swords (General Counsel/Corporate Secretary, Petsec Energy Inc.) |
| | F Steele (Vice President Land, Petsec Energy Inc.) – Resigned 26 July 2010 |
| | F Robertson (Chief Financial Officer, Petsec Energy Ltd) |
| | P Gahdmar (Company Secretary and Group Financial Controller, Petsec Energy Ltd) |

### Key management personnel compensation

The key management personnel compensation included in personnel expenses (see Note 6) is as follows:

| | Consolidated | | The Company | |
|---|---|---|---|---|
| | 2010 US$ | 2009 US$ | 2010 US$ | 2009 US$ |
| Wages and salaries | **1,034,703** | 954,680 | **230,383** | 234,371 |
| Service agreements for executives | **823,699** | 653,888 | **823,699** | 653,888 |
| Superannuation & 401(k) plans | **104,783** | 54,183 | **18,639** | 18,783 |
| Retirement benefits | **179,049** | 23,700 | **179,049** | 23,700 |
| Share-based payment compensation | **164,672** | 222,307 | **98,390** | 112,149 |
| Other benefits | **132,962** | 98,908 | **32,959** | 29,890 |
| | **2,439,868** | 2,007,666 | **1,383,119** | 1,072,781 |

### Individual directors and executives compensation disclosures

Information regarding individual directors' and executives' compensation and some equity instruments disclosures as permitted by Corporations Regulations 2M.3.03 and 2M.6.04 are provided in the Remuneration Report section of the Directors' Report on pages 18 to 24.

Apart from the details disclosed in this note, no director has entered into a material contract with the Company or consolidated entity since the end of the previous financial year and there were no material contracts involving directors' interests existing at year-end.

Non-executive directors appointed prior to 2003 are entitled to receive a retirement benefit that is equivalent to the remuneration received in the three years prior to retirement. Incoming non-executive directors appointed thereafter are not entitled to receive retirement benefits in accordance with the recommendations made by the ASX Corporate Governance Council. Directors' retirement obligations are presently US$198,000 in total (2009: US$268,000).

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 31. Related parties continued

### Transactions with key management personnel

Key management personnel of the Company and their immediate relatives control approximately 17.3 percent of the voting shares of the Company. No loans were made to key management personnel during the year and no such loans were outstanding.

The aggregate amounts recognised during the year relating to key management personnel and their personally related entities, were a total expense of US$824,000 (2009: US$654,000). Refer to Remuneration Report for further details.

### Assets and liabilities arising from the above related party transactions

| | 2010 US$000 | 2009 US$000 |
|---|---|---|
| **Current liabilities** | | |
| Related party payables | **3** | 5 |

### Other related party disclosures

Information relating to subsidiaries is set out in Note 26.

Refer to Notes 5 and 9 for information regarding related party transactions during the year.

Refer to Notes 12 and 16 for information regarding balances outstanding with subsidiaries at year-end.

## 31. Related parties continued

### Options and rights over equity instruments

The movement during the reporting period in the number of options over ordinary shares in Petsec Energy Ltd held, directly, indirectly or beneficially, by each key management person, including their related parties, is as follows:

| | Held at 1 January 2010 | Granted as compensation | Exercised | Other changes[1] | Held at 31 December 2010 | Vested during the year | Vested and exercisable at 31 December 2010 |
|---|---|---|---|---|---|---|---|
| **Directors** | | | | | | | |
| T Fern | 2,000,000 | – | – | – | 2,000,000 | 500,000 | – |
| **Executives** | | | | | | | |
| R Keogh | 1,150,000 | – | – | (1,000,000) | 150,000 | 50,000 | 50,000 |
| R Krenzke | – | – | – | – | – | – | – |
| D Swords | 310,000 | 200,000 | – | (250,000) | 260,000 | 20,000 | 20,000 |
| F Steele[2] | 200,000 | 200,000 | – | (400,000) | – | – | – |
| F Robertson | 225,000 | – | – | – | 225,000 | 56,250 | – |
| P Gahdmar | 100,000 | 200,000 | – | (75,000) | 225,000 | 8,333 | 8,333 |

| | Held at 1 January 2009 | Granted as compensation | Exercised | Other changes[1] | Held at 31 December 2009 | Vested during the year | Vested and exercisable at 31 December 2009 |
|---|---|---|---|---|---|---|---|
| **Directors** | | | | | | | |
| T Fern | 2,000,000 | – | – | – | 2,000,000 | 500,000 | – |
| **Executives** | | | | | | | |
| R Keogh | 1,000,000 | 150,000 | – | – | 1,150,000 | 250,000 | – |
| R Krenzke | – | – | – | – | – | – | – |
| F Steele | 200,000 | – | – | – | 200,000 | 50,000 | – |
| D Swords | 250,000 | 60,000 | – | – | 310,000 | 62,500 | 125,000 |
| F Robertson | 225,000 | – | – | – | 225,000 | 56,250 | – |
| P Gahdmar | 75,000 | 25,000 | – | – | 100,000 | 18,750 | – |
| C Jones[3] | 225,000 | – | – | (225,000) | – | – | – |

1 Other changes represent options that expired or were forfeited during the year.
2 Mr F Steele resigned on 26 July 2010.
3 Mr C Jones resigned on 5 March 2009.

No options held by key management personnel are vested but not exercisable at 31 December 2009 or 2010.

Key management personnel related parties held no options.

# Notes to the consolidated financial statements continued

For the year ended 31 December 2010

## 31. Related parties continued)

### Movements in shares

The movement during the reporting period in the number of ordinary shares in Petsec Energy Ltd held, directly, indirectly or beneficially, by each key management person, including their related parties, is as follows:

| | Held at 1 January 2010 | Rights Issue Entitlement | Purchases | Received on exercise of options | Sales/ Disposal of relevant interest | Held at 31 December 2010 |
|---|---|---|---|---|---|---|
| **Directors** | | | | | | |
| T Fern | 28,826,876 | – | – | – | – | 28,826,876 |
| D Mortimer | 9,326,550 | – | – | – | – | 9,326,550 |
| M Harvey | – | – | – | – | – | – |
| **Executives** | | | | | | |
| R Keogh | 1,612,500 | – | – | – | – | 1,612,500 |
| R Krenzke | – | – | 250,000 | – | – | 250,000 |
| D Swords | – | – | – | – | – | – |
| F Robertson | 172,625 | – | – | – | – | 172,625 |
| P Gahdmar | 120,000 | – | – | – | – | 120,000 |

| | Held at 1 January 2009 | Rights Issue Entitlement | Purchases | Sales/ Received on exercise of options | Disposal of relevant interest | Held at 31 December 2009 |
|---|---|---|---|---|---|---|
| **Directors** | | | | | | |
| T Fern | 24,825,549 | 12,412,775 | – | – | 8,411,448 | 28,826,876 |
| D Mortimer | 610,068 | 305,034 | 8,411,448 | – | – | 9,326,550 |
| P Power[1] | 225,323 | 112,662 | – | – | – | 337,985 |
| M Harvey | – | | – | – | – | – |
| **Executives** | | | | | | |
| R Keogh | 1,075,000 | 537,500 | – | – | – | 1,612,500 |
| R Krenzke | – | – | – | – | – | – |
| F Steele[2] | – | – | – | – | – | – |
| D Swords | – | – | – | – | – | – |
| F Robertson | 115,083 | 57,542 | – | – | – | 172,625 |
| P Gahdmar | 40,000 | 40,000 | 40,000 | – | – | 120,000 |

[1] Dr Power retired from the Board on 21 May 2010.
[2] Mr Steele resigned on 26 July 2010.

No shares were granted to key management personnel during the reporting period as compensation in 2009 or 2010.

## 32. Events subsequent to balance date

Other than any matter disclosed, there have been no other events subsequent to balance date that would have a material effect on the consolidated entity's financial statements at 31 December 2010.

# Directors' Declaration

1 In the opinion of the directors of Petsec Energy Ltd ("the Company"):

(a) the financial statements and notes and the Remuneration report in the Directors' Report, set out on pages 18 to 70, are in accordance with the Corporations Act 2001 including:

(i) giving a true and fair view of the financial position of the Company and the consolidated entity as at 31 December 2010 and of their performance, as represented by the results of their operations and their cash flows, for the year ended on that date; and

(ii) complying with Australian Accounting Standards and the Corporations Regulation 2001; and

(b) the financial report also complies with International Financial Reporting Standards as disclosed in Note 2; and

(c) there are reasonable grounds to believe that the Company will be able to pay its debts as and when they become due and payable.

2 There are reasonable grounds to believe that the Company and the controlled entities identified in Note 25 will be able to meet any obligations or liabilities to which they are or may become subject to by virtue of the Deed of Cross Guarantee between the Company and those controlled entities pursuant to ASIC Class Order 98/1418.

3 The directors have been given the declarations required by Section 295A of the Corporations Act 2001 from the chief executive officer and chief financial officer for the financial year ended 31 December 2010.

Signed in accordance with a resolution of the directors:

**T N Fern**
Director

Sydney, 28 February 2011

# Independent auditor's report
## to the members of Petsec Energy Limited

### Report on the financial report

We have audited the accompanying financial report of Petsec Energy Ltd (the Company), which comprises the balance sheets as at 31 December 2010, and statements of comprehensive income, statements of changes in equity and statements of cash flows for the year ended on that date, Notes 1 to 32 comprising a summary of significant accounting policies and other explanatory information and the directors' declaration of the company and the Group comprising the company and the entities it controlled at the year's end or from time to time during the financial year.

### Directors' responsibility for the financial report

The directors of the company are responsible for the preparation of the financial report that gives a true and fair view in accordance with Australian Accounting Standards and the *Corporations Act 2001* and for such internal control as the directors determine is necessary to enable the preparation of the financial report that is free from material misstatement whether due to fraud or error. In note 2, the directors also state, in accordance with Australian Accounting Standard AASB 101 *Presentation of Financial Statements*, that the financial statements of the Group comply with International Financial Reporting Standards.

### Auditor's responsibility

Our responsibility is to express an opinion on the financial report based on our audit. We conducted our audit in accordance with Australian Auditing Standards. These Auditing Standards require that we comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance whether the financial report is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial report. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial report, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the financial report that gives a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial report.

We performed the procedures to assess whether in all material respects the financial report presents fairly, in accordance with the *Corporations Act 2001* and Australian Accounting Standards, a true and fair view which is consistent with our understanding of the Company's and the Group's financial position and of their performance.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### Independence

In conducting our audit, we have complied with the independence requirements of the *Corporations Act 2001*.

#### *Auditor's opinion*

In our opinion:

(a) the financial report of Petsec Energy Ltd is in accordance with the *Corporations Act 2001*, including:

- (i) giving a true and fair view of the Company's and the Group's financial position as at 31 December 2010 and of their performance for the year ended on that date; and
- (ii) complying with Australian Accounting Standards and the Corporations Regulations 2001.

(b) the financial report also complies with International Financial Reporting Standards as disclosed in Note 2.

*Emphasis of Matter*

Without qualifying our opinion, we draw attention to Note 2(d) and Note 17 in the financial report. As detailed in Note 2(d) the financial report has been prepared on the basis of a going concern. The going concern basis of preparation assumes that an entity will realise its assets and discharge its liabilities in the normal course of business.

As detailed in Note 17, Petsec Energy Inc ("PEI"), a wholly owned subsidiary, has an outstanding $29.2 million subordinated term loan due to be repaid by November 2011. Petsec Energy Ltd has not provided any guarantee or security in respect of this loan.

In December 2010, PEI and the lender entered into a memorandum of understanding in relation to the settlement and extinguishment of the amount outstanding under this facility. PEI continues to work with the lender in finalising the legal documentation to complete the memorandum of understanding. During these discussions the lender has extended a waiver over a covenant. The current waiver matures on 28 February 2011. PEI expects to obtain a further extension of this waiver.

In the event that the parties are unable to complete the necessary documentation, and settlement and extinguishment of the amount outstanding under this facility does not eventuate, then PEI as borrower under this facility is unlikely to have sufficient cash flow to extinguish the liability in full under this facility in accordance with the current repayment schedule. Whilst the carrying value of PEI's oil and gas properties are supported by projections of future cash flows from operations, any forced disposal of such assets may be at amounts that are significantly less than their respective carrying values as at 31 December 2010. A forced liquidation of PEI's assets, or filing by PEI for US Chapter 11 bankruptcy protection, would represent a fundamental change in the consolidated entity's balance sheet. This would also require further significant write downs against certain of the Company's receivables and the Company's investment in subsidiaries.

## Report on the remuneration report

We have audited the Remuneration Report included in section 20 of the directors' report for the year ended 31 December 2010. The directors of the company are responsible for the preparation and presentation of the remuneration report in accordance with Section 300A of the *Corporations Act 2001*. Our responsibility is to express an opinion on the remuneration report, based on our audit conducted in accordance with auditing standards.

## Auditor's opinion

In our opinion, the remuneration report of Petsec Energy Ltd for the year ended 31 December 2010, complies with Section 300A of the *Corporations Act 2001*.

KPMG

KPMG

**Paul Zammit**
Partner

Sydney, 28 February 2011

# Corporate Governance Statement

The Board of Petsec Energy Ltd ("Petsec") is committed to good corporate governance.

This statement sets out the main corporate governance practices adopted by the Company in the format of the Corporate Governance Principles and Recommendations (2nd Edition) (including the 2010 amendments) (**Recommendations**) issued by the ASX Corporate Governance Council.

Unless otherwise stated, the Company's corporate governance practices were in place throughout the 2010 year and comply with the Recommendations. In a limited number of instances there are departures from the Recommendations, with the details and reasons for the departures stated below in italics.

## 1. Laying Solid Foundations for Management and Oversight

The Board operates within the requirements of the Company's Constitution and Board Charter which sets out the functions and responsibilities reserved for the Board and the matters which have been delegated to executive management. The Board Charter is posted on the Company's website.

The performance of the CEO and senior executives is reviewed annually by the Remuneration and Nomination Committee and is reported to and confirmed by the full Board.

## 2. Structure the Board to Add Value

### Board Composition and Director Independence

A majority of the Board are independent Directors. Currently the Board comprises three Directors, being one executive Director and two non-executive Directors. The non-executive Directors are considered by the Board to be independent, based on the criteria in the Recommendations.

Mr T N Fern acts in the roles of both Chairman and Managing Director. *Although Recommendations 2.2 and 2.3 provide that the Chairman should be an independent director and the roles of Chairman and Managing Director should not be exercised by the same individual, Directors consider that the current composition of the Board is appropriate for the Company at its current stage of development.*

To ensure that independent judgment is achieved and maintained in respect of its decision-making processes, the Board has adopted a number of measures which include the following:

- Directors are entitled to seek independent professional advice at the Company's expense,
- Directors having a conflict of interest in relation to a particular item of business must declare their interest and not vote on that item of business and absent themselves from the Board Meeting if required by the Board before commencement of discussion on the topic; and
- Non-executive Directors confer on a needs basis without management in attendance.

The Board is balanced in its composition with each Director bringing a range of complementary skills and experience to the Company as set out in the Directors' Report.

### Board Committees

To assist the Board in discharging its responsibilities, the Board has a Remuneration and Nomination Committee and an Audit Committee. Each of these committees has its own written charter which has been approved by the Board.

Both Committees now comprise two independent Directors and are chaired by Mr D A Mortimer. *The Company does not comply with Recommendations 4.2 and 8.2, as the Audit Committee and the Remuneration and Nomination Committee do not have three members, as the size of the Board does not allow for this.*

It is the Board's policy that Board Committees should:

- be chaired by a non-executive Director;
- should comprise a majority of non-executive Directors;
- be entitled to obtain independent professional or other advice at the cost of the Company; and
- be entitled to obtain such resources and information from the Company, including direct access to employees of and advisors to the Company, as they may require.

The qualifications and experience of Directors and Committee Members are included in the Directors' Report as are details of the number of Board and Committee meetings held during the year.

### Evaluation of performance of the Board, its Committees and individual Directors.

A review of the Board's own performance is conducted annually together with reviews of the performance of Board Committees and individual Directors. Each Director completes a questionnaire, with the collective responses being discussed by the Board to identify actions and goals to guide performance improvement. The questionnaire covers general and governance issues, overall Board performance and performance of individual Directors. Each of these evaluations has been performed during the past year.

Further details of the Company's performance evaluation processes are detailed in the Board Charter and Nomination and Remuneration Committee Charter, which are posted on the Company's website.

## 3. Promoting Ethical and Responsible Decision Making

### Code of Corporate Conduct

Petsec has always placed great importance on the maintenance of high ethical standards. The Board has adopted a Code of Corporate Conduct which is contained within the Board Charter posted on the Company's website. A similar document has been issued to all employees setting out the principles and standards with which they are expected to comply. Petsec participates in a "whistle-blower" programme with an independent third party which provides a means for staff to report any violation of the Company's Code of Ethics and Corporate Conduct or other wrongdoing.

The Company also has a Share Trading Policy, which is posted on the website.

### Diversity

The Company's values diversity amongst its employees as stated in the Code of Corporate Conduct and requires employment decisions to be based on business qualifications, talents and achievements.

During 2011 the Nomination and Remuneration Committee will oversee and make recommendations to the Board in relation to the development and implementation of a more comprehensive diversity policy in accordance with the ASX Corporate Governance Council Recommendations.

## 4. Safeguarding Integrity in Financial Reporting

The Audit Committee is comprised of two independent Directors, each with relevant financial and technical experience, and is chaired by Mr D A Mortimer. Details of the qualifications of the Audit Committee members are set out in the Directors' Report.

The responsibilities of the Audit Committee include the monitoring and review of the external audit function, management reporting and internal controls, integrity of financial reporting and risk management. The Committee's Charter is posted on the Company's website.

The Audit Committee also appoints the auditor and monitors the 5-year auditor rotation policy, as set out in the Company's Auditor Appointment Policy posted on the website.

## 5. Making Timely and Balanced Disclosure

The Company has policies and procedures in place to ensure the timely and appropriate release of all information required to be disclosed to shareholders in accordance with the ASX Continuous Disclosure regime. The Company Secretary has been appointed as the Continuous Disclosure Officer and with the approval of the Managing Director is responsible for ensuring compliance by overseeing and coordinating the release of information to the ASX, brokers, shareholders, the media and the public. The Continuous Disclosure policy is posted on the Company's website.

## 6. Respecting the Rights of Shareholders

In addition to market disclosure through the ASX, Directors ensure that shareholders and other interested parties are informed through a range of other means including the Company's website at www.petsec.com.au which contains copies of all key disclosure information including announcements to the market, periodic reports, broker and analyst briefings and notices of meetings. The website also contains corporate governance information and general information regarding the Company's activities.

Shareholders and other interested parties are also able to register their email address with the Company to receive announcements made to the ASX.

It is the Company's policy that its external auditors attend each Annual General Meeting and be available to respond to questions from shareholders.

The Communications Policy is posted on the Company's website.

## 7. Recognising and Managing Risk

The Company recognises that an effective system of risk oversight, management and internal control is critical for its success.

A brief summary of the Company's processes are set out below. A more detailed summary is posted in the Corporate Governance section of the Company's website.

### (a) Control Environment

The Board oversees the overall risk management and control framework of the Company to ensure an appropriate control environment is established and maintained spanning Petsec's operations, financial reporting and compliance activities.

The Audit Committee assists the Board in fulfilling its responsibilities in this regard by reviewing and monitoring financial and reporting matters, and the Company's risk management and internal control processes.

# Corporate Governance Statement continued

### (b) Risk Assessment

Petsec runs two parallel risk management processes, one to identify and manage business and operational risk and the other to manage the financial reporting risks and underlying internal controls.

Identification and evaluation of key business and operational risks is conducted through:

I. the annual risk management review, a formal process which is based on the approach prescribed in Australian Standard AS/NZS ISO 31000:2009 and carried out in the fourth quarter each year in conjunction with the preparation of the budget and strategic plan; and

II. assessment of risk as part of all business proposals for management or Board approval.

Key financial statement and financial reporting risks are reviewed and assessed, prior to the commencement of the internal and external audit programmes each year.

### (c) Mitigation and Control

Petsec employs a range of techniques to mitigate and control risk including insurance, oil and gas price hedging, establishment of management accountabilities, and compliance with policies and procedures documented in the Company's Internal Control Policy manual and supporting documents.

### (d) Information and Communication

Monthly management reports to the Board, which draw from both structured management information systems and management input, provide a regular and formal channel of communication within Petsec.

### (e) Monitoring

Formal monitoring of risk and controls at senior management and Board level is achieved by means of:

I. the monthly management report to the Board;

II. detailed audit questionnaires and management sign-offs, which form part of the semi-annual audit process, and

III. an internal audit programme to evaluate and test the key controls over financial reporting that is conducted over the course of each year.

Petsec's Managing Director and Chief Financial Officer have provided a written statement to the Audit Committee in relation to each recent six-month reporting period in accordance with section 295A of the Corporations Act stating that, to the best of their knowledge and belief:

- the declaration given is founded on a sound system of risk management and internal compliance and control which implements the policies adopted by the Board; and
- the Company's risk management and internal compliance and control framework is operating efficiently and effectively in all material respects.

## 8. Remunerate Fairly and Responsibly

The objective of the Company's remuneration policies is to provide fair and competitive remuneration to its Board, executives and staff in order for the Company to benefit by attracting and retaining a high quality team. The level and composition of Directors' and senior executives' remuneration is set out in the Remuneration Report in the Directors' Report together with further information on the structure and basis of remuneration paid.

The Nomination and Remuneration Committee is responsible for reviewing and making recommendations on remuneration policies for Directors and senior executives based on assessment of relevant market conditions, and linking remuneration to the Company's financial and operational performance. The Nomination and Remuneration Committee consists of two independent Directors, and is chaired by Mr D A Mortimer.

Executive remuneration may comprise salary, short term bonuses and share participation. All equity-based remuneration is made in accordance with thresholds approved by shareholders.

Non-executive Directors do not participate in equity-based remuneration and are remunerated by fees which are not performance-based. Non-executive Directors appointed prior to 2003 are entitled to receive a retirement allowance which is equivalent to the remuneration received in the three years prior to retirement. Incoming non-executive Directors are not entitled to receive retirement benefits, in accordance with the recommendations in the Recommendations.

# Exploration and Production Interests – USA

| Lease/Project | | Wells | Lease Date | Term (Years) | Operator | Status | Working Interest | Net Revenue Interest |
|---|---|---|---|---|---|---|---|---|
| **Onshore Louisiana, USA**<br>Moonshine Project | | | | | Petsec Energy | HBP | 0.50000-0.80000 | 0.36000-0.60000 |
| | | E. Laurent No. 1 Well | | | | | 0.80000 | 0.60000 (est.) |
| | | W.P. Miles Timber No. 1 Well | | | | | 0.62000 | 0.45000 (est.) |
| South Sunrise Field | | | | | Badger Oil | HBP | 0.75000 | 0.56000 |
| | | Lawrence Theriot No. 1 Well<br>Serial No. 233936 | | | | | 0.75000 | 0.56464 |
| | | Anthony Theriot No. 1 Well<br>Serial No. 234166 | | | | | 0.75000 | 0.56056 |
| South Thornwell Field (Biscuit Island) | | | | | Manti | HBP | 0.46000 | 0.32000 |
| | | Broussard No. 1 Well<br>Serial No. 233464 | | | | | 0.46206 | 0.32395 |
| Marathon Prospect *(Note 1)* | SL 20221 | SL 20221 No. 1 Well | 9/12/09 | 3 | Phoenix Energy | Primary | 0.100000 | 0.073000 |
| | SL 20367 | | 9/06/10 | 3 | Phoenix Energy | Primary | 0.100000 | 0.073000 |
| | SL 20368 | | 9/06/10 | 3 | Phoenix Energy | Primary | 0.100000 | 0.073000 |
| | SL 20369 | | 9/06/10 | 3 | Phoenix Energy | Primary | 0.100000 | 0.073000 |
| **Gulf of Mexico, USA**<br>Chandeleur 31 | OCS-G 27215 | | 1/6/05 | 5 | Petsec Energy | HBP | 1.00000 | 0.81330 |
| | | A 001 Well<br>Serial No. 1772840870 | | | | | 1.00000 | 0.81333 |
| | | A 002 ST 1 Well<br>Serial No. 1772840871 | | | | | 1.00000 | 0.81333 |
| Chandeleur 32 | OCS-G 27214 | A 001/1D Well<br>Serial No. 1772840872 | 1/6/05 | 5 | Petsec Energy | HBP | 1.00000 | 0.81333 |
| Main Pass 18 | OCS-G 27194 | | 1/07/05 | 5 | Petsec Energy | HBP | 1.00000 | 0.83330 |
| | | G-6 Well<br>API No. 17-725-40815-00 | | | | | 1.00000 | 0.83333 |
| Main Pass 19 | OCS-G 26146 | | 1/7/04 | 5 | Petsec Energy | HBP | 0.55000 | 0.45830 |
| | | G-1 Well<br>API No. 17-725-40800-00 | | | | | 0.55000 | 0.45833 |
| | | G-2 Well<br>API No. 17-725-40801-00 | | | | | 0.55000 | 0.45833 |
| | | G-3 Well<br>API No. 17-725-40802-00 | | | | | 0.55000 | 0.45833 |
| | | G-4 Well<br>API No. 17-725-40813-00 | | | | | 0.55000 | 0.45833 |
| | | G-5 Well<br>API No. 17-725-40814-00 | | | | | 0.55000 | 0.45833 |
| | | G-7 Well<br>API No. 17-725-40817-00 | | | | | 0.55000 | 0.45833 |
| Main Pass 91 *(Note 3)* | OCS-G 27964 | | 1/07/06 | 5 | Petsec Energy | Primary | 1.00000 | 0.83330 |
| Main Pass 270 *(Note 2)* | OCS-G 22812 | | 1/07/01 | 5 | ENI US Operating | HBP | 0.25000 | 0.20800 |
| | | A 001 Well<br>Serial No. 1772440889 | | | | | 0.25000 | 0.20833 |
| | | A 002 Well<br>Serial No. 1772440890 | | | | | 0.25000 | 0.20833 |
| | | A 003 Well<br>Serial No. 1772440906 | | | | | 0.25000 | 0.20833 |

# Exploration and Production Interests continued

| Lease/Project | Wells | Lease Date | Term (Years) | Operator | Status | Working Interest | Net Revenue Interest |
|---|---|---|---|---|---|---|---|
| North Padre Island 929 *(Note 3)* | OCS-G 32720 | 1/10/08 | 5 | Petsec Energy | Primary | 1.00000 | 0.81250 |
| North Padre Island 934 *(Note 3)* | OCS-G 32721 | 1/10/08 | 5 | Petsec Energy | Primary | 1.00000 | 0.81250 |
| West Cameron 462 *(Note 3)* | OCS-G 22555 | 1/05/01 | 5 | ATP O&G | | | 0.04000 ORRI |
| Breton Sound 39 *(Note 3)* | OCS-G 33683 | 1/07/01 | 5 | Petsec Energy | Primary | 0.75000 | 0.609375 |
| Breton Sound 42 *(Note 3)* | OCS-G 33684 | 1/07/01 | 5 | Phoenix Energy | Primary | 0.50000 | 0.40625 |
| Main Pass 18 N/2 *(Note 3)* | OCS-G 33675 | 1/07/10 | 5 | Petsec Energy | Primary | 1.00000 | 0.81250 |
| Main Pass 132 *(Note 3)* | OCS-G 33682 | 1/07/10 | 5 | Petsec Energy | Primary | 1.00000 | 0.81250 |
| Main Pass 273 *(Note 3)* | OCS-G 33690 | 1/07/10 | 5 | Petsec Energy | Primary | 0.50000 | 0.40625 |
| Main Pass 274 *(Note 3)* | OCS-G 33691 | 1/07/10 | 5 | Petsec Energy | Primary | 0.50000 | 0.40625 |
| Ship Shoal 36 *(Note 3)* | OCS-G 33637 | 1/05/10 | 5 | Petsec Energy | Primary | 1.00000 | 0.81250 |
| Ship Shoal 74 *(Note 3)* | OCS-G 33638 | 1/05/10 | 5 | Petsec Energy | Primary | 1.00000 | 0.81250 |

Note 1: Effective 1 January 2011 a 2% working interest in the leases covering the Marathon Prospect was assigned as part of the Term Loan settlement.
Note 2: Effective 1 January 2011 a 2.5% working interest in the producing wells and a 6.25% working interest in the undrilled portion of Main Pass 270 was assigned as part of the Term Loan settlement.
Note 3: Effective 1 January 2011 25% of Petsec Energy Inc's working interest in these undrilled leases were assigned as part of the Term Loan settlement.

# Shareholder Information

as at 15 March 2011

## Number of Shareholders

Issued capital was 231,283,622 ordinary shares held by 5,274 shareholders.
All issued shares carry equal voting rights on a one for one basis.

## Distribution of Shareholders

| Size of Holding | No of Holders |
|---|---|
| 1-1,000 | 1,425 |
| 1,001-5,000 | 1,657 |
| 5,001-10,000 | 750 |
| 10,001-100,000 | 1,224 |
| 100,001 and over | 218 |
| **Total number of shareholders** | **5,274** |
| Number holding less than a marketable parcel | **2,267** |

## Largest Twenty Shareholders

The largest twenty shareholders held 128,137,440 ordinary shares being 55.40% of the issued ordinary capital.

| Name of Holder | No of Shares | % |
|---|---|---|
| CANNING OIL PTY LTD | 25,709,116 | 11.12 |
| MARTIN PLACE SECURITIES NOMINEES PTY LTD | 24,426,981 | 10.56 |
| LIPPO SECURITIES NOMINEES (BVI) LTD <CLIENT A/C> | 11,332,500 | 4.90 |
| HSBC CUSTODY NOMINEES (AUSTRALIA) LIMITED | 10,239,872 | 4.43 |
| CITICORP NOMINEES PTY LIMITED | 9,056,533 | 3.92 |
| MR DAVID A MORTIMER & MRS BARBARA L MORTIMER <WALLAROY PROVIDENT FUND A/C> | 8,636,448 | 3.73 |
| NATIONAL NOMINEES LIMITED | 7,690,207 | 3.33 |
| HESTIAN PTY LTD | 4,281,950 | 1.85 |
| HUMBOLDT CAPITAL CORPORATION | 3,674,532 | 1.59 |
| DEN DUYTS CORPORATION PTY LTD | 3,057,635 | 1.32 |
| CALVESTON WORLDWIDE LTD | 2,460,000 | 1.06 |
| SINO CHAMPION DEVELOPMENT LIMITED | 2,459,579 | 1.06 |
| MRS ELIZABETH HEATH | 2,363,065 | 1.02 |
| ASIAN CORPORATE ADVISERS (BVI) LIMITED | 2,250,000 | 0.97 |
| EVELIND PTY LTD <THE ALPHA A/C> | 2,063,198 | 0.89 |
| MR SHANE MARK FITZSIMMONS | 1,971,000 | 0.85 |
| KEY RESOURCE ANALYSTS LTD | 1,754,824 | 0.76 |
| MR ROSS A KEOGH | 1,612,500 | 0.70 |
| MINARA PTY LTD | 1,597,500 | 0.69 |
| PIAT CORP PTY LTD | 1,500,000 | 0.65 |
| **Substantial shareholders disclosed in substantial shareholder notices given to the Company are as follows:** | | |
| CANNING OIL PTY LTD including its associates | **28,826,876** | 12.46 |

# Five Year Comparative Data Summary

| Financial Performance | | 2006 | 2007 | 2008 | 2009 | 2010 | % change |
|---|---|---|---|---|---|---|---|
| Net Production (Bcfe)[1] | | 8.2 | 8.1 | 12.1 | 7.1 | **3.9** | (45%) |
| Average Gas Price Received | (US$/Mcfe) | 7.24 | 7.93 | 8.70 | 7.36 | **6.98** | (5%) |
| **US$ millions** | | | | | | | |
| Net Revenue | (US$m) | 59.2 | 64.0 | 105.3 | 52.0 | **27.1** | (48%) |
| EBITDAX[2] | (US$m) | 45.3 | 45.9 | 79.6 | 31.3 | **12.6** | (60%) |
| EBITDAX Margin/Mcfe | (US$/Mcfe) | 5.54 | 5.69 | 6.58 | 4.43 | **3.26** | (26%) |
| Depreciation, Depletion & Amortisation | (US$m) | 20.9 | 27.7 | 57.3 | 21.0 | **12.5** | (40%) |
| Net Financial Income/(Expense) | (US$m) | 0.5 | (1.0) | (7.1) | (5.5) | **(3.0)** | n/a |
| Underlying Net Profit/(Loss)[3] | (US$m) | 24.7 | 16.6 | 12.1 | 3.3 | **(2.2)** | n/a |
| Exploration Write-offs, Provisions & Expenses | (US$m) | (16.7) | (19.4) | (71.9) | (10.3) | **(19.5)** | n/a |
| Net Profit/(Loss) after Tax[4] | (US$m) | 5.1 | (2.0) | (44.5) | (14.9) | **(35.2)** | n/a |
| Operating Cashflow after Tax | (US$m) | 44.4 | 35.1 | 85.2 | 28.0 | **1.8** | (94%) |
| **Balance Sheet** | | | | | | | |
| Total Assets | (US$m) | 132.9 | 254.7 | 161.7 | 130.7 | **90.1** | (31%) |
| Cash[5] | (US$m) | 26.5 | 27.2 | 13.7 | 25.4 | **23.1** | (9%) |
| Debt[6] | (US$m) | – | 101.8 | 48.8 | 28.4 | **28.9** | 2% |
| Shareholders Equity | (US$m) | 115.1 | 123.3 | 85.9 | 80.0 | **42.8** | (46%) |
| **Cashflow and Capital Expenditures** *Net Cashflow from:* | | | | | | | |
| Operations | (US$m) | 44.4 | 35.1 | 85.2 | 28.0 | **1.8** | (94%) |
| Investing | (US$m) | (71.5) | (146.5) | (43.5) | (10.2) | **(11.9)** | n/a |
| Financing | (US$m) | 43.4 | 110.7 | (53.7) | (7.4) | **(0.2)** | n/a |
| | | 16.3 | (0.7) | (12.0) | 10.4 | **(10.3)** | |
| **Capital Expenditures[7]** | | | | | | | |
| Exploration | (US$m) | 34.2 | 22.1 | 30.8 | 1.5 | **7.7** | 400% |
| Development | (US$m) | 22.9 | 20.0 | 11.4 | 3.5 | **1.2** | (65%) |
| Acquisition | (US$m) | 14.2 | 103.8 | 1.1 | 0.2 | **1.7** | 839% |
| | | 71.3 | 145.9 | 43.3 | 5.2 | **10.6** | |
| **A$ million** | | | | | | | |
| EBITDAX[2] | (A$m) | 60.0 | 54.8 | 93.0 | 39.6 | **13.7** | (65%) |
| Underlying Net Profit[3] | (A$m) | 32.5 | 19.8 | 14.1 | 4.1 | **(2.4)** | (158%) |
| Net Profit after Tax[4] | (A$m) | 6.8 | (2.4) | (52.0) | (18.9) | **(38.3)** | n/a |
| Operating Cashflow after Tax | (A$m) | 58.8 | 41.9 | 99.6 | 35.5 | **2.0** | (94%) |
| (US$/A$ exchange rate) | | 0.76 | 0.84 | 0.86 | 0.79 | **0.92** | 16% |
| **Operating Margins & Costs** | | | | | | | |
| Average Gas Price Received | (US$/Mcfe) | 7.24 | 7.93 | 8.70 | 7.36 | **6.98** | (5%) |
| + Other Income | (US$/Mcfe) | 0.03 | 0.04 | (0.06) | 0.00 | **0.27** | n/a |
| – Operating Costs (GG&A + LOE) | (US$/Mcfe) | 1.73 | 2.28 | 2.06 | 2.93 | **3.99** | 36% |
| = EBITDAX[2] | (US$/Mcfe) | 5.54 | 5.69 | 6.58 | 4.43 | **3.26** | (26%) |
| Depreciation, Depletion & Amortisation | (US$/Mcfe) | 2.56 | 3.44 | 4.73 | 2.97 | **3.22** | 8% |
| Finding and Development Costs (three year average 2P)[8] | (US$/Mcfe) | 2.52 | 4.10 | 6.20 | 24.38 | **n/a** | n/a |
| **Reserves** | | | | | | | |
| Proved and Probable Reserves (2P)[9] | (Bcfe) | 59.7 | 69.6 | 51.9 | 40.4 | **34.3** | (15%) |
| Reserves Replacement Ratio (%) | | 359% | 222% | (46%) | (62%) | **(55%)** | |

[1] Bcfe = billion cubic feet of gas equivalent. Mcfe = thousand cubic feet of gas equivalent.

[2] EBITDAX = earnings before interest (financial income and expense), income tax, depreciation, depletion, amortisation, rehabilitation and exploration (including dry hole, impairment and abandonment expense, seismic and repair expense).

[3] Underlying Net Profit (Earnings before exploration write-offs, provisions and tax).

[4] Net Profit/(Loss) after Tax: 2009 and 2010 results were impacted by US$10.3 million and US$19.5 million, respectively, in relation to exploration write-offs and impairment provisions (refer to note 7 – Profit/(loss) for the period of the notes to the consolidated financial statements for details) and provisions of US$7.8m and US$12.5 million, respectively, against deferred tax assets recognised in prior periods (refer to note 10 – Income Tax Expense of the notes to the consolidated financial statements for further details).

[5] Includes US$5.7m in restricted cash deposits used to collaterise letter of credit amounts in excess of the Company's bank borrowing base facility and amounts held in escrow to fund certain abandonment obligations (for further details refer to note 17 – Loans and Borrowings of the notes to the consolidated financial statements).

[6] 2007 through 2010 debt is shown net of original issue discount and transaction costs (refer note 17 – Loans and Borrowings of the notes to the consolidated financial statements).

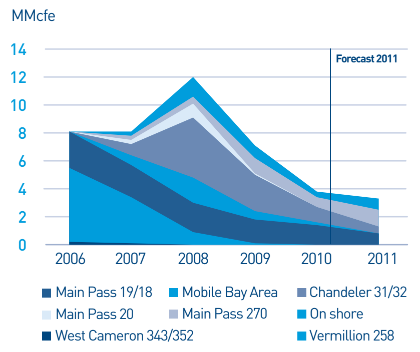
[7] Excludes minor (non oil & gas) property, plant & equipment expenditure and investments.

[8] Finding & Development (F&D) costs include all exploration write-offs. 2007 through 2010 includes the acquisition of interests in producing assets. 2010 is n/a as a result of net reserve revisions over the three year period.

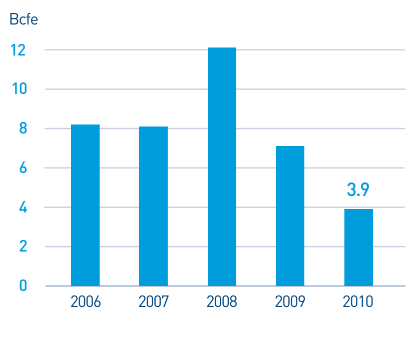
[9] Petsec Energy – estimated recoverable proved and probable (2P) reserves.

## Results

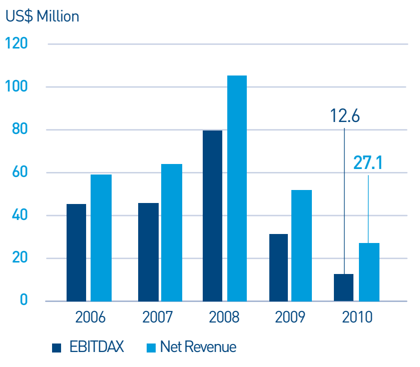
### Production History by Field



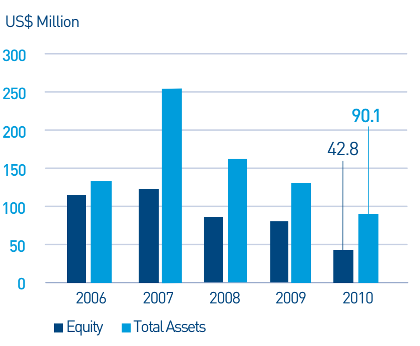

### Production




### EBITDAX and Net Revenue

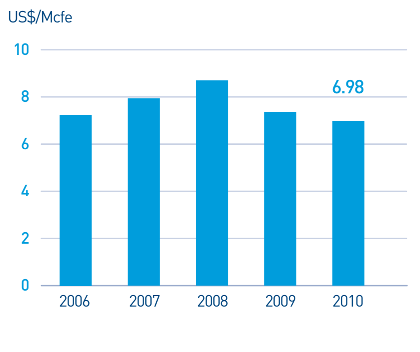



### Balance Sheet Equity and Total Assets

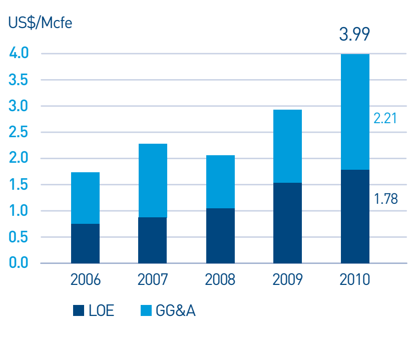



## Operating Margins

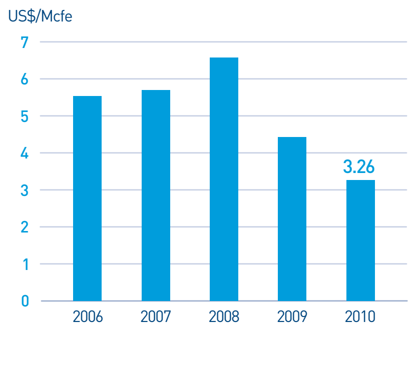
### Average Gas Equivalent Price Received per Mcfe



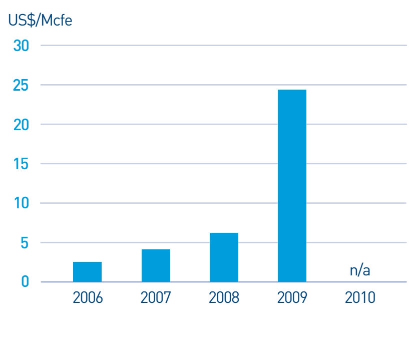

### Total Operating Expense (LOE & GG&A) per Mcfe




### Cash Operating Margins

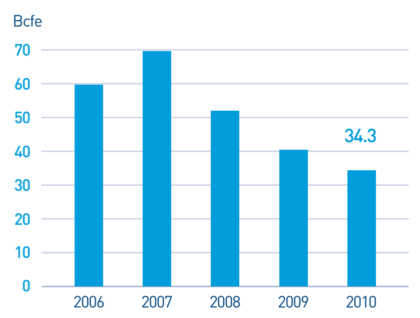



### Finding & Development Costs 3 yr Average on Petsec 2P Reserves



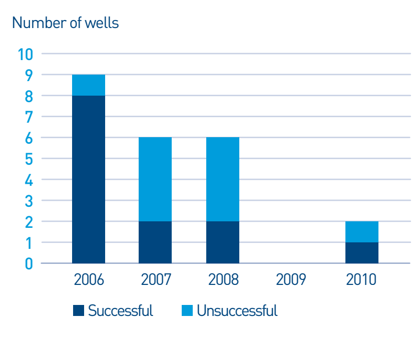

## Reserves/Drilling

### Proved and Probable Reserves* at Year End

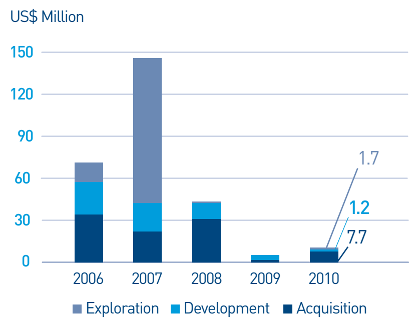



*Petsec Internal Estimate

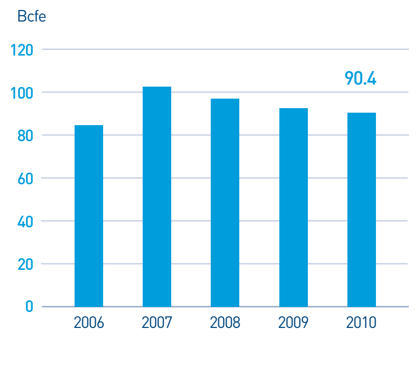
### Wells Drilled/Successful – USA/China (57% success rate – 5 years to 2010)




### Exploration, Development and Acquisition Expenditure




### Cumulative 2P Reserve Additions



Petsec Energy

**PETSEC ENERGY LTD**
ABN 92 000 602 700



# Corporate Directory

**Board of Directors**
Terry N Fern – Chairman & Managing Director
Mike L Harvey – Non-executive Director
David A Mortimer – Non-executive Director

**Company Secretary**
Paul Gahdmar

**Australian Management**
Fiona A Robertson – Chief Financial Officer
Paul Gahdmar – Company Secretary & Group Financial Controller

**USA Management**
Ross A Keogh – President, Petsec Energy Inc
Ron A Krenzke – Executive Vice President – Exploration
Nick M Repar – Exploration Manager
Denis C Swords – General Counsel & Corporate Secretary

**Registered Office and Principal Business Office**
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Telephone: +1 713 457 5800
Facsimile: +1 713 457 5838

**Share Register**
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International: +61 2 9290 9600
Facsimile: 1300 653 459
International: +61 2 9279 0664
Email: registries@registries.com.au

**Depositary Receipts Register**
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Facsimile: +1 646 885 3043

**Auditors**
KPMG Chartered Accountants
King Street Wharf
10 Shelley Street
Sydney NSW 2000 Australia

**Stock Exchange**
Listed on the Australian Stock Exchange, Symbol: PSA
Traded in USA on ADRs, Symbol: PSJEY

**For further information:**
Web: www.petsec.com.au