

# **Primeline Energy Holdings Inc.**

(an exploration stage company)

Consolidated Financial Statements

**March 31, 2011 and 2010**

(expressed in Canadian Dollars)

July 21, 2011

## **Independent Auditor's Report**

### **To the Shareholders of Primeline Energy Holdings Inc.**

We have audited the accompanying consolidated financial statements of Primeline Energy Holdings Inc., which comprise the consolidated balance sheet as at March 31, 2011 and 2010 and the consolidated statements of operations, comprehensive income (loss) and deficit and cash flows for the years then ended, and the related notes including a summary of significant accounting policies.

#### **Management's responsibility for the consolidated financial statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

#### **Auditor's responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements 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 management, as well as evaluating the overall presentation of the consolidated financial statements.

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

#### **Opinion**

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Primeline Energy Holdings Inc. as at March 31, 2011 and 2010 and its results of operations and cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

**Emphasis of Matter**

Without qualifying our opinion, we draw attention to Note 1 in the financial statements which discloses conditions and matters that indicate the existence of a material uncertainty that may cast significant doubt about Primeline Energy Holding Inc.'s ability to continue as a going concern.

*Signed "PricewaterhouseCoopers LLP"*

**Chartered Accountants**

Vancouver, BC

# Primeline Energy Holdings Inc.

(an exploration stage company)

Consolidated Balance Sheets

As at March 31, 2011 and 2010

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(expressed in Canadian Dollars)

	2011 \$	2010 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents (note 3)	1,051,177	30,328,566
Prepaid expenses and deposit	331,478	87,938
	<hr/> 1,382,655	<hr/> 30,416,504
<b>Petroleum exploration costs</b> (note 4)	63,962,941	39,312,933
	<hr/> 65,345,596	<hr/> 69,729,437
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	473,141	2,552,959
Cash call payable (note 7 (c))	222,583	2,411,470
	<hr/> 695,724	<hr/> 4,964,429
<b>Non-current liabilities</b>		
Rights issue deposit (note 5)	-	23,510,311
Advance from a related party (notes 5 and 7(d))	1,700,000	-
Future income tax liability (note 8)	425,551	425,551
	<hr/> 2,125,551	<hr/> 23,935,862
	<hr/> 2,821,275	<hr/> 28,900,291
<b>Shareholders' Equity</b>		
<b>Capital stock</b> (note 5)	128,619	64,309
<b>Contributed surplus</b> (note 5)	74,592,906	51,573,067
<b>Deficit</b>	(12,197,204)	(10,808,230)
	<hr/> 62,524,321	<hr/> 40,829,146
	<hr/> 65,345,596	<hr/> 69,729,437

**Nature of operations and going concern** (note 1)

**Commitments** (notes 4 and 6)

**Subsequent Events** (note 12)

**Approved by the Board of Directors**

(signed) Guang Ming Wang

Director

(signed) Brian Chan

Director

# Primeline Energy Holdings Inc.

(an exploration stage company)

## Consolidated Statements of Operations, Comprehensive Income (Loss) and Deficit For the years ended March 31, 2011 and 2010

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(expressed in Canadian Dollars)

	<b>2011</b>	<b>2010</b>
	\$	\$
<b>Expenses</b>		
Audit	103,155	53,000
Bank charges and interest	15,644	13,979
Business promotion	79,916	86,759
Foreign exchange (gain) loss	(19,983)	625,444
Non-executive directors retainer fee	25,000	-
Office	270,626	234,902
Professional fees	839,342	397,763
Stock-based compensation (note 5(d))	20,899	4,088
Travel	63,044	33,615
Interest income	(8,669)	(1,504)
	<hr/>	<hr/>
<b>Loss for the year and comprehensive loss for the year</b>	(1,388,974)	(1,448,046)
<b>Deficit - Beginning of year</b>	(10,808,230)	(9,360,184)
	<hr/>	<hr/>
<b>Deficit - End of year</b>	(12,197,204)	(10,808,230)
	<hr/>	<hr/>
<b>Basic and diluted loss per common share</b>	(0.02)	(0.03)
	<hr/>	<hr/>
<b>Weighted average number of common shares outstanding</b>	89,403,596	47,020,623
	<hr/>	<hr/>

Accompanying notes are integral part of the financial statements

# Primeline Energy Holdings Inc.

(an exploration stage company)

Consolidated Statements of Cash Flows

For the years ended March 31, 2011 and 2010

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(expressed in Canadian Dollars)

	2011 \$	2010 \$
<b>Cash flows from operating activities</b>		
Loss for the year	(1,388,974)	(1,448,046)
Items not affecting cash		
Stock-based compensation	20,899	4,088
Changes in non-cash working capital items		
Prepaid expenses and deposit	(243,540)	(60,361)
Accounts payable and accrued liabilities	189,527	79,700
	(54,013)	19,339
	(1,422,088)	(1,424,619)
<b>Cash flows from investing activities</b>		
Expenditures on deferred petroleum exploration costs	(26,919,353)	(2,839,036)
<b>Cash flows from financing activities</b>		
Right issuance proceeds	8,733,411	23,510,311
Repaid deposit of right issue	(1,049,180)	-
Right issuance costs	(447,061)	-
Cash call (utilized for) received from a related party	(8,173,118)	2,383,991
	(935,948)	25,894,302
<b>(Decrease) Increase in cash and cash equivalents</b>	(29,277,389)	21,630,647
<b>Cash and cash equivalents - Beginning of year</b>	30,328,566	8,697,919
<b>Cash and cash equivalents - End of year</b>	1,051,177	30,328,566
<b>Supplemental cash flow information</b>		
<b>Non-cash investing activities</b>		
Change in accrued liabilities as a result of investing activities	(2,269,345)	2,060,036
Stock-based compensation and related future income taxes capitalized as deferred petroleum exploration costs	-	1,734

# Primeline Energy Holdings Inc.

(an exploration stage company)

Notes to Consolidated Financial Statements

March 31, 2011 and 2010

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(expressed in Canadian Dollars)

## 1 Nature of operations and going concern

Primeline Energy Holdings Inc. (PEHI or the Company) was incorporated under the Companies Law of the Cayman Islands on March 31, 1995 and is in the business of exploration and development of off-shore oil and gas properties. To date, PEHI has not realized any revenues from its oil and gas properties and is considered to be an exploration stage company.

Primeline Energy China Ltd. (PECL), a wholly owned subsidiary, owns a 75% interest in a petroleum sharing contract (the Petroleum Contract) which entitles PECL to participate in the exploration, development and production of oil and gas in Block 25/34 in the East China Sea. The participation interests are detailed in note 3. Primeline Energy Operations International Limited (PEOIL), another wholly owned subsidiary, holds the operator rights under the Petroleum Contract.

PECL is currently exploring for oil and gas under the Petroleum Contract for Block 25/34 in the East China Sea of the People's Republic of China (PRC) and is also working with China National Offshore Oil Corporation (CNOOC) on a development proposal for the LS 36-1 gas field.

These financial statements have been prepared on the basis of accounting principles applicable to a going concern, which assumes that the Company will be able to continue in operation for the foreseeable future and will be able to realize its assets and discharge its liabilities in the normal course of business.

Several adverse conditions cast significant doubt upon the validity of this assumption. Consistent with other entities in the exploration stage, the Company has incurred operating losses since inception, has no source of revenue, is unable to self-finance operations, and has significant cash requirements to meet its overhead and continue its exploration activities..

The Company's ability to continue as a going concern is dependent upon management's ability to secure the additional financing.. While management has been successful in obtaining funding in the past including support from a related party (note 12(c)), there can be no assurance that it will be able to do so in the future.

If the going concern assumption were not appropriate for these financial statements then adjustments would be necessary to the carrying value of assets and liabilities, the reported expenses and the balance sheet classifications used, and such adjustments would be material.

# **Primeline Energy Holdings Inc.**

(an exploration stage company)

Notes to Consolidated Financial Statements

**March 31, 2011 and 2010**

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(expressed in Canadian Dollars)

## **2 Significant accounting policies**

### **Principles of consolidation**

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and include the accounts of PEHI and its wholly owned subsidiaries, PECL and PEOIL, also incorporated in the Cayman Islands (collectively, the Company). Inter-company balances and transactions are eliminated on consolidation.

### **Cash and cash equivalents**

Cash and cash equivalents consist of cash on deposits with banks and highly liquid short-term interest-bearing securities with maturities at the purchase date of three months or less.

### **Deferred petroleum exploration costs**

The Company follows the full cost method of accounting for its oil and gas interests whereby all costs relating to the exploration for and development of oil and gas reserves are capitalized and charged against income as set out below. Capitalized costs include expenditures for lease acquisition, geological and geophysical surveys, drilling exploration and development wells, gathering and production facilities and other development expenditures. Expenditures related to renewals or betterments that improve the productive capacity or extend the life of an asset are capitalized. Maintenance and repairs are expensed as incurred.

Capitalized costs, including estimated asset retirement costs, along with estimated future capital costs to develop proved reserves, net of estimated salvage value, are depleted on a unit-of-production basis using estimated proved oil and gas reserves as determined by independent reserve evaluators. Natural gas reserves are converted to equivalent barrels of oil based on the ratio of six thousand cubic feet (“mcf”) of natural gas to one barrel of oil (“bbl”).

Costs of acquiring and evaluating unproved properties and major development projects are initially excluded from the depletion and depreciation calculation until it is determined whether or not proved reserves can be assigned to such properties. Costs of unproved properties and major development projects are transferred to depletable costs based on the percentage of reserves assigned to each project. Unproved properties are evaluated for impairment on at least an annual basis. If an unproved property is considered to be impaired, the amount of the impairment is added to costs subject to depletion. To date, the Company does not have any proven resources.

Gains or losses from the sale of oil and gas interests in the producing stage are recognized only when the effect of crediting the proceeds to capitalized costs would result in a change of 20 percent or more in the depletion rate.

The net amount at which oil and gas interests are carried is subject to a cost recovery test (the “ceiling test”). The ceiling test is a two-stage process which is performed at least annually. The first stage is a recovery test whereby undiscounted estimated future cash flows from proved reserves at oil and gas prices in effect at the balance sheet date (“forecast prices”) plus the cost of unproved properties less any

# **Primeline Energy Holdings Inc.**

(an exploration stage company)

Notes to Consolidated Financial Statements

**March 31, 2011 and 2010**

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(expressed in Canadian Dollars)

impairment is compared to the net book value of the oil and gas interests to determine if the assets are impaired. An impairment loss exists if the net book value of the oil and gas interests exceeds such undiscounted estimated cash flows. The second stage determines the amount of the impairment loss to be recorded. The impairment is measured as the amount by which the net book value of the oil and gas interests exceeds the future estimated cash flows discounted at the risk-free rate from proved plus probable reserves at the forecast prices. Any impairment is recorded as additional depletion.

## **Foreign currency translation**

For the purposes of consolidation, the Company's foreign subsidiaries are considered integrated operations and are translated into Canadian dollars using the temporal method. Under this method, the Company translates monetary assets and liabilities denominated in foreign currencies at period-end rates. Non-monetary assets and liabilities are translated at historical rates. Revenues and expenses are translated at average rates in effect during the period except for depreciation and amortization which are translated at historical rates. The resulting gains or losses are reflected in operating results in the period of translation.

At the entity level, monetary assets and liabilities denominated in foreign currencies are translated into the measurement currency at the exchange rate in effect at the balance sheet date and non-monetary assets and liabilities are translated at the exchange rates in effect at the time of acquisition or issue. Revenues and expenses are translated at rates approximating the exchange rates in effect at the time of the transactions. All exchange gains and losses are included in statement of operations.

## **Use of estimates, risks and uncertainties**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions which affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. While management believes that these estimates and assumptions are reasonable, actual results could vary significantly.

A significant area requiring the use of management estimates relates to the recoverability of the petroleum exploration costs. Realization of the Company's assets is subject to risks and uncertainties, including reserves estimation; future oil and gas prices; estimated costs of future production; changes in government legislation and regulations; and various operational factors.

## **Capitalization of interest**

The Company capitalizes interest directly attributable to petroleum exploration costs until the commencement of commercial production.

# **Primeline Energy Holdings Inc.**

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Notes to Consolidated Financial Statements

**March 31, 2011 and 2010**

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(expressed in Canadian Dollars)

## **Income taxes**

Income taxes are calculated using the liability method. Temporary differences arising from the difference between the tax basis of an asset or liability and its carrying amount on the balance sheet are used to calculate future income tax liabilities or assets. Future income tax liabilities or assets are calculated using enacted or substantively enacted tax rates anticipated to apply in the periods that the temporary differences are expected to reverse. A valuation allowance is applied to the extent that it is not more likely than not that future income tax assets will be realized.

## **Stock-based compensation**

The Company has a stock option plan, details of which are described in note 5. The Company applies the fair value method of accounting for stock-based compensation for both employees and non-employees. The fair value method requires recognition of an expense arising from stock options granted to both employees and non-employees. The fair value of options granted is established at the date of grant using the Black-Scholes option pricing model. For employees, the fair value of the options at the date of the grant is accrued and charged to operations and/or mineral property, with the offsetting credit to the contributed surplus over the option's vesting period. For non-employees, the fair value of the options is measured at the earlier of the date at which counterparty's performance is complete, the date the performance commitment is reached or the date at which the equity instruments are granted if they are fully vested and non-forfeitable. On the exercise of stock options, share capital is credited for consideration received for fair value amounts previously credited to contributed surplus.

## **Asset retirement obligations**

Asset retirement obligations are recorded for statutory, contractual, or legal obligations associated with the retirement of property, plant and equipment, when those obligations result from the acquisition, construction, development, or normal operation of the assets. The obligations are measured initially at fair value (using present value methodology), and the resulting costs capitalized into the carrying amount of the related asset. In subsequent periods, the liability is adjusted for the accretion of discounts and any changes in the amount or timing of the underlying future cash flows.

The related asset is adjusted only as a result of changes in the amount or timing of the underlying cash flows. The capitalized asset retirement cost is depreciated on the same basis as the related asset. Management has determined that, based on the exploration work carried out to date, there is no legal obligation requiring remediation of the company's oil and gas property at this time.

## **Earnings (Loss) per Share**

Basic earnings (loss) per share is calculated using the weighted-average number of shares outstanding during the period. The company uses the treasury stock method to compute the dilutive effect of options, warrants and similar instruments. Under this method, the dilutive effect on earnings per share is recognized assuming the proceeds that could be obtained upon exercise of options, warrants and similar instruments would be used to purchase common shares at the average market price during the year.

# Primeline Energy Holdings Inc.

(an exploration stage company)

Notes to Consolidated Financial Statements

March 31, 2011 and 2010

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(expressed in Canadian Dollars)

## Financial instruments

Financial assets and financial liabilities are recognized when the Company becomes a party to the contractual provisions of the financial instrument. The Company classifies financial instruments as held-to-maturity, available-for-sale, held-for-trading, loans and receivables, or other financial liabilities. Financial assets held to maturity, loans and receivables, and financial liabilities other than those held-for-trading, are measured at amortized cost. Available-for-sale instruments are measured at fair value with unrealized gains and losses recognized in other comprehensive income ("OCI"). Instruments classified as held for trading are measured at fair value with unrealized gains and losses recognized in the statement of operations. Transaction costs are expensed as incurred.

Cash and cash equivalents are classified as loans and receivables, which are measured at amortized cost. Accounts payable and accrued liabilities, cash call payable and advance from a related party are classified as other liabilities, which are measured at amortized cost.

## 3 Cash and cash equivalents

Cash and cash equivalents consist of:

	2011 \$	2010 \$
Cash on hand	956,776	620,939
Interest bearing deposits	94,401	29,707,627
	<u>1,051,177</u>	<u>30,328,566</u>

# Primeline Energy Holdings Inc.

(an exploration stage company)

Notes to Consolidated Financial Statements

March 31, 2011 and 2010

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(expressed in Canadian Dollars)

## 4 Petroleum exploration costs

	2011	2010
	\$	\$
Exploration drilling related services		
Drilling services	27,652,491	5,634,766
Drilling technical supervision and evaluation	582,117	337,001
Exploration Geological & Geophysical Surveys & Works		
Geological & geophysical survey acquisition & processing	9,787,442	9,787,442
Technical evaluations & management	5,705,724	4,887,397
Pre-development study	4,910,475	4,902,689
Interest on funding of deferred exploration expenditure	3,547,169	3,548,686
Deferred costs acquired from Primeline Petroleum Corporation	1,394,307	1,394,307
Project administration	3,522,007	2,969,484
Salaries and benefits	4,894,394	4,158,177
Travel and accommodation	2,247,985	1,974,154
Contract signing fee	539,917	539,917
Other	(821,087)	(821,087)
	<hr/>	<hr/>
	63,962,941	39,312,933

The Company and Primeline Petroleum Corporation (PPC), a company with the same majority shareholder, are contractors (collectively, the Contractors) under a Petroleum Contract dated March 24, 2005 with China National Offshore Oil Corp. (CNOOC) to explore, develop and produce oil and gas reserves that may exist in an area known as Block 25/34 (the Contract Area) in Lishui and Jiaojiang Basins, East China Sea. The Contract Area includes the majority of previous Block 32/32 covered by a prior petroleum contract between the Contractors and CNOOC which was in effect during the period from December 12, 1994 to February 28, 2005. The Company and PPC hold 75% and 25% of the Contractors' interest, respectively.

The Petroleum Contract became effective on May 1, 2005, and has three periods: exploration, development and production, with a maximum contract term of 30 years. The exploration period is normally seven years while the production period is normally 15 years. The exploration period is further subdivided into three exploration phases, which includes the first phase of three contract years (the first contract year through the third contract year); the second phase of two contract years (the fourth contract year through the fifth contract year); and the third phase of two contract years (the sixth contract year through the seventh contract year).

Under the initial contract the Contractors were committed to drilling one exploration well in each of the three exploration phases (plus an additional 200 square kilometres of 3D seismic in phase one) and the minimum cost of completing these exploration operations should be US\$6,000,000 in the first phase and US\$5,000,000 in each of the second and third phases. At the end of each of the first and second exploration phases, the Contractors must decide whether to enter into the next exploration phase and relinquish 25% of the remaining Contract Area, or terminate the Petroleum Contract. At the end of the third exploration phase, the Contract Area, except for any discovery, development or production area that may exist in the Contract Area, is relinquished.

The Petroleum Contract provides that the Contractors will fund all costs incurred during the exploration period, and CNOOC has the right to participate up to 51% in any future development and production of oil and/or gas fields in the Contract Area by paying its pro rata share of the development and production costs.

# Primeline Energy Holdings Inc.

(an exploration stage company)

Notes to Consolidated Financial Statements

March 31, 2011 and 2010

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(expressed in Canadian Dollars)

The Contractors will remain as operators for the development and production period until at least full cost recovery.

By an Amendment Agreement dated February 18, 2008 between CNOOC, the Company and PPC, the parties agreed that the Petroleum Contract be amended to provide that the exploration period beginning on the date of the commencement of the implementation of the contract shall be divided into three phases and shall consist of 8 years rather than 7 years. The first exploration period shall be for a period of four years from the date of commencement on May 1, 2005, and the second and the third exploration phases shall be for two year periods respectively. The Company is in compliance with all explorations requirements for phase 1 except for the commitment to drill one exploration well which has been transferred by agreement with CNOOC into phase 2 such that the minimum exploration requirement for phase 2, which ends on April 30, 2011, is two wells, one of which was completed during the current financial year (see Note 12).

On July 15, 2011, the Company has signed a Memorandum of Agreement ("MOA") with CNOOC to amend the Petroleum Contract and to enter into a new petroleum contract. The MOA amends the existing Petroleum Contract so that no further exploration activity will be carried out under that contract and the Company and PPC will relinquish all of the current area of 5,221 sq kms held under the Existing Contract, save for the development area for the LS36-1 gas field, comprising 84.7 sq kms. The existing Petroleum Contract will remain in effect in relation to the continuing development and production operations for the LS36-1 gas field.

The MOA also provides that a new petroleum contract ("New Contract") will be granted on the following basis:

**Area:** The exploration area under the New Contract will cover the same area as that currently held under the Existing Contract but with an additional adjacent area to the east making a new contract area of 5,877 sq kms. The new area has been designated as Block 33/07.

**Term:** The New Contract will have a 7 year exploration period divided into 3 exploration periods of 3, 2 and 2 years each with a minimum work commitment in the first phase of two wells plus 600 sq kms of 3D seismic. The commitment for each of the second and third phases is one well.

Future discoveries in the new contract area (and any CNOOC self financed discoveries nearby, if there is spare capacity and subject to payment of a proportion of operational costs) will enjoy the right to free use of the production facilities to be built for the LS36-1 gas field.

All other terms are the same as the Existing Contract and the New Contract will be held by Primeline and PPC in the same proportions in which they held the Existing Contract of 75%/25%.

The Company, PPC and CNOOC have signed a Supplemental Development Agreement and other agreements with regard to the development of LS36-1 gas field which was discovered by the Company, following the completion of the Overall Development Program (ODP). The ODP comprises a formal development engineering plan, backed up by survey results and environmental studies, together with a full economic analysis of the development, which is required to be approved by the Chinese government before the Development can officially commence. Under these agreements, CNOOC became the Operator with the development and production operations and is proceeding with the development preparation whilst preparing for the full government approval submission of the development. PEOIL continues to be the exploration Operator on Block 33/07 under the new petroleum contract.

# Primeline Energy Holdings Inc.

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Notes to Consolidated Financial Statements

March 31, 2011 and 2010

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(expressed in Canadian Dollars)

## 5 Capital stock and contributed surplus

### a) Authorized

	Number of shares	
	2011	2010
Common shares with a par value of US\$0.001 each	500,000,000	500,000,000

### b) Issued and outstanding

	Number of common shares	Amount \$	Contributed surplus \$
Balance - March 31, 2009	47,020,623	64,309	51,567,679
Fair value of options	-	-	5,388
Balance - March 31, 2010	47,020,623	64,309	51,573,067
Rights issue	47,020,623	64,310	22,998,940
Fair value of options	-	-	20,899
Balance - March 31, 2011	94,041,246	128,619	74,592,906

	2011	2010
Weighted average number of common shares outstanding	89,403,596	47,020,623

### c) Rights issuance

On March 25, 2010, the Company filed a preliminary short form prospectus in the provinces of British Columbia, Alberta, Ontario and Quebec relating to a rights offering (the "Offering") to raise gross proceeds of C\$23,510,311.

According to the Offering, each holder of the Company's common shares ("Shares") would be entitled to receive one right (a "Right") for each Share held. One Right would entitle the holder to acquire one Share at a price of \$0.50 per share (the "Subscription Price").

The Company's largest shareholder, Primeline International (Holdings) Inc. ("Primeline International"), had agreed to provide a standby commitment (the Standby Guarantee) under which Primeline International would purchase from the Company at the Subscription Price any Shares (the "Standby Shares") that are not otherwise subscribed for under the Offering. Accordingly, Primeline International deposited C\$23,510,311 into the Company's bank account on March 26, 2010 as deposit for the Standby Guarantee.

# Primeline Energy Holdings Inc.

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(expressed in Canadian Dollars)

The rights were issued to holders of common shares of record on April 15, 2010 and expired on May 6, 2010. Under the Offering, a total of 39,640,833 common shares were subscribed. Under the Standby Guarantee Agreement with the Company, Primeline International purchased the remaining balance of 7,379,790 common shares available under Offering.

Aggregate total gross proceeds of C\$8,733,411 were received by the Company from external shareholders during the year. The Company had repaid \$1,049,180 of the standby guarantee deposits to Primeline International during the year, with the remaining balance of \$7,684,231 being reassigned to as an advance from PPC (note 7(c), (d)).

d) Stock options

The company had a stock option plan (the Plan), pursuant to which the directors were authorized to grant up to 7,053,000 common shares in options. The options enabled the directors, officers, consultants and employees to acquire common shares. The exercise price of a share option was set by the board of directors, subject to TSX Venture Exchange policy. Options granted under the Plan have a maximum term of five years and vest in stages over at least 18 months the options vesting equally on a quarterly basis, as determined by the board of directors at the grant date.

Since November 26, 2010 the Company has had a stock option plan (the Plan), pursuant to which the directors are authorized to grant options to purchase a number of common shares equal to 10% of the number of common shares issued and outstanding from time to time. The options enable the directors, officers, consultants and employees to acquire common shares. The exercise price of a stock option will be set by the board of directors, subject to TSX Venture Exchange policy. Options granted under the Plan may have a maximum term of ten years. The vesting schedule, if any, is determined by the board of directors at the grant date.

# Primeline Energy Holdings Inc.

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March 31, 2011 and 2010

(expressed in Canadian Dollars)

The following table summarizes information about the stock options outstanding and exercisable at March 31, 2011 and 2010:

	2011		2010	
	Options outstanding	Weighted average exercise price \$	Options outstanding	Weighted average exercise price \$
Outstanding - Beginning of year	5,725,000	1.59	5,725,000	1.59
Expired	(50,000)	1.59	-	-
Granted	350,000	0.50	-	-
Outstanding - End of year	6,025,000	1.52	5,725,000	1.59
Options exercisable – End of year	5,975,000	1.53	5,725,000	1.59

On April 4, 2006, the Company granted 4,500,000 options at an exercise price of \$1.50 per share to directors, officers, employees and consultants, of which 4,300,000 options are outstanding and expired on April 4, 2011.

On December 1, 2006, the company awarded options to its non-executive directors, management and consultants to purchase up to 1,200,000 common shares at an exercise price of \$1.60 per share. 217,000 of the 1,200,000 options have been cancelled by agreement with the option holders. 433,000 of the 1,200,000 options expired on May 31, 2008 while the balance of 550,000 options expire on November 30, 2011.

On November 1, 2007, the company awarded options to purchase a total of 875,000 common shares at an exercise price of \$2.00 per share. 250,000 of the 875,000 options were awarded to CHF Investor Relations, the company's investor relations counsel, while 625,000 options were awarded to executive directors, management and consultants. All such options expire on October 31, 2012.

On June 1, 2010, one employee with 25,000 options granted to him on each of December 1, 2006 and November 1, 2007 left the Company. Those options accordingly expired on September 1, 2010 under the terms of the stock option plan.

On November 29, 2010, 350,000 options were granted to a consultant, and 300,000 of such options vested as of March 31, 2011.

# Primeline Energy Holdings Inc.

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Notes to Consolidated Financial Statements

March 31, 2011 and 2010

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(expressed in Canadian Dollars)

Assumptions used in the Black-Scholes option pricing model for revaluation of the options granted to non-employees for the years ended 2011 are as follows:

	2011
Risk-free interest rate	1.64 – 1.72%
Expected life	5 years
Expected volatility	90%
Expected dividends	Nil

In connection with the grant of stock options to directors, officers, consultants and employees, the company recognized a stock-based compensation expense of \$20,899 for the year ended March 31, 2011 (March 31, 2010 - \$4,088) and capitalized Nil to deferred exploration costs for the year ended March 31, 2011 (March 31, 2010 – \$1,300).

As at March 31, 2011 stock options outstanding and exercisable are as follows:

Exercise price	Number of outstanding options as at March 31, 2011	Weighted average remaining contractual life	Number of exercisable options as at March 31, 2011
1.5	4,300,000	0.01 year	4,300,000
1.6	525,000	0.7 years	525,000
2.0	850,000	1.6 years	850,000
0.5	350,000	0.2 years	300,000
	<b>6,025,000</b>	<b>0.35 years</b>	<b>5,975,000</b>

## 6 Commitments

- a) Under the original petroleum contract, the Company had a commitment to drill 2 wells prior to April 30, 2011 during exploration phase 1 and 2. On April 27, 2011, CNOOC agreed to grant a three-month period to the Company so that the expiration date of phase 2 is extended to July, 31, 2011. If the Company elects to enter into phase 3, the starting date of such phase will be May 1, 2011. The Company did not elect to enter into phase 3. On July 15, 2011, the Company has signed a Memorandum of Agreement with CNOOC to amend the existing petroleum contract for Block 25/34 and to enter into a new petroleum contract.

Under the new petroleum contract the Company and CNOOC will enter into, the Company will have a 7 year exploration period divided into 3 exploration periods of 3, 2 and 2 years with a minimum work commitment in the first phase of two wells plus 600 sq kms of 3D seismic. The commitment for each of the second and third phases is one well. Under current market conditions, the cost of drilling one well is estimated to be US\$ 30 million including any testing cost which is estimated to be US\$10 million of which the Company's 75% obligation would be a total of US\$ 22.5 million.

- b) The company entered into two lease agreements for the rental of PEHI's Shanghai offices in the

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People's Republic of China. The leases are for a period of two years from September 1, 2010 to August 31, 2012 with a monthly rental fee of approximately \$7,936 (RMB 53,510).

## 7 Related party transactions

During the year ended March 31, 2011, the Company paid or accrued the following:

- a) London office rent of \$60,470 (2010 - \$66,335) to a company under common control of which the shareholder of that company is also the shareholder of the Company's ultimate holding company, Primeline International Holdings Inc, ("PIHI"), a private British Virgin islands corporation, all of the issued and outstanding shares of which are beneficially owned by Mr. Victor Hwang, President and a director of the Company.
- b) Fees and expenses of \$18,472 (2010 - \$26,062) to a company controlled by Mr. Peter Kelty, a director for advisory services associated with investor relations, securities and exchange matters and other administrative services. This agreement terminated on December 31, 2010.
- c) Cash call of \$8,173,118 utilized for (2010 - \$2,383,991 received from) a company under common control of which the shareholder of that company is also the shareholder of the company's ultimate holding company PIHI. As at March 31, 2011, the remaining cash call payable is \$222,583.
- d) Advance of \$1,700,000 (2010 - \$nil) from a company which the shareholder of that company is also the shareholder of the company's ultimate holding company PIHI.
- e) A retainer fees of \$25,000 (2010: \$ Nil) were paid to the 4 non-executive directors for the period ended March 31, 2011.

These transactions, which occur in the normal course of operations, are measured at the exchange amount, which is the amount of the consideration established and agreed to by the related parties.

## 8 Income taxes

The Company is domiciled in an income tax-exempt jurisdiction and carries out its oil exploration activities in the PRC; these activities are subject to PRC income tax at a rate of 25%. In accordance with PRC tax regulation, exploration costs incurred by foreign oil and gas enterprises can be deferred and amortized from commencement of oil/gas production. All exploration activities incurred in PRC had been capitalized during the year (2010: NIL).

Significant components of the company's future income tax liabilities are as follows:

	2011 \$	2010 \$
Resource properties	425,551	425,551
Net future income tax liability	425,551	425,551

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For certain acquisitions predominately stock based compensation and other payments for mineral property interests, the company records a future income tax liability and a corresponding adjustment to the related asset carrying amount.

## 9 Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, and advances from a related party.

Fair values of assets and liabilities approximate amounts at which these items could be exchanged in transaction between knowledgeable parties. Fair value is based on available public market information or when such information is not available, estimated using present value techniques and assumptions concerning the amount and timing of future cash flows and discount rates which factor in the appropriate credit risk. The calculation of estimated fair value is based on market conditions at the specific point in time and in the respective geographic locations and may not be reflective of future values.

Cash and cash equivalent are classified as loans and receivables and recorded at amortized cost. Receivables and accounts payable and accrued liabilities and advances from a related party approximate their fair value as the effect of interest and credit risk is not significant taking into the account the counterparty's creditworthiness and short term maturity of the balance.

The Company's financial instruments are exposed to certain financial risks, including currency risk, credit risk, liquidity risk, interest rate risk and price risk.

### (a) Currency risk

The Company holds cash balances of HKD\$2,720,731, USD73,066 and RMB315,139 (2010 - US\$135,031 in term deposits which mature in 7 days and cash balances of US\$226,603 and RMB1,983,820).

Based on the above net exposures as at March 31, 2011, and assuming that all other variables remain constant, a 10% depreciation or appreciation of the Canadian dollar against the HK dollar, US dollar and Renminbi, would result in an increase/decrease of approximately \$33,982, \$7,102 and \$4,674 (2010- Nil, \$36,706 and \$29,599) respectively in the company's net loss.

### (b) Credit risk

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its contractual obligations.

The Company's cash and cash equivalents are held at a large international financial institution in interest bearing accounts. Minimal cash balances are held in Chinese financial institutions. The company has no investments in asset-backed commercial paper.

### (c) Liquidity risk

Liquidity risk is the risk that the company will not be able to meet its financial obligations as they fall due.

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The Company manages liquidity risk through its capital management as outlined in note 10 to the consolidated financial statements. Accounts payable relating to petroleum exploration costs and other accounts payable and accrued liabilities are due within the current operating period. Additional information regarding liquidity risk is disclosed in Note 1.

(d) Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The risk that the Company will realize a loss as a result of a decline in the fair value of the short-term investments included in cash and cash equivalents is minimal because these investments roll over very short periods (seven days to one month).

(e) Price risk

The Company closely monitors commodity prices to determine the appropriate course of action to be taken by the Company.

## 10 Capital management

The Company's objectives when managing capital are to safeguard the company's ability to continue as a going concern in order to pursue the exploration and development of its petroleum interest, acquire additional petroleum property interests and to maintain a flexible capital structure which optimizes the costs of capital at an acceptable risk. In the management of capital, the company includes its cash and cash equivalent balances and components of shareholders' equity.

The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. To maintain or adjust the capital structure, the company may attempt to issue new shares, issue debt, acquire or dispose of assets or adjust the amount of cash and cash equivalents and investments.

In order to facilitate the management of its capital requirements, the company prepares annual expenditure budgets that are updated as necessary depending on various factors, including successful capital deployment and general industry conditions. The annual and updated budgets are approved by the Board of Directors.

At this stage of the Company's development, in order to maximize ongoing development efforts, the company does not pay dividends.

The company's investment policy is to invest its cash in highly liquid short-term interest-bearing R1-High investment rated (DBRS) investments with maturities 90 days or less from the original date of acquisition.

The company currently is not subject to externally imposed capital requirements.

Additional information regarding capital management is disclosed in note 1.

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## 11 Segment reporting

The Company has one operating segment, which is the exploration of oil and gas properties. The Company's assets are located in Canada, China and United Kingdom.

The following is a summary of assets by geographic location as at March 31, 2011 and 2010:

<b>As at March 31, 2011</b>	<b>Canada</b>	<b>China</b>	<b>United Kingdom</b>	<b>Total</b>
<b>Total assets</b>	<b>99,002</b>	<b>65,200,998</b>	<b>45,596</b>	<b>65,345,596</b>

  

<b>As at March 31, 2010</b>	<b>Canada</b>	<b>China</b>	<b>United Kingdom</b>	<b>Total</b>
<b>Total assets</b>	<b>98,805</b>	<b>69,401,319</b>	<b>229,313</b>	<b>69,729,437</b>

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## 12 Subsequent events

- a) Extension of expiration of Petroleum contract Phase 2

On April 27, 2011, CNOOC agreed to grant a three-month period to the Company so that the expiration date of phase 2 is extended to July 31, 2011. If the Company eventually elects to enter into phase 3, the starting date of such phase will be May 1, 2011. The remaining one well minimum work commitment in phase 2 will be transferred to phase 3, which ends on April 30, 2013. Therefore, the Company will have to drill two wells in phase 3.

- b) Letter of intent with China Oilfield Services Limited for at turnkey drilling contract

On April 27, 2011, the Company has signed a letter of intent ("LOI") with China Oilfield Services Limited ("COSL") to enter into a turnkey drilling contract for one well, with an option for a second well, to continue its step out exploration drilling program.

Pursuant to the LOI; COSL has agreed, subject to contract, to enter into a turnkey drilling contract with Primeline under which COSL will drill one exploration well, LS 30-3-1, in Block 25/34 sometime in the fourth quarter of 2011. In addition, Primeline will have an option to drill a further well in the nearby area after completion of the proposed well at the same rates.

The turnkey price for drilling LS30-3-1 well, as defined by LOI, is US\$15.8m including site survey and mobilisation costs. The total budget for the well is up to about US\$25m for a success case, depending on the level of testing to be carried out. Before entering into the LOI, Primeline obtained confirmation from its major shareholder and Chairman, Victor Hwang, that he would underwrite the cost of the drilling contract in order to enable Primeline to secure the rig.

However, following the recent MOA (see "Petroleum Contract" below), it is now anticipated that drilling will be delayed until after the new petroleum contract is signed and a new drilling slot confirmed.

- c) Loan facility of US\$4,000,000

On May 17, 2011, the Company has signed an agreement with Victor Hwang, its President, Chairman and largest shareholder, under which Mr. Hwang has granted the Company a loan facility of up to US\$4,000,000 (the "Loan") which may be drawdown in multiple tranches at any time before 30th November 2011. The Loan, which will be used for working capital purposes, is interest free and is repayable on written demand at any time after 30th November 2011.

- d) Memorandum of Agreement ("MOA") with CNOOC to amend the existing petroleum contract for Block 25/34 ("Existing Contract") and to enter into a new petroleum contract

On July 15, 2011, the Company has signed a MOA with CNOOC to amend the Existing Contract and to enter into a new petroleum contract. The MOA amends the Existing Contract so that no further exploration activity will be carried out under that contract and the Company and PPC will relinquish all of the current area of 5,221 sq kms held under the Existing Contract, save for the development area for the LS36-1 gas field, comprising 84.7 sq kms. The Existing Contract will remain in effect in

# **Primeline Energy Holdings Inc.**

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relation to the continuing development and production operations for the LS36-1 gas field. In order to provide Primeline with continuing exploration rights in the area, the MOA also provides that a new petroleum contract ("New Contract") will be granted on the following basis:

**Area:** The exploration area under the New Contract will cover the same area as that currently held under the Existing Contract but with an additional adjacent area to the east making a new contract area of 5,877 sq kms. The new area has been designated as Block 33/07.

**Term:** The New Contract will have a 7 year exploration period divided into 3 exploration periods of 3, 2 and 2 years each with a minimum work commitment in the first phase of two wells plus 600 sq kms of 3D seismic. The commitment for each of the second and third phases is one well.

Future discoveries in the new contract area (and any CNOOC self financed discoveries nearby, if there is spare capacity and subject to payment of a proportion of operational costs) will enjoy the right to free use of the production facilities to be built for the LS36-1 gas field.

All other terms are the same as the Existing Contract and the New Contract will be held by the Company and PPC in the same proportions in which they held the Existing Contract of 75%/25%.

The Company and CNOOC will finalise and enter into the New Contract shortly, which will then be subject to the approval of the Ministry of Commerce in China.