

# Echo Energy Canada Inc.

## Management's Discussion and Analysis of Financial Statements For the year ended December 31, 2006

March 29, 2007

### Forward-Looking Statements

This MD&A contains forward-looking statements relating to future events. In some cases, forward-looking statements can be identified by such words as "anticipate", "continue", "estimate", "expect", "may", "will", "project", "should", "believe" or similar expressions. These statements represent management's best projections, but undue reliance should not be placed upon them as they are derived from numerous assumptions. These assumptions are subject to known and unknown risks and uncertainties, including the business risks discussed in the MD&A for the year ended December 31, 2006, which may cause actual performance and financial results to differ materially from any projections of future performance or results expressed or implied by such forward-looking statements. Accordingly, readers are cautioned that events or circumstances could cause results to differ materially from those predicted.

### Overall Performance

Echo Energy Canada Inc. (the "Company") is in the business of exploring for, developing and operating natural gas and hydro-carbon properties.

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, 1490564 Ontario Inc., Pecho Pipelines Inc. ("Pecho") and Echo Energy Inc. ("EEI"). Its investments in Echo Power Generation Inc. ("EPG") and Ontex Resources Limited ("Ontex") are accounted for under the equity method. The company and EEI were amalgamated on April 1, 2006 and continue as Echo Energy Canada Inc. All figures are in Canadian dollars.

The Company recorded a net loss of \$1,350,262 for the year ended December 31, 2006 compared to net earnings of \$436,085 for the same period in 2005. Operating earnings of \$25,375 for the year ended December 31, 2006 were offset by equity in losses of EPG totaling \$530,982 and a write-down in the investment in EPG of \$961,993. The company also recorded equity in losses of Ontex totaling \$36,452 and exchange loss on foreign currency of \$33,292. Cumulative exploration expenses as at December 31, 2006 were \$44,245,578 including expenditures of \$1,750,469 and an adjustment to the asset retirement obligation of \$58,300 for the year ended December 31, 2006 offset by \$581,348 of depletion for the year. Depletion rates for 2006 were increased significantly as a result of the independent engineer's re-evaluation of forecasted flow rates based on actual performance for the year. The Company also incurred expenditures of \$249,752 in the construction of a gas pipeline and distribution system through its subsidiary Pecho.

### Selected Annual Information

	December 31, 2006	December 31, 2005	December 31, 2004
	\$	\$	\$
Total revenues	2,486,313	4,079,318	504,184
Net income (loss)	(1,350,262)	436,085	(2,158,686)
Basic income (loss) per share	(0.026)	0.01	(0.13)
Diluted income (loss) per share	(0.026)	0.01	(0.13)
Total assets	52,176,548	53,750,698	49,768,621
Total long term financial liabilities	6,200,000	6,200,000	5,000,000

The above selected information and the summary of quarterly results presented below have been prepared by management, in Canadian currency, in accordance with Canadian generally accepted accounting principles and following the same accounting principles and methods of computation as the audited consolidated financial statements for the fiscal year ended December 31, 2005 unless otherwise disclosed. The disclosures provided below are incremental to those included with the annual audited consolidated financial statements. This discussion and analysis should be read in conjunction with the consolidated financial statements and the notes thereto for the year ended December 31, 2006.

### **Results of Operations**

The Company reflected gross sales of natural gas in the amount of \$2,639,381 for 2006 offset by royalties of \$161,401. The 39% sales decrease from \$4,318,912 in the same period of 2005 resulted from lower gas sales of 310,060 Mcf (2005 – 410,926 Mcf) as a result of shut-downs for 2006 well stimulation programs, lower than expected flow rates following stimulation and in response to reduced sales rates per Mcf compared to 2005. Production exceeded sales and, as a result, inventory at December 31, 2006 increased by 9,093 Mcf from the December 31, 2005 balance of 12,942 Mcf. Interest income increased 31% from \$6,372 for the year ended December 31, 2005 to \$8,333 for 2006 as a result of continued positive cash balances.

Expenses directly related to gas sales decreased 3% overall for the year ended December 31, 2006 compared to the same period in 2005. Expense components were \$235,374 for transportation [2005 – 254,561], \$405,501 for operations [2005 – 738,151] and \$621,211 [2005 – 304,673] for depletion. Depletion rates were adjusted as at December 31, 2006 for 2006 based on the engineer's re-evaluation of gas reserves. Interest costs, in the amount of \$388,231 [2005 – 320,262], related to financing of the gathering system were also expensed.

General and administrative expenses decreased 24% from \$370,828 for the year ended December 31, 2005 to \$281,756 for 2006 due primarily to reduced office expenses in 2006. Professional fees decreased by 41% from \$879,121 for the year ended December 31, 2005 to \$521,449 for 2006 due in part to legal fees incurred in 2005 for an injunction application and in part to capitalization of management service costs of \$312,839 incurred regarding exploration of oil and gas properties in 2006.

During the year ended December 31, 2006, the Company acquired 4,509,833 common shares of Ontex and recorded its share of losses of \$36,452 [2005 – nil]. The Company also recorded its share of losses in EPG of \$530,982 (2005 – \$375,483) and reflected a write-down in the investment of \$961,993. Ontex common shares are traded on the Toronto Stock Exchange. Ontex is currently focused on identifying an experienced and suitable joint-venture partner to develop the Brookbank gold deposit and become a gold producer. EPG is an Ontario corporation engaged in the business of exploring for wind power resources in Ontario. EPG has entered into license and easement option agreements with several land owners in Houghton and Bayham Townships.

## **Summary of Quarterly Results**

	For the three month period ended,							
	Dec 31, 2006	Sept 30, 2006	June 30, 2006	March 31, 2006	Dec 31, 2005	Sept 30, 2005	June 30, 2005	March 31, 2005
Revenues	648,949	745,028	544,882	700,522	1,247,895	1,093,607	1,078,696	898,714
Income from continuing operations	n/a	n/a	n/a	n/a	431,910	58,229	n/a	n/a
Net income (loss)	(1,190,567)	15,546	(101,813)	(73,428)	431,910	58,229	(24,904)	(29,150)
Net income per share - basic (loss)	(0.023)	(0.002)	(0.002)	(0.001)	0.008	0.001	(0.000)	(0.001)
Net income per share - fully diluted (loss)	(0.023)	(0.002)	(0.002)	(0.001)	0.008	0.001	(0.000)	(0.001)

In the first quarter of 2005, the decrease in the loss is primarily due to increased gas sales offset by the Company's share of increased losses of EPG relating to EPG's expenditures on a renewable energy bid.

In the second quarter of 2005, improved gas sales were offset by

- a) an adjustment to increase royalty expense from preliminary estimates to final rate calculations based on the first full year of production and
- b) legal fees incurred in pursuit of an unsuccessful injunction designed to control possible interference caused by the activities of another company on lands under lease by the Company.

During the third and fourth quarters of 2005, gas sales improvements and operating expense reductions resulted in improving net earnings for the Company.

In the first and second quarters of 2006, gas delivery and sales rate reductions resulted in net losses for the Company mitigated by reduced equity losses in EPG.

In the third quarter of 2006, the Company responded to a sales rate increase in August by selling gas accumulated in storage resulting in increased sales and net earnings.

In the fourth quarter of 2006, the net loss was impacted by recognition of a write-down in the investment in EPG of \$961,993 and by an adjustment to depletion rates for 2006 arising from a re-evaluation of flow rates from wells and resulting reserve estimates.

## **Liquidity**

### **[a] Shareholder Financing**

On October 28, 2004 the Company granted a total of 4,700,000 stock options to certain of its directors, officers and employees exercisable at a price of \$2.00 per share prior to October 28, 2007.

On December 1, 2006, 265,000 options, exercisable at a price of \$0.50, were granted to Agoracom Investor Relations Corp under an investor relations agreement with vesting of one-quarter of the options on each of February 28, 2007, May 31, 2007, August 31, 2007 and November 30, 2007. The fair value of the option compensation will be recognized on the vesting dates. A total of 155,000 shares remain available for issuance under the stock option plan.

In 2005, the Company received subscriptions for 1,577,600 flow-through common shares by private placement, which resulted in gross proceeds of \$1,972,000.

**[b] Bank Financing**

In January 2005, the Company secured a \$6,000,000 revolving production facility. \$5,000,000 of the facility was used to repay an interim loan which financed construction of the gas gathering pipeline and compressor system.

In October 2005, the facility credit limit was increased to \$6,500,000 and in August 2006 the revolving period was extended from July 31, 2006 to July 30, 2007 at which time the facility will be extended for a further 364 day period or converted to a one year term with quarterly principal payments of one twentieth of the advanced amount, if necessary, commencing October 31, 2007.

Interest is charged at a rate of prime plus 0.5% and paid monthly during the revolving period. The facility is secured by an \$8,000,000 debenture representing a first floating charge on all assets and undertakings of the Company and a fixed charge on gas properties.

**[c] Working Capital**

As at December 31, 2006, the Company had a working capital surplus of \$309,532 compared to a December 31, 2005 surplus of \$2,608,811. The Company reasonably expects to fund 2007 operations through cash flow from deliveries of gas.

**[d] Commitments**

The Company has contractual obligations under management consulting agreements, expiring between September 15, 2011 and September 15, 2013, to compensate its Chairman, President and Vice-President for management services provided by them in the aggregate amount of \$632,491 for 2006, escalating at the rate of ten percent per annum.

In September 2001, the Company's subsidiary, 1490564 Ontario Inc., entered into an agreement for the purchase of certain oil and gas leases for \$90,000 subject to regulatory approval. At December 31, 2006, no payments in respect of this agreement have been made.

The Company has also entered into a number of exclusive lease rights with land owners. These leases contemplate a minimum or maximum amount payable in the form of rent per acre of land under lease and royalties on revenues generated on gas, oil and minerals extracted from the land. While the leases grant rights to the Company over a specified term, the Company may at any time release all or part of its interest and thereby terminate its obligations. Payments totaling \$224,891 are expected to be paid under existing leases during 2007.

In addition, the Company entered into an agreement to lease compressor equipment with a remaining minimum lease commitment for 2007 of \$88,846.

**Capital Resources**

**[a] Oil and Gas Leases**

As at December 31, 2006, the Company's cumulative expenditures on oil and gas exploration were \$9,263,187 plus \$34,882,391 of value acquired on the business combination with EEI in 2004. The Company's oil and gas properties, located in Southwestern Ontario, include approximately 54,000 acres of leased lands located in Houghton and Middleton Townships in Norfolk County and Bayham and Malahide Townships in Elgin County. The Company has completed drilling of 72 gas wells and has purchased 2 existing wells. The Company expects to drill up to 38 infill development wells and up to 81 additional wells to completely test additional probable acreage. On March 20, 2007 the Company announced that it

had secured 3 new drilling licences to target the potentially lucrative Thorold Grimsby Zone. The Company reasonably expects to fund its capital program, including expenditures to maintain capacity, meet planned growth and fund development activities, through cash flow from deliveries of gas.

As at March 7, 2007, the Company's independent engineer reported reserves as follows:

Reserves Category	Gross Gas Reserves (BCF)	Net Gas Reserves (BCF)
Proved developed and undeveloped	16.14	15.00
Additional probable	25.05	23.78
Proved plus probable	41.19	38.79

A few of the wells show signs of dramatically increased flow rates many months after the start of production as the fracture treatment fluids are slowly removed from the wells. Many of the other wells have not yet seen this rate increase associated with well cleanup but must be given more time to determine if increased production rates can be realized after recovery of fracture fluids. In the meantime, the significant reduction to probable reserves reflects current production rates pending completion of the stimulation process and subsequent re-evaluation of production characteristics.

#### **[b] Gas Gathering System**

The gathering pipeline and compressor system consists of three sales points for gas produced from the Company's properties: sales through the Talisman Energy operated Lakeview Compressor, sales through the Union Gas system near the village of Mabees Corners, and sales through the Union Gas system just east of the city of Tillsonburg.

Gas deliveries through the Talisman Lakeview compressor station and the Tillsonburg station have been stored using the Union Gas storage system in southwestern Ontario. Gas is sold directly to Union Gas through the Mabees station. The storage purchased by the Company allows for storage of gas on an ongoing basis, with restrictions on maximum storage volumes and the rates at which gas can be put in or removed from the storage account. Gas deliveries during 2006 totaled 319,152 thousand cubic feet ("mcf") and 310,060 mcf were sold. Deliveries during the year ended December 31, 2005 totalled 394,594 mcf and 410,927 mcf was sold.

#### **[c] Investment in Echo Power Generation Inc. ("EPG")**

At December 31, 2006, the Company held a 37.78% interest in EPG. The Company's initial investment was \$150,000. During the period from its initial investment to December 31, 2004 the Company recorded its share of losses in EPG of \$150,000 resulting in a nil net investment in EPG as at August 26, 2004. The Company increased the amount of its investment in EPG on August 27, 2004 by \$1,830,608 to record its acquisition of Echo Energy Inc.'s 25% interest in EPG which had been acquired by that company for \$150,000. In April 2006, the Company participated in a rights offering by EPG, acquiring rights to an additional 3,000,000 shares for \$300,000. On May 1, 2006, EPG notified the Company that the offering was fully subscribed and that 34,409,295 common shares were issued and outstanding.

For the year ended December 31, 2006, the Company recorded its share of losses of EPG of \$530,982 [2005 – 375,483].

EPG has continued to record losses, has expended the funds raised in the April 2006 rights offering and must raise additional funding to support future operations. The timing of long-term plans remains uncertain. As a result, the Company has recorded a write-down of its investment in EPG of \$961,993 to record the investment at nil as at December 31, 2006.

**[d] Investment in Ontex Resources Limited (“Ontex”)**

On March 16, 2006, the Company acquired 4,509,833 common shares of Ontex Resources Limited (“Ontex”) at a price of \$0.18 per share pursuant to a debt to shares conversion agreement under which Ontex settled a \$811,770 debt owed to the Company. The debt comprised a number of cash advances made by the Company to Ontex. In October 2006, the Company participated in a rights offering to acquire a further 1,127,458 shares at a price of \$0.10 per share for \$112,746 to maintain its proportionate interest. In December 2006, the Company sold 1,647,058 shares at a price of \$0.17 per share for \$280,000 to an arms length purchaser resulting in a gain of \$9,882.

In January 2007, the Company sold an additional 620,000 shares at a price of \$0.17 per share for \$105,400.

**Transactions with Related Parties**

All related party transactions have been recorded at the exchange amount which represented the amount of consideration established and agreed to by the related parties.

During the year ended December 31, 2006, the Company paid certain of its directors and executive officers \$749,293 [2005 - \$557,400] in consulting fees. The Company also paid \$55,769 [2005 - \$89,507] in respect of rent and office services to a company influenced by the Chairman.

On March 16, 2006, the Company acquired 4,509,833 common shares of Ontex Resources Limited (“Ontex”) at a price of \$0.18 per share pursuant to a debt to shares conversion agreement under which Ontex settled a \$811,770 debt owed to the Company as discussed in Note 6. In October 2006, the Company acquired a further 1,127,458 shares at a price of \$0.10 per share and, in December 2006, sold 1,647,058 shares at a price of \$0.17 per share to an arms length purchaser. Ontex has two common directors with the Company and, as a result of the above transactions, owns 5.87% of the Company’s outstanding shares at December 31, 2006

**Critical Accounting Estimates**

The Company makes accounting estimates in its financial statements in order to provide timely information to users. A critical accounting estimate is one that requires management to make assumptions about matters that are highly uncertain at the time the estimate is made and, if a different estimate was used, financial results would be materially different.

The Company must estimate its natural gas reserves and that estimate is considered critical. Reserves are evaluated and reported on from time to time by an independent consulting engineer who uses various subjective factors and assumptions, including forecasts of costs based on geological and engineering data, projected future rates of production, and timing and amounts of future development costs. Although reserves are estimated, management believes the estimates are reasonable based on information available at the time the estimates were prepared. Management and the Reserve Committee of the Board of Directors review the estimates reported by the independent consulting engineer.

As new information becomes available, changes are made to reserve estimates and future development cost estimates. Historically, the Company has had no significant changes to these estimates, with the exception of adjusting reserves for the results of new drilling. Future actual results could vary greatly from the estimates made, resulting in material changes to the depletion calculation and the asset impairment test.

The estimated asset retirement obligation is also considered critical. The amount recorded for the asset retirement obligation is based on estimated timing and costs to abandon and restore properties. Actual requirements could vary greatly from the estimates made, resulting in material changes to the obligations.

## **Significant Accounting Policies**

### **[a] Oil and gas leases**

The Company follows the full cost method of accounting for natural gas leases, whereby all costs associated with the acquisition of, exploration for and development of gas reserves are capitalized. Costs capitalized include lease acquisition costs, geological and geophysical expenditures, drilling of productive and non-productive wells and related plan and production equipment costs. General and administrative expenses are not capitalized other than to the extent of the Company's interest in Company operated capital expenditure programs to which operation's fees have been charged in accordance with standard industry operating agreements. While in the development stage, revenues derived from the sale of gas were presented as a reduction of capitalized cost. Proceeds from the sale of gas properties would reduce capitalized costs with recognition of a gain or loss if such a sale would significantly alter the rate of depletion and depreciation.

During the operational stage, capitalized costs plus estimated future development costs of proven reserves are depleted and depreciated using the unit-of-production method based upon estimated proven developed and undeveloped gas reserves before royalties as determined by independent consulting engineers.

In applying the full cost method, the Company performs an impairment test, which restricts the net capitalized costs from exceeding an amount equal to the estimated undiscounted value of future net revenues from proven oil and gas reserves based on current prices and costs, after deducting estimated future general and administrative expenses, financing costs, income taxes and site restoration costs.

### **[b] Measurement Uncertainty**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. Significant areas requiring the use of management estimates relate to the amounts recorded for depletion and depreciation of the natural gas properties, the determination of impairment of oil and gas property costs, the accretion of asset retirement obligations, and the balances of asset retirement obligations which are based on estimates of reserves and future costs. By their nature, these estimates, and those related to future fund flows used to assess impairment, are subject to measurement uncertainty and the impact on the financial statements of future periods could be material.

## **Outstanding Share Data**

As at the date hereof, the Company had 52,779,515 common shares outstanding.

## **Risks and Uncertainties**

### **[a] Operations**

The Company's operations are subject to all of the risks normally incidental to the operation and development of natural gas properties and the drilling of natural gas wells, including encountering unexpected formations or pressures, blow-outs, premature decline of reservoirs, invasion of water into producing formations, craterings and fires and explosions, all of which could result in personal injuries, loss of life and damage to property of the Company and others. The Company conducts its activities in accordance with customary industry practice and, in accordance with such practice, will not be fully insured against all such risks, nor are all such risks insurable and, as a result, liability arising from these risks could have a material adverse effect upon its financial condition. Business interruption insurance may also be purchased for selected facilities, to the extent that such insurance is available. The Company may

become liable for damages arising from such events against which it cannot insure or against which it may elect not to insure because of high premium costs or other reasons.

The marketability of natural gas acquired or discovered will be affected by numerous factors beyond the control of the Company. These factors include reservoir characteristics, market fluctuations, the proximity and capacity of natural gas pipelines and processing equipment and government regulation. Natural gas operations (exploration, production, pricing, marketing and transportation) are subject to extensive controls and regulations imposed by various levels of government which may be amended from time to time. Natural gas operations are affected in varying degrees by government regulation such as restrictions on production, price controls, tax increases, expropriation of property, environmental and pollution controls or changes in conditions under which natural gas may be marketed. The Company's natural gas operations may also be subject to compliance with federal, provincial and local laws and regulations controlling the discharge of materials into the environment or otherwise relating to the protection of the environment.

The Company may experience growth through acquisitions. Its continued profitability and growth will depend in part upon its ability to successfully integrate its acquired assets with its existing business. There is no assurance that the Company will be able to successfully assimilate its acquisitions and its failure to do so could have a material adverse affect on its business, operating results and prospects.

Although satisfactory title reviews are conducted in accordance with industry standards, such reviews do not guarantee or certify that a defect in the chain of title may not arise to defeat the claim of the Company to certain properties. In addition, the success of the Company will be largely dependent upon the performance of its key officers and employees and consultants.

#### **[b] Natural Gas Prices**

The Company's results of operations and financial condition are dependent on the prices received for its natural gas production. Natural gas prices have fluctuated widely during recent years and are determined by supply and demand factors, including weather and general economic conditions as well as conditions in other natural gas producing regions, which are beyond the control of the Company. Any decline in natural gas prices could have a material adverse effect on the Company's operations, financial condition, natural gas reserves and the level of expenditures of the development of its natural gas reserves. The Company may manage the risk associated with changes in commodity prices and foreign exchanges rates from time to time, by entering into natural gas price hedges and forward foreign exchange contracts. To the extent that the Company engages in risk management activities related to commodity prices and foreign exchange rates, it will be subject to credit risks associated with counterparties with which it contracts. The Company has not engaged in such activities during the current or prior periods.

#### **[c] Delay in Cash Payments**

In addition to the usual delays in payment by purchasers of and natural gas to the operators of the properties, payments between any of such parties may also be delayed by restrictions imposed by lenders, delays in the sale or delivery of products, delays in the connection of wells to a gathering system, blowouts or other accidents, recovery by the operator of expenses incurred in the operation of the properties or the establishment by the operator of reserves for such expenses.

#### **[d] Reserve Estimates**

The reserve and recovery information contained in reserve estimations on the Company's properties, as evaluated by an independent engineer, are only estimates and no assurance can be given that the indicated levels of reserves will be produced. Probable Reserves estimated for properties may require revision based on the actual development strategies employed to prove such reserves.

#### **[e] Environmental Concerns**

The oil and natural gas industry is subject to environmental regulation pursuant to local, provincial and federal legislation. A breach of such legislation may result in the imposition of fines or issuance of clean up orders in respect of the Company or its properties. Such legislation may be changed to impose higher standards and potentially more costly obligations on the Company. There can be no assurance that the Company will be able to satisfy its actual future environmental and reclamation obligations.

**[f] Key Personnel Factors**

The Company is highly dependent on the services of members of senior management. The loss of the services of any of these individuals may adversely affect the Company's leadership and direction, which may impact its business, financial condition and results of operation.

**Disclosure Controls and Procedures**

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the Company is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure. The Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of December 31, 2006, that the Company's disclosure controls and procedures are effective to provide reasonable assurance that material information related to the Company is made known to them.

It should be noted that, while the Company's Chief Executive Officer and Chief Financial Officer believe that the Company's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that the Company's disclosure controls and procedures or internal control over financial reporting will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

**Internal Control over Financial Reporting**

The Chief Executive Officer and Chief Financial Officer are responsible for establishing and maintaining internal control over financial reporting for the Company and have designed such controls to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

It should be noted that, while the Company's Chief Executive Officer and Chief Financial Officer believe that the Company's internal controls over financial reporting provide a reasonable level of assurance that they are effective, they do not expect that the Company's internal control over financial reporting will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

**Additional Information**

Additional information relating to the Company is available on SEDAR at [www.sedar.com](http://www.sedar.com).