

# **High Arctic Energy Services Trust**

Consolidated Financial Statements  
**December 31, 2006 and 2005**  
(in millions of dollars)

March 21, 2007

## **Auditors' Report**

### **To the Trustees of High Arctic Energy Services Trust**

We have audited the consolidated balance sheets of **High Arctic Energy Services Trust** as at December 31, 2006 and 2005 and the consolidated statements of earnings and retained earnings (deficit), and cash flows for the years ended then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Trust as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years ended then ended in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

**Chartered Accountants**

Calgary, Canada

# High Arctic Energy Services Trust

## Consolidated Balance Sheets

As at December 31, 2006 and 2005

(in millions of dollars)

	2006 \$	2005 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	3.1	1.2
Accounts receivable	38.4	31.8
Inventory	2.3	1.2
Prepaid expenses	0.8	0.5
Due from related parties (note 9)	-	0.9
	<hr/> 44.6	<hr/> 35.6
<b>Investment</b> (note 3)	3.0	3.0
<b>Property and equipment</b> (note 4)	123.9	51.1
<b>Rigs and equipment under construction</b> (note 5)	<hr/> 61.9	<hr/> 27.1
	<hr/> <hr/> 233.4	<hr/> <hr/> 116.8
<b>Liabilities</b>		
<b>Current liabilities</b>		
Current portion of credit facility (note 6)	10.9	14.9
Accounts payable and accrued liabilities	35.1	18.2
Distributions payable (note 9)	3.3	1.9
Due to related parties (note 9)	<hr/> 0.4	<hr/> -
	49.7	35.0
<b>Credit facility</b> (note 6)	<hr/> 107.7	<hr/> -
	157.4	35.0
<b>Non-controlling interest</b> (note 7)	-	52.4
<b>Unitholders' Equity</b>		
Unitholders' capital (note 7)	89.2	35.2
Contributed surplus (note 8)	0.7	0.2
Retained earnings (deficit)	15.6	(1.5)
Accumulated distributions	<hr/> (29.5)	<hr/> (4.5)
	<hr/> 76.0	<hr/> 29.4
	<hr/> <hr/> 233.4	<hr/> <hr/> 116.8

### Commitments and contingencies (note 10)

See accompanying notes.

Approved on behalf of the Trust by its administrator, High Arctic Energy Corp.

(signed) "Jed Wood" \_\_\_\_\_ Director

(signed) "Michael Binnion" \_\_\_\_\_ Director

# High Arctic Energy Services Trust

Consolidated Statements of Earnings and Retained Earnings (Deficit)

For the years ended December 31, 2006 and 2005

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(in millions of dollars, except per unit amounts)

	2006 \$	2005 \$
<b>Revenue</b>	123.8	82.7
<b>Expenses</b>		
Oilfield services	72.3	45.8
General and administration	16.7	9.5
Amortization	16.1	10.3
Foreign exchange (gain) loss	(0.1)	0.1
	105.0	65.7
<b>Operating earnings</b>	18.8	17.0
Interest (note 5)	0.9	0.9
Pre-initial public offering management restructuring and bonus payments (note 14)	-	13.7
<b>Net earnings before income taxes</b>	17.9	2.4
<b>Income taxes</b>	0.8	0.7
<b>Net earnings before non-controlling interest</b>	17.1	1.7
<b>Non-controlling interest</b> (note 7)	-	1.1
<b>Net earnings</b>	17.1	0.6
<b>Deficit – Beginning of year</b>	(1.5)	(2.1)
<b>Retained earnings (deficit) – End of year</b>	15.6	(1.5)
<b>Earnings per unit – basic and diluted</b>	0.67	0.07

See accompanying notes.

# High Arctic Energy Services Trust

## Consolidated Statements of Cash Flows

For the years ended December 31, 2006 and 2005

(in millions of dollars)

	2006 \$	2005 \$
<b>Cash provided by (used in)</b>		
<b>Operating activities</b>		
Net earnings	17.1	0.6
Add non-cash items		
Amortization	16.1	10.3
Non-controlling interest	-	1.1
Unit-based compensation	0.5	0.2
	33.7	12.2
Change in non-cash working capital balances	5.4	(15.2)
	39.1	(3.0)
<b>Investing activities</b>		
Property and equipment, and rigs and equipment under construction	(123.7)	(52.2)
Investment	-	(3.0)
Acquisition (note 13)	-	(3.6)
Change in non-cash working capital balance	3.5	4.9
	(120.2)	(53.9)
<b>Financing activities</b>		
Advances from (to) related parties	1.3	(1.1)
Advances to a shareholder	-	(6.8)
Proceeds from credit facility	107.7	12.5
Repayment of credit facility	-	(32.5)
Issuance of units, net of costs	-	87.2
Unitholder distributions	(23.4)	(9.9)
Change in non-cash working capital balances	1.4	1.9
Change in current portion of credit facility	(4.0)	6.8
	83.0	58.1
<b>Net increase in cash and cash equivalents</b>	1.9	1.2
<b>Cash and cash equivalents – Beginning of year</b>	1.2	-
<b>Cash and cash equivalents – End of year</b>	3.1	1.2
<b>Supplemental information</b>		
Cash paid for:		
Interest	3.2	0.9
Taxes	0.8	0.7
<b>Non-cash items</b>		
Units issued for acquisition (note 13)	-	4.7
Units issued for DRIP Plan (note 7)	1.6	-

See accompanying notes.

# High Arctic Energy Services Trust

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

## 1 Basis of presentation and structure of the Trust

The Trust is an open-end unincorporated investment trust governed by the laws of the Province of Alberta and created pursuant to the Declaration of Trust dated June 10, 2005. The Trust was created to invest indirectly in the former business of High Arctic Energy Services Inc. ("HAES"), through an acquisition of a minority participating interest in High Arctic Energy Services Limited Partnership ("High Arctic"). High Arctic commenced operations on July 21, 2005 by acquiring all the business assets and interest of HAES and High Arctic Energy Corp. and is continuing with the same operations. Comparative figures represent the assets, liabilities, equity, and operations of these entities.

The Trust's principal focus is to engage in the global oilfield services business by providing underbalanced drilling and production services, equipment, design and development and technical support and training to the Canadian and international oil and gas industry.

The consolidated financial statements of the Trust give effect to the acquisition by the Trust of an indirect participating interest in High Arctic, which acquired the operating assets at the carrying value of HAES. The Trust has effective control of High Arctic and is considered a continuation of HAES and High Arctic Energy Corp. The indirect participating interest has been accounted for as a reverse takeover that does not constitute a business combination.

The Trust's business is considered to have some seasonality with peak levels in the first and fourth quarters.

These financial statements are stated in Canadian dollars and have been prepared in accordance with Canadian generally accepted accounting principles.

## 2 Summary of significant accounting policies

### Measurement uncertainty

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Such estimates include the amortization of property and equipment, recoverability of accounts receivable, valuation of unit-based compensation, accruals for contingencies and potential impairment of property and equipment. Actual results could differ from these estimates.

### Principles of consolidation

These financial statements represent the accounts of the Trust and its subsidiary partnership, High Arctic, and include the latter's wholly-owned subsidiaries - High Arctic Energy Services (Barbados) Inc. and High Arctic Energy Services LLC.

# High Arctic Energy Services Trust

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

### Consolidation of variable interest entities

The recommendations of Accounting Guideline AcG15 were adopted in the December 31, 2004 and May 31, 2004 audited consolidated financial statements, resulting in the consolidation of two companies (High Arctic Energy Corp. and Tri-Equity Group Insurance Ltd.). These companies were consolidated as if they were subsidiaries of High Arctic with a non-controlling interest being recorded. In the quarter ended September 30, 2005, all the assets of High Arctic Energy Corp. were acquired by High Arctic and the business of Tri-Equity Group Insurance Ltd. was incorporated into the Trust.

### Cash and cash equivalents

Cash and cash equivalents are comprised of cash and short-term market investments that are highly liquid in nature and have a maturity date of three months or less.

### Inventory

Inventory consists primarily of operating supplies and spare parts and is valued at the lower of average cost and replacement cost.

### Property and equipment

Property and equipment are recorded at cost less accumulated amortization. Equipment is amortized using the declining balance method over their estimated useful lives at the following rates:

Automotive	30%
Computer hardware	30%
Computer software	100%
Equipment – field	10 – 30%
Equipment – hydraulic workover rigs	10 – 30%
Equipment – snubbing, air drilling and nitrogen	10 – 30%
Equipment – office	20%
Leasehold improvements	Lease term or five years

Management assesses the carrying amount of property and equipment for impairment when events indicate that the carrying amounts is not recoverable and an impairment loss is recognized when the carrying amount is not recoverable and exceeds fair value. No impairment loss has been recorded to date.

The Trust has revised its estimate of useful life of property and equipment to more effectively allocate costs over the assets' useful lives. The adjusted amortization rates on a declining balance method range from 10% to 30%. This change has been adopted prospectively beginning July 1, 2006. The impact of this change in estimate resulted in lower depreciation expense of \$ 2.6 million for the year ended December 31, 2006.

# High Arctic Energy Services Trust

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

### **Rigs and equipment under construction**

Design and construction costs related to drilling and surface recovery equipment under construction, including all costs for preparing the asset for its intended use and interest capitalized during the construction period, are recorded as rigs and equipment under construction and are not subject to amortization until the asset is placed into service.

### **Investments**

Investments in other companies over which the Trust does not have significant influence are accounted for by the cost method. Investments are written down to their net realizable value should a decline in value occur that is other than temporary.

### **Income taxes**

The Trust is a taxable entity under the Canadian Income Tax Act and is taxable only on earnings that are not distributed to Unitholders. The tax deductions received by the Trust for distributions to Unitholders represent an exemption from taxation equivalent to the Trust's earnings. As a trust, it is also exempt from future income taxes as it is contractually committed to annually distribute sufficient amounts to eliminate income taxes (see also note 16).

The Trust's subsidiaries use the liability method of tax allocation in accounting for income taxes. Under this method, future tax assets and liabilities are determined for the income tax consequences attributable to differences between amounts recorded in the financial statements and their respective tax bases, using substantially enacted tax rates. The effect of any change in income tax rates on future tax assets and liabilities is recognized in earnings in the period that the change occurs.

On December 21, 2006 the Minister of Finance for Canada released for comment draft legislation concerning the taxation of certain publicly traded trusts and partnerships (such as the Trust). The legislation reflects proposals originally announced by the Minister on October 31, 2006. Under the proposed legislation, certain distributions will not be deductible to publicly traded income trusts and partnerships with the exception of real estate investment trusts and, as a result, these entities will in effect be taxed as corporations on the amount of the non-deductible distributions. For entities in existence on October 31, 2006, the proposed rules, if passed into law, would not apply until 2011.

### **Research and development**

Research and development expenditures are expensed as incurred unless recovery of costs associated with the development of new tools and systems can be reasonably assured given existing and anticipated future industry conditions, in which case the costs are deferred and amortized.

### **Employee benefit plans**

The Trust provides a defined contribution pension plan for employees. Contributions by the Trust are expensed when accrued. The Trust has no other post-retirement benefit plans.

# High Arctic Energy Services Trust

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

## Foreign currency translation

Transactions denominated in foreign currencies are translated at the rate of exchange in effect on the date of the transaction.

Monetary assets and liabilities of integrated foreign operations are translated using the rate of exchange in effect at the balance sheet date, whereas non-monetary assets and liabilities are translated at historical rates of exchange. Revenues and expenses are measured at average monthly exchange rates, except for amortization, which is determined using the historical exchange rate. Gains and losses resulting from translation are included in the statement of income (loss).

## Revenue recognition

The Trust's services are generally sold through contracts that include fixed or determinable prices based upon daily, hourly or job rates. Contract terms do not include provisions for significant post-service delivery obligations. Revenue is recognized when services are rendered or over equipment rental periods, and when collectability is reasonably assured.

## Unit-based compensation plans

The Trust has a Trust Unit Option Plan which is described in Note 8. The fair value of Unit purchase options is calculated at the date of the grant using the Black-Scholes option pricing model. The value is recorded as compensation expense over the grant's vesting period with an offsetting credit to contributed surplus. Upon exercise of the Unit purchase option, the associated amount is reclassified from contributed surplus to Unit capital. Consideration received from employees upon exercise of options is credited to Unitholders' capital.

## Per Unit amounts

Basic per Unit amounts are calculated using the weighted average number of Trust Units outstanding during the year. Diluted per Unit amounts are calculated as if all Exchangeable Shares are converted to Units and the non-controlling interest eliminated as well as the proceeds on the exercise of options being used to purchase Units at the average market price during the period.

## Comparative figures

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

# High Arctic Energy Services Trust

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

### 3 Investment

	2006	2005
	\$	\$
Investment – at cost	3.0	3.0

On October 14, 2005, the Trust exercised its option to acquire 10 per cent of the outstanding shares of Sense EDM AS (“Sense/EDM”), for total cash consideration of 16.5 million kroner, or approximately \$3.0 million Canadian. The entity is based in Norway and is a designer and manufacturer of drilling and well-service equipment. The Trust currently uses Sense/EDM equipment in its operations, has an exclusive license for use of their patented drilling technology and acquired one rig from Sense/EDM in 2005 and four rigs in 2006. Additionally, the Trust has two rigs under construction at December 31, 2006 and had previously agreed to purchase further rigs from Sense/EDM for future delivery (see note 10).

### 4 Property and equipment

	2006		
	Cost	Accumulated amortization	Net
	\$	\$	\$
Automotive	0.7	0.6	0.1
Computer hardware	0.7	0.2	0.5
Computer software	0.4	0.3	0.1
Equipment – field	29.6	7.0	22.6
Equipment – drilling rigs	16.2	0.6	15.6
Equipment – hydraulic workover rigs	60.7	11.5	49.2
Equipment – snubbing, air drilling and nitrogen	52.1	19.4	32.7
Equipment – office	0.5	0.1	0.4
Leasehold improvements	3.2	0.5	2.7
	164.1	40.2	123.9

# High Arctic Energy Services Trust

Notes to Consolidated Financial Statements

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(tabular amounts in millions of dollars, except per unit amounts)

	<b>2005</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net</b>
	\$	amortization	\$
		\$	
Automotive	6.5	4.6	1.9
Computer hardware	0.3	0.1	0.2
Computer software	0.2	0.2	-
Equipment – field	19.6	4.7	14.9
Equipment – hydraulic workover rigs	20.7	5.4	15.3
Equipment – snubbing, air drilling and nitrogen	28.1	9.7	18.4
Equipment – office	0.2	-	0.2
Leasehold improvements	0.3	0.1	0.2
	<b>75.9</b>	<b>24.8</b>	<b>51.1</b>

## 5 Rigs and equipment under construction

	<b>2006</b>	<b>2005</b>
	\$	\$
<b>Equipment – hydraulic workover and drillings rigs</b>		
Opening balance	16.5	-
Construction costs and capitalized interest added in the year	44.0	24.7
Units completed and transferred to property and equipment	(36.6)	(8.2)
	<b>23.9</b>	<b>16.5</b>
<b>Equipment – snubbing, air drilling and nitrogen</b>		
Opening balance	10.6	-
Construction costs and capitalized interest added in the year	40.0	11.5
Units completed and transferred to property and equipment	(12.6)	(0.9)
	<b>38.0</b>	<b>10.6</b>
	<b>61.9</b>	<b>27.1</b>

The Trust has capitalized interest on the equipment loan relating to rigs and equipment under construction. This policy was adopted beginning April 1, 2006 and not on a retroactive basis, as the interest on the equipment loan was not material in prior periods. A total of \$2.3 million was capitalized to rigs and equipment under construction during the period ended December 31, 2006.

# High Arctic Energy Services Trust

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

### 6 Credit facility

The Trust has a credit facility with a syndicate of commercial lenders. This credit facility is composed of a \$20-million operating line and a \$100-million equipment based revolving loan. Amounts drawn bear interest at prime plus 0.5% to prime plus 1% depending on the level to which the facility is drawn. At December 31, 2006 and at the date of these financial statements the rate in effect was prime plus 1%. The operating line may be drawn to a maximum of the lesser of \$20 million and 75% of Canadian accounts receivable aged less than 90 days. The equipment loan may be drawn to a maximum of the lesser of \$100 million and 75% of the appraised orderly liquidation value of eligible equipment. The obligations under the credit facility are secured by debentures under which the Trust and its Canadian subsidiaries grant security over all of their respective assets.

At December 31, 2006, a total of \$118.6 million of the facility had been drawn (December 31, 2005 - \$14.9 million).

The credit facility has a one year revolving term, which may be extended for an additional 364 days at the discretion of the lenders on application by the Trust. If the revolving period is not extended then the outstanding principal will become repayable in scheduled repayments over the subsequent three years as follows: 2007 - \$10.9 million; 2008 - \$43.1 million; 2009 - \$43.1 million and 2010 - \$21.5 million.

At December 31, 2006, the Trust had a consolidated leverage ratio (generally defined in its credit facility agreement as total debt divided by the 12-month trailing adjusted earnings before interest, depreciation, amortization and taxes) of approximately 3.4 to 1.0. This exceeds the consolidated leverage ratio covenant required by the terms of the credit facility of 3.0 to 1.0. On March 9, 2007 the Trust and its lenders executed an amendment agreement effective December 31, 2006, that amends the maximum permitted consolidated leverage ratio at December 31, 2006 and March 31, 2007 to 3.6 to 1.0 and for each quarter ended thereafter to 2.75 to 1.00.

### 7 Unitholders' capital

#### Authorized

##### Trust Units

The Declaration of Trust provides that an unlimited number of Trust Units may be issued. Each Trust Unit represents an equal, undivided beneficial interest in any distribution from the Trust in the event of termination or wind-up. All Trust Units are of the same class with equal rights and privileges.

##### LP Units

High Arctic will be authorized to issue, in addition to the 0.001% managing general partner's interest held by the General Partner, an unlimited number of LP Class A Units and an unlimited number of LP Class B Units and, subject to certain restrictions, such other classes of partnership interests as the General Partner may decide from time to time. All of the LP Class A Units will be held by a Holding Trust and all of the LP Class B Units will be held by HAES. Each LP Unit will rank equally with each other unit of the same class or series and no partner is entitled to any privilege, priority or preference in relation to any other partner holding units of the same class or series.

# High Arctic Energy Services Trust

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

(tabular amounts in millions of dollars, except per unit amounts)

Initially, (i) the number of issued LP Class A Units equalled the number of issued Trust Units and (ii) the number of issued LP Class B Units equalled the number of issued Series A Exchangeable Shares. The terms and conditions of the Partnership Agreement adjust the numbers of LP Class A Units and LP Class B Units from time to time to maintain such equalities until such time as all of the LP Units are owned directly or indirectly by the Trust.

### Exchangeable Shares

Two series of Exchangeable Shares have been issued by a subsidiary of the Trust. The holders of Exchangeable Shares of each series have the right to receive Trust Units at any time after a specified hold period in exchange for their Exchangeable Shares, on the basis of the exchange ratio in effect at the time of the exchange. The Shares have voting attributes (through the benefit of the Special Voting Right granted to the trustee pursuant to the Voting and Exchange Trust Agreement) equivalent to those of the Trust Units into which they are exchangeable from time to time.

	2006		2005	
	Units	Amount \$	Units	Amount \$
<b>Trust and LP Class A Units</b>				
Opening balance	9,769,706	35.2	-	-
Issuance on the Initial Public Offering (“IPO”)	-	-	8,000,000	80.0
Issuance on over allotment IPO	-	-	400,000	4.0
Issuance on private placement	-	-	996,572	10.0
Issuance on the purchase of Alberta Mobile Air Ltd.	-	-	373,134	4.7
Units issued during the year for DRIP Plan and options	164,699	1.6	-	-
Unit issuance costs	-	-	-	(6.8)
Non-controlling interest at initial public offering	-	-	-	(56.7)
Options exercised	2,000	-	-	-
<b>Total Trust and LP Class A Units issued</b>	<b>9,936,405</b>	<b>36.8</b>	<b>9,769,706</b>	<b>35.2</b>
<b>Exchangeable shares (non-controlling interest as at December 31, 2005)</b>				
Opening balance	15,745,453	52.4	-	-
Issuance on the IPO – Series A Exchangeable shares	-	-	11,460,571	41.6
Issuance on the IPO – Series B Exchangeable shares	-	-	4,152,381	15.1
Change in conversion ratio – Series B Exchangeable shares <sup>(1)</sup>	445,355	-	132,501	-
Non-controlling interest in net earnings	-	-	-	1.1
Distributions	-	-	-	(5.4)
	<b>16,190,808</b>	<b>52.4</b>	<b>15,745,453</b>	<b>52.4</b>
	<b>26,127,213</b>	<b>89.2</b>	<b>25,515,159</b>	<b>87.6</b>

<sup>(1)</sup>The Series B Exchangeable shares do not receive cash distributions. The exchange ratio of these shares is adjusted each month, on the distribution date, by an amount equal to the cash distributions converted to Trust Units based on the previous five trading days’ weighted average unit price.

# High Arctic Energy Services Trust

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

During the year, the Trust introduced a Distribution Reinvestment Program (“DRIP Plan”). The DRIP Plan allowed eligible unitholders of the Trust to direct that their cash distributions to be reinvested in additional Trust units on the applicable distribution payment date. During the year \$1.6 million of new equity was raised under this plan. The DRIP Plan was suspended on December 21, 2006 for distributions declared on or after that date.

At the Annual General Meeting of the Trust and the Partnership, the unitholders voted for the removal of the subordination clause attached to the LP Class B units. As a result, the attributes of the Exchangeable Shares and the presentation of these shares have changed. The Exchangeable Shares, totalling \$52.4 million, have been transferred from non-controlling interest to equity at carrying values, resulting in the elimination of the non-controlling interest.

### Cash Distributions

On each distribution record date, the Trust distributes, to limited partners of record holding LP Class A Units and LP Class B Units, their portions of distributable cash as set out in the partnership agreement (see also note 16).

### Per Unit Amounts

The weighted average number of units outstanding for the year ended December 31, 2006 was 25,684,439 basic fully and diluted units (year ended December 31, 2005 – 25,324,061 basic and fully diluted units).

## 8 Unit-based compensation plans

The Trust has a Trust Unit Option Plan that provides incentive for directors, management and key employees that provides options to purchase Units. A total of 2,589,000 Units (10% of all outstanding units) are available for grants under the plan.

At December 31, 2006, a total of 1,619,000 Unit options are exercisable up to 2011, at amounts that range from \$5.83 to \$13.87 per Unit. These options have all been issued since July 21, 2005, have a term of 5 years and allow the holder to exercise their options over a three-year vesting period with 40% exercisable on the first anniversary date, 30% on the second anniversary date and 30% on the third anniversary date. The exercisable options have an average remaining contractual life of 4.17 years and 854,250 may be exercised in 2007.

# High Arctic Energy Services Trust

## Notes to Consolidated Financial Statements

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(tabular amounts in millions of dollars, except per unit amounts)

	Units	Amount \$
Granted	991,000	10.36
Forfeited	(50,500)	10.42
<b>Total at December 31, 2005</b>	<b>940,500</b>	<b>10.35</b>
Granted	1,063,500	10.66
Exercised	(2,000)	10.00
Forfeited	(383,000)	11.33
<b>Total at December 31, 2006</b>	<b>1,619,000</b>	<b>12.62</b>

The Trust recognized unit-based compensation expense and contributed surplus of \$0.5 million for the year ended December 31, 2006 (2005 – \$0.2 million) using the following assumptions in the Black-Scholes model: average risk-free interest rate of 4.2%; average expected life of 5 years; expected volatility of 40% and a weighted average estimate of distribution yield of 10.99%.

### 9 Related party transactions

In the normal course of business, during the year ended December 31, 2006, the Trust paid premises rent of \$1.1 million (\$0.7 million during the year ended December 31, 2005) and equipment and vehicle leases payments of \$0.9 million (\$0.5 million during the year ended December 31, 2005), to companies controlled by the CEO. The Trust had amounts payable in connection with the transactions at December 31, 2006 of \$0.3 million (December 31, 2005 – \$0.3 million).

These transactions are measured at exchange values based on rates charged to arms length customers which, in the opinion of management, approximate fair value.

Included in revenues and accounts receivable for the year ended December 31, 2006 are \$nil and \$nil million respectively (2005 – \$13.6 million and \$9.0 million) in relation to a contract that commenced in August 2005 and ended in July 2006 with a company in which the CEO has an ownership interest.

Included in distributions payable is an amount of \$2.2 million due to companies controlled by the CEO that elected to defer receipt of monthly distributions to which they were entitled for November and December 2006.

Amounts due to or from the related parties are non-interest bearing, unsecured and repayable on demand.

# High Arctic Energy Services Trust

## Notes to Consolidated Financial Statements

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(tabular amounts in millions of dollars, except per unit amounts)

### 10 Commitments and contingencies

#### Rigs Under Construction

In July 2005, the Trust entered into a contract with Sense/EDM AS (“Sense/EDM”), a Norwegian rig manufacturer, to purchase sixteen drilling rigs with an option to cancel the order for all but five of the rigs, subject to certain conditions. During 2006, the Trust determined that it only wished to take delivery of and complete ten of the contracted-for rigs for an estimated cost of approximately \$65.0 million, with deliveries forecast to take place in 2006 and 2007. As a result, the Trust cancelled the order for the remaining six rigs.

In 2006, the Trust took delivery of and completed four rigs for a total cost of \$29.2 million. At December 31, 2006, rigs and equipment under construction includes \$16.9 million for the remaining rigs, with an additional estimated cost of approximately \$6.0 million to complete two of the rigs in 2007. In accordance with performance provisions in the contract and in light of late deliveries and other performance issues of Sense/EDM, the Trust commenced negotiations to suspend the order for the final four of six rigs under construction.

On March 6, 2007, Sense/EDM asserted that the Trust was still required to take delivery of the final four rigs and that they are owed approximately \$20 million, including interest, for costs pertaining to the acquisition and completion of these rigs and for the rigs delivered to date or under construction.

At December 31, 2006, the Trust had recorded net amounts payable to Sense/EDM of approximately \$3 million. After a review of the Sense/EDM assertions, the Trust recorded an additional provision as of that date of \$5 million. The Trust believes that the total of \$8 million now provided for in these financial statements represents the maximum amount it is exposed for under this contract as at December 31, 2006.

The Trust has continued negotiations with Sense/EDM regarding the rig delivery schedule and the assertions referred to above. On March 21, 2007 Sense/EDM notified the Trust that it will consider alternatives for resolution that would include a potential sale of the investment in Sense/EDM shares held by the Trust to parties affiliated with Sense/EDM at an amount that exceeds their net book value, a renegotiation of the delivery schedule for the four suspended rigs and a joint audit of all disputed costs, including interest.

#### Income Taxes

The Trust has been informed by a customer in Turkmenistan that there is a possible exposure to the Trust of US\$1.9 million for taxes in that jurisdiction. Management believes that it has calculated and remitted all taxes properly due in Turkmenistan and the remaining tax exposure is without merit. Therefore, no amount has been accrued in these financial statements for this potential exposure.

# High Arctic Energy Services Trust

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

### Lease Obligations

The Trust has entered into long-term premises leases with a related party, described in note 9, that expire in 2009. The leases contain an option to renew for a further five years. Future minimum lease payments as at December 31, 2006 are:

	\$
2007	1.3
2008	1.2
2009	0.8
	<hr/>
	3.3
	<hr/>

## 11 Financial instruments

### Fair value

The carrying value of accounts receivable, accounts payable and accrued liabilities, distributions payable and amounts drawn under the credit facility approximate their fair value due to the relatively short period to maturity of the instruments or the interest rates attached to the instruments. The fair value of due to related parties is not practical to determine since there are no specified repayment terms.

### Credit risk

The Trust is exposed to credit risk on the accounts receivable from its customers. To reduce its credit risk, the Trust has adopted credit policies which include the analysis of the financial position of its customers and the regular review of their credit limits. An allowance for doubtful accounts has been established based upon factors surrounding the credit risk of specific customers, historical trends and other information.

During the year ended December 31, 2006, 39% of the Trust's sales (December 31, 2005 – 42%) were to two customers. At December 31, 2006, 56% of the Trust's accounts receivable (December 31, 2005 – 53%) were from these customers.

### Interest rate risk

The Trust is exposed to interest rate price risk in respect of any long-term debt which bears a fixed rate of interest.

### Foreign exchange risk

Foreign exchange risk is the risk that variations in exchange rates between the Canadian dollar and foreign currencies will affect the Trust's operating and financial results. The Trust earns a portion of revenue and pays a portion of expenses in foreign currencies and does not use derivative instruments to reduce its exposure to foreign exchange risk.

# High Arctic Energy Services Trust

## Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

### 12 Segmented information

The Trust operates one business of providing oilfield services to customers. This business has the following geographic characteristics:

	2006 \$	2005 \$
<b>Revenue</b>		
Canada	104.8	64.2
International		
Turkmenistan	5.8	6.0
Ukraine	3.4	0.7
United Arab Emirates	2.8	5.9
Oman	2.2	-
Papua New Guinea	1.8	0.5
Other	3.0	5.4
	<hr/>	<hr/>
Total International	19.0	18.5
	<hr/>	<hr/>
	123.8	82.7
	<hr/>	<hr/>
<b>Property and equipment and rigs and equipment under construction</b>		
Canada	148.0	66.0
United Arab Emirates	32.8	12.2
	<hr/>	<hr/>
	180.8	78.2
	<hr/>	<hr/>

### 13 Acquisitions

On September 1, 2005 the Trust, through High Arctic, acquired the property and equipment of Alberta Mobile Air Services (1998) Inc. ("AMA"). The aggregate purchase price was \$8.3 million, composed of \$3.6 million in cash and \$4.7 million in Trust Units. The amount by which the purchase price exceeded the net book value of the assets acquired was allocated to property and equipment representing their estimated fair market value. AMA provides portable compression services to the drilling and pipeline industries, including underbalanced drilling with air-generated nitrogen from skid-mounted units and the purging and air drying of pipelines.

On February 1, 2006, the Trust purchased the assets of Kamber Well Service Ltd. for \$4.7 million. The purchase included two rigs and related support equipment, and has been accounted for as an addition to property and equipment. The Trust utilized cash and its credit facility to acquire the assets.

# High Arctic Energy Services Trust

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

## 14 Pre-initial public offering management restructuring and bonus payments

### Options

In 2002, HAES granted an option to a Canadian employee to purchase 10% of the issued shares of the company for \$1.00 per common share. The option was subject to certain conditions specified in the agreement, including repayment of company debt on or before July 1, 2007. Upon closing of the initial public offering, these options were cancelled and in return the employee received 830,476 Series A Exchangeable Shares from those held by the Chief Executive Officer of HAES.

In 2004, HAES granted further options to two Dubai employees whereby each employee had an option to purchase 10% of the issued shares of the company for \$1.00 per common share. The options were subject to certain conditions specified in the respective agreements, including repayment of company debt and that the employee must be an employee of HAES as at September 14, 2007. Pursuant to an agreement with these employees, immediately prior to the issuance of Units by the Trust an amount of approximately \$10.0 million was paid to the Dubai employees for the cancellation of their respective stock options. This amount was expensed in these financial statements as a pre-initial public offering management restructuring payment. The employees reinvested the \$10.0 million through a private placement for 996,572 trust units, concurrent with the closing of the initial public offering.

### Retirement compensation arrangement and bonuses

During the year ended May 31, 2004, a retirement compensation arrangement (“RCA”) was established. The RCA allowed funds to be contributed at a level determined by management to fund the retirement of the Chief Executive Officer. Additionally, prior to the creation of the Trust, amounts were paid to the Chief Executive Officer to optimize the tax expense of HAES.

For the year ended December 31, 2006 \$nil (December 31, 2005 \$3.7 million) was expensed for the RCA and bonuses.

# High Arctic Energy Services Trust

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

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(tabular amounts in millions of dollars, except per unit amounts)

## 15 Supplementary information

The net change in the following non-cash working capital items increases (decreases) cash flow as follows:

	2006 \$	2005 \$
<b>Operations</b>		
Accounts receivable	(6.6)	(18.1)
Inventory and prepaid expenses	(1.4)	(0.7)
Accounts payable and accrued liabilities	13.4	5.5
Bonuses and RCA payable	-	(1.9)
	<hr/>	<hr/>
	5.4	(15.2)
	<hr/>	<hr/>
<b>Investing</b>		
Accounts payable and accrued liabilities	3.5	4.9
	<hr/>	<hr/>
<b>Financing</b>		
Distributions	1.4	1.9
	<hr/>	<hr/>

## 16 Subsequent events

On February 26, 2007, the Trust announced that its Board of Directors had formed a special committee, comprised solely of independent directors, to consider the benefits of a reorganization of the Trust. It is expected that the proposed reorganization will include a conversion to a corporation; a restructuring of the Trust's long-term debt; and an issuance of equity from treasury. The Trust also announced that it was suspending distributions.

In March 2007, the Trust entered into an amendment agreement with its lender as discussed in note 6 and commenced negotiations of a new \$10 million short-term debt facility with an existing lender. The new facility is anticipated to be due May 30, 2007 and bear interest payable monthly at an annualized rate of prime plus 4.75% on any amounts drawn. This rate will increase to prime plus 6.75% on April 1, 2007 and prime plus 8.75% on May 1, 2007. In addition, the Trust will issue the lender warrants to acquire 1% of the fully-diluted Trust units, exercisable for three years, at a price based on the 10 day weighted average trading price prior to closing of the facility.

In March 2007, the Trust and a key equipment supplier continued negotiations to resolve disputed matters pertaining to an agreement to supply rigs (see note 10).