

## HIGHLIGHTS: BY THE NUMBERS

	Three Months Ended June 30,			Six Months Ended June 30,		
	2012	2011	Change	2012	2011	Change
<i>(000s, except per share amounts)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(%)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(%)</i>
<b>Financial</b>						
Oil and natural gas revenues	<b>18,437</b>	9,465	95	<b>32,714</b>	11,434	186
Funds from operations <sup>(1)</sup>	<b>9,852</b>	4,777	106	<b>15,593</b>	3,944	295
Per share – basic	<b>0.15</b>	0.08	88	<b>0.24</b>	0.08	200
Per share – diluted	<b>0.14</b>	0.08	75	<b>0.22</b>	0.08	175
Cash flow from (used in)						
operating activities	<b>14,696</b>	2,299	539	<b>18,760</b>	(2,564)	832
Net income (loss)	<b>5,603</b>	(899)	723	<b>2,404</b>	(2,890)	183
Per share – basic	<b>0.08</b>	(0.01)	900	<b>0.04</b>	(0.06)	167
Per share – diluted	<b>0.08</b>	(0.01)	900	<b>0.03</b>	(0.06)	150
Capital expenditures <sup>(2)</sup>	<b>29,699</b>	12,490	138	<b>66,414</b>	142,019	(53)
Working capital (deficit) <sup>(3)</sup>	<b>(50,803)</b>	17,871	(384)	<b>(50,803)</b>	17,871	(384)
Shareholders' equity	<b>185,207</b>	174,850	6	<b>185,207</b>	174,850	6
<i>(000s)</i>	<i>(#)</i>	<i>(#)</i>	<i>(%)</i>	<i>(#)</i>	<i>(#)</i>	<i>(%)</i>
<b>Share Data</b>						
At period-end	<b>66,986</b>	62,572	7	<b>66,986</b>	62,572	7
Weighted average – basic	<b>66,986</b>	62,572	7	<b>65,153</b>	49,596	31
Weighted average – diluted	<b>70,161</b>	62,572	12	<b>69,484</b>	49,596	40
			<i>(%)</i>			<i>(%)</i>
<b>Operating<sup>(4)</sup></b>						
<b>Production</b>						
Natural gas (mcf/d)	<b>8,687</b>	8,214	6	<b>8,672</b>	5,991	45
Crude oil (bbls/d)	<b>2,091</b>	609	243	<b>1,704</b>	341	400
NGLs (bbls/d)	<b>266</b>	189	41	<b>274</b>	104	163
Total (boe/d)	<b>3,805</b>	2,167	76	<b>3,423</b>	1,444	137
<b>Average wellhead prices</b>						
Natural gas (\$/mcf)	<b>2.06</b>	3.85	(46)	<b>2.11</b>	3.82	(45)
Crude oil and NGLs (\$/bbl)	<b>78.67</b>	90.74	(13)	<b>81.42</b>	90.37	(10)
Total (\$/boe)	<b>53.25</b>	47.99	11	<b>52.51</b>	43.74	20
<b>Netbacks</b>						
Operating netback (\$/boe)	<b>30.86</b>	28.04	10	<b>28.08</b>	24.82	13
Funds flow netback (\$/boe)	<b>28.36</b>	24.18	17	<b>24.94</b>	15.06	66
<b>Gross (net) wells drilled</b>						
Oil (#)	<b>7 (6.8)</b>	2 (2.0)	250 (240)	<b>15 (13.9)</b>	4 (4.0)	275 (248)
Standing (#)	–	–	–	<b>2 (2.0)</b>	–	–
Total (#)	<b>7 (6.8)</b>	2 (2.0)	250 (240)	<b>17 (15.9)</b>	4 (4.0)	325 (298)
Average working interest (%)	<b>97</b>	100	(3)	<b>94</b>	100	(6)

(1) Funds from operations and funds from operations per share are not recognized measures under International Financial Reporting Standards ("IFRS"). Refer to the commentary in the Management's Discussion and Analysis under the heading "Non-IFRS Measurements" for further discussion.

(2) Total capital expenditures, including acquisitions and excluding non-cash transactions. Refer to commentary in the Management's Discussion and Analysis under the heading "Capital Expenditures and Acquisitions" for further information.

(3) Current assets less current liabilities, excluding current derivative financial instruments.

(4) For a description of the boe conversion ratio, refer to the commentary in the Management's Discussion and Analysis under the heading "Other Measurements".

## LETTER TO SHAREHOLDERS

DeeThree continued to deliver impressive financial and operating results during the three months ended June 30, 2012. Highlighting the strength of our oil targets in the Lethbridge Alberta Bakken and Brazeau Belly River properties, DeeThree increased its operating netback per barrel to \$30.86 in the second quarter of 2012, being a 25 percent increase as compared to the first quarter of 2012.

### Company Highlights:

We are pleased to provide the following highlights of our financial and operating results for the three and six months ended June 30, 2012.

- Current field production is approximately 5,000 boe/d. Current production consists of approximately 70 percent oil and NGLs and 30 percent natural gas.
- The Company achieved record production for the second quarter averaging 3,805 boe/d (62 percent oil and NGLs and 38 percent natural gas), an increase of 76 percent over the same quarter of 2011 and a 25 percent increase over the first quarter of 2012.
- Increased oil and NGL production by 47 percent over the previous quarter to 2,357 bbls/d compared to 1,599 bbls/d.
- Funds flow from operations grew to \$9.9 million, representing a 106 percent increase from the second quarter of 2011 and a 72 percent improvement from the first quarter of 2012.
- Funds from operations on a per share basis increased to \$0.15, up 88 percent from the same quarter last year and 67 percent from the first quarter of this year.
- Invested \$30.0 million in capital expenditures which included the drilling of 7 (6.8 net) wells, achieving 100 percent success rate.
- Exited the quarter with total net debt of \$50.8 million. This represents a debt to annualized cash flow ratio of 1.3:1.
- A 100 percent drilling success rate to date in 2012.
- Increased 2012 exit production rate guidance by 1,000 boe/d to 6,000 boe/d due to strong results from the Company's drilling program to date.

### Operational Update

Continued success in the Company's Alberta Bakken and Belly River oil resource plays has driven significant production increases early in the third quarter with DeeThree recently achieving a production rate of 5,000 boe/d, being equal to DeeThree's previously forecast 2012 exit rate. DeeThree is currently operating two drilling rigs on its Alberta Bakken property.

### Lethbridge Bakken

DeeThree continued to develop its Alberta Bakken area throughout the second quarter drilling 4 gross (4.0 net) wells. The Company's two most recently drilled wells tested at 808 boe/d over a nine day test, and 630 boe/d over an eight day test respectively. See table below.

The sixth location drilled this year was a 6.8 mile step out and is of unique significance as it is the first well drilled by DeeThree on the Crown lands that comprise part of its Bakken properties. This well is subject to the five percent Crown royalty rate holiday with this lower rate being anticipated to drive substantial netback and cash flow benefits for DeeThree. Based on the success of this well, DeeThree acquired an additional 22 sections of offsetting Crown land in the second quarter and DeeThree now has a total of 39 sections of Crown land believed to be highly prospective for Alberta Bakken potential in addition to its extensive freehold landholdings in the area.

The 2012 drilling program has successfully tested the upper Bakken formation over an eight mile east-west by three mile north-south fairway. DeeThree intends to further test the limits of the known Bakken oil pool throughout the second half of the year by drilling an additional 8 gross (8.0 net) Bakken wells. In order to accommodate anticipated additional production increases from its Alberta Bakken drilling program, DeeThree is currently installing an amine plant to handle CO<sub>2</sub> volumes associated with Alberta Bakken solution gas. Additionally, DeeThree is designing and procuring equipment for a second 4,000 bbl/d expandable crude oil facility to be operational by year end.

The table below highlights results of our 2012 Bakken drilling program to date:

Well Identification	Average Test Rate (bbl/d oil) <sup>(1)</sup>	End of Test Rate (bbl/d oil) <sup>(1)</sup>	IP 30 (bbl/d oil)	IP 60 (bbl/d oil)	IP 90 (bbl/d oil)	Oil Current Rate (bbl/d oil)	Cumulative (bbls)
Location #1	765 (4 day)	550	415	370	320	107	38,000
Location #2	957 (6 day)	800	520	429	390	270	41,000
Location #3	940 (10 day)	620	497	–	–	308	20,000
Location #4	960 (5 day)	650	442	–	–	306	20,000
Location #5	808 (9 day)	525	467	–	–	–	17,000
Location #6	630 (8 day)	508	–	–	–	–	6,000

(1) Test rates are not necessarily indicative of long-term performance or of ultimate recovery.

### Brazeau Belly River

DeeThree continued to have success on its Belly River light oil resource play during the second quarter with 3.0 gross (2.8 net) horizontal wells drilled. These wells targeted different sands than previously drilled in this multi-zone play. Two wells were drilled into the “upper” Belly River sands highlighted by an IP30 rate of 400 boe/d (76 percent oil and NGLs) on the first location and 222 boe/d (100 percent oil) on a five day test on its most recently completed well. The third well was drilled into a “lower” Belly River marine sand which tested at 512 boe/d (78 percent oil & NGLs) over an eight day test and has recently been brought on-stream. These results have confirmed the multi-zone potential of the hydrocarbon bearing Belly River package over DeeThree’s significant land position at Brazeau. The success of these three wells has resulted in a substantial increase in DeeThree’s drilling inventory and reserves at Brazeau as DeeThree’s 2011 year-end reserve report did not attribute any reserves associated with the exploitation of these sands by horizontal drilling methods.

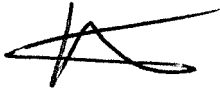
### Increased 2012 Guidance

DeeThree is well positioned to continue to deliver strong growth in its production, cash flow and reserves over the balance of 2012. Having already achieved its forecast 2012 year end production rate of 5,000 boe/d, the Board of Directors has approved an increase in DeeThree's 2012 capital expenditures budget from \$82 million to \$110 million.

DeeThree now anticipates to exit 2012 with a production rate of approximately 6,000 boe/d (76 percent oil and NGLs), up 20 percent from our previous guidance. Throughout the second half of 2012, DeeThree plans to deploy its capital primarily on its Lethbridge Alberta Bakken properties with plans to drill another 8 (8.0 net) wells prior to the year end. This expanded budget is fully funded through cash flow and funds available from its credit facility. The Company expects to exit 2012 with net debt of approximately \$60 - \$65 million and debt to fourth quarter annualized cash flow of approximately 0.8:1.0 times.

We look forward to reporting the results of our ongoing activities in the coming months.

On behalf of the Board of Directors,



Martin Cheyne  
President & Chief Executive Officer

August 13, 2012

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following Management's Discussion and Analysis ("MD&A") of financial condition and results of operations for DeeThree Exploration Ltd. ("DeeThree" or the "Company") is dated August 13, 2012 and should be read in conjunction with the Company's unaudited interim financial statements and related notes for the three and six months ended June 30, 2012 as well as the audited financial statements and notes for the year ended December 31, 2011. The interim financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

Additional information regarding the Company and factors that could affect the Company's operations and financial results are included in reports on file with Canadian securities regulatory authorities, including the Company's Annual Information Form, and may be accessed through the SEDAR website ([www.sedar.com](http://www.sedar.com)), or at the Company's website ([www.deethree.ca](http://www.deethree.ca)). Furthermore, the forward-looking statements contained in this MD&A are made as of the date of this MD&A and the Company does not undertake any obligation to update publicly or to revise any of the included forward-looking statements, whether as a result of new information, future events or otherwise, except as may be required by applicable securities laws. The Company's forward-looking statements are expressly qualified in their entirety by this cautionary statement.

### Non-IFRS Measurements

This MD&A contains the terms "funds from (used in) operations" and "funds from (used in) operations per share", which should not be considered an alternative to or more meaningful than cash flow from (used in) operating activities as determined in accordance with IFRS. These terms do not have any standardized meaning as prescribed by IFRS. DeeThree's determination of funds from (used in) operations and funds from (used in) operations per share may not be comparable to that reported by other companies. Management uses funds from (used in) operations to analyze operating performance and leverage, and considers funds from (used in) operations to be a key measure as it demonstrates the Company's ability to generate cash necessary to fund future capital investments and to repay debt, if applicable. Funds from (used in) operations is calculated using cash flow from (used in) operating activities as presented in the statement of cash flows before changes in non-cash working capital. DeeThree presents funds from (used in) operations per share whereby per share amounts are calculated using weighted average shares outstanding consistent with the calculation of earnings per share.

The following table reconciles funds from operations to cash flow from (used in) operating activities, which is the most directly comparable measure calculated in accordance with IFRS:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Cash flow from (used in) operating activities	<b>14,696</b>	2,299	<b>18,760</b>	(2,564)
Changes in non-cash working capital	<b>(4,844)</b>	2,478	<b>(3,167)</b>	6,508
Funds from operations	<b>9,852</b>	4,777	<b>15,593</b>	3,944

During the three and six months ended June 30, 2012, the Company's funds from operations totaled \$9,852,000 (\$0.15 per basic share and \$0.14 per diluted share) and \$15,593,000 (\$0.24 per basic share and \$0.22 per diluted share), respectively, versus \$4,777,000 (\$0.08 per basic and diluted share) and \$3,944,000 (\$0.08 per basic and diluted share) in the respective periods of 2011.

The Company considers corporate netbacks to be a key measure as they demonstrate DeeThree's profitability relative to current commodity prices. Corporate netbacks are comprised of operating, funds flow and net income (loss) netbacks. Operating netback is calculated as the average sales price of its commodities and then subtracts royalties, operating costs and transportation expenses. Funds flow netback starts with the operating netback and further deducts general and administrative costs, finance expense and adds finance income as well as realized gains on financial instruments.

To calculate the net income (loss) netback, DeeThree takes the funds flow netback and deducts share-based compensation expense as well as depletion and depreciation charges, accretion expense, unrealized gains on financial instruments, any impairment or exploration and evaluation expense and deferred income taxes. There is no IFRS measure that is reasonably comparable to netbacks. See the section entitled “Netbacks (per unit)” for the netback calculations.

Net debt and working capital (deficit), which represent current assets less current liabilities, excluding current derivative financial instruments, are used to assess efficiency, liquidity and the general financial strength of the Company. There is no IFRS measure that is reasonably comparable to net debt or working capital (deficit).

### Other Measurements

All dollar amounts quoted are in Canadian dollars. Where amounts are expressed on a barrel of oil equivalent (“boe”) basis, natural gas volumes have been converted to oil equivalence at six thousand cubic feet of gas to one barrel of oil. This conversion ratio of 6:1 is based on an energy equivalent conversion for the individual products, primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Such disclosure of boes may be misleading, particularly if used in isolation. Readers should be aware that historical results are not necessarily indicative of future performance.

### Forward-Looking Statements

Certain statements contained in this MD&A may constitute forward-looking statements. These statements relate to future events or the Company’s future performance. All statements other than statements of historical fact may be forward-looking statements. Forward-looking statements are often, but not always, identified by the use of words such as “seek”, “anticipate”, “plan”, “continue”, “estimate”, “expect”, “may”, “will”, “project”, “predict”, “potential”, “targeting”, “intend”, “could”, “might”, “should”, “believe” and similar expressions. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. The Company believes that the expectations reflected in those forward-looking statements are reasonable, but no assurance can be given that these expectations will prove to be correct and such forward-looking statements included in this MD&A should not be unduly relied upon by investors. These statements speak only as at the date of this MD&A and are expressly qualified, in their entirety, by this cautionary statement.

In particular, this MD&A contains forward-looking statements pertaining to the following: projections of market prices and costs, supply and demand for natural gas and crude oil, the quantity of reserves, natural gas and crude oil production levels, capital expenditure programs, treatment under governmental regulatory and taxation regimes, and expectations regarding the Company’s ability to raise capital and to continually add to reserves through acquisitions and development.

With respect to forward-looking statements contained in this MD&A, the Company has made assumptions regarding, among other things, the legislative and regulatory environments of the jurisdictions where the Company carries on business or has operations, the impact of increasing competition and the Company’s ability to obtain additional financing on satisfactory terms.

The Company’s actual results could differ materially from those anticipated in these forward-looking statements as a result of the risk factors included in this MD&A such as: volatility in the market prices for natural gas and crude oil; uncertainties associated with estimating reserves; geological, technical, drilling and processing problems; liabilities and risks, including environmental liabilities and risks inherent in natural gas and crude oil operations; incorrect assessments of the value of acquisitions; and, competition for, among other things, capital, acquisitions of reserves, undeveloped lands and skilled personnel. In addition, test results are not necessarily indicative of long-term performance or of ultimate recovery.

This forward-looking information represents the Company's views as at the date of this MD&A and such information should not be relied upon as representing its views as of any date subsequent to the date of this MD&A. DeeThree has attempted to identify important factors that could cause actual results, performance or achievements to vary from those current expectations or estimates expressed or implied by the forward-looking information. However, there may be other factors that cause results, performance or achievements not to be as expected or estimated and that could cause actual results, performance or achievements to differ materially from current expectations. There can be no assurance that forward-looking information will prove to be accurate, as results and future events could differ materially from those expected or estimated in such statements. Accordingly, readers should not place undue reliance on forward-looking information. The Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as expressly required by applicable securities legislation.

### **Description of the Company**

DeeThree is a Calgary based resource company actively engaged in light crude oil and natural gas exploration, development and production in key areas of the Western Canadian Sedimentary Basin. DeeThree commenced operations in 2007 as a private company focused on creating long-term shareholder value through prudent operational and financial management.

DeeThree has created a platform for growth through a sound business strategy that includes low risk development, high impact exploration and strategic acquisitions. The Company has three core operating areas: the Peace River Arch area of northwestern Alberta as well as the Brazeau area of west central Alberta, which are prospective for light crude oil, natural gas and natural gas liquids, and the Lethbridge area of southern Alberta, which features shallow gas and Bakken light oil. These three areas have provided the Company with a balanced and diverse production base.

Common shares of DeeThree are listed for trading on the Toronto Stock Exchange under the symbol DTX and the United States OTCQX under the symbol DTHRF.

In late 2008, DeeThree completed its first significant acquisition from a major oil and gas producer of properties in the Lethbridge area of southern Alberta (the "Lethbridge property"). The Lethbridge property was the primary focus of the Company until late in the first quarter of 2011 when DeeThree closed a transformational acquisition of properties in the Peace River Arch and Brazeau areas (the "Peace River Arch and Brazeau properties"). In this acquisition, which closed on March 22, 2011 (effective January 1, 2011), the Company acquired approximately 1,830 boe/d (40 percent light crude oil and NGLS) of primarily high working interest, operated crude oil, natural gas and NGLs production and reserves.

### **First Quarter 2012 Transactions**

In February 2012, the Company received payment of \$1,000,000 as proceeds from the default on a farm-out agreement entered into during 2011. Details of the farm-out are included in the December 31, 2011 MD&A.

On March 27, 2012, the Company issued 3,834,100 flow-through shares at a price of \$4.50 per flow-through share for total gross proceeds of \$17,253,450 (\$16,027,450 net of estimated share issue expenses), including 500,100 flow-through shares (\$2,250,450) issued on the exercise in full of the underwriters' over-allotment option. The proceeds of the flow-through share offering will be used to conduct exploration activity on the Company's properties.

### **Second Quarter 2012 Transactions**

In April 2012, the Company's lender approved an increase to the Company's existing credit facility from \$50,000,000 to \$60,000,000.

## Financial and Operating Results

### Sales Volumes

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<b>Sales</b>				
Natural gas ( <i>mcf/d</i> )	<b>8,687</b>	8,214	<b>8,672</b>	5,991
Crude oil ( <i>bbls/d</i> )	<b>2,091</b>	609	<b>1,704</b>	341
NGLs ( <i>bbls/d</i> )	<b>266</b>	189	<b>274</b>	104
Total sales ( <i>boe/d</i> )	<b>3,805</b>	2,167	<b>3,423</b>	1,444
	(%)	(%)	(%)	(%)
<b>Production Split</b>				
Natural gas	<b>38</b>	63	<b>42</b>	69
Crude oil	<b>55</b>	28	<b>50</b>	24
NGLs	<b>7</b>	9	<b>8</b>	7
Total	<b>100</b>	100	<b>100</b>	100

For the second quarter of 2012, the Company's production averaged 3,805 boe/d compared to 2,167 boe/d in the same period of 2011 and 3,042 boe/d recorded in the first quarter of 2012. This represents a 76 percent year-over-year and 25 percent quarter-over-quarter increase. These increases were directly attributed to the Company's drilling success.

For the first half of 2012, DeeThree's production averaged 3,423 boe/d compared to 1,444 boe/d a year ago, representing a 137 percent increase. During the 2012 six-month period, production was comprised of 8,672 mcf/d of natural gas, 1,704 bbls/d of crude oil and 274 bbls/d of NGLs, thereby increasing the Company's crude oil and NGLs production to 58 percent of total corporate production versus 31 percent in the comparable period of 2011.

### Revenue

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
(000s)	(\$)	(\$)	(\$)	(\$)
Natural gas	<b>1,625</b>	2,874	<b>3,331</b>	4,146
Crude oil	<b>15,452</b>	5,240	<b>26,047</b>	5,840
NGLs and other	<b>1,360</b>	1,351	<b>3,336</b>	1,448
Total oil and natural gas revenue	<b>18,437</b>	9,465	<b>32,714</b>	11,434

During the three months ended June 30, 2012, revenue increased 95 percent to \$18,437,000 from \$9,465,000 recorded in the comparative period of 2011 and rose 29 percent from \$14,277,000 in the first quarter of 2012. These increases were a result of increased production, as explained in the "Sales Volumes" section above, compounded by a change to a higher percentage of oil and NGLs (62 percent vs. 37 percent) and the resulting increase in corporate average price per boe.

For the first half of 2012, revenue totaled \$32,714,000 versus \$11,434,000 for the same period of 2011. During the first six months of 2012, total revenue increased 186 percent compared to 2011 primarily as a result of the 76 percent year-over-year increase in sales volumes.



## Commodity Prices and Foreign Exchange

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(\$)	(\$)	(\$)	(\$)
<b>Benchmark Prices</b>				
Natural gas				
NYMEX (US\$/mmbtu) <sup>(1)</sup>	2.26	4.36	2.52	4.23
AECO (CDN\$/GJ) <sup>(2)</sup>	1.80	3.67	1.92	3.62
Crude oil				
WTI (US\$/bbl)	93.49	102.56	98.21	98.33
Edmonton light (CDN\$/boe)	84.20	102.63	88.34	95.57
<b>Average Realized Prices</b>				
Natural gas (\$/mcf)	2.06	3.85	2.11	3.82
Crude oil (\$/bbl)	81.21	96.30	84.01	96.08
NGLs (\$/bbl)	58.72	72.86	65.39	71.64
Total sales price (\$/boe)	53.25	47.99	52.51	43.74
<b>Foreign Exchange</b>				
CDN\$/US\$	1.0102	0.9677	1.0057	0.9768
US\$/CDN\$	0.9899	1.0334	0.9943	1.0238

(1) Mmbtu is the abbreviation for millions of British thermal units. One mcf of natural gas is approximately 1.02 mmbtu.

(2) GJ is the abbreviation for gigajoule. One mcf of natural gas is approximately equal to 1.05 GJ.

The Company's financial results are significantly influenced by fluctuations in commodity prices, including price differentials and foreign exchange rates. The Company seeks to protect itself from fluctuations in prices and exchange rates by maintaining an appropriate hedging strategy. As at the date of this MD&A, DeeThree had seven crude oil hedges in place (see "Risk Management" section below for details), five which were entered into during 2011 and two entered into during the first quarter of 2012. Most commodity prices are based on U.S. dollar benchmarks, which result in the Company's realized prices being influenced by the Canadian/U.S. exchange rates. The Company does not sell or transact in foreign currency, but may be impacted by foreign currency exchange rate changes related to commodity prices as outlined above. As at the date of this MD&A, DeeThree also had three foreign currency exchange risk management contracts in place to mitigate these risks (see "Risk Management" section below for contract details), two of which were entered into during 2011 and one which was entered into during the second quarter of 2012.

During the three-month period ended June 30, 2012, benchmark natural gas prices in Canada fell 51 percent from the same period last year. In Canada, the benchmark index is the price set at the AECO hub, a major storage site near the TransCanada Energy pipeline exit point from Alberta at Empress. The benchmark index for United States natural gas prices is the market price as established by the New York Mercantile Exchange at Henry Hub ("NYMEX"), a major point of natural gas pipeline intersection in Louisiana. NYMEX is linked to AECO through transportation tariffs from the respective hubs to common markets and through foreign exchange rates. AECO prices averaged \$1.80/GJ throughout the second quarter of 2012 compared to \$3.67/GJ a year ago. DeeThree's average realized gas price during the three-month period was \$2.06/mcf versus \$3.85/mcf last year.

Oil prices continue to decline in the second quarter of 2012 with West Texas Intermediate ("WTI") averaging \$93.49/bbl compared to \$102.56/bbl in the same period last year. The benchmark for crude oil prices in North America, and substantially globally, is WTI delivered to Cushing, Oklahoma, again as determined by the NYMEX. Canadian crude prices are based on refiner postings in Canadian dollars at Edmonton, Alberta, and as with natural gas, are linked to WTI through transportation tariffs to common markets and the foreign exchange rate. The average realized price of DeeThree's crude oil was \$81.21/bbl for the second quarter of 2012 compared to \$96.30/bbl a year ago. During the quarter, the Company was impacted by widening differentials as growing crude oil supply exhausts pipeline capacities, leading to lower realized prices on this commodity. Information regarding the Company's risk management program can be found in the "Business Risks and Risk Mitigation" section of this MD&A.

## Royalties

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Oil and natural gas revenues	<b>18,437</b>	9,465	<b>32,714</b>	11,434
Total royalties	<b>3,413</b>	1,489	<b>6,150</b>	1,757
Total royalties <i>(\$/boe)</i>	<b>9.86</b>	7.55	<b>9.87</b>	6.72
Percent of revenue (%)	<b>19</b>	16	<b>19</b>	15

The Lethbridge property is primarily subject to freehold royalties, which is a sliding scale royalty determined monthly on a well-by-well basis using a calculation that is based on the New Alberta Crown Royalty 2009 with a cap of 30 percent. The sliding scale varies based on productivity (a higher royalty is payable from wells with higher production rates) and commodity prices (a higher royalty is payable in times of higher natural gas and crude oil prices).

The Peace River Arch and Brazeau properties are primarily subject to Crown royalties payable to the provincial government and overriding royalties on oil, natural gas and NGLs production. These types of royalties are also sensitive to both production levels and commodity prices; therefore, the Company's royalties will continue to fluctuate with commodity prices, well production rates, production declines of existing wells along with performance and location of new wells drilled.

For the second quarter of 2012, royalties totaled \$3,413,000 or 19 percent of revenue compared to \$1,489,000 or 16 percent of revenue for the same quarter in 2011 and \$2,737,000 or 19 percent of revenue in the first quarter of 2012. The year-over-year royalty rate change was primarily due to new production from the Company's wells brought on-stream during the past year, some of which are subject to a freehold royalty based on the New Alberta Crown Royalty 2009, while others qualify for the 5 percent royalty holiday under the Government of Alberta royalty framework. The total royalties for the quarter was positively influenced by a retroactive gas cost allowance ("GCA") recovery that was received in Q2 2012 but related to prior periods, which was offset by an amendment to prior period amounts related to freehold royalties.

During the first six months of 2012, royalties totaled \$6,150,000 or 19 percent of revenue versus \$1,757,000 or 15 percent of revenue a year ago, which was directly attributable to the increase in the Company's crude oil production, which attracts a higher royalty rate.

## Operating and Transportation Expenses

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Operating expenses	<b>3,790</b>	2,117	<b>8,078</b>	2,776
Transportation expenses	<b>548</b>	330	<b>993</b>	414
Total operating and transportation expenses	<b>4,338</b>	2,447	<b>9,071</b>	3,190
Operating expenses <i>(\$/boe)</i>	<b>10.95</b>	10.73	<b>12.97</b>	10.62
Transportation expenses <i>(\$/boe)</i>	<b>1.58</b>	1.67	<b>1.59</b>	1.58
Total operating and transportation expenses <i>(\$/boe)</i>	<b>12.53</b>	12.40	<b>14.56</b>	12.20

Operating costs include all costs associated with the production of crude oil and natural gas. The major components of operating costs include charges for contract operating, processing fees, lease rentals, property and pipeline taxes, utilities and well maintenance charges.

Operating expenses for the second quarter of 2012 totaled \$3,790,000 or \$10.95/boe compared to \$2,117,000 or \$10.73/boe in the same period last year and \$4,288,000 or \$15.49/boe in the first quarter of 2012. As production volumes increase, the Company has been able to realize economies of scale in the Lethbridge and Brazeau properties, contributing to a lower operating cost per barrel when compared to the first quarter of 2012.

Transportation expenses for the three months ended June 30, 2012 were \$548,000 or \$1.58 /boe compared to \$330,000 or \$1.67/boe recorded in the second quarter of 2011 and \$445,000 or \$1.61/boe in the first quarter of 2012. Transportation expenses reflect NOVA and ATCO transportation costs and fluctuate depending on the proportion of the Company's gas that was flowing on firm service versus interruptible service (interruptible service is slightly more expensive) as well as the proportion of Company volumes on ATCO versus NOVA (ATCO is less expensive). Over the past year, the Company has increased production of both crude oil and NGLs, and the transportation costs associated with those products consist primarily of pipeline tariffs, terminal charges and trucking (crude oil and NGLs attract a higher cost per boe for transportation compared to natural gas). As this is a per unit charge, the Company expects the cost per boe for transportation to remain within the range experienced during Q2 going forward.

For the six months ended June 30, 2012, the Company incurred operating expenses of \$8,078,000 or \$12.97/boe compared to \$2,776,000 or \$10.62/boe in the corresponding 2011 period. Transportation expenses for the first half of 2012 totaled \$993,000 or \$1.59/boe versus \$414,000 or \$1.58/boe in the same period last year.

### Risk Management

The Company has elected not to use hedge accounting, and accordingly, the fair value of the financial contracts is recorded at each period-end. The fair value may change substantially from period to period depending on commodity and foreign exchange forward strip prices for the financial contracts outstanding at the balance sheet date. The change in fair value from period-end to period-end is reflected in the earnings for that period. As a result, earnings may fluctuate considerably based on the period ending commodity and foreign exchange forward strip prices.

As at June 30, 2012, the Company had the following crude oil and foreign exchange risk management contracts in place with a total mark-to-market asset value of \$4,209,000 (\$2,864,000 current and \$1,345,000 non-current):

Period	Commodity	Type of Contract	Quantity	Pricing Point	Contract Price
Jan.1/12 – Dec.31/12	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$95.00/bbl (floor) – US\$115.00/bbl (cap) <sup>(1)</sup>
Jan.1/12 – Dec.31/12	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$85.00/bbl (floor) – US\$112.50/bbl (cap) <sup>(2)</sup>
Jan.1/12 – Dec.31/12	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$90.00/bbl (floor) – US\$116.60/bbl (cap) <sup>(3)</sup>
Jan.1/13 – Dec.31/13	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$85.00/bbl (floor) – US\$111.00/bbl (cap) <sup>(4)</sup>
Jan.1/13 – Dec.31/13	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$90.00/bbl (floor) – US\$113.25/bbl (cap) <sup>(5)</sup>
Jan.1/13 – Dec.31/13	Crude oil	Collar	250 bbls/d	WTI - NYMEX	US\$90.00/bbl (floor) – US\$116.25/bbl (cap) <sup>(6)</sup>
May.1/12 – Dec.31/13	Crude oil	Collar	250 bbls/d	WTI-NYMEX	US\$95.00/bbl (floor) – US\$118.00/bbl (cap) <sup>(7)</sup>

(1) Unless the monthly WTI price averages over US\$115.00/bbl every day for the entire month, in which case the cap becomes US\$100.00/bbl.

(2) Unless the monthly WTI price averages over US\$112.50/bbl every day for the entire month, in which case the cap becomes US\$95.00/bbl.

(3) Unless the monthly WTI price averages over US\$116.60/bbl every day for the entire month, in which case the cap becomes US\$95.00/bbl.

(4) Unless the monthly WTI price averages over US\$111.00/bbl every day for the entire month, in which case the cap becomes US\$90.00/bbl.

(5) Unless the monthly WTI price averages over US\$113.25/bbl every day for the entire month, in which case the cap becomes US\$92.00/bbl.

(6) Unless the monthly WTI price averages over US\$116.25/bbl every day for the entire month, in which case the cap becomes US\$92.00/bbl.

(7) Unless the monthly WTI price averages over US\$118.00/bbl every day for the entire month, in which case the cap becomes US\$100.00/bbl.

Period	Currency	Type of Contract	Quantity	Pricing Point
Jan.1/12 – Dec. 31/12	US\$	Average Rate Participating Forward	US\$1,400,000	Strike – \$1.0275 Fade In – \$0.9300 Participating – \$1.0800 <sup>(1)</sup>
Jan.1/12 – Dec.31/13	US\$	Average Rate Range Bonus Accumulator	US\$700,000	Target – \$1.10 CDN\$/US\$ + \$1,000 bonus/day <sup>(2)</sup>
Jun.1/12 – Dec.31/13	US\$	Average Rate Range Bonus Accumulator	US\$900,000	Target – \$1.0775 CDN\$/US\$ + \$900 bonus/day <sup>(3)</sup>

(1) If the Bank of Canada average daily noon rate ("average rate") for the month is equal to or greater than the fade in level and equal to or less than the strike, the Company is committed to sell U.S. dollars at the strike price. If the average rate settles greater than the strike and equal to or less than the participating level, no transaction occurs. If the average rate for the month settles above the participating level, the Company is obligated to settle at the strike price and if the average rate settles less than the fade in level, no transaction occurs.

(2) The Company can earn a bonus payout of up to \$1,000/day depending on the period in which the exchange rate remains in the applicable range of equal to or greater than \$0.9350 and equal to or less than \$1.10.

(3) The Company can earn a bonus payout of up to \$900/day depending on the period in which the exchange rate remains in the applicable range of equal to or greater than \$0.9300 and equal to or less than \$1.0775.

These contracts are considered to be financial instruments and the resulting derivative financial asset has been recorded on the Company's statement of financial position, with the unrealized gain or loss being recorded on the statement of operations and comprehensive income (loss).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
(000s)	(\$)	(\$)	(\$)	(\$)
Unrealized gain on financial instruments	<b>(7,066)</b>	(92)	<b>(5,237)</b>	(92)
Unrealized gain on financial instruments (\$/boe)	<b>(20.41)</b>	(0.47)	<b>(8.41)</b>	(0.35)

During the three months and six months ended June 30, 2012, the Company also realized a gain on these financial instruments as a result of the forward strip prices in relation to the terms of the contracts.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
(000s)	(\$)	(\$)	(\$)	(\$)
Realized gain on financial instruments	<b>(430)</b>	–	<b>(606)</b>	–
Realized gain on financial instruments (\$/boe)	<b>(1.24)</b>	–	<b>(0.97)</b>	–

## G&A Expense

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
(000s)	(\$)	(\$)	(\$)	(\$)
Gross G&A expense	<b>1,429</b>	982	<b>3,071</b>	3,004
Capitalized G&A (direct)	<b>(288)</b>	(187)	<b>(753)</b>	(305)
Overhead recoveries	<b>(157)</b>	(19)	<b>(280)</b>	(84)
G&A expenses (net)	<b>984</b>	776	<b>2,038</b>	2,615
Transaction costs	–	(6)	–	(1,125)
G&A expense (net)	<b>984</b>	770	<b>2,038</b>	1,490
G&A expense (net) (\$/boe)	<b>2.84</b>	3.90	<b>3.27</b>	5.70

Gross G&A expenses totaled \$1,429,000 for the three-month period ended June 30, 2012 compared to \$982,000 recorded in the comparable period of 2011 and \$1,642,000 in the first quarter of 2012. Net G&A costs were \$984,000 or \$2.84/boe in the second quarter of 2012 compared to \$770,000 or \$3.90/boe a year ago and \$1,054,000 or \$3.81/boe recorded in the first quarter of 2012. When compared to the same quarter of the prior year, G&A costs net of transaction costs have increased on an absolute basis due to increased staffing costs (including salaries, bonuses and office rent) associated with higher activity levels. Throughout the second quarter of 2012, the Company had an average of 19 full-time employees and 4 consultants versus 14 full-time employees and 2 consultants in the same period of 2011.

The Company capitalized direct G&A expenses amounting to \$288,000 and had overhead recoveries of \$157,000 in the second quarter of 2012 versus \$187,000 and \$19,000, respectively, in the comparative period of 2011, and \$465,000 and \$123,000, respectively, in the first quarter of 2012.

G&A net expenses for the first six months of 2012 totaled \$2,038,000 or \$3.27/boe compared to \$1,490,000 or \$5.70/boe in the same period of 2011. During the six months ended June 30, 2012, the Company capitalized \$753,000 in direct costs relating to its exploration and development efforts and \$280,000 of overhead recoveries compared to \$305,000 and \$84,000, respectively, in the same period of 2011.

### Share-Based Compensation

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Gross share-based compensation	856	382	1,581	629
Share-based compensation reclassified to operating costs	(31)	(10)	(58)	(10)
Capitalized share-based compensation	(303)	(145)	(584)	(196)
Share-based compensation expense (net)	522	227	939	423
Share-based compensation expense (net) <i>(\$/boe)</i>	1.51	1.15	1.51	1.62

The Company has a stock option plan, which is described in note 10 of the unaudited interim financial statements. Options granted under the plan have a four-year vesting term, expire five years from the grant date and the fair value of all options granted is estimated at the grant date using the Black-Scholes option pricing model. Share-based compensation expense is a non-cash expense that reflects the amortization over the vesting period of the fair value of stock options granted to the employees, consultants and directors of the Company. For those stock options granted to field employees, their portion of the share-based compensation is reclassified to operating expenses to be consistent with the recognition of their salaries on the statement of operations and comprehensive loss.

For the quarter ended June 30, 2012, the Company incurred a net expense of \$522,000 or \$1.51/boe versus \$227,000 or \$1.15/boe in the same period of 2011 and \$417,000 or \$1.51 in the first quarter of 2012. This year-over-year increase was directly attributable to increased staffing.

During the first six months of 2012, DeeThree incurred a net expense of \$939,000 or \$1.51/boe compared to \$423,000 or \$1.62/boe recorded in the first half of 2011.

### Depletion and Depreciation ("D&D")

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
D&D provision	6,898	4,244	12,850	5,115
D&D provision <i>(\$/boe)</i>	19.92	21.52	20.62	19.57

D&D is computed on a unit-of-production basis. Such expense, on a boe basis, fluctuates period to period primarily as a result of changes in the underlying proved plus probable reserves base and in the amount of costs subject to D&D, including future development costs. Such costs are segregated and depleted on an area-by-area basis relative to the respective underlying proved plus probable reserves base.

Depreciation is provided on certain field facilities using the straight-line method over a 20-year useful life and on office assets using the declining balance method at rates between 20 percent and 30 percent.

The Company's D&D expense for the three months ended June 30, 2012 was \$6,898,000 or \$19.92/boe compared to \$4,244,000 or \$21.52/boe in the comparable period of 2011 and \$5,952,000 or \$21.50/boe in the first quarter of 2012. The year-over-year absolute increase was attributable to the increased value of the proved plus probable reserves added during 2011 and the first half of 2012 from the Company's drilling program, increased production related to those assets and related future development costs. However, the year-over-year per unit amounts have decreased due to the fact that successful 2012 wells have been added to the asset base at a lower cost per boe than the assets purchased in the March 2011 acquisition, which contributes to a lower D&D rate overall.

For the six months ended June 30, 2012, D&D expense totaled \$12,850,000 or \$20.62/boe compared to \$5,115,000 or \$19.57/boe recorded in the same period of 2011.

### Exploration and Evaluation ("E&E") Expense

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
E&E expense	1,388	–	2,520	–
E&E expense <i>(\$/boe)</i>	4.01	–	4.04	–

Under IFRS, DeeThree accumulates those costs related to E&E assets in one cost pool, pending determination of technical feasibility and commercial viability of the asset. This primarily includes costs for seismic data, undeveloped land and drilling costs until the drilling of the well is complete and results have been evaluated. Costs related to wells that have been determined to be uneconomical as well as cost of undeveloped land lease expiries are expensed as they occur.

During the second quarter of 2012, the Company recorded E&E expense of \$1,388,000 or \$4.01/boe, which related to lease expiries in several of the Company's areas versus \$nil in the same period of 2011 and \$1,132,000 or \$4.09/boe in the first quarter of 2012. During the six months ended June 30, 2012, the Company recorded E&E expense of \$2,520,000 or \$4.04/boe versus \$nil in the comparable period of 2011.

### Finance Income

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Finance income	–	79	–	154
Finance income <i>(\$/boe)</i>	–	0.40	–	0.59

In the second quarter of 2012, the Company recorded \$nil finance income, compared to \$79,000 or \$0.40/boe during the same quarter of 2011 which was a result of the Company's positive cash balance during that period.

For the six-month period ended June 30, 2012, the Company's finance income was \$nil compared to \$154,000 or \$0.59/boe in the first half of 2011.

## Accretion and Finance Expenses

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)</i>	(\$)	(\$)	(\$)	(\$)
Accretion expense on decommissioning liabilities	97	65	192	90
Finance expense	311	65	526	92
Total accretion and finance expenses	408	130	718	182
Accretion expense on decommissioning liabilities <i>(\$/boe)</i>	0.28	0.33	0.31	0.34
Finance expense <i>(\$/boe)</i>	0.90	0.33	0.84	0.35
Total accretion and finance expenses <i>(\$/boe)</i>	1.18	0.66	1.15	0.69

Accretion expense represents the increase in the present value of the Company's decommissioning liabilities. In the second quarter of 2012, the Company recorded accretion expense of \$97,000 or \$0.28/boe compared to \$65,000 or \$0.33/boe in the same period of 2011 and \$95,000 or \$0.34/boe in the first quarter of 2012. The absolute increase is primarily due to the decommissioning liabilities added for the 2011 and 2012 drills. However, the expense per boe has decreased as a result of increased production – accretion is not a unit-based calculation and as production volumes increase, the expense is spread over a larger number of barrels. The underlying liability may increase over time based on new obligations incurred from drilling wells, constructing facilities, acquiring operations, adjusting future estimates of timing or estimated decommissioning costs. The liability can also be reduced as a result of abandonment work actually completed.

During the three months ended June 30, 2012, the Company recorded finance expenses of \$311,000 or \$0.90/boe compared to \$65,000 or \$0.33/boe in the same period of 2011 and \$215,000 or \$0.78/boe in the first quarter of 2012. The Company incurred interest charges and standby fees related to the \$60,000,000 credit facility (2011 – \$20,000,000), which was drawn to \$36,870,000 at the end of the second quarter.

For the 2012 six-month period, the Company recorded accretion expense of \$192,000 or \$0.31/boe versus \$90,000 or \$0.34/boe and finance expenses of \$526,000 or \$0.84/boe versus \$92,000 or \$0.35/boe in the comparable period last year.

## Income Taxes

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)</i>	(\$)	(\$)	(\$)	(\$)
Deferred income tax expense	2,379	1,222	1,867	1,288
Deferred income tax expense <i>(\$/boe)</i>	6.87	6.20	3.00	4.93

During the second quarter of 2012, the Company recorded a deferred income tax expense of \$2,379,000 that was primarily related to an increase in the taxable base of the oil and gas assets offset by a change to the non-capital loss provision from the prior year. The movement in the taxable base of oil and gas assets is due to the Company's capital spending associated with flow-through shares. As costs are incurred, the Company reverses the flow-through share liability and recognizes the deferred income tax expense at that time. During the three months ended June 30, 2012, the Company spent approximately \$2,309,000 in eligible capital expenditures related to the March 2011 issuance and an additional \$649,000 related to the March 2012 issuance of flow-through shares.

DeeThree does not have current income taxes payable and does not expect to pay current income taxes in 2012 as the Company had estimated tax pools available at June 30, 2012 of \$234,000,000.

## Funds from Operations

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Net income (loss)	<b>5,603</b>	(899)	<b>2,404</b>	(2,890)
Non-cash items:				
D&D	<b>6,898</b>	4,244	<b>12,850</b>	5,115
Accretion	<b>97</b>	65	<b>192</b>	90
Share-based compensation <sup>(1)</sup>	<b>553</b>	237	<b>997</b>	433
Unrealized gain on financial instruments	<b>(7,066)</b>	(92)	<b>(5,237)</b>	(92)
E&E expense	<b>1,388</b>	–	<b>2,520</b>	–
Deferred income tax expense	<b>2,379</b>	1,222	<b>1,867</b>	1,288
Funds from operations	<b>9,852</b>	4,777	<b>15,593</b>	3,944

(1) The share-based compensation amount included in the calculation of funds from operations has been adjusted for the non-cash portion related to certain field employees that was reclassified to operating expenses for presentation in the statement of operations and comprehensive income (loss).

During the three months ended June 30, 2012, the Company generated funds from operations totaling \$9,852,000 or \$0.15 per basic share and \$0.14 per diluted share compared to \$4,777,000 or \$0.08 per basic and diluted share in the comparative period of 2011 and \$5,741,000 or \$0.09 per basic and diluted share in the first quarter of 2012. This 106 percent year-over-year increase was primarily due to increased revenue from production offset by increased royalties and operating and transportation costs.

Funds from operations totaled \$15,593,000 or \$0.24 per basic share and \$0.22 per diluted share for the six months ended June 30, 2012 compared to \$3,944,000 or \$0.08 per basic and diluted share recorded in the same period of 2011.

## Net Income (Loss)

For the three months ended June 30, 2012, the Company recorded a net income of \$5,603,000 or \$0.08 per basic and diluted share compared to a net loss of \$899,000 or \$0.01 per basic and diluted share in the same period of 2011 and a net loss of \$3,199,000 or \$0.05 per basic and diluted share in the first quarter of 2012. The Company's positive net income for the quarter was primarily due to a significant unrealized gain on the crude and foreign exchange financial contracts during the period.

The net income for the six months ended June 30, 2012 was \$2,404,000 or \$0.04 per basic share and \$0.03 per diluted share versus a net loss of \$2,890,000 or \$0.06 per basic and diluted share in the comparative period of 2011.



### Netbacks (per unit) <sup>(3)</sup>

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(\$/boe)	(\$/boe)	(\$/boe)	(\$/boe)
Sales prices	<b>53.25</b>	47.99	<b>52.51</b>	43.74
Royalties	<b>(9.86)</b>	(7.55)	<b>(9.87)</b>	(6.72)
Operating	<b>(10.95)</b>	(10.73)	<b>(12.97)</b>	(10.62)
Transportation	<b>(1.58)</b>	(1.67)	<b>(1.59)</b>	(1.58)
Operating netback <sup>(1)</sup>	<b>30.86</b>	28.04	<b>28.08</b>	24.82
G&A and other (excludes non-cash items) <sup>(2)</sup>	<b>(2.84)</b>	(3.93)	<b>(3.27)</b>	(10.00)
Realized gain on financial instruments	<b>1.24</b>	–	<b>0.97</b>	–
Finance income	–	0.40	–	0.59
Finance expenses	<b>(0.90)</b>	(0.33)	<b>(0.84)</b>	(0.35)
Funds flow netback <sup>(1)</sup>	<b>28.36</b>	24.18	<b>24.94</b>	15.06
D&D	<b>(19.92)</b>	(21.52)	<b>(20.62)</b>	(19.57)
Accretion	<b>(0.28)</b>	(0.33)	<b>(0.31)</b>	(0.34)
Share-based compensation	<b>(1.51)</b>	(1.15)	<b>(1.51)</b>	(1.62)
Unrealized gain on financial instruments	<b>20.41</b>	0.47	<b>8.41</b>	0.35
E&E expense	<b>(4.01)</b>	–	<b>(4.04)</b>	–
Deferred income tax expense	<b>(6.87)</b>	(6.20)	<b>(3.00)</b>	(4.93)
Net income (loss) netback <sup>(1)</sup>	<b>16.18</b>	(4.55)	<b>3.87</b>	(11.05)

(1) Non-IFRS measure: refer to the commentary at the beginning of this MD&A. Operating netback, funds flow netback and net income (loss) netback are calculated by dividing operating income, funds flow from operations and the net income (loss) by the sales volume in boes for the period then ended. For a description of the boe conversion ratio, refer to the "Other Measurements" commentary at the beginning of this MD&A.

(2) For the six month period ended June 30, 2011, G&A and other includes transaction costs of \$1,125,000 relating to the acquisition of the Peace River Arch and Brazeau properties.

(3) For a description of the boe conversion ratio, refer to the commentary at the beginning of this MD&A.

The operating netback was \$30.86/boe for the three months ended June 30, 2012 compared to \$28.04/boe in the same period last year and \$24.59/boe in the first quarter of 2012. As compared to the prior year, the Company experienced a higher realized average price throughout the three months ended June 30, 2012. Even though each individual product had a lower realized price in the period as compared to the same period of 2011, the higher realized average price and resulting higher netback was largely the result of a shift to a proportionately higher oil production base, which attracts higher pricing.

For the first six months of 2012, DeeThree achieved an operating netback of \$28.08/boe versus \$24.82/boe in the same period of 2011, again related to higher pricing but offset by slightly higher royalties and operating expenses.

## Investment and Investment Efficiencies

### Capital Expenditures and Acquisitions

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)(excluding decommissioning liabilities and capitalized share-based compensation)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Property acquisitions and adjustments	–	1,898	–	124,445
Drilling and completions	<b>21,548</b>	9,856	<b>51,775</b>	15,566
Equipment and facilities	<b>3,664</b>	193	<b>6,062</b>	235
Land and lease retention	<b>4,110</b>	317	<b>7,598</b>	1,462
Geological and geophysical	<b>84</b>	18	<b>206</b>	(37)
Capitalized G&A and other	<b>293</b>	208	<b>773</b>	348
Total capital expenditures	<b>29,699</b>	12,490	<b>66,414</b>	142,019
Proceeds from farm-outs	–	(5,000)	<b>(1,000)</b>	(5,000)
Total capital expenditures, net proceeds from farm-outs	<b>29,699</b>	7,490	<b>65,414</b>	137,019

During the second quarter of 2012, the Company incurred a total of \$29,699,000 (2011 – \$12,490,000) in capital expenditures, excluding the non-cash decommissioning liabilities and capitalized share-based compensation. With the Company's current shift in focus to deep horizontal Bakken and Brazeau locations, drilling and completion expenditures totaled \$21,548,000 (2011 – \$9,856,000), including the drilling of 7 gross (6.8 net) wells. In the comparative quarter of 2011, the Company drilled 2 gross (2.0 net) shallow wells and did not incur significant completion expenditures. For the three months ended June 30, 2012, DeeThree spent \$3,664,000 (2011 – \$193,000) on equipping and tie-ins, which in 2012 consisted primarily of expenditures related to tie-in of the 2012 drills as well as construction of an amine plant and battery in the Lethbridge area. The Company spent \$4,110,000 (2011 – \$317,000) at Crown land sales and \$84,000 (2011 – \$18,000) related to the purchase of seismic programs. The remaining \$293,000 (2011 – \$208,000) was invested in capitalized G&A and other corporate assets.

For the first six months of 2012, capital expenditures totaled \$66,414,000 versus \$142,019,000 in the comparative period of 2011. A significant portion of the 2011 first half capital spending was directed towards the acquisition of the Peace River and Brazeau properties for a consideration of \$124,445,000 after certain adjustments. As the Company's focus has shifted to drilling mainly in the Brazeau and Lethbridge properties this year, no capital was spent on acquisitions so far during 2012. Drilling and completion expenditures totaled \$51,775,000 (2011 – \$15,566,000), equipping and tie-in costs were \$6,062,000 (2011 – \$235,000), \$7,598,000 (2011 – \$1,462,000) was spent on land purchases, \$206,000 was spent related to the purchase of seismic programs (2011 – \$37,000 related to credit adjustments on the Company's two seismic programs that were shot in 2011) and the remaining \$773,000 (2011 – \$348,000) was invested in capitalized G&A and other corporate assets. In the first half of 2012, the Company also received \$1,000,000 as proceeds from a default on a farm-out agreement entered into during the second quarter of 2011 (2011 - \$5,000,000 as initial payment for the farm-out), which was recorded against E&E and partially offset the total capital expenditures for the period.

## Drilling Activity

	Exploration		Development		Total	
	Gross	Net	Gross	Net	Gross	Net
	(#)	(#)	(#)	(#)	(#)	(#)
<b>Three Months Ended June 30, 2012</b>						
Natural gas	-	-	-	-	-	-
Crude oil and NGLs	1	1.0	6	5.8	7	6.8
Standing	-	-	-	-	-	-
Dry and abandoned	-	-	-	-	-	-
<b>Total wells</b>	<b>1</b>	<b>1.0</b>	<b>6</b>	<b>5.8</b>	<b>7</b>	<b>6.8</b>
Success rate (%)		100		100		100
Average working interest (%)		100		97		97
<b>Three Months Ended June 30, 2011</b>						
Natural gas	-	-	-	-	-	-
Crude oil and NGLs	2	2.0	-	-	2	2.0
Standing	-	-	-	-	-	-
Dry and abandoned	-	-	-	-	-	-
<b>Total wells</b>	<b>2</b>	<b>2.0</b>	<b>-</b>	<b>-</b>	<b>2</b>	<b>2.0</b>
Success rate (%)		100		-		100
Average working interest (%)		100		-		100
<b>Six Months Ended June 30, 2012</b>						
Natural gas	-	-	-	-	-	-
Crude oil and NGLs	2	2.0	13	11.9	15	13.9
Standing	-	-	2	2.0	2	2.0
Dry and abandoned	-	-	-	-	-	-
<b>Total wells</b>	<b>2</b>	<b>2.0</b>	<b>15</b>	<b>13.9</b>	<b>17</b>	<b>15.9</b>
Success rate (%)		100		100		100
Average working interest (%)		100		93		94
<b>Six Months Ended June 30, 2011</b>						
Natural gas	-	-	-	-	-	-
Crude oil and NGLs	4	4.0	-	-	4	4.0
Standing	-	-	-	-	-	-
Dry and abandoned	-	-	-	-	-	-
<b>Total wells</b>	<b>4</b>	<b>4.0</b>	<b>-</b>	<b>-</b>	<b>4</b>	<b>4.0</b>
Success rate (%)		100		-		100
Average working interest (%)		100		-		100

During the second quarter of 2012, DeeThree drilled 4 gross (4.0 net) Bakken wells on its Lethbridge property and 3 gross (2.8 net) wells on its Brazeau property. The Company achieved a 100 percent success rate. During the three months ended June 30, 2011, the Company drilled 2 gross (2.0 net) Bakken wells on its Lethbridge property for a 100 percent success rate.

During the first half of 2012, DeeThree drilled 10 gross (10.0 net) wells at Lethbridge, 6 gross (5.6 net) wells at Brazeau and 1 gross (0.29 net) wells at Rycroft for a 100 percent success rate compared to 4 gross (4.0 net) wells at Lethbridge for a 100 percent success rate a year ago.

## Liquidity and Capital Resources

### Working Capital

The following table summarizes the change in working capital during the six months ended June 30, 2012 and the year ended December 31, 2011:

	Six Months Ended June 30, 2012	Year Ended December 31, 2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>
Working capital (deficit) – beginning of period	(16,901)	28,505
Abandonment and reclamation costs	(108)	(116)
Funds from operations	15,593	11,833
Issue of capital stock for cash (net of share issue expenses)	16,027	122,434
Capital expenditures	(66,414)	(61,578)
Acquisitions	–	(125,979)
Proceeds from farm-outs	1,000	8,000
Working capital (deficit) – end of period	(50,803)	(16,901)

DeeThree entered 2012 with a working deficit of \$16,901,000. In March 2012, the Company issued 3,834,100 flow-through shares at a price of \$4.50 per flow-through share for total gross proceeds of \$17,253,450 (\$16,027,450 net of estimated share issue expenses). The proceeds of the flow-through share offering will be used by the Company to conduct exploration activity on its properties. During the period, the Company generated funds from operations of \$15,593,000 and invested a total of \$66,414,000 in capital. The Company also received \$1,000,000 as proceeds from a farm-out agreement entered into during the second quarter, which was recorded against E&E and partially offset the total capital expenditures for the period. DeeThree exited the period with a working deficit of \$50,803,000.

As at June 30, 2012, the Company had a revolving demand credit facility to \$60,000,000 with interest charged at the bank's prime rate plus a range of 1.0 percent to 1.25 percent per annum based on the Company's consolidated debt to cash flow ratio. Standby fees associated with this facility range from 0.40 percent to 0.70 percent per annum on the undrawn portion of the facility, again based on the Company's consolidated debt to cash flow ratio. As at June 30, 2012, \$36,870,000 was drawn against the facility. Collateral for this facility consists of a general security agreement, providing a security interest over all present and after acquired personal property, and a floating charge on all present and after acquired land interests of the Company. The facility is a subject to semi-annual reviews by the Company's lender with the next review scheduled for the fall of 2012.

DeeThree expects to fund future capital expenditures with its funds flow from operations and the unused demand credit facility.

### Related Party Transactions and Off-Balance Sheet Transactions

As at June 30, 2012, the Company had the following related party transactions:

The Company has retained a law firm to provide legal services. The Corporate Secretary of DeeThree is a partner of this firm. During the six months ended June 30, 2012, the Company incurred \$215,000 in costs with the firm (2011 – \$375,000), which have been included in G&A expenses and share issue costs, and \$32,400 (2011 – \$800) remained in accounts payable at June 30, 2012. Services provided related to advice and counsel primarily in the areas of general legal, corporate governance and banking matters. The Company expects to continue using the services of this firm throughout the balance of 2012.

All related party transactions were in the normal course of operations and have been measured at exchange amounts established and agreed to by the related parties and which are similar to those that the Company would expect to have negotiated with third parties in similar circumstances.

There were no off-balance sheet transactions entered into during the period nor were there any outstanding as at the date of this MD&A.

### Contractual Obligations and Commitments

Years Ended December 31,	2012	2013	2014	2015	Total
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Operating lease – office	320	640	640	800	2,400
Operating lease – equipment	108	76	17	–	201
Exploration expenditures (flow-through)	–	16,604	–	–	16,604
Drilling contracts	3,002	5,853	–	–	8,855
Bank debt	36,870	–	–	–	36,870
<b>Total</b>	<b>40,300</b>	<b>23,173</b>	<b>657</b>	<b>800</b>	<b>64,930</b>

As at June 30, 2012, the Company had contractual obligations for its office lease totaling approximately \$2,400,000 to March 2016. The head office lease obligations are comprised of the lease and includes parking and an estimate of occupancy costs of the Company's head office space. The Company also had contractual obligations for several vehicles totaling approximately \$201,000 to the end of 2014.

In connection with the issuance of flow-through shares by the Company during the first quarter of 2012, DeeThree is required to spend \$17,253,450 of eligible exploration expenditures by December 31, 2013. As at June 30, 2012, \$649,000 of these eligible exploration expenditures had been incurred. The remaining \$16,604,450 will be incurred during the rest of 2012 and 2013. These expenditures will be renounced to shareholders in January 2013 effective December 31, 2012.

In connection with the issuance of flow-through shares by the Company during the first quarter of 2011, DeeThree is required to spend \$15,450,000 of eligible exploration expenditures by December 31, 2012. As at June 30, 2012, 100 percent of the eligible exploration expenditures have been incurred. These expenditures were renounced to shareholders in January 2012 effective December 31, 2011.

During 2011, DeeThree entered into contracts for drilling rig services, and as at June 30, 2012, the Company had committed to using services totaling \$8,855,000 extending into 2013.

At June 30, 2012, the Company also had the obligation to repay the amount outstanding on the revolving demand credit facility, which was drawn to \$36,870,000 at period-end.

In connection with the acquisition of the Lethbridge property in November 2008, the Company had an operational commitment to drill 30 wells in the area covered in the agreement over a three-year period commencing November 14, 2008 (ten wells per year). In addition, DeeThree had committed to shoot four townships of seismic data over the same period (one township in year one, two townships in year two and one township in year three). The Company has fulfilled all of the commitments related to this agreement.

On April 13, 2010 and effective March 1, 2010, the Company executed a two-year extension to its primary lease agreement, which is part of a lease issuance, seismic and drilling commitment agreement. This extension involved a commitment to drill an additional 20 wells over the two-year period (ten wells per year) into the Mississippian horizon and was set to expire on November 15, 2013.

In May 2012, DeeThree extended the lease terms on its Lethbridge property for an additional two year term to November 30, 2015. In exchange for the lease extension, the Company surrendered approximately 50,000 acres while still retaining approximately 180,000 acres of what it feels is the most prospective acreage for Bakken reserves. DeeThree will retain all wells purchased under the original agreement on the surrendered lands and retain existing corresponding leases for producing/capable formations only. Also as part of the extension, and in place of the 20 well commitment from the April 13, 2010 agreement, the Company now has a commitment to drill 12 wells over the three year period (five wells in each of 2012 and 2013 and two wells in 2014). To the date of this MD&A, the Company has drilled six of the new commitment wells.

## Share Capital

As at August 13, 2012, the Company had 66,986,191 common shares outstanding and 5,881,058 stock options outstanding.

### Selected Quarterly Information <sup>(1)</sup>

Three Months Ended	Jun.30, 2012	Mar.31, 2012	Dec.31, 2011	Sep.30, 2011	Jun.30, 2011	Mar.31, 2011	Dec.31, 2010	Sep.30, 2010
<i>(000s, except per share amounts)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Oil and natural gas revenues	<b>18,437</b>	14,277	11,873	9,440	9,465	1,969	1,483	1,618
Funds from (used in) operations	<b>9,852</b>	5,741	4,094	3,795	4,777	(833)	8	462
Per share – basic	<b>0.15</b>	0.09	0.06	0.06	0.08	(0.02)	–	0.02
Per share – diluted	<b>0.14</b>	0.09	0.06	0.06	0.08	(0.02)	–	0.02
Cash flow from (used in) operating activities	<b>14,696</b>	4,064	754	8,910	2,299	(4,863)	(23)	687
Net income (loss)	<b>5,603</b>	(3,199)	(9,330)	(353)	(899)	(1,991)	(5,738)	(6,664)
Per share – basic and diluted	<b>0.08</b>	(0.05)	(0.15)	(0.01)	(0.01)	(0.05)	(0.23)	(0.29)
Total assets	<b>266,649</b>	240,124	213,239	206,885	195,267	192,682	65,334	52,336
Capital expenditures <sup>(2)</sup>	<b>29,699</b>	36,715	20,529	25,009	12,490	129,529	7,532	3,572
Working capital (deficit) <sup>(3)</sup>	<b>(50,803)</b>	(30,898)	(16,901)	(3,356)	17,871	20,659	28,505	20,668
Shareholders' equity	<b>185,207</b>	178,732	167,568	176,346	174,850	175,423	55,126	47,479
<b>Production</b>								
Natural gas ( <i>mcf/d</i> )	<b>8,687</b>	8,657	7,714	8,167	8,214	3,744	3,691	3,958
Crude oil ( <i>bbls/d</i> )	<b>2,091</b>	1,316	957	597	609	71	18	17
NGLs ( <i>bbls/d</i> )	<b>266</b>	283	161	177	189	18	1	1
Total ( <i>boe/d</i> )	<b>3,805</b>	3,042	2,403	2,135	2,167	713	635	678

(1) The selected quarterly information has been prepared in accordance with the accounting principles as contained in the notes to the unaudited interim financial statements, except for funds from (used in) operations, which is a non-prescribed measure under IFRS.

(2) Total capital expenditures, including acquisitions.

(3) Current assets less current liabilities, excluding current derivative financial instruments.

### Factors That Have Caused Variations over the Quarters

During the first quarter of 2011, DeeThree completed the acquisition of the Peace River and Brazeau properties that significantly increased the Company's revenues, funds from operations and cash flow in subsequent periods. DeeThree's production also increased significantly and shifted from an approximate 98 percent natural gas focus to approximately 63 percent natural gas and 37 percent crude oil and NGLs for the year ended December 31, 2011.

During 2012, the Company has been successful with an active drilling program primarily in the Lethbridge Bakken and Brazeau properties. Capital expenditures of \$66,414,000 in the first six months have resulted in 17 net (15.9 gross) wells drilled. This has contributed to a 76 percent year-over-year volume increase and a production split of 42 percent natural gas and 58 percent oil and NGLs for the six month period.

For the quarter ended June 30, 2012, the Company achieved an improved operating netback of \$30.86/boe, which is attributable to several factors. First, with a revised production split of 58 percent oil and NGLs and average production of 3,805 boe per day, the average realized price was \$53.25/boe. The Company has also seen a decrease in operating costs per barrel, both as a function of economies of scale from increased production and from positive improvements to operations (including expanding the battery and infrastructure owned and used in Lethbridge). The higher netbacks ultimately resulted in positive funds from operations of \$9,852,000 for the period.

Please refer to the "Financial and Operating Results" section and other sections of this MD&A for detailed discussions on variations during the comparative quarters and to DeeThree's previously issued interim and annual MD&A for changes in prior quarters.

### Critical Estimates

The preparation of the Company's financial statements requires management to adopt accounting policies that involve the use of significant estimates and assumptions. These estimates and assumptions are developed based on the best available information and are believed by management to be reasonable under the existing circumstances. New events or additional information may result in the revision of these estimates over time. The following discussion outlines some of the accounting policies and practices that are critical to determining DeeThree's financial results and a summary of the critical estimates and judgements used by DeeThree can be found in note 2 to the December 31, 2011 audited annual financial statements.

### Reserves Determination

The proved natural gas, crude oil and NGLs reserves that are used in determining DeeThree's depletion rates, the magnitude of the borrowing base available to the Company from its lender and the ceiling test are based on management's best estimates, and are subject to uncertainty. Through the use of geological, geophysical and engineering data, the reservoirs and deposits of natural gas, crude oil and NGLs are examined to determine quantities available for future production, given existing operations and economic conditions and technology. The evaluation of recoverable reserves is an ongoing process impacted by current production, continuing development activities and changing economic conditions as reflected in natural gas and crude oil prices. Consequently, the reserves are estimated, which are subject to variability. To assist with the reserves evaluation process, the Company employs the services of independent oil and gas reservoir engineers.

### Income Taxes

The determination of DeeThree's income and other tax liability requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from the liability estimated or recorded.

### Other Estimates

The accrual method of accounting will require management to incorporate certain estimates, including revenues, royalties, production costs and capital expenditures as at a specific reporting date but for which actual revenue and royalties have not yet been received, and estimates on capital projects that are in progress or recently completed where actual costs have not been received at a specific reporting date.

### Controls and Procedures

#### Disclosure Controls

Disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company is accumulated and communicated to management (including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO")) to allow timely decisions regarding required disclosure.

DeeThree's CEO and CFO have designed, or caused to be designed under their supervision, internal controls over financial reporting to provide reasonable assurance regarding the reliability of the Company's financial reporting and the preparation of financial statements for external purposes. Based on their evaluation, DeeThree's CEO and CFO have concluded that, as of December 31, 2011, the Company's internal controls and procedures over financial reporting were effective. DeeThree is required to disclose herein any change in the design of the Company's internal control over financial reporting that occurred during the period ended June 30, 2012 that has materially affected, or is reasonably likely to materially affect, DeeThree's internal control over financial reporting. DeeThree confirms that no such changes were made to its internal controls over financial reporting during the period.

#### Internal Controls over Financial Reporting

DeeThree is required to comply with Multilateral Instrument 52-109 – "Certification of Disclosure in Issuers' Annual and Interim Filings". The certificate of interim filings for the period ended June 30, 2012 requires that DeeThree disclose in the interim MD&A any changes in the Company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect DeeThree's internal control over financial reporting. DeeThree confirms that no such changes were made to internal controls over financial reporting during the period.

It should be noted that while DeeThree's CEO and CFO believe that the Company's internal controls and procedures provide a reasonable level of assurance and are effective, they do not expect that these controls will prevent all errors or 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.

#### **Accounting Standards Issued But Not Yet Applied**

IFRS 9 – "Financial Instruments" was issued by the IASB in November 2009 and was the first step to replace IAS 39 – "Financial Instruments: Recognition and Measurement". In October 2010, the requirements for classifying and measuring financial liabilities were added to IFRS 9. Under this guidance, entities would be required to reverse the portion of the fair value change due to a company's own credit risk out of earnings and recognize the change in other comprehensive income. IFRS 9 is effective for the Company on January 1, 2015. DeeThree is currently evaluating the impact of IFRS 9 on its financial statements and believes there will be no significant impact to the Company upon implementation of the standard.

IAS 12 – "Income Taxes" was amended on December 20, 2010 to remove subjectivity in determining on which basis an entity measures the deferred tax relating to an asset. The amendment introduces a presumption that an entity will assess whether the carrying value of an asset will be recovered through the sale of the asset. The amendment to IAS 12 is effective for reporting periods beginning on or after January 1, 2012. The Company is currently evaluating the impact of this amendment to IAS 12 on its financial statements.

IFRS 10 – "Consolidated Financial Statements" replaces IAS 27 – "Consolidated Separate Financial Statements". IFRS 10 introduces a single control model to assess whether to consolidate an investee. The standard was issued as part of a new suite of consolidation and related standards replacing existing requirements for joint ventures (now joint arrangements) and making limited amendments in relation to associates. The new requirements are effective in annual periods beginning on or after January 1, 2013. The Company is currently evaluating the impact of IFRS 10 and believes the standard will not be applicable to the preparation of its financial statements.

IFRS 11 and IAS 28 – "Joint Arrangements and Investments in Subsidiaries" were issued as part of its new suite of consolidation and related standards, replacing existing requirements for subsidiaries. Under IFRS 11 and IAS 28, classification of the joint arrangement depends on whether parties have rights to, and obligations for, underlying assets and liabilities; joint ventures are no longer allowed to use proportionate consolidation and must use equity accounting. The new requirements are effective in annual periods beginning on or after January 1, 2013. The Company is currently evaluating the impact of IFRS 9 and IAS 28 and believes the standard will not be applicable to the preparation of its financial statements.

IFRS 12 – "Disclosure of Interests in Other Entities" is a new standard, which combines all of the disclosure requirements for subsidiaries, associates and joint arrangements, as well as unconsolidated structured entities. The new requirements are effective in annual periods beginning on or after January 1, 2013. The Company is currently evaluating the impact of IFRS 12 and believes the standard will not be applicable to the preparation of its financial statements.

IFRS 13 – "Fair Value Measurement" is a new standard meant to clarify the definition of fair value, provide guidance on measuring fair value and improve disclosure requirements related to fair value measurement. DeeThree is currently evaluating the impact of IFRS 13 on its financial statements and believes there will be no significant impact to the Company upon implementation of the standard.



In June 2011, the IASB published amendments to IAS 1 – “Presentation of Financial Statements: Presentation of Items of Other Comprehensive Income”, which are effective for annual periods beginning on or after July 1, 2012 and are to be applied retrospectively. Early adoption is permitted. The amendments require that an entity present separately the items of other comprehensive income that may be reclassified to profit or loss in the future from those that would never be reclassified to profit or loss. The Company intends to adopt the amendments in its financial statements for the annual period beginning on January 1, 2013. As the amendments only require changes in the presentation of items in other comprehensive income, the Company does not expect the amendments to IAS 1 to have a material impact on the financial statements.

### **Business Risks and Risk Mitigation**

DeeThree’s exploration and production activities are concentrated in the Western Canadian Sedimentary Basin where the industry is very competitive. There are a number of risks facing participants in the oil and gas industry, some of which are common to all businesses, while others are specific to the sector. Such risks include finding and developing oil and natural gas reserves economically, estimating amounts of recoverable reserves, producing the reserves in commercial quantities, finding a suitable market at attractive commodity prices, financial and liquidity risks, and environmental and safety risks.

DeeThree mitigates these risks by utilizing a team of highly qualified professionals with expertise and experience in these areas. DeeThree attempts to maximize drilling success by exploring areas that have multi-zone horizons, targeting deeper horizons with uphole potential, continuously assessing new acquisition opportunities to complement existing activities and balancing higher risk exploratory drilling with lower risk development drilling.

Beyond exploration risk, there is the potential that the Company’s natural gas and crude oil reserves may not be economically produced at prevailing prices. DeeThree minimizes this risk by generating exploration prospects internally, targeting high quality projects, attempting to operate the project by accessing sales markets through Company owned infrastructure or mid-stream operators.

DeeThree has retained an independent engineering consulting firm that assists the Company in evaluating recoverable amounts of oil and natural gas reserves. Values of recoverable reserves are based on a number of variable factors and assumptions such as commodity prices, projected production, future production costs and governmental regulation. Consequently, estimates could vary from actual results.

DeeThree is exposed to commodity price risk whereby the fair value of future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian and United States dollars, but also global economic events that dictate the levels of supply and demand. The Company protects itself from fluctuations in prices by maintaining an appropriate hedging strategy. As at the date of this MD&A, DeeThree has seven crude oil hedges in place (see “Commodity Prices and Foreign Exchange” section). Most commodity prices are based on U.S. dollar benchmarks, which result in the Company’s realized prices being influenced by the Canadian/U.S. exchange rates. The Company does not sell or transact in foreign currency, but may be impacted by foreign currency exchange rate changes related to commodity prices as outlined above. At the date of this MD&A, DeeThree had three foreign currency exchange risk management contracts in place.

Credit risks arise from a counterparty failing to meet its obligations in accordance with the agreed upon terms. The Company may be exposed to third party credit risk through its contractual arrangements with its current or future joint venture partners, marketers of its commodities and other parties. DeeThree makes every effort to sell its commodities to major companies with excellent credit ratings.

The oil and natural gas industry is a very capital intensive industry, and in order to fully realize the Company's strategic goals and business plans, DeeThree will rely on equity markets as a source of new capital in addition to bank financing and internally generated cash flow to fund its ongoing capital investments. DeeThree's ability to raise additional capital will depend on a number of factors such as general economic and market conditions that are beyond the Company's control. Internally generated funds will also fluctuate with changing commodity prices. DeeThree anticipates it will continue to have adequate liquidity to fund its financial liabilities through its future funds from operations and available bank credit. DeeThree is committed to maintaining a strong balance sheet along with an adaptable capital expenditures program that can be adjusted to capitalize on, or reflect, acquisition opportunities and, if necessary, a tightening of liquidity sources. DeeThree has had no defaults or breaches on its bank debt or any of its financial liabilities.

There are numerous environmental risks associated with oil and natural gas exploration and production. Some of these risks can involve pollution of the environment and destruction of natural habitat as well as safety risks such as personal injury. DeeThree has established an Environmental, Health and Safety Program and has updated its operational emergency response plan and operational safety manual to address these operational issues. In addition, a comprehensive insurance program is maintained to mitigate risks and protect against significant losses where possible. DeeThree operates in accordance with all applicable environmental legislation and strives to maintain compliance with such regulations.

In addition, DeeThree is also subject to other risks and uncertainties which are described in the Company's Annual Information Form dated March 28, 2012.

### Outlook

DeeThree is well positioned to continue to deliver strong growth in its production, cash flow and reserves over the balance of 2012. Having already achieved its forecast 2012 year end production rate of 5,000 boe/d, the Board of Directors has approved an increase in DeeThree's 2012 capital expenditures budget from \$82 million to \$110 million.

DeeThree now anticipates to exit 2012 with a production rate of approximately 6,000 boe/d (76 percent oil and NGLs), up 20 percent from our previous guidance. Throughout the second half of 2012, DeeThree plans to deploy its capital primarily on its Lethbridge Alberta Bakken properties with plans to drill another 8 (8.0 net) wells prior to the year end. This expanded budget is fully funded through cash flow and funds available from its credit facility. The Company expects to exit 2012 with net debt of approximately \$60 - \$65 million and debt to fourth quarter annualized cash flow of approximately 0.8:1.0 times.

## STATEMENTS OF FINANCIAL POSITION

As at	June 30, 2012	December 31, 2011
<i>(000s)(unaudited)</i>	(\$)	(\$)
<b>Assets</b>		
<b>Current assets</b>		
Accounts receivable	14,920	15,906
Deposits and prepaid expenses	947	500
Derivative financial instruments <i>(note 12)</i>	2,864	–
	18,731	16,406
<b>Non-current assets</b>		
Exploration and evaluation assets <i>(note 5)</i>	25,343	18,631
Property and equipment <i>(note 6)</i>	221,230	176,562
Deferred tax asset	–	1,640
Long-term derivative financial instruments <i>(note 12)</i>	1,345	–
<b>Total assets</b>	<b>266,649</b>	<b>213,239</b>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Bank debt <i>(note 7)</i>	36,870	8,521
Accounts payable and accrued liabilities	29,800	24,786
Derivative financial instruments <i>(note 12)</i>	–	383
	66,670	33,690
<b>Non-current liabilities</b>		
Decommissioning liabilities <i>(note 8)</i>	11,200	10,363
Flow-through share premium liabilities <i>(note 9)</i>	2,583	973
Deferred tax liability	989	–
Long-term derivative financial instruments <i>(note 12)</i>	–	645
<b>Total liabilities</b>	<b>81,442</b>	<b>45,671</b>
<b>Shareholders' equity</b>		
Share capital <i>(note 9)</i>	210,555	196,901
Contributed surplus	4,332	2,751
Deficit	(29,680)	(32,084)
<b>Total shareholders' equity</b>	<b>185,207</b>	<b>167,568</b>
<b>Total liabilities and shareholders' equity</b>	<b>266,649</b>	<b>213,239</b>

### Commitments *(note 13)*

See accompanying notes to the financial statements.

## STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s, except per share amounts)(unaudited)</i>	(\$)	(\$)	(\$)	(\$)
<b>Revenue</b>				
Oil and natural gas revenues	18,437	9,465	32,714	11,434
Royalties	(3,413)	(1,489)	(6,150)	(1,757)
Oil and natural gas revenues, net of royalties	15,024	7,976	26,564	9,677
<b>Expenses</b>				
Operating and transportation	4,338	2,447	9,071	3,190
General and administrative	984	776	2,038	2,615
Depletion and depreciation <i>(note 6)</i>	6,898	4,244	12,850	5,115
Share-based compensation <i>(note 10)</i>	522	227	939	423
Exploration and evaluation expense <i>(note 5)</i>	1,388	–	2,520	–
	14,130	7,694	27,418	11,343
Unrealized gain on financial instruments	(7,066)	(92)	(5,237)	(92)
Realized gain on financial instruments	(430)	–	(606)	–
Accretion and finance expenses <i>(note 8)</i>	408	130	718	182
Finance income	–	(79)	–	(154)
	7,042	7,653	22,293	11,279
Income (loss) before income tax	7,982	323	4,271	(1,602)
<b>Taxes</b>				
Deferred income tax expense	2,379	1,222	1,867	1,288
<b>Net income (loss) and comprehensive income (loss) for the period</b>	<b>5,603</b>	<b>(899)</b>	<b>2,404</b>	<b>(2,890)</b>
<b>Deficit, beginning of period</b>	<b>(35,283)</b>	<b>(21,502)</b>	<b>(32,084)</b>	<b>(19,511)</b>
<b>Deficit, end of period</b>	<b>(29,680)</b>	<b>(22,401)</b>	<b>(29,680)</b>	<b>(22,401)</b>
Net income (loss) per share <i>(note 9)</i>				
Basic	0.08	(0.01)	0.04	(0.06)
Diluted	0.08	(0.01)	0.03	(0.06)

See accompanying notes to the financial statements.

## STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

	Share Capital	Contributed Surplus	Deficit	Total Equity
<i>(000s)(unaudited)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
<b>Balance – January 1, 2012</b>	<b>196,901</b>	<b>2,751</b>	<b>(32,084)</b>	<b>167,568</b>
Flow-through shares issued	17,253	–	–	17,253
Share issue costs	(1,226)	–	–	(1,226)
Tax benefit of share issue costs	311	–	–	311
Premium on flow-through shares	(2,684)	–	–	(2,684)
Share-based compensation	–	1,581	–	1,581
Net loss	–	–	2,404	2,404
<b>Balance – June 30, 2012</b>	<b>210,555</b>	<b>4,332</b>	<b>(29,680)</b>	<b>185,207</b>
Balance – January 1, 2011	73,530	1,107	(19,511)	55,126
Common shares issued	115,219	–	–	115,219
Flow-through shares issued	15,450	–	–	15,450
Share issue costs	(8,276)	–	–	(8,276)
Tax benefit of share issue costs	2,094	–	–	2,094
Premium on flow-through shares	(2,550)	–	–	(2,550)
Share-based compensation	–	629	–	629
Exercise of options	58	(10)	–	48
Net loss	–	–	(2,890)	(2,890)
Balance – June 30, 2011	195,525	1,726	(22,401)	174,850

See accompanying notes to the financial statements.

## STATEMENTS OF CASH FLOWS

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s)(unaudited)</i>	(\$)	(\$)	(\$)	(\$)
<b>Cash flow from (used in):</b>				
<b>Operating activities</b>				
Net income (loss) for the period	5,603	(899)	2,404	(2,890)
Adjustments for:				
Depletion and depreciation	6,898	4,244	12,850	5,115
Deferred income tax expense	2,379	1,222	1,867	1,288
Share-based compensation	553	237	997	433
Accretion <i>(note 8)</i>	97	65	192	90
Unrealized gain on financial instruments	(7,066)	(92)	(5,237)	(92)
Exploration and evaluation expense	1,388	–	2,520	–
Change in non-cash working capital <i>(note 11)</i>	4,844	(2,478)	3,167	(6,508)
	<b>14,696</b>	<b>2,299</b>	<b>18,760</b>	<b>(2,564)</b>
<b>Financing activities</b>				
Increase in bank debt	23,616	–	28,349	–
Issuance of share capital	–	–	17,253	130,717
Share issue expenses	16	(76)	(1,226)	(8,276)
Changes in non-cash working capital <i>(note 11)</i>	(48)	–	50	–
	<b>23,584</b>	<b>(76)</b>	<b>44,426</b>	<b>122,441</b>
<b>Investing activities</b>				
Property and equipment expenditures	(28,156)	(78)	(56,362)	1,248
Exploration and evaluation expenditures	(1,543)	(10,514)	(10,052)	(18,822)
Proceeds from farm-outs <i>(note 5)</i>	–	5,000	1,000	5,000
Property acquisitions <i>(note 4)</i>	–	(1,898)	–	(124,445)
Changes in non-cash working capital <i>(note 11)</i>	(8,581)	5,813	2,228	6,124
	<b>(38,280)</b>	<b>(1,677)</b>	<b>(63,186)</b>	<b>(130,895)</b>
<b>Change in cash and cash equivalents</b>	<b>–</b>	<b>546</b>	<b>–</b>	<b>(11,018)</b>
<b>Cash and cash equivalents – beginning of period</b>	<b>–</b>	<b>21,430</b>	<b>–</b>	<b>32,994</b>
<b>Cash and cash equivalents – end of period</b>	<b>–</b>	<b>21,976</b>	<b>–</b>	<b>21,976</b>

See accompanying notes to the financial statements.

# NOTES TO THE FINANCIAL STATEMENTS

As at and for the period ended June 30, 2012  
(unaudited)

## 1. Reporting Entity

DeeThree Exploration Ltd. ("DeeThree" or the "Company") is a publicly traded company incorporated under the laws of Alberta. The Company is principally engaged in the exploration for and exploitation, development and production of oil and natural gas, and conducts many of its activities jointly with others. These interim financial statements reflect only the Company's interests in such activities. DeeThree is registered and domiciled in Canada. The address of its main office is Suite 2200, 520 Third Avenue S.W., Calgary, Alberta.

## 2. Basis of Presentation

### Statement of Compliance

These interim financial statements for the three and six months ended June 30, 2012 are unaudited and have been prepared in accordance with International Accounting Standard ("IAS") 34 – "Interim Financial Reporting" using accounting policies consistent with IFRS.

The interim financial statements should be read in conjunction with the Company's annual audited financial statements for the year ended December 31, 2011.

The interim financial statements were authorized for issue by the Board of Directors on August 13, 2012.

## 3. Significant Accounting Policies

The Company's accounting policies are described in Note 3 to the December 31, 2011 audited annual financial statements. Those accounting policies have been applied consistently to all periods presented in these interim financial statements.

## 4. Acquisitions

During the first quarter of 2011, the Company acquired oil and gas assets principally located in the Peace River Arch area of northern Alberta and the Brazeau area of central Alberta for total cash consideration of \$123,185,000. The property acquisition closed on March 22, 2011 and was accounted for as a business combination under IFRS 3 – "Business Combinations". Acquisition costs of \$1,125,000 were charged to general and administrative expense on the statement of income and comprehensive income. Had the acquisition closed January 1, 2011, for the year ended December 31, 2011, the Company estimates that its pro forma revenue and net loss would have been approximately \$39,200,000 and \$13,064,000, respectively.

(000s)	(\$)
<b>Net assets acquired</b>	
Petroleum and natural gas assets	122,081
E&E assets	7,773
Adjustments related to January 1 to March 22, 2011 period	(1,815)
Decommissioning liabilities	(4,854)
	123,185
<b>Consideration</b>	
Total cash consideration	123,185

## 5. Exploration and Evaluation Assets

	Three Months Ended June 30, 2012	Year Ended December 31, 2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>
Balance – beginning of period	18,631	11,052
Additions	60,477	57,010
Proceeds from farm-outs	(1,000)	(8,000)
Acquisitions through business combinations	–	8,249
Transfers to property and equipment	(50,245)	(41,693)
E&E expenses	–	(7,474)
Lease expiries	(2,520)	(513)
Balance – end of period	25,343	18,631

During the period ended June 30, 2012, an expense of \$2,520,000 was recorded to recognize lease expiries on undeveloped land that occurred during the period (year ended December 31, 2011 - \$513,000).

## 6. Property and Equipment

	Oil and Natural Gas Properties	Office Equipment	Total
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Cost or deemed cost			
<b>Balance – January 1, 2011</b>	37,692	59	37,751
Acquisitions through business combinations	122,883	–	122,883
Additions	8,926	194	9,120
Transfers from E&E assets	41,693	–	41,693
Balance – December 31, 2011	211,194	253	211,447
Additions	7,254	19	7,273
Transfers from E&E assets	50,245	–	50,245
<b>Balance – June 30, 2012</b>	<b>268,693</b>	<b>272</b>	<b>268,965</b>
Accumulated depletion and depreciation			
Balance – January 1, 2011	19,970	23	19,993
Depletion and depreciation for the year	14,871	21	14,892
Balance – December 31, 2011	34,841	44	34,885
Depletion and depreciation for the period	12,829	21	12,850
<b>Balance – June 30, 2012</b>	<b>47,670</b>	<b>65</b>	<b>47,735</b>
<b>Net book value</b>			
December 31, 2011	176,353	209	176,562
<b>June 30, 2012</b>	<b>221,023</b>	<b>207</b>	<b>221,230</b>

### (a) Capitalization of General and Administrative and Share-Based Compensation Expenses

During the six months ended June 30, 2012, approximately \$753,000 of directly attributable general and administrative expense and \$584,000 of directly attributable share-based compensation expense were capitalized as expenditures on property and equipment (year ended December 31, 2011 – \$884,000 and \$576,000, respectively).

### (b) Amortization and Impairment Charges

For the period ended June 30, 2012, management performed an assessment and determined that no impairment indicators existed as of June 30, 2012.



### (c) Future Development Costs and Salvage Value

During the six months ended June 30, 2012, an estimated \$10,877,000 of future development costs associated with proved plus probable undeveloped reserves was included in the calculation of depletion and depreciation expense and an estimated \$2,821,000 of salvage value of production equipment was excluded (December 31, 2011 – \$44,747,000 and \$2,791,000, respectively).

## 7. Bank Debt

At June 30, 2012, the Company had a revolving demand credit facility with an authorized borrowing base of \$60,000,000 with interest charged at the bank's prime rate plus a range of 1.0 percent to 1.25 percent per annum based on the Company's consolidated debt to cash flow ratio. Standby fees associated with this facility range from 0.4 percent to 0.7 percent per annum on the undrawn portion of the facility, again based on the Company's consolidated debt to cash flow ratio. At June 30, 2012, \$36,870,000 (December 31, 2011 – \$8,521,000) was drawn against the revolving demand credit facility. The next semi-annual review of the credit facility is scheduled for the fall of 2012. The amount of the facility is subject to a borrowing base test performed on a periodic basis by the lenders, based primarily on reserves and using commodity prices estimated by the lenders as well as other factors. A decrease in the borrowing base could result in a reduction to the credit facility. Collateral for this facility consists of a general security agreement, providing a security interest over all present and after acquired personal property and a floating charge on all present and after acquired land interests of the Company.

## 8. Decommissioning Liabilities

The Company has estimated the net present value of decommissioning obligations to be \$11,200,000 as at June 30, 2012 (December 31, 2011 – \$10,363,000) based on an undiscounted total future liability of \$16,154,000 (December 31, 2011 – \$14,398,000). These payments are expected to be incurred over a period of one to 20 years with the majority of costs to be incurred between 2013 and 2026. At June 30, 2012, a risk-free rate of 3.5 percent (December 31, 2011 – 3.5 percent) and an inflation rate of 2 percent (December 31, 2011 – 2 percent) were used to calculate the net present value of the decommissioning liabilities.

	Six Months Ended June 30, 2012	Year Ended December 31, 2011
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>
Balance – beginning of period	10,363	2,498
Liabilities incurred	720	538
Liabilities acquired	–	5,154
Revisions	33	2,055
Settlements	(108)	(116)
Accretion of decommissioning liabilities	192	234
Balance – end of period	11,200	10,363

## 9. Share Capital

### (a) Authorized

Unlimited number of common voting shares, no par value.

Unlimited number of preferred shares, no par value, issuable in series.

(b) Issued – Common Shares

	Six Months Ended June 30, 2012		Year Ended December 31, 2011	
	Shares	Amount	Shares	Amount
	(#)	(\$000s)	(#)	(\$000s)
Balance – beginning of period	63,152,091	196,901	32,937,091	73,530
Common shares issued (i)	–	–	27,195,000	116,602
Flow-through shares issued (ii)	3,834,100	17,253	3,000,000	15,450
Premium on flow-through shares (ii)	–	(2,684)	–	(2,550)
Exercise of options (iii)	–	–	20,000	58
Share issue costs	–	(1,226)	–	(8,283)
Tax benefit of share issue costs	–	311	–	2,094
Balance – end of period	66,986,191	210,555	63,152,091	196,901

(i) *Common Share Issuances*

In July 2011, DeeThree issued 400,000 common shares at a price of \$3.46 per common share in exchange for approximately 12,800 net acres of undeveloped land located primarily in the Peace River Arch area of Alberta. Share issue expenses of approximately \$7,000 were recorded in relation to this transaction and the value of the acquired land has been included in the Company's E&E balance at December 31, 2011.

In March 2011, DeeThree issued 26,795,000 common shares at a price of \$4.30 per common share for total gross proceeds of \$115,219,000 (\$107,934,000 net of share issue expenses), including 3,495,000 common shares (\$15,029,000) issued on the exercise in full of the underwriters' over-allotment option.

(ii) *Flow-Through Share Issuances*

In March 2012, DeeThree issued 3,834,100 flow-through shares at a price of \$4.50 per flow-through share for total gross proceeds of \$17,253,450 (\$16,027,450 net of estimated share issue expenses), including 500,100 flow-through shares (\$2,250,450) issued on the exercise in full of the underwriters' over-allotment option. The implied premium on the flow through shares of \$0.70 per share or \$2,683,870 was initially recorded as a liability on the statement of financial position and \$2,583,000 remains at June 30, 2012. To date, the Company has incurred \$649,000 of the total \$17,253,450 of qualified exploration and development expenditures and the remainder will be spent by December 31, 2013.

In March 2011, DeeThree issued 3,000,000 flow-through shares at a price of \$5.15 per flow-through share for total gross proceeds of \$15,450,000 (\$14,460,000 net of share issue expenses) and \$0.85 per share or \$2,550,000 was determined to be the implied premium on the flow-through shares. As at June 30, 2012, \$nil of the flow-through share premium remains on the statement of financial position as a liability as the Company fulfilled this commitment for qualified exploration and development expenditures during the second quarter.

(iii) *Options Exercises*

On January 6, 2011, 10,000 options were exercised at a weighted average price of \$2.45 per share and on March 16, 2011, 10,000 options were exercised at a weighted average price of \$2.29 per share for total cash proceeds of \$48,000 and previously recognized share-based compensation expense of \$10,000.

### (c) Per Share Amounts

Per share amounts have been calculated on the weighted average number of shares outstanding. The basic and diluted shares outstanding were as follows:

	Six Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<i>(000s, except per share amounts)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Income (loss) for the period	<b>5,603</b>	(899)	<b>2,404</b>	(2,890)
	<i>(#)</i>	<i>(#)</i>	<i>(#)</i>	<i>(#)</i>
Weighted average number of common shares				
– basic	<b>66,986</b>	62,752	<b>65,153</b>	49,596
– diluted	<b>70,161</b>	62,752	<b>69,484</b>	49,596
	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Net income (loss) per weighted average common share				
– basic	<b>0.08</b>	(0.01)	<b>0.04</b>	(0.06)
– diluted	<b>0.08</b>	(0.01)	<b>0.03</b>	(0.06)

## 10. Share-Based Compensation

The Company has an option program that entitles officers, directors, employees and certain consultants to purchase shares in the Company. Options are granted based on the five-day volume weighted average prior to the date of grant, vest 20 percent after six months and then 20 percent on the first, second, third and fourth anniversaries from the grant date and expire five years from the grant date.

The number and weighted average exercise prices of stock options are as follows:

	Six Months Ended June 30, 2012		Year Ended December 31, 2011	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
	<i>(#)</i>	<i>(\$)</i>	<i>(#)</i>	<i>(\$)</i>
Outstanding – January 1	<b>4,382,200</b>	<b>2.89</b>	1,885,000	2.26
Issued	<b>1,500,058</b>	<b>3.84</b>	2,603,000	3.35
Exercised	–	–	(20,000)	2.37
Forfeited	<b>(1,200)</b>	<b>4.22</b>	(85,800)	3.00
Outstanding – end of period	<b>5,881,058</b>	<b>3.13</b>	4,382,200	2.89
Exercisable – end of period	<b>1,947,400</b>	<b>2.69</b>	1,177,900	2.57

The fair value of the common share purchase options granted was estimated as at the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

Weighted Average Exercise Price	Options Outstanding	Weighted Average Contractual Life	Options Exercisable
(\$)	(#)	(years)	(#)
<b>As at June 30, 2012</b>			
<b>1.20 – 1.99</b>	<b>200,000</b>	<b>0.92</b>	<b>200,000</b>
<b>2.00 – 2.99</b>	<b>2,970,000</b>	<b>3.42</b>	<b>1,219,500</b>
<b>3.00 – 3.99</b>	<b>1,102,500</b>	<b>4.57</b>	<b>32,500</b>
<b>4.00 – 4.63</b>	<b>1,608,558</b>	<b>4.08</b>	<b>495,400</b>
	<b>5,881,058</b>	<b>3.73</b>	<b>1,947,400</b>

The fair value of the common share purchase options granted during the year was estimated as at the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

As at	June 30, 2012	December 31, 2011
Risk-free interest rate (%)	1.22	1.48
Expected life (years)	3.1	2.1
Expected volatility (%)	77	77
Expected dividend yield (%)	0	0
Fair value of options granted during the year (\$/share)	1.94	1.39

A forfeiture rate of 0 percent for those options granted during the period ended June 30, 2012 (year ended December 31, 2011 – 0 percent) was used when recording share-based compensation expense. This estimate is adjusted to the actual forfeiture rate. Share-based compensation cost of \$939,000 was expensed during the six months ended June 30, 2012 (year ended December 31, 2011 – \$1,030,000).

## 11. Supplemented Cash Flow Information

Changes in non-cash working capital is comprised of:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
(000s)	(\$)	(\$)	(\$)	(\$)
Accounts receivable	(1,458)	(829)	986	(5,056)
Prepaid expenses and other	(551)	(254)	(447)	(225)
Accounts payable and accrued liabilities	(1,702)	4,418	5,014	4,897
Abandonment and reclamation costs	(74)	–	(108)	–
	<b>(3,785)</b>	<b>3,335</b>	<b>5,445</b>	<b>(384)</b>
Related to operating activities	<b>4,844</b>	<b>(2,478)</b>	<b>3,167</b>	<b>(6,508)</b>
Related to financing activities	<b>(48)</b>	<b>–</b>	<b>50</b>	<b>–</b>
Related to investing activities	<b>(8,581)</b>	<b>5,813</b>	<b>2,228</b>	<b>6,124</b>
	<b>(3,785)</b>	<b>3,335</b>	<b>5,445</b>	<b>(384)</b>

## 12. Financial Risk Management

The Company has exposure to credit, liquidity and market risk. The Company's risk management policies are established to identify and analyze the risks faced by the Company, set appropriate limits and controls, and to monitor risks and adherence to market conditions and the Company's activities.

**(a) Risk Management Contracts**

The fair value of forward contracts is determined by discounting the difference between the contracted prices and published forward price curves as at the reporting date, using the remaining contracted oil and natural gas volumes and a risk-free interest rate (based on published government rates). The fair value of options is based on option models that use published information with respect to volatility, prices and interest rates.

DeeThree classifies the fair value of these transactions according to the following hierarchy based on the amount of observable inputs used to value the instrument.

- Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices are either directly or indirectly observable as of the reporting date. Level 2 valuations are based on inputs, including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace.
- Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

The carrying value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities and bank debt included in the statement of financial position approximate fair value due to the short-term nature of those instruments or, in the case of bank debt, due to the interest rate applied. The fair value measurement of the derivative financial instruments has a fair value hierarchy of Level 2.

As at June 30, 2012, the Company had the following crude oil and foreign exchange risk management contracts in place with a total mark-to-market asset value of \$4,209,000 (\$2,864,000 current and \$1,345,000 non-current):

Period	Commodity	Type of Contract	Quantity	Pricing Point	Contract Price
Jan.1/12 – Dec.31/12	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$95.00/bbl (floor) – US\$115.00/bbl (cap) <sup>(1)</sup>
Jan.1/12 – Dec.31/12	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$85.00/bbl (floor) – US\$112.50/bbl (cap) <sup>(2)</sup>
Jan.1/12 – Dec.31/12	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$90.00/bbl (floor) – US\$116.60/bbl (cap) <sup>(3)</sup>
Jan.1/13 – Dec.31/13	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$85.00/bbl (floor) – US\$111.00/bbl (cap) <sup>(4)</sup>
Jan.1/13 – Dec.31/13	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$90.00/bbl (floor) – US\$113.25/bbl (cap) <sup>(5)</sup>
Jan.1/13 – Dec.31/13	Crude oil	Collar	250 bbls/d	WTI – NYMEX	US\$90.00/bbl (floor) – US\$116.25/bbl (cap) <sup>(6)</sup>
May.1/12 – Dec.31/13	Crude oil	Collar	250 bbls/d	WTI-NYMEX	US\$95.00/bbl (floor) – US\$118.00/bbl (cap) <sup>(7)</sup>

(1) Unless the monthly WTI price averages over US\$115.00/bbl every day for the entire month, in which case the cap becomes US\$100.00/bbl.

(2) Unless the monthly WTI price averages over US\$112.50/bbl every day for the entire month, in which case the cap becomes US\$95.00/bbl.

(3) Unless the monthly WTI price averages over US\$116.60/bbl every day for the entire month, in which case the cap becomes US\$95.00/bbl.

(4) Unless the monthly WTI price averages over US\$111.00/bbl every day for the entire month, in which case the cap becomes US\$90.00/bbl.

(5) Unless the monthly WTI price averages over US\$113.25/bbl every day for the entire month, in which case the cap becomes US\$92.00/bbl.

(6) Unless the monthly WTI price averages over US\$116.25/bbl every day for the entire month, in which case the cap becomes US\$92.00/bbl.

(7) Unless the monthly WTI price averages over US\$118.00/bbl every day for the entire month, in which case the cap becomes US\$100.00/bbl.

Period	Currency	Type of Contract	Quantity	Pricing Point (CDN\$/US\$)
Jan.1/12 – Dec. 31/12	US\$	Average Rate Participating Forward	US\$1,400,000	Strike – \$1.0275 Fade In – \$0.9300 Participating – \$1.0800 <sup>(1)</sup>
Jan.1/12 – Dec.31/13	US\$	Average Rate Range Bonus Accumulator	US\$700,000	Target – \$1.10 CDN\$/US\$ + \$1,000 bonus/day <sup>(2)</sup>
Jun.1/12 – Dec.31/13	US\$	Average Rate Range Bonus Accumulator	US\$900,000	Target – \$1.0775 CDN\$/US\$ + \$900 bonus/day <sup>(3)</sup>

(1) If the Bank of Canada average daily noon rate (“average rate”) for the month is equal to or greater than the fade in level and equal to or less than the strike, the Company is committed to sell U.S. dollars at the strike price. If the average rate settles greater than the strike and equal to or less than the participating level, no transaction occurs. If the average rate for the month settles above the participating level, the Company is obligated to settle at the strike price and if the average rate settles less than the fade in level, no transaction occurs.

(2) The Company can earn a bonus payout of up to \$1,000/day depending on the period in which the exchange rate remains in the applicable range of equal to or greater than \$0.9350 and equal to or less than \$1.10.

(3) The Company can earn a bonus payout of up to \$900/day depending on the period in which the exchange rate remains in the applicable range of equal to or greater than \$0.9300 and equal to or less than \$1.0775.

## (b) Capital Management

The Company manages its capital to maintain its ability to continue as a going concern and to provide returns to shareholders and benefits to other stakeholders. The capital structure of the Company consists of cash and cash equivalents, bank debt and equity comprising of issued share capital, contributed surplus and deficit.

The following is a breakdown of the Company’s capital structure:

As at	June 30, 2012	December 31, 2011
(000s)	(\$)	(\$)
Cash and cash equivalents	–	–
Bank debt	36,870	8,521
Shareholders’ equity	185,207	167,568

The Company manages its capital structure and makes adjustments to it in light of economic conditions. In order to maintain or adjust capital structure, DeeThree may issue new common shares, issue new debt, adjust exploration and development capital expenditures or acquire or dispose of assets. In the second quarter of 2012, the Company increased its revolving demand credit facility to an authorized borrowing base of \$60,000,000. During the first quarter of 2012, the Company issued 3,834,100 flow-through shares at a price of \$4.50 per flow-through share, including 500,100 flow-through shares issued on the exercise in full of the underwriters’ over-allotment option. During 2011, the Company issued 26,795,000 common shares at a price of \$4.30 per share, 3,000,000 flow-through shares at a price of \$5.15 per share and 400,000 common shares at a price of \$3.46 per share in exchange for approximately 12,800 net acres of undeveloped land. The Company, upon approval from its Board of Directors, will balance its overall capital structure through new share issues, the issue of debt or by undertaking other activities as deemed appropriate under the specific circumstances.

DeeThree does not have any externally imposed financial covenants governing its capital structure. The current credit facility has no financial ratio covenants; however, there are certain covenants in the agreement with respect to restrictions to significantly altering the Company’s capital structure without the approval of the lender.

The Company’s overall strategy with respect to capital risk management remains unchanged from the year ended December 31, 2011.

### 13. Commitments

Years Ended December 31,	2012	2013	2014	2015+	Total
<i>(000s)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
Operating lease – office	320	640	640	800	2,400
Operating lease – equipment	108	76	17	–	201
Exploration expenditures (flow-through)	–	16,604	–	–	16,604
Drilling contracts	3,002	5,853	–	–	8,855
Bank debt	36,870	–	–	–	36,870
Total	40,300	23,173	657	800	64,930

In connection with the issuance of flow-through shares by the Company during the first quarter of 2012, DeeThree is required to spend \$17,253,450 of eligible exploration expenditures by December 31, 2013. As at June 30, 2012, \$649,000 of these eligible exploration expenditures has been incurred. The remaining \$16,604,450 of eligible expenditures will be incurred during 2012 and 2013. These expenditures will be renounced to shareholders in January 2013 effective December 31, 2012.

In connection with the issuance of flow-through shares by the Company during the first quarter of 2011, DeeThree was required to spend \$15,450,000 of eligible exploration expenditures by December 31, 2012. As at June 30, 2012, 100 percent of those eligible exploration expenditures have been incurred and the commitment has been fulfilled. These expenditures were renounced to shareholders in January 2012 effective December 31, 2011.

At June 30, 2012, the Company also had the obligation to repay the amount outstanding on the revolving demand credit facility, which was drawn to \$36,870,000 at period-end.

# CORPORATE INFORMATION

## Board of Directors

**Michael Kabanuk**  
Executive Chairman  
DeeThree Exploration Ltd.

**Brendan Carrigy**  
Independent Businessman

**Martin Cheyne**  
President & Chief Executive Officer  
DeeThree Exploration Ltd.

**Henry Hamm** <sup>(1)(2)(3)</sup>  
Independent Businessman

**Dennis Nerland** <sup>(1)(2)(3)</sup>  
Partner  
Shea Nerland Calnan LLP

**Brad Porter** <sup>(1)(2)(3)</sup>  
Independent Businessman

- <sup>(1)</sup> Audit Committee Member
- <sup>(2)</sup> Reserves Committee Member
- <sup>(3)</sup> Corporate Governance & Compensation Committee Member

## Officers

**Martin Cheyne**  
President & Chief Executive Officer

**Gail Hannon**  
Chief Financial Officer

**Trevor Murray**  
Vice President, Land

**Clayton Thatcher**  
Vice President, Exploration

**Daniel Kenney**  
Corporate Secretary

## Head Office

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Facsimile: (403) 263-9710  
Website: [www.deethree.ca](http://www.deethree.ca)

## Auditors

KPMG LLP  
Calgary, Alberta

## Banker

Canadian Imperial Bank of Commerce  
Calgary, Alberta

## Evaluation Engineers

Sproule Associates Limited  
Calgary, Alberta

## Legal Counsel

Davis LLP  
Calgary, Alberta

## Registrar and Transfer Agent

Olympia Trust Company  
Calgary, Alberta

## Stock Trading

Toronto Stock Exchange  
Trading Symbol: DTX

OTCQX  
Trading Symbol: DTHRF



## Abbreviations

bbls	barrels
boe	barrels of oil equivalent
GJ	gigajoules
/d	per day
mbbls	thousand barrels
mboe	thousand barrels of oil equivalent
mcf	thousand cubic feet
mm	million
mmbtu	million British thermal units
mmcf	million cubic feet
NGLs	natural gas liquids

## Conversion of Units

1,0 mcf	=	1.02 mmbtu
1.0 mcf	=	1.05 GJ
1.0 acre	=	0.40 hectares
2.5 acres	=	1.0 hectare
1.0 bbl	=	0.159 cubic metres
6.29 bbls	=	1.0 cubic metre
1.0 foot	=	0.3048 metres
3.281 feet	=	1.0 metre
1.0 mcf	=	28.2 cubic metres
0.035 mcf	=	1.0 cubic metre
1.0 mile	=	1.61 kilometres
0.62 miles	=	1.0 kilometre

Natural gas is equated to oil on the basis of 6 mcf : 1 bbl



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