



GALLEON ENERGY INC.

THIRD QUARTER REPORT 2004



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Report to Shareholders

In the third quarter of 2004, Galleon:

- *Increased average production to 1,781 Boe/d — a 27% increase over the second quarter production and a 13% increase on a per share basis*
- *Drilled 12 wells in the third quarter with 6 cased for production*
- *Acquired a private company with properties in the Two Rivers and Flatrock areas of the Peace River Arch thereby increasing drilling opportunities, production and control of infrastructure*
- *Increased the owned and identified drilling locations in the Peace River Arch to 80*
- *Closed an \$8 per share, \$24 million, private placement equity financing*
- *Increased available bank lines to \$25 million*

Subsequent to the third quarter of 2004, Galleon:

- *Signed an agreement to acquire in the Dawson area, 1,100 Boe/d of production, strategic infrastructure with eight gas plants, 91 miles of gas gathering systems and approximately 98,000 net acres of undeveloped land. Closing is expected by mid December 2004.*
- *Announced a bought deal \$15 million flow through financing at \$15 per share which is expected to close on November 23, 2004*
- *Increased owned undeveloped land to over 170,000 net acres with total access in the Peace River Arch area exceeding 416,000 gross acres.*

Excellent progress has been made on growing your company since we last reported to you on August 19, 2004. While weather in the third quarter slowed drilling operations and hampered production, Galleon is on target to exit the year with 4,100 Boe/d. The addition of properties at Two Rivers and Flatrock combined with the recent acquisition at Dawson helps to ensure strong, stable and predictable growth on a per share basis. Galleon continues to pursue consolidation through both farm-in and acquisitions in its operating areas. The fourth quarter drilling program will include 15 to 20 wells and to date the program is going very well.

We thank you for your support and look forward to reporting on the ongoing drilling results.

[Signed]

*Glenn R. Carley
Chairman and Chief Executive Officer*

November 18, 2004

[Signed]

*Steve Sugianto
President and Chief Operating Officer*

Highlights

| <i>As at September 30, 2004</i> | <i>Q3 2004</i> | <i>Q2 2004</i> | <i>Q1 2004</i> | <i>Q4 2003</i> | <i>Q3 2003</i> | <i>Q2 2003</i> |
|---|----------------|----------------|----------------|----------------|----------------|----------------|
| Production | | | | | | |
| Light oil (Bbl/d) | 92 | 84 | 56 | – | – | – |
| Heavy/Medium oil (Bbl/d) | 297 | 274 | 265 | 152 | – | – |
| Natural Gas (Mcf/d) | 8,272 | 6,328 | 2,841 | 42 | – | – |
| Liquids (Bbl/d) | 13 | 1 | 1 | – | – | – |
| Boe/d at 6:1 gas | 1,781 | 1,414 | 796 | 159 | – | – |
| Total Boe produced | 163,812 | 128,667 | 72,378 | 14,615 | – | – |
| Daily Boe of production per million Class A shares | 90 | 80 | 55 | 19 | – | – |
| Prices | | | | | | |
| Light oil (\$/Bbl) | 55.69 | 49.40 | 45.26 | – | – | – |
| Heavy/medium oil (\$/Bbl) | 35.30 | 29.70 | 27.56 | 24.61 | – | – |
| Crude oil with hedge (\$/Bbl) | 35.87 | 28.57 | 26.48 | 23.79 | – | – |
| Natural Gas (\$/Mcf) | 5.83 | 6.67 | 5.71 | 6.41 | – | – |
| NGLs (\$/Bbl) | 47.92 | 34.78 | 42.88 | – | – | – |
| Per Boe (\$) | | | | | | |
| Gross revenues (net of hedges and transportation costs) | 35.27 | 37.10 | 31.13 | 24.43 | – | – |
| Royalties, net of ARTC | (7.79) | (8.10) | (6.56) | (5.41) | – | – |
| Operating costs | (5.77) | (5.43) | (7.08) | (11.65) | – | – |
| Operating netback | 21.71 | 23.57 | 17.49 | 7.37 | – | – |
| Other revenue | 0.03 | 0.03 | 0.13 | 5.80 | – | – |
| G&A | (2.96) | (4.07) | (4.61) | (14.12) | – | – |
| Interest – cash | (0.18) | (0.28) | (0.07) | – | – | – |
| Current tax – cash | (0.28) | (0.58) | – | – | – | – |
| Cash flow from (used in) operations | 18.32 | 18.67 | 12.94 | (0.95) | – | – |

| <i>As at September 30, 2004</i> | <i>Q3 2004</i> | <i>Q2 2004</i> | <i>Q1 2004</i> | <i>Q4 2003</i> | <i>Q3 2003</i> | <i>Q2 2003</i> |
|---|----------------|----------------|----------------|----------------|----------------|----------------|
| Financial (\$) | | | | | | |
| Gross revenues (net of hedges and transportation costs) | 5,778,082 | 4,773,723 | 2,253,149 | 357,090 | – | – |
| Royalties, net of ARTC | (1,275,588) | (1,042,773) | (474,615) | (79,087) | – | – |
| Operating costs | (945,635) | (699,145) | (512,095) | (170,317) | – | – |
| Other revenue | 4,708 | 4,706 | 9,373 | 84,836 | 31,181 | 13,455 |
| G&A | (484,804) | (523,263) | (333,500) | (206,481) | (112,842) | (32,787) |
| Interest – cash | (30,245) | (35,681) | (5,599) | – | – | – |
| Current tax – cash | (46,190) | (75,111) | – | – | – | – |
| Cash flow from (used in) operations | 3,000,328 | 2,402,456 | 936,713 | (13,959) | (81,661) | (19,332) |
| Depletion, depreciation & accretion | (2,276,487) | (1,335,956) | (763,207) | (170,472) | (39,016) | (6,054) |
| Future tax (expense) recovery | (229,437) | (484,515) | 37,394 | 94,008 | – | – |
| Stock-based compensation | (187,289) | (122,238) | (87,720) | – | – | – |
| Earnings (loss) | 307,115 | 459,747 | 123,180 | (90,423) | (120,677) | (25,386) |
| Total assets | 90,698,030 | 60,289,729 | 47,029,699 | 15,075,622 | 10,471,707 | 875,571 |
| Long term financial liabilities | – | – | – | – | – | – |
| Weighted average outstanding Class A shares-basic | 19,733,778 | 16,957,614 | 14,580,107 | 8,300,001 | 4,063,610 | 671,670 |
| Cash flow \$ per share-basic | 0.15 | 0.14 | 0.06 | – | – | – |
| Earnings (loss) \$ per share-basic | 0.02 | 0.03 | 0.01 | (0.01) | (0.03) | (0.04) |

Management's Discussion and Analysis

Management's Discussion & Analysis ("MD&A") is intended to assist in the understanding of the trends and significant changes in the financial condition and results of operations of Galleon Energy Inc. ("Galleon") for the third quarter of 2004. The MD&A has been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP") and should be read in conjunction with the audited financial statements for the year ended December 31, 2003 and the unaudited interim consolidated financial statements as at and for the quarters ended September 30, June 30 and March 31, 2004.

Petroleum and natural gas reserves and volumes are converted to a common unit of measure on a basis of six thousand cubic feet (Mcf) of gas to one barrel (Bbl) of oil. This MD&A is based on information available as of November 18, 2004.

NON-GAAP MEASUREMENTS

The MD&A contains the terms "cash flow" and "cash flow from operations" which should not be considered an alternative to, or more meaningful than, cash flow from operating activities or net earnings as determined in accordance with Canadian GAAP as an indicator of Galleon's performance. Galleon's determination of cash flow may not be comparable to that reported by other companies. The reconciliation between net earnings and cash flow from operations can be found in the Consolidated Statements of Cash Flow. The Corporation also presents "cash flow per share" whereby cash flow from operations is divided by the weighted average number of shares outstanding to determine per share amounts.

Galleon uses the term net debt in the MD&A and presents a table showing how it has been determined. This measure does not have any standardized meaning prescribed by Canadian GAAP and therefore may not be comparable to similar measures presented by other companies.

FORWARD LOOKING STATEMENTS

Statements throughout this interim report that are not historical facts may be considered "forward looking statements." These forward looking statements sometimes include words to the effect that management believes or expects a stated condition or result. All estimates and statements that describe the Corporation's objectives, goals or future plans are forward looking statements. Since forward looking statements address future events and conditions, by their very nature they involve inherent risks and uncertainties. Actual results could differ materially from those currently anticipated due to any number of factors, including such variables as new information regarding recoverable reserves, changes in demand for, and commodity prices of crude oil and natural gas, legislative, environmental and other regulatory or political changes, competition in areas where the Corporation operates and other factors discussed in this interim report.

COMPARISON TO THIRD QUARTER 2003

Galleon commenced oil and gas operations at the end of June 2003 and commenced receiving oil and gas revenues on October 1, 2003. Accordingly, no comparative year over year oil and gas data is shown in this MD&A.

During third quarter 2003, Galleon received interest income of \$31,181, incurred net general and administrative expenses of \$112,842 and recorded depreciation on a compressor of \$39,016. Capital expenditures were \$81,597 for land, geological and geophysical costs. In addition, a compressor was sold for proceeds of \$320,000. A loss of \$120,677 was recorded and cash of \$81,661 was used in operations during third quarter 2003.

On September 30, 2003, Galleon issued 4,100,000 Class A shares on a flow through basis at an issue price of \$0.25 per share for gross proceeds of \$1,025,000. At this time, 922,500 Class B shares were issued on a flow through basis at an issue price of \$10.00 per share for gross proceeds of \$9,225,000. Share issue costs were \$882,821. Galleon also issued 732,000 founder's shares for gross proceeds of \$183,000 during the third quarter of 2003.

THIRD QUARTER 2004 HIGHLIGHTS

- Cash flow from operations of \$3,000,328, a 25% increase from second quarter 2004
- Operating netbacks of \$21.71/Boe
- Average daily production of 1,781 Boe; natural gas — 8.3 Mmcf and liquids — 402 Bbl, a 27% increase from second quarter 2004
- Purchase of Inisfail Energy Ltd. for cash of \$16,063,827 plus the assumption of net debt of \$3,967,733
- Share equity issuance of 3 million Class A shares at \$8.00 per share for gross proceeds of \$24 million
- Increase in the bank credit facility to \$25 million
- Drilled 12 gross wells resulting in 6 gross (6 net) natural gas wells
- Capital expenditures of \$12.9 million

PETROLEUM AND NATURAL GAS REVENUES

Galleon recorded another quarter of significant revenue growth due to strong commodity prices and the addition of natural gas and liquids volumes from the purchase of Inisfail Energy Ltd. ("Inisfail") on July 28, 2004. Also, production increased at Calais and Dawson, Alberta during the third quarter of 2004. Revenue increased by 20% from second quarter 2004 due to a 16% increase in natural gas revenues and a 33% increase in crude oil and liquids revenues.

| <i>Netbacks</i> | <i>Q3 2004</i> | | <i>YTD 2004</i> | |
|---------------------------------------|--------------------|--------|--------------------|--------|
| | <i>163,812 Boe</i> | | <i>364,857 Boe</i> | |
| | \$ | \$/Boe | \$ | \$/Boe |
| Gross revenues, net of transportation | 5,929,950 | 36.20 | 13,267,156 | 36.36 |
| Hedges | (151,868) | (0.93) | (462,202) | (1.27) |
| Royalties, net of ARTC | (1,275,588) | (7.79) | (2,792,976) | (7.65) |
| Subtotal | 4,502,494 | 27.48 | 10,011,978 | 27.44 |
| Operating costs | (945,635) | (5.77) | (2,156,875) | (5.91) |
| Operating netback | 3,556,859 | 21.71 | 7,855,103 | 21.53 |
| Other revenue | 4,708 | 0.03 | 18,787 | 0.05 |
| G&A | (484,804) | (2.96) | (1,341,567) | (3.68) |
| Interest costs | (30,245) | (0.18) | (71,525) | (0.20) |
| Current taxes | (46,190) | (0.28) | (121,301) | (0.33) |
| Cash flow from operations | 3,000,328 | 18.32 | 6,339,497 | 17.37 |

| <i>Revenue contribution analysis</i> | <i>Q3 2004</i> | | <i>YTD 2004</i> | |
|---------------------------------------|----------------|-----|-----------------|-----|
| | \$ | % | \$ | % |
| Oil | 1,434,781 | 24 | 3,449,461 | 26 |
| NGLs | 57,330 | 1 | 64,423 | 1 |
| Natural gas | 4,437,839 | 75 | 9,753,272 | 73 |
| Gross revenues, net of transportation | 5,929,950 | 100 | 13,267,156 | 100 |

Volumes increased by 27% in third quarter 2004 compared to second quarter 2004. This was primarily due to an increase in natural gas volumes — 32% and an increase in liquids volumes - 13%.

| <i>Product mix analysis</i> | <i>Q3 2004</i> | | <i>YTD 2004</i> | |
|-----------------------------|----------------|-----|-----------------|-----|
| Oil (Bbls/d) | 389 | 22 | 356 | 27 |
| NGLs (Bbls/d) | 13 | 1 | 5 | – |
| Natural gas (Mcf/d) | 8,272 | 77 | 5,823 | 73 |
| Boe/d (6:1) | 1,781 | 100 | 1,332 | 100 |

COMMODITY PRICING AND MARKETING

Petroleum products are sold to major Canadian marketers at spot reference prices based on US WTI for crude oil and AECO-C for natural gas. The Corporation had one hedge contract in place during the third quarter which covered 25% of total liquids sales in the quarter. The cost of the crude oil hedge contract was \$151,868 in Q3/04 or \$4.25/Bbl based on total crude oil sold in the quarter.

The hedge contract commenced on January 1, 2004 for 100 Bbl/day with a fixed price of \$40.80/Bbl WTI Cdn and expires on December 31, 2004.

Natural gas prices softened by 13% to average \$5.83/mcf in third quarter 2004 compared to \$6.67/mcf realized in second quarter 2004.

| <i>Prices</i> | <i>Q3 2004</i> | <i>YTD 2004</i> |
|---------------------------|----------------|-----------------|
| Light oil (\$/Bbl) | 55.69 | 50.90 |
| Heavy/medium oil (\$/Bbl) | 35.30 | 31.03 |
| Hedge impact (\$/Bbl) | (4.25) | (4.74) |
| Net crude oil (\$/Bbl) | 35.87 | 30.62 |
| Natural gas (\$/Mcf) | 5.83 | 6.11 |
| NGLs (\$/Bbl) | 47.92 | 46.75 |

PERFORMANCE BY PROPERTY

| | <i>Q3 2004 Production</i> | | <i>Operating netbacks/ Boe</i> | <i>YTD 2004 Production</i> | | <i>Operating netbacks/ Boe</i> | <i>YTD 2004 operating cash flow</i> |
|----------------|-------------------------------|------------|--|--------------------------------|------------|--|---|
| | <i>Boe/day</i> | <i>%</i> | <i>\$</i> | <i>Boe/day</i> | <i>%</i> | <i>\$</i> | <i>%</i> |
| Calais | 398 | 22 | 23.85 | 255 | 19 | 25.10 | 22 |
| Dawson | 361 | 20 | 19.79 | 244 | 18 | 20.96 | 17 |
| Wymark | 286 | 16 | 24.69 | 287 | 22 | 26.25 | 26 |
| Lloydminster | 176 | 10 | 14.28 | 151 | 11 | 12.92 | 7 |
| Flatrock | 129 | 7 | 25.61 | 43 | 3 | 25.61 | 4 |
| Delta West | 121 | 7 | 15.45 | 128 | 10 | 13.06 | 6 |
| Two Rivers | 94 | 5 | 18.33 | 31 | 2 | 18.33 | 2 |
| Princess | 70 | 4 | 27.19 | 56 | 4 | 28.36 | 5 |
| Progress | 65 | 4 | 28.30 | 74 | 6 | 24.16 | 5 |
| Bindloss | 43 | 3 | 19.49 | 24 | 2 | 19.92 | 2 |
| Monitor | 21 | 1 | 18.12 | 22 | 2 | 21.96 | 2 |
| John Lake | 17 | 1 | 27.03 | 17 | 1 | 27.69 | 2 |
| Boe/day | 1,781 | 100 | 21.59 | 1,332 | 100 | 21.84 | 100 |

ROYALTIES

Royalty expenses were 24.4% of gross revenues (18.6% crown, 4.4% freehold and 1.4% other) for third quarter 2004 compared to 24.6% (19.6% crown, 3.2% freehold and 1.8% other) for second quarter 2004. Royalty rates recorded in the third quarter 2004 were 28.4% for Calais and 31.2% for Dawson compared to 28.7% and 35.4%, respectively, in second quarter 2004. Royalty rates at Dawson have decreased due to a conversion of a gross overriding royalty interest to a working interest in July 2004. Crown royalties have decreased slightly in third quarter 2004 due to lower natural gas prices offset by higher liquids prices. Freehold royalties have increased in third quarter 2004 due to increased production from Lloydminster, Saskatchewan. ARTC of \$171,377 was accrued in third quarter 2004 and \$348,000 was accrued year to date 2004. YTD 2004 royalty expenses were 23.7% of gross revenues (18.1% crown, 4.2% freehold and 1.4% other).

OPERATING EXPENSES

Operating expenses averaged \$5.77/Boe in third quarter 2004 compared to \$5.43/Boe in second quarter 2004. This 6% quarter over quarter increase is partially due to the addition of the Inisfail properties which averaged \$6.99/Boe during third quarter 2004. Year to date operating expenses were \$5.91/Boe. Operating costs are expected to decrease on a unit basis when additional volumes are added from the lower operating cost natural gas properties at Calais and Dawson. Operating costs averaged \$2.73/Boe at Calais and \$4.27/Boe at Dawson during third quarter 2004.

GENERAL AND ADMINISTRATION COSTS

Year to date 2004 G&A costs by category include: salary and employee – 52%, office – 13%, corporate – 12%, consulting – 9%, audit, engineering and legal – 8%, and computer – 6%.

| | <i>Q3 2004</i> | | <i>YTD 2004</i> | |
|---------------------|----------------|---------------|-----------------|---------------|
| | <i>\$</i> | <i>\$/Boe</i> | <i>\$</i> | <i>\$/Boe</i> |
| Gross | 671,712 | 4.10 | 1,845,313 | 5.06 |
| Overhead recoveries | (186,908) | (1.14) | (503,746) | (1.38) |
| Subtotal | 484,804 | 2.96 | 1,341,567 | 3.68 |

INTEREST

Interest expense was \$30,245 in third quarter 2004 compared to \$35,681 in second quarter 2004. These costs are related to interest paid on bank debt utilized. Year to date 2004 interest expense was \$71,525.

DEPLETION, DEPRECIATION AND ACCRETION

Depletion and depreciation rates for oil and gas properties were \$13.73/Boe in Q3/04 compared to \$10.21/Boe in Q2/04. Capital expenditures of \$8.6 million related to undeveloped land and seismic costs have been excluded from the depletion and depreciation calculation and \$0.9 million of future costs have been added. Reserve additions from drilling in 2004 have been estimated internally. Reserve additions for the Venture, Inisfail and property acquisitions were based on independent engineering evaluations. The total depletion and depreciation for the three months ended September 30, 2004 was \$2,249,341. Accretion expense of \$27,146 was recorded in Q3/04.

TAXES

| <i>Future income tax</i> | \$ |
|---------------------------------|-------------|
| Balance at December 31, 2003 | 3,302,125 |
| Tax effect of share issue costs | (1,087,474) |
| Venture acquisition | 485,860 |
| Inisfail acquisition | 2,887,515 |
| Provision for 2004 | 676,558 |
| Balance at September 30, 2004 | 6,264,583 |

A future tax provision of \$676,558 was recorded in year to date 2004 earnings of which \$229,437 was recorded in third quarter 2004. Large corporation tax of \$46,190 was recorded in third quarter 2004 and \$121,301 was recorded to September 30, 2004.

In 2003, the Corporation issued \$10.25 million in flow-through shares and had renounced the tax benefit of \$10.25 million to the shareholders. Under the look back provision governing flow-through shares, the Corporation was required to spend the \$10.25 million in eligible capital expenditures in 2004. As of September 30, 2004, the Corporation has spent the required \$10.25 million.

On June 17, 2004, the Corporation issued 1,000,000 Class A shares at \$10.00 each on a flow-through basis for gross proceeds of \$10 million. These expenditures will be renounced to the shareholders in 2004. Under the look back provision governing flow-through shares, the Corporation is required to incur eligible expenditures prior to December 31, 2005. To September 30, 2004, the Corporation has incurred approximately \$7.7 million of the required expenditures.

NET EARNINGS

Third quarter 2004 net earnings of \$307,115 are net of a future tax provision of \$229,437 and non cash expenses for stock-based compensation of \$187,289. Year to date 2004, net earnings were \$890,042 with a future tax provision of \$676,558 and non cash expenses for stock-based compensation of \$397,247.

CAPITAL EXPENDITURES

| | \$ |
|--|-------------------|
| Property & equipment balance at December 31, 2003 | 11,277,905 |
| Additions (net) | 33,783,628 |
| Acquisition of property and equipment | 2,374,248 |
| Asset retirement obligation | 361,210 |
| Acquisition of Venture | 16,465,762 |
| Acquisition of Inisfail | 13,904,000 |
| Depletion and depreciation | (4,305,622) |
| Property & equipment balance at September 30, 2004 | <u>73,861,131</u> |

| <i>Exploration and development expenditures</i> | <i>YTD 2004</i> | |
|---|-------------------|------------|
| | \$ | % |
| Land | 4,951,282 | 15 |
| Geological and geophysical | 4,910,303 | 15 |
| Drilling and completion | 20,661,425 | 61 |
| Plant and facilities | 3,179,668 | 9 |
| Other assets | 80,950 | – |
| Total exploration and development | <u>33,783,628</u> | <u>100</u> |

An active 12 well drilling program during the third quarter of 2004 resulted in 6 cased natural gas wells; 4 at Calais and 2 at Dawson both in Alberta.

LIQUIDITY AND CAPITAL RESOURCES AND SUBSEQUENT EVENTS

For the third quarter of 2004, cash flow from operations of \$3,000,328, an equity issuance of \$24 million and an increase in bank credit facilities were used to fund the \$12.9 million capital expenditure program and the Inisfail acquisition. Cash flow from operations per average weighted basic share was \$0.15 in Q3/04 compared to \$0.14 in Q2/4.

DEBT AND WORKING CAPITAL

| | <i>September 30</i> <i>2004</i> | <i>December 31</i> <i>2003</i> |
|--|------------------------------------|-----------------------------------|
| | \$ | \$ |
| Cash | – | 3,204,663 |
| Bank debt | (4,560,586) | – |
| Working capital (deficiency) | (4,654,059) | (3,755,208) |
| Total net debt | 9,214,645 | 550,545 |
| | | |
| <i>Source of funds</i> | <i>Q3 2004</i> \$ | <i>YTD 2004</i> \$ |
| Issuance of shares, net of costs | 22,558,533 | 43,082,533 |
| Funds provided by operations | 3,000,328 | 6,339,497 |
| Bank debt | 4,560,586 | 4,560,586 |
| Change in cash and working capital | (1,177,386) | (1,760,913) |
| Net additions to property and equipment | 28,942,061 | 52,221,703 |

The Corporation has an extendible revolving credit facility in place with a Canadian chartered bank. The amount of the facility is \$25 million Cdn with interest at the bank's prime rate. If borrowings exceed \$22 million Cdn, then the interest rate charged on all loans will increase by 25 basis points. In addition, the Corporation has in place a \$3.5 million US swap facility. Collateral for the facilities consists of a demand debenture for \$75 million secured by a first floating charge over all of the property and equipment of the Corporation. At September 30, 2004, \$4,560,586 was drawn on the credit facility.

On August 4, 2004, the Corporation issued 3,000,000 Class A shares at \$8.00 each for gross proceeds of \$24 million. The shares issued are subject to a hold period under applicable securities laws expiring December 5, 2004.

At September 30, 2004, the market value of Galleon's class A shares was approximately \$187.7 million based on the September 30, 2004 closing price of \$9.00 per share and 20,860,771 (excluding 500,000 shares owned by Venture) class A shares outstanding.

Galleon has no off-balance sheet financing arrangements. The Corporation has lease arrangements for office space to April 30, 2006. The future minimum lease payments total \$237,975 (balance of 2004 - \$37,575; 2005 - \$150,300; and, 2006 - \$50,100).

At November 18, 2004, 20,865,771 (excluding 500,000 shares owned by Venture) Class A shares, 922,500 Class B shares and 1,797,667 options were outstanding.

CHANGES IN ACCOUNTING POLICIES

Stock-based compensation

Effective January 1, 2004, the Corporation adopted a new accounting standard on stock based compensation as presented in the CICA Handbook section 3870. The standard requires the recognition of stock based compensation expense for all employees and non-employees using the fair value method.

For 2003, options were issued at current market value and had no intrinsic value, therefore no compensation expense was recorded when the options were granted. Consideration paid by employees and non-employees on the exercise of stock options was credited to share capital.

The standard was amended in November 2003 requiring all stock based compensation awards to be expensed. The Corporation adopted the new accounting policy in 2004 on a retroactive basis with no restatement of prior periods as the amount was not material. The Black-Scholes option pricing model has been used to calculate the fair value of the stock options granted. To September 30, 2004 the Corporation has recognized a compensation expense of \$397,247, of which \$187,289 was recorded in third quarter 2004.

Asset retirement obligation

Effective January 1, 2004, the Corporation has adopted the new standard for asset retirement obligations as set out in the CICA Handbook section 3110. The new standard requires the recognition and measurement of liabilities related to the legal obligation to abandon and reclaim property, plant and equipment upon acquisition, construction, development and/or normal use of the asset. The initial liability must be measured at fair value and subsequently adjusted for the accretion of discount and changes in the fair value. The asset retirement cost is capitalized as part of property and equipment and depleted into earnings over time.

The adoption of this standard has increased the asset retirement liability by \$644,357 at December 31, 2003, and added an asset retirement cost of \$660,271 to property, plant and equipment which was reduced by depletion on the increased asset retirement cost for 2003 of \$8,796. The comparative balance sheet for 2003 has been restated. To September 30, 2004, in addition to reflecting the effect of the Venture and Inisfail acquisitions, \$361,210 of additional asset retirement liability and \$70,028 in accretion expense have been recognized. The accretion expense has been applied to depletion, depreciation and accretion expense on the Consolidated Statement of Operations and Deficit.

Full cost accounting guideline

Effective January 1, 2004, the Corporation adopted the new guidelines for full cost accounting as per CICA accounting guideline 16. Under the new guideline, future net revenues from total proven reserves used in the ceiling test calculation are estimated using expected future escalating product prices and costs, whereas prior to the adoption, constant pricing was used. Future general and administrative, and financing charges, associated with the future net revenues are no longer deducted in arriving at the ceiling value. Where a ceiling test failure occurs, probable reserve values may now be included in determining the impairment amount which is based on the fair value of the associated reserves.

The adoption of the new guideline at December 31, 2003 resulted in no change to net income, fixed assets or any reported amounts in the December 31, 2003 financial statements.

CRITICAL ACCOUNTING ESTIMATES

There are a number of critical estimates underlying the accounting policies employed in preparing the Consolidated Financial Statements.

Revenue estimates

Payment for sales in the oil and gas industry occurs up to two months after the month of production. Sales are estimated based upon information received from field offices regarding production levels and published industry pricing and transportation data.

Cost estimates

Costs for services performed but not yet billed are estimated based on original quotes and historical cost information.

Reserves

The full cost method of accounting, which is used to account for oil and gas activities, relies on estimates of proven reserves that will ultimately be recoverable from the properties. These estimates are utilized in calculating the unit-of-production depletion, potential impairment of asset carrying costs and future site restoration expense. The process of estimating reserves is complex and requires significant judgment, based on available geological, geophysical, engineering and economic data.

Reserves are evaluated at year-end by an independent engineering firm and quarterly updates to those reserves, as well as new reserves from wells drilled in the current year are estimated by the Corporation's engineers.

Although every effort is made to ensure that critical estimates are accurate, changing economic and operational conditions, as well as governmental regulations, can significantly affect those estimates, which may cause significant fluctuation in earnings and cash flows.

BUSINESS RISKS

Galleon is engaged in the exploration, development and production of crude oil and natural gas. The oil and gas business is inherently risky and there is no assurance that hydrocarbon reserves will be discovered and economically produced. Operational risks include competition, reservoir performance uncertainties, environmental factors, and regulatory, environment and safety concerns. Financial risks associated with the petroleum industry include fluctuations in commodity prices, interest rates, currency exchange rates and the cost of goods and services.

Galleon employs highly qualified people, uses sound operating and business practices, and evaluates all potential and existing wells using the latest applicable technology. Galleon complies with government regulations and has in place an up-to-date emergency response test. Environment and safety policies and standards are adhered to. Asset retirement obligations are recognized upon acquisition, construction, development and/or normal use of the assets. Galleon maintains property and liability insurance coverage. The coverage provides a reasonable amount of protection from risk of loss; however, not all risks are foreseeable or insurable.

A commodity hedging program is in place to protect product pricing on 100 Boe/d of production and ensure cash flows are available for reinvestment.

OUTLOOK

Plans for the fourth quarter of 2004 include the drilling of 15-20 wells in the core areas of Calais and Dawson, Alberta and Two Rivers, British Columbia. Exploration and development capital expenditures are estimated at \$12-15 million and will be funded from cash flow and available bank credit facilities.

The acquisition of the Dawson properties for \$46.7 million will be funded by share issuance, cash flow, expanded bank lines and potential exercise of a right of first refusal.

Consolidated Balance Sheets

(unaudited)

| | September 30 2004 \$ | December 31 2003 \$ |
|--|----------------------------|---------------------------|
| ASSETS | | (Restated – Note 1) |
| Current | | |
| Cash | – | 3,204,663 |
| Accounts receivable | 3,905,494 | 1,230,087 |
| Deposits and prepaid expenses | 634,276 | 14,442 |
| | 4,539,770 | 4,449,192 |
| Goodwill (notes 3, 4 and 5) | 12,297,129 | – |
| Property and equipment (notes 1, 2, 4, 5 and 6) | 73,861,131 | 11,277,905 |
| | 90,698,030 | 15,727,097 |
| LIABILITIES | | |
| Current | | |
| Accounts payable and accrued liabilities | 9,193,829 | 4,999,737 |
| Bank loan (note 2) | 4,560,586 | – |
| | 13,754,415 | 4,999,737 |
| Asset retirement obligation (note 1) | 2,186,462 | 660,271 |
| Future tax liability (note 8) | 6,264,583 | 3,302,125 |
| | 22,205,460 | 8,962,133 |
| Commitments (notes 9 and 10) | | |
| SHAREHOLDERS' EQUITY | | |
| Share capital (note 7) | 68,816,767 | 7,001,450 |
| Contributed surplus (notes 1 and 7) | 397,247 | – |
| Deficit | (721,444) | (236,486) |
| | 68,492,570 | 6,764,964 |
| | 90,698,030 | 15,727,097 |

See accompanying notes

Consolidated Statements of Operations and Deficit

(unaudited)

| | Three months ended September 30 | | Nine months ended September 30 | |
|--|---------------------------------------|------------------|--------------------------------------|---|
| | 2004 | 2003 | 2004 | Period March 27 to September 30 2003 |
| | \$ | \$ | \$ | \$ |
| REVENUE | | | | |
| Petroleum and natural gas | 5,929,950 | – | 13,267,156 | – |
| Crude oil hedge cost | (151,868) | – | (462,202) | – |
| Royalties, net of ARTC | (1,275,588) | – | (2,792,976) | – |
| Other income | 4,708 | 31,181 | 18,787 | 44,636 |
| | 4,507,202 | 31,181 | 10,030,765 | 44,636 |
| EXPENSES | | | | |
| Operating | 945,635 | – | 2,156,875 | – |
| General and administration | 484,804 | 112,842 | 1,341,567 | 145,629 |
| Stock-based compensation | 187,289 | – | 397,247 | – |
| Interest | 30,245 | – | 71,525 | – |
| Depletion, depreciation & accretion | 2,276,487 | 39,016 | 4,375,650 | 45,070 |
| | 3,924,460 | 151,858 | 8,342,864 | 190,699 |
| Earnings (loss) before taxes | 582,742 | (120,677) | 1,687,901 | (146,063) |
| Current taxes | 46,190 | – | 121,301 | – |
| Future income taxes (note 8) | 229,437 | – | 676,558 | – |
| NET EARNINGS (LOSS) | 307,115 | (120,677) | 890,042 | (146,063) |
| DEFICIT, BEGINNING OF PERIOD | (1,028,559) | (25,386) | (236,486) | – |
| Repurchase of class A shares (notes 5&7) | – | – | (1,375,000) | – |
| DEFICIT, END OF PERIOD | (721,444) | (146,063) | (721,444) | (146,063) |
| NET EARNINGS (LOSS) PER SHARE | | | | |
| Basic | 0.02 | (0.03) | 0.05 | (0.06) |
| Diluted | 0.01 | (0.03) | 0.05 | (0.06) |
| Weighted average shares – basic | 19,733,778 | 4,063,610 | 17,099,855 | 2,313,692 |
| – diluted | 21,844,513 | 4,073,637 | 19,325,411 | 2,318,599 |

See accompanying notes

Consolidated Statements of Cash Flow

(unaudited)

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---------------------------------------|------------|--------------------------------------|------------|
| | 2004 | 2003 | 2004 | 2003 |
| | \$ | \$ | \$ | \$ |
| Cash provided by (used in): | | | | |
| OPERATING ACTIVITIES | | | | |
| Net earnings (loss) | 307,115 | (120,677) | 890,042 | (146,063) |
| Add items not requiring cash: | | | | |
| Depletion, depreciation and accretion | 2,276,487 | 39,016 | 4,375,650 | 45,070 |
| Future income taxes | 229,437 | – | 676,558 | – |
| Stock-based compensation (note 1) | 187,289 | – | 397,247 | – |
| CASH FLOW FROM (USED IN) OPERATIONS | 3,000,328 | (81,661) | 6,339,497 | (100,993) |
| Change in non-cash working capital relating to operating activities | (1,206,684) | 96,038 | 898,851 | 27,739 |
| | 1,793,644 | 14,377 | 7,238,348 | (73,254) |
| FINANCING ACTIVITIES | | | | |
| Issue of common shares | 24,115,679 | 10,433,000 | 46,170,579 | 11,300,000 |
| Share issue costs | (1,557,146) | (882,821) | (3,088,046) | (895,221) |
| Bank loan | 4,560,586 | – | 4,560,586 | – |
| Repayment of bank debt assumed in Venture and Inisfail acquisitions (notes 4 & 5) | (3,967,733) | – | (5,864,427) | – |
| | 23,151,386 | 9,550,179 | 41,778,692 | 10,404,779 |
| INVESTING ACTIVITIES | | | | |
| Additions to oil and gas properties | (12,872,910) | (81,597) | (33,783,628) | (622,700) |
| Acquisition of Inisfail Energy Ltd. (note 4) | (16,063,827) | – | (16,063,827) | – |
| Acquisition of oil and gas properties (note 6) | (5,324) | – | (2,374,248) | – |
| Proceeds on disposition of oil and gas properties | – | 320,000 | – | 320,000 |
| | (28,942,061) | 238,403 | (52,221,703) | (302,700) |
| INCREASE (DECREASE) IN CASH | (3,997,031) | 9,802,959 | (3,204,663) | 10,028,825 |
| CASH, BEGINNING OF PERIOD | 3,997,031 | 225,866 | 3,204,663 | – |
| CASH, END OF PERIOD | – | 10,028,825 | – | 10,028,825 |
| SUPPLEMENTARY INFORMATION | | | | |
| Cash interest paid | 30,245 | – | 71,525 | – |
| Cash taxes paid | 46,190 | – | 121,301 | – |

See accompanying notes

Notes to the Consolidated Financial Statements

1. ACCOUNTING POLICIES

These unaudited interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"), and follow the same accounting policies as for the financial statements for the fiscal year ended December 31, 2003, except as noted below. These notes are incremental to, and should be read in conjunction with, the audited financial statements for the fiscal period ended December 31, 2003. These consolidated financial statements include the operations of Venture Energy Inc. ("Venture") and Inisfail Energy Ltd. ("Inisfail").

Stock-based compensation

Effective January 1, 2004, the Corporation adopted a new accounting standard on stock based compensation as presented in the CICA Handbook section 3870. The standard requires the recognition of stock-based compensation expense for all employees and non-employees using the fair value method.

In 2003, options were issued at current market value and had no intrinsic value, therefore no compensation expense was recorded when the options were granted. Consideration paid by employees and non-employees on the exercise of stock options was credited to share capital.

The amended standard requires all stock based compensation awards to be expensed. The Corporation adopted the new accounting policy in 2004 on a retroactive basis with no restatement of prior periods as the amount was not material.

The Black-Scholes option pricing model has been used to calculate the fair value of the stock options granted. To September 30, 2004 the Corporation has recognized a compensation expense of \$397,247.

Asset retirement obligation

Effective January 1, 2004, the Corporation adopted, on a retroactive basis with restatement, the new standard for asset retirement obligations as set out in the CICA Handbook section 3110. The new standard requires the recognition and measurement of liabilities related to the legal obligation to abandon and reclaim property, plant and equipment upon acquisition, construction, development and/or normal use of the asset. The initial liability must be measured at fair value and subsequently adjusted for the accretion of discount and changes in the fair value. The asset retirement cost is capitalized as part of property and equipment and depleted into earnings over time. A credit adjusted risk free rate of 5% and an inflation rate of 1.5% were used to calculate the fair value of the asset retirement obligation.

The adoption of this standard increased the asset retirement liability by \$644,357 at December 31, 2003 and added a gross asset retirement cost of \$660,271 to property, plant and equipment which was reduced by depletion on the increased asset retirement cost for 2003 of \$8,796. The comparative balance sheet for 2003 has been restated. To September 30, 2004, in addition to reflecting the effect of the Venture and Inisfail acquisitions, \$361,210 of additional asset retirement liability and \$70,028 in accretion expense has been recognized. The accretion expense has been recorded in depletion, depreciation and accretion expense on the Consolidated Statement of Operations and Deficit.

Full cost accounting guideline

Effective January 1, 2004, the Corporation has adopted the new guideline for full cost accounting as per CICA accounting guideline 16. Under the new guideline, future net revenues from total proven reserves used in the ceiling test calculation are estimated using expected future escalating product prices and costs, whereas prior to the adoption, constant pricing was used. Future general and administrative, and financing charges, associated with the future net revenues are no longer deducted in arriving at the ceiling value. Where a ceiling test failure occurs, probable reserve values may now be included in determining the impairment amount which is based on the fair value of the associated reserves.

The adoption of the new guideline resulted in no change to net income, fixed assets or other reported amounts in the December 31, 2003 financial statements.

Transportation

Clean oil trucking charges and transportation charges related to the delivery of natural gas are deducted from gross prices received for these products. To September 30, 2004 these charges were \$483,937 in aggregate which includes \$259,648 recorded in third quarter 2004.

2. AVAILABLE CREDIT FACILITY

The Corporation has an extendible revolving credit facility in place with a Canadian chartered bank. During the quarter, the amount of the facility was increased from \$15 to \$25 million Cdn with interest at the bank's prime rate. If borrowing exceeds \$22 million Cdn, the interest rate charged on all loans will increase by 25 basis points. In addition, the Corporation has in place a \$3.5 million US swap facility. Collateral for the facilities consists of a demand debenture for \$75 million secured by a first floating charge over all of the property and equipment of the Corporation. At September 30, 2004, an amount of \$4,560,586 was drawn against the credit facility.

3. GOODWILL

Goodwill, which represents the excess of purchase price over fair value of net assets acquired, is not amortized and is assessed by the Corporation for impairment at least annually. Impairment is assessed based on a comparison of the fair value of the net assets acquired to the carrying value of the net assets, including goodwill. Any excess of carrying value over and above fair value is the impairment amount, and is charged to earnings in the period identified.

4. ACQUISITION OF INISFAIL ENERGY LTD.

On July 28, 2004, the Corporation acquired all of the issued and outstanding shares of Inisfail. The Inisfail acquisition was accounted for by the purchase method and shares were acquired for cash of \$15,128,219 plus the assumption of \$3,967,733 of net debt. Transaction costs included a cash payment of \$868,000 for outstanding share options.

The calculation of the purchase price and the preliminary allocation to assets and liabilities is shown below. The purchase price and goodwill allocation is preliminary because certain items such as the determination of the fair values of the assets and liabilities as of the acquisition date have not been completed.

| <i>Calculation of Purchase Price</i> | \$ |
|---------------------------------------|-------------------|
| Cash for purchase of shares | 15,128,219 |
| Transaction costs | 935,608 |
| | <u>16,063,827</u> |
| <i>Allocation of Purchase Price</i> | |
| Goodwill | 9,658,940 |
| Property and equipment | 13,904,000 |
| Bank debt and working capital assumed | (3,967,733) |
| Asset retirement obligation | (643,865) |
| Future income tax | (2,887,515) |
| | <u>16,063,827</u> |

5. ACQUISITION OF VENTURE ENERGY INC.

On January 15, 2004, the Corporation acquired all of the issued and outstanding shares of Venture. The Venture acquisition was accounted for by the purchase method and shares were acquired for an aggregate of \$17,770,311 by the issuance of 5,923,437 Class A shares of Galleon at a deemed value of \$3.00 per share plus the assumption of \$1,896,694 of net debt. Prior to the acquisition, Venture owned 500,000 of the Class A shares of the Corporation. At the time of the acquisition, the fair value of the 500,000 Class A shares was \$1,500,000. An adjustment of \$1,375,000 being the difference between cost and fair value was made to retained earnings.

| <i>Calculation of Purchase Price</i> | \$ |
|--------------------------------------|-------------------|
| Fair value of shares issued | 17,770,311 |
| Transaction costs | 34,236 |
| | <u>17,804,547</u> |
| <i>Allocation of Purchase Price</i> | |
| Goodwill | 2,638,189 |
| Property and equipment | 16,500,000 |
| Fair value of Galleon class A shares | 1,500,000 |
| Bank debt assumed | (1,896,694) |
| Asset retirement obligation | (451,088) |
| Future income tax | (485,860) |
| | <u>17,804,547</u> |

6. PROPERTY AND EQUIPMENT

On January 30, 2004, the Corporation completed the purchase of interests in certain oil and gas properties and a gas plant for cash of \$2.4 million net of adjustments. At September 30, 2004, \$8.6 million of undeveloped land and seismic costs have been excluded from and \$0.9 million in future development costs have been added into the depletion calculation.

7. SHARE CAPITAL

Authorized

Unlimited number of preferred shares with no par value

Unlimited number of voting Class A shares with no par value

Unlimited number of voting Class B shares with no par value, convertible (at the option of the Corporation) at any time after December 31, 2006 and before December 31, 2008, into Class A shares. The fraction is calculated by dividing \$10 by the greater of \$1 and the then current market price of Class A shares. If conversion has not occurred by the close of business on December 31, 2008, the Class B shares become convertible (at the option of the shareholder) into Class A shares on the same basis. Effective February 1, 2009, all remaining Class B shares will be deemed to be converted to Class A shares.

| <i>Issued and outstanding</i> | <i>Number of Shares</i> | <i>Amount</i> \$ |
|--|-------------------------|------------------|
| Class A shares | | |
| Balance at December 31, 2003 | 8,300,001 | 1,633,985 |
| Issued on acquisition of Venture (note 5) | 5,923,437 | 17,770,311 |
| Repurchase of shares held by Venture (note 5) | (500,000) | (125,000) |
| Issue of Special Warrants for cash (a) | 3,000,000 | 12,000,000 |
| Issue of Flow Through shares for cash (b) | 1,000,000 | 10,000,000 |
| Issued for cash (c) | 3,000,000 | 24,000,000 |
| Share issue costs, net of tax of \$1,087,474 (a)(b)(c) | – | (2,000,572) |
| Issued for cash on exercise of stock options (d) | 137,333 | 170,579 |
| Balance at September 30, 2004 | 20,860,771 | 63,449,303 |
| Class B shares | | |
| Balance at December 31, 2003, March 31, June 30 and September 30, 2004 | 922,500 | 5,367,464 |
| Total share capital - September 30, 2004 | 21,783,271 | 68,816,767 |

- a) On February 10, 2004, the Corporation issued 3,000,000 Special Warrants at \$4.00 each for gross proceeds of \$12 million. Each Special Warrant entitled the holder to receive one Class A share without payment of any additional consideration, subject to adjustment in certain events. The resale of the Special Warrants and the Class A shares issuable on exercise thereof was initially subject to a hold period expiring February 11, 2005. On March 30, 2004 certain amendments to securities legislation came into effect which changed the hold period to June 11, 2004. Also as a result of the amendment, the Special Warrants were deemed to be exercised into Class A shares.
- b) The Corporation renounced \$10,250,000 of expenditures to the shareholders in 2003 in connection with a flow through offering on September 30, 2003, and under the look back provision governing flow-through shares is required to expend the amount in 2004. By June 30, 2004 these expenditures had been incurred.

On June 17, 2004, the Corporation issued 1,000,000 Class A shares at \$10.00 each on a flow-through basis for gross proceeds of \$10 million. The shares issued are subject to a hold period under applicable securities laws expiring October 18, 2004. These expenditures will be renounced to the shareholders in 2004. Under the look back provision governing flow-through shares, the Corporation is required to incur eligible expenditures prior to December 31, 2005. To September 30, 2004 approximately \$7.7 million has been incurred.

- c) On August 4, 2004, the Corporation issued 3,000,000 Class A shares at \$8.00 each for gross proceeds of \$24 million. The shares issued are subject to a hold period under applicable securities laws expiring December 5, 2004.
- d) As described in note 1, the Corporation has adopted a new accounting policy with respect to stock based compensation in 2004. Options granted vest 1/3 immediately upon grant, 1/3 on the first anniversary date of the grant and 1/3 on the second anniversary date of the grant.

To September 30, 2004, the Corporation granted an additional 930,000 options at a weighted average exercise price of \$5.83 per share. In accordance with the Corporation's accounting policy, an expense of \$397,247 has been recognized to September 30, 2004 of which \$187,289 was recorded in third quarter 2004. The fair value of options granted during the quarter was estimated at the date of grant using a Black-Scholes Option Pricing Model with the following assumptions: risk-free interest rate of 3%; dividend yield of 0%; volatility factor of the market price of the Corporation's common shares of 46%; and, an average expected life of the options of 3 years.

| | <i>Number of Shares</i> | <i>Weighted Average Exercise Price \$</i> |
|---------------------------------|-----------------------------|---|
| Outstanding, December 31, 2003 | 900,000 | 0.35 |
| Granted | 930,000 | 5.83 |
| Exercised | (137,333) | (1.24) |
| Outstanding, September 30, 2004 | 1,692,667 | 3.29 |

8. FUTURE INCOME TAXES

A provision to the Corporation's future income tax of \$676,558 was recognized to September 30, 2004. This was primarily due to earnings in the current period.

9. FINANCIAL INSTRUMENTS

The Corporation has one crude oil fixed price commodity hedge in place for 100 barrels of oil per day commencing on January 1, 2004 for a 12 month period. The fixed price for the hedge is \$40.80 WTI Cdn.

At September 30, 2004, the unrealized cost of the commodity hedge on a mark to market basis was \$193,292.

10. SUBSEQUENT EVENTS

On November 4, 2004, the Corporation entered into an agreement to purchase oil and gas properties from an arms length company for cash of \$46.7 million. The acquisition will be funded from cash flow, through an expanded bank credit facility and potentially the exercise of the rights of first refusal. The properties are located in Dawson, Alberta which is one of Galleon's three core areas located in the Peace River Arch region. Closing is expected by mid-December 2004.

Subject to the closing of the acquisition, the Corporation's credit facilities will increase to \$45 million Cdn and a bridge facility in the amount of \$5 million Cdn will be secured. The credit facilities are committed with terms remaining to be finalized.

On November 8, 2004, the Corporation announced that it had entered into a bought deal to issue 1,000,000 Class A shares on a "flow through" basis at \$15.00 each for gross proceeds of \$15 million. The issue is subject to normal regulatory approvals and closing is expected on November 23, 2004. The shares issued will be subject to a hold period under applicable securities laws expiring March 24, 2005.

Corporate Information

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Glenn R. Carley, Chairman²

Fred C. Coles^{1 2}

William L. Cooke¹

Brad Munro¹

Steve Sugianto

¹ Member of the Audit and Reserves Committee

² Member of the Compensation Committee

Officers

Glenn R. Carley,
Chairman and Chief Executive Officer

Steve Sugianto,
President and Chief Operating Officer

Shivon M. Crabtree,
VP Finance & Chief Financial Officer

C. Steve Cohen,
Secretary

Tom Greschner,
VP Production

Darrin Hanik,
VP Engineering

Jennifer Klotz,
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Brent Lacey,
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Valiant Trust Company,
Calgary, Alberta

Stock Exchange Listing

TSX Venture Exchange,
Trading Symbols GO.A and GO.B



GALLEON
ENERGY INC.

GO.A