



Paramount
resources ltd.

**Management's Discussion and Analysis
For the year ended December 31, 2010**

MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis ("MD&A"), dated March 3, 2011, should be read in conjunction with the audited Consolidated Financial Statements of Paramount Resources Ltd. ("Paramount" or the "Company") for the year ended December 31, 2010. The Company's Consolidated Financial Statements and the financial information included in this MD&A are presented in accordance with Generally Accepted Accounting Principles ("GAAP") in Canada. Certain comparative figures have been reclassified to conform to the current year's presentation.

This document contains forward-looking information, non-GAAP measures, disclosures of barrels of oil equivalent volumes and disclosures concerning contingent resources. Readers are referred to the "Advisories" section at the end of this document concerning such matters.

Additional information concerning Paramount, including its Annual Information Form, can be found on the SEDAR website at www.sedar.com.

Paramount is an independent Canadian energy company involved in the exploration, development, production, processing, transportation and marketing of natural gas, crude oil and natural gas liquids ("NGLs"). Management's strategy is to maintain a balanced portfolio of opportunities, to grow reserves and production in Paramount's Principal Properties while maintaining a large inventory of undeveloped acreage, and to selectively pursue higher risk/higher return prospects.

Paramount has spun-out three public entities: (i) Paramount Energy Trust, now Perpetual Energy Inc., in February, 2003; (ii) Trilogy Energy Trust, now Trilogy Energy Corp. ("Trilogy"), in April, 2005; and (iii) MGM Energy Corp. ("MGM Energy") in January, 2007. Paramount continues to hold investments in the securities of Trilogy and MGM Energy in its portfolio of Strategic Investments.

Paramount's operations are divided into three business segments, established by management to assist in resource allocation, to assess operating performance and to achieve long-term strategic objectives: i) Principal Properties; ii) Strategic Investments; and iii) Corporate.

Paramount's Principal Properties are divided into four Corporate Operating Units ("COUs") as follows:

- the Kaybob COU, which includes properties in West Central Alberta;
- the Grande Prairie COU, which includes properties in the Peace River Arch area of Alberta;
- the Southern COU, which includes properties in Southern Alberta, Saskatchewan, Montana and North Dakota; and
- the Northern COU, which includes properties in Northern Alberta, the Northwest Territories and Northeast British Columbia.

Strategic Investments include: (i) investments in other entities, including affiliates; (ii) investments in development stage assets where there is no near-term expectation of production, but a longer-term value proposition based on spin-outs, dispositions, or future revenue generation; and (iii) three drilling rigs owned by Fox Drilling Inc. ("Fox Drilling") and Paramount Drilling U.S. L.L.C. ("Paramount Drilling").

The Corporate segment is comprised of income and expense items, including general and administrative expense and interest expense, which have not been specifically allocated to Principal Properties or Strategic Investments.

HIGHLIGHTS⁽¹⁾

	2010	2009	2008
FINANCIAL			
(\$ millions, except as noted)			
Petroleum and natural gas sales	184.4	161.7	318.1
Funds flow from operations	86.9	60.3	179.6
per share – basic and diluted (\$/share)	1.19	0.90	2.65
Net loss	(122.5)	(97.9)	(116.6)
per share – basic and diluted (\$/share)	(1.68)	(1.46)	(1.72)
Exploration and development expenditures	199.0	93.4	170.8
Investments in other entities – market value ⁽²⁾	502.9	342.9	249.9
Total assets	1,377.2	1,102.0	1,144.6
Long-term debt	294.2	93.7	109.5
Net debt	295.2	50.9	97.5
OPERATIONAL			
Sales volumes			
Natural gas (MMcf/d)	57.7	51.8	61.0
Oil and NGLs (Bbl/d)	3,417	3,580	3,594
Total (Boe/d)	13,029	12,207	13,764
Net wells drilled (excluding oil sands evaluation)	43	14	38
Net oil sands evaluation wells drilled	45	7	–
FUNDS FLOW FROM OPERATIONS (\$/Boe)			
Petroleum and natural gas sales	38.77	36.29	63.14
Royalties	(4.46)	(4.64)	(9.49)
Operating expense and production tax	(10.70)	(12.72)	(14.31)
Transportation	(3.62)	(3.11)	(3.12)
Netback	19.99	15.82	36.22
Financial commodity contract settlements	2.72	2.89	3.45
Netback including commodity contract settlements	22.71	18.71	39.67
General and administrative	(3.24)	(3.86)	(5.15)
Interest	(2.79)	(2.52)	(1.97)
Distributions from investments	2.73	3.37	4.28
Asset retirement obligation expenditures	(0.67)	(0.91)	(1.67)
Other	(0.48)	(1.26)	0.48
	18.26	13.53	35.64

⁽¹⁾ Readers are referred to the advisories concerning non-GAAP measures and oil and gas measures and definitions in the "Advisories" section of this document.

⁽²⁾ Based on the period-end prices of publicly traded enterprises and book value of the remaining investments.

2010 OVERVIEW

- Funds flow from operations in 2010 increased by 44 percent to \$86.9 million from \$60.3 million in 2009, primarily due to the impact of higher revenues and lower operating and general and administrative expenses, partially offset by higher transportation and interest expense.
- Paramount's net loss increased \$24.6 million to \$122.5 million in 2010 compared to \$97.9 million in 2009, primarily due to higher stock-based compensation and depletion, depreciation and accretion expenses, partially offset by higher revenue and income from investments.

Principal Properties

- Paramount focused on its major developments in the Kaybob and Grande Prairie COUs in 2010, investing \$144.8 million in extensive drilling programs and \$46.6 million in gathering and processing facilities. The Company's 2010 exploration and development expenditures exceeded the original budget of \$130 million as the Company accelerated development plans in the Deep Basin program in the Kaybob COU and at Karr-Gold Creek and Valhalla in the Grande Prairie COU based on favorable results from the 2009/2010 winter drilling program. The Company expects to add production from the 2010 drilling programs in 2011 when the new infrastructure is in place and all of the wells are completed and placed on production.
- Paramount invested \$82.7 million to acquire additional undeveloped acreage, primarily in the Kaybob and Grande Prairie COUs, and solidified its significant Peace River Arch land position targeting the liquids rich Montney and Nikanassin formations at Karr-Gold Creek with the acquisition of Redcliffe Exploration Inc. ("Redcliffe").
- Production increased seven percent to 13,029 Boe/d in 2010 compared to 12,207 Boe/d in 2009, due primarily to new well production in the Kaybob and Grande Prairie COUs and the impact of acquisitions, partially offset by natural declines.
- Netback increased 35 percent to \$95.1 million in 2010 from \$70.5 million in the prior year, primarily due to higher revenue and lower operating expenses.
- The Kaybob COU drilled 16 (6.5 net) wells and confirmed plans for major processing capacity expansions, including the construction of a 50 MMcf/d processing plant at Musreau and nominating for an additional 50 MMcf/d of processing capacity in a third party facility expansion at Smoky.
- The Grande Prairie COU drilled 16 (13.7 net) wells and completed the construction of the first phase of the Karr-Gold Creek compression/dehydration plant. Commissioning of the new plant commenced in mid-December and previously shut-in wells are being tied-in and re-started.
- The North Dakota joint development partner has drilled and completed three horizontal wells to date. The wells have not performed as expected, with the first two producing at nominal rates.
- Subsequent to December 31, 2010, Paramount sold approximately 6,000 net acres of undeveloped land in North Dakota, unrelated to the farm-out lands, for cash proceeds of US\$40 million.

Strategic Investments

- In May 2010, Paramount received an updated independent evaluation of its Grand Rapids oil sands resource at Hoole, having a before-tax net present value of future net revenue of \$1.9 billion, discounted at ten percent (Best Estimate (P50)). Paramount expects to file a regulatory application for commercial development in the third quarter of 2011.
- In August 2010, MEG Energy Corp. ("MEG") completed its initial public offering on the Toronto Stock Exchange. As a result, Paramount now carries its MEG investment at market value, and the December 31, 2010 carrying value was increased to \$168.3 million or \$45.49 per share, compared to \$101.8 million or \$27.50 per share in the prior year.

Corporate

- In July 2010, following the acquisition of Redcliffe, the borrowing base and lender commitments under the Company's credit facility were increased from \$125 million to \$160 million.
- Paramount was active in the capital markets late in 2010 raising funds in preparation for the acceleration of its Principal Properties developments in 2011:
 - In November 2010, Paramount closed a public offering and a private placement of an aggregate 2.3 million flow-through common shares for gross proceeds of \$59.1 million.
 - In December 2010, Paramount closed a public offering of \$300 million principal amount of 8.25 percent senior unsecured notes ("Senior Notes") at par and, in February 2011, the Company closed an additional public offering of \$70 million principal amount of Senior Notes at a premium price of \$1,030 per \$1,000 principal amount. A portion of the proceeds were used to repay and redeem the remaining US\$90.2 million of US Senior Notes and to initially repay the outstanding balance on the credit facility.
- The Company continued its focus on cost control, including general and administrative expenses. Salary costs in 2010 were consistent with the prior year, with an overall decrease in general and administrative expenses resulting from increased recoveries related to higher capital spending.

CONSOLIDATED RESULTS

Net Loss

Year ended December 31 (\$ millions)	2010	2009	2008
Principal Properties	(113.1)	(106.9)	33.6
Strategic Investments	(14.9)	(18.0)	(96.4)
Corporate	(66.8)	(27.6)	(39.1)
Taxes	72.3	54.6	(14.7)
Net Loss	(122.5)	(97.9)	(116.6)

The 2010 net loss increased by \$24.6 million compared to 2009 primarily as a result of:

- An increase of \$41.2 million in stock-based compensation due to the appreciation of the trading price of the Company's shares; and
- An increase of \$36.4 million in depletion, depreciation and accretion due to a 2009 change in the pricing methodology for proved reserves used in the calculation of depletion rates, higher lease expiries and increased production in 2010;

Partially offset by:

- An increase in petroleum and natural gas sales of \$22.7 million due to higher realized prices for oil and NGLs and increased natural gas production volumes; and
- Income from investments of \$8.2 million in 2010 compared to a loss of \$7.3 million in 2009, increasing earnings by \$15.5 million.

The 2009 net loss decreased by \$18.7 million compared to 2008 primarily as a result of:

- An \$86.0 million decrease in losses from investments, primarily due to write-downs of the Company's investments in MEG and MGM Energy in 2008;
- An income tax recovery of \$54.6 million in 2009 compared to income tax expense of \$14.7 million in 2008; and
- A \$35.7 million decrease in petroleum and natural gas asset impairments and goodwill write-downs;

Partially offset by:

- A decrease in petroleum and natural gas sales of \$156.4 million due to lower realized prices and lower production volumes; and
- A \$28.9 million decrease in financial commodity contract gains.

Funds Flow From Operations

The following is a reconciliation of funds flow from operations to the nearest GAAP measure:

Year ended December 31 (\$ millions, except as noted)	2010	2009	2008
Cash from operating activities	63.4	72.1	194.9
Change in non-cash working capital	23.5	(11.8)	(15.3)
Funds flow from operations	86.9	60.3	179.6
Funds flow from operations (\$/Boe)	18.26	13.53	35.64

- Funds flow from operations in 2010 increased by \$26.6 million from the prior year, primarily due to the impact of higher petroleum and natural gas sales and lower operating and general and administrative expenses, partially offset by higher transportation and interest expenses.
- Funds flow from operations in 2009 decreased by \$119.3 million from 2008 due primarily to the impact of lower realized commodity prices and lower production, partially offset by lower royalties, operating costs and general and administrative expenses.

PRINCIPAL PROPERTIES

Netback and Segment Loss

Year ended December 31 (\$ millions, except as noted)	2010		2009	
		(\$/Boe)		(\$/Boe)
Petroleum and natural gas sales	184.4	38.77	161.7	36.29
Royalties	(21.2)	(4.46)	(20.7)	(4.64)
Operating expense and production tax	(50.9)	(10.70)	(56.7)	(12.72)
Transportation	(17.2)	(3.62)	(13.8)	(3.11)
Netback	95.1	19.99	70.5	15.82
Financial commodity contract settlements	12.9	2.72	12.9	2.89
Netback including financial commodity contract settlements	108.0	22.71	83.4	18.71
Other principal property items (see below)	(221.1)		(190.3)	
Segment loss	(113.1)		(106.9)	

Petroleum and Natural Gas Sales

Year ended December 31 (\$ millions, except as noted)	2010	2009	% Change
Natural gas	94.8	83.9	13
Oil and NGLs	89.6	77.8	15
	184.4	161.7	14

Revenue from natural gas, oil and NGLs sales in 2010 was \$184.4 million, an increase of \$22.7 million from 2009 due primarily to the impact of higher liquids prices and higher natural gas sales volumes.

The impact of changes in prices and volumes on petroleum and natural gas sales revenue are as follows:

(\$ millions)	Natural gas	Oil and NGLs	Total
Year ended December 31, 2009	83.9	77.8	161.7
Effect of changes in prices	1.3	16.0	17.3
Effect of changes in sales volumes	9.6	(4.2)	5.4
Year ended December 31, 2010	94.8	89.6	184.4

Sales Volumes

	Natural Gas (MMcf/d)			Oil and NGLs (Bbl/d)			Total (Boe/d)		
	2010	2009	Change	2010	2009	Change	2010	2009	Change
Kaybob	23.5	18.9	4.6	573	470	103	4,495	3,615	880
Grande Prairie	12.4	7.5	4.9	951	960	(9)	3,012	2,204	808
Southern	9.3	10.7	(1.4)	1,422	1,602	(180)	2,973	3,382	(409)
Northern	12.5	14.7	(2.2)	471	548	(77)	2,549	3,006	(457)
Total	57.7	51.8	5.9	3,417	3,580	(163)	13,029	12,207	822

Natural gas sales volumes increased to 57.7 MMcf/d in 2010 compared to 51.8 MMcf/d in 2009. Crude oil and NGLs sales volumes decreased to 3,417 Bbl/d in 2010 compared to 3,580 Bbl/d in 2009.

The overall increase in 2010 sales volumes to 13,029 Boe/d was primarily a result of production from new wells drilled in the 2010 capital program at Resthaven, Musreau and Smoky in the Kaybob COU and at Karr-Gold Creek in the Grande Prairie COU, and from wells acquired through the Redcliffe acquisition. These increases were partially offset by declines at Bistcho and Cameron Hills in the Northern COU where limited investments were made in 2010.

Annual production of 13,029 Boe/d in 2010 was below expectations of 13,425 Boe/d due to prolonged wet weather in the fall, which delayed planned well completions, well tie-ins and facilities construction, including the commissioning of the Company's new 20 MMcf/d plant at Karr-Gold Creek, which did not go on-stream until late December.

Average Realized Prices

Year ended December 31	2010	2009	% Change
Natural gas (\$/Mcf)	4.50	4.44	1
Oil and NGLs (\$/Bbl)	71.83	59.50	21
Total (\$/Boe)	38.77	36.29	7

Commodity Prices

Key monthly average commodity price benchmarks and foreign exchange rates are as follows:

Year ended December 31	2010	2009	% Change
Natural Gas			
AECO (Cdn\$/GJ)	3.91	3.93	(1)
New York Mercantile Exchange (Henry Hub US\$/MMbtu)	4.40	4.00	10
Crude Oil			
Edmonton par (Cdn\$/Bbl)	76.80	65.70	17
West Texas Intermediate (US\$/Bbl)	78.39	61.68	27
Foreign Exchange			
\$Cdn / 1 \$US	1.04	1.14	(9)

Paramount's average realized natural gas price for 2010, before financial commodity contract impacts, was \$4.50/Mcf compared to \$4.44/Mcf in 2009. Paramount's natural gas sales portfolio primarily consists of sales priced at the Alberta spot market, Eastern Canadian markets, and California markets and is sold in a combination of daily and monthly contracts.

The average realized oil and NGLs price for 2010, before financial commodity contracts impacts, increased to \$71.83/Bbl compared to \$59.50/Bbl in 2009. Paramount's Canadian oil and NGLs sales portfolio primarily consists of sales priced relative to Edmonton Par, adjusted for transportation and quality differentials. The Company's United States oil and NGLs sales portfolio is sold at the well head with differentials negotiated relative to West Texas Intermediate crude oil prices.

Commodity Price Management

From time to time Paramount uses financial and physical commodity price contracts to manage exposure to commodity price volatility. Paramount has not designated any of its financial commodity contracts as hedges, and as a result, changes in the fair value of these contracts are recognized in earnings.

Receipts from the settlement of natural gas financial contracts are as follows:

Year ended December 31 (\$ millions)	2010	2009
Gas contracts	12.9	12.9

At December 31, 2010, Paramount had the following financial commodity sales contract outstanding:

Instrument	Notional	Fixed Price	Fair Value (\$ millions)	Remaining Term
Crude Oil – NYMEX Swap	500 Bbl/d	USD\$89.95/Bbl	(0.7)	January 2011 – December 2011

Subsequent to December 31, 2010, the Company entered into an additional financial commodity sales contract:

Instrument	Notional	Fixed Price	Remaining Term
Crude Oil – NYMEX Swap	500 Bbl/d	USD\$97.50/Bbl	March 2011 – December 2011

Royalties

Year ended December 31 (\$ millions, except as noted)	2010	Royalty rate	2009	Royalty rate
Natural gas	4.6	4.8 %	3.7	4.4 %
Oil and NGLs	16.6	18.6 %	17.0	21.8 %
Total	21.2	11.5 %	20.7	12.8%

Natural gas royalties increased by \$0.9 million in 2010 compared to the prior year, primarily due to higher natural gas production. Oil and NGLs royalties decreased \$0.4 million compared to the prior year due to lower rates as a result of an increase in NGLs production from new wells which benefit from the first year maximum 5 percent royalty rate and deep gas royalty credit program.

Operating Expense and Production Tax

Year ended December 31 (\$ millions, except as noted)	2010	2009	% Change
Operating expense	48.6	54.5	(11)
Production tax	2.3	2.2	5
Total	50.9	56.7	(10)

Operating expenses decreased by \$5.9 million or 11 percent compared to the prior year, primarily due to lower expenses in the Northern COU due to lower current year production and lower maintenance and well suspension activities compared to 2009. Operating expenses were lower in the Kaybob COU, although production was 24 percent higher, due to the addition of new wells with low operating costs and lower current year suspension activities and processing fees. The decreases in operating costs were partially offset by additional costs related to new well production at Karr-Gold Creek in the Grande Prairie COU and wells added through the Redcliffe acquisition.

Transportation Expense

Year ended December 31 (\$ millions, except as noted)	2010	2009	% Change
Transportation expense	17.2	13.8	25

Transportation expense increased to \$17.2 million in 2010 compared to \$13.8 million in 2009 primarily due to increased tolls and higher production volumes. Transportation expenses include the costs of shipping natural gas to sales points in California and the United States east coast.

Other Principal Property Items

Year ended December 31 (\$ millions)	2010	2009
Depletion, depreciation and accretion	175.9	140.4
Exploration and dry hole expenses	18.2	29.4
Gain on sale of property plant and equipment	(0.2)	(0.5)
Commodity contracts – net of settlements	2.9	7.6
Write-down of petroleum and natural gas assets	25.3	14.9
Other	(1.0)	(1.5)
Total	221.1	190.3

Depletion, depreciation, and accretion increased to \$175.9 million or \$36.98 per Boe in 2010 compared to \$140.4 million or \$31.51 per Boe in the prior year. The increase was primarily due to a full year of increased depletion rates in 2010 resulting from the fourth quarter 2009 change in pricing methodology for proved reserves used in the calculation of depletion rates, higher lease expiries and increased current year production.

Exploration and dry hole expenses include \$7.8 million of costs related to unsuccessful wells drilled in the first quarter of 2010 at Cameron Hills in the Northern COU.

The 2010 write-down of petroleum and natural gas assets related primarily to conventional reserves in the Liard and Haro areas in the Northern COU, the Puskwa area in the Grande Prairie COU and various others where the property's carrying value exceeded its expected discounted cash flows from the production of estimated proved and probable reserves. Reserve estimates for Liard and Haro were impacted by downward revisions to estimated net cash flows due to lower estimated future natural gas prices. Reserve estimates for Puskwa were impacted by declining well performance.

STRATEGIC INVESTMENTS

Year ended December 31 (\$ millions)	2010	2009
Income (loss) from investments	8.2	(7.3)
Drilling rig revenue	3.9	0.4
Drilling rig expense	(2.7)	(2.9)
General and administrative	(3.6)	(2.5)
Stock-based compensation	(18.0)	(4.6)
Interest	(1.2)	(0.5)
Other (expense) income	(1.5)	(0.6)
Segment Loss	(14.9)	(18.0)

Strategic Investments at December 31, 2010 include:

- investments in the shares of Trilogy, MEG, MGM Energy, NuLoch Resources Inc. ("NuLoch"), Paxton Corporation, and other public and private corporations;
- oil sands resources at Hoole, situated within the western portion of the Athabasca Oil Sands region, and carbonate bitumen holdings in Northeast Alberta, including at Saleski;
- shale gas holdings in the Horn River and Liard Basins in Northeast British Columbia and the Northwest Territories; and
- three drilling rigs operating by Paramount's wholly-owned subsidiaries: Fox Drilling in Canada and Paramount Drilling in the United States.

Income from investments in 2010 includes \$0.4 million of equity earnings, dilution gains of \$4.3 million and a gain of \$3.5 million related to the reclassification of gains on the investment in Redcliffe previously recognized in other comprehensive income. The prior year includes \$17.4 million of equity losses, a net dilution gain of \$6.9 million and a \$3.2 million gain realized on the disposition of shares in Nuloch.

Stock-based compensation increased \$13.4 million due to the appreciation of the trading price of the Company's shares.

In August 2010, MEG completed its initial public offering on the Toronto Stock Exchange. As a result, Paramount now carries its investment in MEG at market value, and the December 31, 2010 carrying value was increased to \$168.3 million or \$45.49 per share, compared to \$101.8 million or \$27.50 per share in 2009. The increase in carrying value resulted in a gain of \$66.5 million, which was recorded in other comprehensive income.

The Company's investments in other entities are as follows:

Year ended December 31 (\$ millions)	Carrying Value		Market Value ⁽¹⁾	
	2010	2009	2010	2009
Trilogy	103.0	104.5	297.0	206.1
MEG	168.3	101.8	168.3	101.8
MGM Energy	5.2	5.9	8.8	12.5
Other ⁽²⁾	28.8	22.4	28.8	22.5
Total	305.3	234.6	502.9	342.9

⁽¹⁾ Based on the period-end closing price of publicly-traded investments and book value of remaining investments.

⁽²⁾ Includes investments in NuLoch, Paxton, Redcliffe (2009 only), and other public and private corporations.

The Hoole oil sands project continued to progress in 2010. In the first quarter, the Company invested \$9.9 million to drill 45 oil sands evaluation wells to further delineate the reservoir and bitumen resource, and design work continued throughout the year.

In May 2010, Paramount received an updated independent evaluation of its Grand Rapids resource at Hoole from McDaniel & Associates Consultants Ltd. ("McDaniel"), with an evaluation date of April 30, 2010, incorporating the results of the drilling program. The report estimated contingent bitumen resources at 634 million barrels (Best Estimate (P50)), having a before-tax net present value of future net revenue of \$1.9 billion, discounted at ten percent (Best Estimate (P50)). A full description of the estimated resources at the Hoole property is available in the Company's 2010 Annual Information Form on the SEDAR website at www.sedar.com.

During 2011, the Company plans to continue design and other necessary work to prepare for a regulatory application for commercial development, which is expected to be filed in the third quarter. In support of this, in the first quarter of 2011 Paramount plans to invest \$7 million to drill an additional 15 oil sands evaluation wells and complete a 25 km seismic program, after which the Company plans to obtain an updated resource evaluation from McDaniel.

The Company has invested an aggregate of \$25.5 million in the Hoole project to December 31, 2010 (2009 - \$11.3 million).

In the first quarter of 2011, Paramount plans to begin the delineation of its Carbonate bitumen resource. The Carbonate bitumen trend is differentiated from conventional oil sands in that the bitumen is contained within Devonian-aged dolomites and limestone rocks, as opposed to the Cretaceous sands currently being exploited. Paramount has allocated \$8 million for a 15 well drilling and delineation program targeting the Grosmont formation to provide data for a detailed analysis of the property.

CORPORATE

Year ended December 31 (\$ millions)	2010	2009
General and administrative	11.8	14.7
Stock-based compensation	40.7	12.9
Depletion and depreciation	1.0	1.0
Interest and financing	12.3	10.7
Foreign exchange	(0.8)	(11.5)
Debt extinguishment	1.7	–
Other (income) expense	0.1	(0.2)
Corporate costs	66.8	27.6

Corporate segment net costs increased \$39.2 million to \$66.8 million in 2010, compared to \$27.6 million in 2009, primarily due to the impact of higher stock-based compensation and changes in foreign exchange rates, partially offset by lower general and administrative expenses.

Salary costs in 2010 were consistent with the prior year, and general and administrative expenses decreased overall due to increased cost recoveries related to increased capital spending. Costs of \$0.3 million related to the Redcliffe acquisition were included in 2010 general and administrative expenses.

Capital Expenditures

Year ended December 31 (\$ millions)	2010	2009
Geological and geophysical	7.6	5.2
Drilling, completion and tie-ins	144.8	68.0
Facilities and gathering	46.6	20.2
Exploration and development expenditures	199.0	93.4
Land and property acquisitions	82.7	6.4
Principal Properties	281.7	99.8
Strategic Investments	16.3	17.6
Corporate	0.2	0.1
Capital expenditures	298.2	117.5

Exploration and development expenditures in 2010 were \$199.0 million compared to \$93.4 million in 2009. Spending in 2010 focused on drilling and completing wells and constructing/expanding facilities and gathering systems for the Karr-Gold Creek deep gas project in the Grande Prairie COU and the Deep Basin development at Musreau, Smoky and Resthaven in the Kaybob COU. Exploration and development expenditures in 2010 were reduced by \$11.4 million (2009 - \$3.8 million) as a result of the Alberta Drilling Royalty Credit program.

Land and property acquisitions include undeveloped land purchases of \$36.0 million in the Deep Basin at Musreau, Resthaven and Smoky, \$10.2 million at Valhalla and \$8.6 million in North Dakota.

In the United States, Paramount operates through Summit Resources Inc. ("Summit"), a wholly owned subsidiary. In April 2010, Summit entered into a joint development agreement with a United States exploration and development company that has significant operations and experience in the Bakken play in North Dakota. Under the agreement, which covers approximately 39,900 net acres of Summit's undeveloped Bakken lands in North Dakota, the U.S. company is carrying out a multiple well horizontal drilling program using multi-stage fracture technology in order to earn an undivided 50 percent of Summit's interests in these lands (19,950 net acres). The North Dakota joint development partner has drilled and completed three horizontal wells. The wells have not performed as expected, with the first two producing at nominal rates.

Subsequent to December 31, 2010, Paramount sold approximately 6,000 net acres of undeveloped land in North Dakota, unrelated to the farm-out lands, for cash proceeds of US\$40 million.

Strategic investments capital expenditures in 2010 consist primarily of \$14.2 million related to the Hoole Oil Sands Project, including \$9.9 million for drilling and delineation.

Wells drilled are as follows:

(wells drilled)	2010		2009	
	Gross ⁽¹⁾	Net ⁽²⁾	Gross ⁽¹⁾	Net ⁽²⁾
Gas	34	23	22	13
Coal bed methane	13	10	—	—
Oil	13	6	2	1
Oil sands evaluation	45	45	7	7
Dry and abandoned	4	4	—	—
Total	109	88	31	21

(1) Gross is the number of wells in which Paramount has a working interest or a royalty interest that may be converted to a working interest.

(2) Net is the aggregate number of wells obtained by multiplying each gross well by Paramount's percentage of working interest.

OUTLOOK

Based on encouraging drilling and completion results, Paramount accelerated 2010 development plans in the Kaybob and Grande Prairie COUs, increasing total exploration and development spending to \$199.0 million. Paramount expects to invest \$425 million in its Principal Properties in 2011, excluding land acquisitions. The 2011 Principal Properties capital program will focus on drilling and facility construction at Musreau, Smoky and Resthaven in the Kaybob COU and at Karr-Gold Creek and Valhalla in the Grande Prairie COU. The Company plans to invest an additional \$25 million in the Hoole oil sands and Saleski carbonate bitumen areas. Paramount has flexibility within its current capital plan to increase or decrease spending, depending upon future economic conditions, among other factors.

Based on current production levels, market conditions, and the current exploration and development budget, 2011 annual average production is expected to be approximately 20,000 Boe/d, with an anticipated 2011 exit rate of 25,000 Boe/d.

LIQUIDITY AND CAPITAL RESOURCES

Paramount manages its capital structure to support current and future business plans and periodically adjusts the structure in response to changes in economic conditions and the risk characteristics of the Company's underlying assets and operations. Paramount may adjust its capital structure by issuing or repurchasing shares, altering debt levels, modifying capital programs, acquiring or disposing of assets and participating in joint ventures.

As at December 31 (\$ millions)	2010	2009	Change
Working capital deficit (surplus) ⁽¹⁾	(4.8)	(43.5)	38.7
Senior Notes ⁽²⁾	300.0	–	300.0
US Senior Notes ⁽²⁾	–	94.4	(94.4)
Net debt⁽³⁾	295.2	50.9	244.3
Share capital	458.9	393.1	65.8
Contributed surplus	3.9	2.9	1.0
Retained earnings	251.3	373.7	(122.4)
Accumulated other comprehensive income	71.6	3.2	68.4
Total Capital	1,080.9	823.8	257.1

(1) Excludes risk management assets and liabilities and stock-based compensation liabilities.

(2) Excludes unamortized financing costs.

(3) 2010 Net debt excludes the \$19.8 million deposit on account with the CRA, pending resolution of the Company's notices of objection.

Working Capital

Paramount's working capital surplus at December 31, 2010 was \$4.8 million compared to a surplus of \$43.5 million at December 31, 2009. Working capital at December 31, 2010 included \$74.7 million of cash and cash equivalents, \$33.3 million of accounts receivable and \$78.8 million of accounts payable and accrued liabilities. The decrease in working capital is primarily a result of capital spending, the Redcliffe acquisition and the repayment of the Company's 8.5 percent US Senior Notes, partially offset by proceeds from the Senior Notes offering, the equity offerings and funds flow from operations. Principal payments of \$2.5 million were made on the drilling rig loan in 2010.

Paramount expects to fund its 2011 operations, obligations, and capital expenditures with existing cash and cash equivalents, funds flow from operations, drawings under its bank credit facility, and by accessing the capital markets, if required.

Bank Credit Facility

In April 2010, Paramount renewed its credit facility with the borrowing base and lender commitments remaining at \$125 million. In July 2010, following the acquisition of Redcliffe, the borrowing base and lender commitments under the credit facility were increased from \$125 million to \$160 million. The credit facility is secured by a first fixed and floating charge over substantially all of the assets of Paramount, excluding assets securing the drilling rig loan. The maximum amount that Paramount may borrow under the credit facility is subject to semi-annual review, and is dependent upon the Company's reserves and lenders' projections of future commodity prices, among other factors.

The credit facility is available on a revolving basis to April 30, 2011. The Company has requested an extension to the revolving term of its credit facility and expects to finalize details of the extension before April 30, 2011. In the event the revolving period is not extended, the credit facility would be available on a non-revolving basis for an additional year, at which time it would be due and payable.

At December 31, 2010, no balance was drawn on the credit facility. Paramount had undrawn letters of credit outstanding at December 31, 2010 of \$24.1 million that reduce the amount available to the Company.

Senior Notes

In December 2010, Paramount completed a public offering of \$300 million principal amount of senior unsecured notes ("Senior Notes") at par, of which \$11.4 million principal amount was purchased by certain directors, associates, officers, and management of the Company. The Senior Notes bear interest at 8.25 percent per annum, payable semi-annually in arrears on June 13 and December 13 in each year and mature on December 13, 2017. The Senior Notes are direct senior unsecured obligations of Paramount and rank equally with all other senior unsecured indebtedness of the Company. A portion of

the proceeds of the Senior Notes were used to purchase/redeem the remaining outstanding balance of the Company's US Senior Notes.

The Company may redeem all or any portion of the Senior Notes at any time on or prior to December 13, 2013 at par, plus accrued and unpaid interest, plus a redemption premium equal to the greater of: (i) one percent; and (ii) a make-whole amount based on the then current yield of a Government of Canada bond with a similar maturity. Paramount may also redeem up to an aggregate of 35 percent of the Senior Notes with the net cash proceeds of an equity offering at any time prior to December 13, 2013, at par plus a redemption premium of 8.25 percent. On or after December 13, 2013, the Company may redeem some or all of the Senior Notes at par plus a redemption premium, if applicable, of up to 4.125 percent depending on when redeemed, plus accrued and unpaid interest.

In February 2011, Paramount closed a public offering of an additional \$70 million principal amount of its 8.25 percent Senior Notes at a premium price of \$1,030 per \$1,000 principal amount, of which \$1.4 million principal amount was purchased by an entity that is associated with the Company's Chairman and Chief Executive Officer.

US Senior Notes

During the fourth quarter of 2010, Paramount's obligations under the indenture governing its US\$90.2 million principal amount of US Senior Notes were discharged as a result of Paramount: (i) purchasing US\$64.2 million principal amount of US Senior Notes pursuant to a tender offer; (ii) delivering all US Senior Notes held by the Company to the trustee for cancellation; (iii) issuing a redemption notice for US\$26.0 million principal amount of US Senior Notes not tendered under the tender offer (the "Redeemed Notes"); and (iv) irrevocably depositing sufficient cash with the trustee to pay all amounts due on the Redeemed Notes on the January 31, 2011 redemption date. As a result, the 12.8 million Trilogy common shares held by the trustee as security were released to the Company.

Share Capital

In April 2010, Paramount received regulatory approval under Canadian securities laws to purchase Common Shares under a normal course issuer bid ("NCIB") commencing April 13, 2010 for a 12-month period. Under the NCIB, Paramount is permitted to purchase for cancellation up to 3,626,476 Common Shares. No shares have been purchased under the NCIB to March 3, 2011.

In November 2010, Paramount issued 1,100,000 Canadian Exploration Expense ("CEE") flow-through Common Shares for gross proceeds of \$30.0 million through a public offering. Concurrently, Paramount also issued 1,020,000 Canadian Development Expense ("CDE") flow-through Common Shares and 150,000 CEE flow-through Common Shares through a private placement for aggregate gross proceeds of \$29.1 million to the Company's Chairman and Chief Executive Officer and certain other members of management, and companies controlled by them.

The Company is committed to renounce \$59.1 million of qualifying expenditures related to the 2010 CEE and CDE flow-through Common Shares issued, and is required to incur these expenditures by December 31, 2011.

Paramount has incurred sufficient qualifying expenditures to satisfy its commitments associated with flow-through shares issued in October and November 2009.

At February 28, 2011, Paramount had 75,360,174 Common Shares and 4,829,550 Stock Options outstanding (1,190,551 exercisable).

QUARTERLY INFORMATION

(\$ millions, except as noted)	2010				2009			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Petroleum and natural gas sales	46.0	44.9	44.6	48.9	45.0	36.3	40.2	40.2
Funds flow from operations	19.9	23.2	22.1	21.6	18.8	10.2	13.7	17.6
per share – basic and diluted (\$/share)	0.27	0.32	0.31	0.30	0.27	0.15	0.21	0.27
Net loss	(75.5)	(3.7)	(28.8)	(14.5)	(46.4)	(25.2)	(2.6)	(23.7)
per share – basic and diluted (\$/share)	(1.03)	(0.05)	(0.40)	(0.20)	(0.67)	(0.38)	(0.04)	(0.36)
Sales volumes								
Natural gas (MMcf/d)	60.4	62.9	57.0	50.2	47.0	49.9	59.1	51.1
Oil and NGLs (Bbl/d)	3,387	3,480	3,287	3,514	3,673	3,733	3,512	3,398
Total (Boe/d)	13,461	13,967	12,787	11,875	11,514	12,046	13,362	11,912
Average realized price								
Natural gas (\$/Mcf)	4.04	4.12	4.49	5.59	4.85	3.24	4.03	5.73
Oil and NGLs (\$/Bbl)	75.48	65.85	71.32	74.78	71.00	62.33	57.83	45.38

Significant Items Impacting Quarterly Results

Quarterly earnings variances include the impacts of changing production volumes and market prices.

- Fourth quarter 2010 earnings include \$35.7 million of stock-based compensation charges and a \$25.3 million write-down of petroleum and natural gas properties.
- Third quarter 2010 earnings include a future income tax recovery of \$37.0 million, increased depletion, depreciation and accretion expense and \$8.1 million of stock-based compensation charges.
- Second quarter 2010 earnings include increased depletion, depreciation and accretion expense and \$7.3 million of stock-based compensation charges.
- First quarter 2010 earnings include \$8.2 million of dry hole expenses and \$7.7 million of stock-based compensation charges.
- Fourth quarter 2009 earnings include \$24.3 million of dry hole expenses related to suspended exploratory well costs and a \$14.9 million write-down of petroleum and natural gas properties.
- Third quarter 2009 earnings include higher stock-based compensation charges, and lower earnings from Strategic Investments.
- Second quarter 2009 earnings include increased future income tax recoveries and lower operating expenses.
- First quarter 2009 earnings include lower Corporate costs and Strategic Investments losses.

Fourth Quarter Review

Netback

Three months ended December 31		
(\$ millions, except as noted)		
	2010	2009
Petroleum and natural gas sales	46.0	45.0
Royalties	(4.4)	(7.4)
Operating expense and production tax	(12.8)	(12.5)
Transportation	(4.3)	(3.4)
Netback	24.5	21.7
Financial commodity contract settlements	1.8	1.7
Netback including financial commodity contract settlements	26.3	23.4
Netback including financial commodity contract settlements (\$/Boe)	21.22	22.13

Funds Flow from Operations

Three months ended December 31		
(\$ millions, except as noted)		
	2010	2009
Cash flow from operating activities	11.1	21.3
Change in non-cash working capital	8.8	(2.5)
Funds flow from operations	19.9	18.8
Funds flow from operations (\$/Boe)	16.10	17.75

Sales Volumes

	Three months ended December 31								
	Natural Gas (MMcf/d)			Oil and NGLs (Bbl/d)			Total (Boe/d)		
	2010	2009	Change	2010	2009	Change	2010	2009	Change
Kaybob	28.8	19.0	9.8	713	473	240	5,506	3,636	1,870
Grande Prairie	11.4	5.7	5.7	761	1,046	(285)	2,667	1,993	674
Southern	9.1	9.7	(0.6)	1,455	1,563	(108)	2,976	3,198	(222)
Northern	11.1	12.6	(1.5)	458	591	(133)	2,312	2,687	(375)
Total	60.4	47.0	13.4	3,387	3,673	(286)	13,461	11,514	1,947

Paramount's fourth quarter sales volumes of 13,461 Boe/d consisted of 60.4 MMcf/d of natural gas and 3,387 Bbl/d of oil and NGLs, generating revenue of \$46.0 million, an increase of \$1.0 million from the prior year comparable quarter due to higher natural gas volumes and higher oil and NGLs prices, partially offset by lower natural gas prices and lower oil and NGLs production volumes. Production levels in the Grande Prairie COU in the fourth quarter of 2010 were impacted by the commissioning of the new Karr-Gold Creek plant, which temporarily shut-in some wells while they were being tied-in to the new facility, and by drilling new wells on pad sites, requiring producing wells on the pads to be shut-in during drilling operations.

Fourth quarter royalties decreased to \$4.4 million in 2010 compared to \$7.4 million in 2009, primarily as a result of production from new wells which benefit from the first year maximum five percent royalty rate and deep natural gas royalty holidays. Operating expenses were \$0.3 million higher in the fourth quarter of 2010 compared to the prior year primarily due to higher production volumes in the Grande Prairie and Kaybob COUs.

Funds flow from operations in the fourth quarter of 2010 increased by \$1.1 million to \$19.9 million compared to \$18.8 million in 2009, primarily due to lower royalties, partially offset by higher interest expenses.

Fourth quarter exploration and development expenditures of \$78.1 million were primarily related to the Grande Prairie COU's Karr-Gold Creek deep gas program and the Deep Basin development in the Kaybob COU.

OTHER INFORMATION

Significant Equity Investee

The following table summarizes the assets, liabilities and results of operations of Trilogy. The amounts summarized have been derived directly from Trilogy's financial statements as at and for the periods ended December 31, 2010 and 2009, and do not include Paramount's adjustments in applying the equity method of investment accounting. As a result, the amounts included in the table below cannot be used to derive Paramount's equity income and net investment in Trilogy.

As at December 31 (\$ millions)	2010	2009
Current assets	51.6	54.1
Long term assets	960.5	839.1
Current liabilities	84.1	63.8
Long term liabilities	493.4	394.8
Equity	434.6	434.6

Year ended December 31 (millions, except as noted)	2010	2009
Revenue	261.0	220.8
Expenses	248.4	260.1
Tax expense (recovery)	3.2	(5.9)
Net earnings (loss)	9.4	(33.4)
Shares/units outstanding at December 31 (thousands)	115,037	110,490
Paramount's equity interest at December 31 ⁽¹⁾	21.0%	21.7%

(1) Readers are cautioned that Paramount does not have any direct or indirect interest in or right to Trilogy's assets or revenue, nor does Paramount have any direct or indirect obligation in respect of or liability for Trilogy's expenses or obligations.

Trilogy had 5.9 million stock options outstanding (1.8 million exercisable) at December 31, 2010 at exercise prices ranging from \$4.85 to \$12.88 per share.

Related Party Transactions

Service Agreements

In 2010 Paramount charged \$0.5 million (2009 – \$0.6 million) for certain operational and administrative services that the Company provided to Trilogy. Paramount also has transactions with Trilogy, MGM Energy and Perpetual Energy Inc. in the normal course of business, including joint venture operations. Trilogy, Perpetual Energy Inc., MGM Energy and Paramount are related by common significant influence. All transactions between the entities are recorded at their exchange amounts.

Contractual Obligations

Paramount had the following contractual obligations at December 31, 2010:

(\$ millions)	2011	2012-2013	2014-2015	After 2015	Total
Senior Notes, including interest	24.8	49.5	49.5	348.3	472.1
Drilling rig loan, including interest	5.1	11.7	12.9	–	29.7
Pipeline transportation commitments ⁽¹⁾	14.5	28.1	25.8	67.1	135.5
Operating leases	2.3	1.9	–	–	4.2
Total	46.7	91.2	88.2	415.4	641.5

⁽¹⁾ Certain of the pipeline transportation commitments are secured by \$10.4 million of outstanding letters of credit million at December 31, 2010.

Contingencies

Paramount is party to various legal claims associated with the ordinary conduct of business. Paramount does not anticipate that these claims will have a material impact on its financial position.

Tax and royalty legislation and regulations, and government interpretation and administration thereof, continually changes. As a result, there are often tax and royalty matters under review by relevant government authorities. All tax filings are subject to subsequent government audit and potential reassessments. Accordingly, the final liability may differ materially from amounts estimated and recorded.

In October 2010, the Company received reassessments from the Canada Revenue Agency (the "CRA") and provincial tax authorities of its income taxes relating to a prior year transaction (the "Reassessments"). Paramount disagrees with the Reassessments and has filed notices of objection with the CRA and provincial tax authorities. Despite its disagreement, and as a condition of its right to proceed with its objection to the Reassessments, the Company was required to deposit approximately \$19.8 million with the CRA, which amount will remain on account until the dispute is resolved.

Crown royalties for Paramount's production in the Northwest Territories have been accrued based on the Company's interpretation of the relevant legislation and regulations. To date, Paramount has not received assessments from the Government of Canada of its liability under such legislation and regulations for its past filings. Although Paramount believes that its interpretations of the relevant legislation and regulations have merit, Paramount is unable to predict the ultimate outcome of audits and/or assessments by the Government of Canada. Additional material amounts could potentially become payable.

As a result of flow through share issuances in the fourth quarter of 2010, Paramount is required to incur and renounce \$34.1 million of Canadian Exploration Expense and \$25.0 million of Canadian Development Expense. The Company is required to incur all qualifying expenditures by December 31, 2011.

Critical Accounting Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and disclosure of contingent assets and liabilities. The following is a discussion of the accounting estimates that are considered critical.

Property, Plant and Equipment

Paramount follows the successful efforts method of accounting for its petroleum and natural gas operations. The application of the successful efforts method of accounting requires the use of judgment to determine, among other things, the designation of wells as development or exploratory and whether exploratory wells have discovered economically recoverable quantities of reserves. All costs of development wells are capitalized. Costs of drilling exploratory wells are initially capitalized, pending evaluation of reserves. If economically recoverable reserves are not found, such costs are charged to earnings.

Effective October 1, 2009, for purposes of calculating depletion, the Company adopted the Financial Accounting Standards Board update for Oil and Gas Reserve Estimation and Disclosures applicable to Accounting Standards Codification Topic 932 ("ASC 932"). The ASC 932 update changes the pricing methodology for proved reserves from period end pricing to an average of first day of month pricing for 12 months, consistent with the modernized US Securities and Exchange Commission reserves definition. The effect of adopting ASC 932 for the year ended December 31, 2009 was to increase depletion expense by \$7.2 million, decrease future income tax expense by \$1.9 million, decrease net earnings by \$5.3 million, and decrease basic and diluted earnings per share by \$0.08.

Paramount recognizes Alberta drilling royalty credits as a reduction to property plant and equipment. The credits are recognized as they are earned, as determined by well depth, to the extent the Company anticipates being able to use the credits to reduce crown royalties.

Reserve Estimates

Reserve engineering is an inherently complex and subjective process of estimating underground accumulations of petroleum and natural gas. The process relies on interpretations of available geological, geophysical, engineering and production data. The accuracy of a reserves estimate is a function of the quality and quantity of available data, the interpretation of that data, the accuracy of various economic assumptions and the judgment of those preparing the estimate.

In 2010, all of Paramount's reserves were evaluated by a qualified independent reserves evaluator. Because these estimates depend on many assumptions, all of which may differ from actual results, reserves estimates and estimates of future net revenue may be different from the sales volumes ultimately recovered and net revenues actually realized. The results of changes in market conditions, regulatory changes, subsequent drilling, testing and production may require revisions to the original estimates.

Estimates of reserves impact: (i) the assessment of whether or not an exploratory well has found economically recoverable reserves; (ii) depletion rates; and (iii) impairment assessments of oil and gas properties, all of which could have a material impact on earnings.

Impairment of Petroleum and Natural Gas Properties

Proved properties are reviewed for impairment annually, or as economic events dictate, on a field basis. An impairment provision is recorded when the carrying value of a field exceeds its estimated expected future cash flows from proved and probable reserves. Reserve estimates, as well as estimates for petroleum and natural gas prices, royalties, transportation and production costs, may change and there can be no assurance that additional impairment provisions will not be required in the future.

If an exploratory well encounters hydrocarbons, but further appraisal activity is required to conclude whether reserves are economically recoverable, the well costs remain capitalized as long as sufficient progress is being made in assessing the reserves and the economic and operating viability of the well. The concept of "sufficient progress" is a judgmental area, where the accounting rules prohibit the continued capitalization of suspended well costs on the chance that future market conditions will improve or new technologies will be found that would make the project's development economically

profitable. For certain exploratory projects, it is possible to have exploratory costs remain capitalized for several years while additional drilling is performed, or the Company seeks government, regulatory or partner approval of development plans.

Management reviews suspended well costs regularly and expenses the suspended well costs when the project does not warrant further development. Criteria utilized in making this determination include evaluation of the reservoir characteristics and hydrocarbon properties, expected development costs, and regulations.

Purchase Price Allocations

Business acquisitions are accounted for using the acquisition method of accounting, where all of the assets acquired and liabilities assumed are recorded at fair value. Any excess of purchase price over the fair value of identifiable assets and liabilities acquired is recorded as goodwill. Determinations of fair value often require management to make assumptions and estimates about future events. Changes in any of the assumptions or estimates used in determining the fair value of acquired assets and liabilities could impact the amounts assigned to property, plant and equipment, working capital and goodwill in the purchase price allocation.

Asset Retirement Obligations

Paramount recognizes the fair value of an asset retirement obligation in the period in which it is incurred and when a reasonable estimate of the fair value can be made. The accumulated asset retirement obligation is adjusted for the passage of time, which is recognized as accretion expense, and for revisions in either the timing or the amount of the estimated cash flows associated with the liability.

Estimates of asset retirement costs are subject to uncertainty associated with the method, timing, economic environment and regulatory standards that exist at the time assets are retired. Accordingly, actual payments to settle the obligations may differ materially from amounts estimated.

Carrying Value of Investments

The carrying value of investments is assessed for impairment at least annually. The Company estimates fair value based on factors including the expected future cash flows from the investment and public trading prices of investees' shares. If the carrying value of an investment exceeds its estimated fair value and the impairment is assessed to be other than temporary, an impairment loss is recognized and the carrying value is written down to the fair value estimate. The process of assessing investments for impairment requires the application of various assumptions and judgments, including assessing whether the fair value of an investment will return to its carrying value in a reasonable period and estimating the duration the investment will be held.

Carrying Value of Goodwill

Goodwill is tested for impairment at least annually using the expected future cash flows of the respective reporting unit to determine its fair value. Impairment is assessed based on the difference between the fair value of each reporting unit and its carrying value, including goodwill. Any excess of the carrying value of the reporting unit over the fair value is charged to earnings. The process of assessing goodwill for impairment requires estimates of fair values involving various assumptions and judgments.

Income Taxes

The Company follows the liability method of accounting for income taxes, whereby future income taxes are recognized based on the difference between the carrying amount of an asset or liability reported in the financial statements and its respective tax basis, using substantively enacted income tax rates. Accounting for income taxes is a complex process requiring management to interpret frequently changing laws and regulations and make judgments related to the application of tax law, estimate the

timing of temporary difference reversals, and estimate the realization of tax assets. All tax filings are subject to subsequent government audit and potential reassessment. These interpretations and judgments and changes related to them impact the current and future tax provisions, future income tax assets and liabilities and net earnings.

Change in Accounting Policy

Effective January 1, 2010, Paramount early adopted CICA Handbook section 1582 – "Business Combinations", which replaces the previous business combinations standard. The new standard requires that all of the assets acquired and the liabilities assumed in a business combination be recorded at fair value, which was not the case under the previous standard. The new standard also requires that previously held ownership interests be remeasured to the acquisition date fair value, rather than being restated to cost. In addition, the new standard requires that all acquisition costs associated with the acquisition be expensed, rather than capitalized as part of the acquisition, that contingent liabilities be recognized at fair value at the acquisition date and subsequently re-measured to fair value with changes recognized in earnings, and that a bargain purchase be recognized in earnings rather than being allocated to non-monetary assets. This new standard was applied to the Company's acquisition of Redcliffe in 2010.

Effective January 1, 2010, Paramount also early adopted CICA Handbook sections 1601 – "Consolidations" and 1602 - "Non-controlling Interests", which together replaced section 1600 – "Consolidations". Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 requires non-controlling interests to be presented within equity. There was no impact on the Consolidated Financial Statements from the adoption of these standards.

Future Accounting Changes

International Financial Reporting Standards

Accounting standards in Canada, as used by publicly accountable enterprises, will be converted to International Financial Reporting Standards ("IFRS") for fiscal years beginning on or after January 1, 2011. Paramount's IFRS conversion project is proceeding according to plan and the Company expects to be ready for the transition in the first quarter of 2011.

Significant components of Paramount's IFRS conversion project completed to date include:

- compilation of a diagnostic analysis that identified key differences between existing Canadian GAAP and IFRS, as they relate to the Company;
- preparation of Company specific draft accounting position papers;
- implementation of modifications to information systems required to accumulate and process information in order to generate IFRS financial information;
- preparation of draft IFRS financial statement disclosures; and
- identification of changes to internal controls over financial reporting and disclosure controls and procedures.

Accounting Policy Changes

The following describes certain changes that Paramount expects to make upon transition to IFRS:

Property, Plant and Equipment

The transition to IFRS requires certain policy, process and disclosure changes, including exploration phase accounting and impairment testing levels and methodologies.

Exploration and evaluation ("E&E") costs are those expenditures for an area or project for which technical feasibility and commercial viability have not yet been determined. Paramount's E&E asset balance will primarily consist of costs related to undeveloped land and incomplete exploratory drilling projects. Under IFRS, Paramount will initially capitalize these costs as E&E assets on the balance sheet. When the area or project is determined to be technically feasible and commercially viable, the costs will be, subject to an impairment evaluation, transferred to property, plant and equipment. Costs related to unsuccessful projects will be expensed. The Company expects to reclassify approximately \$150 million to E&E assets from property, plant and equipment in its opening IFRS balance sheet as of January 1, 2010.

Under Canadian GAAP, impairment of the Company's petroleum and natural gas properties is assessed on a property-by-property basis. Under IFRS, assets are grouped together in cash-generating units ("CGUs"), which consist of the smallest group of assets that generate cash inflows that are largely independent of the cash inflows of other assets or groups of assets. Paramount expects to group its properties into ten cash generating units which will be used in the impairment assessment upon transition to IFRS.

IFRS requires an impairment to be recognized when the carrying value of a CGU exceeds its recoverable amount. The recoverable amount of a CGU is defined as the greater of its value in use and its fair value less costs to sell. Under Canadian GAAP, a two step approach to determining an impairment is applied: (i) the carrying value of a property is compared to its expected undiscounted before-tax cash flows, and (ii) where the carrying value is found to exceed its expected undiscounted cash flows, an impairment charge is calculated based on the difference between the property's carrying amount and its expected discounted before-tax cash flows. The IFRS method of determining impairments will generally result in higher impairment charges. The Company expects to record an impairment charge relating to certain CGUs on conversion to IFRS, the extent of which has not yet been finalized.

Paramount expects to apply the IFRS 1 "First Time Adoption of International Reporting Standards" exemption to measure certain CGUs at fair value on transition to IFRS and to subsequently deem that fair value to be historical cost.

Stock-based Compensation

Under Canadian GAAP, the Company's stock option plan liability is revalued each period using the intrinsic value method, where a liability is calculated based on the amount by which the market price of the Company's shares exceeds the exercise price of an option. Under IFRS, the stock option plan liability must be remeasured each period using a fair value option pricing model, and Paramount has determined that it will use the Black-Scholes-Merton model. As a result of the change in valuation method, Paramount's stock-based compensation liability is expected to increase by approximately \$3 million in its opening IFRS balance sheet as of January 1, 2010.

The Company intends to utilize the IFRS 1 exemption under which amounts recorded in respect of options settled prior to January 1, 2010 will not be retrospectively restated.

Asset Retirement Obligations

Under Canadian GAAP, the discount rate applied to calculate the present value of asset retirement obligations ("ARO") is determined when the liability is initially recognized and is not adjusted for changes in discount rates in future periods. Canadian GAAP permits the use of credit-adjusted rates in the present value calculations. Under IFRS, the present value of ARO liabilities is determined using the relevant period end risk-free rate at each reporting date. As a result, the Company expects to recognize an increase in the ARO liability of approximately \$90 million in the opening IFRS balance sheet. Generally,

the change in discount rates results in a balance being added to or deducted from property, plant and equipment.

Foreign Exchange Translation

Under Canadian GAAP, the assets and liabilities of the Company's integrated foreign operations are translated into Canadian dollars using the temporal method, where non-monetary items are translated at historical exchange rates. Changes in the carrying value of monetary assets and liabilities are recognized in earnings. Under IFRS, all assets and liabilities of subsidiaries with functional currencies that are not the Canadian dollar will be translated at the exchange rate in effect at the end of the reporting period and all resulting exchange differences will be recognized in other comprehensive income. This change in translation is expected to result in a decrease in the carrying amount of Paramount's property, plant and equipment assets of approximately \$5 million in the opening IFRS balance sheet.

The Company expects to apply the IFRS 1 exemption to deem the cumulative translation difference as of January 1, 2010 to be nil.

Flow-Through Shares

Under Canadian GAAP, when flow-through shares are issued they are recorded based on proceeds received. Upon filing the renouncement documents with the tax authorities, a future tax liability is recognized and shareholders' equity is reduced for the tax effect of expenditures renounced to subscribers. Under IFRS, the Company expects to allocate the proceeds from the issuance of flow-through shares between the sale of the shares, which are allocated to share capital, and the sale of the tax benefits, which are accrued as a liability. The allocation is made based on the difference between the issue price of flow-through shares and the market price of the Common Shares. A liability is recognized for this difference, which is reversed upon the renunciation of the qualifying expenditures to subscribers. The difference between the liability recognized and the deferred tax liability recorded upon renunciation is recognized as income tax expense. The IFRS adjustment associated with flow-through shares in the opening IFRS balance sheet as of January 1, 2010 is expected to increase share capital by approximately \$25 million, reduce retained earnings by \$21 million and increase accrued liabilities by \$4 million.

Income Taxes

The Company's future income tax asset and liability balances will be adjusted to reflect the tax impacts of the IFRS adjustments as described in the preceding discussion.

Business Combinations

Paramount elected to early adopt CICA handbook section 1582 "Business Combinations" with respect to the acquisition of Redcliffe. This new Canadian standard is substantially converged with IFRS 3 "Business Combinations" and, as a result, no adjustments are expected on transition to IFRS.

Paramount expects to apply the IFRS 1 exemption which allows an entity to elect not to apply IFRS 3 to past business combinations.

Implementation

The Company is currently focused on the following activities:

- finalizing the opening balance sheet adjustments including future income tax;
- preparing comparative IFRS adjustments to the 2010 quarterly Canadian GAAP financial statement balances; and

- finalizing Paramount's IFRS policy choices, IFRS 1 elections and IFRS disclosures for publication in 2011.

As IFRS accounting policies and processes are being finalized, corresponding changes to internal controls over financial reporting and to disclosure controls and procedures are being identified to ensure controls remain effective. Paramount does not anticipate making significant changes to control processes and procedures.

Business Activities

The borrowing base under Paramount's credit facility is based on the value of the Company's reserves, and, as a result, changes to the carrying value of its assets are not expected to have a significant impact on the Company's debt structure or agreements. Paramount's renewed credit facility agreement incorporates provisions regarding changes in accounting policies, including the adoption of IFRS.

The indenture governing the new Senior Notes issued in November 2010 contains provisions that permit the modification of accounting terms and calculations included therein should a change in GAAP (including the adoption of IFRS) cause any of the accounting terms or calculations to be materially different than using Canadian GAAP as at the date of the indenture. As a result, the Company does not expect the adoption of IFRS will have a material impact on the Company under the indenture.

Disclosure Controls and Procedures

As of the year ended December 31, 2010, an evaluation of the effectiveness of Paramount's disclosure controls and procedures, as defined by the rules of the Canadian Securities Administrators, was performed by the Company's management with the participation of the chief executive officer and chief financial officer. Based upon that evaluation, the Company's chief executive officer and chief financial officer have concluded that as of the end of that fiscal year, the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company is (i) recorded, processed, summarized and reported within the time periods specified in Canadian securities law and (ii) accumulated and communicated to the Company's management, including its chief executive officer and chief financial officer, to allow timely decisions regarding required disclosure.

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

Internal Controls Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over the Company's financial reporting. The Company's internal control system was designed to provide reasonable assurance that all transactions are accurately recorded, that transactions are recorded as necessary to permit preparation of financial statements in accordance with Generally Accepted Accounting Principles, and that the Company's assets are safeguarded.

Management has assessed the effectiveness of the Company's internal control over financial reporting as at December 31, 2010. In making its assessment, management used the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") framework in Internal Control – Integrated

Framework to evaluate the effectiveness of the Company's internal control over financial reporting. Based on this assessment, management has concluded that the Company's internal control over financial reporting was effective as of December 31, 2010.

Internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedure may deteriorate.

Changes in Internal Controls Over Financial Reporting

During the fiscal year and quarter ended December 31, 2010, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Advisories

Forward-looking Information

Certain statements in this document constitute forward-looking information under applicable securities legislation. Forward-looking information typically contains statements with words such as "anticipate", "believe", "estimate", "expect", "plan", "intend", "propose", or similar words suggesting future outcomes or an outlook. Forward looking information in this document includes, but is not limited to:

- expected production volumes and the timing thereof;
- planned exploration and development expenditures and the timing thereof;
- exploration and development plans and strategies;
- budget allocations and capital spending flexibility;
- adequacy of facilities to process natural gas production;
- estimated reserves and resources and the undiscounted and discounted present value of future net revenues from such reserves and resources (including the forecast prices and costs and the timing of expected production volumes and future development capital);
- timing of regulatory applications;
- ability to fulfill future pipeline transportation commitments;
- undeveloped land lease expiries;
- timing and cost of future abandonment and reclamation;
- business strategies and objectives;
- sources of and plans for financing;
- acquisition and disposition plans;
- operating and other costs and royalty rates;
- expected accounting policies under IFRS and the related impact on the Company's financial statement balances;
- expected drilling programs, well tie-ins, facility construction and expansions, completions and the timing thereof; and
- the outcome of any legal claims, audits, assessments or other regulatory matters or proceedings.

Such forward-looking information is based on a number of assumptions which may prove to be incorrect. The following assumptions have been made, in addition to any other assumptions identified in this document:

- future oil and gas prices and general economic and business conditions;
- the ability of Paramount to obtain required capital to finance its exploration, development and operations;
- the ability of Paramount to obtain equipment, services, supplies and personnel in a timely manner to carry out its activities;
- the ability of Paramount to secure adequate product transportation and storage;
- the ability of Paramount and its industry partners to obtain drilling success consistent with expectations;
- the timely receipt of required regulatory approvals; and
- currency exchange and interest rates.

- the ability of Paramount to market its oil and natural gas successfully to current and new customers;

Although Paramount believes that the expectations reflected in such forward looking information is reasonable, undue reliance should not be placed on it as Paramount can give no assurance that such expectations will prove to be correct. Forward-looking information is based on expectations, estimates and projections that involve a number of risks and uncertainties which could cause actual results to differ materially from those anticipated by Paramount and described in the forward looking information. The material risks and uncertainties include, but are not limited to:

- fluctuations in crude oil, natural gas and NGLs prices, foreign currency exchange rates and interest rates;
- the uncertainty of estimates and projections relating to future production, costs and expenses;
- the ability to secure adequate product processing, transportation and storage;
- the uncertainty of exploration, development and drilling;
- operational risks in exploring for, developing and producing crude oil and natural gas, and the timing thereof;
- the ability to obtain equipment, services, supplies and personnel in a timely manner;
- potential disruption or unexpected technical difficulties in designing, developing or operating new or existing facilities;
- risks and uncertainties involving the geology of oil and gas deposits;
- the uncertainty of reserves and resource estimates;
- the ability to generate sufficient cash flow from operations and other sources of financing at an acceptable cost to meet current and future obligations;
- changes to the status or interpretation of laws, regulations or policies;
- changes in environmental laws including emission reduction obligations;
- the timing of governmental or regulatory approvals;
- changes in general business and economic conditions;
- uncertainty regarding aboriginal land claims and co-existing with local populations;
- the effects of weather;
- the ability to fund exploration, development and operational activities and meet current and future obligations;
- the timing and cost of future abandonment and reclamation activities;
- cleanup costs or business interruptions due environmental damage and contamination;
- the ability to enter into or continue leases;
- existing and potential lawsuits and regulatory actions; and
- other risks and uncertainties described elsewhere in this document and in Paramount's most recent Annual Information Form.

The foregoing list of risks is not exhaustive. Additional information concerning these and other factors which could impact Paramount are included in Paramount's most recent Annual Information Form. The forward-looking information contained in this document is made as of the date hereof and, except as required by applicable securities law, Paramount undertakes no obligation to update publicly or revise any forward-looking statements or information, whether as a result of new information, future events or otherwise.

Non-GAAP Measures

In this document "Funds flow from operations", "Funds flow from operations - per Boe", "Funds flow from operations per share - diluted", "Netback", "Netback including settlements of financial commodity contracts", "Net Debt", "Exploration and development expenditures" and "Investments in other entities – market value", collectively the "Non-GAAP measures", are used and do not have any standardized meanings as prescribed by GAAP. They are used to assist management in measuring the Company's ability to finance capital programs and meet financial obligations. Funds flow from operations refers to cash flows from operating activities before net changes in operating working capital. Netback equals petroleum and natural gas sales less royalties, operating costs, production taxes and transportation costs. Refer to the calculation of Net Debt in the liquidity and capital resources section of this document.

Exploration and development expenditures refers to capital expenditures incurred by the Company's COUs excluding land and property acquisitions. Investments in other entities – market value reflects the Company's investments in enterprises whose securities trade on a public stock exchange at their period end closing price (e.g. Trilogy, MEG, MGM Energy and others at December 31, 2010), and all other investments in other entities at book value. Paramount provides this information in its MD&A because the market values of equity accounted investments, which are significant assets of the Company, are often materially different than their carrying values.

Non-GAAP measures should not be considered in isolation or construed as alternatives to their most directly comparable measure calculated in accordance with GAAP, or other measures of financial performance calculated in accordance with GAAP. The Non-GAAP measures are unlikely to be comparable to similar measures presented by other issuers.

Oil and Gas Measures and Definitions

This document contains disclosure expressed as "Boe", and "Boe/d". All oil and natural gas equivalency volumes have been derived using the ratio of six thousand cubic feet of natural gas to one barrel of oil. Equivalency measures may be misleading, particularly if used in isolation. A conversion ratio of six thousand cubic feet of natural gas to one barrel of oil is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the well head.

This document contains disclosure of the results of an updated evaluation of the Company's contingent bitumen resources from the Grand Rapids formation at Hoole, Alberta. Contingent resources are those quantities of bitumen estimated, as of a given date, to be potentially recoverable from known accumulations using established technology or technology under development, but are classified as a resource rather than a reserve due to one or more contingencies, such as the absence of regulatory approvals, detailed design estimates or near term development plans. A low estimate means high certainty (P90), a best estimate means most likely (P50) and a high estimate means low certainty (P10).

The before tax net present value of contingent bitumen resources disclosed represents the Company's share of future net revenue, before the deduction of income tax and does not represent fair value. The calculation considers such items as revenues, royalties, operating costs, abandonment costs and capital expenditures. Royalties have been calculated based on Alberta's Royalty Framework applicable to oil sands projects in Alberta. The calculation does not consider financing costs and general and administrative costs. The net present value was calculated assuming natural gas is used as a fuel for steam generation. Revenues and expenditures were calculated based on the reserve evaluator's forecast prices and costs as of April 1, 2010.



Consolidated Financial Statements
As at December 31, 2010 and 2009 and for the years then ended

Management's Report

The accompanying Consolidated Financial Statements of Paramount Resources Ltd. (the "Company") are the responsibility of Management and have been approved by the Board of Directors. The Consolidated Financial Statements have been prepared by Management in Canadian dollars in accordance with Canadian Generally Accepted Accounting Principles and include certain estimates that reflect Management's best judgments. When alternative accounting methods exist, Management has chosen those it considers most appropriate in the circumstances. Financial information contained throughout the Company's annual report is consistent with these Consolidated Financial Statements.

Management is also responsible for establishing and maintaining adequate internal control over the Company's financial reporting. The Company's internal control system was designed to provide reasonable assurance that all transactions are accurately recorded, that transactions are recorded as necessary to permit preparation of financial statements in accordance with Generally Accepted Accounting Principles, and that the Company's assets are safeguarded.

The Board of Directors is responsible for ensuring that Management fulfills its responsibilities for financial reporting and internal control. The Board of Directors exercises this responsibility through the Audit Committee. The Audit Committee meets regularly with Management and the independent auditors to ensure that Management's responsibilities are properly discharged and to review the Consolidated Financial Statements. The Audit Committee reports its findings to the Board of Directors for consideration when approving the annual Consolidated Financial Statements for issuance to the shareholders. The Audit Committee also considers, for review by the Board of Directors and approval by the shareholders, the engagement or re-appointment of the external auditors. The Audit Committee of the Board of Directors is comprised entirely of non-management directors.

Ernst & Young LLP, independent auditors appointed by the shareholders of the Company, conducts an examination of the Consolidated Financial Statements in accordance with Canadian Generally Accepted Auditing Standards. Ernst & Young LLP has full and free access to the Audit Committee and Management.

/s/ Clayton H. Riddell
Clayton H. Riddell
Chief Executive Officer

/s/ Bernard K. Lee
Bernard K. Lee
Chief Financial Officer

March 3, 2011

INDEPENDENT AUDITORS' REPORT

To the shareholders of Paramount Resources Ltd.:

We have audited the accompanying consolidated financial statements of Paramount Resources Ltd. (the "Company") which comprise the consolidated balance sheets as at 31 December 2010 and 2009 and the consolidated statements of loss, cash flows, shareholders' equity and comprehensive loss for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

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

Auditors' responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as at 31 December 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Calgary, Canada
2 March 2011

Ernst + Young LLP

Chartered Accountants

PARAMOUNT RESOURCES LTD.

Consolidated Balance Sheets

(\$ thousands)

As at December 31	2010	2009
ASSETS (Note 7)		
Current assets		
Cash and cash equivalents (Note 14)	\$ 74,659	\$ 93,238
Accounts receivable (Note 12)	33,280	23,488
Risk management (Note 12)	—	2,187
Prepaid expenses and other	2,572	2,301
	110,511	121,214
Deposit (Note 11)	19,788	—
Property, plant and equipment, net (Note 4)	884,525	716,235
Investments (Note 5)	305,288	234,586
Future income taxes (Note 11)	48,489	29,940
Goodwill (Note 2)	8,623	—
	\$ 1,377,224	\$ 1,101,975
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Drilling rig loan (Note 6)	\$ 26,880	\$ 29,380
Accounts payable and accrued liabilities	78,806	46,162
Risk management (Note 12)	693	—
Current portion of stock-based compensation liability (Note 10)	45,232	11,441
	151,611	86,983
Long-term debt (Note 7)	294,205	93,655
Asset retirement obligations (Note 8)	130,564	103,462
Stock-based compensation liability (Note 10)	15,110	3,771
Future income taxes (Note 11)	—	41,194
	591,490	329,065
Commitments and contingencies (Note 16)		
Shareholders' equity		
Share capital (Note 9)	458,895	393,087
Contributed surplus	3,940	2,890
Retained earnings	251,277	373,745
Accumulated other comprehensive income	71,622	3,188
	785,734	772,910
	\$ 1,377,224	\$ 1,101,975

See the accompanying notes to these Consolidated Financial Statements.

On behalf of the Board

/s/ J.H.T. Riddell
J.H.T. Riddell
 Director

/s/ J.C. Gorman
J.C. Gorman
 Director

PARAMOUNT RESOURCES LTD.**Consolidated Statement of Loss**

(\$ thousands, except as noted)

Year ended December 31	2010	2009
Revenue		
Petroleum and natural gas sales	\$ 184,395	\$ 161,671
Gain on financial commodity contracts (Note 12)	10,047	5,277
Royalties	(21,227)	(20,659)
	173,215	146,289
Expenses		
Operating expense and production tax	50,892	56,669
Transportation	17,219	13,842
General and administrative	15,417	17,217
Stock-based compensation	58,764	17,599
Depletion, depreciation and accretion	178,007	141,597
Exploration	8,829	5,316
Dry hole (Note 4)	9,492	24,343
Gain on sale of property, plant and equipment	(3)	(534)
Write-down of petroleum and natural gas assets (Note 4)	25,332	14,939
Interest and financing	13,560	11,214
Foreign exchange	(801)	(11,503)
Debt extinguishment	1,708	—
	378,416	290,699
Income (loss) from investments (Note 5)	8,227	(7,333)
Other income (loss)	2,184	(773)
Loss before tax	(194,790)	(152,516)
Income tax expense (recovery) (Note 11)		
Current	213	(889)
Future	(72,535)	(53,743)
	(72,322)	(54,632)
Net loss	\$ (122,468)	\$ (97,884)
Net loss per common share (\$/share) (Note 9)		
Basic and diluted	\$ (1.68)	\$ (1.46)

See the accompanying notes to these Consolidated Financial Statements.

PARAMOUNT RESOURCES LTD.
Consolidated Statement of Cash Flows

(\$ thousands)

Year ended December 31	2010	2009
Operating activities		
Net loss	\$ (122,468)	\$ (97,884)
Add (deduct)		
Items not involving cash (Note 14)	195,399	134,318
Asset retirement obligation expenditures (Note 8)	(3,209)	(4,050)
Exploration and dry hole expenses	18,321	29,659
Debt extinguishment costs	1,708	–
Stock incentive plan	(2,901)	(1,775)
	86,850	60,268
Change in non-cash working capital (Note 14)	(23,467)	11,797
Cash from operating activities	63,383	72,065
Financing activities		
Drilling rig loan, net (Note 6)	(2,500)	29,307
Repayment/Redemption of US Senior Notes (Note 7)	(92,234)	–
Proceeds from Senior Notes, net of issue costs (Note 7)	294,171	–
Repayment of debt assumed on Redcliffe acquisition (Note 2)	(10,521)	–
Settlement of foreign exchange contract	–	12,205
Common shares issued, net of issue costs	62,989	91,170
Common shares repurchased (Note 9)	–	(4,219)
Cash from financing activities	251,905	128,463
Investing activities		
Property, plant and equipment and exploration	(298,141)	(117,510)
Redcliffe acquisition (Note 2)	(46,172)	–
Proceeds on sale of property, plant and equipment	1,196	791
Proceeds on sale of investment	–	4,605
Investments in other entities	(11,100)	(20,005)
Deposit	(19,788)	–
Change in non-cash working capital (Note 14)	40,138	(29,302)
Cash used in investing activities	(333,867)	(161,421)
Net (decrease) increase in cash and cash equivalents	(18,579)	39,107
Cash and cash equivalents, beginning of year	93,238	54,131
Cash and cash equivalents, end of year	\$ 74,659	\$ 93,238

Supplemental cash flow information (Note 14)

See the accompanying notes to these Consolidated Financial Statements.

PARAMOUNT RESOURCES LTD.
Consolidated Statement of Shareholders' Equity
(\$ thousands, except as noted)

Year ended December 31	2010		2009	
	Shares (000's)		Shares (000's)	
Share Capital				
Balance, beginning of year	72,058	\$ 393,087	66,741	\$ 302,727
Issued, net of issuance costs	2,270	57,984	6,000	91,227
Issued on exercise of stock options	678	14,862	111	1,540
Tax effect of flow-through share renunciations	–	(6,940)	–	–
Common shares repurchased	–	–	(616)	(2,815)
Change in unvested common shares for stock incentive plan	28	(98)	(178)	408
Balance, end of year	75,034	\$ 458,895	72,058	\$ 393,087
Contributed Surplus				
Balance, beginning of year		\$ 2,890		\$ 2,398
Change in value of unvested common shares for stock incentive plan		455		–
Stock-based compensation expense on investees' options		595		492
Balance, end of year		\$ 3,940		\$ 2,890
Retained Earnings				
Balance, beginning of year		\$ 373,745		\$ 473,362
Net loss		(122,468)		(97,884)
Common shares repurchased		–		(1,404)
Change in value of unvested common shares for stock incentive plan		–		(329)
Balance, end of year		\$ 251,277		\$ 373,745
Accumulated Other Comprehensive Income				
Balance, beginning of year		\$ 3,188		\$ –
Other comprehensive income, net of tax		68,434		3,188
Balance, end of year		\$ 71,622		\$ 3,188
Total Shareholders' Equity		\$ 785,734		\$ 772,910

See the accompanying notes to these Consolidated Financial Statements.

Consolidated Statement of Comprehensive Loss
(\$ thousands)

Year ended December 31	2010		2009	
Net loss	\$ (122,468)		\$ (97,884)	
Other comprehensive income, net of tax				
Change in unrealized gain on available-for-sale investments, net of tax	71,602		6,381	
Reclassification of accumulated (gains) to earnings, net of tax	(3,168)		(3,193)	
Comprehensive loss	\$ (54,034)		\$ (94,696)	

See the accompanying notes to these Consolidated Financial Statements.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

1. Summary of Significant Accounting Policies

Paramount Resources Ltd. ("Paramount" or the "Company") is an independent Canadian energy company that explores for, develops, produces, processes, transports, and markets natural gas, crude oil and natural gas liquids ("NGLs"). Paramount's properties are located in Alberta, the Northwest Territories, British Columbia, and Saskatchewan in Canada, and in North Dakota and Montana in the United States. These Consolidated Financial Statements are stated in Canadian dollars and have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP").

a) Principles of Consolidation

These Consolidated Financial Statements include the accounts of Paramount and its wholly owned subsidiaries, including Summit Resources, Inc., Paramount Drilling U.S. LLC ("Paramount Drilling") and Fox Drilling Inc. ("Fox Drilling").

Investments in jointly controlled partnerships and unincorporated joint ventures are accounted for using the proportionate consolidation method, whereby only Paramount's proportionate share of revenues, expenses, assets, and liabilities are included in the Consolidated Financial Statements.

Investments in entities in which Paramount does not have direct or joint control over the strategic operating, investing, and financing decisions, but over which it has significant influence are accounted for using the equity method. All other investments are accounted for as available-for-sale financial instruments.

b) Measurement Uncertainty

The timely preparation of these Consolidated Financial Statements in conformity with GAAP requires that management make estimates and assumptions and use judgment regarding the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates primarily relate to fair value measurements and unsettled transactions and events as of the date of the Consolidated Financial Statements. Actual results could materially differ from these estimates.

Depletion, depreciation and accretion, asset retirement obligation, and impairment calculations are based on estimates of reserves, future costs, petroleum and natural gas prices and other relevant assumptions. Fair values of the Company's investments are highly dependent on economic conditions, oil and natural gas prices, and the results of investees' operations, among other factors. Assessments of the fair value of the Company's investments are based on management's interpretation of such information, and where available, publicly quoted trading prices of the investees' securities. By their nature, these estimates are subject to measurement uncertainty, and the impact of changes in these estimates and assumptions on the Consolidated Financial Statements of future periods could be material.

Crown royalties for Paramount's production in the Northwest Territories have been accrued based on the Company's interpretation of the relevant legislation and regulations. To date, Paramount has not received assessments from the Government of Canada of its liability under such legislation and regulations for its past filings. Although Paramount believes that its interpretations of the relevant legislation and regulations have merit, Paramount is unable to predict the ultimate outcome of audits and/or assessments by the Government of Canada. Additional material amounts could potentially become payable.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

Tax legislation, regulations, and the interpretation thereof in the various jurisdictions in which the Company operates are complex and subject to change. In addition, the Company's income tax filings are subject to audit and reassessment by tax authorities from time to time. As such, the Company's provision for income taxes are subject to measurement uncertainty.

c) Revenue Recognition

Revenues from the sale of Paramount's natural gas, crude oil and NGLs are recognized when title passes to third parties. Revenues from the Company's drilling rigs (the "Rigs") are recognized as services are rendered and collectability is reasonably assured. When the Rigs drill on a property owned by the Company, Paramount capitalizes its working interest share of the drilling expenses, and eliminates the intercompany drilling revenue and profit.

d) Cash and Cash Equivalents

Cash and cash equivalents are recorded at amortized cost and include short-term investments with original maturities of three months or less.

e) Property, Plant and Equipment

Paramount follows the successful efforts method of accounting for its petroleum and natural gas operations. Under this method, all development costs, including property acquisitions and costs of drilling and equipping development wells are capitalized. Costs of drilling exploratory wells are initially capitalized, pending determination of proved reserves. If economically recoverable reserves are not found, such costs are charged to earnings as dry hole expense. If hydrocarbons are found, but further appraisal activity is required to conclude whether they are economically recoverable, the costs continue to be carried as an asset. All such costs are subject to management review at least once per year to confirm that sufficient progress is being made to develop the discovery. Exploratory geological and geophysical costs and annual lease rentals are expensed as incurred.

Producing areas and significant unproved properties are assessed annually, or more frequently as economic events dictate, for potential impairment. If the carrying value of the oil and gas assets is assessed not to be fully recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the aggregate discounted cash flows expected from the production of proved plus probable reserves.

Paramount recognizes Alberta drilling royalty credits as a reduction to property plant and equipment. The credits are recognized as they are earned, as determined by well depth, to the extent the Company anticipates being able to use the credits to reduce crown royalties.

Paramount's Rigs are recorded at cost, including costs of direct material, labour, and overhead. Costs incurred to extend the useful life of the Rigs or to increase their capabilities are capitalized. Costs incurred to maintain and repair the Rigs are expensed as incurred.

f) Depletion and Depreciation

Capitalized costs of proved oil and gas properties are depleted using the unit-of-production method. For purposes of these calculations, natural gas production and reserves are converted to barrels of oil equivalent on the basis of six thousand cubic feet per barrel. Depletion rates are revised annually, or more frequently when events dictate. Costs of drilling exploratory wells and unproved properties are not depleted while under active evaluation for commercial reserves.

Capitalized costs of gas plants, gathering systems and production equipment are depreciated on a unit-of-production basis over the proved developed reserves of the field to which they relate.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

The Rigs and significant components are depreciated over their expected useful lives, varying from 1,095 to 3,650 drilling days.

Leasehold improvements are amortized over the term of the lease. Other assets are depreciated on a declining balance method at rates varying from 35 to 50 percent.

Change in Estimate

Effective December 31, 2009, the Company adopted the Financial Accounting Standards Board update for Oil and Gas Reserve Estimation and Disclosures applicable to Accounting Standards Codification Topic 932 ("ASC 932"). The ASC 932 update changes the pricing methodology for proved reserves used in calculating depletion from end of period pricing to an average of first day of month pricing for 12 months, consistent with the modernized US Securities and Exchange Commission reserves definition. ASC 932 is considered a change in accounting estimate and therefore was adopted prospectively and applied to the quarter ended December 31, 2009 and thereafter, consistent with the Company's policy.

g) *Asset Retirement Obligations*

Asset retirement obligations include those legal obligations where Paramount will be required to retire tangible long-lived assets. The Company recognizes the present value of an asset retirement obligation in the period in which it is incurred and when its fair value can be reasonably estimated. The estimated fair value of asset retirement costs are capitalized as part of the related long-lived asset and depreciated on the same basis as the underlying asset. The asset retirement obligation is adjusted for the passage of time, which is recognized as accretion expense, and for revisions to the timing or the amount of the estimated liability. Actual costs incurred are charged against the asset retirement obligation to the extent of the liability recorded. Differences between the actual costs incurred and the liability are recognized in earnings when reclamation of the field is completed.

h) *Goodwill*

Goodwill is not amortized, but is assessed by Paramount for impairment at least annually. Impairment is assessed based on a comparison of the fair value of each reporting unit to its carrying value, including goodwill. Any excess of the carrying value of the properties, including goodwill, over the fair value is written off as an impairment charge.

i) *Foreign Currency Translation*

Paramount's functional currency is the Canadian dollar. The Company's foreign operations are integrated and therefore, translated into Canadian dollars using the temporal method.

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at exchange rates in effect at the balance sheet date. Non-monetary assets are translated at rates in effect on the dates the assets were acquired. Results of foreign operations are translated into Canadian dollars at the monthly average exchange rates for revenues and expenses, except for depreciation and depletion, which are translated at the rate of exchange applicable to the related assets. Resulting translation gains and losses are included in earnings.

j) *Financial Instruments, Comprehensive Income and Hedges*

Financial Instruments

Financial instruments are measured at fair value on initial recognition. Measurement in subsequent periods is dependent upon whether the financial instrument has been classified as "held-for-trading",

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

"available-for-sale", "held-to-maturity", "loans and receivables", or "other financial liabilities" as defined by GAAP.

Held-for-trading financial assets and financial liabilities are measured at fair value, with changes in fair values recognized in earnings. Available-for-sale financial assets are measured at fair value, with changes in fair values recognized in other comprehensive income ("OCI"), net of tax. Held-to-maturity financial assets, loans and receivables and other financial liabilities, including transaction costs, are measured at amortized cost using the effective interest method of amortization. Derivative financial instruments are classified as held-for-trading unless designated for hedge accounting.

Where Paramount designates and documents a contract as a "normal sales exception", its fair value is not recognized in the Consolidated Financial Statements prior to settlement. Where a contract is not designated as a "normal sales exception", it is measured at fair value and changes in its fair value are recognized in earnings.

Paramount recognizes earnings and cash flow effects of derivatives with the related underlying items.

A three-level hierarchy is used by Paramount for fair value measurements, based on the transparency of inputs to the valuation of financial instruments recognized at fair value. These three levels are defined as follows:

- Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 – Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

At December 31, 2010, Paramount's publicly traded investments were classified as level 1 fair values and risk management liabilities were classified as level 2 fair values. The carrying value of all other financial instruments approximates their fair value due to their short-term maturities.

Other Comprehensive Income

For Paramount, other comprehensive income ("OCI") is comprised of changes in the market value of available-for-sale investments. OCI is presented in the Consolidated Statement of Comprehensive Loss. The cumulative changes in OCI are included in accumulated other comprehensive income, which is presented within shareholders' equity.

Hedges

Paramount does not presently employ hedge accounting for any of its financial instruments.

k) *Income Taxes*

Paramount follows the liability method of accounting for income taxes. Under this method, future income taxes are recognized for the effect of any difference between the carrying amount of an asset or liability reported in the Consolidated Financial Statements and its respective tax basis, using substantively enacted income tax rates. Accumulated future income tax balances are adjusted to reflect changes in substantively enacted income tax rates, with adjustments being recognized in earnings in the period in which the change occurs.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

l) Flow-Through Shares

As permitted under the *Income Tax Act* (Canada), the tax attributes of eligible expenditures incurred with the proceeds of flow-through share issuances are renounced to subscribers. On the date that Paramount files the renouncement documents with the tax authorities, a future income tax liability is recognized and shareholders' equity is reduced for the tax effect of expenditures renounced to subscribers.

m) Stock-Based Compensation

Stock Options

Paramount uses the intrinsic value method to recognize compensation expense for stock options, whereby a liability and expense are recorded over the vesting period of the options, based on the difference between the market price of the underlying securities and the option exercise price. When options are surrendered for cash, the cash settlement paid reduces the outstanding liability. When options are exercised for Common Shares, the consideration paid by the option holder and the previously recognized liability associated with the options are recorded as an increase to share capital.

Stock Appreciation Rights

Stock Appreciation Rights ("SARs") entitled the holder to receive a cash payment equal to the difference between the fair market value and the stated exercise price of an underlying security or notional security on the date of surrender, and were accounted for using the intrinsic value method.

Stock Incentive Plan

Paramount's stock incentive plan provides that rights to Common Shares may be awarded to employees annually. Common Shares are purchased in the open market and held by an independent trustee until the completion of the vesting period. Generally, one third of an award vests immediately, with the remaining tranches vesting annually over two years. The unvested Common Shares balance is recorded as a reduction of share capital. The fair value of the Common Shares awarded is recognized in stock-based compensation over the vesting period, with a corresponding charge to equity.

n) Comparative Figures

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

o) Changes in Accounting Policies

Effective January 1, 2010, Paramount early adopted CICA Handbook section 1582 – "Business Combinations", which replaces the previous business combinations standard. The new standard requires that all of the assets acquired and the liabilities assumed in a business combination be recorded at fair value, which was not the case under the previous standard. The new standard also requires that previously held ownership interests be remeasured to the acquisition date fair value, rather than being restated to cost. In addition, the new standard requires that all acquisition costs associated with the acquisition be expensed, rather than capitalized as part of the acquisition, that contingent liabilities be recognized at fair value at the acquisition date and subsequently re-measured to fair value with changes recognized in earnings, and that a bargain purchase be recognized in earnings rather than being allocated to non-monetary assets. This new standard was applied to the Company's acquisition of Redcliffe Exploration Inc. ("Redcliffe") in 2010.

Effective January 1, 2010, Paramount also early adopted CICA Handbook sections 1601 – "Consolidations" and 1602 – "Non-controlling Interests", which together replaced section 1600 –

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

"Consolidations". Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 requires non-controlling interests ("NCI") to be presented within equity. There is no impact on the Consolidated Financial Statements from the adoption of these standards.

International Financial Reporting Standards

Accounting standards in Canada, as used by publicly accountable enterprises, will be converted to International Financial Reporting Standards for fiscal years beginning on or after January 1, 2011. Paramount's IFRS conversion project is proceeding according to plan and the Company expects to be ready for the transition. The project team has identified key differences, including accounting for property, plant and equipment, stock-based compensation, foreign currency transactions, and asset retirement obligations, among others, has developed IFRS accounting policies and is in the process of drafting new financial statement disclosures. The Company continues to monitor the development of the standards.

2. Acquisition of Redcliffe Exploration Inc.

On June 29, 2010, Paramount acquired, for cash consideration of \$46.2 million, all 109.9 million issued and outstanding Class A shares of Redcliffe that it did not already own, including 340,000 Class A shares owned by certain officers of Paramount. Immediately prior to the acquisition, Paramount owned 23.5 million Class A shares of Redcliffe. Redcliffe was a Calgary based company with interests in petroleum and natural gas properties primarily in the Karr-Gold Creek and Greater Pembina areas of Alberta. These financial statements include the results of operations of the acquired business for the period following the closing of the transaction on June 29, 2010.

The acquisition of Redcliffe was accounted for using the acquisition method whereby all of the assets acquired and liabilities assumed were recorded at fair value. The following table summarizes the net assets acquired:

Property, plant, and equipment	\$ 66,943
Goodwill	8,623
Working capital deficit	(706)
Bank debt	(10,521)
Asset retirement obligations	(4,581)
Future income tax liability	(3,710)
Net assets acquired	\$ 56,048
Cash purchase price	\$ 46,172
Fair value of Redcliffe shares previously held	9,876
Total	\$ 56,048

Upon the acquisition of Redcliffe, a gain of \$3.5 million previously recorded in Paramount's OCI related to its investment in Redcliffe was reclassified to income from investments. Goodwill recorded on the acquisition of Redcliffe is not deductible for tax purposes. The net assets acquired, including goodwill, have been allocated to the Principal Properties business segment.

Paramount incurred \$0.3 million of transaction costs related to the Redcliffe acquisition, which were recognized in general and administrative expense.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

If the acquisition of Redcliffe had been completed on January 1, 2010, Paramount's petroleum and natural gas sales for the twelve months ended December 31, 2010 would have been \$190.6 million (unaudited). From the date of acquisition to December 31, 2010, petroleum and natural gas sales related to properties acquired through the Redcliffe acquisition were \$4.2 million (unaudited). The impact of the acquisition on net income for the period January 1 to December 31, 2010 and June 29 to December 31, 2010 is impracticable to determine.

3. Segmented Information

Paramount's operations are divided into three business segments established by management to assist in resource allocation, to assess operating performance and to achieve long-term strategic objectives:

- **Principal Properties:** Principal properties consist of: (i) the Kaybob Corporate Operating Unit ("COU"), which includes properties in West Central Alberta; (ii) the Grande Prairie COU, which includes properties in the Peace River Arch area of Alberta; (iii) the Northern COU, which includes properties in Northern Alberta, the Northwest Territories and Northeast British Columbia; and (iv) the Southern COU, which includes properties in Southern Alberta, Saskatchewan, Montana and North Dakota.
- **Strategic Investments:** Strategic investments include: (i) investments in other entities, including affiliates; (ii) investments in development stage assets where there is no near-term expectation of production, but a longer-term value proposition based on spin-outs, dispositions, or future revenue generation; and (iii) three Rigs owned by Fox Drilling and Paramount Drilling.
- **Corporate:** Corporate is comprised of income and expense items, including general and administrative expense and interest expense, that have not been specifically allocated to Principal Properties or Strategic Investments.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

Year ended December 31, 2010	Principal Properties	Strategic Investments	Corporate	Inter-segment Eliminations	Total
Revenue					
Petroleum and natural gas sales, net of royalties	\$ 163,168	\$ —	\$ —	\$ —	\$ 163,168
Gain on financial commodity contracts	10,047	—	—	—	10,047
	173,215	—	—	—	173,215
Expenses					
Operating expense, production tax and transportation	68,111	—	—	—	68,111
General and administrative	—	3,602	11,815	—	15,417
Stock-based compensation	—	18,048	40,716	—	58,764
Depletion, depreciation and accretion	175,879	3,929	955	(2,756)	178,007
Exploration and dry hole	18,244	77	—	—	18,321
(Gain) loss on sale of property, plant and equipment	(227)	224	—	—	(3)
Write-down of petroleum and natural gas assets	25,332	—	—	—	25,332
Interest and financing charges	—	1,243	12,317	—	13,560
Foreign exchange	—	—	(801)	—	(801)
Debt extinguishment	—	—	1,708	—	1,708
	287,339	27,123	66,710	(2,756)	378,416
Income from investments	—	8,227	—	—	8,227
Other income (expense)	1,066	—	(109)	—	957
Drilling rig revenue	—	13,425	—	(9,534)	3,891
Drilling rig expense	—	(8,001)	—	5,337	(2,664)
	(113,058)	(13,472)	(66,819)	(1,441)	(194,790)
Inter-segment eliminations	—	(1,441)	—	1,441	—
Segment loss	\$ (113,058)	\$ (14,913)	\$ (66,819)	\$ —	(194,790)
Income tax recovery					(72,322)
Net loss					\$ (122,468)

Year ended December 31, 2009	Principal Properties	Strategic Investments	Corporate	Inter-segment Eliminations	Total
Revenue					
Petroleum and natural gas sales, net of royalties	\$ 141,012	\$ —	\$ —	\$ —	\$ 141,012
Gain on financial commodity contracts	5,277	—	—	—	5,277
	146,289	—	—	—	146,289
Expenses					
Operating expense, production tax and transportation	70,511	—	—	—	70,511
General and administrative	—	2,510	14,707	—	17,217
Stock-based compensation	—	4,644	12,955	—	17,599
Depletion, depreciation and accretion	140,388	1,154	959	(904)	141,597
Exploration and dry hole	29,389	270	—	—	29,659
Gain on sale of property, plant and equipment	(534)	—	—	—	(534)
Write-down of petroleum and natural gas assets	14,939	—	—	—	14,939
Interest and financing charges	—	489	10,725	—	11,214
Foreign exchange	—	—	(11,503)	—	(11,503)
	254,693	9,067	27,843	(904)	290,699
Loss from investments	—	(7,333)	—	—	(7,333)
Other income	1,500	—	238	—	1,738
Drilling rig revenue	—	4,768	—	(4,388)	380
Drilling rig expense	—	(5,640)	—	2,749	(2,891)
	(106,904)	(17,272)	(27,605)	(735)	(152,516)
Inter-segment eliminations	—	(735)	—	735	—
Segment loss	\$ (106,904)	\$ (18,007)	\$ (27,605)	\$ —	(152,516)
Income tax recovery					(54,632)
Net loss					\$ (97,884)

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

Capital Expenditures

Year ended December 31	2010	2009
Principal Properties	\$ 274,106	\$ 94,692
Strategic Investments	15,703	17,543
Corporate	160	79
	\$ 289,969	\$ 112,314

Total Assets

As at December 31	2010	2009
Principal Properties	\$ 881,510	\$ 685,108
Strategic Investments	370,553	291,083
Corporate	125,161	125,784
	\$ 1,377,224	\$ 1,101,975

Capital expenditures for Principal Properties during the year ended December 31, 2010 include \$5.3 million (2009 – \$2.2 million) of drilling expenses for services provided by Paramount Drilling and Fox Drilling.

Geographical Information

2010	Property, Plant and Equipment	Goodwill	Revenue	Capital Expenditures
Canada	\$ 812,977	\$ 8,623	\$ 157,292	\$ 279,012
United States	71,548	–	27,103	10,957
Total	\$ 884,525	\$ 8,623	\$ 184,395	\$ 289,969

2009	Property, Plant and Equipment	Goodwill	Revenue	Capital Expenditures
Canada	\$ 641,163	\$ –	\$ 135,427	\$ 101,028
United States	75,072	–	26,244	11,286
Total	\$ 716,235	\$ –	\$ 161,671	\$ 112,314

4. Property, Plant and Equipment

	2010			2009
	Cost	Accumulated Depletion and Depreciation	Net Book Value	Net Book Value
Petroleum and natural gas assets	\$ 2,178,959	\$ (1,336,033)	\$ 842,926	\$ 668,997
Drilling rigs	47,892	(8,307)	39,585	44,633
Other	19,909	(17,895)	2,014	2,605
	\$ 2,246,760	\$ (1,362,235)	\$ 884,525	\$ 716,235

Capitalized costs of \$300.7 million at December 31, 2010 were not subject to depletion (2009 - \$165.3 million), including \$199.5 million for undeveloped land (2009 - \$132.1 million).

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

At December 31, 2010, the Company recorded an impairment write-down related to its petroleum and natural gas assets of \$25.3 million (2009 – \$14.9 million). The write-down was primarily related to the Liard and Haro areas in the Northern COU and the Puskwa area in the Grande Prairie COU where the carrying value of properties exceeded their expected discounted cash flows from the production of estimated proved and probable reserves.

Continuity of Suspended Exploratory Well Costs

	2010	2009
Balance, beginning of year	\$ 19,391	\$ 39,575
Additions pending the determination of proved reserves	59,646	18,715
Reclassifications to proved reserves	(5,356)	(15,264)
Well costs charged to dry hole expense	(3,132)	(23,635)
Balance, end of year	\$ 70,549	\$ 19,391

Aging of Capitalized Exploratory Well Costs

	2010	2009
Exploratory well costs capitalized for one year or less	\$ 59,768	\$ 13,059
Exploratory well costs capitalized for greater than one year	10,781	6,332
Balance, end of year	\$ 70,549	\$ 19,391
Number of projects capitalized for more than one year	12	20

At December 31, 2010, capitalized costs of suspended exploratory wells primarily relate to wells, that have not been completed, that have not been assigned proved reserves and projects where Paramount is continuing to assess the reserves and their potential development. At December 31, 2010, the Company recorded dry hole expenses on suspended exploratory wells costs of \$1.7 million (2009 – \$24.3 million) related to wells that have been suspended for more than one year, and where it was determined that sufficient progress was no longer being made in assessing reserves.

5. Investments

As at December 31	2010		2009	
	(Shares) (000's)		(Shares) (000's)	
Equity accounted investments:				
Trilogy Energy Corp. ("Trilogy")	24,144	\$ 103,003	23,995	\$ 104,472
MGM Energy Corp. ("MGM Energy")	43,834	5,237	43,834	5,876
Paxton Corporation	1,750	4,338	1,750	4,574
Other		2,993		4,280
		115,571		119,202
Available-for-sale investments:				
MEG Energy Corp. ("MEG")	3,700	168,313	3,700	101,750
NuLoch Resources Inc.	6,579	13,684	6,579	5,921
Other		7,720		7,713
		\$ 305,288		\$ 234,586

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

Income (loss) from investments is composed of the following:

Year ended December 31	2010			2009		
	Equity income (loss)	Dilution gain	Total	Equity income (loss)	Dilution gain (loss)	Total
Trilogy	\$ 2,069	\$ 4,109	\$ 6,178	\$ (16,215)	\$ 8,458	\$ (7,757)
MGM Energy	(1,067)	209	(858)	(1,192)	(1,548)	(2,740)
Paxton Corporation	(236)	—	(236)	(310)	—	(310)
Other	(356)	—	(356)	281	—	281
	\$ 410	\$ 4,318	4,728	\$ (17,436)	\$ 6,910	(10,526)
Reclassification of gains from OCI			3,499			3,193
			\$ 8,227			\$ (7,333)

The carrying value of Paramount's investment in Trilogy includes \$23.0 million (2009 – \$25.0 million) related to the unamortized excess of the aggregate purchase price over the underlying net book value of Trilogy's assets at various acquisition dates, of which \$12.6 million is attributable to property, plant and equipment and \$10.4 million is attributable to goodwill. The excess attributed to the value of property, plant and equipment is amortized over the estimated reserve life of Trilogy's proved reserves. The excess attributable to goodwill is not subject to amortization.

On February 5, 2010, Trilogy Energy Trust converted from an income trust to a corporation, named Trilogy Energy Corp., through a business combination with a private company. Paramount's 24.1 million Trilogy Energy Trust units (as of February 5, 2010) were converted into 12.8 million common shares of Trilogy Energy Corp., and 11.3 million non-voting shares of Trilogy Energy Corp. The non-voting shares convert to Trilogy common shares on a one-for-one basis if: i) beneficial ownership of the non-voting shares are transferred to any person that is not related to or affiliated with Paramount; or ii) Trilogy exercises its right to convert the non-voting shares to common shares. As a result of the conversion and issuance of Trilogy shares to the shareholder of the private company, Paramount recognized a dilution gain of \$4.1 million. Following the Company's 2010 distribution reinvestment plan purchase and the conversion, Paramount owned approximately 21 percent of Trilogy's equity (22 percent at December 31, 2009) and approximately 15 percent of its voting shares.

In August 2010 MEG completed its initial public offering on the Toronto Stock Exchange. As a result, Paramount's basis of accounting for its investment in MEG changed from historical cost net of impairments to fair value and, for the year ended December 31, 2010, an unrealized gain of \$66.6 million was recorded in other comprehensive income.

6. Drilling Rig Loan

During 2009, Paramount entered into a \$30.4 million demand loan facility (the "Drilling Rig Loan") with a Canadian bank. Interest is payable at the bank's prime lending rate or bankers acceptance rate, as selected at the discretion of the Company, plus an applicable margin. At December 31, 2010, \$26.9 million (2009 - \$29.4 million) was outstanding on the drilling rig loan. Recourse and security for the Drilling Rig Loan is limited to three drilling rigs and drilling contracts guaranteed by Paramount. The current carrying value of the rigs is \$39.6 million. The effective interest rate on the loan for the period ended December 31, 2010 was 4.2 percent. During 2010, Paramount made principal repayments of \$2.5 million. Unless demanded by the bank, the remaining annual scheduled principal repayments are as follows: 2011 - \$4.0 million; 2012 - \$5.1 million; 2013 - \$5.1 million and 2014 - \$12.7 million.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

7. Long-Term Debt

As at December 31	2010	2009
Canadian Dollar Denominated Debt		
Bank credit facility	\$ —	\$ —
8 ¼ percent Senior Notes due 2017	300,000	—
U.S. Dollar Denominated Debt		
8 ½ percent US Senior Notes due 2013	—	94,394
	300,000	94,394
Unamortized debt financing costs	(5,795)	(739)
	\$ 294,205	\$ 93,655

Bank Credit Facility

In April 2010, Paramount renewed its credit facility with the borrowing base and lender commitments remaining at \$125 million. In July 2010, following the acquisition of Redcliffe, the borrowing base and lender commitments under the credit facility were increased from \$125 million to \$160 million. The credit facility is secured by a first fixed and floating charge over substantially all of the assets of Paramount, excluding assets securing the drilling rig loan. The maximum amount that Paramount may borrow under the credit facility is subject to semi-annual review, and is dependent upon the Company's reserves and lenders' projections of future commodity prices, among other factors.

The credit facility is available on a revolving basis to April 30, 2011. The Company has requested an extension to the revolving term of its credit facility and expects to finalize details of the extension before April 30, 2011. In the event the revolving period is not extended, the credit facility would be available on a non-revolving basis for an additional year, at which time it would be due and payable.

At December 31, 2010, no balance was drawn on the credit facility. Paramount had undrawn letters of credit outstanding at December 31, 2010 of \$24.1 million that reduce the amount available to the Company.

Senior Notes

In December 2010, Paramount completed a public offering of \$300 million principal amount of senior unsecured notes ("Senior Notes") at par, of which \$11.4 million principal amount was purchased by certain directors, associates, officers, and management of the Company. The Senior Notes bear interest at 8.25 percent per annum, payable semi-annually in arrears on June 13 and December 13 in each year and mature on December 13, 2017. The Senior Notes are direct senior unsecured obligations of Paramount and rank equally with all other senior unsecured indebtedness of the Company. A portion of the proceeds of the Senior Notes were used to purchase/redeem the remaining outstanding balance of the Company's US Senior Notes.

The Company may redeem all or any portion of the Senior Notes at any time on or prior to December 13, 2013 at par, plus accrued and unpaid interest, plus a redemption premium equal to the greater of: (i) one percent; and (ii) a make-whole amount based on the then current yield of a Government of Canada bond with a similar maturity. Paramount may also redeem up to an aggregate of 35 percent of the Senior Notes with the net cash proceeds of an equity offering at any time prior to December 13, 2013, at par plus a redemption premium of 8.25 percent. On or after December 13, 2013, the Company may redeem some or all of the Senior Notes at par plus a redemption premium, if applicable, of up to 4.125 percent depending on when redeemed, plus accrued and unpaid interest.

In February 2011, Paramount closed a public offering of an additional \$70 million principal amount of its 8.25 percent Senior Notes at a premium price of \$1,030 per \$1,000 principal amount, of which \$1.4

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

million principal amount was purchased by an entity that is associated with the Company's Chairman and Chief Executive Officer.

US Senior Notes

During the fourth quarter of 2010, Paramount's obligations under the indenture governing its US\$90.2 million principal amount of US Senior Notes were discharged as a result of Paramount: (i) purchasing US\$64.2 million principal amount of US Senior Notes pursuant to a tender offer; (ii) delivering all US Senior Notes held by the Company to the trustee for cancellation; (iii) issuing a redemption notice for US\$26.0 million principal amount of US Senior Notes not tendered under the tender offer (the "Redeemed Notes"); and (iv) irrevocably depositing sufficient cash with the trustee to pay all amounts due on the Redeemed Notes on the January 31, 2011 redemption date. As a result, the 12.8 million Trilogy common shares held by the trustee as security were released to the Company.

8. Asset Retirement Obligations

Year ended December 31	2010	2009
Asset retirement obligations, beginning of year	\$ 103,462	\$ 87,237
Liabilities incurred	6,823	2,693
Liabilities settled	(3,209)	(4,050)
Disposal of properties	(327)	(88)
Accretion expense	9,105	8,603
Revision in estimated costs of abandonment	10,314	9,334
Assumed on Redcliffe acquisition	4,581	–
Foreign exchange	(185)	(267)
Asset retirement obligations, end of year	\$ 130,564	\$ 103,462

The undiscounted asset retirement obligations at December 31, 2010 total \$284.3 million (2009 – \$227.4 million). The asset retirement obligation has been determined using credit-adjusted risk-free rates between 7 7/8 percent and 9 1/2 percent and an inflation rate of 3 percent. These obligations will be settled over the useful lives of the assets, which extend up to 43 years.

9. Share Capital

Authorized

Paramount's authorized capital is comprised of an unlimited number of voting Class A common shares ("Common Shares") and an unlimited number of non-voting Preferred Shares issuable in series, both of such classes of shares being without par value.

At December 31, 2010, 149,763 (2009 – 178,131) Common Shares relating to the Company's Stock Incentive Plan were held by a trustee on behalf of Paramount's employees.

Normal Course Issuer Bid

In April 2010, Paramount received regulatory approval under Canadian securities laws to purchase Common Shares under a normal course issuer bid, commencing April 13, 2010 for a twelve month period (the "2010 NCIB"). Under the 2010 NCIB, Paramount is permitted to purchase for cancellation up to 3,626,476 Common Shares, of which no shares have been purchased to March 3, 2011.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

In November 2008, Paramount received regulatory approval under Canadian securities laws to purchase Common Shares under a normal course issuer bid, commencing November 20, 2008 for a twelve month period (the "2008 NCIB"). Under the 2008 NCIB, Paramount was permitted to purchase for cancellation up to 3,387,456 Common Shares. During 2009, Paramount purchased 615,600 Common Shares under the 2008 NCIB for \$4.2 million, of which \$2.8 million was charged to share capital and \$1.4 million was charged to retained earnings. Including purchases made in 2008, a total of 1,623,900 Common Shares were purchased under the 2008 NCIB for a total cost of \$11.4 million.

Share Issuances

In November 2010, Paramount issued 1,100,000 Canadian Exploration Expense flow-through Common Shares at a price of \$27.25 per share for gross proceeds of \$30.0 million through a public offering. Paramount also concurrently issued 1,020,000 Canadian Development Expense flow-through Common Shares at a price of \$24.50 per share and 150,000 Canadian Exploration Expense flow-through Common Shares at a price of \$27.25 per share for aggregate gross proceeds of \$29.1 million through a private placement to certain officers and management of the Company, and companies controlled by them.

Costs for the 2010 share issuances were \$1.1 million, net of \$0.4 million future tax benefits.

In October 2009, Paramount issued 1,000,000 Canadian Development Expense flow-through Common Shares for gross proceeds of \$16.9 million to a company controlled by Paramount's Chairman and Chief Executive Officer.

In November 2009, Paramount issued 500,000 Canadian Exploration Expense flow-through Common Shares for gross proceeds of \$9.4 million through a private placement, and 4,500,000 Common Shares for gross proceeds of \$67.5 million through a public offering.

The Company has incurred sufficient qualifying expenditures to satisfy its commitment associated with the flow-through shares issued in October and November 2009.

Costs for the 2009 share issuances were \$2.5 million, net of \$0.9 million future tax benefits.

Weighted Average Shares Outstanding

(Thousands)	2010	2009
Weighted average Common Shares outstanding – Basic and diluted	72,705	67,039

10. Stock-Based Compensation

Paramount Options

Paramount has a stock option plan that enables the Board of Directors or its Compensation Committee to grant to key employees and directors options to acquire Common Shares of the Company ("Paramount Options"). The exercise price of a Paramount Option is equal to the closing market price of the Common Shares on the day preceding the grant date. Paramount Options generally vest over five years and expire within six years after the grant date.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

	2010		2009	
	Weighted Average Exercise Price	Number	Weighted Average Exercise Price	Number
	(\$/share)		(\$/share)	
Balance, beginning of year	\$ 8.61	4,571,500	\$ 14.48	6,117,700
Granted	28.98	1,276,500	9.73	2,344,000
Exercised	7.90	(683,700)	7.89	(121,500)
Cancelled or surrendered	8.74	(158,000)	18.86	(3,768,700)
Balance, end of year	\$ 13.90	5,006,300	\$ 8.61	4,571,500
Options exercisable, end of year	\$ 8.13	1,367,301	\$ 7.51	1,208,834

Additional information about Paramount Options outstanding at December 31, 2010 is as follows:

	Outstanding			Exercisable	
	Number	Weighted Average Contractual Life	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
Exercise Prices		(years)	(\$ / share)		(\$ / share)
\$ 6.87-\$10.00	2,841,800	2.9	\$ 7.34	1,195,801	\$ 7.34
\$10.01-\$20.00	922,000	4.0	13.37	165,500	13.34
\$20.01-\$29.46	1,242,500	4.9	29.27	6,000	21.55
Total	5,006,300	3.6	\$ 13.90	1,367,301	\$ 8.13

Stock Appreciation Rights

In 2008, the Company issued 1,280,000 SARs to certain employees, which entitled the holder to receive a cash payment equal to the difference between the market price of the Company's Common Shares and the exercise price on date of surrender. The SARs had a weighted average contractual life of five years at December 31, 2008 and a vesting period of four years. The exercise price per SAR of \$7.34 was equal to the closing market price of the Common Shares on the grant date.

In February 2009, the SARs were surrendered and cancelled in exchange for the same number of Paramount Options with the same exercise price and vesting terms.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

11. Income Taxes

The following table reconciles income taxes calculated at the Canadian statutory rate to Paramount's recorded income tax recovery:

Year ended December 31	2010	2009
Earnings (loss) before tax	\$ (194,790)	\$ (152,516)
Effective Canadian statutory income tax rate	28.10%	29.15%
Expected income tax expense (recovery)	\$ (54,736)	\$ (44,458)
Increase (decrease) resulting from:		
Statutory and other rate differences	(14,985)	906
Non-taxable portion of (gain) loss	(1,460)	(3,859)
(Income) from investments and other	(4,934)	(1,088)
De-recognition of future tax assets	627	755
Stock-based compensation	15,346	4,631
Change in estimate	(11,737)	(10,896)
Other	(443)	(623)
Income and other tax expense (recovery)	\$ (72,322)	\$ (54,632)

Components of Future Income Tax Asset (Liability)

	2010	2009
Future income tax asset (liability)		
Timing of partnership items	\$ (38,808)	\$ (31,370)
Property, plant and equipment	(1,382)	(13,087)
Investments	(3,308)	(400)
Asset retirement obligations	33,359	26,572
Non-capital and net operating losses	47,707	22,050
Other	10,921	(15,019)
	\$ 48,489	\$ (11,254)

Paramount has \$148.9 million (2009 - \$136.0 million) of unused tax losses expiring between 2014 and 2030. In addition, Paramount has \$179.6 million (2009 - \$227.6 million) of deductible temporary differences in respect of investments for which no future income tax asset has been recognized.

In October 2010, the Company received reassessments from the Canada Revenue Agency (the "CRA") and provincial tax authorities of its income taxes relating to a prior year transaction (the "Reassessments"). Paramount disagrees with the Reassessments and has filed notices of objection with the CRA and provincial tax authorities. Despite its disagreement, and as a condition of its right to proceed with its objection to the Reassessments, the Company was required to deposit approximately \$20 million with the CRA, which amount will remain on account until the dispute is resolved.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

12. Financial Instruments and Risk Management

Financial Instruments

Financial instruments at December 31, 2010 consisted of cash and cash equivalents, accounts receivable, available-for-sale investments, the Drilling Rig Loan, accounts payable and accrued liabilities, risk management assets/liabilities, and long-term debt.

Fair Values of Financial Assets and Liabilities

Risk management assets and liabilities are carried at fair value, which are based on forward market curves and compared to quotes provided by financial institutions. The carrying value of Paramount's long-term debt is measured at amortized cost. The Senior Notes had a market value of 100.3 percent of their principal amount at December 31, 2010.

Available-for-sale investments are carried at market value. Paramount's investment in MEG was carried at historical cost, net of impairment, prior to MEG's initial public offering in August 2010, as it was a private corporation and its shares were not traded in an active market. Subsequent to MEG's initial public offering, Paramount's investment in MEG is now carried at market value. The Company has no immediate plans to dispose of its available-for-sale investments.

At December 31, 2010, Paramount had the following financial commodity sales contract outstanding:

Instrument	Notional	Fixed Price	Fair Value	Remaining Term
Oil – NYMEX Swap	500 Bbl/d	USD \$89.95/Bbl	\$ (693)	January 2011 – December 2011

Changes in fair value of risk management assets and liabilities are as follows:

	2010			2009		
	Commodity	Foreign Exchange	Total	Commodity	Foreign Exchange	Total
Fair value, beginning of year	\$ 2,187	\$ –	\$ 2,187	\$ 9,807	\$ 9,883	\$ 19,690
Changes in fair value	10,047	–	10,047	5,277	2,322	7,599
Settlements (received)	(12,927)	–	(12,927)	(12,897)	(12,205)	(25,102)
Fair value, end of year	\$ (693)	\$ –	\$ (693)	\$ 2,187	\$ –	\$ 2,187

Risk Management

Paramount is exposed to market risks where the fair values or future cash flows of financial instruments fluctuate because of underlying changes in market prices. The principal market risks impacting Paramount are commodity price risk, foreign currency risk, interest rate risk, equity price risk, credit risk and liquidity risk. Paramount periodically uses derivative instruments such as forwards, futures, swaps and options to manage its exposure to fluctuations in crude oil and natural gas prices, foreign exchange rates, and interest rates.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

Commodity Price Risk

At December 31, 2010, assuming all other variables are held constant, a 10 percent increase or decrease in the applicable forward market curves would have had the following impact on Paramount's net earnings from changes in the fair value of financial commodity contracts:

	10% increase	10% decrease
Crude Oil	\$ (1,211)	\$ 1,211

Foreign Currency Risk

Paramount is exposed to foreign currency risk on financial instruments denominated in US dollars including cash and cash equivalents, accounts receivable, risk management assets and liabilities, and accounts payable and accrued liabilities.

Sales prices of natural gas, crude oil, and NGLs are determined with reference to US benchmark prices, therefore a strengthening of the Canadian dollar relative to the US dollar will decrease the revenue received for natural gas, crude oil, and NGLs. Paramount's expenditures are primarily in Canadian dollars but include capital and operating expenditures in US dollars, largely related to the Company's US operations.

Interest Rate Risk

Paramount is exposed to interest rate risk from time to time on outstanding balances on its floating rate bank credit facility and the Drilling Rig Loan, and on interest bearing cash and cash equivalents. Paramount's Senior Notes bear interest at a fixed rate and are subject to fair value changes as market interest rates change.

Equity Price Risk

Paramount is exposed to equity price risk associated with changes in the market value of its investments.

Credit Risk

Paramount is exposed to credit risk on its financial instruments where a financial loss would be experienced if a counterparty to a financial asset failed to meet its obligations. The Company manages credit risk by endeavoring to enter into contracts with counterparties that possess high credit ratings, employ net settlement agreements, employ letters of credit, and limiting available credit when necessary. The maximum credit risk exposure at December 31, 2010 is limited to the carrying values of cash and cash equivalents, and accounts receivable. Accounts receivable include balances due from customers and joint venture partners in the oil and gas industry and are subject to normal industry credit risk. At December 31, 2010, Paramount had balances due from one joint venture partner that represented approximately 14 percent of the Company's total accounts receivable, and one sales customer that represented approximately 13 percent of the Company's total accounts receivable.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

Liquidity Risk

Liquidity risk is the risk that Paramount will be unable to meet its financial obligations. The Company manages liquidity risk by ensuring that it has sufficient cash and cash equivalents, credit facilities and other financial resources available to meet its obligations.

The Company forecasts cash flows for a period of at least 12 months to identify financial requirements. These requirements are met through a combination of cash flows from operations, credit facilities, dispositions of assets, and accessing capital markets.

In addition to commitments disclosed in note 16, contractual obligations related to financial liabilities are as follows:

	2011	2012	2013	2014	2015	Thereafter	Total
Drilling rig loan, including interest	\$ 5,081	\$ 5,934	\$ 5,726	\$ 12,937	\$ –	\$ –	\$ 29,678
Accounts payable and accrued liabilities	78,806	–	–	–	–	–	78,806
Risk management liabilities	693	–	–	–	–	–	693
Senior Notes, including interest	24,750	24,750	24,750	24,750	24,750	348,347	472,097
	\$109,330	\$ 30,684	\$ 30,476	\$ 37,687	\$ 24,750	\$348,347	\$581,274

13. Capital Structure

Paramount's primary objectives in managing its capital structure are to:

- (i) maintain a flexible capital structure which optimizes the cost of capital at an acceptable level of risk;
- (ii) maintain sufficient liquidity to support ongoing operations, capital expenditure programs, strategic initiatives, and the repayment of debt obligations when due; and
- (iii) maximize shareholder returns.

Paramount manages its capital structure to support current and future business plans and periodically adjusts the structure in response to changes in economic conditions and the risk characteristics of the Company's underlying assets and operations. Paramount monitors metrics such as the Company's debt-to-equity and debt-to-cash flow ratios as calculated in accordance with the Company's Senior Notes indenture, among others, to measure the status of its capital structure. The Company has not established fixed quantitative thresholds for such metrics. The capital structure may be adjusted by issuing or repurchasing shares, issuing or repurchasing debt, refinancing existing debt, modifying capital spending programs, and disposing of assets, the availability of any such means being dependent upon market conditions.

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

Paramount's capital structure consists of the following:

	2010	2009
Working capital ⁽¹⁾	\$ (4,825)	\$ (43,485)
Senior Notes ⁽²⁾	300,000	–
US Senior Notes ⁽²⁾	–	94,394
Net Debt ⁽³⁾	295,175	50,909
Share capital	458,895	393,087
Contributed surplus	3,940	2,890
Retained earnings	251,277	373,745
Accumulated other comprehensive income	71,622	3,188
Total Capital	\$ 1,080,909	\$ 823,819

(1) Excludes risk management assets and liabilities, and stock-based compensation liabilities

(2) Excludes unamortized financing costs

(3) 2010 Net Debt excludes the \$19.8 million deposit on account with the CRA, pending resolution of the Company's Notice of Objection (see Note 11)

Paramount is subject to covenants under its credit facility, the Drilling Rig Loan, and Senior Notes agreements which contain certain restrictions on Paramount's ability to repurchase equity, issue or refinance debt, acquire or dispose of assets, and pay dividends.

14. Consolidated Statements of Cash Flows – Selected Information

Items not involving cash

Year ended December 31	2010	2009
Financial commodity contracts	\$ 2,880	\$ 7,620
Stock-based compensation	58,703	17,553
Depletion, depreciation and accretion	178,007	141,597
Gain on sale of property, plant and equipment	(3)	(534)
Write-down of petroleum and natural gas assets	25,332	14,939
Foreign exchange	(2,137)	(15,274)
Distributions in excess of equity earnings and dilution	8,258	25,559
Gain on available-for-sale investments	(3,499)	(3,193)
Future income tax	(72,535)	(53,743)
Other	393	(206)
	\$ 195,399	\$ 134,318

Changes in non-cash working capital

Year ended December 31	2010	2009
Accounts receivable	\$ (7,807)	\$ 19,716
Prepaid expenses and other	387	(570)
Account payable and accrued liabilities	24,091	(36,651)
	\$ 16,671	\$ (17,505)
Operating activities	\$ (23,467)	\$ 11,797
Investing activities	40,138	(29,302)
	\$ 16,671	\$ (17,505)

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

Supplemental cash flow information

Year ended December 31	2010	2009
Interest paid	\$ 15,615	\$ 11,640
Current tax paid	\$ 368	\$ 159

Components of cash and cash equivalents

Year ended December 31	2010	2009
Cash	\$ 29,679	\$ 23,250
Banker's acceptances	44,980	69,988
	\$ 74,659	\$ 93,238

15. Related Party Transactions

Service Agreements

In addition to the debt and equity instruments issued to related parties, in 2010 Paramount charged \$0.5 million (2009 – \$0.6 million) for certain operational and administrative services that the Company provided to Trilogy. Paramount also has transactions with Trilogy, MGM Energy and Perpetual Energy Corp. in the normal course of business, including joint venture operations. Trilogy, Perpetual Energy Inc., MGM Energy and Paramount are related by common significant influence. All transactions between the entities are recorded at their exchange amounts.

16. Commitments and Contingencies

Commitments

Paramount had the following commitments as at December 31, 2010:

	2011	2012	2013	2014	2015	After 2015
Pipeline transportation commitments ⁽¹⁾	\$ 14,501	\$ 14,529	\$ 13,560	\$ 13,835	\$ 12,011	\$ 67,163
Operating leases	2,299	1,855	–	–	–	–
Total	\$ 16,800	\$ 16,384	\$ 13,560	\$ 13,835	\$ 12,011	\$ 67,163

(1) Certain of the pipeline transportation commitments are secured by outstanding letters of credit totaling \$10.4 million at December 31, 2010.

Flow-Through Shares

As a result of flow through share issuances in the fourth quarter of 2010, Paramount is required to incur and renounce \$34.1 million of Canadian Exploration Expense and \$25.0 million of Canadian Development Expense. The Company is required to incur all qualifying expenditures by December 31, 2011.

Contingencies

Paramount is a party to various legal claims associated with the ordinary conduct of business. Paramount does not anticipate that these claims will have a material impact on its financial position.

Tax and royalty legislation and regulations, and government interpretation and administration thereof, continually changes. As a result, there are often tax and royalty matters under review by relevant

Notes to Consolidated Financial Statements

(\$ thousands, except as noted)

government authorities. All tax filings are subject to subsequent government audit and potential reassessments. Accordingly, the final liability may differ materially from amounts estimated and recorded.

Crown royalties for Paramount's production from frontier lands in the Northwest Territories have been recognized in the Consolidated Financial Statements based on the Company's interpretation of the relevant legislation and regulations. Although Paramount believes that its interpretation of the relevant legislation and regulations has merit, Paramount is unable to predict the ultimate outcome of ongoing audits and/or assessments by the Government of Canada. Additional material amounts could potentially become payable.

17. Subsequent Events

- In February 2011, Paramount closed a public offering of an additional \$70 million principal amount of Senior Notes (see Note 7).
- Subsequent to December 31, 2010, the Company entered into an additional financial commodity sales contract:

Instrument	Total Notional	Average Fixed Price	Remaining Term
Crude Oil– NYMEX Swap	500 Bbl/d	USD\$97.50/Bbl	March 2011 – December 2011

- Subsequent to December 31, 2010, the Company sold approximately 6,000 net acres of undeveloped land in North Dakota, unrelated to the farm-out lands, for cash proceeds of US\$40 million.