



Annual Report | 2010



■ Corporate Profile

Gastem is a Quebec-based oil and gas exploration and development company holding exploration and storage rights to over 1.1 million acres of land in the St-Lawrence Lowlands, the Gaspé Peninsula and the Magdalen Islands in Quebec. Gastem USA, a Gastem wholly owned subsidiary, holds exploration licenses to approximately 32,000 acres in New York State and 2,300 acres in Virginia. Gastem was incorporated under the Canada Business Corporations Act in 2002 and listed on the TSX-Venture Exchange in January 2004 (GMR, TSX-V). Gastem USA was incorporated in 2007 in the State of Delaware.



■ Our Mission

Gastem's mission is to create shareholder value through the exploration and development of high impact projects. Gastem's strategy is to acquire, explore and develop new and prospective areas with a high level impact potential on a first mover basis. In order to reduce exploration risks and to increase technical input, Gastem may undertake programs with exploration partners.

2010 Achievements | 2010 Achievements

- The St-Hyacinthe No 1H horizontal well and the vertical and horizontal wells at St-Barnabé were drilled and the La Présentation No 1H well fraced in early summer 2010.
- Gastem prepared a detailed conventional drill program for the Magdalen Islands and is now reviewing sites and permitting.
- In New York State, Gastem completed an aeromagnetic Survey in Broom, Delaware, Otsego and Chenango Counties, successfully frac-stimulated the Ross No 1 well and acquired, processed and interpreted 16.1 km of seismic in Otsego County.
- A flow through financing for Quebec exploration programs and a financing for New York State activities were completed.
- The secondary listing on the Oslo Exchange in Norway was postponed as a result of difficult market conditions.
- Gastem participated actively in the public hearings by the Bureau d'audiences publiques (the BAPE hearings) on shale gas development in the Province of Quebec.

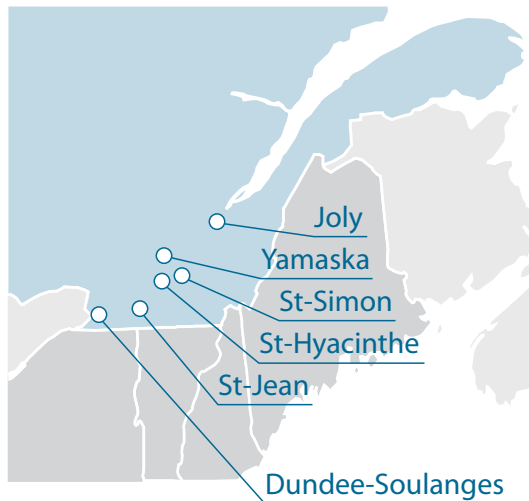
2011 Milestones | 2011 Milestones

- New projects are being evaluated and a series of properties being reviewed with a focus on new areas and production.
- Gastem plans to undertake a drilling program on the Joly property, in 2011, subject to authorisation by the strategic environmental assessment committee.
- In the Gulf of St-Lawrence, the Magdalen Islands program is now being finalized for a conventional exploration well proposed for fall 2011.
- In New York State, a new project targeting conventional production is being finalized.

■ Environmental Values

Gastem strives to apply 'best industry practices' in order to respect environmental and community concerns. These receive constant attention and our exploration and development programs are prepared with the best possible environmental supervision and quality controls.

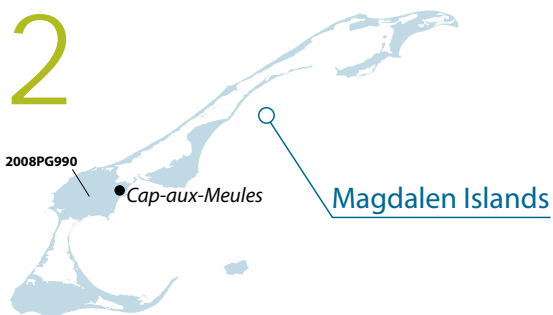
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St-Lawrence Lowlands

The 2010 program for one vertical well and three horizontal wells in St-Hyacinthe has been completed. The horizontal well La Présentation No 1H was drilled in May, the vertical and horizontal wells St-Barnabé No 1 and St-Barnabé No 1H in July and the drilling of the last horizontal well, St-Hyacinthe No 1H, was finalised in August. Frac-stimulation of the La Présentation No 1H well was performed in July 2010. Work on the Yamaska property with partner Forest Oil consisted of an 81.5 km 2-D seismic survey which was undertaken in June. The processing has been completed and the interpretation has indicated several drill targets. Work on the Joly property resumed during fall 2010 with the preparation of a drill program (Gastem, Joly No 5) to evaluate the shallow carbonate thrust sheets and the deep Utica Shale.

2



Magdalen Islands and Basin

A detailed conventional drill program and costs estimates for the Magdalen Islands have been prepared. A review and analysis of potential drill sites is being conducted. A comparative analysis of the different rig options was completed and preliminary discussions were held with a drilling contractor. The spud date has been postponed to fall 2011 as a result of the negative repercussions of the BP accident in the Gulf of Mexico and the resulting increased concern by local environmental groups and representatives, with whom we are in

discussion. In March 2011, the Governments of Canada and Quebec announced that they had reached an important agreement relative to the revenues from offshore oil and gas production for the Quebec portion of the Gulf of St-Lawrence. This is an important step towards an administrative agreement similar to those in force in Nova Scotia and Newfoundland, and which may be expected to be completed in 2012.

Local gas for local use and respect for the community

Respect for the community and good neighbour policies are fundamental to our company's growth. We consider our efforts in this area as not only necessary but a key factor in assuring constant and sustained growth.

3



Gaspe Peninsula

On the Matapedia-Cyr block in the Gaspe Peninsula, Gastem 2007 and 2008 surveys identified various live oil seeps in the surface soils and the company completed a 40 km 2-D seismic survey over these anomalies during fall 2009. The 2-D seismic data has been processed and interpreted. The company is currently reviewing identified targets over the anticline with an emphasis on defining areas in which to acquire additional seismic and potential drilling targets. A complementary aeromagnetic survey has also been initiated in December 2010, in order to refine the possible location of a test well on the Causapsca Anticline and to further assist in the delineation of the prospective zones in the southern part of the block.

4



New York State

In New York State, in September 2010, Gastem-USA received from the Department of Environmental Conservation the authorization to proceed with the frac-stimulation of the Marcellus Shale in the Ross No1 well and the Upper Utica Shale in the Sheckels No1 well. The Ross No1 fracs were performed during late October (Marcellus Shale). Gastem USA tested the Marcellus with a small two stage nitrogen assisted frac that produced a 120 mcf/d flow in the Ross 1. Gastem-USA also completed an aeromagnetic survey over about 85% of Chenango County, 20% of Broome County and 30% of Delaware County. This survey allowed Gastem-USA to evaluate land to the west and south of its current leases. In Q4, the company completed a 10

mile high resolution 2D seismic program in the areas of interest in Otsego County New York, completed an evaluation of natural gas potential and selected three sites to target conventional gas wells in Otsego County.

Gastem Acreage

Property	Operator	Partners	Stake	Gross Acres	Net Acres
■ St-Lawrence Lowlands, Quebec					
St-Hyacinthe	Canbriam Qc	Canbriam Qc 68%, Forest Oil 0.425%	16.575%	92,039	15,256
Yamaska *	Ca. Forest Oil	Ca. Forest Oil 60%, Questerre 20%	20%	112,139	22,428
Joly	Intragaz	Intragaz 65%	35%	34,123	11,943
St-Jean East *	Gastem/Questerre	Questerre 50%	50%	124,983	62,492
St-Jean West *	Gastem	—	100%	71,337	71,337
St-Jean North	Questerre	Questerre 80%	20%	53,953	10,791
Dundee *	Gastem	—	100%	228,671	228,671
■ Gastem USA					
New York State	Gastem USA	Utica Energy 20%	80%	29,000	23,200
Virginia	Gastem USA	—	100%	2,300	2,300
■ Magdalen Islands, Quebec					
Magdalen Islands	Gastem	—	100%	43,293	43,293
■ Gaspé Peninsula, Quebec					
Matapedia-Cyr *	Gastem	—	100%	469,214	469,214
				960,925	

* Epsilon has 25% undivided participating interest (has yet to participate in Yamaska)

Letter to shareholders



With the recent and sustained difficulties related to the perception of environmental issues for shale gas development in both Quebec and New York State, Gastem has decided to move forward in new areas with conventional high impact potential. We will also continue to monitor the situation in Quebec and New York State and assist, where possible and if reasonable, in presenting information to those responsible for the Studies and Assessments regarding shale gas fracturing. However, our focus and attention will clearly be in developing conventional gas projects in the Magdalen Basin and obtaining new properties in areas with conventional oil and gas production with strong potential.

Gastem has a very favourable position for these new developments as it has always had properties, and a strong interest, in Appalachia and Eastern Canada. The company has been actively acquiring new information for conventional plays in these areas. Regional and area airborne surveys, reviews and reports were undertaken particularly since last fall. As a result, we have established new approaches and new opportunities for our company's development.

Over the course of the next few months, shareholders can expect to see Gastem moving ahead with new and solid major projects aimed at increasing shareholder value and company development. Work in 2010 established new opportunities in Appalachia and the Magdalen Basin area where we fully intend to profit from the information and experience acquired.

The company has sufficient funds and is properly staffed to meet these new objectives. Our team is firmly dedicated to achieving the company's goals. As Obama has stated, "success is the only option."

Although shareholder value is particularly low at this time, we expect that with hard work, a clear focus and a firm determination, we will reward shareholders for their patience. Oil and gas will continue to be an area of major interest by all markets and Gastem fully intends to deliver on the high growth potential we see for ourselves this coming year.

It is necessary to state that at the time of writing this letter, the Quebec government has undertaken an environmental review of Utica shale operations in Quebec. The process, which may take up to 2 years or more, is led by a committee of ten people on which two representatives of the industry are present. During this review process, all drilling operations on the Utica shale and all fracturing operations on the Utica or elsewhere in Quebec are subject to committee approval. Conventional programs and wells are not subject to this procedure. During the review process, the government has proposed via Bill 18 that permits and work obligations are to be put on hold. Bill 18 is now before the Assembly and may be adopted this session.

Raymond Savoie
Chairman and CEO
Gastem

Corporate Information

Management Team

Raymond Savoie, LL.L
Chairman and CEO

Orville Cole
COO and President of Gastem-USA

Bernard Hénault
CFO

François Lapierre, CA
Assistant Controller

Estelle S. Dufresne, LL.B., J.D.
Corporate Secretary and Legal Counsel

David Vincent, MBA, M.Sc.
Director, Investor Relations

Richard Nyahay, M.A.
Vice-President Exploration (Gastem-USA)

Stephan Séjourné, Ph.D., P.Geo.
Geologist

Transfer Agent, Registrar and Auditors

Transfer Agent and Registrar
Computershare Investors Services Inc., Montreal

Auditors
KPMG, Montreal

Gastem Board of Directors

Raymond Savoie, LL.L
Chairman and CEO
Former Quebec Minister of Mines

Zoran Arandjelovic, B.A.
Executive Chairman, Epsilon Energy
Board Member, MartinRea International

Jon Kelafant, M.Sc.
President, Utica Energy
Vice-President, Advanced Resources

Michel Lemoine, LL.L, Ing. * ♦
Former CEO and Founder, Pellemon Engineering
Former Head of Industrial Division, SNC-Lavalin

Régent Watier, CA and Fellow * ♦
Chief Investment Officer, FondAction (CSN)

* Members of the Audit Committee

♦ Members of the Compensation Committee

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MANAGEMENT DISCUSSION AND ANALYSIS

ANNUAL REPORT FOR THE YEAR ENDED DECEMBER 31ST 2010

The following Management Discussion and Analysis („MD&A’) is issued as a supplement to the audited financial statements for the period ending December 31st 2010 available at www.sedar.com under “Gastem, Public Documents.” This report, along with all recent press releases and previous financial statements with related documents are also available on Gastem’s (the „Company’) website at www.gastem.ca.

This MD&A prepared by Gastem’s Management, contains comments on the Company’s audited financial statements to December 31st 2010 and a synopsis of current activities and properties, including a brief outlook.

1. DATE

This MD&A for the year ended December 31st 2010 was completed on April 26th 2011. As required, this analysis contains notes and comments on important events subsequent to December 31st 2010.

2. COMPANY PROFILE

The Company was incorporated under the Canada Business Corporations Act in 2002 and listed on the TSX-Venture Exchange in January 2004 under the symbol GMR.

Gastem is an oil and gas exploration and development company with exploration properties, rights and interests located in the St. Lawrence Lowlands, the Magdalen Islands and the Gaspé Peninsula in Quebec.

The Company also has properties situated in New York State and Virginia, held and operated by a wholly owned American subsidiary named Gastem-USA. It is also in the process of obtaining new properties in Appalachia and Eastern Canada. The Company has, at present, no formal oil or gas reserves and no revenue from oil and gas producing wells.

3. EXPLORATION ACTIVITIES

The Company’s exploration activities for 2010, with references to significant events after that date, are presented initially in the form of highlights, followed by a property exploration program summary table, and a more detailed property review.

3.1 Highlights

Highlights of the Company's main activities for 2010 are as follows:

- **ST-HYACINTHE PROPERTY:**
 - The La Presentation No 1H well was drilled in May and fraced in Q3
 - The vertical and horizontal wells at St. Barnabe were drilled in July
 - The Saint-Hyacinthe No 1H horizontal well was drilled in August
- **YAMASKA PROPERTY:**
 - 81.5 km of seismic line during Q2 and subsequent processing
 - Interpretation of the survey finalised and drill targets identified during Q4
- **MAGDALEN ISLANDS PROPERTY:**
 - Detailed conventional drill program prepared
 - Analysis of potential drill sites on-going
- **MATAPEDIA-CYR PROPERTY:**
 - Regional aeromagnetic survey initiated during Q4 and completed
- **DUNDEE-SOULANGES PROPERTY:**
 - Regional gravimetric survey initiated during Q4 and completed
- **JOLY PROPERTY:**
 - Spudding of Joly No 5, initially planned for December 2010, is now scheduled for 2011 due to surface environmental issues
- **NEW YORK STATE PROPERTIES (Gastem-USA):**
 - Completion of an aeromagnetic survey in Broome, Delaware, Otsego and Chenango Counties, NY during Q2
 - Finalization of OGIP calculations for the Ross No 1 well in Otsego County during Q3
 - Frac-stimulation of the Ross No 1 well during Q4
 - Acquisition, processing and interpretation of 16.1 km of seismic in Otsego County, NY during Q4
- A flow through financing for Quebec exploration programs was completed during Q1 and a financing for New York State activities was completed during Q3
- The secondary listing on the Oslo Exchange in Norway postponed as a result of difficult market conditions
- During Q3 and Q4 2010, Gastem participated actively in the public hearings by the Bureau d'audiences publiques (the BAPE hearings) on shale gas development in the Province of Quebec

3.2 Summary of Exploration Activities and Programs

A summary of the Company's main exploration properties, earn-in options, programs and projected expenses are presented in the following table. Exploration programs are subject to revision and control by the Board of Directors and may or may not be undertaken at the Board's discretion. Projected expenses may increase or decrease subject to results and priorities.

Summary of Exploration Activities and Programs	
St. Lawrence Lowlands, Quebec	
Yamaska – 45,381 hectares (20% Gastem, 60% Forest Oil, 20% Questerre)	
Summary	<ul style="list-style-type: none"> • Shale gas prospect in the Utica and Lorraine shales • 2 vertical wells drilled by Gastem in 2007 and one frac-stimulated by Forest Oil in 2007/2008 • Partner Forest Oil earned 60% interest during Q3 2008 • Drilling and hydraulic fracture stimulations of 2 horizontal wells completed in early Q4 2008 with preliminary results announced in Q1 2009 • 81.5km 2-D seismic survey during Q2-Q3 2010 by operator Forest Oil • Epsilon Energy has the right to participate for 5% (gross) of future wells
Proposed Program	<ul style="list-style-type: none"> • Several drilling targets identified based on new seismic survey, site locations under review
Projected Expenses	<ul style="list-style-type: none"> • Program to be made known shortly by Lone Pine Resources (as successor to Forest Oil)
St-Hyacinthe – Farm In – 37,247 hectares (16.575% Gastem, 68% Canbriam, 0.425% Forest, 15% Suncor et al.)	
Summary	<ul style="list-style-type: none"> • Joint Gastem–Canbriam Energy farm-in on Suncor et al. acreage • Adjacent and geologically similar to Yamaska property with Utica and Lorraine shales present • Gastem's participation for 19.5% of costs for a 16.575% working interest • Two vertical wells drilled in 2009 • One vertical and three horizontal wells drilled during Q2 and Q3 2010 • One horizontal well stimulated during Q3
Proposed Program	<ul style="list-style-type: none"> • Frac-stimulations for two horizontal wells planned for 2011 and subject to permitting • Possible 3-D seismic program adjacent to test wells to define future horizontal targets and refine structural model
Projected Expenses	<ul style="list-style-type: none"> • Gastem participation equals 19.5% of costs, and total cost is presently estimated to be approximately \$5 M for frac operations
St-Jean East – 50,668 hectares (50% Gastem with 12.5% Epsilon, 50% Questerre)	
Summary	<ul style="list-style-type: none"> • Subject to a Joint Operating Agreement with Questerre Energy • Potential targets in platform carbonates and Utica Shale • High-resolution aeromagnetic survey undertaken during spring 2007
Proposed Program	<ul style="list-style-type: none"> • Gastem reviewing existing seismic and aeromagnetic data • Possible program to test the Utica Shale potential in 2011
Projected Expenses	<ul style="list-style-type: none"> • To be determined at a later date
St-Jean West – 28,869 hectares (75% Gastem, 25% Epsilon)	
Summary	<ul style="list-style-type: none"> • Potential targets in platform carbonates and granite wash, analogous to Dundee-Soulanges • High-resolution aeromagnetic survey undertaken in 2007
Proposed Program	<ul style="list-style-type: none"> • Gastem reviewing existing seismic and aeromagnetic data and developing a possible drilling program to test the platform targets in 2011
Projected Expenses	<ul style="list-style-type: none"> • No significant exploration expenses projected for 2011 at this time
St-Jean North – 21,834 hectares (20% Gastem, 80% Questerre)	
Summary	<ul style="list-style-type: none"> • Permit obtained by Questerre with a subsequent 20% working interest transferred to Gastem • St-Jean No 1 well drilled to the base of Utica Shale in Q2 2008 and frac-stimulated in Q1 2009 • Exploration program may be integrated with the adjacent Gastem St-Jean East permits
Proposed Program	<ul style="list-style-type: none"> • Project review on-going and work may be undertaken in 2011
Projected Expenses	<ul style="list-style-type: none"> • No significant exploration expenses projected for 2011 at this time

Dundee-Soulanges – 92,540 hectares (75% Gastem, 25% Epsilon)	
Summary	<ul style="list-style-type: none"> • Current exploration focussed on identification of commercial reservoirs in Beekmantown fractured carbonates and in the granite wash at the Potsdam/basement contact • Permit-wide surface geochemical survey undertaken during summer 2007 • 19.5km 2-D seismic survey completed over gas seep anomalies in 2009 • 1,066km² airborne gravimetric survey initiated in December 2010
Proposed Program	<ul style="list-style-type: none"> • Two drilling targets identified based on new seismic survey, site locations under review • Gastem preparing exploration program for 2011 – Possible 2-well program in 2011 • Processing and interpretation of the gravimetric survey
Projected Expenses	<ul style="list-style-type: none"> • Estimated \$600,000 for exploration well program
July – Farm In – 13,809 hectares (35% Gastem, 65% Intragaz)	
Summary	<ul style="list-style-type: none"> • Joint Intragaz–Gastem exploration project for production and storage • Gas exploration and storage play in highly porous, permeable formation adjacent to existing gas storage installations at St. Flavien • Gastem is Operator for all exploration activities pertaining to this project and has earned both a 35% interest on the property and a 34% interest in gas storage rights • Joly No 4 drilled in December 2007, expected dolomite sequence not encountered – well abandoned in early Q3 2009 • Spud of Joly No 5 delayed for surface and environmental issues
Proposed Program	<ul style="list-style-type: none"> • Drilling of Joly No 5 to test Utica Shale at 3.5 km depth
Projected Expenses	<ul style="list-style-type: none"> • Possible exploration expenses projected for 2011 pending surface issues are solved
Gaspe Peninsula, Quebec	
Matapedia – Cyr – 189,884 hectares (75% Gastem, 25% Epsilon)	
Summary	<ul style="list-style-type: none"> • Regional geochemical survey (2007) undertaken by Gastem in vicinity of recent Ministry and Petrolia seismic lines in northern part of block • Detailed geochemical survey (2008) undertaken by Gastem on the Causapsca Anticline • Regional tectonic and thermal maturity study undertaken by the Institut National de la Recherche Scientifique in Quebec City • Acquired 40km of 2-D seismic in 2009 • 8,727km² aeromagnetic survey initiated in December 2010
Proposed Program	<ul style="list-style-type: none"> • Processing and interpretation of the aeromagnetic survey • Gastem preparing exploration program for 2011 – Possible 1-well program based on new data
Projected Expenses	<ul style="list-style-type: none"> • Possible exploration expenses projected for 2011 pending drilling program development
Magdalen Islands, Quebec	
Magdalen Islands – 17,520 hectares (100% Gastem)	
Summary	<ul style="list-style-type: none"> • Exploration permit acquired in July 2008 • Review of existing data and geophysical modelling (seismic, gravity, magnetism) completed • Detailed geological report completed
Proposed Program	<ul style="list-style-type: none"> • Update on geophysical modelling based on new, MRNF regional surveys • Drilling program prepared and being reviewed, surface location under review
Projected Expenses	<ul style="list-style-type: none"> • Drill program being established and costs under final review
Gastem – USA	
New York State Shale and Tight Sand Project – approx. 32,000 acres (80% Gastem, 20% Covalent Energy)	
Summary	<ul style="list-style-type: none"> • Covalent Energy (now Utica Energy LLC) drilled and completed two wells on acreage in the summer of 2007, with encouraging results • Gastem earned-in an 80% interest by drilling 1 vertical well and issuing 3,500,000 Gastem common shares as well as paying US\$35,000 in early 2009 • All funds directed towards exploration and development programs • Aeromagnetic survey over about 85% of Chenango County, 20% of Broome County and 30% of Delaware County • 16.1km 2-D seismic acquired in Otsego County, focussing on the Oneida Sand Formation • Ross No 1 fraced for the Utica and Marcellus intervals, Oneida Sand interval tested

Proposed Program	<ul style="list-style-type: none"> • Land acquisition, seismic surveys and the drilling of new wells in 2011 • Other programs subject to results of new wells and New York State regulations
Projected Expenses	<ul style="list-style-type: none"> • Program to be prepared shortly • Further land acquisition and drilling programs subject to well results, regulations and funding
Virginia – approx. 2,300 acres (80% Gastem, 20% Covalent Energy)	
Summary	<ul style="list-style-type: none"> • Gastem-USA signed a Letter of Agreement with Covalent Energy in 2008 with regard to lease acquisition in the Commonwealth of Virginia, but the earn-in conditions (10,000 to 20,000 acres leased or 1,000,000 US\$ spending) have not been triggered yet • Gastem-USA engaged the process of leases acquisition in 2009
Proposed Program	<ul style="list-style-type: none"> • The company continues evaluating lease acquisition opportunities
Projected Expenses	<ul style="list-style-type: none"> • No significant exploration expenses projected for 2011 at this time

3.3 Property Review

3.3.1 St. Lawrence Lowlands

In early 2009, Gastem significantly increased its net land position in the heart of the Utica fairway by signing a joint farm-in agreement for a 17% interest on 37,247 hectares held in a consortium led by Suncor Energy. The St-Hyacinthe acreage is adjacent to, and immediately south-east of the Yamaska block and shares a similar geology. According to the terms of the farm-in agreement, Canbriam and Gastem have to drill, evaluate and complete three vertical wells and three horizontal wells on this acreage prior to December 31st 2010. The partners drilled two vertical test wells on the St-Hyacinthe property during August and September 2009: the wells St-Hyacinthe No 1 and La Présentation No 1 reached their projected target depths in the Trenton Limestone immediately below the Utica Shale and were completed in the middle Dolgeville member of the Utica Shale during the winter 2009. The results of core and log analyses and the vertical fractures from these wells indicate significant Original Gas In Place (OGIP) values. The results of the Dolgeville stimulations, announced in early 2010, showed that stable gas rates could be achieved with vertical wellbores. Following detailed analysis of the stimulations and flowback operations, the partners expect that subsequent frac-stimulations in horizontal wellbores will significantly improve the gas rates.

The 2010 program for one vertical well and three horizontal wells in St-Hyacinthe has been completed. The horizontal well La Présentation No 1H was drilled in May, the vertical and horizontal wells St-Barnabé No 1 and St-Barnabé No 1H in July and the drilling of the last horizontal well, Saint-Hyacinthe No 1H, was finalised in August. Frac-stimulation of the La Présentation No 1H well was performed in July 2010. Due to the public hearings on shale gas development in the Province of Quebec, the frac-stimulation of the two remaining horizontal wells have been postponed to 2011.

Work on the Yamaska property with partner Forest Oil consisted of an 81.5 km 2-D seismic survey which was undertaken in June. The processing has been completed and the interpretation has indicated several drill targets. Further work on the property will be announced by the operator in the coming months.

Work on the Joly property resumed during the fall of 2010 with the preparation of a drill program (Gastem, Joly No5) to evaluate the shallow carbonate thrust sheets and the deep Utica Shale. The carbonates have a potential for gas storage (reservoirs analogous to St. Flavien) and the potential of the Utica Shale could be two-fold: the naturally fractured shale at moderate depths (analogous to Villeroy) and the underlying undeformed shale, the later being located in the deepest of the three prospective zones of the Utica fairway, a zone that to date has never been tested. Acknowledging the possible risks inherent to the exploration of a new area, Gastem's program mitigates these risks in its test well by combining the deep Utica target with two alternative targets as discussed above. The drill permit was delivered to Gastem on November 23th, 2010.

As a result of concerns by the regional office of the Ministère du Développement durable, de l'Environnement et des Parcs (MDDEP) regarding the possible presence of a swamp on a portion of the site

(part of a former agricultural land, now abandoned), drilling preparations were stopped on December 8th. In order to resume the drilling operations of Joly No5, an application has been filed with the Quebec Environment Department in early 2011 to obtain a certificate of authorization under Article 22 of the Environment Quality Act. As a precautionary measure, an alternative site (Gastem, Joly No6) located along the same seismic line as Joly No5 has been identified. As with all Gastem wells, meetings with the municipality of Joly and the MRC of Lotbinière have been the occasion to present the company's program and to address the communities' concerns and issues. Additional meetings are planned with the communities before the drilling operations resume.

The BAPE (Bureau d'audiences publiques sur l'environnement) Report, entitled the « Sustainable Development of the Shale Gas Industry in Quebec » was made public in late February 2011. The main recommendation of the Report consists in the undertaking of a “Strategic Environmental Evaluation Study” (SEES). MDDEP will soon set up a committee to prepare for the SEES study which may or will make recommendations to the government. For the duration of the SEES study, the announced intention is that the committee will review and approve programs on the Utica Shale as well as hydraulic fracturing in Quebec. All other conventional exploration program should continue as before.

3.3.2 Dundee Property

During the autumn of 2009, Gastem undertook a 19.48 km 2-D seismic survey in the south western portion of the block, adjacent to the previous Gastem and Ditem Explorations wildcat wells and various methane seep anomalies observed during the 2007 soil geochemistry survey. After processing and interpretation of this survey, Gastem identified two possible drilling targets. Site validations are underway and drilling of these targets could take place during 2011.

Jointly with this review, Gastem contracted a firm in December 2010 to perform an airborne gravimetric survey over part of the property. The gravimetric survey was completed after the end of the reporting period, in March 2011. It covers 1,066 km² and the data are currently being processed.

3.3.3 Magdalen Islands Property

In July of 2008, the Company acquired the 17,520 hectares exploration permit (2008-PG-990) for the Magdalen Islands (Iles-de-la-Madeleine) located in the Quebec sector of the Magdalen Basin in the Gulf of St. Lawrence. Gastem has completed a comprehensive review and integrated re-evaluation of the existing available geological and geophysical data in late 2008 and early 2009, including the purchase of existing seismic data, with the processing and reinterpretation completed by Boyd Petrosearch of Calgary. This comparative analysis highlighted the need for complementary geophysical data and therefore, an onshore/offshore gravity survey was initiated in Q2 2009. This survey and mapping report was prepared by Excel Geophysics, which integrated the 2009 survey data with the existing gravity database in order to refine the geophysical model and the geometry and structure of the salt diapirs underlying the Islands.

The primary onshore drill target was confirmed and delineated accordingly. The main exploration target remains the Cable Head formation (Upper Carboniferous) which should be encountered at 2,300 meters or slightly less. A 94 km high quality seismic line located offshore south of Magdalen Islands was also acquired. The line has been interpreted and correlated with other seismic data by Boyd Petrosearch with the objective of increasing our level of confidence relative to the depth of the target formation. The results suggest that the Cable Head formation could be slightly higher than previous studies had indicated.

A detailed conventional drill program and costs estimates have been prepared. A review and analysis of potential drill sites is being conducted. A comparative analysis of the different rig options was completed and preliminary discussions were held with a drilling contractor. The spud date has been postponed to Fall 2011 as a result of the negative repercussions of the BP accident in the Gulf of Mexico and the resulting increased concern by local environmental groups and representatives, with whom we are discussing.

The recent acquisition by Southwestern Energy Company of exclusive exploration licenses covering 2.5 million acres in New Brunswick is significant. The proposed three-year exploration program represents one of Southwestern's first ventures outside of the United States. The recently released five year Geological Survey of Canada (GSC) study, Open File 6174, states that the Magdalen Basin, specifically the salt diapir zone associated with the Upper Carboniferous area, has a high TCF (trillion cubic feet) natural gas potential. The GSC resource assessment estimate for the Magdalen Basin is (P50) 21tcf, and the Basin will indeed be an area for increased exploration in the near future.

In March 2011, the Governments of Canada and Quebec announced that they reached an important agreement related to the revenues from offshore oil and gas production for the Quebec portion of the Gulf of St. Lawrence. This is an important step towards an administrative agreement similar to those in force in Nova Scotia and Newfoundland and which may be expected to be completed in 2012.

3.3.4. Matapedia-Cyr Property

On the Matapedia-Cyr block in the Gaspé Peninsula, Gastem undertook two geochemical surveys in 2007 and 2008 in order to identify possible live oil seeps in the surface soils that would indicate potential subsurface oil accumulations. The 2008 survey focussed on the Causapsal anticline in the northern part of the block and covered over 19,000 hectares. Both surveys identified various live oil seeps in the surface soils and Gastem completed a 40 km 2-D seismic survey over these anomalies during fall 2009. The 2-D seismic data has been processed and interpreted.

The company is currently reviewing identified targets over the anticline with an emphasis on defining areas in which to acquire additional seismic and potential drilling targets. A complementary aeromagnetic survey has also been initiated in December 2010, in order to refine the possible location of a test well on the Causapsal Anticline and to further assist in the delineation of the prospective zones in the southern part of the block. Processing of the survey is underway.

3.3.5 Gastem-USA

In September 2009, Gastem and its wholly owned subsidiary, Gastem-USA, announced an agreement with Utica Energy revising Gastem-USA's earn-in terms on the approximately 34,400 acres of land in New York State on which Gastem-USA has been a partner since January 2008. According to the terms of the new Agreement, Gastem-USA paid US\$35,000 and provided 3,500,000 common shares of Gastem vested over a period of six months to Utica Energy. The agreement also required Gastem-USA to drill and complete one vertical well for which Gastem-USA would pay 100% of the drilling and completion costs. As the terms were completed during the drilling and completion of the Ross No1 well discussed below, Gastem-USA now has an 80% interest in the acreage (including recently obtained leases). Utica Energy has a 20% working interest and retains a 2% ORRI on existing and new mineral rights leases within the partners Area of Mutual Interest in New York State. Utica Energy also retains the option to participate with a working interest of up to 20% in new land acquisitions within the AMI.

The Ross No1 well was drilled to target depth in the Utica Shale in August and September of 2009. The coring and logging program for the well was configured to analyse the natural gas potential of the Utica Shale, the Oneida Sandstone and Marcellus Shale, the latter two formations possessing proven commercial production in the region. Following an initial analysis of the sidewall cores, Gastem-USA completed the well in the Utica shale using nitrogen assisted hydraulic fracturing. Gastem-USA received the final report from Weatherford for Gas Storage Capacity and Gas in Place for the Utica and Marcellus Formations from the Ross No1. Highlights of this report have been released.

Gastem-USA applied for three oil and gas permits in 2010. In September 2010 Gastem-USA received from the New York State Department of Environmental Conservation the authorization to proceed with the frac-stimulation of the Marcellus Shale in the Ross No1 well and the Upper Utica Shale in the Sheckels No1

well. The Ross No1 fracs were performed during late October (Marcellus Shale). Gastem USA tested the Marcellus with a small two stage nitrogen assisted frac that produced a 120 mcf/d flow in the Ross 1.

Gastem-USA completed an aeromagnetic survey over about 85% of Chenango County, 20% of Broome County and 30% of Delaware County. This survey allowed Gastem-USA to evaluate land to the west and south of its current leases. In Q4, the company completed a 10 mile high resolution 2D seismic program in the areas of interest in Otsego County New York, completed an evaluation of natural gas potential and selected three sites to target conventional gas wells in Otsego County.

Gastem-USA has added a new employee to oversee the water sampling and organization of the company's extensive database of water wells and surface waters. Our knowledge of the local aquifers was expanded by our continued testing water wells in the area of interest. To date we have extensive analysis on over 121 water wells and 38 surface waters in Otsego County.

To study the effects to local aquifers and surface waters from the impact of shale gas development, Gastem USA initiated a comparative study with the USGS, State Health Dept, Otsego County Soil & Water Conservation District, and SUNY College at Oneonta. This study includes water supply, water containment and transport, and water treatment and disposal as well as the issue of stray gas migration into potable aquifers. Furthermore, the company invited a scientist from Duke University to independently test water wells in the Ross 1 area to give an objective opinion on whether hydraulic fracturing of the Utica formation had any effect on local water wells.

Finally, Gastem-USA continued its policy of transparent awareness and environmental sensitivity to the Otsego County community by continuing discussions with all interested parties regarding water well testing, frac fluids and operations in general. A research plan was submitted to the United States Environmental Protection Agency to be considered as a candidate to document the potential impacts of hydraulic fracturing of organic rich shales through baseline water testing.

4. SELECTED FINANCIAL INFORMATION

Selected annual information for 2010 as compared to 2009 and 2008 is discussed where useful in the present MD&A.

SELECTED ANNUAL INFORMATION	Results as of December 31st 2010	Results as of December 31st 2009	Results as of December 31st 2008
Shareholder Equity	\$33,261,187	\$28,481,376	\$21,948,513
Accumulated Deficit	\$16,025,766	\$12,082,352	\$9,910,490
Exploration Expenses	\$8,764,588	\$6,830,746	\$7,488,568
Net Loss	\$1,642,516	\$1,636,206	\$1,302,169
Current Assets and Exploration Funds	\$8,824,133	\$10,621,838	\$12,207,446
Gas Properties Net Value	\$26,142,826	\$17,494,081	\$12,323,750
Total Assets	\$35,453,666	\$29,126,826	\$24,765,661

5. ASSETS AND CAPITAL

Assets as of December 31st 2010 totalled \$35,453,666. Cash, short-term investments, accounts receivable and exploration funds totalled \$8,824,133. Property net book value increased from \$17,494,081, at the end of 2009, to \$26,142,826, at the end of 2010, mostly as a result of exploration programs on the NYS projects, the St-Hyacinthe property and the Joly property.

Accounts receivable of \$1,178,800 are composed of sales tax returns for \$388,177, partner contributions for \$336,739 consisting of exploration and property expenses from Epsilon Energy and Covalent Energy, and

finally, on-going accounts with various companies and suppliers for a total of \$453,883 including \$33,118 from Tawsho Mining for expenses, \$296,949 from Ditem Exploration for on-going expenses, and \$123,777 for wages paid in advance to a director of the Company.

Accounts payable of \$2,192,479 are composed of statutory source deductions, salaries and accrued liabilities for amounts of \$174,075, current accounts of \$1,969,243 for exploration programs for which cheques have, on December 31st 2011, been made but all not yet deposited by the various service providers and current US accounts of \$49,161. At the writing of this report, a total \$2,017,866 has been paid and all cheques paid.

Flow-through exploration funds are being used to finance drilling, exploration programs and related expenses on the Company's Quebec properties. Funds have also been reserved for general and administrative expenses for 2011 and 2012. Present liquidities are sufficient to finance exploration obligations for the remainder of 2011 and well into 2012.

Shareholder equity increased from \$28,481,376 at the end of 2009 to \$33,261,187 at the end of 2010 essentially as a result of March and August 2010 financings.

6. OPERATIONS AND DEFICIT

Revenues for Q4 2010 totalled \$21,773 for a total of \$93,456 for the year 2010 as compared to \$80,766 in 2009. The revenues in 2010 were composed entirely of interest on bank deposits.

Cost of operations and expenses for 2010, including stock-based compensation (options) to directors and officers, foreign exchange loss and gain on disposal of properties were \$3,223,423 as compared to \$2,092,972 for 2009. The increase is related to professional fees and the Oslo Stock Exchange proposed listing, as well as salaries including transfers from US project costs to the consolidated expenses. Expenses were in keeping with exploration activities in Quebec and New York State.

The Company is continually striving to reduce general and administrative expenses and strong control measures were put in place in 2009 and 2010. Those policies continue to be improved and carried into 2011 but are subject to increase exploration and development activity.

REVENUES AND LOSSES FOR THE LAST 8 QUARTERS				
Quarter	Total Revenues (\$)	Net Loss (\$)	Loss per Share (\$0.00)	
			Basic	Diluted
31/12/2010	21,773	813,983	0.010	0.010
30/09/2010	22,763	500,630	0.006	0.006
30/06/2010	29,531	109,204	0.001	0.001
31/03/2010	19,389	218,699	0.003	0.003
31/12/2009	11,226	536,056	0.012	0.012
30/09/2009	10,415	392,461	0.006	0.006
30/06/2009	21,058	303,530	0.005	0.005
31/03/2009	38,067	404,159	0.007	0.007

Net loss for Q4 was \$813,983 for a total of \$1,642,516 for the year 2010 as compared to \$1,636,206 for 2009. The increase in net loss is mostly due to fees and disbursements from the proposed Oslo Stock Exchange inscription. The cumulated deficit increased to \$16,025,766 as compared to \$12,082,352, at the end of 2009.

7. FINANCINGS

The following summarises all financings undertaken by the Company from January 1st 2006 to December 31st 2010.

FINANCINGS in 2006				
Date of Closing	Shares Issued	\$/Share	Warrants/ Price and Number	Total
Jan. 31 st 2006	1,462,500	\$ 0.10	1,462,500 at \$0.10	\$ 146,250
May 19 th 2006	4,666,000	\$ 0.15	4,666,000 at \$0.20	\$ 699,900
Oct. 31 st 2006	2,777,777	\$ 0.18	None	\$ 500,000
Dec. 27 th 2006	4,600,000	\$ 0.25	1,150,000 at \$0.35	\$ 1,150,000
Dec. 27 th 2006	4,400,000	\$ 0.25	1,500,000 at \$0.35	\$ 1,100,000
Dec. 29 th 2006	420,000	\$ 0.25	None	\$ 105,000
			Total (2006)	\$ 3,701,150
FINANCINGS in 2007				
Mar 16 th 2007	4,615,000	\$0.65	2,307,500 at \$0.80	\$ 2,999,750
Nov. 6 th 2007	2,500,000	\$0.60	1,250,000 at \$0.70	\$1,500,000
Nov. 6 th 2007	1,428,571	\$0.70	None	\$1,000,000
Dec. 12 th 2007	1,333,333	\$0.60	1,333,333 at \$0.75	\$800,000
Dec. 12 th 2007	292,000	\$0.70	None	\$204,400
			Total (2007)	\$6,504,150
FINANCING in 2008				
April 3 rd 2008	4,725,000	\$2.15	2,362,500 at \$3.00	\$10,158,750
			Total (2008)	\$10,158,750
FINANCINGS in 2009				
Dec. 4 th 2009	8,107,691	\$0.65	8,107,691 at \$0.85	\$5,269,999
Dec. 9 th 2009	1,507,693	\$0.65	1,507,693 at \$0.85	\$980,001
Dec. 31 st 2009	143,085	\$0.65	143,085 at \$0.85	\$93,005
			Total (2009)	\$6,343,005
FINANCINGS in 2010				
Mar. 23 rd 2010	6,764,707	\$0.85	6,764,707 at \$1.05	\$5,750,000
Aug. 17 th 2010	8,510,000	\$0.325	8,510,000 at \$0.45	\$2,765,750
			Total (2010)	\$8,515,750
			Total (2006 to 2010)	\$35,222,805

On March 23rd, 2010, Gastem closed a private placement for a total of 6,764,706 flow-through units at a price of \$0.85 per unit for a total of \$5,750,000.

On August 17th 2010, Gastem closed a financing for a total of 8,510,000 units at a price of \$0.325 per unit to raise \$2,765,750. Each unit consisted of one common share and one common share purchase warrant. Each warrant entitles the holder to acquire one common share at a price of \$0.45 per share for a period of 2 years from the closing.

There have been no financings to date in 2011.

8. EXPLORATION EXPENSES AND USE OF PROCEEDS

In Quebec, exploration and development expenses in 2010 were focused in the St. Lawrence Lowlands. On the St-Hyacinthe property, Gastem with operator Canbriam completed the 2010 drilling program and has applied for the completion permits. Gastem also began a drilling program on the Joly property in fall of 2010. Other programs included notably, airborne surveys on the Dundee and the Matapedia properties.

Gastem-USA expenses were related to geological work and to a frac and test programs on specific formations in an existing well. The Ross well frac program has been completed and evaluations have been released. The Company is continuing its program with the objective of developing production and acquiring new properties.

All Gastem exploration expenses were paid with Gastem funds.

8.1 Gastem Operations in Quebec

Exploration expenses in Quebec for 2010 totalled \$6,567,288. Most of this amount was spent for the St-Hyacinthe and Joly drill programs as well as for airborne surveys on the Dundee and the Matapedia properties.

The St-Hyacinthe drill program included one vertical well and three horizontal wells. The horizontal well La Présentation No 1H was drilled in May, the vertical and horizontal wells St-Barnabé No 1 and St-Barnabé No 1H in July and the drilling of the last horizontal well, Saint-Hyacinthe No 1H, was finalised in August. Fracture stimulation of the La Présentation No 1H well was performed in July 2010. Due to the public hearings on shale gas development in Quebec, the fracture stimulation of the remaining horizontal wells has been postponed to 2011.

Work on the Joly property has resumed during the fall of 2010 with the preparation of a drill program (Gastem, Joly No5) to evaluate the shallow carbonate thrust sheets and the deep Utica Shale.

		Magnetic Surveys and Related Programs	Other Geological Programs	Professional Fees	Sampling	TOTAL
(\$)	Drilling and Drill Related Expenses					
Dundee	9,311	291,677	0	1,912	2,000	304,900
St-Jean	15,818	8,965	1,500	4,401	808	31,492
St-Hyacinthe	2,062,068	50,638	75	1,874	0	2,114,655
St-Simon	0	-2,2284	0	0	0	-2,284
Yamaska	569,502	35,723	891	7,625	404	614,145
LSP	0	0	0	0	0	0
Joly	2,479,363	91,593	26,008	147,256	5,216	2,749,436
Matapedia	9,311	547,313	6,655	700	1,500	565,479
Magdalen Isl.	9,488	29,611	53,675	77,537	19,154	189,465
TOTAL	5,154,861	1,056,236	88,804	241,305	29,082	6,567,288

8.2 Gastem-USA Operations

Gastem-USA applied for three oil and gas permits to the NYS authorities in late spring 2010. In September 2010 Gastem-USA has received from the NYS DEC the authorization to proceed with the frac-stimulation of the Marcellus Shale in the Ross No1 well and the Upper Utica Shale in the Sheckels No1 well. The Ross No1 fracs were performed during late October (Marcellus Shale). Gastem USA tested the Marcellus with a small two stage nitrogen assisted frac that produced a 120 mcfd flow in the Ross 1.

In Q4, the company started and completed a cableless 10 mile high resolution 2D seismic program in the areas of interest in Otsego County New York and completed an evaluation of natural gas potential and selected three sites to target conventional gas wells in Otsego County New York.

(\$)	Drilling and Drill Related Expenses	Seismic and airborne surveys	Geological Programs	TOTAL
New York	1,204,085	692,554	150,181	2,046,820
Virginia	0	0	0	0
TOTAL	1,204,085	692,554	150,181	2,046,820

Flow-Through Reserve

As of December 31st 2010, Gastem's flow-through reserve was \$5,631,653.

FLOW-THROUGH EXPLORATION RESERVE			
	CEE	CEE (Qc)	Total
Flow-Through Reserve March 31 st 2007	\$ 753,164	\$ 609,152	\$1,362,316
Flow-Through Exploration Expenses to September 30 th 2007	\$753,164	\$609,152	\$1,362,316
Flow-Through Reserve to September 30 th 2007	\$0	\$0	\$0
Flow-Through Funds Raised in November and December 2007	\$0	\$1,204,400	\$1,204,400
Flow-Through Exploration Expenses to January 31 st 2008	\$0	\$1,204,400	\$1,204,400
Flow-Through Reserve as of December 31 st 2008	\$0	\$0	\$0
Flow-through Funds raised in December 2009	\$0	\$6,343,005	\$6,643,005
Flow-Through Reserve as of December 31 st 2009	\$0	\$6,343,005	\$6,343,005
Flow-Through Exploration Expenses to March 31 st 2010	\$0	\$179,468	\$6,163,537
Flow-Through Funds Raised in March 2010	\$0	\$5,750,000	\$11,913,537
Flow-Through Exploration Expenses from March 31 st to December 31 st 2010	\$0	\$6,281,884	\$5,631,653
Flow-through Reserve as of December 31st 2010			\$5,631,653

It is important to note that the flow-through reserve come from an amount of \$5,750,000, raised in March 2010, will be spent in admissible exploration expenses prior to December 31st 2011.

9. FINANCIAL COMMITMENTS AND LITIGATION

Financial commitments of the Company are related only to exploration expenditures and normal operating expenses. The Company has no outstanding debts (possible, indicated or alleged) and is capable of meeting all on-going operational obligations.

There are no commitments or obligations, other than normal and on-going exploration programs, which Gastem may or may not continue, depending on financial resources, new exploration programs and development or exploration opportunities. With the possible exception of an issue related to noise involving Canadian Forest Oil (with Gastem as co-defendant) and for an amount not material, there are no known legal issues which may give rise to litigation and the Company, its Directors or Officers have not received directly or indirectly any information which may be construed as implying legal issues which could give rise to litigation.

10. RELATED PARTY TRANSACTIONS

The Company has its offices at 1155 University St., suite 1215 in Montreal and pays its share of the cost of the lease, communications, taxes, office insurance, telecommunications and sundries jointly with others to 3915671 Canada Inc. The sole shareholder of the latter is Gastem Director Raymond Savoie. 3915671 Canada Inc. does not charge fees for this service nor does it produce a profit or benefit on operations. The Company has been created solely to facilitate administration and reduce costs. Rent and office expenses are shared with two other companies.

11. CHANGES IN ACCOUNTING POLICIES

International Financial Reporting Standards (“IFRS”)

In February 2008, the Accounting Standards Board (“ASB”) confirmed that Canadian publicly accountable enterprises will be required to adopt IFRS in its version published by the International Accounting Standards Board (“IASB”) for fiscal years beginning on or after January 1, 2011. After that date, the IFRS will replace Canadian GAAP for these entities. Therefore, the Company will have to adopt IFRS from January 1, 2011, and as such these new standards will have to be applied to interim and annual financial statements for periods beginning on or after January 1, 2011. In its financial information for periods after that date, the Company will have to provide comparative information for equivalent periods of the prior year, and as such the date of transition will be January 1, 2010.

IFRS use a conceptual framework similar to Canadian GAAP, but there are significant differences on recognition, measurement and disclosures.

Conversion plan

The Company elaborated a conversion plan in four phases:

- Awareness phase – phase to mobilize the Company regarding the conversion, preliminary training.
- Assessment phase – detailed assessment of the IFRS transition’s impacts:
 - o Analysis of accounting policies differences and choices, including exemptions at transition date in accordance with IFRS 1 – First-time adoption of international financial reporting standards.
 - o Analysis of the impacts on business activities, internal control and information systems.
- Design phase – design of tools and planning of adjustments, preparation of blank financial statements, design of potential changes on business activities, internal control and information systems.
- Implementation phase – calculation of adjustments, preparation of financial statements with figures, implementation of potential changes on business activities, internal control and information systems.

The Company is assisted by its auditors at each phase. The awareness phase is completed. The Company is currently finalizing the assessment phase and plans to be able to complete other phases by the date of the issuance of its first interim financial statements of 2011.

Accounting policies

As part of the evaluation phase, and based on the analysis performed as of today, the Company analysed more particularly the impact of the following standards:

Standards according to which IFRS adjustments will be recorded:

IFRS 2 – Payments based on shares: When the acquisition of awards is gradual, this IFRS requires that each vesting be evaluated and accounted for separately. Also, under IFRS, forfeitures must be estimated; they may not be accounted for as they occur as is current practice for the Company. The impact of these differences may be assessed by the Company.

IAS 12 – Income Taxes: While the overall methodology for recording deferred taxes is consistent between Canadian GAAP and IFRS, there are several areas of differences that may have an impact on the Company's financial statements. The Company is currently in the process of evaluating these differences, in particular with respect to flow-through shares and refundable credits on mining duties.

Standards according to which no IFRS adjustments were identified as of today:

IFRS 1 – First-time adoption of international financial reporting standards: This guideline details the steps to follow when implementing the IFRS for the first time. Most adjustments required on transition to IFRS will be made, retrospectively, against opening deficit as of January 1, 2010, the date of the first comparative balance sheet presented under IFRS. However, IFRS 1 provides entities adopting IFRS for the first time a number of optional exemptions and mandatory exemptions, in certain areas, to the general requirement for full retrospective application of IFRS on the date of transition. The Company does not expect to apply any of the optional exemptions permitted by IFRS 1.

IFRS 6 – Exploration and Evaluation assets: According to this IFRS, the Company must establish an accounting policy in order to identify which exploration expenses and mineral resources should be capitalized. The Company's policy under Canadian GAAP requires exploration and evaluation costs to be capitalized when a project is determined to be potentially economically viable. The Company only capitalizes costs that are closely related to its exploration and evaluation activities. This policy is compliant with IFRS 6 and as such the Company plans to adopt the same policy under IFRS. As a result, there is no accounting policy change on transition on this respect.

IAS 36 – Impairment: Canadian GAAP generally uses a two-step approach to impairment testing while IFRS uses a one-step approach for both testing for and measurement of impairment. In addition, IFRS requires the reversal of any previous impairment losses where circumstances leading to the original impairment have changed while Canadian GAAP prohibits reversal of impairment losses. These differences are not expected to have an impact for the Company.

IAS 37 – Restoration obligation: A provision for restoration obligation is recognized on the basis of a legal or constructive obligation arising from a past event, if there is a probable outflow of resources and the amount can be estimated reliably, while under Canadian GAAP liabilities for asset retirement obligations are recognised only when there is a legal obligation. The Company evaluated that as of today this difference had no impact for the Company.

IAS 39 – Financial instruments: recognition and measurement: under IFRS all financial assets are classified into "loans and receivables", "held-to-maturity", "fair value through profit or loss" or "available-for-sale" categories. Canadian GAAP present certain differences from IFRS with respect to designating assets into the fair value through profit or loss category which is stricter under IFRS. Therefore under IFRS, the Company's cash and cash equivalents, restricted cash and exploration funds will not meet the criteria for

designation at fair value through profit and loss. Thus they will be classified as loans and receivables. This classification change will not have a financial impact but only a disclosure impact.

The Company does not anticipate that the IFRS transition will have significant impacts other than the above-mentioned differences and apart from the impact on financial information disclosures.

Information systems

The accounting process of the Company is rather simple as it is at the exploration stage. The Company considers that it will be able to adapt its information systems to IFRS quite easily.

Internal control

The Company does not expect that the IFRS transition will have a significant impact on its internal control over financial reporting neither on disclosure controls and procedures.

Training on IFRS is provided to members of the financial team on an on going basis.

Impact on business activities

The Company's business processes are simple and no significant challenge is expected in order to operate under IFRS. Business processes have been monitored during 2009 and 2010 and will still be during 2011, in order to identify potential impacts that would not have been initially identified.

12. OIL AND GAS RESERVES

The Company's hydrocarbon reserves, resources and revenues are discussed in section 3 of this report, and states that the company has no oil or gas reserves. Detailed data has been published as part of the Company's annual 51-101 report for 2010 deposited in April 29th 2011, within the Annual Information Form.

13. CERTIFICATION OF ANNUAL FILINGS

For the financial period ending December 31st 2010, the Chief Executive Officer and the Chief Financial Officer in collaboration with the Audit Committee of the Company reviewed the annual financial statements and annual MD&A (together, the "annual filings") of the Company.

The Chief Executive Officer and the Chief Financial Officer of the Company represent that, based on their knowledge and having exercised reasonable diligence, the annual filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, for the financial period covered by the annual filings and fairly presents in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date of and for the periods presented in the annual filings.

The Chief Executive Officer and the Chief Financial Officer are responsible for ensuring and confirming that processes are in place to provide them with sufficient knowledge to support the above mentioned representations.

14. ISSUED SHARES, WARRANTS AND OPTIONS

As of December 31st 2010, the Company had issued 89,787,007 shares and, on a fully diluted basis, 118,177,576 shares were outstanding.

Total Shares Issued

Shares Issued	Note
74,302,300	As of December 31 st , 2009
15,484,707	Shares issued during 2010
89,787,007	As of December 31st, 2010

Share Issuance During 2010

Share Issuance	Note
0	Warrants exercised
210,000	Options exercised
15,274,707	Private Placement
15,484,707	Total Share Issuance during 2010

Warrants Not Exercised as of December 31st 2010

Warrants	Exercise Price	Date of Expiry
8,107,691	\$0.85	2011-06-04
1,507,693	\$0.85	2011-06-09
143,085	\$0.85	2011-06-30
6,764,706	\$1.05	2011-09-24
8,510,000	\$0.45	2012-08-17
25,033,175	Total	

Options Not Exercised as of December 31st 2010

Options	Exercise Price	Date of Expiry
295,000	\$0.26	2011-12-19
400,000	\$0.35	2011-12-22
425,000	\$0.65	2012-08-31
761,189	\$0.60	2012-12-14
25,000	\$0.62	2013-01-28
500,000	\$0.63	2013-02-21
25,000	\$2.18	2013-07-28
25,000	\$0.58	2014-01-28
25,000	\$0.37	2014-07-28
85,000	\$0.37	2014-07-31
691,205	\$0.58	2014-10-29
50,000	\$0.53	2015-02-06
50,000	\$0.28	2020-08-31
3,357,394	Total	

15. FORWARD LOOKING STATEMENTS

The MD&A contains certain forward-looking statements that involve substantial known and unknown risks and uncertainties which could cause actual events or results to differ materially from those reflected in the MD&A. Forward looking statements are based on estimates and opinions of Management at the time the statements were made.

16. RISKS RELATED TO FINANCING AND EXPLORATION WORK

To date, the Company has incurred losses through exploration expenses. Exploration and development of the properties therefore depends on its ability to obtain the required financing. There can be no assurance that the Company will succeed in obtaining the required funding. Failure to do so may lead to substantial dilution or loss of its interests (existing or proposed) on its properties.

At the time of writing this report, Gastem has, subject to an on-going financing, sufficient funds to undertake exploration and development programs that are of importance for the Company, renew all existing properties and undertake exploration programs to which it is committed.

In Quebec, work on the Company's Utica Shale properties is subject to authorization by the Strategic Environmental Evaluation Committee created by the government and specifically the Ministère du Développement durable, de l'Environnement et des Parcs and the Bureau des audiences publiques sur l'environnement (BAPE). Work may or may not proceed on these shale properties subject to their decision and their priorities during the period of study which is, it is stated, take 18 to 30 months. The report of the Committee may or will propose, among other things, new regulations concerning shale gas production and exploration.

In New York State, the revised draft the Supplemental Generic Environmental Impact Statement Study is to be presented in June of 2011 and may or will contain various regulatory recommendations to the government regarding fracturing operations in the Marcellus and Utica shales.

17. OUTLOOK

In Quebec, the Bureau d'audiences publiques sur l'environnement (BAPE) submitted its report on February 28th and the report was released by the Ministry on March 8th of this year. Following the BAPE's recommendations, a committee of 10 persons will undertake a Strategic Environmental Evaluation Study and during the preparation of the study will oversee Utica shale activities and, it was stated, all fracturing operations in Quebec. As the committee should be formed in early May, it remains to be seen how it will administer and execute its mandate. The Company is nevertheless hopeful that this Study will be constructive and will favour social acceptability of the proposed exploration programs for the Utica Shale properties in Quebec as stated by the Ministry's press release.

Over the coming months, Gastem expects to undertake with operator Canbriam, a fracture stimulation program for the two remaining St-Hyacinthe property horizontal wells, if authorised by the BAPE committee. The Company believes it will also receive authorisation for the Joly well as this is a key project. Both of these programs are important for the exploration and development of the Utica Shale in Quebec and are recognised as such.

The Company plans to move ahead with its conventional (non-Utica shale) projects in Quebec. The Magdalen Islands program is now being finalised for a conventional exploration well proposed for this fall. Gastem expects to present its revised project to the residents and municipal officers over the coming weeks. Conventional drill programs on the Dundee and the Matapedia properties are also proposed based on the results of this winter's airborne surveys. Permitting applications for these should be submitted shortly. As these are also conventional wells, the permits are not subject to the new procedures.

In New York State, pursuant to Executive Order No. 41, the New York Department of Environmental Conservation is expected to publish on or about June 1st 2011 a revised draft of the Supplemental Generic Environmental Impact Statement (SGEIS). Public comment on the revisions within a period of not less than thirty days may be accepted, and there may be public hearings on such revisions to be conducted in the Marcellus and Utica Shale region of the State. As a result, we are expecting that the new regulations allowing high-volume hydraulic fracturing and shale gas development could be in place by the end of 2011. The company will continue to move ahead with its objective of obtaining production from conventional wells. New projects are being analysed and will be announced as soon as possible.

Over the next few weeks, Gastem will also be discussing with third parties regarding new opportunities in proven jurisdictions for the purpose of undertaking exploration and production programs.

We thank shareholders for their continued support and look forward to seeing you at our Annual Shareholder's Meeting to be held on June 27th in Montreal at the Queen Elizabeth Hotel. Additional information concerning this meeting will be available shortly.

April 26th 2011

(s) Raymond Savoie _____
Raymond Savoie
Chairman and CEO

Consolidated Financial Statements of

GASTEM INC.

Years ended December 31, 2010 and 2009



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INDEPENDANT AUDITORS' REPORT

To the Shareholders of Gastem Inc.

We have audited the accompanying consolidated financial statements of Gastem Inc., which comprise the balance sheets as at December 31, 2010 and 2009, the consolidated statements of deferred expenditures, operations, comprehensive loss and deficit and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management 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 audit. We conducted our audit 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 our 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, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures in 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 is sufficient and appropriate to provide a basis for our audit opinion.

KPMG LLP is a Canadian limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. KPMG Canada provides services to KPMG LLP.



Opinion

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

Emphasis of Matter

Without qualifying our opinion, we draw attention to note 1 in the financial statements which indicates that Gastem Inc. is still at the exploration stage and, as such, no revenue has been yet generated from its operating activities. Accordingly, Gastem Inc. depends on its ability to raise financing in order to discharge its commitments and liabilities in the normal course of business. These conditions, along with other matters as set forth in note 1, indicate the existence of a material uncertainty that may cast significant doubt about Gastem Inc.'s ability to continue as a going concern.

KPMG LLP

Chartered Accountants

April 26, 2011

Montréal, Canada

GASTEM INC.

Consolidated Financial Statements

Years ended December 31, 2010 and 2009

Financial Statements

Consolidated Balance Sheets	29
Consolidated Statements of Deferred Expenditures.....	30
Consolidated Statements of Operations, Comprehensive Loss and Deficit	31
Consolidated Statements of Cash Flows	32
Notes to Consolidated Financial Statements	33

GASTEM INC.

Consolidated Balance Sheets

December 31, 2010 and 2009

	2010	2009
Assets		
Current assets:		
Cash and cash equivalents (note 4)	\$ 391,280	\$ 1,217,033
Restricted cash (note 4)	1,600,000	-
Funds reserved for exploration (note 4)	5,631,653	6,343,005
Accounts receivable (note 5)	1,178,800	2,948,404
Prepaid expenses and deposits	22,400	113,396
	<u>8,824,133</u>	<u>10,621,838</u>
Fixed assets (note 6)	201,707	62,825
Gas properties and deferred exploration costs (note 7)	26,142,826	17,494,081
Deposits on long-term assets (note 8)	285,000	948,082
	<u>\$ 35,453,666</u>	<u>\$ 29,126,826</u>

Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable and accrued liabilities (note 9)	\$ 2,192,479	\$ 645,450
Shareholders' equity:		
Share capital and warrants (note 10)	46,628,221	37,951,898
Contributed surplus (note 12)	2,658,732	2,611,830
Deficit	(16,025,766)	(12,082,352)
	<u>33,261,187</u>	<u>28,481,376</u>
Nature of operations and going concern (note 1)		
Commitments and contingencies (note 17)		
Subsequent event (note 18)		
	<u>\$ 35,453,666</u>	<u>\$ 29,126,826</u>

See accompanying notes to consolidated financial statements.

On behalf of the Board:

_____, Director

_____, Director

GASTEM INC.

Consolidated Statements of Deferred Expenditures

Years ended December 31, 2010 and 2009

	2010	2009
Balance, beginning of year	\$ 11,819,555	\$ 8,716,850
Increase (decrease):		
Drilling	4,945,471	4,613,201
Seismic work	727,964	-
Geological work	99,573	660,810
Site preparation, evaluation and others	2,991,580	1,556,735
Less contribution received from a partner	(147,730)	(681,541)
Less disposal of gas properties	(2,750)	(948,316)
Less other income	-	(79,438)
Less resource tax credits	-	(2,018,746)
	8,614,108	3,102,705
Balance, end of year (note 7)	\$ 20,433,663	\$ 11,819,555

See accompanying notes to consolidated financial statements.

GASTEM INC.

Consolidated Statements of Operations, Comprehensive Loss and Deficit

Years ended December 31, 2010 and 2009

	2010	2009
Revenue:		
Interest income	\$ 93,456	\$ 78,126
Other income	-	2,640
	93,456	80,766
Expenses:		
Professional fees	800,958	610,595
Office, trustees and reports to shareholder	708,786	605,178
Stock-based compensation (note 11)	135,775	506,720
Salaries and benefits	538,690	376,273
Travel and promotion	166,528	181,372
Rent	93,884	71,478
Amortization	30,523	11,292
Financial expense	80,202	8,480
Foreign exchange loss	15,015	72,446
Fees related to subscription to the Oslo Stock Exchange	547,692	-
Loss (gain) on disposal of properties	2,620	(350,862)
Write-off of properties	102,750	-
	(3,223,423)	2,092,972
Loss before income taxes	(3,129,967)	(2,012,206)
Future income taxes (note 13)	1,487,451	(376,000)
Net loss and comprehensive loss	(1,642,516)	(1,636,206)
Deficit, beginning of year	(12,082,352)	(9,910,490)
Share issue expense	(813,447)	(535,656)
Future taxes arising from flow-through shares	(1,706,268)	-
Future taxes arising from share issuance costs	218,817	-
Deficit, end of year	\$ (16,025,766)	\$ (12,082,352)
Loss per share, basic and diluted	\$ (0.02)	\$ (0.03)

See accompanying notes to consolidated financial statements.

GASTEM INC.

Consolidated Statements of Cash Flows

Years ended December 31, 2010 and 2009

	2010	2009
Cash flows from operating activities:		
Net loss and comprehensive loss	\$ (1,642,516)	\$ (1,636,206)
Adjustments for:		
Amortization	30,523	11,292
Future income taxes	(1,487,451)	(376,000)
Write-off of properties	102,750	-
Loss (gain) on disposal of properties	2,620	(350,862)
Stock-based compensation	135,775	506,720
Changes in non-cash working capital items:		
Accounts receivable	(100,665)	752,416
Prepaid expenses and deposits	90,996	(96,321)
Accounts payable and accrued liabilities	1,547,029	(1,795,697)
	(1,320,939)	(2,984,658)
Cash flows from financing activities:		
Proceeds from share issuance	8,587,450	6,343,005
Share issue expenses	(813,447)	(535,656)
	7,774,003	5,807,349
Cash flows from investing activities:		
Gas properties and deferred exploration costs	(8,751,496)	(6,435,371)
Amounts received from resource tax credits	1,320,269	1,798,000
Deposits on long-term assets	663,082	(752,420)
Additions to fixed assets	(172,024)	(35,313)
Proceeds on disposal of properties	-	902,154
Balance receivable on sale of properties	550,000	-
Funds reserved for exploration	711,352	(6,343,005)
Restricted cash	(1,600,000)	-
	(7,278,817)	(10,865,955)
Net decrease in cash and cash equivalents	(825,753)	(8,043,264)
Cash and cash equivalents, beginning of year	1,217,033	9,260,297
Cash and cash equivalents, end of year	\$ 391,280	\$ 1,217,033
Additional information concerning cash flows:		
Other non-cash activities:		
Share issue expenses representing cost of options exercised	\$ 88,873	\$ -
Acquisition of properties against share issuance	-	1,855,000
Balance receivable on sale of properties	-	550,000
Resource tax credits netted against deferred exploration costs	-	2,018,746

See accompanying notes to consolidated financial statements.

GASTEM INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2010 and 2009

Gastem inc. ("Gastem" or the "Company") is incorporated under the *Canada Business Corporations Act*. The Company was set up to hold interests in gas properties, which are presently at the exploration stage and it has not yet been determined whether the properties contain reserves that are economically recoverable.

1. Nature of operations and going concern:

The Company holds gas properties or interest in such properties and permits ("properties") in the province of Québec and in the United States.

Although the Company has taken steps to verify title to gas properties in which it has an interest in accordance with industry standards for the current stage of exploration of such properties, these procedures do not guarantee the Company's title. Property title may be subject to unregistered prior agreements and non-compliance with regulatory requirements.

The financial statements were prepared under the assumption of going concern, which presumes that the Company will continue its operations in the foreseeable future and will be able to realize its assets and discharge its liabilities in its normal course of operations.

The Company is in the process of exploring and evaluating its gas properties and projects and has not yet determined whether its properties and projects contain reserves that are economically recoverable. The ability of the Company to meet its commitments as they become payable, including the acquisitions of gas properties and the development of projects, is dependent on the ability of the Company to obtain necessary financing. The recoverability of amounts shown for gas properties is dependent upon the ability of the Company to obtain necessary financing to complete the acquisition, exploration and development thereof, and upon future profitable production or proceeds from the disposal of properties.

It should also be noted that the Minister of Sustainable Development, Environment and Parks has released a report to the Bureau d'audiences publiques sur l'environnement ("BAPE") filed on February 28, 2011 about the sustainable development of the shale gas industry in Quebec. In its report the commission of inquiry of the BAPE presents a number of findings and recommendations. Among others, all fracturing operations in the oil and gas industry in Quebec will now be subject to the Strategic Environmental Study ("SES"). Thus, all the fracturation activities will be authorized only for the purpose of developing scientific knowledge of environmental assessment, until the end of the SES.

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

1. Nature of operations and going concern (continued):

The Company's gas properties located in Quebec and the related deferred exploration costs, totalling \$18,166,001 as at December 31, 2010, include fracture wells affected by these new procedures. In addition, as part of a farm-out contract, the operator of the St-Hyacinthe project and the Company are required to complete work on fracture wells of this property totalling approximately 6 million dollars by June 1, 2011, without which the society and its partner will lose their interest in the property. The amounts capitalized as gas properties and deferred exploration costs for this property totalled \$5,559,239 as at December 31, 2010. To date, management is unable to determine when the exploration will continue on these properties.

These conditions indicate the existence of a significant uncertainty which may cast significant doubt on the ability of the Company to continue as a going concern.

These financial statements do not reflect adjustments that should be made to the book value of assets and liabilities, if the going concern assumption was inappropriate.

2. Change in accounting policies:

Future accounting pronouncements:

International financial reporting standards ("IFRS"):

In February 2008, the Accounting Standards Board ("AcSB") announced that accounting standards in Canada were to converge with IFRS and that public companies would be required to present their financial statements, with comparative data, under these standards for fiscal years beginning on or after January 1, 2011. The Company is currently evaluating the impact of these requirements on its financial statements.

3. Significant accounting policies:

(a) Basis of consolidation:

These consolidated financial statements include the accounts of Gastem and its wholly-owned subsidiary, Gastem USA inc. Intercompany transactions and balances were eliminated upon consolidation.

(b) Cash and cash equivalents, restricted cash and funds reserved for exploration:

Cash and cash equivalents, restricted cash and funds reserved for exploration include temporary investments with a maturity date of three months or less.

The restricted cash corresponds to an amount extended as an irrevocable letter of credit to a supplier. This letter of credit has a short-term expiry.

The funds reserved for exploration represent proceeds from private placements of flow through shares not yet expensed. The Company must use these funds for exploration of gas properties in accordance with restrictions imposed by these private placements.

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

3. Significant accounting policies (continued):

(c) Gas properties and deferred exploration costs:

The Company follows the full cost method of accounting whereby all costs associated with the exploration for and development of natural gas reserves are capitalized. Such costs include geological and geophysical carrying charges of non-producing properties and costs of drilling both productive and non-productive wells and related overhead charges.

If economically profitable gas reserves are developed, the capitalized costs of the properties in question are amortized using units of production for the year, based on probable and proven gas reserves. If it is determined that capitalized acquisition, exploration and development costs are not recoverable over the estimated useful life of the property, or if the project is abandoned, the project is written down to its net realizable value. The recovery of amounts recorded as gas properties and the related deferred exploration costs depends on the discovery of economically recoverable reserves, the Company's ability to obtain the necessary financing to complete development and future profitable production or the proceeds from disposal of such properties. Amounts recorded under properties and deferred exploration costs do not necessarily represent the present or future value.

(d) Property and equipment:

Property and equipment consist of computers and furniture and equipment and are carried at cost. Depreciation is calculated using the diminishing balance method at the rate of 20%.

(e) Depreciation of long-term assets:

The Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3063, *Impairment of Long-Lived Assets*, provides guidance on the recognition, measurement and disclosure of the impairment of long-lived assets. The provisions of the Section require an impairment loss for a long-lived asset to be held and used to be recognized when its carrying amount exceeds the sum of the undiscounted cash flows expected from its use and eventual disposition. The impairment loss is measured at the amount by which its carrying amount exceeds its fair value.

(f) Income taxes:

The Company uses the asset and liability of accounting for income taxes. Under this method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment or substantive enactment date.

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

3. Significant accounting policies (continued):

(f) Income taxes (continued):

The Company renounces tax deductions relating to resource expenditures that are financed by the issuance of flow-through shares for the benefit of its shareholders, as permitted by the tax legislation. Under the asset and liability method used to account for income taxes, future income taxes related to the temporary differences created by this renouncement are recorded in accordance with EIC-146, when the Company renounces these deductions and a corresponding cost of issuing the securities is also recorded.

(g) Stock option plan:

The Company records stock-based compensation to its participants at fair value. According to the fair value method, a compensation expense is charged to operating expenses and credited to contributed surplus based on the fair value of the stock options issued over their vesting period. Upon the exercise of stock options, capital stock is credited in the amount paid plus the corresponding employee compensation amount previously recorded in contributed surplus.

(h) Resource tax credits:

The Company incurs exploration expenses that are eligible for tax credits. The tax credits are recorded based on the estimated amounts to be recovered. The amounts claimed are subject to an audit by the tax authorities.

Tax credits on exploration costs relating to gas and exploration assets are deducted from the related asset.

(i) Use of estimates:

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect 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. Significant areas requiring the use of estimates relate to assessing the realizable values of properties and deferred exploration costs, the valuation of accounts receivable and the fair value estimation of stock options. Consequently, actual results could differ from those estimates.

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

3. Significant accounting policies (continued):

(j) Financial instruments:

Sections 3855 and 3865 of CICA Handbook establish standards for recognizing and measuring financial assets, financial liabilities and derivatives. Under these standards, financial instruments are now classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other financial liabilities, and measurement in subsequent periods depends on their classification. Transaction costs are expensed as incurred for financial instruments classified as held-for-trading. For other financial instruments, transaction costs are capitalized on initial recognition and presented as an adjustment to the underlying financial instruments, depending on their classification:

- Financial assets and financial liabilities held-for-trading are measured at fair value with changes recognized in income.
- Available-for-sale financial assets are measured at fair value or at cost, in the case of financial assets that do not have a quoted market price in an active market, and changes in fair value are recorded in comprehensive income.
- Financial assets held-to-maturity, loans and receivables, and other financial liabilities are measured at amortized cost using the effective interest method of amortization.

The Company has classified its cash, restricted cash and funds reserved for exploration and short-term investments as held-for-trading. Accounts receivable and deposits on long-term assets were classified as loans and receivables. All of the Company's financial liabilities were classified as other financial liabilities.

The CICA Handbook Section 3862, *Financial Instruments - Disclosures*, also requires a three-level hierarchy that reflects the significance of the inputs used in making the fair value measurements. The hierarchy of fair values includes the following levels:

Level 1: inputs are unadjusted quoted prices of identical instruments in active markets.

Level 2: inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3: one or more significant inputs used in a valuation technique are unobservable in determining the fair values of the instruments.

(k) Foreign currency translation:

The Company uses the temporal method to record its foreign currency transactions and the financial statements of the integrated foreign operations. Under this method, monetary items are translated at the rate of exchange in effect at the balance sheet date, non-monetary items are translated at the historical exchange rate while revenue and expenses are translated at the rate of exchange in effect on the date they occur. Gains or losses resulting from these translations are reflected in the statement of earnings.

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

4. Cash and cash equivalents, restricted cash and funds reserved for exploration:

	2010	2009
Cash	\$ 1,658,177	\$ 502,893
Money market funds and guaranteed investment certificates	5,964,756	7,057,145
Less exploration funds	(5,631,653)	(6,343,005)
Less restricted cash, which was released on March 3, 2011	(1,600,000)	-
	\$ 391,280	\$ 1,217,033

5. Accounts receivable:

	2010	2009
Resource tax credit	\$ -	\$ 1,320,269
Sales tax	388,177	134,144
Partners' contribution	336,739	657,953
Balance on sale of properties, maturing in February 2010	-	550,000
Amounts receivable from related parties ⁽ⁱ⁾	420,726	251,801
Other	33,158	34,237
	\$ 1,178,800	\$ 2,948,404

⁽ⁱ⁾ As at December 31, 2010, following a cost sharing agreement, included in the accounts receivable, is an amount of \$296,949 (2009 - \$251,801) receivable from companies in which an officer of the Company is also an administrator, as well as an amount of \$123,777 (2009 - nil) receivable from an officer of the Company as an advance for expenses incurred.

6. Fixed assets:

	2010		
	Cost	Accumulated amortization	Net book value
Furniture and tools	\$ 191,414	\$ 26,443	\$ 164,971
Computer equipment	61,271	24,535	36,736
	\$ 252,685	\$ 50,978	\$ 201,707

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

6. Fixed assets (continued):

	2009		
	Cost	Accumulated amortization	Net book value
Furniture and tools	\$ 32,771	\$ 5,032	\$ 27,739
Computer equipment	52,355	17,269	35,086
	<u>\$ 85,126</u>	<u>\$ 22,301</u>	<u>\$ 62,825</u>

7. Gas properties and deferred exploration costs:

	2010		
	Cost of gas properties	Deferred exploration cost	Net book value
Magdalen Island	\$ 5,420	\$ 406,022	\$ 411,442
St-Jean	86,560	289,641	376,201
Dundee	338,257	716,391	1,054,648
Matapédia	181,099	985,816	1,166,915
Yamaska	18,868	4,578,339	4,597,207
Miguasha	79,584	2,900	82,484
St-Hyacinthe	2,437,500	3,121,739	5,559,239
Joly	–	4,917,865	4,917,865
New York	2,561,875	5,414,950	7,976,825
	<u>\$ 5,709,163</u>	<u>\$ 20,433,663</u>	<u>\$ 26,142,826</u>

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

7. Gas properties and deferred exploration costs (continued):

In 2010, the cost of the St-Simon property, as well as the deferred exploration costs incurred on this property in the total amount of \$102,285, were written-off following the decision by the operator to abandon the well.

			2009
	Cost of gas properties	Deferred exploration cost	Net book value
Magdalen Island	\$ 3,669	\$ 216,556	\$ 220,225
St-Jean	85,661	258,149	343,810
Dundee	327,446	411,491	738,937
Matapédia	167,074	420,337	587,411
Yamaska	22,726	3,964,194	3,986,920
Miguasha	80,002	2,900	82,902
Shell Saint-Simon	100,000	2,285	102,285
St-Hyacinthe	2,437,500	1,007,084	3,444,584
Joly	-	2,168,429	2,168,429
New York	2,450,448	3,368,130	5,818,578
	\$ 5,674,526	\$ 11,819,555	\$ 17,494,081

In 2004, the Company acquired an interest in 15 permits for the oil and natural gas properties of St-Jean, Dundee, Matapédia and Yamaska in consideration of the issue of 3,757,408 common shares to Ditem Exploration Inc. In addition, the Company obtained 117,000 hectares of exploration permits in the Gaspé Peninsula adjacent to the existing Matapédia blocks.

In 2005, the Company acquired an interest of 10% in the Shell Saint-Simon property by issuing 1,000,000 common shares and by assuming 10% of the future development costs. In 2011, the operator decided to abandon this well.

In 2006, the Company acquired an interest of 10% in the Haldimand 1 (Petrolia 3) exploratory well by issuing 1,000,000 common shares and by assuming 10% of the future development costs. The interest was sold in 2009.

In 2007, the Company granted Forest Oil Corporation the right to earn up to a 60% working interest in the Yamaska property, which covers 45,381 hectares, by spending up to \$10,000,000 in exploration. In 2008, Forest Oil notified the Company of its election to exercise its financial commitments option on the Yamaska property. The Yamaska property was subject to a 7.5% convertible gross overriding royalty ("GORR") with another partner, which was converted into a 20% working interest.

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

7. Gas properties and deferred exploration costs (continued):

In 2007, the Company acquired an interest of 35% in the permit of Joly property. The Company maintained an option to drill a second well before September 1, 2010.

In 2008, the Company signed an agreement with Covalent Energy (now Utica Energy) for an option to acquire a working interest up to 65% on exploration permits covering 29,000 hectares in consideration of the cost of an exploration program (New York property). In September 2009, Gastem signed a final Amendment to the agreement. The Company paid an amount of US\$35,000, issued 3,500,000 common shares to Utica and completed an exploratory vertical well and acquired an 80% interest in 34,150 acres. Utica retains a 2% overriding royalty interest ("ORRI") in existing permits and in new permits within the area of mutual interest in New York state. Utica also retains a participation right to a 20% working interest in new land acquisitions within the area of mutual interest.

In 2008, the Company signed, together with its partner Canbriam Energy, a farm-in agreement for a total of 85% working interest in the two St-Hyacinthe (formerly Mundiregina) permits (92,104 acres) situated in the St-Lawrence Lowlands. According to the terms of the Agreement, Gastem may earn a 17% interest and Canbriam, 68%, with the sellers maintaining a 15% carried interest. Under the terms of the Agreement, Gastem paid to the seller an upfront consideration of \$2.5M and committed to pay 20% of a 6-well and seismic program to be carried out.

In 2008, Gastem acquired the petroleum and gas exploration permits to the Magdalen Islands known to be prospective for gas and situated in the Magdalen Basin from the Québec Natural Resources Department. The Magdalen permit is located in the central part of the Gulf of St-Lawrence.

In January 2009, the Company acquired permits in the Appalache area in order to carry out exploration and development programs.

8. Deposits on long-term assets:

Deposits on long-term assets consist principally of payments made to the government of Québec to restore drilling sites in the event of the termination of a project.

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

9. Accounts payable and accrued liabilities:

	2010	2009
Trade payables	\$ 2,018,404	\$ 525,585
Accrued liabilities	127,546	80,000
Salaries and benefits	46,529	39,865
	<u>\$ 2,192,479</u>	<u>\$ 645,450</u>

10. Share capital:

Authorized:

An unlimited number of common shares, without par value

	2010	2009
Issued:		
89,787,007 common shares (2009 - 74,302,300)	\$ 46,628,221	\$ 37,951,898

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

10. Share capital (continued):

	2010	2009
Issuance during the year:		
For cash:		
15 274 707 common shares and warrants (2009 - 9,758,469) pursuant to private placements ⁽ⁱ⁾ ⁽ⁱⁱ⁾	\$ 8,515,750	\$ 6,343,005
210,000 common shares (2009 - nil) pursuant to exercise of options (including the cost of options of \$88,873 (2009 - nil))	160,573	-
For acquisition of a property: (2009 - 3,500,000 shares)	-	1,855,000
	<u>\$ 8,676,323</u>	<u>\$ 8,198,005</u>
Weighted average number of outstanding shares during the year	82,926,962	62,630,364

(i) In March 2010, 6,764,707 flow-through shares were issued. Each share was issued for \$0.85, for a total financing of \$5,750,000. Each unit sold consisted of one flow-through share and one warrant. Each warrant entitles the holder to purchase one common share at a price of \$1.05 for an 18-month period.

(ii) In August 2010, 8,510,000 common shares were issued at a price of \$0.325 per share, for a total financing of \$2,765,750. Each unit sold consists of one common share and one warrant. Each warrant entitles the holder to purchase one common share at a price of \$0.45 for a 24-month period.

Share purchase warrants:

The Company has granted share purchase warrants and could be required to issue shares as follows, upon the exercise of such warrants:

Number of options	Exercise price	Expiring date
8,107,691	\$ 0.85	June 4, 2011
1,507,693	0.85	June 9, 2011
143,085	0.85	June 30, 2011
6,764,706	1.05	September 24, 2011
8,510,000	0.45	August 17, 2012

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

11. Stock option plan:

Under the stock option plan for the benefit of the directors and officers of the Company, 5,822,612 common shares are available; the life of the options cannot exceed five or ten years and the options vest immediately or over a period of one, two or three years.

The number of outstanding stock options changed as follows:

	2010	Average exercisable price	2009	Average exercisable price
Balance, beginning of year	4,733,000	\$ 0.55	3,553,000	\$ 0.55
Issued	100,000	0.41	1,180,000	0.56
Exercised	(210,000)	0.34	—	—
Cancelled	(1,265,606)	0.59	—	—
Balance, end of year	3,357,394	\$ 0.55	4,733,000	\$ 0.55
Exercisable options, end of year	3,279,771	\$ 0.55	3,453,000	\$ 0.55

As at December 31, 2010, the following options were outstanding:

Number of options	Exercise price	Expiring date
295,000	\$ 0.26	December 19, 2011
400,000	0.35	December 22, 2011
425,000	0.65	August 31, 2012
761,189	0.60	December 14, 2012
25,000	0.62	January 28, 2013
500,000	0.63	February 21, 2013
25,000	2.18	July 28, 2013
25,000	0.58	January 28, 2014
25,000	0.37	July 28, 2014
85,000	0.37	July 31, 2014
691,205	0.58	October 29, 2014
50,000	0.53	February 6, 2015
50,000	0.28	August 31, 2020

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

11. Stock option plan (continued):

During the year ended December 31, 2010, the Company granted 100,000 stock options (2009 - 1,180,000) at a price from \$0.28 to \$0.53 per share (2009 - \$0.37 to \$0.58). The fair value of each option granted was determined using the Black-Scholes option pricing model. At the date of the grant, this weighted average fair value of stock options granted was \$0.36 per option (2009 - \$0.39). The following assumptions were used in these calculations:

	2010	2009
Risk-free interest rate	3 to 4%	2.5%
Expected life	5 to 10 years	2 years
Expected volatility	102 to 132%	138 to 144%
Expected dividend yield	0%	0%

12. Contributed surplus:

	2010	2009
Balance, beginning of year	\$ 2,611,830	\$ 2,105,110
Stock-based compensation	135,775	506,720
Cost of warrants exercised	(88,873)	—
Balance, end of year	\$ 2,658,732	\$ 2,611,830

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

13. Income taxes:

Income tax expense (recovery) differs from the amounts computed by applying the combined federal and provincial income tax rate of 29.9% (2009 - 30.9%) as a result of the following:

	2010	2009
Loss before taxes	\$ (3,129,967)	\$ (2,012,206)
Computed "expected" tax recovery	\$ (935,860)	\$ (621,772)
Increase in income taxes resulting from:		
Non-deductible stock-based compensation	40,597	156,576
Income tax at future rate	74,272	89,200
Valuation allowance	(1,487,451)	(17,000)
Current year losses not recognized	770,451	—
Other	50,540	16,996
Total income tax expenses	\$ (1,487,451)	\$ (376,000)

The income tax effect of temporary differences that give rise to future tax assets and liabilities is as follows:

	2010	2009
Future tax assets:		
Operating losses	\$ 1,871,000	\$ 1,074,000
Share issuing costs	369,000	301,000
Fixed assets	10,000	2,000
Other eligible capital expenditures	104,000	—
	2,354,000	1,377,000
Valuation allowance	(566,000)	(1,283,000)
	1,788,000	94,000
Future tax liabilities:		
Deferred exploration expenditures	(1,788,000)	(94,000)
Net future tax liabilities	\$ —	\$ —

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

13. Income taxes (continued):

As at December 31, 2010, the Company has tax losses of approximately \$6,234,000 at the federal and provincial levels and approximately \$583,000 of tax losses for foreign jurisdiction available to apply against future taxable income as follows:

Expiry date	USA	Canada
2027	\$ 14,000	\$ -
2028	296,000	1,469,000
2029	88,000	2,039,000
2030	185,000	2,726,000
	<u>\$ 583,000</u>	<u>\$ 6,234,000</u>

The Company also has Canadian exploration expenditures and other costs of approximately \$11,307,000 which may be deducted from future income, with no defined period.

The future tax benefit resulting from these items which will serve to decrease future taxable revenues was not recorded.

14. Related party transactions:

During the year, the Company paid its share of the cost of the lease and other office costs to a company controlled by a director of the Company in the amount of \$111,687 (2009 - \$102,848). These transactions were recorded at the exchange amount.

15. Financial instruments:

Exposure and risk management:

The Company is exposed to various financial risks resulting from both its operations and its investment activities. The Company's management monitors financial risks. The Company does not enter into financial instrument agreements including derivative financial instruments for speculative purposes.

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

15. Financial instruments (continued):

Exposure and risk management (continued):

The Company's main financial risk exposure and its financial risk management policies are as follows:

(a) Credit risk:

Credit risk results from the possibility that a loss may occur from the failure of another party to perform according to the terms of the contract. Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, restricted cash and funds reserved for exploration, partners' contribution receivable, balance receivable on sale of properties and long-term deposits which consist of advance payments made to contractors and partners. Cash is maintained with high-credit, quality financial institutions. Cash equivalents consist of money market funds and guaranteed investment certificates.

The Company grants credit to its debtors in the normal course of business. The credit risk of the Company is also attributable to the following debtors:

- Receivables from partners in the amount of \$336,739, of which \$88,314 has been outstanding for more than 90 days.
- Receivable from a company controlled by an officer of Gastem Inc., in the amount of \$296,950, which has been outstanding for more than 90 days.
- Receivable from an officer of the Company, in the amount of \$123,776, with no stated due date.
- Receivable from a mining company in the amount of \$33,118 which has been outstanding for more than 90 days.

The Company extends credit in its normal course of operations. The Company regularly monitors its receivables, ensures a follow-up on outstanding amounts and evaluates the need for a provision on these receivables. A provision is based on the best estimates made by the Company as to the eventual collection of these doubtful accounts. As at December 31, 2010, no such provision has been accounted for (2009 - nil).

(b) Interest rate risk:

The certified investment certificates bear interest at a fixed rate and the Company is, therefore, not exposed to the risk of changes in fair value resulting from interest rate fluctuations. The money market funds bear interest at a variable rate and therefore expose the Company to the risk of changes in fair value arising from interest rate fluctuations. The Company's other financial assets and liabilities limit the Company's interest rate risk since they expire on a short-term basis.

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

15. Financial instruments (continued):

Exposure and risk management (continued):

(c) Liquidity risk:

Management strives to maintain a sufficient amount of cash and cash equivalents, and to ensure that the Company has at its disposal sufficient sources of financing such as private placements. The Company establishes cash budgets to ensure it has the necessary funds to meet its obligations as they come due. Being able to obtain new funds allows the Company to pursue its activities and even though the Company was successful in the past, there is no guarantee that it will succeed in the future.

The accounts payable and accrued liabilities have stated repayment terms of less than six months.

(d) Foreign exchange risk:

The Company incurs exploration costs in US dollars and is consequently exposed to foreign exchange risk as follows:

	2010	2009
	US\$	US\$
(Bank indebtedness) cash	(36,616)	49,395
Accounts receivable	269,701	-
Trade accounts payable and accrued liabilities	(58,942)	(299,590)

As at December 31, 2010, if the exchange rate (\$CA/\$US) has increased or decreased by 5%, the impact on the net results would not have been significant.

Fair value:

The fair value of the accounts receivable, accounts payable and accrued liabilities approximates their carrying value due to their short-term nature.

The fair value of the deposits on long-term assets approximates its carrying value, given that there has been no significant variations in the risk-free interest rates and in the economic situation of the Company since these deposits were made.

The level of significance of the inputs used by the Company in valuing its money market funds and its guaranteed investment certificates is Level 2.

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

16. Capital disclosures:

The Company's objectives when managing its capital are to safeguard the Company's ability to continue as a going concern in order to support ongoing exploration programs and the development of its gas assets, to provide sufficient working capital to meet its ongoing obligations and to pursue potential investments.

In the management of capital, the Company includes the components of shareholders' equity.

The Company manages its capital structure and makes adjustments to it in accordance with the aforementioned objectives, as well as in light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust its capital structure, the Company may issue new shares, or acquire or sell gas properties to improve its flexibility and financial performance. The Company does not use long-term debts since it does not generate operating revenues. There is no dividend policy. The Company is not subject to externally imposed capital requirements.

The Company's management of capital remained unchanged since the last period.

17. Commitments and contingencies:

Under the terms of exploration permits granted by the ministère des Ressources naturelles, the Company is committed to pay annuity of \$26,869 until 2013. In addition, the Company is required to perform yearly, on the land covered by its permits, work for which the minimum expenditure varies according to the age of the permit; for the first year, such work must be no less than the greater of \$0.50 per hectare or \$3,000, \$1.00 or \$6,000 for the second year, \$1.50 or \$9,000 for the third year, \$2.00 or \$12,000 for the fourth year and \$2.50 or \$15,000 for the fifth year of the permit. For subsequent renewal years, minimum costs are the greater of \$2.50 per hectare or \$20,000.

	Annuities	Expenditures	Total
2011	\$ 17,852	\$ 1,027,704	\$ 1,075,161
2012	5,537	363,910	381,762
2013	3,480	15,000	18,480
	\$ 26,869	\$ 1,406,614	\$ 1,433,483

GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

17. Commitments and contingencies (continued):

Environment:

The Company's operations are subject to governmental laws and regulations regarding environmental protection. Environmental consequences, their impact and their duration are difficult to determine. Management endeavours to carry out its activities in compliance with all applicable laws and regulations and ensures to follow instructions and recommendations of competent authorities when potential issues are encountered.

As at December 31, 2010, a provision for site restoration is not considered necessary.

18. Subsequent event:

In March 2011, following an issue of public opinion relative to a gas leak, it is possible that one of the wells of the St-Hyacinthe property (vertical well) will be abandoned by the operator.

19. Comparative figures:

Certain of the 2009 comparative figures have been reclassified to conform with the financial statement presentation adopted for the current year.

