

**PARAMOUNT RESOURCES LTD.**  
ANNUAL REPORT 2005

05



Letter to Shareholders	03
Core Producing Areas	06
Review of Operations	13
Areas of Interest	22
Management's Discussion & Analysis	30
Management's Report	52
Report of Independent Auditors	53
Financial Statements	54
Notes to Financial Statements	57
Corporate Information	82

# FINANCIAL HIGHLIGHTS<sup>(1)</sup>

	Year Ended December 31		
(thousands of dollars except per share amounts and where stated otherwise)	2005	2004	% Change
<b>FINANCIAL</b>			
Petroleum and natural gas sales			
As reported	482,670	592,546	(19)
Excluding Spinout Assets	376,702	258,808	46
Funds flow from operations – As reported	252,517	294,352	(14)
Per share – diluted	3.89	4.82	(19)
Net earnings (loss) – As reported	(63,932)	41,174	n/a
Per share – diluted	(0.99)	0.67	n/a
Net capital expenditures <sup>(2)</sup>			
As reported	423,337	576,357	(27)
Excluding Spinout Assets	374,528	302,315	24
Long-term investments			
Market value <sup>(3)</sup>	358,464	–	n/a
Total assets	1,111,530	1,542,786	(28)
Net debt <sup>(4)</sup>	428,700	451,043	(5)
Common shares outstanding (thousands)	66,222	63,186	5
Market capitalization <sup>(5)</sup>	2,046,250	1,699,693	20
<b>OPERATING</b>			
Total sales (Boe/d)			
As reported	24,888	36,150	(31)
Excluding Spinout Assets	18,676	15,862	18
Gas weighting			
As reported	82%	80%	3
Excluding Spinout Assets	83%	78%	6
<b>RESERVES <sup>(6)</sup></b>			
Proved plus probable			
Natural gas (Bcf)	255.4	568.6	(55)
Crude oil and liquids (MMbbl)	8,016	20,461	(61)
Total (MBoe)	50,590	115,230	(56)
Estimated net present value before tax @ 10%			
Proved (\$millions)	638.6	1,156.0	(45)
Proved plus probable (\$millions)	1,020.2	1,659.3	(39)
<b>OIL SANDS RESOURCES <sup>(8)(9)</sup> – Best Estimate <sup>(7)</sup></b>			
MMBbl	923.0	–	n/a
Estimated NPV before tax @ 10% (\$ millions)	1,176.0	–	n/a
Net undeveloped land holdings (thousands of acres)	2,979	3,442	(13)
Total wells drilled (gross)	341	271	26
Success rate <sup>(10)</sup>	95%	95%	–

(1) Readers are referred to the advisories concerning forward-looking statements, non-GAAP measures, barrel of oil equivalent conversions and finding and development costs under the heading "Advisories" towards the end of this document.

(2) Excludes capital expenditures of discontinued operations.

(3) Based on period end closing prices of Trilogy Energy Trust on the Toronto Stock Exchange and book value for remaining long-term investments.

(4) Net debt is equal to the sum of long-term debt, working capital deficit (surplus) and stock based compensation liability (excluding the stock based compensation liability associated with Paramount Options amounting to \$46.6 million at December 31, 2005, and \$41.0 million at December 31, 2004 – see Liquidity and Capital Resource section of MD&A).

(5) Based on the period end closing prices of Paramount Resources Ltd. on the Toronto Stock Exchange.

(6) The significant decrease in reserves is primarily attributable to the spinout of assets to Trilogy Energy Trust on April 1, 2005.

(7) The engineering reports prepared by GLJ Petroleum Consultants Ltd. ("GLJ") and McDaniel and Associates Consultants Ltd. ("McDaniel") provide "low estimate", "best estimate" and "high estimate" cases. "Best estimate" refers to the most likely case.

(8) Paramount owns a 100% interest in oil sands leases in the Surmont area of Alberta, and has a 50% interest in a joint venture (the "Joint Venture") with North American Oil Sands Corporation, which holds oil sands leases in the central Athabasca area of Alberta. 100% of the oil sands resources at Surmont were evaluated by McDaniel. 100% of the oil sands resources held within the Joint Venture were evaluated by GLJ. Figures in the above table refer to Paramount's working interest share.

(9) Resources refers to the sum of the contingent resources and prospective resources. Contingent resources, as evaluated by GLJ and McDaniel, are those quantities of bitumen estimated to be potentially recoverable from known accumulations, but are classified as a resource rather than a reserve primarily due to the absence of regulatory approvals, detailed design estimates and near term development plans. Prospective resources are those quantities of bitumen estimated to be potentially recoverable from undiscovered accumulations. The resources attributable to Surmont have been classified by McDaniel as contingent resources. The resources attributable to the Joint Venture have been classified by GLJ as a combination of contingent and prospective resources for the case shown in the table above.

(10) Success rate excludes oilsands wells.



# LETTER TO SHAREHOLDERS

**Paramount shareholders enjoyed a very successful year in 2005. The Company continued to realize significant value by harvesting the assets that have been accumulated through its first several decades of the Company's existence while at the same time continuing to add additional high quality reserves and assets to the Company's inventory. Three main initiatives highlighted 2005: Paramount completed the spinout out of Trilogy Energy Trust ("Trilogy") delivering significant value to shareholders; the remaining conventional asset base produced an average 18 percent higher than last year; and, the Company quantified the bitumen resource on its oil sands assets in Northeast Alberta which are now estimated to total in excess of one billion barrels of recoverable bitumen.**

The Spinout of Trilogy Energy Trust was completed April 1, 2005 and Paramount Resources shareholders received one unit of Trilogy for each share of Paramount Resources held. These high quality, high working interest assets in the Kaybob and Marten Creek areas of Alberta transferred to the Trust were producing approximately 25,100 Boe/d on April 1, 2005 and have future exploitation opportunities on undeveloped acreage as well as the potential to further develop the lands that are already producing. The opportunity exists to drill hundreds of wells targeting tighter natural gas charged reservoirs in the Kaybob area to capture reserves that would not otherwise be drained with the existing wells. These development opportunities provide Trilogy with the ability to maintain a stable production base, as well as replace the reserves that are produced annually to maintain a stable reserve life index on a relatively low risk basis. Trilogy has quickly executed on its business plan to transform itself into a stand-alone fully operational energy trust with a future opportunity base second to none. The Trilogy Energy Trust Spinout was designed to provide Paramount shareholders with a stable cash distribution which would be sustainable for the foreseeable future.

Within Paramount's conventional asset business units, many new opportunities were added and existing assets were further developed in the operating units during 2005. Total conventional production grew in the Kaybob, Southern, Northwest Territories and Northwest Alberta Operating Units and contributed to an overall 18 percent increase in production excluding the assets transferred to Trilogy. A new, deep, light oil discovery was made on Company lands in the Grande Prairie area. Further evaluation will be done through 2006 to quantify its potential and put the play on production. A new, deep gas discovery was also made in the Ante Creek area and this will also be placed on production; as well, follow-up drilling will proceed. The Kaybob area saw several high rate gas discoveries made in early 2006 which will be placed on production starting in the second quarter. Further exploitation of these discoveries will follow over the next several years with the thought that these plays may be harvested in a way similar to the assets that were transferred to Trilogy. Paramount was very successful with its coal bed methane development in Southern Alberta, achieving production rates of over 5 MMcf/d in the first quarter of 2006 and initiating a similar development plan of an additional 100 wells to be completed through the remainder of the year. A substantial asset base has been assembled for deep oil resource plays in North Dakota which will be evaluated when drilling equipment is secured in the second half of 2006. Also, Paramount will be a participant in the Mackenzie Valley Pipeline hearings and anticipates clarity as to the timing of this development so that Paramount can better schedule the development of its discoveries at Colville Lake.

Paramount Resources Ltd. received the results of the initial evaluations of its oil sands interests from the independent reserves evaluators, GLJ Petroleum Consultants Ltd. ("GLJ") and McDaniel & Associates Consultants Ltd. ("McDaniel") and press released them on January 18, 2006. The combined evaluations estimate Paramount's potential recoverable bitumen resources associated with its oil sands interests to be as much as 1.6 billion barrels. Paramount owns 100 percent of 12 sections of in-situ oil sands leases in the Surmont area of Alberta and has a 50 percent interest in a Joint Venture (the Paramount "JV") with North American Oil Sands Corporation ("NAOSC") which holds in-situ oil sands leases in the Leismer, Corner, Thornbury and Hangingstone areas of Alberta. Paramount is currently drilling additional oil sands evaluation wells and acquiring 3D seismic on the prospects to further quantify the accumulations in order to apply for development approval from the Alberta Energy and Utilities Board in the spring of this year. Front end engineering design has commenced on an initial 10 MBbl/d oil sands development project at Leismer, slated to commence steam injection in 2008. Paramount has also commenced

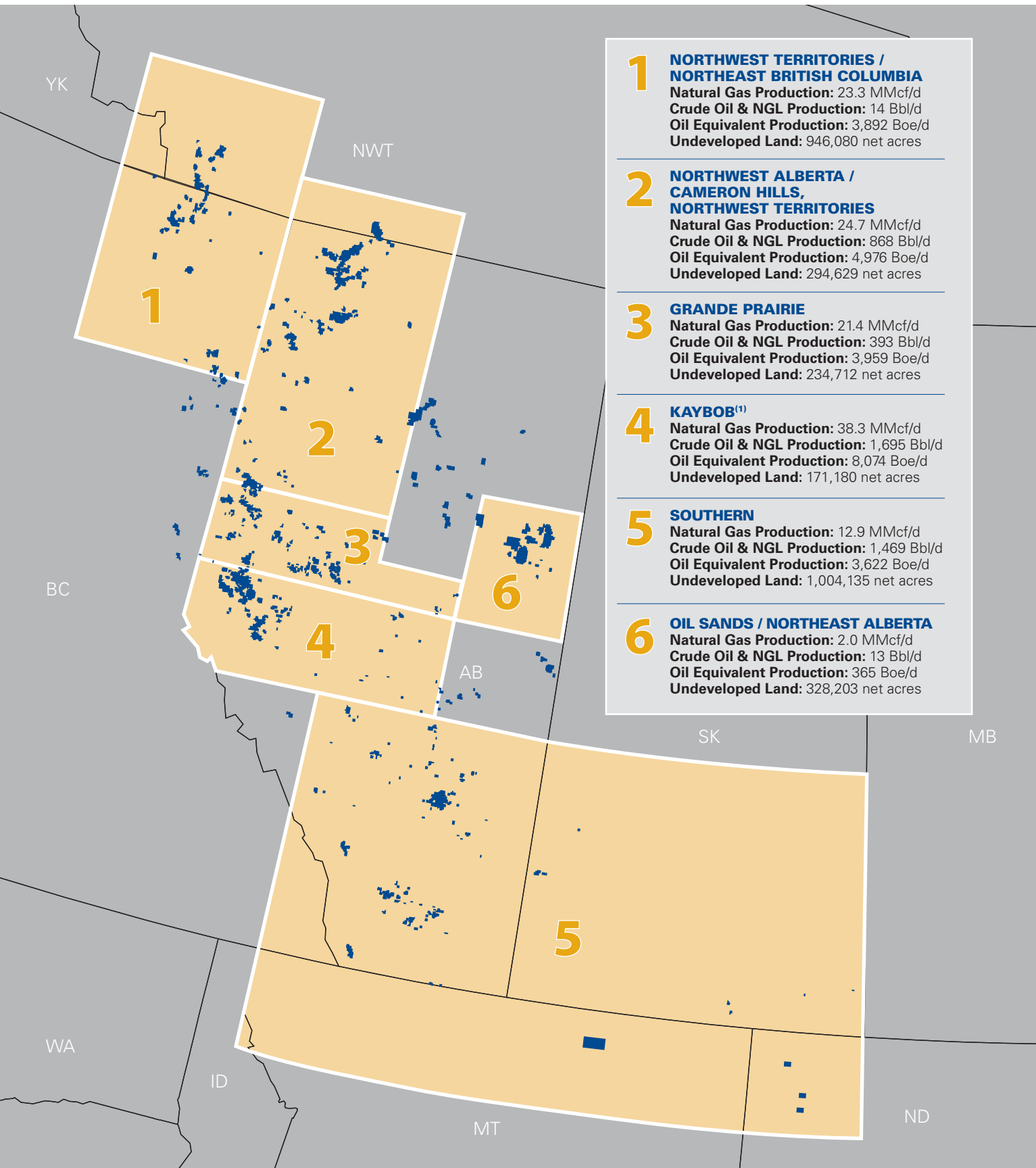
front end engineering design on an initial 10 MBbl/d oil sands development project at Surmont, slated to commence steam injection in 2009 or 2010. Paramount has budgeted \$70 million for oil sands delineation and development in 2006. Each of the oil sands development projects referred to above are expected to require capital expenditures by Paramount (in the case of Surmont) and Paramount and NAOSC (in the case of the Paramount JV) of approximately \$180 million to bring these projects on production. Paramount estimates a further 30 MBbl/d expansion of these projects would require additional capital expenditures of approximately \$400 million to bring on production. Paramount will focus significant resources to put a strategy in place and plan to finance these developments while at the same time, continuing to develop our inventory of conventional oil and gas assets. We are of the view that it will be in Paramount's best interest to dilute its ownership in the oil sands assets as opposed to diluting the entire Company to achieve this financing.

Prices for both oil and natural gas were very strong in 2005 and crude oil prices have topped all time highs in recent months. This has resulted in industry participants generating record levels of cash flow and the general strengthening of the financial positions of companies in the oil and gas sector. This environment has also created a higher cost environment as increased capital available to industry has increased the demand for equipment, services, and skilled people. Natural gas prices have recently come under pressure as North America has seen the warmest winter on record in the first part of 2006. Paramount's contention is that the unseasonably warm winter experienced by North America has merely delayed the future supply shortage by one season. The longer that a reduced natural gas price persists, the higher the demand for natural gas will be, which will amplify the price recovery when normal conditions return. Until major supply increments can be provided through northern gas development and liquefied natural gas capacity, we believe that high natural gas prices will remain.

Paramount has budgeted a total of \$420-\$470 million for capital expenditures for 2006 with the expectation that this will allow us to increase production from 18,800 Boe/d in the fourth quarter of 2005 to an exit rate of 28,000 Boe/d in 2006 with average production for the year of approximately 24,000 Boe/d. With visible short-term growth in all of the core operating areas, combined with an exciting portfolio of long-term prospects in the oil sands and the far north at Colville Lake, Paramount considers its value creation potential for shareholders to be unparalleled. We maintain a corporate culture that supports safety, creativity, innovation and teamwork, to provide our shareholders with high quality investment opportunities.

**signed Jim Riddell** President and Chief Operating Officer  
March 16, 2006





**1 NORTHWEST TERRITORIES / NORTHEAST BRITISH COLUMBIA**  
 Natural Gas Production: 23.3 MMcf/d  
 Crude Oil & NGL Production: 14 Bbl/d  
 Oil Equivalent Production: 3,892 Boe/d  
 Undeveloped Land: 946,080 net acres

**2 NORTHWEST ALBERTA / CAMERON HILLS, NORTHWEST TERRITORIES**  
 Natural Gas Production: 24.7 MMcf/d  
 Crude Oil & NGL Production: 868 Bbl/d  
 Oil Equivalent Production: 4,976 Boe/d  
 Undeveloped Land: 294,629 net acres

**3 GRANDE PRAIRIE**  
 Natural Gas Production: 21.4 MMcf/d  
 Crude Oil & NGL Production: 393 Bbl/d  
 Oil Equivalent Production: 3,959 Boe/d  
 Undeveloped Land: 234,712 net acres

**4 KAYBOB<sup>(1)</sup>**  
 Natural Gas Production: 38.3 MMcf/d  
 Crude Oil & NGL Production: 1,695 Bbl/d  
 Oil Equivalent Production: 8,074 Boe/d  
 Undeveloped Land: 171,180 net acres

**5 SOUTHERN**  
 Natural Gas Production: 12.9 MMcf/d  
 Crude Oil & NGL Production: 1,469 Bbl/d  
 Oil Equivalent Production: 3,622 Boe/d  
 Undeveloped Land: 1,004,135 net acres

**6 OIL SANDS / NORTHEAST ALBERTA**  
 Natural Gas Production: 2.0 MMcf/d  
 Crude Oil & NGL Production: 13 Bbl/d  
 Oil Equivalent Production: 365 Boe/d  
 Undeveloped Land: 328,203 net acres

(1) Includes the results of the Spinout Assets for the period January 1, 2005 to March 31, 2005.



# CORE PRODUCING PROPERTIES

## KAYBOB

The successful completion of the Trilogy Spinout resulted in the transfer of properties producing approximately 22,000 Boe/d from the Kaybob Operating Unit to Trilogy effective April 1, 2005; representing approximately 90 percent of the average daily production as at the time of the Trilogy Spinout. The assets remaining in the Kaybob Operating Unit are characterized as deeper, higher pressure, larger reserve potential assets that are expected to be significant to the future growth of Paramount.

Excluding the results attributable to the Spinout Assets, the Kaybob Operating Unit's 2005 natural gas sales volumes averaged 13.0 MMcf/d, a 94 percent increase over 2004 average natural gas sales volume of 6.7 MMcf/d; oil and natural gas liquids sales volumes averaged 474 Bbl/d, a 118 percent increase over 2004 average sales volumes of 217 Bbl/d. These increases are primarily a result of new production additions from the 2005 drilling program.

Paramount and its partners drilled a number of wells in remote geographic areas of Alberta. Access to these areas was restricted, in part due to wet weather and also because some of the lands are within Caribou habitat. These factors caused delays in the completion and construction activity relating to wells that were drilled last winter. There are two plants currently being constructed in the Resthaven and Smoky areas that will process some of the gas from new discoveries. Paramount will have a working interest in both of these new plants. Paramount and its partners have made it a priority to complete and tie in a number of the wells that have recently been drilled and the successful wells from last winter's drilling that were stranded due to access restrictions.

Excluding the assets transferred to Trilogy, Paramount drilled 44 (15.8 net) wells in the Kaybob area during 2005. These wells range in depths from 3,000 to 3,800 meters and tend to be challenging to drill and complete. Well costs range from \$2 million to \$5 million for the drilling and casing operations for each well. The multi-zone potential of these wells creates some of the challenges and can cost between \$1 million and \$4 million to complete each well. Paramount believes that the ability to commingle all the producing zones and the potential for reserve additions from each producing formation, justify the costs of drilling and completing these wells. Access to drilling rigs has forced operators to focus activity on higher working interest properties and as a result budgeted joint venture drilling activity has been delayed.

Paramount originally budgeted \$45 million for capital expenditures in 2005 for the remaining Kaybob assets. At the end of the first quarter, this budget was increased to \$95 million, reflecting the large number of opportunities available to Paramount. Capital expenditures in 2005 totaled \$110.4 million, for Kaybob, excluding the Spinout Assets. Included in this amount is \$22.0 million for the acquisition of an additional 23,120 net acres (36.1 net sections) of land in the Kaybob area from Crown land sales.

Paramount has been extremely active in acquiring acreage in the Kaybob area, as we believe the resource potential and economics of drilling and completing multi-zone wells will be significant to the growth of the Company. Paramount's developed land base was 27,317 net acres and the Company owned an additional 171,180 net acres of undeveloped land as of December 31, 2005. This significant land base is expected to provide Paramount with a large inventory of development and exploratory drilling prospects to support future growth. We expect to continue to be active acquiring new acreage through Crown land sales and farm-in opportunities.

Paramount's 2006 capital program includes planned expenditures of between \$160 and \$180 million for the Kaybob Operating Unit. The Company anticipates this will contribute significant production and reserve additions for the year. We have very good joint venture relationships with our partners to ensure that we are aware of the developments within our focus areas. We have developed a strategy that will see us active throughout most of the year with our drilling and completions rigs. Assuming success in executing our 2006 plan within the Kaybob Operating Unit, we will have participated in the drilling of up to 80 (40 net) wells and have added significant reserves and production to Paramount. Average production for 2006 is estimated to be 6,000 Boe/d from the Kaybob Operating Unit.

## GRANDE PRAIRIE

The successful completion of the Trilogy Spinout resulted in the transfer of properties producing approximately 3,100 Boe/d from the Grande Prairie Operating Unit to Trilogy effective April 1, 2005, representing approximately 50 percent of the average daily production as at the time of the Trilogy Spinout. The properties remaining in the Grande Prairie Operating Unit include Mirage, Valhalla, Saddle Hills and Ante Creek.

Excluding the results attributable to the Spinout Assets, the Grande Prairie Operating Unit's 2005 natural gas sales volumes averaged 16.8 MMcf/d, an 8 percent decrease from 2004 average natural gas sales volumes of 18.2 MMcf/d. Excluding the results attributable to the Spinout Assets, the Grande Prairie Operating Units 2005 oil and natural gas liquids sales volumes averaged 393 Bbl/d, a 33 percent decrease from 2004 average oil and natural gas liquids sales volumes of 585 Bbl/d. These decreases are primarily a result of adverse weather conditions that inhibited lease access and a tight supply of equipment and services that delayed the tie in of approximately 6 MMcf/d that we anticipate to come onstream in the first quarter of 2006.

Excluding capital expenditures attributable to the Spinout Assets, the Grande Prairie Operating Unit's 2005 capital expenditures totaled \$56.3 million. Paramount drilled a total of 33 (23.1 net) wells in the Grande Prairie Operating Unit during 2005, with the Mirage area being the most active with 18 (11.8 net) wells drilled. These Mirage wells were a continuation of our development of the shallow Dunvegan gas discoveries as well as new opportunities in deeper horizons. The interpretation of a large 3D seismic program completed in 2005 has been successfully used to select the deeper targets. In the Ante Creek area, two wells were drilled in 2005 that had multi-zone discoveries. These discoveries are being followed up with a large farm-in program. Recent Crown land acquisitions combined with the lands earned through a farm-in, have increased the development potential of the Ante Creek property. Paramount expects to exit 2006 with a land base of approximately 56 gross sections within the Ante Creek area. Existing infrastructure is being expanded to accommodate the development. In addition, Paramount is following-up on a significant deep light oil discovery with wells and seismic. A total of 15 (11 net) wells were tied in and placed on production during 2005. Six (4.0 net) additional wells have been tested and are awaiting tie in.

Paramount's 2006 capital program includes planned expenditures of \$45 to \$55 million for the Grande Prairie Operating Unit. In 2006, we plan to exploit our growth potential from new discoveries and drill 34 (26 net) wells and install four compressors. Average production for 2006 is estimated to be 4,400 Boe/d from the Grande Prairie Operating Unit.

## NORTHWEST ALBERTA / CAMERON HILLS, NORTHWEST TERRITORIES

The Northwest Alberta Operating Unit covers the extreme northwest corner of Alberta, extending into the Cameron Hills area in the Northwest Territories. The southern and eastern boundaries are located at township 85, and range 14 west of the fifth meridian, respectively. The Alberta provincial border defines the western edge.

The Northwest Alberta Operating Unit targets hydrocarbon bearing zones in the region starting with Pleistocene-aged sands and gravels located at depths of 30 meters through Cretaceous-aged Bluesky/Gething sands, Mississippian carbonates and ending with Middle Devonian carbonates at depths of 1,600 meters. Production facility design and operation in the region accommodate a range of raw production including sweet low-pressure natural gas and high-pressure sour oil and natural gas.

The Northwest Alberta Operating Unit's 2005 natural gas sales volumes averaged 24.7 MMcf/d, a 22 percent increase over 2004 average natural gas sales volumes of 20.2 MMcf/d. The Northwest Alberta Operating Unit's 2005 oil and natural gas liquids sales volumes averaged 868 Bbl/d, a nine percent increase over 2004 average oil and natural gas liquids sales volumes of 797 Bbl/d. These increases are primarily a result of production success in the Bistcho non-operated property with the drilling of 15 (7.5 net) gas wells. In addition, the tie in of 8 (4.0 net) of these new wells during 2005 resulted in an annualized net production increase of 1.9 MMcf/d.

The Northwest Alberta Operating Unit's 2005 capital expenditures totaled \$39.8 million. The majority of these expenditures were spent on drilling, completion and tie in activities. A total of \$21.7 million was spent to drill 27 (15.8 net) wells during 2005, of which 1 (0.5 net) well was dry and abandoned. A significant portion of this drilling took place in the Bistcho Lake properties. The total cost to tie in new wells in 2005 was \$11.8 million. A considerable amount of field activities relating to seismic acquisition, drilling, completion, and facility construction occurred in the first quarter of 2005 due to restricted seasonal access as a result of soft ground conditions.

Paramount's 2006 capital program includes planned expenditures of \$40 to \$45 million for the Northwest Alberta Operating Unit. 2006 activity will focus on the Bistcho, Zama, and Larne properties with expectations of participating in the drilling of 14 (7.5 net) operated and non-operated gas wells. Additional activities include the drilling of: 8 (7.0 net) wells targeting natural gas and oil in the Cameron Hills area, 6 (6 net) gas wells in the Haro area, and 10 (10 net) gas wells on existing and recently acquired lands in Peerless, a new exploration property in Northwest Alberta. Average production for 2006 is estimated to be 5,000 Boe/d from the Northwest Alberta Operating Unit.

### **NORTHWEST TERRITORIES / NORTHEAST BRITISH COLUMBIA**

The Northwest Territories Operating Unit's 2005 natural gas sales volumes averaged 23.3 MMcf/d, a 44 percent increase over 2004 average natural gas sales volumes of 16.2 MMcf/d. 2005 oil and natural gas liquids sales volumes averaged 14 Bbl/d, a 17 percent increase over 2004 average oil and natural gas liquids sales volumes of 12 Bbl/d. These increases are primarily a result of successful workovers, recompletions and drilling activities within the four main producing areas of Liard/Maxhamish, Tattoo, Clarke Lake and West Liard. In addition, operations have expanded outside of the Liard Basin with one new well on production in the Caribou area of Northeast British Columbia.

The Northwest Territories Operating Unit's 2005 capital expenditures totaled \$67 million. In the Liard Basin area, the capital program was focused on development and optimization of the producing properties. Production from the Liard/Maxhamish properties was more than doubled as a result of three successful workovers and recompletions in the Mattson and Fantasque zones. Production declines experienced at West Liard were a result of higher than expected water production rates which have reduced the estimated ultimate recovery of reserves from existing gas wells. As a result, Paramount recorded negative reserve revisions of 15.9 Bcfe (proved) and 13.1 Bcfe (probable) relating to West Liard for 2005. A horizontal well at K29A was drilled and completed late in 2005 to access additional reserves within the pool and it is anticipated to be on production in Q1 2006. Two wells were drilled for Slave Point gas at the non-operated Clarke Lake property with one brought on production in the second quarter of 2005.

Paramount and its partner drilled five (2.5 net) wells in Colville Lake of which three were cased and two were abandoned. The completion of two previously drilled Cambrian-age Mount Clarke wells confirmed potential reserves estimates of 250 Bcf for the Nogha structure. Through a Crown land sale in May 2005, Paramount and its partner jointly acquired two leases for approximately 132,645 hectares in the Nogha and Maunoir areas. The Northwest Territories Operating Unit drilled a total of 13 (9.5 net) wells during 2005.

Paramount's 2006 capital program includes planned expenditures of \$30 to \$35 million for the Northwest Territories Operating Unit. The 2006 activity will focus on the drilling of 11 (7.8 net) wells and seven workovers/recompletions in the Liard Basin area. This will include a multi-well drilling program in the first quarter of 2006, targeting the Mattson zone at Tattoo, while locations at Clarke Lake and West Liard are planned for later in 2006. Production rates are anticipated to be maximized in the West Liard area as a result of facility upgrades, including the installation of compression, planned for 2006. A seismic program will be shot at Colville Lake over Exploration License 424. In addition, our participation in the Mackenzie Valley Pipeline hearings will continue. Average production for 2006 is estimated to be 3,100 Boe/d from the Northwest Territories Operating Unit.

## SOUTHERN

The Southern Operating Unit produces oil and natural gas in southern Alberta, northern Montana and southwest North Dakota. The core areas are the gas producing Chain/Craigmyle field near Drumheller, Alberta and the oil producing area near Medora, North Dakota.

The Southern Operating Unit's 2005 natural gas sales volumes averaged 12.9 MMcf/d, a 19 percent increase over 2004 average natural gas sales volumes of 10.8 MMcf/d. 2005 oil and natural gas liquids sales volumes averaged 1,469 Bbl/d, an 18 percent decrease from 2004 average oil and natural gas liquids sales volumes of 1,798 Bbl/d. This decrease is directly related to the sale of Paramount's southeast Saskatchewan properties in July 2004. Liquids production on remaining properties increased due to successful drilling results in North Dakota.

The Southern Operating Unit's 2005 capital expenditures totaled \$62.9 million. These expenditures primarily consisted of; drilling and completions activity of \$26.7 million, facility construction \$19.9 million and land purchases 15.9 million. Approximately 80 percent of the 2005 capital expenditures of the Southern Operating Unit focused on areas in Alberta, the remainder of which was spent on the United States properties.

In the Chain region, Paramount installed two large compressors and a low pressure gathering system designed to produce natural gas from the Horseshoe Canyon coal beds. In addition, the Southern Operating Unit drilled 83 (55 net) coal bed methane gas wells in order to target natural gas production from the Horseshoe Canyon area and was able to tie in 39 (22 net) of these wells by year end 2005. Paramount is now successfully producing from the shallowest coal beds of any company in the province of Alberta. The production system built for producing from coal beds is designed to operate at a very low cost, maximizing returns to Paramount. The success of this program has led Paramount to plan for an additional 100 (72 net) wells to be drilled in 2006, with the installation of two more legs of the low pressure gathering system.

During 2005, Paramount drilled 13 (11.5 net) Belly River and Mannville conventional gas wells, with nine (7.8 net) being placed on production and one awaiting tie in. The positive results of this drilling program enabled us to produce to the full capacity of our gathering system by the end of the year.

Our entire program was conducted in the wettest conditions seen in many years in southern Alberta. The weather delays that put us behind our schedule by up to 60 days, were somewhat offset by good results from the program that put us very close to our production forecast.

In the United States, Paramount operates as Summit Resources Inc. ("Summit"). In North Dakota, Paramount participated in seven (2.15 net) wells targeting the Birdbear formation, a dolomite in the Beaver Creek field, with one (1.0 net) further location drilling over the year end. These wells were 71 percent successful in finding oil, with average initial production rates of 300 Bbl/d for the first month. Summit has also been acquiring acreage focused on the Bakken play in North Dakota throughout this past year, and expects to begin an aggressive drilling program in the second half of 2006.

Paramount's 2006 capital program includes planned expenditures of \$75 to \$85 million for the Southern Operating Unit. Average production for 2006 is estimated to be 5,000 Boe/d from the Southern Operating Unit.

## OIL SANDS / NORTHEAST ALBERTA

In 2005, Paramount increased its oil sands acreage by approximately 20 percent with the acquisition of 27,520 net acres at a total cost of \$4.2 million. Paramount currently holds oil sands interests in 237,440 (141,250 net) acres, or 371 (221 net) sections. In 2005 Paramount drilled 24 (14.5 net) oil sands evaluation ("OSE") wells. OSE wells are typically 300 to 400 meters deep, drilled to evaluate the oil sand resource and then abandoned. Oil sand production will come from 800 meter long horizontal Steam Assisted Gravity Drainage ("SAGD") well pairs.

During 2005 Paramount formed a joint venture with North American Oil Sands Corporation ("NAOSC") to find, develop, produce and market jointly-held bitumen resources in the central Athabasca oil sands area. In 2006, the Joint Venture expects to drill 150 OSE wells and shoot 132 miles of 2D and 25 square miles of 3D seismic. Paramount expects that this commercial delineation program will lead to an application to the Alberta Energy and Utilities Board in the second quarter of 2006 for a 10,000 Bbl/d oil sands in-situ development. Steam start-up is expected in late 2008.

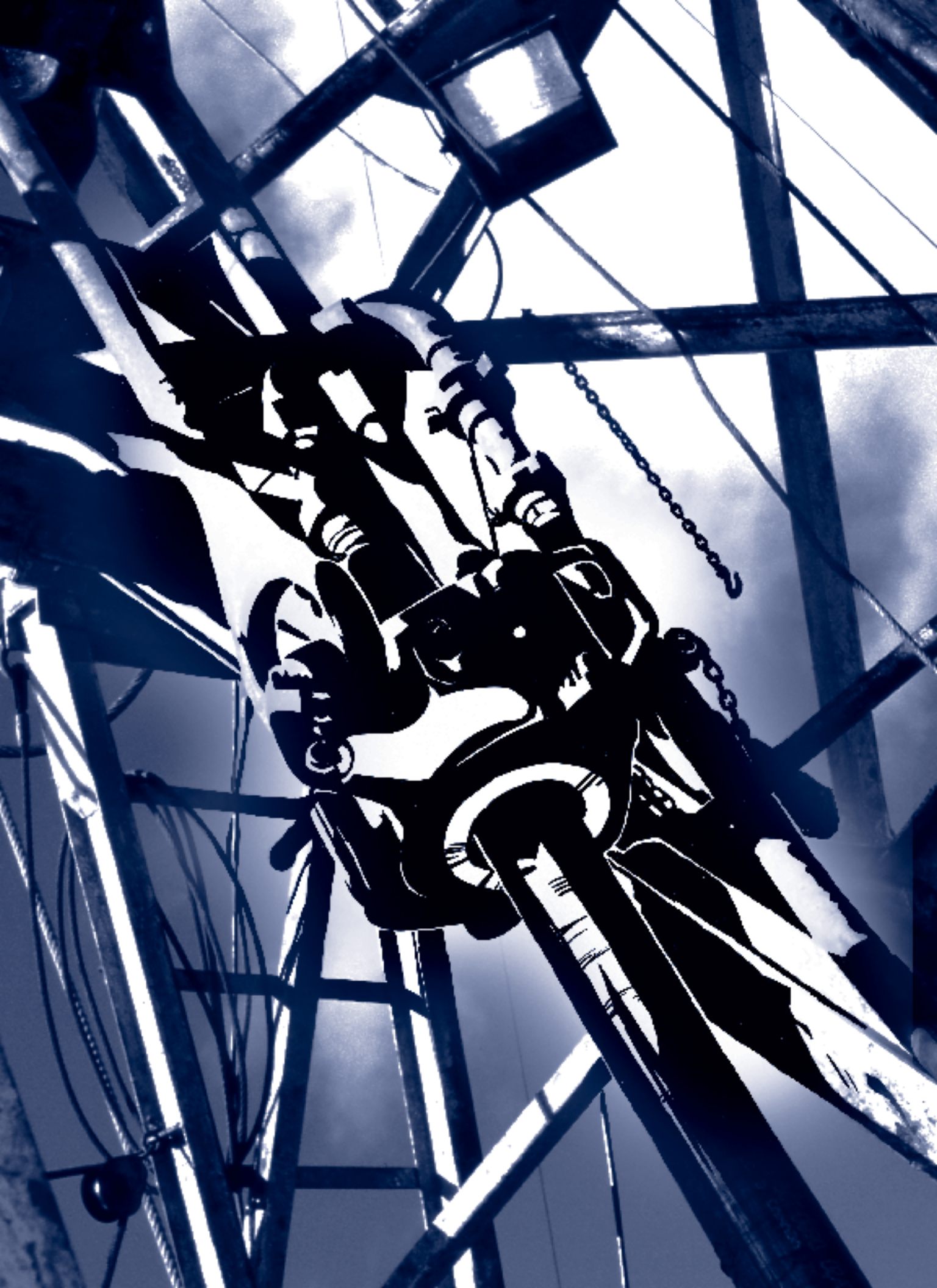
In January of 2006, Paramount released its independent engineers' assessment of the Company's oil sands resource. Paramount currently estimates a SAGD recoverable oil sands resource of between 0.9 billion and 1.6 billion barrels of heavy oil. This estimate includes both resources held, in the Joint Venture and resources attributed to Paramount's 100% owned oil sands leases in the Surmont area of Alberta. Please refer to Paramount's press release of January 18, 2006.

Paramount's 2006 oil sands capital program includes planned expenditures of \$70 million, although weather and equipment availability may inhibit completion of the full program and thus lower capital expenditures.

Gas sales volumes in northeast Alberta averaged 3.1 MMcf/d in 2005, a 94 percent increase over 2004 average gas sales volumes of 1.6 MMcf/d. This increase is primarily a result of the GRIPE project start-up, outlined in the next paragraph.

During late 2005, production increased with the start-up of the gas re-injection and production experiment ("GRIPE") undertaken at the Paramount's Surmont property in northeast Alberta. This experiment is designed to test whether exhaust gas injection can maintain pressure in a gas-over-bitumen zone during production. Paramount believes this would allow the eventual return to production of the majority of the shut-in gas-over-bitumen resource. The experimental pilot has averaged over 90 percent up-time since injection was started and there has been no evidence of pressure decline or nitrogen breakthrough to date. With continued positive performance, Paramount expects to commence conceptual design of a commercial follow-up in late 2006.

Average Northeast Alberta production for 2006 is estimated to be 500 Boe/d.



# REVIEW OF OPERATIONS

## PRODUCTION

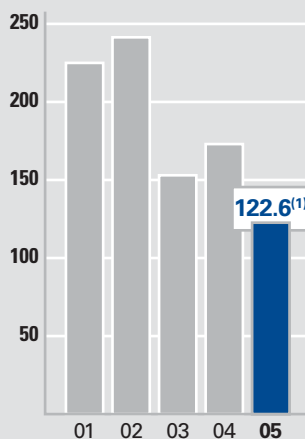
The successful completion of the Trilogy Spinout resulted in Paramount's transfer of properties producing approximately 25,100 Boe/d at the time of the Trilogy Spinout to Trilogy effective April 1, 2005. As a result, reported year-over-year average sales volumes decreased to 24,888 Boe/d in 2005 as compared to 36,150 Boe/d in 2004. Excluding the results attributable to the Spinout Assets, Paramount's 2005 sales volumes averaged 18,676 Boe/d, an 18 percent increase over 2004 average sales volumes of 15,862 Boe/d.

Excluding the results attributable to the Spinout Assets, Paramount's 2005 natural gas sales volumes averaged 92.7 MMcf/d, a 24 percent increase over 2004 average natural gas sales volumes of 74.8 MMcf/d. This increase is primarily a result of Paramount's capital program, including asset acquisitions in the latter part of 2004, successful drilling leading to the tie in of new conventional gas wells, the success of Paramount's coal bed methane drilling program, and facility construction in southern Alberta.

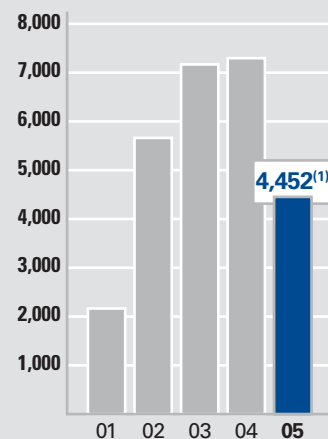
Excluding the results attributable to the Spinout Assets, Paramount's 2005 oil and natural gas liquids sales volumes averaged 3,231 Bbl/d, a five percent decrease from 2004 average oil and natural gas liquids sales volumes of 3,417 Bbl/d. This decrease is primarily a result of well declines, weather related delays and the disposition of oil producing properties in southeast Saskatchewan in the third quarter of 2004.

Paramount's 2005 production profile continued to be significantly weighted to natural gas. Excluding the results attributable to the Spinout Assets, natural gas sales volumes represented 83 percent of Paramount's 2005 average sales volumes as compared to 78 percent in 2004.

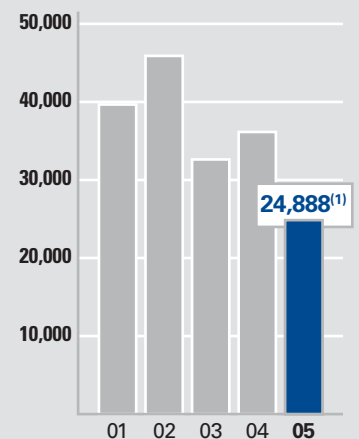
**NATURAL GAS SALES**  
(MMcf/d)



**CRUDE OIL and NATURAL GAS LIQUIDS SALES**  
(Bbl/d)



**TOTAL SALES**  
(Boe/d @ 6:1)



(1) As a result of the Trilogy Spinout, daily average sales volumes decreased during 2005 as compared to 2004.

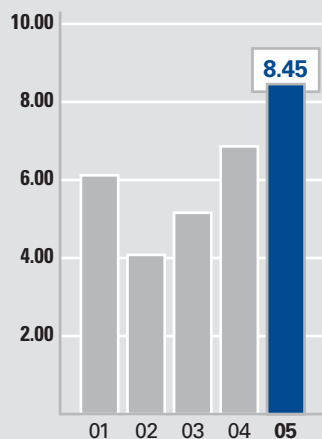
The following table highlights the Company's average sales volumes by Corporate Operating Unit for the years ended December 31, 2005 and December 31, 2004.

<b>Natural Gas Sales</b> (MMcf/d)	<b>2005</b>	2004	Change (%)
Kaybob <sup>(1)</sup>	<b>13.0</b>	6.7	94
Grande Prairie <sup>(1)</sup>	<b>16.8</b>	18.2	(8)
Northwest Alberta / Cameron Hills	<b>24.7</b>	20.2	22
Northwest Territories / Northeast British Columbia	<b>23.3</b>	16.2	44
Southern	<b>12.9</b>	10.8	19
Other	<b>2.0</b>	2.7	(26)
Subtotal	<b>92.7</b>	<b>74.8</b>	<b>24</b>
Spinout Assets <sup>(2)</sup>	<b>29.9</b>	98.3	(70)
<b>Total</b>	<b>122.6</b>	173.1	(29)
<b>Crude Oil &amp; Natural Gas Liquids Sales</b> (Bbl/d)			
Kaybob <sup>(1)</sup>	<b>474</b>	217	118
Grande Prairie <sup>(1)</sup>	<b>393</b>	585	(33)
Northwest Alberta / Cameron Hills	<b>868</b>	797	9
Northwest Territories / Northeast British Columbia	<b>14</b>	12	17
Southern	<b>1,469</b>	1,798	(18)
Other	<b>13</b>	8	63
Subtotal	<b>3,231</b>	<b>3,417</b>	<b>(5)</b>
Spinout Assets <sup>(2)</sup>	<b>1,221</b>	3,880	(69)
<b>Total</b>	<b>4,452</b>	7,297	(39)
<b>Total Sales</b> (Boe/d)			
Kaybob <sup>(1)</sup>	<b>2,635</b>	1,340	97
Grande Prairie <sup>(1)</sup>	<b>3,186</b>	3,621	(12)
Northwest Alberta / Cameron Hills	<b>4,976</b>	4,165	19
Northwest Territories / Northeast British Columbia	<b>3,892</b>	2,710	44
Southern	<b>3,622</b>	3,596	1
Other	<b>365</b>	430	(15)
Subtotal	<b>18,676</b>	<b>15,862</b>	<b>18</b>
Spinout Assets <sup>(2)</sup>	<b>6,212</b>	20,288	(69)
<b>Total</b>	<b>24,888</b>	36,150	(31)

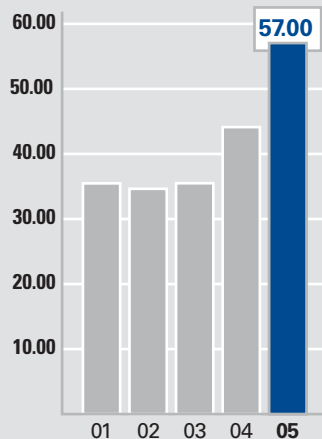
(1) Excludes daily production from the Spinout Assets.

(2) Daily sales volumes for 2005 are computed by dividing total sales volumes from the Spinout Assets for the three months ended March 31, 2005 by 365 days.

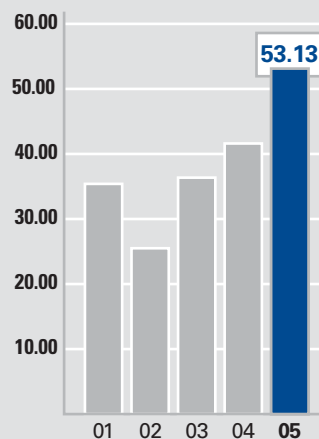
**NATURAL GAS PRICE**  
(after realized gains and losses  
on financial instruments)  
(\$/Mcf)



**CRUDE OIL and NATURAL GAS LIQUIDS PRICE**  
(after realized gains and losses  
on financial instruments) (\$/Bbl)



**GROSS REVENUE**  
(\$/Boe)





**PROFITABILITY**

Paramount continues to focus its effort on the control of factors directly related to profitability. Production volumes, operating costs, general and administrative costs, and capital spending are all factors that are within our control and remain closely monitored. The mandate of every employee is to turn ideas into value. This strategy has continued to result in a history of increased shareholder value.

**NATURAL GAS AND CRUDE OIL PRICES**

Paramount’s 2005 average price for natural gas before financial instruments was \$8.61/Mcf, a 17 percent increase over the 2004 average price of \$7.35/Mcf. Paramount’s 2005 average price for natural gas after realized gains and losses on financial instruments was \$8.45/Mcf, a 13 percent increase over the 2004 figure of \$7.49/Mcf.

Paramount’s 2005 average price for oil and Natural gas liquids before financial instruments was \$60.01/Bbl, a 26 percent increase over the 2004 figure of \$47.55/Bbl. Paramount’s 2005 average price for oil and natural gas liquids after realized gains and losses on financial instruments was \$57.00/Bbl, a 27 percent increase over the 2004 figure of \$44.88/Bbl.

**OPERATING COSTS**

Including the results attributable to the Spinout Asset, operating costs on a per unit-of-production basis averaged \$8.76/Boe, a 13 percent increase from the 2004 figure of \$7.75/Boe. There was a general increase in the cost of good and services in the energy industry in 2005 which was partially responsible for the increase in costs. Higher commodity prices in 2005 increased activity in the industry, creating shortages of equipment and premium costs for guaranteed availability.

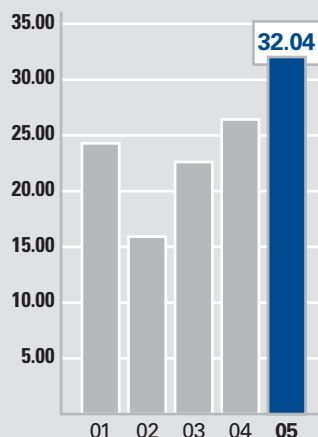
**ROYALTIES**

Royalties were lower at \$91.2 million in 2005 as compared to \$105.0 million in 2004 as a result of the Trilogy Spinout, partially offset by an increase in the average royalty rate. As a percentage of petroleum and natural gas sales, royalties were 18.9 percent in 2005 compared to 17.8 percent in 2004. The increase in royalties as a percentage of sales is due mainly to increased royalties in the Northwest Territories.

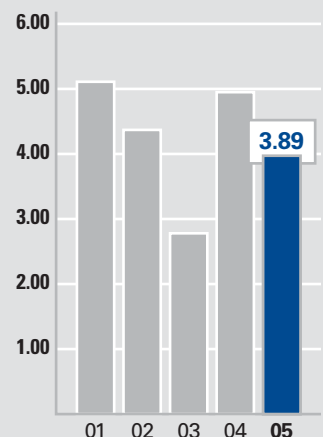
**GENERAL AND ADMINISTRATIVE COSTS**

General and administrative expenses, net of operating recoveries, increased to \$86.1 million in 2005 as compared to \$66.4 million in 2004 due mainly to the increase in stock-based compensation expense. Non-cash stock-based compensation expense was recognized to reflect the change in the intrinsic value of outstanding stock options as a result of the significant appreciation in the market price of Paramount’s common shares and Trilogy trust units during 2005.

**OPERATING NETBACK**  
(\$/Boe)



**CASH FLOW PER SHARE**  
(\$/share, basic)



## NET CAPITAL EXPENDITURES

Net capital expenditures totaled \$423.3 million in 2005, a decrease of 27 percent over net capital expenditures in 2004 of \$576.4 million.

Capital Expenditures (\$ millions)	2005	2004
Land	\$ 54.0	\$ 37.9
Geological and geophysical	12.5	8.7
Drilling	254.1	184.5
Production equipment and facilities	87.8	85.2
Exploration and development expenditures	408.4	316.3
Property acquisitions	24.2	322.6
Proceeds received on property dispositions	(10.6)	(61.9)
Other	1.5	(0.6)
Net capital expenditures	\$ 423.3	\$ 576.4

## LAND

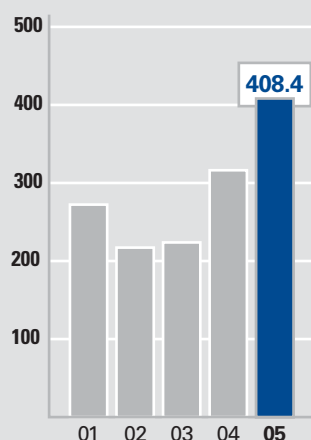
Paramount's land inventory at December 31, 2005 totaled 3,412 thousand net acres, a 16 percent decrease compared to 4,082 thousand net acres reported last year. This decrease is primarily a result of the Trilogy Spinout. Undeveloped land decreased 13 percent from 3,442 thousand net acres to 2,979 thousand net acres on December 31, 2005.

The following table summarizes the Company's land position at December 31, 2005.

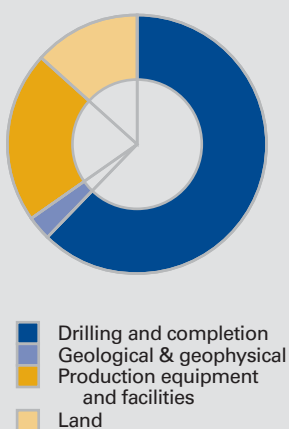
Land (thousands of acres)	2005			2004		
	Gross	Net	Average Working Interest	Gross	Net	Average Working Interest
Land assigned reserves	752	433	58%	1,098	640	58%
Undeveloped land	5,031	2,979	59%	5,536	3,442	62%
Total	5,783	3,412	59%	6,634	4,082	62%
Appraised value of undeveloped land <sup>(1)</sup> (\$millions)	\$ 159.5			\$ 185.4		

(1) Based on McDaniel Summary of Acreage evaluation.

### EXPLORATION and DEVELOPMENT EXPENDITURES (\$ millions)



### 2005 EXPLORATION and DEVELOPMENT EXPENDITURES \$423.3 MILLION



## DRILLING

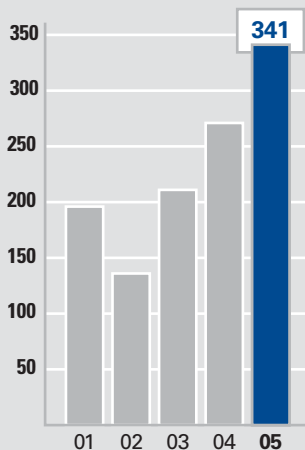
Paramount participated in the drilling of 341 (171.5 net) wells in 2005 with a gross success rate of 95 percent. This total includes wells that were drilled in the first quarter of 2005 that were subsequently part of the Spinout Assets. A large part of the drilling activity in 2005 was concentrated in the Southern Operating Unit which drilled 153 (64.8) net wells, including 70 (41.7 net) coal bed methane gas wells. The Kaybob Operating Unit drilled 65 (30.0 net) wells, the Grande Prairie Operating Unit drilled 47 (36.9 net) wells, the Northwest Alberta/Cameron Hills, Northwest Territories Operating Unit drilled 27 (15.8 net) wells; and the Liard, Northwest Territories/Northeast British Columbia Operating Unit drilled 13 (9.5 net) wells. The Company also participated in the drilling of 35 (14.0 net) oil sands wells and 1 (0.5 net) gas well in northeast Alberta.

The following table summarizes the drilling activity for the year ended December 31, 2005.

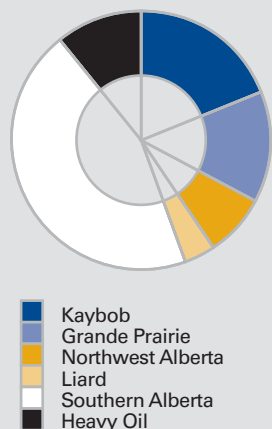
	2005				2004			
	Development		Exploration		Development		Exploration	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Gas	185	86.6	88	51.7	164	102.8	65	42.8
Oil	16	7.8	2	1.0	11	8.6	1	0.9
D&A	5	2.0	10	8.4	9	4.9	4	3.3
Oil Sands	35	14.0	-	-	17	17.0	-	-
Total	241	110.4	100	61.1	201	133.3	70	47.0
Total All Wells	341	171.5			271	180.3		
Success (gross) <sup>(1)</sup>	95%				95%			

(1) Success rate excludes oil sands wells.

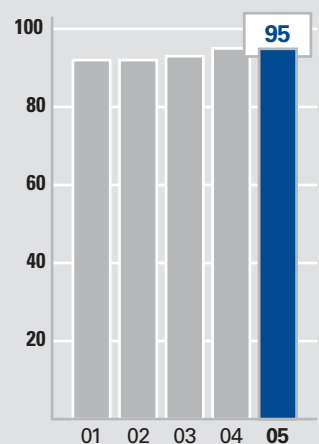
**WELLS DRILLED**  
(gross)



**DRILLING DISTRIBUTION**  
341 WELLS



**DRILLING SUCCESS RATE**  
(gross) (%)



## RESERVES

Paramount's reserves for the year ended December 31, 2005 were evaluated by McDaniel and Associates Consultants Ltd. ("McDaniel"). Paramount's reserves have been prepared in accordance with the National Instrument 51-101 definitions, standards and procedures.

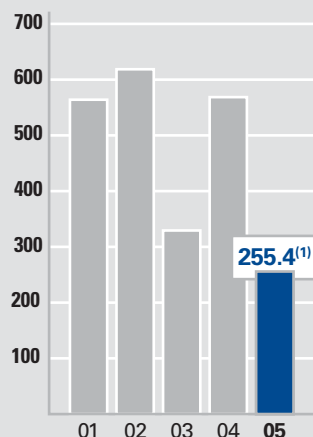
The following table summarizes the gross reserves for the year ended December 31, 2005 using forecast prices and cost:

Reserve Category <sup>(1)</sup>	Gross Proved and Probable Reserves <sup>(1)</sup>				Before Tax Net Present Value <sup>(1)</sup> (\$ millions)		
	Natural Gas	Light and Medium Crude Oil	Natural Gas Liquids	Boe	Discount Rate		
	(Bcf)	(MBbl)	(MBbl)	(MBoe)	0%	5%	10%
Canada							
Proved							
Developed Producing	77.6	1,606	675	15,215	525.4	464.4	422.5
Developed Non-Producing	37.3	342	299	6,861	190.4	156.2	133.1
Undeveloped	18.5	308	50	3,437	89.4	57.5	40.7
Total Proved	133.4	2,256	1,024	25,513	805.2	678.1	596.2
Probable	121.3	1,220	485	21,928	610.8	465.5	372.7
Total Proved Plus Probable Canada	254.7	3,476	1,508	47,441	1,416.0	1,143.7	969.0
United States							
Proved							
Developed Producing	0.5	2,272	112	2,471	57.1	48.7	42.6
Developed Non-Producing	-	-	-	-	(0.4)	(0.3)	(0.3)
Undeveloped	-	-	-	-	-	-	-
Total Proved	0.5	2,272	112	2,471	56.7	48.4	42.4
Probable	0.2	611	38	678	16.2	11.6	8.9
Total Proved Plus Probable US	0.7	2,883	149	3,149	72.9	60.0	51.3
Total Proved	133.9	4,528	1,135	27,984	861.9	726.5	638.6
Total Probable	121.5	1,831	522	22,606	627.0	477.2	381.6
Total Reserves	255.4	6,359	1,657	50,590	1,488.9	1,203.7	1,020.2

(1) Columns and rows may not add due to rounding.

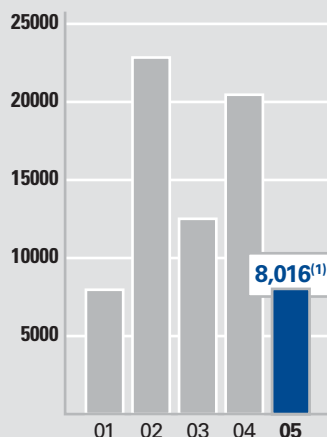
### NATURAL GAS RESERVES

PROVED and PROBABLE  
(gross before royalties) (Bcf)



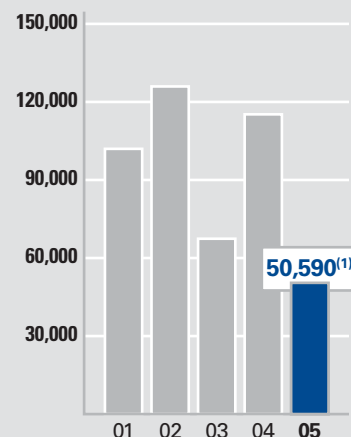
### CRUDE OIL AND NATURAL GAS LIQUID RESERVES

PROVED and PROBABLE  
(gross before royalties) (MBbl)



### RESERVES

PROVED and PROBABLE  
(gross before royalties) (MBoe)



(1) As a result of the Trilogy Spinout total proved and probable reserves decreased 61,987 MBoe.

## RESERVE RECONCILIATION

Total proved reserves at December 31, 2005 were approximately 134 Bcf of natural gas and 6 MMBbl of oil and natural gas liquids (28 MMBoe) and proved plus probable reserves were 255 Bcf of natural gas and 8 MMBbl of oil and natural gas liquids (51 MMBoe). On a barrel of oil equivalent basis, proved plus probable reserves decreased approximately 56 percent or 65 MMBoe over year end 2004. The majority of the change to Paramount's proved plus probable reserves was due to the divestment of the Spinout Assets. The Company's new reserves and extensions to existing proved plus probable reserves totaled 10.6 MMBoe.

The following table sets forth the reconciliation of Paramount's gross reserves for the year ended December 31, 2005, as evaluated by McDaniel using forecasted prices and costs. Gross reserves include working interest reserves before royalties.

### Reserves (Company share before royalty)<sup>(1)</sup>

	Proved Reserves			Probable Reserves			Proved & Probable Reserves		
	Gas	Oil & NGL	Boe	Gas	Oil & NGL	Boe	Gas	Oil & NGL	Boe
	Bcf	MBbl	MBoe	Bcf	MBbl	MBoe	Bcf	MBbl	MBoe
Total Reserves Jan 1, 2005	347.2	15,041	72,910	221.4	5,420	42,318	568.6	20,460	115,228
Total 2005 Divestments <sup>(2)</sup>	(199.4)	(9,213)	(42,454)	(95.4)	(3,648)	(19,532)	(294.8)	(12,861)	(61,986)
Total 2005 Acquisitions <sup>(2)</sup>	0.6	20	117	0.3	8	55	0.9	28	172
2005 Capital Program									
Additions <sup>(2)</sup>	33.7	875	6,495	21.0	578	4,074	54.7	1,453	10,570
Total 2005 Production	(44.8)	(1,625)	(9,084)	-	-	-	(44.8)	(1,625)	(9,084)
Technical Revisions <sup>(2)</sup>	(3.4)	566	-	(25.8)	(6)	(4,313)	(29.2)	560	(4,310)
Total Reserves Dec 31, 2005	133.9	5,663	27,984	121.5	2,353	22,606	255.4	8,016	50,590

(1) Columns and rows may not add due to rounding.

(2) Paramount estimates.

## FINDING AND DEVELOPMENT COSTS

Paramount has calculated the capital associated with its 2005 reserve additions and as such has excluded certain capital expenditures. The calculation excluded \$47.4 million of expenditures from the finding and development cost calculation associated with the exploration at Colville Lake and the evaluation of oil sands assets. This capital will be included in the finding and development calculation during the year in which reserves are first booked for Colville Lake and oil sands by Paramount. In addition, capital was reduced by \$30.0 million to reflect the net increase in the value of our undeveloped acreage inventory. The finding and development cost calculation also included a negative change of \$1.1 million in future capital. Paramount's finding and development costs were calculated to be \$43.49/Boe for proved reserves and \$45.31/Boe for proved plus probable reserves. Excluding the negative reserve revisions in West Liard, finding and development costs would have been \$30.89/Boe for proved results and \$25.57/Boe for proved plus probable reserves. Finding and development costs for 2004 were \$13.57/Boe on a proved basis and \$9.48/Boe on a proved plus probable basis.

### Finding and Development Capital

#### 2005 Working Interest Capital Expenditures<sup>(1)</sup>

(\$ millions)	2005 Capital	Future Capital New Additions		Total F&D Capital	
		Proved	Proved Plus Probable	Proved	Proved Plus Probable
Land	51.1	-	-	51.1	51.1
Seismic	10.3	-	-	10.3	10.3
Exploration and development	225.7	(2.6)	(1.2)	223.1	224.5
Facilities	72.5	1.5	1.2	74.0	73.7
Total net capital expenditures	359.6	(1.1)	-	385.5	359.6
Less 2005 increase in undeveloped land	30.0	-	-	30.0	30.0
Less 2005 Colville expenditures	(34.1)	-	-	34.1	34.1
Less 2005 disposition properties	(13.3)	-	-	13.3	13.3
<b>2005 F&amp;D net capital expenditures</b>	<b>282.2</b>	<b>(1.1)</b>	<b>-</b>	<b>281.1</b>	<b>282.2</b>

(1) Excludes capital expenditures relating to the Spinout Assets for the quarter ended March 31, 2005.

## PRE-TAX NET ASSET VALUE

The following table provides an estimate of Paramount's pre-tax net asset value as of December 31, 2005.

<b>Pre-tax Net Asset Value</b> (\$ millions as at December 31)	<b>2005</b>
Present value of appraised reserves <sup>(1)</sup>	\$ 1,020.2
Appraised value of undeveloped land <sup>(2)</sup>	159.5
Seismic (at cost)	66.6
Projects under evaluation (at cost) <sup>(3)</sup>	119.5
Present value of best estimate oil sands resources <sup>(4)</sup>	1,176.0
Market value of short-term investments <sup>(5)</sup>	16.2
Market value of long-term investments <sup>(6)</sup>	358.4
Other	17.4
<b>Total assets</b>	<b>2,933.8</b>
Bank loans	105.5
Senior notes	248.4
Working capital deficiency <sup>(7)</sup>	84.7
Long-term portion of stock-based compensation liability <sup>(8)</sup>	4.1
Minority interest	1.3
<b>Total liabilities</b>	<b>444.0</b>
<b>Pre-tax net asset value</b>	<b>\$ 2,489.8</b>
<b>Pre-tax net asset value per basic common share <sup>(9)</sup></b>	<b>\$ 37.60</b>

(1) Based on forecast price and costs and proved plus probable reserves discounted at 10 percent before income tax.

(2) Based on McDaniel Summary of Acreage Evaluation.

(3) 2005 excludes oil sands wells and wells with probable reserves.

(4) Based on GLJ Petroleum Consultants Ltd. and McDaniel & Associates Consultants Ltd. best estimate discounted at 10 percent before income taxes.

(5) Based on period end closing prices on the Toronto Stock Exchange prices for publicly traded investment and the book value for the remaining short-term investments.

(6) Based on the closing price of Trilogy trust units on the Toronto Stock Exchange of \$23.80 per trust unit on December 30, 2005 and the book value for the remaining long-term investments.

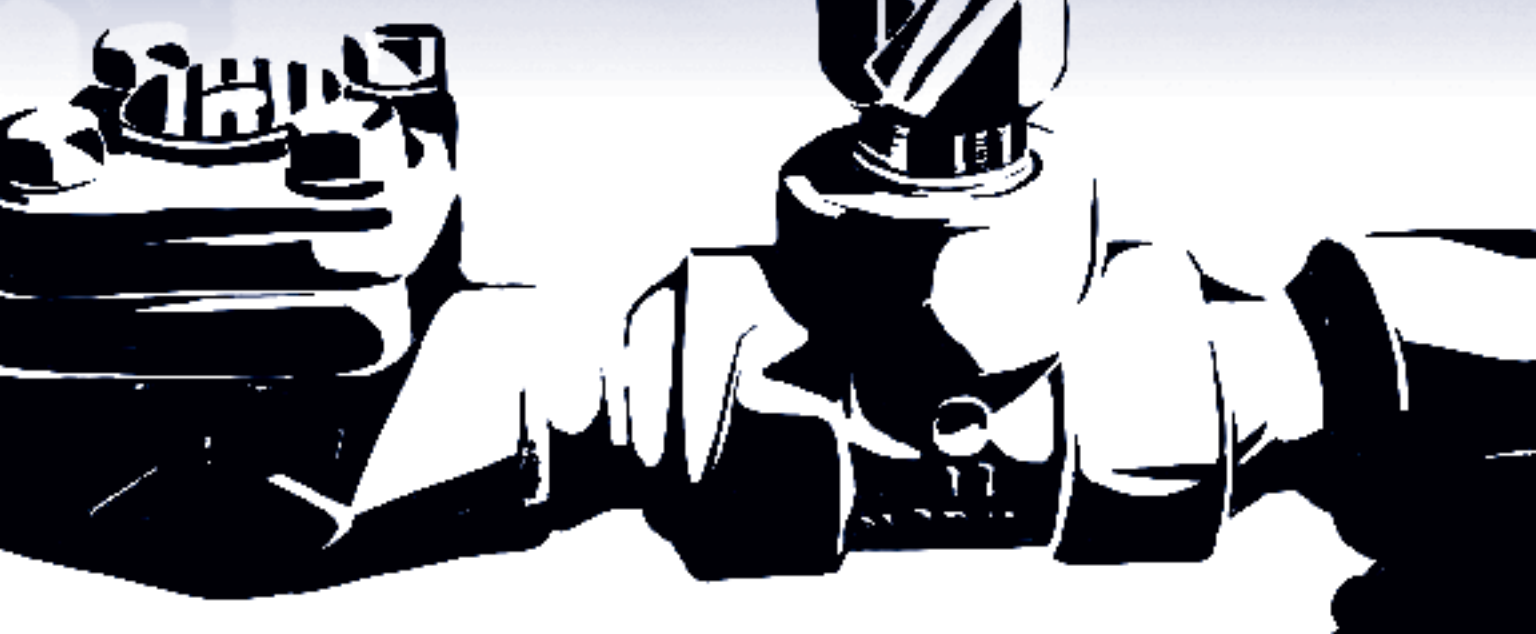
(7) Excludes short-term investments but includes current portion of stock based compensation liability.

(8) Since August 2005, Paramount has generally declined an optionholder's request for a cash payment relating to vested Paramount Options, thereby necessitating optionholders to exercise their vested Paramount Options, and to pay the aggregate exercise price of their stock option to Paramount as consideration for the issuance by Paramount of Common Shares. Paramount expects that this will continue. As a result, the stock-based compensation liability associated with Paramount Options amounting to \$46.6 million has been excluded from the long-term portion of stock-based compensation liability.

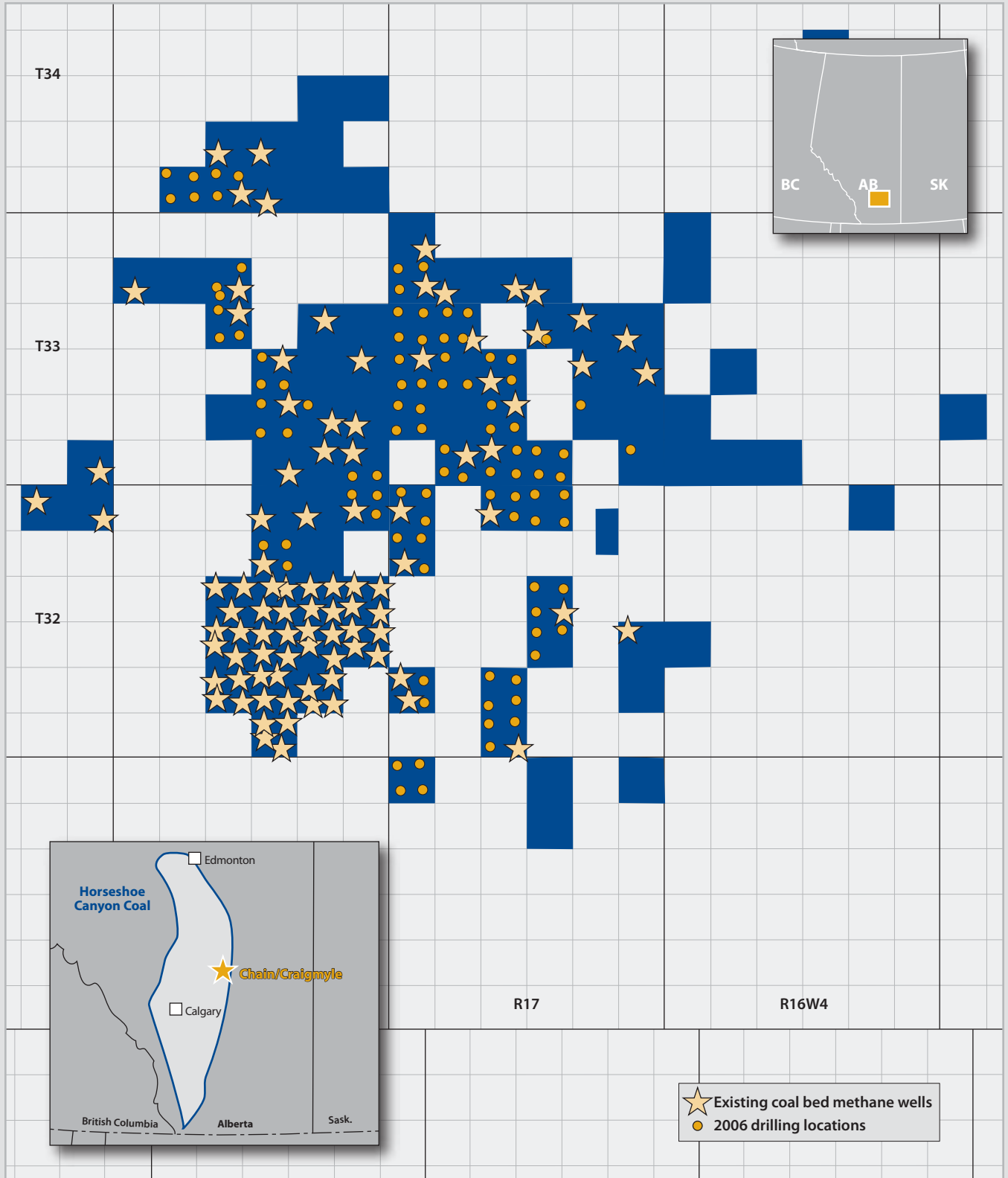
(9) Outstanding shares: December 31, 2005 - 66,221,675 (December 31, 2004 - 63,185,600)

## NOTES TO PRE-TAX NET ASSET VALUE

- The December 31, 2005 reserve value was determined by McDaniel, using their forecast prices and cost case.
- No value has been assigned to tangible assets other than those associated with proved producing reserves and surplus inventory.
- Paramount's financial instruments, which extend past December 31, 2005, have not been valued by McDaniel. However, the mark-to-market values of financial instruments at December 31, 2005 have been included in the working capital deficiency.
- Reserve values have been evaluated under a blow-down scenario.



**COAL BED METHANE – southern Alberta**





# AREAS OF INTEREST

## **COAL BED METHANE: from idea to production**

Paramount Resources is into its second year of development drilling in the Horseshoe Canyon coal bed methane ("CBM") play in the Chain/Craigmyle region of southern Alberta. Our entry into the play occurred in early 2003, when we air drilled through the Horseshoe Canyon coals as we were drilling to a deeper gas bearing sand target. During this operation, our well produced dry natural gas at a rate of twenty five thousand cubic feet per day from the coal beds.

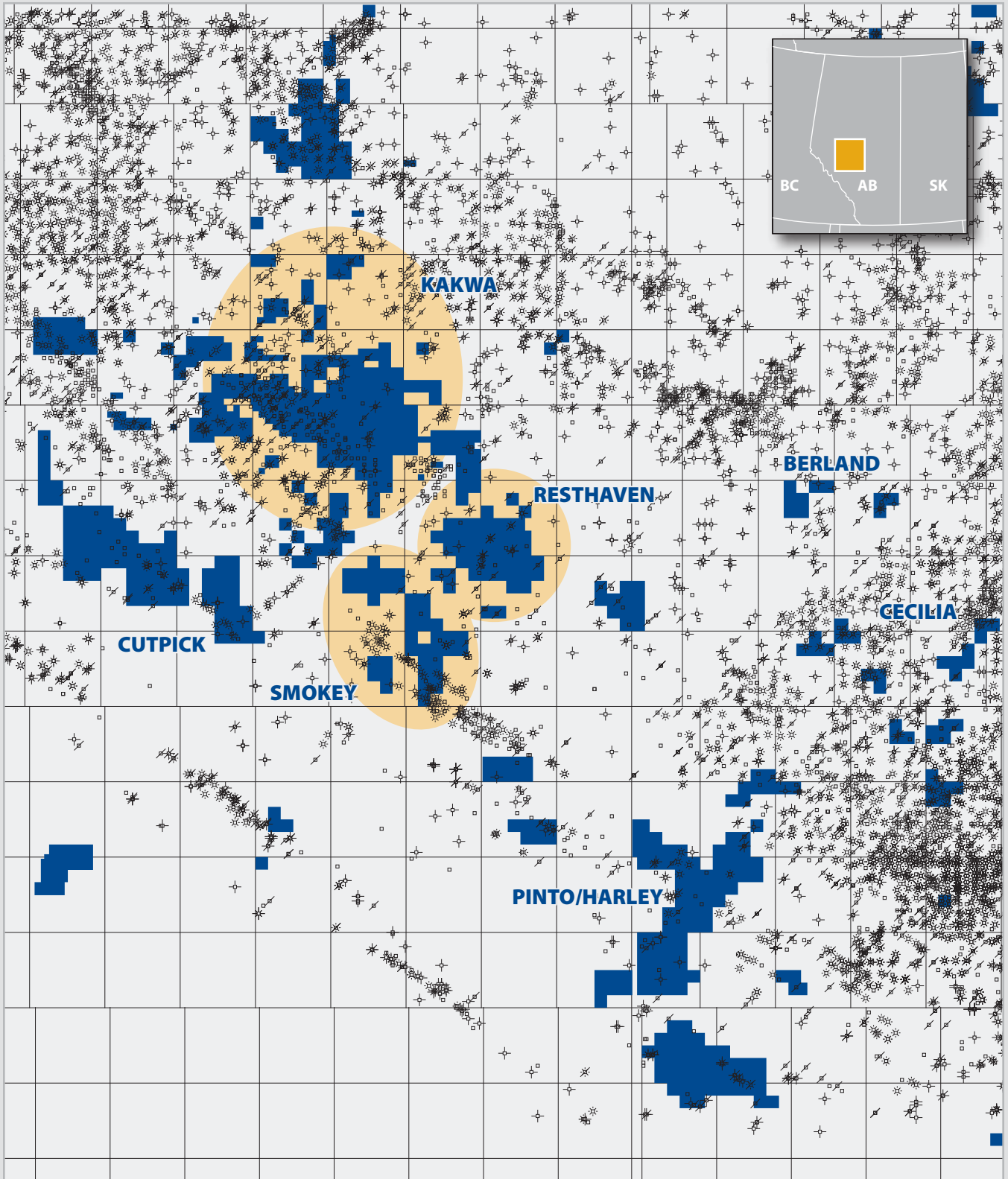
We found this of academic interest, and decided that before we could proceed on this play, we needed a better understanding of the relevant economics. We were able to gain experience and knowledge of this reservoir by participating in a non-operated 3 (0.5 net) well drilling program. At the same time we completed 2 (2 net) existing shut-in well bores for production out of the Horseshoe Canyon coals. All 5 (2.5 net) of these operations proved successful; with proper stimulation, drilling the coal beds could be an economically positive venture.

By the end of 2004, we embarked on a 20 (14 net) well drilling program to see how much of our acreage was prospective. A minor issue we were realizing was that the target coal beds can occur at depths that were shallower than the the surface casing in most of our existing wells. In drilling and completing these wells, it became apparent that the coals in our area are gas saturated starting from around 80 meters to about 350 meters.

The drawback we found was that the pressure in the shallowest coals, which we discovered to be the most permeable, was only approximately 30 pounds per square inch. We needed to be able to draw the pressure down during production to close to one third of that pressure to produce the gas from the coal at full potential. Our production system, on the other hand, could only flow down to a minimum pressure of approximately nineteen pounds per square inch. Thus, to produce this gas we had to build a completely new gathering system capable of producing below ten pounds per square inch at the well head.

In 2005 using what we learned over the past two years, we drilled 83 (55 net) new wells for Horseshoe Canyon CBM, and built a low pressure gathering system utilizing large diameter pipelines, central compression and group metering to produce this gas; in keeping with the production methods we pioneered 27 years ago producing the low pressure shallow gas in northeast Alberta. The reason for using large central compressors is multifold. The compressors were placed on existing sites and upgraded to incorporate the latest sound engineering to minimize the visual as well as aural impacts on the surrounding community. By not relying on wellhead compressors, we expect to reduce our capital and operating costs, and keep man-hour requirements of our operating staff to a minimum. By utilizing group metering, each individual well is measured once per month by a mobile test unit, thus keeping the well sites as small as possible, and limiting up front capital costs. As of December 31, 2005, 39 (22 net) wells were tied in and producing an average of 100 Mcf/d per well. Tie in work will continue in the second quarter of 2006, and we will be drilling a further 100 (72 net) development wells on our lands through the remainder of the year. We also anticipate expanding the low pressure gathering system with two new compressors being fed by two new large diameter pipeline legs.

**KAYBOB – central Alberta**



# AREAS OF INTEREST

## KAYBOB CORPORATE OPERATING UNIT

Over the past three years Paramount has been dedicating an increasing amount of capital and human resources to this area. The capital budget has doubled each year since we first became active in 2003. The 2006 capital budget has been set at \$160–\$180 million to drill approximately 80 (40 net) wells, targeting all formations down to the Cadomin.

There are numerous producing formations from the Cadomin up to the Cardium in this area. The depositional environments for these formations are such that the reservoirs can be stacked vertically so that a well drilled in this area has the potential to penetrate multiple hydrocarbon bearing sands. The majority of the deeper formations are set in a deep basin hydrodynamic environment; this means that the pore spaces in reservoir quality rocks are preferentially filled with natural gas instead of formation water. This reduces one of the risks typically found in a conventionally trapped reservoir, where there is a concern for water to be filling the pore space as opposed to natural gas. However, formations in the deep basin generally have lower permeability than reservoir rocks in conventionally trapped reservoirs which ultimately can affect the deliverability of the well; conversely, tight gas reservoirs will typically have a longer reserve life.

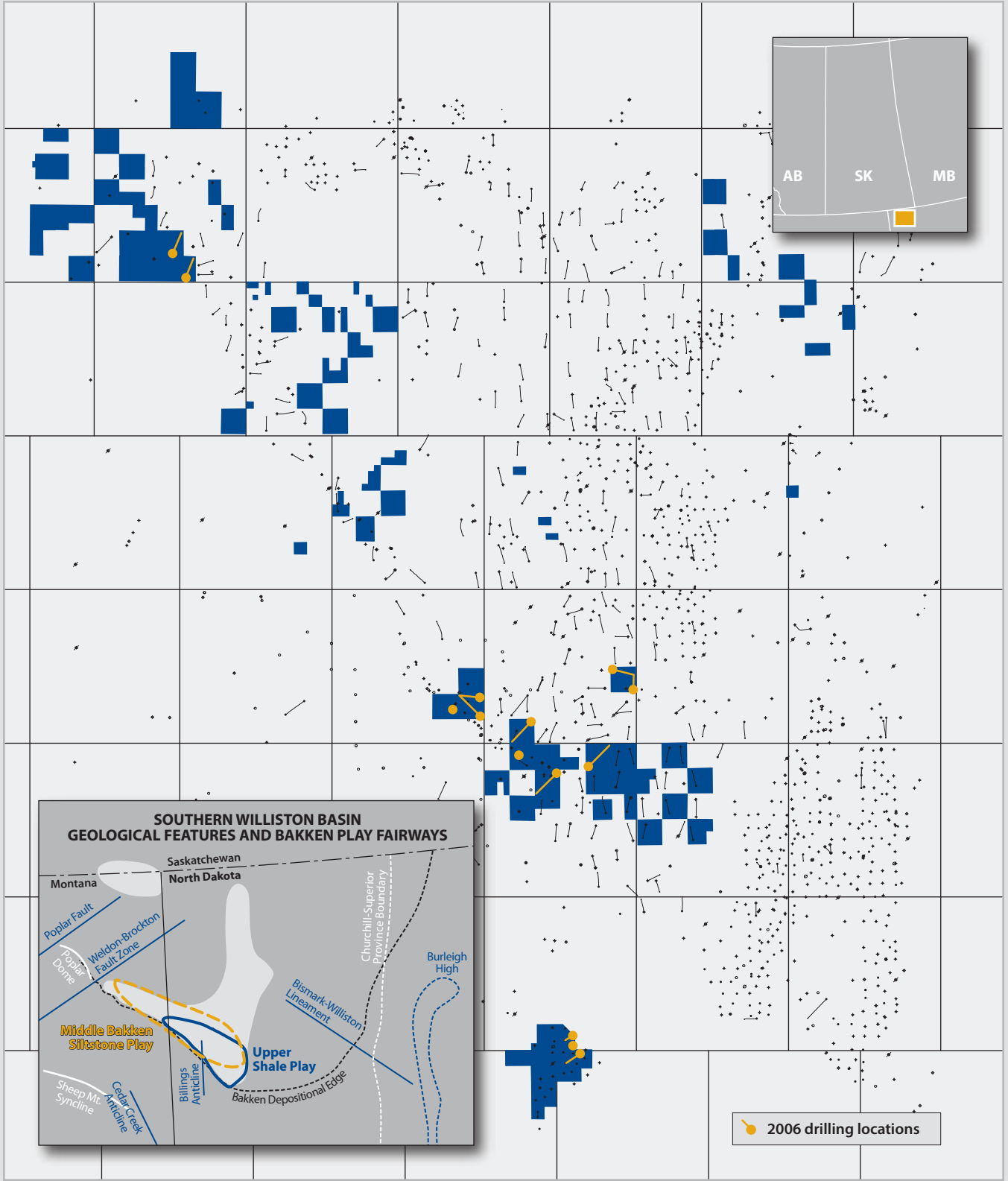
In the Kakwa area, Paramount has plans to participate in approximately 16 wells that will be targeting the Cardium, Cadotte, Falher and Gething formations. These wells are drilled to approximately 2,800 meters and cost approximately \$2 million to drill and case and up to \$2 million to complete and tie in, depending on the number of zones and proximity of the well to pipeline. Paramount and its partners have plans to add additional field compression to accommodate the increase in gas production from this region.

The Resthaven area has been extremely active this past winter and we expect to drill 17 wells throughout 2006. Plans are to replace the existing Resthaven gas plant with a new facility that is capable of handling up to 25 MMcf/d; Paramount will have a 50 percent interest in the new plant. These wells are around 3,200 meters in depth and the cost to drill, complete and tie in with a three zone completion can be up to \$7 million for a well that has reserve potential to be greater than 1 MMBoe.

The Smokey area has attracted a lot of attention recently due the land sale activity, that has seen land sale prices as high as \$6,000 per hectare. Paramount has high expectations for this area, as there are numerous Dunvegan, Falher and Gething sands that can contribute a significant amount of natural gas reserves per section. It is expected that this area will require down spacing to capture all of the resource from these tight gas reservoirs. Paramount will participate with a 10 percent working interest in the construction of a new gas plant that will be capable of producing up to 100 MMcf/d. Construction is expected to be completed by the end of the first quarter of 2006 and will allow for gas in this area to be produced without any significant production restrictions. Ultimate capacity of this plant could be increased to 300 MMcf/d if required.

There have been numerous challenges related to weather, rig availability and surface access that have forced us to be innovative in executing our business plan for this area. We feel that our experience in the area has given a competitive advantage and will allow us to exploit our large land base and create significant value for our shareholders.

**WILLISTON BASIN – North Dakota**



# AREAS OF INTEREST

## NORTH DAKOTA

The Williston Basin of North Dakota is one of the only underexploited basin capable of oil production in the continental United States. The activity in this basin started in the 1950s, and continued until the drop in the price of oil in 1986 made exploration uneconomic. Except for a brief flurry in 1989-90, the basin was quiet until very recently.

Geologically, the southern Williston Basin is an exciting place to be as there are many plays which can be very prolific. Most of the plays drilled to date are on or around deep basement structures which have several productive zones present in each well bore. Stratigraphically controlled plays have not been as important historically, but have gained relevance with the emergence of the prolific Middle Bakken and Birdbear plays.

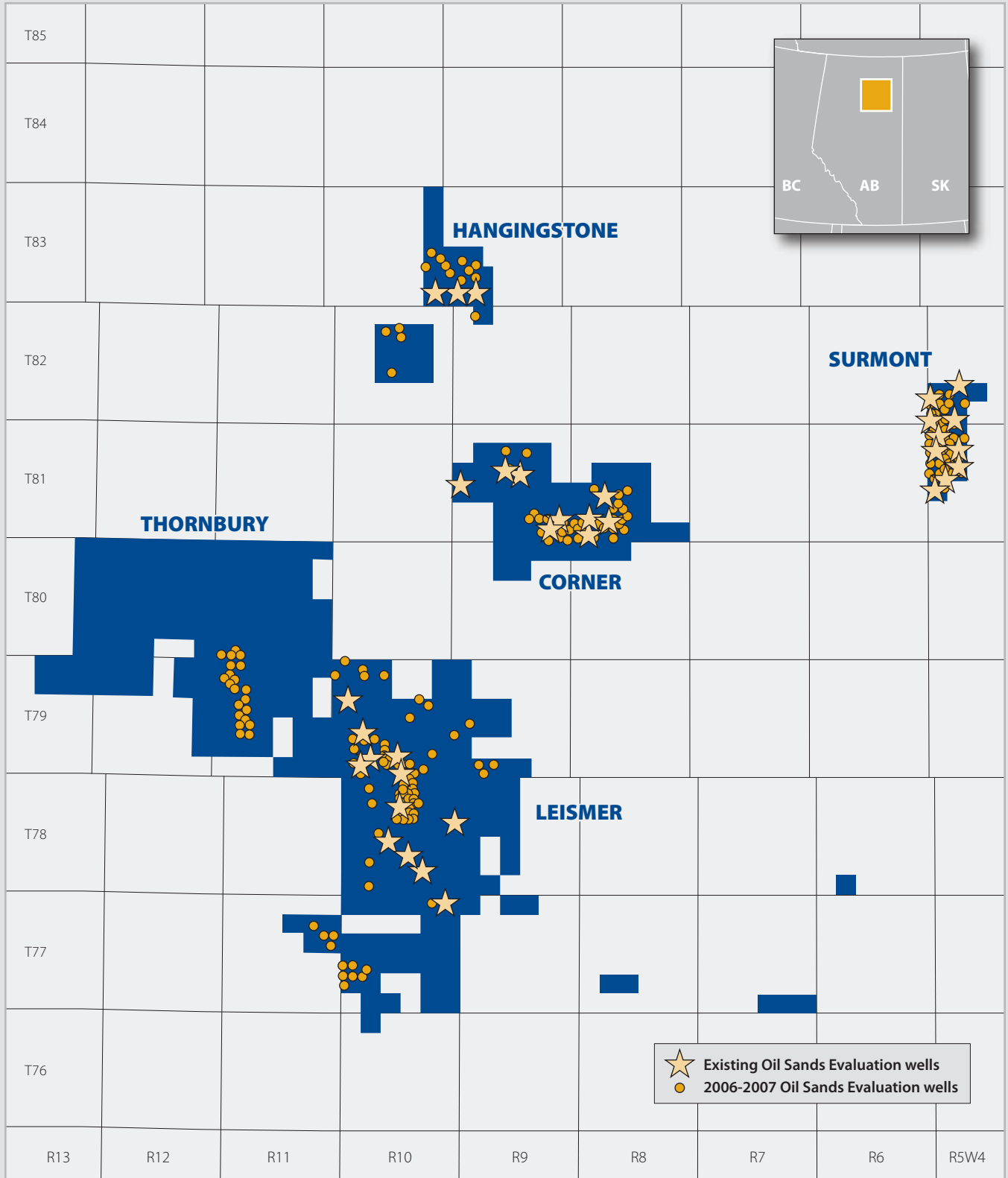
Logistics, however, are the challenge of the Williston Basin. There are not many rigs available which causes a slower pace of activity and the targets are deeper on average than just about anywhere on the continent, ranging in depth from 7000 feet to 14,000 feet. The oil market is dominated by local refinery interests giving a discount to NYMEX prices, and pipeline infrastructure has not been updated to keep pace with development.

Paramount gained entry into this region through the acquisition of Summit Resources Limited in 2002. Since that time we have worked to optimize our business in the state. Initially, we divested several underperforming assets and kept those with obvious upside opportunities. This year (2005) we intended to drill several new wells, but were stymied by the unavailability of drilling rigs. We were able to proceed with a modified program where we re-entered old existing well bores to drill 7 (2.2 net) horizontal wells in an emerging play utilizing a modified service rig. This play is in the upper Birdbear dolomite, a near shore carbonate reservoir which was deposited in a very warm hyper-saline environment, similar to the present day near shore deposits on the east coast of the Arabian Peninsula. The reservoir rock is very thin, with average pay thicknesses less than five feet, but it is very porous, exceeding 28 percent in some wells. Though located near some of the deep basement structures, a large stratigraphic component is present due to the thinness and variability of the reservoir. The wells drilled into this reservoir start production at rates averaging 300 Boe/d and will produce upwards of 250,000 Boe, giving an average rate of return exceeding 70 percent.

The other major play Paramount is targeting in North Dakota is for oil out of the Bakken formation. The Bakken is one of the most prolific source rocks known, and will charge any porous zones occurring nearby with light oil. The main reservoirs of interest occur within the Bakken interval and are either the middle sandstone or fractured Bakken shale. The sandstone play occurs along a broad fairway trending into North Dakota from Richland County in Montana. Horizontal wells in this zone have initial production rates ranging from 150 to 1,500 Boe/d, and will produce upwards of 250,000 barrels of light crude oil. The fractured shale play occurs near the deep basement structures, and displays similar rates and recoveries to the sand play.

Paramount will be drilling 9 of our 12 budgeted wells in North Dakota chasing one of these two plays. These wells take an average of one month to drill; we are planning to have two rigs working commencing the third quarter of 2006.

**OIL SANDS – northeast Alberta**



# AREAS OF INTEREST

## OIL SANDS

The Alberta oil sands are the largest known single deposit of hydrocarbons in the world, second in reserves only to Saudi Arabia. Oil sands are deposits of bitumen, a molasses-like viscous crude oil which will not flow unless heated or diluted with a solvent. The oil sands underlie 140,800 square kilometers in northeastern Alberta, an area larger than the state of Florida.

Paramount Resources has interest in over 237,440 acres (141,250 net acres), or 371 sections (221 net), of oil sands in the central Athabasca oil sands area. In Athabasca the recoverable bitumen is located in the Cretaceous McMurray sands of the Mannville group, of which the Company has extensive knowledge through previous gas exploration and production success. In 2004 and 2005 Paramount drilled 34 OSE wells to identify bitumen in place. The OSE wells are 300 to 500 meter deep vertical wells that are usually abandoned immediately after coring.

During 2005 the Company formed a Joint Venture with NAOSC to find, develop, produce and market jointly-held bitumen resources from the Leismer, Corner, Hangingstone and Thornbury areas. In 2006 the Joint Venture plans to drill 150 OSE wells and shoot 132 miles of 2D and 25 square miles of 3D seismic. We expect that this commercial delineation program will lead to an application to the Alberta Energy and Utilities Board in the second quarter of 2006 for a 10,000 Bbl/d oil sands in-situ development. Steam start-up is expected in late 2008. Successful results from the initial project will lead to a second 30,000 Bbl/d commercial project for start-up in 2009 or 2010. Paramount continues to hold 100 percent of the Surmont lease and plans to conduct a commercial delineation program there in early 2007.

In January of 2006, the Company released our independent engineers' assessment of the Company's oil sands resource. The Company currently estimates a SAGD recoverable resource of between 923 million and 1.6 billion barrels of bitumen. Ultimate net production levels for bitumen could exceed 100,000 Bbl/d.

The bitumen in the oil sands is essentially immobile at room temperature and is usually recovered through mining or in-situ thermal methods. Paramount plans to recover bitumen using SAGD. In SAGD two parallel 800 meter horizontal wells are drilled in at the bottom of the reservoir, one well situated five meters higher than the other. About 2,000 Bbl/d of steam is injected in the upper well, the bitumen is heated, and then drains by gravity into the lower well where it is produced at rates of approximately 750 Bbl/d.

Over the past decade the cost to produce bitumen has dropped dramatically through the development and application of new technologies. Technology development is exploration in the oil sands. The Company is pursuing technology development in two key areas to reduce operating costs and increase recovery. The first area of examination is the optimization of SAGD by varying pressures and combining steam with solvent. By altering pressures, steam oil ratios, a key measure of fuel costs, can be reduced by up to 15 percent from the forecast level of three barrels of water equivalent per barrel of oil. The addition of appropriate solvents, while in the conceptual design stage, would further improve recovery and costs.

Conventional SAGD plants use natural gas to generate the steam used to recover bitumen. The Company is committed to developing fuels other than natural gas for use in its commercial oil sands plants. During 2005, Paramount and partners conducted an alternate fuel research and development program that has led to the filing of a patent to burn an emulsion fuel manufactured with bitumen and to sequester the air emissions underground. The sequestration process also enables the recovery of additional bitumen as well as gas shut-in as a result of the gas over bitumen debate. The sequestration and recovery process is currently being piloted at the Company's Surmont Gas Re-Injection and Production Experiment.

# MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis ("MD&A") should be read in conjunction with Paramount's audited Consolidated Financial Statements for the year ended December 31, 2005, and Paramount's audited Consolidated Financial Statements and MD&A for the year ended December 31, 2004. The Consolidated Financial Statements have been prepared in Canadian dollars and in accordance with Canadian generally accepted accounting principles ("GAAP"). The effect of significant differences between Canadian GAAP and United States GAAP is disclosed in Note 19 of the Consolidated Financial Statements.

This MD&A contains forward-looking statements, non-GAAP measures, and disclosures of barrel of oil equivalent volumes. Readers are referred to the advisories concerning forward-looking statements, non-GAAP measures, and barrel of oil equivalent conversions contained under the heading "Advisories".

This MD&A is dated March 12, 2006. Additional information concerning Paramount, including its Annual Information Form, can be found on the SEDAR website at [www.sedar.com](http://www.sedar.com).

Paramount is an independent Canadian energy company involved in the exploration, development, production, processing, transportation and marketing of petroleum and natural gas. Paramount's principal properties are located in Alberta, the Northwest Territories and British Columbia in Canada. Paramount also has properties in Saskatchewan and offshore the East Coast in Canada, and in California, Montana and North Dakota in the United States. Management's strategy is to maintain a balanced portfolio of opportunities, to grow reserves and production in Paramount's core areas while maintaining a large inventory of undeveloped acreage, to focus on natural gas as a commodity, and to selectively enter into joint venture agreements for high risk/high return prospects.

## TRUST SPINOUT

On April 1, 2005, Paramount completed a reorganization pursuant to a plan of arrangement under the *Business Corporations Act* (Alberta), resulting in the creation of Trilogy Energy Trust ("Trilogy") as a new publicly-traded energy trust (the "Spinout").

Through the Spinout:

- Certain properties owned by Paramount that were located in the Kaybob and Marten Creek areas of Alberta, producing approximately 25,100 Boe/d at the time of the Spinout, and three natural gas plants operated by Paramount became the property of Trilogy (the "Spinout Assets");
- Paramount received an aggregate \$220 million in cash and 79.1 million trust units of Trilogy (64.1 million of such trust units ultimately being received by shareholders of Paramount – see below) as consideration for the Spinout Assets and related working capital adjustments;
- Paramount's shareholders received one Class A Common Share of Paramount and one trust unit of Trilogy for each Common Share of Paramount previously held, resulting in Paramount's shareholders owning 64.1 million (81 percent) of the 79.1 million issued and outstanding trust units of Trilogy, and Paramount holding the remaining 15.0 million (19 percent) of such Trilogy trust units; and
- Paramount transferred 2.3 million of the 15.0 million Trilogy trust units it held to a wholly-owned subsidiary ("Holdco"), being that number of Trilogy trust units equal to the number of Common Shares issuable pursuant to Paramount Options then outstanding.

Upon completion of the Spinout, shareholders of Paramount owned all of the issued and outstanding Class A Common Shares of Paramount.

Paramount's Consolidated Financial Statements for the year ended December 31, 2005 include the results of operations and cash flows of the Spinout Assets to March 31, 2005. Daily production from the Spinout Assets represented approximately 60 percent of Paramount's aggregate daily production as of the time of the Spinout<sup>(1)</sup>.

(1) Based on average daily production rates for the quarter ended March 31, 2005.



Paramount accounts for its investment in Trilogy trust units using the equity method. The market value of Paramount's investment in Trilogy trust units as of December 31, 2005 was \$357.8 million<sup>(1)</sup>. The carrying value of such trust units in the Consolidated Financial Statements was \$51.7 million as of December 31, 2005.

The following table shows Paramount's reported results for 2005 and 2004, separating the results of the Spinout Assets from Paramount's other properties and assets ("PRL Props"):

	2005			2004			Change		
	Spinout Assets <sup>(2)</sup>	PRL Props	Reported	Spinout Assets	PRL Props	Reported	Spinout Assets	PRL Props	Reported
<b>Product sales volumes</b>									
Natural gas (MMcf/d)	29.9	92.7	122.6	98.3	74.8	173.1	(68.4)	17.9	(50.5)
Oil and NGLs (Bbl/d)	1,221	3,231	4,452	3,880	3,417	7,297	(2,659)	(186)	(2,845)
Combined (Boe/d)	6,212	18,676	24,888	20,288	15,862	36,150	(14,076)	2,814	(11,262)
<b>Average price</b>									
Natural gas (\$/Mcf)	7.46	8.98	8.61	7.30	7.42	7.35	0.16	1.56	1.26
Oil and NGLs (\$/Bbl)	54.77	61.98	60.01	49.89	44.90	47.55	4.88	17.08	12.46
<b>Operating netback</b>									
(\$ thousands)									
Revenue <sup>(3)</sup>									
Natural gas sales	81,569	303,590	385,159	262,900	202,646	465,546	(181,331)	100,944	(80,387)
Oil and NGLs sales	24,399	73,112	97,511	70,838	56,162	127,000	(46,439)	16,950	(29,489)
Total revenue	105,968	376,702	482,670	333,738	258,808	592,546	(227,770)	117,894	(109,876)
Royalties	25,269	65,958	91,227	67,571	37,475	105,046	(42,302)	28,483	(13,819)
Operating costs	16,123	59,735	75,858	50,775	44,992	95,767	(34,652)	14,743	(19,909)
Transportation	4,805	19,747	24,552	24,017	17,913	41,930	(19,212)	1,834	(17,378)
Operating netback	59,771	231,262	291,033	191,375	158,428	349,803	(131,604)	72,834	(58,770)

(1) Based on the closing price of Trilogy units on the Toronto Stock Exchange of \$23.80 per trust unit on December 30, 2005.

(2) Daily product sales volumes for 2005 are computed by dividing total product sales volumes from the Spinout Assets for the three months ended March 31, 2005 by 365 days.

(3) Revenue does not include gain/loss on financial instruments.

## BUSINESS ENVIRONMENT

Crude oil prices reached record highs in 2005 with West Texas Intermediate (WTI) averaging US\$56.29/Bbl during the year, 36 percent higher than the WTI average in 2004. The WTI monthly average price reached US\$69.81/Bbl at its peak in September 2005. Continued strong demand and concerns around supply disruptions and inventories as a result of hurricane destruction of major refineries in the Gulf Coast and political instability in major oil producing countries contributed to the increase. During 2005, there was significant volatility in both crude oil and natural gas prices. The table below shows key commodity price benchmarks over the past three years:

	2005	2004	2003
<b>Crude Oil</b>			
West Texas Intermediate monthly average (US\$/Bbl)	56.29	41.40	31.04
<b>Natural Gas</b>			
New York Mercantile Exchange (Henry Hub Close) monthly average (US\$/MMbtu)	8.62	6.14	5.39
AECO monthly average:			
Cdn\$/GJ	8.04	6.44	6.35
US\$/MMbtu	7.01	5.17	4.72
<b>Canadian Dollar – US Dollar Exchange Rate</b>			
Annual average with Company's banker (Cdn\$/1 US\$)	1.21	1.30	1.40

## KEY OPERATING RESULTS

### FOURTH QUARTER 2005 VS. THIRD QUARTER 2005

	Third Quarter 2005	Change	Fourth Quarter 2005
<b>Sales volumes</b>			
Natural gas (MMcf/d)	98.8	(6.1)	<b>92.7</b>
Oil and NGLs (Bbl/d)	3,158	225	<b>3,383</b>
Combined (Boe/d)	19,624	(787)	<b>18,837</b>
<b>Average prices <sup>(1)</sup></b>			
Natural gas (\$/Mcf)	8.80	2.44	<b>11.24</b>
Oil and NGLs (\$/Bbl)	65.95	(4.21)	<b>61.74</b>

	Third Quarter 2005	Change in Price/Cost	Change in Volume	Fourth Quarter 2005
(\$ thousands)				
<b>Revenue <sup>(1)</sup></b>				
Natural gas sales	80,027	22,167	(6,285)	<b>95,909</b>
Oil and NGLs sales	19,160	(1,225)	1,282	<b>19,217</b>
	99,187	20,942	(5,003)	<b>115,126</b>
<b>Royalties</b>	21,060	5,634	(1,071)	<b>25,623</b>
<b>Operating costs</b>	13,116	8,821	(880)	<b>21,057</b>
<b>Transportation costs</b>	6,125	(2,077)	(162)	<b>3,886</b>

(1) Before transportation and financial instruments.

**Sales volumes** – Natural gas sales volumes declined by six percent in the fourth quarter of 2005. This decrease was caused by several factors including production declines in the Liard, Northwest Territories area, disruptions to production in the Kaybob area and production delays caused by unfavorable weather and operational issues. These declines were partially offset by increases in production resulting from new well tie-ins in Northeast Alberta, Grande Prairie and coal bed methane wells in Southern Alberta.

Crude oil and natural gas liquid production increased by seven percent in the fourth quarter of 2005. This increase was primarily the result of new wells being brought on production in North Dakota, and due to a successful well optimization program being carried out in the Northwest Alberta area.

**Average prices** – Natural gas prices before financial instruments improved by 28 percent in the fourth quarter, a result of a significant increase in market prices seen in October and November 2005. Oil and NGL prices declined by 6 percent in the fourth quarter of 2005, reflecting the reduction seen in world oil prices.

**Royalties** – Royalties as a percentage of revenue were higher at 22 percent in the fourth quarter 2005 compared to 21 percent in the third quarter 2005 due mainly to increased royalties on properties in the Northwest Territories.

**Operating costs** – Operating costs averaged \$12.15/Boe in the fourth quarter 2005 compared to \$7.27/Boe in the third quarter of 2005. The increase in operating costs per Boe was primarily a result of annual equalization adjustments made and work-over expenditures incurred in the fourth quarter of 2005.

**Transportation costs** – Transportation costs averaged \$2.24/Boe in the fourth quarter compared to \$3.39/Boe in the third quarter due mainly to the termination of a fixed transportation commitment contract in October 2005.

## 2005 VS. 2004

	2004 Reported	Spinout Assets (2)	Change	2005 Reported
<b>Sales volumes</b>				
Natural gas (MMcf/d)	173.1	(68.5)	18.0	<b>122.6</b>
Oil and NGLs (Bbl/d)	7,297	(2,659)	(186)	<b>4,452</b>
Combined (Boe/d)	36,150	(14,076)	2,814	<b>24,888</b>
<b>Average prices (1)</b>				
Natural gas (\$/Mcf)	7.35	(0.29)	1.55	<b>8.61</b>
Oil and NGLs (\$/Bbl)	47.55	(4.61)	17.07	<b>60.01</b>

(\$ thousands)	2004 Reported	Spinout Assets (2)	Change in Price/Cost	Change in Volume	2005 Reported
<b>Revenue (1)</b>					
Natural gas sales	465,546	(181,331)	42,642	58,302	<b>385,159</b>
Oil and NGLs sales	127,000	(46,439)	21,373	(4,423)	<b>97,511</b>
	592,546	(227,770)	64,015	53,879	<b>482,670</b>
<b>Royalties</b>	105,046	(42,302)	18,698	9,785	<b>91,227</b>
<b>Operating costs</b>	95,767	(34,652)	5,882	8,861	<b>75,858</b>
<b>Transportation costs</b>	41,930	(19,212)	(1,095)	2,929	<b>24,552</b>

(1) Before transportation and financial instruments.

(2) These values are presented in order to isolate the variance in the reported results between 2004 and 2005 relating to the Spinout Assets. See the table of key operating statistics under the caption "Trust Spinout" for the basis of calculation.

**Spinout assets** – Effective April 1, 2005, the Spinout Assets were transferred to Trilogy, as is more fully described under the heading "Trust Spinout". Daily production from the Spinout Assets represented approximately 60 percent of Paramount's aggregate daily production as of the time of the Trilogy Spinout<sup>(3)</sup>. The transfer of the Spinout Assets to Trilogy caused decreases in Paramount's production, revenue, royalties, operating costs and transportation costs. The tables above isolate the variance in the reported results between 2004 and 2005 relating to the Spinout Assets.

**Sales volumes** – Excluding the impact of the Trust Spinout, natural gas sales volume increased in 2005 mainly as a result of asset acquisitions in the latter part of 2004 and Paramount's drilling programs. On the other hand, oil and natural gas liquid sales volumes decreased in 2005 primarily due to the disposition of Paramount's properties in southeast Saskatchewan during the third quarter 2004.

**Average prices** – Higher average prices in 2005 have resulted in an increase in petroleum and natural gas sales. The average prices for both natural gas and oil and natural gas liquids were higher in 2005 compared to 2004 reflecting general increases in the market prices of energy commodity products.

**Royalties** – After taking out the amounts relating to the Spinout Assets, royalties as a percentage of petroleum and natural gas sales were higher at 17 percent in 2005 compared to 14 percent in 2004 due mainly to increased royalties on properties in the Northwest Territories. Historically, these properties had lower royalty rates, as the properties were subject to a minimum royalty which was being offset against a credit pool.

**Operating costs** – After taking out the amounts relating to the Spinout Assets, operating costs averaged \$8.76/Boe in 2005 compared to \$7.75/Boe in 2004. The increase in operating cost per sales volume was primarily the result of general increases in the cost of goods and services in the energy sector and the recording of equalization charges.

**Transportation costs** – After taking out the amounts relating to the Spinout Assets, transportation cost per sales volume was lower in 2005 at \$2.90/Boe compared to \$3.09/Boe in 2004 due mainly to the termination of a fixed transportation commitment contract in the fourth quarter of 2005 as mentioned above.

(3) Based on average daily production rates for the quarter ended March 31, 2005.

## 2004 VS. 2003

	2003 Reported	Net Change	2004 Reported
<b>Sales volumes</b>			
Natural gas (MMcf/d)	152.8	20.3	173.1
Oil and NGLs (Bbl/d)	7,169	128	7,297
Combined (Boe/d)	32,630	3,520	36,150
<b>Average prices</b> <sup>(1)</sup>			
Natural gas (\$/Mcf)	6.75	0.60	7.35
Oil and NGLs (\$/Bbl)	39.03	8.52	47.55

(\$ thousands)	2003 Reported	Change in Price/Cost	Change in Volume	2004 Reported
<b>Revenue</b> <sup>(1)</sup>				
Natural gas sales	376,577	33,129	55,840	465,546
Oil and NGLs sales	102,125	22,303	2,572	127,000
	478,702	55,432	58,412	592,546
<b>Royalties</b>	82,512	12,048	10,486	105,046
<b>Operating costs</b>	81,193	5,015	9,559	95,767
<b>Transportation costs</b>	44,644	(6,899)	4,185	41,930

(1) Before transportation and financial instruments.

**Sales volumes** – Natural gas sales volumes increased in 2004 as compared to 2003 primarily as a result of acquisitions made during 2004. Oil and natural gas liquid sales volumes also increased in 2004 resulting mainly from the acquisitions in 2004 offset by the sale of the Sturgeon Lake properties in October 2003.

**Average prices** – The average prices for both natural gas and oil and natural gas liquids were higher in 2004 compared to 2003 reflecting general increases in the market prices of energy commodity products.

**Royalties** – Royalties as a percentage of petroleum and natural gas sales were stable at 19 percent in 2004 and 19 percent in 2003.

**Operating costs** – Operating costs per sales volume averaged \$7.24/Boe in 2004 compared to \$6.82/Boe in 2003. The increase in operating costs per sales volume was the result of a general increase in the cost of goods and services in the energy sector. In addition, the properties acquired by Paramount during 2004 have higher per unit operating costs than existing Paramount properties.

**Transportation costs** – Transportation cost per sales volume was lower in 2004 at \$3.09/Boe compared to \$3.36/Boe in 2003 due to the increase in sales volume to cover fixed transportation charges.

**NETBACKS**

	2005	2004	2003	2005	2004	2003
	Reported	Reported	Reported	PRL Props <sup>(2)</sup>	PRL Props <sup>(2)</sup>	PRL Props <sup>(2)</sup>
<b>Produced gas</b> (\$/Mcf)						
Revenue <sup>(1)</sup>	<b>8.08</b>	6.72	5.99	<b>8.42</b>	6.61	5.91
Royalties	<b>1.64</b>	1.29	1.13	<b>1.58</b>	0.97	0.89
Operating costs	<b>1.38</b>	1.13	1.03	<b>1.45</b>	1.18	1.08
Operating netback	<b>5.06</b>	4.30	3.83	<b>5.39</b>	4.46	3.94
<b>Conventional oil</b> (\$/Bbl)						
Revenue <sup>(1)</sup>	<b>61.57</b>	48.72	39.19	<b>61.64</b>	44.41	39.02
Royalties	<b>9.64</b>	8.21	7.30	<b>12.90</b>	7.93	7.34
Operating costs	<b>9.23</b>	9.56	9.79	<b>9.70</b>	10.24	10.28
Operating netback	<b>42.70</b>	30.95	22.10	<b>39.04</b>	26.24	21.40
<b>Natural gas liquids</b> (\$/Bbl)						
Revenue <sup>(1)</sup>	<b>54.51</b>	43.47	36.06	<b>59.62</b>	43.56	33.57
Royalties	<b>14.09</b>	9.44	7.92	<b>2.09</b>	13.18	7.38
Operating costs	<b>7.15</b>	7.96	7.43	<b>7.19</b>	9.69	10.25
Operating netback	<b>33.27</b>	26.07	20.71	<b>50.34</b>	20.69	15.94
<b>All products</b> (\$/Boe)						
Revenue <sup>(1)</sup>	<b>50.43</b>	41.62	36.44	<b>52.36</b>	41.49	36.25
Royalties	<b>10.04</b>	7.94	6.93	<b>9.68</b>	6.46	5.90
Operating costs	<b>8.35</b>	7.24	6.82	<b>8.76</b>	7.75	7.56
Operating netback	<b>32.04</b>	26.44	22.69	<b>33.92</b>	27.28	22.79

(1) Revenue is presented net of transportation costs and does not include gain/ loss on financial instruments.

(2) These values are presented in order to isolate the netbacks relating to properties retained by Paramount, and exclude the results of the Spinout Assets. These values have been computed on the same basis as the table of key operating statistics under the caption "Trust Spinout".

**Funds Flow Netback per Boe**

(\$/Boe)	2005	2004	2003
Operating netback	\$ <b>32.04</b>	\$ 26.44	\$ 22.69
Realized loss on financial instruments	<b>1.33</b>	0.05	4.47
Loss (gain) on sale of investments	<b>(0.65)</b>	–	0.08
General and administrative <sup>(1)</sup>	<b>3.39</b>	1.91	1.60
Interest <sup>(2)</sup>	<b>2.95</b>	1.82	1.60
Lease rentals	<b>0.35</b>	0.27	0.30
Bad debt recovery	–	(0.42)	0.50
Asset retirement obligation expenditures	<b>0.11</b>	0.09	–
Distributions from equity investments	<b>(4.31)</b>	–	–
Current and Large Corporations tax	<b>1.07</b>	0.51	0.23
Other	–	(0.05)	(0.13)
Funds flow netback (\$/Boe) <sup>(3)</sup>	\$ <b>27.80</b>	\$ 22.26	\$ 14.04

(1) Net of non-cash general and administrative expenses.

(2) Net of non-cash interest expense.

(3) Funds flow netback is equal to funds flow from operations divided by Boe production for the relevant period.

## OTHER OPERATING ITEMS

### DEPLETION AND DEPRECIATION EXPENSE

	2005	2004	2003
\$ thousands	179,413	191,578	165,098
\$/Boe	19.75	14.48	13.86

Depletion and depreciation expense decreased by \$12.2 million in 2005 compared to 2004 mainly as a result of the Trilogy Spinout discussed above partially offset by the higher depletion and depreciation due to capital expenditures in 2005 combined with higher expired mineral lease expense. Depletion and depreciation expense per unit of sales volume in 2005 was higher compared to 2004 due mainly to an increase in finding and development costs for proved reserves in 2005, a decline in proved reserves in certain Northwest Territories properties, and the Trilogy Spinout, as the Spinout Assets had a lower depletion and depreciation rate.

Depletion and depreciation expense increased by \$26.5 million in 2004 compared to 2003 primarily due to a higher depletable base as a result of acquisitions and increased capital expenditures. This is also the primary reason why depletion and depreciation expense per unit of sales volume increased in 2004.

### DRY HOLE COSTS

Under the successful efforts method of accounting for petroleum and natural gas properties, costs of drilling exploratory wells are initially capitalized and, if subsequently determined to be unsuccessful, are charged to dry hole expense. Other exploration costs, including geological and geophysical costs and annual lease rentals on non-producing properties, are charged to exploration expense as incurred. Dry hole costs for the year ended December 31, 2005 amounted to \$44.9 million as compared to \$24.7 million in 2004 and \$36.6 million in 2003. Previous years' suspended wells with a total carrying value of \$23.8 million were written off in 2005. Dry hole expense in 2005 related mainly to wells drilled in Alberta and the Northwest Territories.

Geological and geophysical expenses increased during the year ended December 31, 2005 to \$12.5 million from \$8.7 million in 2004 and \$8.5 million in 2003, as a result of increased exploratory activities for Paramount during the current year.

### WRITE-DOWN OF PETROLEUM AND NATURAL GAS PROPERTIES

The Company has recorded an impairment provision of \$14.9 million in 2005 as compared to nil in 2004 and \$10.4 million in 2003. The write-down in 2005 related to various non-core oil and gas assets located in Alberta, British Columbia, Southeast Saskatchewan and Montana.

### GENERAL AND ADMINISTRATIVE EXPENSES

(\$ thousands)	2005	2004	2003
General and administrative expenses			
before stock-based compensation expense	23,560	25,247	19,051
Stock-based compensation expense	62,587	41,195	1,214
General and administrative expenses	86,147	66,442	20,265

General and administrative expenses before stock-based compensation totaled \$23.6 million in 2005 as compared to \$25.2 million in 2004. The decrease in general and administrative expenses before stock-based compensation expenses is primarily a result of normalization of shared office and administration services between Paramount and Trilogy (see Related Party Transactions section below), partially offset by an increase in salaries and benefit costs resulting from increased staffing levels to address the increase in operational activities and to ensure compliance with new corporate and reporting obligations in Canada and the United States. Such increase in staffing levels is also the primary reason why general and administrative expenses before stock-based compensation increased in 2004 compared to 2003.

Stock-based compensation increased significantly to \$62.6 million in 2005 as compared to \$41.2 million in 2004. During 2005, non-cash stock-based compensation expense of approximately \$55.3 million was recognized in earnings to reflect the change in the intrinsic value of outstanding stock options as a result of the significant appreciation in the market price

of Paramount's common shares and Trilogy trust units during 2005 (see "Stock-based Compensation Liability"). In 2004, Paramount prospectively adopted the intrinsic value method to account for Paramount's stock-based compensation plan and recorded \$41.2 million of non-cash stock-based compensation expense. Prior to 2004, Paramount accounted for its stock option plan using the fair value method.

### **INTEREST EXPENSE**

Interest expense for 2005 was \$27.4 million, an eight percent increase from \$25.4 million in 2004. The \$2.0 million increase is attributable mainly to higher average credit facility borrowing levels during the first half of 2005 compared to the same period in 2004. The increase in borrowings during the first half of 2005 was a result of Paramount's higher capital expenditure activities and borrowings incurred as a result of the US Senior Notes exchange and consent solicitation for the Trilogy Spinout. The increase in interest expense is also the result of an increase in US Senior Notes issued to partially finance property acquisitions in 2004.

Interest expense increased to \$25.4 million in 2004 from \$19.2 million in 2003. This increase reflects higher average debt levels for the Company in 2004 as a result of acquisitions made in 2004.

### **INCOME ON EQUITY INVESTMENTS**

Paramount had equity income from investments of \$23.2 million and gain on dilution of equity investment of \$21.9 million for the year ended December 31, 2005. The gain on dilution of investment resulted from Trilogy's issuance of Trust Units on December 30, 2005.

### **INCOME TAXES**

For the year ended December 31, 2005, Paramount's current and other tax expense totaled \$9.8 million as compared to \$6.8 million in 2004. The future income tax recovery recorded for 2005 totaled \$50.6 million as compared to an expense of \$40.7 million in 2004. The future income tax recovery in 2005 was as a result of the losses incurred during the year. Paramount does not expect to pay any significant amounts of current cash income tax during 2006.

The determination of Paramount's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. While income tax filings are subject to audits and potential reassessments, management believes adequate provision has been made for all income tax obligations. However, changes in the interpretations or judgments may result in an increase or decrease in the Company's income tax provision in the future.

Paramount records future tax assets and liabilities to account for the expected future tax consequences of events that have been recorded in its Consolidated Financial Statements and its tax returns. These amounts are estimates; the actual tax consequences may differ from the estimates due to changing tax rates and regimes, as well as changing estimates of cash flows and capital expenditures in current and future periods. We periodically assess the realizability of our future tax assets. If Paramount concludes that it is more likely than not that some portion or all of the deferred tax assets will not be realized under accounting standards, the tax asset will be reduced by a valuation allowance.

Paramount estimates that it has approximately \$1,092.4 million of unutilized tax pools at December 31, 2005.

### **RISK MANAGEMENT**

Paramount's financial success is dependent upon the discovery, development and production of petroleum and natural gas reserves and the economic environment that creates a demand for petroleum and natural gas. Paramount's ability to execute its strategy is dependent on the amount of cash flow that can be generated and reinvested into its capital program. To protect cash flow against commodity price volatility, Paramount will, from time to time, enter into financial and/or physical commodity price hedges. Any such hedging transactions are restricted for periods of one year or less and the aggregate of volumes under such hedging transactions are limited to a cumulative maximum of 50 percent of Paramount's forecast production for the duration of the relevant period, determined on a barrel of oil equivalent basis.

Paramount's outstanding forward financial contracts are set out in the Consolidated Financial Statements in Note 13 – Financial Instruments and Note 18 – Subsequent Events. Paramount has chosen not to designate any of the financial forward contracts as hedges. As a result, such instruments are recorded using the mark-to-market method of accounting whereby instruments are recorded in the Consolidated Balance Sheet as either an asset or liability with changes in the fair value recognized in net earnings. The impact of fixed price physical sales contracts are reflected in petroleum and natural gas sales.

The realized and unrealized gain (loss) on financial instruments reflected in the Consolidated Financial Statements are as follows:

(\$ thousands)	2005	2004	2003
Realized loss on financial instruments	(12,053)	(683)	(53,204)
Unrealized gain (loss) on financial instruments	(23,989)	19,376	–
Total gain (loss) on financial instruments	(36,042)	18,693	(53,204)

The significant increase in loss on financial instruments is primarily the result of increases in market prices of oil and gas relative to the prices fixed in forward financial contracts.

## OTHER ANNUAL FINANCIAL INFORMATION

(\$ thousands)	2005	2004	2003
Cash flow from operating activities	302,611	263,073	129,889
Net change in operating working capital and deferred credit	(50,094)	31,279	37,387
Funds flow from operations	252,517	294,352	167,276
Net earnings (loss)	(63,932)	41,174	1,151
Net earnings (loss) per share			
Basic	(0.99)	0.69	0.02
Diluted	(0.99)	0.67	0.02
Total assets	1,111,350	1,542,786	1,177,130
Total long-term liabilities	478,686	768,195	569,308
Shareholders' equity	436,821	625,039	496,033

For the year ended December 31, 2005, funds flow from operations totaled \$252.5 million as compared to \$294.4 million in 2004. The lower product sales volumes as a result of the Trilogy Spinout in 2005, partially offset by an increase in petroleum and natural gas sales resulting from higher commodity prices and distributions from Trilogy were the primary factors for the decrease in funds flow along with other variances described above. The increase in funds flow from operations in 2004 compared to 2003 is primarily the result of higher product sales volumes as a result of acquisitions during 2004 and higher commodity prices.

The net loss for the year ended December 31, 2005 totaled \$63.9 million compared to a net earnings of \$41.2 million in 2004. The change from net earnings to net loss is primarily due to lower product sales volumes as a result of the Trilogy Spinout, increase in stock-based compensation expense as described above, higher dry hole costs, the write-down of petroleum and natural gas properties, the loss on financial instruments of \$36.0 million in 2005 compared to a gain of \$18.7 million in 2004, and premiums paid on the notes exchange, partially offset by the impact of higher prices of petroleum and natural gas products, the future tax recovery in 2005 as compared to future tax expense in 2004, and the dilution gain and equity income relating to Paramount's investment in Trilogy.



## CAPITAL EXPENDITURES

(\$ thousands)	2005	2004	2003
Land	\$ 53,978	\$ 37,919	\$ 22,288
Geological and geophysical	12,548	8,728	8,450
Drilling and completions	254,069	184,466	123,455
Production equipment and facilities	87,764	85,171	69,560
Exploration and development expenditures	408,359	316,284	223,753
Property acquisitions	24,171	322,598	228
Proceeds on property dispositions	(10,643)	(61,939)	(317,792)
Other	1,450	(586)	476
Net capital expenditures	\$ 423,337	\$ 576,357	\$ (93,335)

During 2005, exploration and development expenditures totaled \$408.4 million as compared to \$316.3 million in 2004 and \$223.8 million in 2003. The year-over-year increase in the capital expenditures program from 2003 to 2005 is due primarily to increasing exploration and development activities as a result of property acquisitions and an increased asset base. A comparison of the number of wells drilled for the recently completed three fiscal years is as follows:

(wells drilled)	2005		2004		2003	
	Gross <sup>(1)</sup>	Net <sup>(2)</sup>	Gross <sup>(1)</sup>	Net <sup>(2)</sup>	Gross <sup>(1)</sup>	Net <sup>(2)</sup>
Natural gas	273	139	229	145	180	121
Oil	18	9	12	10	16	12
Oilsands evaluation	35	14	17	17	–	–
D&A	15	10	13	8	15	6
Total	341	172	271	180	211	139

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

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

## QUARTERLY INFORMATION

Quarterly financial information, prepared by Paramount in Canadian dollars and in accordance with GAAP, is as follows:

(\$ thousands, except per share amounts)	Three Months Ended			
	Dec. 31, 2005	Sept. 30, 2005	June 30, 2005	Mar. 31, 2005
Revenue, net <sup>(1)</sup>	\$ 112,422	\$ 36,526	\$ 96,581	\$ 115,741
Net earnings (loss)	\$ 37,758	\$ (69,066)	\$ 12,934	\$ (45,558)
Net earnings (loss) per common share				
– basic	\$ 0.57	\$ (1.05)	\$ 0.20	\$ (0.72)
– diluted	\$ 0.56	\$ (1.05)	\$ 0.20	\$ (0.72)

(\$ thousands, except per share amounts)	Three Months Ended			
	Dec. 31, 2004	Sept. 30, 2004	June 30, 2004	Mar. 31, 2004
Revenue, net <sup>(1)</sup>	\$ 174,067	\$ 138,443	\$ 106,037	\$ 87,614
Net earnings (loss) before discontinued operations	(18,873)	40,599	10,331	2,838
Net earnings (loss) from discontinued operations	1,120	5,213	(395)	341
Net earnings (loss)	\$ (17,753)	\$ 45,812	\$ 9,936	\$ 3,179
Net earnings (loss) before discontinued operations per common share				
– basic	\$ (0.30)	\$ 0.69	\$ 0.17	\$ 0.05
– diluted	\$ (0.30)	\$ 0.68	\$ 0.17	\$ 0.05
Net earnings (loss) per common share				
– basic	\$ (0.28)	\$ 0.78	\$ 0.17	\$ 0.05
– diluted	\$ (0.28)	\$ 0.76	\$ 0.17	\$ 0.05

(1) Represents revenue after gain/loss on financial instruments, royalties and gain/loss on sale of investments and other.

See Fourth Quarter 2005 vs. Third Quarter 2005 comparison under Results of Operations.

Revenue, net for the third quarter of 2005 declined from the second quarter of 2005 mainly due to the unrealized financial instruments loss of \$40.4 million that was recorded in the third quarter of 2005 compared to a \$17.3 million gain in the second quarter, partially offset by higher commodity prices. In addition, royalties were higher at \$21.1 million during the third quarter of 2005 compared to \$9.3 million in the second quarter of 2005.

Revenue, net for the second quarter of 2005 declined from the first quarter of 2005 mainly due to the decrease in production resulting from the Trust Spinout, which was partially offset by higher commodity prices and the unrealized gain on financial instruments of \$17.3 million during the second quarter as compared to an unrealized loss on financial instruments of \$38.6 million during the first quarter of 2005. In addition, a realized financial instruments loss of \$3.7 million was recorded in the second quarter compared to a realized gain of \$10.7 million in the first quarter of 2005. First quarter 2005 net revenues decreased from fourth quarter 2004 net revenues mainly due to financial instrument loss of \$27.9 million during the first quarter compared to the financial instrument gain of \$27.4 million in the fourth quarter of 2004. Quarterly net revenues between the first quarter of 2004 and the fourth quarter 2004 continued to increase as Paramount steadily increased production and commodity prices continued to remain high.

The net loss for the third quarter of 2005 was due mainly to the loss on financial instruments, stock-based compensation expense and higher dry hole costs. The net loss for the first quarter of 2005 was due mainly to the premium on notes exchange and consent solicitation costs incurred to facilitate the Trilogy Trust Spinout. The net loss for the fourth quarter of 2004 was mainly due to the recording of stock option liability using the intrinsic value method to account for stock options as at December 31, 2004.

## LIQUIDITY AND CAPITAL RESOURCES

(\$ thousands)	2005	2004	2003
Working capital deficit (surplus) <sup>(1)</sup>	\$ 70,683	\$ (8,098)	\$ 10,593
Credit facility	105,479	201,305	60,350
US notes	248,409	257,836	226,887
Stock-based compensation liability <sup>(2)</sup>	4,105	–	–
Net debt <sup>(3)</sup>	428,676	451,043	297,830
Share capital	198,417	302,932	200,274
Retained earnings	238,404	322,107	295,759
<b>Total</b>	<b>\$ 865,497</b>	<b>\$ 1,076,082</b>	<b>\$ 793,863</b>

(1) Includes current portion of stock-based compensation liability of \$27.2 million in 2005.

(2) Since August 2005, Paramount has generally declined an optionholder's request for a cash payment relating to vested Paramount Options, thereby necessitating optionholders to exercise their vested Paramount Options, and to pay the aggregate exercise price of their stock options to Paramount as consideration for the issuance by Paramount of Common Shares. Paramount expects that this will continue. As a result, the stock-based compensation liability associated with Paramount Options amounting to \$46.6 million has been excluded from the computation of Net Debt at December 31, 2005.

(3) Net debt includes the stock-based compensation liability associated with Holdco Options totaling \$31.4 million as Paramount has accepted optionholders' requests for cash payments, and expects that this will continue.

## WORKING CAPITAL

Paramount's working capital position at December 31, 2005 was a \$70.7 million deficit compared to an \$8.0 million surplus at December 31, 2004. This decrease is primarily a result of a decrease in the mark-to-market value of oil and natural gas financial forward sales contracts recorded at December 31, 2005 versus at December 31, 2004, and an increase in the current portion of stock-based compensation liability. At December 31, 2005, the aggregate mark-to-market value of unsettled financial instruments was \$4.6 million loss whereas at December 31, 2004 the aggregate mark-to-market value of unsettled financial instruments was \$19.4 million gain. The amount ultimately paid or received by Paramount on settlement of the financial instruments is dependent upon underlying crude oil and natural gas prices when the contracts are settled. The current portion of stock-based compensation liability at December 31, 2005 was \$27.3 million, compared to nil in 2004. The increase in this liability is a result of the Trilogy Spinout and an increase in the value of and distributions on Trilogy trust units.

Paramount's 2006 planned capital spending for 2006 is between \$420 million and \$470 million (excluding land). Paramount anticipates that its working capital deficit and planned 2006 capital program will be funded from cash flows from operations, borrowings under its credit facilities, and through other sources of funds which may include incurring additional debt, issuing additional equity, or disposing of non-core assets. In the event of significantly lower cash flow, Paramount would be able to defer certain of its projected capital expenditures without penalty.

### CREDIT FACILITY

At December 31, 2005, Paramount had a \$189 million committed revolving/non-revolving term facility with a syndicate of Canadian banks. The limit on Paramount's credit facility is based on, among other things, the value of its properties. As a result of a significant proportion of the value of Paramount's properties being transferred to Trilogy through the Spinout, effective April 1, 2005 the limit on Paramount's credit facility was reduced to \$189 million from \$270 million.

Total drawings under the credit facility were \$105.5 million at December 31, 2005. Paramount had outstanding letters of credit totaling \$23.3 million at December 31, 2005 that reduced the amount of available borrowing by Paramount. The unutilized portion of Paramount's credit facility was \$59.9 million at December 31, 2005. The interest rate on borrowings under the credit facility was approximately 4.9 percent at December 31, 2005.

### US SENIOR NOTES

At December 31, 2005, Paramount had US \$213.6 million (Cdn \$248.4 million) outstanding principal amount of 8 1/2 percent Senior Notes due 2013 (the "Senior Notes"). The Senior Notes are secured by 12,755,845 Trilogy trust units owned by Paramount, having a market value of \$303.6 million as of December 31, 2005<sup>(1)</sup>. These Trilogy trust units are reflected in Long-term investments and other assets in Paramount's Consolidated Balance Sheet, and when combined with the other 2,279,500 Trilogy trust units held by Paramount relating to its obligations under Holdco Options, have a carrying value of \$51.7 million at December 31, 2005 on Paramount's Consolidated Balance Sheet. Paramount's obligations respecting its previously existing 7 7/8 percent US Senior Notes due 2010 and 8 7/8 percent US Senior Notes due 2014 were extinguished during 2005 as a result of a notes exchange offer and open market re-purchases. In connection with the notes exchange offer, Paramount paid aggregate cash consideration of \$45.1 million (US \$36.2 million) and has expensed \$8.0 million of deferred financing costs associated with the previous notes. This is the primary reason why premium on redemption of US Notes in the Consolidated Statement of Income increased from \$12.0 million in 2004 to \$53.1 million in 2005.

### SHARE CAPITAL

Under the Trilogy Spinout which became effective April 1, 2005, Paramount's shareholders received one Class A common share of Paramount and one unit of Trilogy for each common share of Paramount previously held. The transfer of the Spinout Assets to Trilogy under the Spinout did not result in a substantive change in ownership of the Spinout Assets under GAAP. Therefore, the transaction was accounted for using the book value of the net assets transferred and did not give rise to a gain or loss in the Consolidated Financial Statements. As a result of the Spinout, share capital was reduced by \$157.1 million and retained earnings was decreased by \$20.3 million.

On July 14, 2005, Paramount completed the private placement of 1.9 million common shares issued on a flow-through basis at \$21.25 per share for gross proceeds of \$40.4 million.

At March 10, 2006, Paramount had 66,644,275 Class A Common Shares outstanding. At March 10, 2006 there were 4,841,625 New Paramount Options outstanding (484,450 exercisable) and 1,839,875 Holdco Options outstanding (772,250 exercisable).

(1) Based on the closing price of Trilogy trust units on the Toronto Stock Exchange on December 30, 2005.

## STOCK-BASED COMPENSATION LIABILITY

Paramount has an Employee Incentive Stock Option plan as disclosed in Note 11 to the Consolidated Financial Statements. Under the terms of the Trilogy Spinout, and in order to preserve but not enhance the economic benefit to the optionholders of their Paramount Options, on April 1, 2005 each outstanding Paramount Option was replaced with one New Paramount Option and one Holdco Option. New Paramount Options derive their value from changes in Paramount's share price and Holdco Options derive their value from changes in Trilogy's unit price and distributions paid by Trilogy. At December 31, 2005, the stock based compensation liability associated with New Paramount Options was \$46.6 million and the stock based compensation liability associated with Holdco Options was \$31.4 million.

Holders of New Paramount Options and Holdco Options have the right to exercise their vested options or to surrender the options for a cash payment. Irrespective of the optionholder's request, for Paramount Options, Paramount may choose to decline an optionholder's request for a cash payment and therefore require the optionholder to exercise their vested options and acquire Paramount common shares.

For exercises of New Paramount Options, Paramount has generally declined an optionholder's request for a cash payment since August 15, 2005 and has therefore required optionholders to exercise their vested options and acquire Paramount common shares. Paramount expects that this will continue.

For exercises of Holdco Options, optionholders have generally requested for cash payments from Paramount. Paramount expects that this will continue.

## CONTRACTUAL OBLIGATIONS

Paramount has the following contractual obligations as at December 31, 2005:

(\$ thousands)	Recognized in financial statements	Less than 1 Year	1 – 3 years	4 – 5 years	After 5 years	Total
US Senior Notes <sup>(1)</sup>	Yes	21,115	42,229	42,229	301,196	406,769
Credit facility <sup>(2)</sup>	Yes	–	105,479	–	–	105,479
Stock-based compensation liability <sup>(3)</sup>	Yes Partially	72,708	35,485	11,869	–	120,062
Asset retirement obligations <sup>(4)</sup>	Yes Partially	–	–	–	138,419	138,419
Pipeline transportation commitments <sup>(5)</sup>	No	20,137	40,188	19,285	58,221	137,831
Capital spending commitment <sup>(6)</sup>	No	40,400	400	–	–	40,800
Leases	No	2,565	5,358	4,447	2,706	15,076
<b>Total <sup>(7)</sup></b>		<b>156,925</b>	<b>229,139</b>	<b>77,830</b>	<b>500,542</b>	<b>964,436</b>

(1) The amounts payable within the next five years represent the estimated annual interest payment on the Senior Notes. The amount payable for the Senior Notes after five years also includes interest payable thereon totaling US\$45.4 million (\$52.8 million).

(2) No interest payable under this credit facility has been included in the above contractual obligations due to the floating interest rate on the facility.

(3) The liability for stock-based compensation includes the full intrinsic value of vested and unvested options as at December 31, 2005. Paramount has the alternative to issue shares on Paramount options being exercised by employees instead of paying the intrinsic value of vested Paramount options. The full intrinsic value of Paramount options included above is \$81.0 million.

(4) Asset retirement obligation represents management's estimate of undiscounted cost of future dismantlement, site restoration and abandonment obligations based on engineering estimates and in accordance with existing legislation and industry practices.

(5) Certain of the pipeline transportation commitments are secured by outstanding letters of credit totaling \$23.3 million as at December 31, 2005.

(6) The capital spending commitment includes \$40 million committed portion of the estimated amount to be spent on Paramount's oil sands project for 2006.

(7) In addition to the above, Paramount has minimum volume commitments to gas transportation service providers under agreements expiring in various years the latest of which expires in 2023.

## RELATED PARTY TRANSACTIONS

### TRILOGY ENERGY TRUST

At December 31, 2005, Paramount held 15,035,345 trust units of Trilogy representing 17.7 percent of the issued and outstanding trust units of Trilogy at such time. In addition to the Trilogy trust units held by Paramount, Trilogy and Paramount have certain common members of management and directors.

- Paramount provided certain operational, administrative, and other services to Trilogy Energy Ltd., a wholly-owned subsidiary of Trilogy, pursuant to a services agreement dated April 1, 2005 (the "Services Agreement"). The Services Agreement had an initial term ending March 31, 2006. It is anticipated that the Services Agreement will be renewed on the same terms and conditions to March 31, 2007 prior to the expiry of its current term of March 31, 2006. Under the Services Agreement, Paramount is reimbursed for all reasonable costs (including expenses of a general and administrative nature) incurred by Paramount in providing the services. The reimbursement of expenses is not intended to provide Paramount with any financial gain or loss. Paramount billed Trilogy an aggregate \$4.2 million under the Services Agreement, which has been reflected as a reduction in Paramount's general and administrative expenses.
- In connection with the Trilogy Spinout, and in order to market Trilogy's natural gas production, Paramount and Trilogy Energy LP, entered a Call on Production Agreement which provided Paramount the right to purchase all or any portion of Trilogy Energy LP's available gas production at a price no less favourable than the price that Paramount Resources received on the resale of the natural gas to a gas marketing limited partnership (see "Gas Marketing Limited Partnership" – below). Trilogy Energy LP is a limited partnership which is indirectly wholly-owned by Trilogy.

For the year ended December 31, 2005, Paramount purchased 8,490,542 GJ of natural gas from Trilogy Energy LP for approximately \$70.3 million under the Call on Production Agreement for sale to the gas marketing limited partnership (see below). The price that Paramount paid Trilogy Energy LP for the natural gas was the same that Paramount Resources received on the resale of the natural gas to the related party gas marketing limited partnership. As a result, such amounts have been netted for financial statement presentation purposes and no revenues or expenses have been reflected in the Consolidated Financial Statements related to these activities.

- During the course of the year, payable and receivable amounts arose between Paramount and Trilogy in the normal course of business.
- At December 31, 2005 Paramount owed Trilogy \$6.4 million, which balance includes a Crown royalty deposit claim of \$5.5 million which, when refunded to Paramount, will be paid to Trilogy.
- As a result of the Trilogy Spinout, certain employees and officers of Trilogy hold Paramount Options and Holdco Options. The stock-based compensation expense relating to these options for the period April 1, 2005 to December 31, 2005 amounted to \$4.4 million, of which 81 percent (\$3.6 million) was charged to general and administration expense and 19 percent (\$0.8 million) was recognized in equity in net earnings of Trilogy.
- Paramount recorded distributions from Trilogy Energy Trust totaling \$35.3 million in 2005. Distributions receivable of \$12 million relating to distributions declared by Trilogy in December 2005 were accrued at December 31, 2005 and received in January 2006.

### GAS MARKETING LIMITED PARTNERSHIP

In March 2005, Paramount acquired an indirect 30 percent interest (25 percent net of minority interest) in Eagle Energy Marketing Canada Limited Partnership ("EEMC") for \$7.5 million (US\$6 million). In connection with this acquisition, Paramount agreed to make available for delivery an average of 150,000 GJ/d of natural gas over a five year term, to be marketed on Paramount's behalf by EEMC with the expectation that prices received for such gas would be at or above market. EEMC commenced operations that month.

During 2005, Paramount sold 10,380,998 GJ of its natural gas production to EEMC for \$83.3 million. The proceeds of such sales have been reflected in petroleum and natural gas sales revenue. In addition, Paramount sold 8,490,542 GJ of natural gas purchased from Trilogy (see above) to EEMC for \$70.3 million. These transactions have been recorded at the exchange amounts.

Because of market conditions, including the significant volatility of natural gas prices in the fall and the resulting margin requirements, the partners of EEMC resolved to cease commercial operations in November 2005 and to dissolve the partnership in due course. Paramount recorded a \$1.1 million provision for impairment on its investment in EEMC, and expects to recover approximately \$5 million on its dissolution. No receivables arising from the sale of natural gas to EEMC are outstanding as at December 31, 2005.

## **PRIVATE OIL AND GAS COMPANY**

At December 31, 2005, Paramount held 2,708,662 shares of Fox Creek Petroleum Corp. ("Fox Creek") representing 24.8 percent of the issued and outstanding share capital of the company at such time. One member of Paramount's management is a member of the board of directors of Fox Creek by virtue of such shareholdings. During the year, Paramount received dividends and a return-of-capital distribution from Fox Creek (the "Distributions"). The Distributions were paid in the form of common shares of a Toronto Stock Exchange ("TSX") listed oil and gas company. The value of such shares received by Paramount was \$5.7 million, based on the market price of the shares on the date of the Distributions. The Distributions reduced the carrying value of Paramount's investment in Fox Creek in the Consolidated Financial Statements, and the shares of the TSX listed oil and gas company received from Fox Creek have been included in short-term investments.

## **DIRECTORS AND EMPLOYEES**

Certain directors, officers and employees of Paramount purchased an aggregate 922,500 flow through shares issued by Paramount for gross proceeds to Paramount of \$21.1 million on July 14, 2005.

Certain directors, officers and employees of Paramount purchased an aggregate 1,016,000 flow through shares issued by Paramount for gross proceeds to Paramount of \$30.0 million on October 15, 2004.

## **RISKS AND UNCERTAINTIES**

Companies involved in the exploration for and production of oil and natural gas face a number of risks and uncertainties inherent in the industry. Paramount's performance is influenced by commodity prices, transportation and marketing constraints and government regulation and taxation.

Natural gas prices are influenced by the North American supply and demand balance as well as transportation capacity constraints. Seasonal changes in demand, which are largely influenced by weather patterns, also affect the price of natural gas.

Stability in natural gas pricing is available through the use of short- and long-term contract arrangements. Paramount utilizes a combination of these types of contracts, as well as spot markets, in its natural gas pricing strategy. As the majority of Paramount's natural gas sales are priced to US markets, the Canada/US exchange rate can strongly affect revenue.

Oil prices are influenced by global supply and demand conditions as well as by worldwide political events. As the price of oil in Canada is based on a US benchmark price, variations in the Canada/US exchange rate further affect the price received by Paramount for its oil.

Paramount's access to oil and natural gas sales markets is restricted, at times, by pipeline capacity. In addition, it is also affected by the proximity of pipelines and availability of processing equipment. Paramount attempts to control as much of its marketing and transportation activities as possible in order to minimize any negative impact from these external factors.

The oil and gas industry is subject to extensive controls, royalties, regulatory policies and income taxes imposed by the various levels of government. These controls and policies, as well as income tax laws and regulations, are amended from time to time. Paramount has no control over government intervention or taxation levels in the oil and gas industry; however, it operates in a manner intended to ensure that it is in compliance with all regulations and is able to respond to changes as they occur.

Paramount's operations are subject to the risks normally associated with the oil and gas industry including hazards such as unusual or unexpected geological formations, high reservoir pressures and other conditions involved in drilling and operating wells. Paramount attempts to minimize these risks using prudent safety programs and risk management, including insurance coverage against potential losses.

Paramount recognizes that the industry is faced with an increasing awareness with respect to the environmental impact of oil and gas operations. Paramount has reviewed the environmental risks to which it is exposed and has determined that there is no current material impact on Paramount's operations; however, the cost of complying with environmental regulations is increasing. Paramount intends to ensure continued compliance with environmental legislation.

## 2006 OUTLOOK AND SENSITIVITY ANALYSIS

The following table sets forth Paramount's current estimate of 2006 production and capital expenditures:

<b>Production</b> (Boe/d)	
2006 Average	24,000
2006 Exit	28,000
<b>Capital Expenditures</b> (\$ millions)	
2006 Conventional <sup>(1)</sup>	350 to 400
2006 Oil Sands	70

(1) Excludes expenditures on land.

The \$70 million estimate of 2006 capital expenditures for oil sands relate to delineation and development. Paramount owns 100 percent of 12 sections of in-situ oil sands leases in the Surmont area of Alberta and has 50 percent interest in a joint venture with North American Oilsands Coporation ("NAOSC") which holds in-situ oil sands leases in the Leismer, Corner, Thornbury and Hangingstone areas of Alberta. Each of these oil sands development projects is expected to require a capital expenditure by Paramount (in the case of Surmont) and Paramount and NAOSC (in the case of the joint venture) of approximately \$180 million to bring on production. Paramount estimates that a larger 30 MBbl/d oil sands development project would require a capital expenditure of approximately \$400 million to bring on production.

Paramount's results are affected by external market factors, such as fluctuations in the price of crude oil and natural gas, foreign exchange rates, and interest rates. The following table provides projected estimates for 2006 of the sensitivity of Paramount's 2006 funds flow from operations to changes in commodity prices, the Canadian/US dollar exchange rate and interest rates:

<b>Sensitivity</b> <sup>(1)(2)</sup>	<b>Funds Flow Effect</b> (\$ millions)
\$0.25/GJ increase in AECO gas price	6.2
US\$1.00 increase in the WTI oil price	0.6
\$0.01 increase in the Canadian/US dollar exchange rate	3.0
1 percent decrease in prime rate of interest	1.5

(1) Includes the impact of financial and physical hedge contracts existing at December 31, 2005.

(2) Based on forward curve commodity price and forward curve estimates dated December 31, 2005.

The following assumptions were used in the sensitivity (above):

<b>2006 Average Production</b>	
Natural gas	120 MMcf/d
Crude oil/liquids	4,000 Bbl/d
<b>2006 Average Prices</b>	
Natural gas	\$8.50/Mcf
Crude oil (WTI)	US\$64.50/Bbl
<b>2006 Exchange Rate</b> (C\$/US\$)	
	\$1.15
<b>Cash taxes</b>	
	None

## **CRITICAL ACCOUNTING ESTIMATES**

The preparation of the Consolidated Financial Statements in accordance with GAAP requires management to make estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities, if any, at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Paramount bases its estimates on historical experience and various other factors that are believed by management to be reasonable under the circumstances. Actual results could differ from these estimates.

The following is a discussion of the critical accounting estimates inherent in Paramount's Consolidated Financial Statements:

### **SUCCESSFUL EFFORTS ACCOUNTING**

Paramount follows the successful efforts method of accounting for its petroleum and natural gas operations. Under this method, acquisition costs of oil and gas properties and costs of drilling and equipping development wells are capitalized. Costs of drilling exploratory wells are initially capitalized pending evaluation as to whether proved reserves have been found. If economically recoverable reserves are not found, such costs are charged to earnings as dry hole costs. If economically recoverable reserves are found, such costs are depleted on a unit-of-production basis. The determination of whether economically recoverable quantities of reserves are found is dependent upon, among other things, the results of planned additional wells and the cost of required capital expenditures to produce the reserves found.

The application of the successful efforts method of accounting requires the use of judgment to determine, among other things, the designation of wells as development or exploratory, and whether exploratory wells have discovered economically recoverable quantities of proved reserves. The results of a drilling operation can take considerable time to analyze, and the determination that proved reserves have been discovered requires both judgment and application of industry experience. The evaluation of petroleum and natural gas leasehold acquisition costs requires management's judgment to evaluate the fair value of exploratory costs related to drilling activity in a given area. Ultimately, these determinations affect the timing of deduction of accumulated costs and whether such costs are capitalized and amortized on a unit-of-production basis or are charged to earnings as dry hole costs.

### **RESERVE ESTIMATES**

Estimates of Paramount's reserves are prepared in accordance with the Canadian standards set out in the Canadian Oil and Gas Evaluation Handbook and National Instrument 51-101. Reserve engineering is a subjective process of estimating underground accumulations of petroleum and natural gas that cannot be measured in an exact manner. The process relies on interpretations of available geological, geophysical, engineering and production data. The accuracy of a reserves estimate is a function of the quality and quantity of available data, the interpretation of that data, the accuracy of various mandated economic assumptions and the judgment of the persons preparing the estimate.

In 2005, 100 percent of Paramount's reserves were evaluated by qualified independent reserves evaluators. Estimates prepared by others may be different than these estimates. Because these estimates depend on many assumptions, all of which may differ from actual results, reserves estimates may be different from the quantities of petroleum and natural gas that are ultimately recovered. In addition, the results of drilling, testing and production after the date of an estimate may justify revisions to the estimate.

The present value of future net revenues should not be assumed to be the current market value of Paramount's estimated reserves. Actual future prices, costs and reserves may be materially higher or lower than the prices, costs and reserves used for the future net revenue calculations.

The estimates of reserves impact (i) Paramount's assessment of whether or not an exploratory well has found economically producible reserves, (ii) Paramount's unit-of-production depletion rates; and (iii) Paramount's assessment of impairment of oil and gas properties. If reserves estimates decline, the rate at which Paramount records depletion expense increases, reducing net earnings. In addition, changes in reserves estimates may impact the outcome of Paramount's assessment of its petroleum and natural gas properties for impairment.



## **IMPAIRMENT OF PETROLEUM AND NATURAL GAS PROPERTIES**

Paramount reviews its proved properties for impairment annually, or as economic events dictate, on a field basis. For each field, an impairment provision is recorded whenever events or circumstances indicate that the carrying value of those properties may not be recoverable. The impairment provision is based on the excess of carrying value over fair value. Fair value is defined as the present value of the estimated future net revenues from production of total proved and probable petroleum and natural gas reserves, as estimated by Paramount's independent reserves evaluators on the balance sheet date. Reserve estimates, as well as estimates for petroleum and natural gas prices, royalties and production costs, may change and there can be no assurance that impairment provisions will not be required in the future.

Unproved leasehold costs and exploratory drilling in progress are capitalized and reviewed periodically for impairment. Costs related to impaired prospects or unsuccessful exploratory drilling are charged to earnings. Acquisition costs for leases that are not individually significant are charged to earnings as the related leases expire. Further impairment expense could result if petroleum and natural gas prices decline in the future or if negative reserves revisions are recorded, as it may be no longer economic to develop certain unproved properties. Management's assessment of, among other things, the results of exploration activities, commodity price outlooks and planned future development and sales impacts the amount and timing of impairment provisions.

## **ASSET RETIREMENT OBLIGATIONS**

Upon retirement of its oil and gas assets, Paramount anticipates incurring substantial costs associated with abandonment and reclamation activities. Estimates of the associated costs are subject to uncertainty associated with the method, timing, and extent of future retirement activities. Accordingly, the annual expense associated with future abandonment and reclamation activities is impacted by changes in the estimates of the expected costs and reserves. The total undiscounted abandonment liability is currently estimated at \$138.4 million, which is based on management's weighted estimate of costs and in accordance with existing legislation and industry practice.

## **PURCHASE PRICE ALLOCATIONS**

The costs of corporate and asset acquisitions are allocated to the acquired assets and liabilities based on their fair value at the time of acquisition. The determination of fair value requires management to make assumptions and estimates regarding future events. The allocation process is inherently subjective and impacts the amount assigned to individually identifiable assets and liabilities. As a result, the purchase price allocation impacts Paramount's reported assets and liabilities and future net earnings due to the impact on future depletion and amortization expense and impairment tests.

## **INCOME TAXES AND ROYALTY MATTERS**

The operations of Paramount are complex, and related tax and royalty legislation and regulations, and government interpretation and administration thereof, in the various jurisdictions in which Paramount operates are continually changing. As a result, there are usually some tax and royalty matters under review by relevant government authorities.

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

Crown royalties for Paramount's production from frontier lands in the Northwest Territories have been provided for in the Consolidated Financial Statements based on the Company's interpretation of the relevant legislation and regulations. At present, Paramount has not received assessments for a significant portion of its past Northwest Territories royalty filings with the Government of Canada. In addition, the Government of Canada is continuing its stakeholder and industry consultations concerning the application of and amendments to the regulations governing the computation of Crown royalties in the Northwest Territories. Although Paramount believes that its interpretation of the relevant legislation and regulations has merit, Paramount is unable to predict the ultimate outcome of future audits and/or assessments by the Government of Canada of Paramount's Northwest Territories crown royalty filings. Additional amounts could become payable and the impact on net earnings may be material.

## RECENT ACCOUNTING PRONOUNCEMENTS

### SUSPENDED WELL COSTS

Paramount follows the successful efforts method of accounting for its petroleum and natural gas operations, applying Statement of Financial Accounting Standards No. 19 ("FAS 19") of the Financial Accounting Standards Board. On July 1, 2005, we adopted FASB Staff Position FAS 19-1 ("FSP FAS 19-1") "Accounting for Suspended Well Costs" issued by the FASB. FSP FAS 19-1 was applied prospectively to existing and newly capitalized exploratory well costs.

Prior to the introduction of FSP FAS 19-1, FAS 19 required that capitalized exploratory well costs, other than those in an area requiring a major capital expenditure before production could begin, be expensed if related reserves could not be classified as proved within one year. Under the provisions of FSP FAS 19-1, the one-year evaluation period is removed and other criteria added such that exploratory well costs can continue to be capitalized after the completion of drilling, potentially beyond one year, when (a) the well has found a sufficient quantity of reserves to justify completion as a producing well and (b) the enterprise is making sufficient progress assessing the reserves and the economic and operating viability of the project. If either condition is not met, or if an enterprise obtains information that raises substantial doubt about the economic or operational viability of the project, the exploratory well would be assumed to be impaired, and its costs, net of any salvage value, would be charged to expense. The FSP provides a number of indicators that can assist an entity to demonstrate sufficient progress is being made in assessing the reserves and economic viability of the project.

The adoption of FSP FAS 19-1 did not result in a significant change to Consolidated Financial Statements other than the requirement to disclose certain information on suspended well costs as set out in the notes to the Consolidated Financial Statements.

### VARIABLE INTEREST ENTITIES

On January 1, 2005, Paramount adopted Accounting Guideline 15 ("AcG-15") "Consolidation of Variable Interest Entities." AcG-15 defines a variable interest entity ("VIE") as a legal entity in which either the total equity at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by other parties or the equity owners lack a controlling financial interest. The guideline requires the enterprise which absorbs the majority of a VIE's expected gains or losses, the primary beneficiary, to consolidate the VIE.

There was no effect on Paramount's Consolidated Financial Statements as a result of the adoption of AcG-15.

### NON-MONETARY TRANSACTIONS

In the quarter ending March 31, 2006, Paramount will adopt Section 3831 "Non-Monetary Transactions" issued by the Canadian Institute of Chartered Accountants ("CICA") in June 2005. Under the new standard, a commercial substance test replaces the culmination of earnings test as the criteria for fair value measurement. In addition, fair value measurement is clarified. Paramount does not expect application of this new standard to have a material impact on its Consolidated Financial Statements.

## FINANCIAL INSTRUMENTS, OTHER COMPREHENSIVE INCOME AND EQUITY

In the year ending December 31, 2007, Paramount will be required to adopt Section 1530 "Comprehensive Income", Section 3251 "Equity", Section 3855 "Financial Instruments – Recognition and Measurement" and Section 3865 "Hedges" issued by the CICA in January 2005.

New Section 3855 sets out comprehensive requirements for recognition and measurement of financial instruments. Under this standard, an entity would recognize a financial asset or liability only when the entity becomes a party to the contractual provisions of the financial instrument. Financial assets and financial liabilities would, with certain exceptions, be initially measured at fair value. After initial recognition, the measurement of financial assets would vary depending on the category of the asset: financial assets held for trading (at fair value with the unrealized gains and losses on assets recorded in income), held-to-maturity investments (at amortized cost), loans and receivables (at amortized cost), and available-for-sale financial assets (at fair value with the unrealized gains and losses on assets recorded in comprehensive income). Financial liabilities held for trading would be subsequently measured at fair value while all other financial liabilities would be subsequently measured at amortized cost using the effective interest method.

In conjunction with the new standard on financial instruments as discussed above, CICA Handbook Section 1530 (Comprehensive Income) has also been issued. A statement of comprehensive income would be included in a full set of financial statements for both interim and annual periods under this new standard. Comprehensive income is defined as the change in equity (net assets) of an enterprise during a period from transactions and other events and circumstances from non-owner sources. The new statement would present net income and each component to be recognized in other comprehensive income. Likewise, the CICA has issued Handbook Section 3251 (Equity) which requires the separate presentation of: the components of equity (retained earnings, accumulated other comprehensive income, the total of retained earnings and accumulated other comprehensive income, contributed surplus, share capital and reserves); and the changes in equity arising from each of these components of equity.

These new standards will be effective for Paramount for its 2007 fiscal year.

## INTERNAL CONTROLS OVER FINANCIAL REPORTING

Management has assessed the effectiveness of Paramount's financial reporting disclosure controls and procedures as at December 31, 2005, and has concluded that such financial reporting disclosure controls and procedures were effective as at that date.

## ADVISORIES

Information included in this annual report and the Consolidated Financial Statements are presented in Canadian dollars unless otherwise stated.

## FORWARD-LOOKING STATEMENTS AND ESTIMATES

Certain statements included in this annual report constitute forward-looking statements under applicable securities legislation. Forward-looking statements or information typically contain statements with words such as "anticipate", "believe", "expect", "plan", "intend", "estimate", "propose", "forecast", "opportunities" or similar words suggesting future outcomes or statements regarding an outlook. Forward-looking statements or information in this document include but are not limited to estimates of future capital expenditures, business strategy and objectives, reserve quantities and the discounted present value of future net cash flows from such reserves, net revenue, estimated future production levels, exploration, development and production plans and the timing thereof, operating and other costs, royalty rates, expectations of the timing and quantum of future cash income taxes, expectations as to Paramount's working capital deficit and 2006 capital program and the funding thereof, sensitivities to Paramount's funds flow from changes in commodity prices, future exchange rates and rates of interest, estimated quantities and the net present value of oil sands resources, the anticipated timing for seeking regulatory approvals, and expectations of growth in production, reserves, undeveloped land and the timing thereof.

Such forward-looking statements or information are based on a number of assumptions which may prove to be incorrect. In addition to other assumptions identified herein, assumptions have been made regarding, among other things:

- the ability of Paramount to obtain equipment, services and supplies in a timely manner to carry out its activities;
- the ability of Paramount to market oil and natural gas successfully to current and new customers;
- the timing and costs of pipeline and storage facility construction and expansion and the ability to secure adequate product transportation;
- the timing and costs to bring Paramount's oil sands projects on production;
- the timely receipt of required regulatory approvals;
- drilling success consistent with past success;
- the ability of Paramount to obtain financing on acceptable terms;
- currency, exchange and interest rates;
- future oil and gas prices; and
- that no cash taxes will be paid by Paramount in 2006.

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

- the ability of management to execute its business plan;
- the risks of the oil and gas industry, such as operational risks in exploring for, developing and producing crude oil and natural gas and market demand;
- risks and uncertainties involving geology of oil and gas deposits;
- risks inherent in Paramount's marketing operations, including credit risk;
- the uncertainty of reserves estimates and reserves life;
- imprecision of resource estimates and reserves life;
- the uncertainty of estimates and projections relating to drilling, production, costs and expenses;
- the uncertainty of estimates and projections relating to the results of exploration and development;
- potential delays or changes in plans with respect to exploration or development projects or capital expenditures;
- Paramount's ability to enter into or renew leases;
- fluctuations in oil and gas prices, foreign currency exchange rates and interest rates;
- health, safety and environmental risks;
- uncertainties as to the availability and cost of financing;
- the ability of Paramount to add production and reserves through development and exploration activities;
- weather;
- general economic and business conditions;
- the possibility that government policies or laws may change or governmental approvals may be delayed or withheld;
- uncertainty in amounts and timing of royalty payments;

- change in taxation laws and regulations and the interpretation thereof;
- risks associated with existing and potential future lawsuits and regulatory actions against Paramount; and
- other risks and uncertainties described elsewhere in this press release or in Paramount's other filings with Canadian securities authorities.

The forward-looking statements or information contained in this document are made as of the date hereof and Paramount undertakes no obligation to update publicly or revise any forward-looking statements or information, whether as a result of new information, future events or otherwise, unless so required by applicable securities laws.

## **NON-GAAP MEASURES**

In this annual report, Paramount uses the term "funds flow from operations", "funds flow from operations per share - basic", "funds flow from operations per share - diluted", "operating netback", "funds flow netback per Boe" and "net debt", collectively the "Non-GAAP Measures", as indicators of Paramount's financial performance. The Non-GAAP measures do not have standardized meanings prescribed by Canadian GAAP and, therefore, are unlikely to be comparable to similar measures presented by other issuers.

"Funds flow from operations" refers to the cash flows from operating activities before net changes in operating working capital. "Funds flow from operations" includes distributions and dividends received on securities held by Paramount. The most directly comparable measure to "funds flow from operations" calculated in accordance with GAAP is cash flows from operating activities. "Funds flow from operations" can be reconciled to cash flows from operating activities by adding (deducting) the net change in operating working capital as shown in the consolidated statements of cash flows. "Funds flow netback per Boe" is calculated by dividing "funds flow from operations" by the total sales volume in Boe. "Operating netback" equals petroleum and natural gas sales less royalties, operating costs and transportation. "Net debt" is calculated as current liabilities minus current assets plus long-term debt and stock-based compensation liability associated with Holdco Options. Management of Paramount believes that the Non-GAAP measures provide useful information to investors as indicative measures of performance.

Investors are cautioned that the Non-GAAP Measures should not be considered in isolation or construed as alternatives to their most directly comparable measure calculated in accordance with GAAP, as set forth above, or other measures of financial performance calculated in accordance with GAAP.

## **BARRELS OF OIL EQUIVALENT CONVERSIONS**

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

## **FINDING AND DEVELOPMENT COSTS**

The aggregate of the exploration and development costs incurred in the most recent financial year and the change during that year in estimated future development costs generally will not reflect total finding and development costs related to reserve additions for that year.

# MANAGEMENT'S REPORT

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

Management has overall responsibility for internal controls and has developed and maintains a system of internal controls that provides reasonable assurance that all transactions are accurately recorded, that the financial statements realistically report the Company's operating and financial results and that the Company's assets are safeguarded.

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

Ernst & Young LLP, an independent firm of chartered accountants, was appointed by a vote of shareholders at the Company's last annual meeting to audit the Consolidated Financial Statements and provide an independent opinion. Ernst & Young LLP have full and free access to the Audit Committee and Management

signed

**Clayton H. Riddell**  
Chief Executive Officer

signed

**Bernard K. Lee**  
Chief Financial Officer

March 12, 2006

# REPORT OF INDEPENDENT AUDITORS

## TO THE SHAREHOLDERS OF PARAMOUNT RESOURCES LTD.

We have audited the consolidated balance sheets of Paramount Resources Ltd. as at December 31, 2005 and 2004 and the consolidated statements of earnings (loss) and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the fairness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2, in 2005, the Company changed its method of accounting for variable interest entities and suspended well costs.

In our opinion, these consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in conformity with Canadian generally accepted accounting principles.

Ernst & Young LLP

**Chartered Accountants**

Calgary, Canada

March 10, 2006

# CONSOLIDATED BALANCE SHEETS

As at December 31 (thousands of dollars)	2005	2004
<b>ASSETS</b> (Note 9)		
<b>Current Assets</b>		
Short-term investments		
(Market value: 2005 - \$16,176; 2004 - \$27,149)	\$ 14,048	\$ 24,983
Accounts receivable	92,772	107,843
Distributions receivable from Trilogy Energy Trust (Note 15)	12,028	–
Financial instruments (Note 13)	2,443	21,564
Prepaid expenses and other	3,869	3,260
	<b>125,160</b>	<b>157,650</b>
<b>Property, Plant and Equipment</b> (Note 6)		
Property, plant and equipment, at cost	1,314,651	1,933,104
Accumulated depletion and depreciation	(400,072)	(587,298)
	<b>914,579</b>	<b>1,345,806</b>
<b>Goodwill</b>	<b>12,221</b>	<b>31,621</b>
<b>Long-term investments and other assets</b> (Notes 8 and 9)	<b>56,467</b>	<b>7,709</b>
<b>Future income taxes</b> (Note 12)	<b>2,923</b>	<b>–</b>
	<b>\$1,111,350</b>	<b>\$ 1,542,786</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable and accrued liabilities	\$ 155,076	\$ 147,364
Due to Trilogy Energy Trust (Note 15)	6,439	–
Financial instruments (Note 13)	7,056	2,188
Current portion of stock-based compensation liability (Note 11)	27,272	–
	<b>195,843</b>	<b>149,552</b>
<b>Long-term debt</b> (Note 9)	<b>353,888</b>	<b>459,141</b>
<b>Asset retirement obligations</b> (Note 7)	<b>66,203</b>	<b>101,486</b>
<b>Deferred credit</b>	<b>6,528</b>	<b>–</b>
<b>Stock-based compensation liability</b> (Note 11)	<b>50,729</b>	<b>41,044</b>
<b>Non-controlling interest</b>	<b>1,338</b>	<b>144</b>
<b>Future income taxes</b> (Note 12)	<b>–</b>	<b>166,380</b>
	<b>478,686</b>	<b>768,195</b>
<b>Commitments and Contingencies</b> (Notes 9, 13 and 16)		
<b>Shareholders' Equity</b>		
Share capital (Note 10)		
Issued and outstanding		
66,221,675 common shares (2004 - 63,185,600 common shares)	198,417	302,932
Retained earnings	238,404	322,107
	<b>436,821</b>	<b>625,039</b>
	<b>\$1,111,350</b>	<b>\$ 1,542,786</b>

See accompanying notes to Consolidated Financial Statements.

On behalf of the Board

signed **J. H.T. Riddell**  
Director

signed **J. C. Gorman**  
Director



# CONSOLIDATED STATEMENTS OF EARNINGS (LOSS) AND RETAINED EARNINGS

Years Ended December 31 (thousands of dollars except per share amounts)	2005	2004
<b>Revenue</b>		
Petroleum and natural gas sales (Note 15)	\$ 482,670	\$ 592,546
Realized loss on financial instruments (Note 13)	(12,053)	(683)
Unrealized gain (loss) on financial instruments (Note 13)	(23,989)	19,376
Royalties (net of Alberta Royalty Tax Credit)	(91,227)	(105,046)
Income on investments and other (Note 8)	5,869	(34)
	<b>361,270</b>	<b>506,159</b>
<b>Expenses</b>		
Operating	75,858	95,767
Transportation (Note 15)	24,552	41,930
Interest	27,361	25,399
General and administrative (Notes 11 and 15)	86,147	66,442
Bad debt recovery	–	(5,523)
Lease rentals	3,139	3,546
Geological and geophysical	12,548	8,728
Dry hole costs	44,895	24,676
Gain on sale of property, plant and equipment	(8,412)	(16,255)
Accretion of asset retirement obligations	5,056	6,920
Depletion and depreciation	179,413	191,578
Write-down of petroleum and natural gas properties	14,867	–
Provision for impairment of investment (Notes 8 and 15)	1,130	–
Unrealized foreign exchange loss (gain) on US Notes	5,861	(24,188)
Realized foreign exchange gain on US Notes	(14,333)	(7,161)
Premium on redemption of US Notes (Note 9)	53,114	11,950
	<b>511,196</b>	<b>423,809</b>
<b>Income from equity investments</b>		
Equity income (Note 8)	23,201	–
Dilution gain (Note 8)	21,880	–
Non-controlling interest	49	–
	<b>(104,796)</b>	<b>82,350</b>
<b>Earnings (loss) before income taxes</b>		
<b>Income and other taxes</b> (Note 12)		
Large corporations tax and other	9,763	6,795
Future income tax (recovery) expense	(50,627)	40,660
	<b>(40,864)</b>	<b>47,455</b>
<b>Net earnings (loss) from continuing operations</b>	<b>(63,932)</b>	<b>34,895</b>
<b>Net earnings from discontinued operations</b> (Note 5)	<b>–</b>	<b>6,279</b>
<b>Net earnings (loss)</b>	<b>(63,932)</b>	<b>41,174</b>
Retained earnings, beginning of year	322,107	295,013
Adjustment due to Trust Spinout (Note 3)	(20,281)	–
Share in Trilogy's other capital transactions	510	–
Purchase and cancellation of share capital (Note 10)	–	(14,080)
<b>Retained earnings, end of year</b>	<b>\$ 238,404</b>	<b>\$ 322,107</b>
<b>Net earnings (loss) from continuing operations per common share</b>		
– basic	\$ (0.99)	\$ 0.58
– diluted	\$ (0.99)	\$ 0.57
<b>Net earnings from discontinued operations per common share</b>		
– basic	\$ –	\$ 0.11
– diluted	\$ –	\$ 0.10
<b>Net earnings (loss) per common share</b>		
– basic	\$ (0.99)	\$ 0.69
– diluted	\$ (0.99)	\$ 0.67
<b>Weighted average common shares outstanding</b> (thousands)		
– basic	64,899	59,755
– diluted	64,899	61,026

See accompanying notes to Consolidated Financial Statements.

# CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31 (thousands of dollars)	2005	2004
<b>Operating activities</b>		
Net earnings (loss) from continuing operations	\$ (63,932)	\$ 34,895
Add (deduct) non-cash and other items:		
Depletion and depreciation	179,413	191,578
Write-down of petroleum and natural gas properties	14,867	–
Provision for impairment of investment	1,130	–
Gain on sale of property, plant and equipment	(8,412)	(16,255)
Accretion of asset retirement obligations	5,056	6,920
Future income tax (recovery) expense	(50,627)	40,660
Amortization of other assets	636	1,277
Non-cash general and administrative expense	55,319	41,195
Unrealized loss (gain) on financial instruments	23,989	(19,376)
Unrealized foreign exchange loss (gain) on US Notes	5,861	(24,188)
Realized foreign exchange gain on US Notes	(14,333)	(7,161)
Premium on redemption of US Notes	53,114	11,950
Asset retirement obligations paid	(990)	(1,214)
Equity income (Note 8)	(23,201)	–
Gain on dilution of equity investment (Note 8)	(21,880)	–
Non-controlling interest	(49)	–
Distributions from equity investments	39,113	–
Dry hole costs	44,895	24,676
Geological and geophysical	12,548	8,728
<b>Funds flow from continuing operations</b>	<b>252,517</b>	<b>293,685</b>
<b>Funds flow from discontinued operations</b>	<b>–</b>	<b>667</b>
<b>Funds flow from operations</b>	<b>252,517</b>	<b>294,352</b>
Decrease (increase) in deferred credit	6,528	(3,959)
Net change in operating working capital (Note 14)	43,566	(27,320)
	<b>302,611</b>	<b>263,073</b>
<b>Financing activities</b>		
Bank loans – draws	489,630	431,951
Bank loans – repayments	(583,439)	(298,173)
Proceeds from US debt offering, net of issuance costs	(4,782)	162,917
Redemption of US debt	(1,088)	(105,686)
Premium on redemption of US Notes (Note 9)	(45,077)	(8,864)
Realized foreign exchange gain on US Notes	–	7,161
Capital stock – issued, net of issuance costs	50,438	115,043
Capital stock – purchased and cancelled	–	(19,401)
Cost of reorganization	(4,004)	–
Receipt of funds from Trilogy Spinout (Note 3)	220,000	–
Discontinued operations	–	(11,301)
	<b>121,678</b>	<b>273,647</b>
<b>Cash flows provided by operating and financing activities</b>	<b>424,289</b>	<b>536,720</b>
<b>Investing activities</b>		
Property, plant and equipment expenditures	(409,809)	(315,698)
Petroleum and natural gas property acquisitions	(24,171)	(322,598)
Proceeds on sale of property, plant and equipment	10,643	61,939
Equity investments	(6,857)	–
Return of capital received (Note 8)	1,931	–
Net change in investing working capital (Note 14)	3,974	27,349
Discontinued operations	–	12,288
<b>Cash flows used in investing activities</b>	<b>(424,289)</b>	<b>(536,720)</b>
Increase (decrease) in cash	–	–
Cash, beginning of year	–	–
<b>Cash, end of year</b>	<b>\$ –</b>	<b>\$ –</b>

See accompanying notes to Consolidated Financial Statements.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(all tabular amounts expressed in thousands of dollars)

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Paramount Resources Ltd. ("Paramount" or the "Company") is an independent Canadian energy company that explores for, develops, processes, transports and markets petroleum and natural gas. Paramount's principal properties are located in Alberta, the Northwest Territories and British Columbia. These Consolidated Financial Statements are stated in Canadian dollars and have been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP"), which differ in some respects from GAAP in the United States. These differences are described in Note 19 – Reconciliation of Financial Statements to United States Generally Accepted Accounting Principles.

### (A) PRINCIPLES OF CONSOLIDATION

These Consolidated Financial Statements include the accounts of Paramount Resources Ltd. and its subsidiaries.

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

Investments in companies and partnerships in which Paramount does not have direct or joint control over the strategic operating, investing and financing decisions, but over which it has significant influence, are accounted for using the equity method.

### (B) MEASUREMENT UNCERTAINTY

The timely preparation of these Consolidated Financial Statements in conformity with Canadian GAAP requires that management make estimates and assumptions and use judgment that affect: (i) the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements; and (ii) the reported amounts of revenues and expenses during the reported period. Such estimates primarily relate to unsettled transactions and events as of the date of the Consolidated Financial Statements. Actual results could differ from these estimates.

The amounts recorded for depletion and depreciation, impairment of petroleum and natural gas properties and equipment, and for asset retirement obligations are based on estimates of reserves, future costs, petroleum and natural gas prices and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact of changes in these estimates and assumptions on the consolidated financial statements of future periods could be material.

Crown royalties for Paramount's production from frontier lands in the Northwest Territories have been provided for in the Consolidated Financial Statements based on the Company's interpretation of the relevant legislation and regulations. At present, Paramount has not received assessments for a significant portion of its past Northwest Territories royalty filings with the Government of Canada. In addition, the Government of Canada is continuing its stakeholder and industry consultations concerning the application of and amendments to the regulations governing the computation of Crown royalties in the Northwest Territories. Although Paramount believes that its interpretation of the relevant legislation and regulations has merit, Paramount is unable to predict the ultimate outcome of future audits and/or assessments by the Government of Canada of Paramount's Northwest Territories crown royalty filings. Additional amounts could become payable and the impact on net earnings may be material.

### (C) REVENUE RECOGNITION

Revenues associated with the sale of natural gas, crude oil, and natural gas liquids ("NGLs") are recognized when title passes from Paramount to third parties.

## **(D) SHORT-TERM INVESTMENTS**

Short-term investments are carried at the lower of cost and market value. Included in short-term investments are investments in common shares and trust units and short-term debentures bearing interest at a rate of eight percent per annum.

## **(E) PROPERTY, PLANT AND EQUIPMENT**

### **Cost**

Property, plant and equipment is recorded at cost.

Paramount follows the successful efforts method of accounting for its petroleum and natural gas operations. Under this method, acquisition costs of oil and gas properties and costs of drilling and equipping development wells are capitalized. Costs of drilling exploratory wells are initially capitalized. If economically recoverable reserves are not found, such costs are charged to earnings as dry hole costs. Exploration wells in areas requiring major capital investments before production can begin are capitalized as long as drilling efforts are under way or firmly planned. If an exploratory well or an exploratory-type stratigraphic well is determined to have found oil and gas reserves, but those reserves cannot be classified as proved when drilling is completed, the capitalized drilling costs continue to be capitalized if the well has found sufficient quantity of reserves to justify its completion as a producing well and Paramount is making sufficient progress assessing the reserves and the economic and operating viability of the project. If either of these criteria are not met, or if Paramount obtains information that raises substantial doubt about the economic or operational viability of the project, the exploratory well or exploratory-type stratigraphic well is assumed to be impaired and its costs, net of any salvage value, are charged to expense. Paramount does not continue to capitalize exploratory well costs on the chance that current market conditions will change or technology will be developed to make the development of the project economically and operationally viable.

Exploration wells are assessed annually, or more frequently as evaluation conditions dictate, for determination of reserves, and as such, success. All other exploration costs, including geological and geophysical costs and annual lease rentals are charged to earnings when incurred.

### **Depletion and Depreciation**

Capitalized costs of proved oil and gas properties are depleted using the unit of production method. For purposes of these calculations, production and reserves of natural gas are converted to barrels on an energy equivalent basis.

Successful exploratory wells and development costs are depleted over proved developed reserves while acquired resource properties with proved reserves are depleted over proved reserves. Acquisition costs of probable reserves are not depleted or amortized while under active evaluation for commercial reserves. Costs are transferred to depletable costs as proved reserves are recognized. At the date of acquisition, an evaluation period is determined after which any remaining probable reserve costs associated with producing fields are transferred to depletable costs.

Costs associated with significant development projects are not depleted until commercial production commences. Depreciation of gas plants, gathering systems and production equipment is provided on a straight-line basis over their estimated useful life varying from 12 to 40 years. Depreciation of other equipment is provided on a declining balance method at rates varying from 20 to 50 percent.

### **Impairment**

Producing areas and significant unproved properties are assessed annually or as economic events dictate for potential impairment. Any impairment loss is the difference between the fair value of the asset and its carrying value .

## **(F) ASSET RETIREMENT OBLIGATIONS**

Paramount recognizes the fair value of an asset retirement obligation in the period in which it is incurred or when a reasonable estimate of the fair value can be made. The fair value of the retirement obligations are capitalized as part of the cost of the related long-lived asset and depreciated on the same basis as the underlying asset. The accumulated asset retirement obligation is adjusted for the passage of time, which is recognized as accretion expense in the consolidated

statement of earnings, and for revisions in either the timing or the amount of the original estimated cash flows associated with the liability. Actual costs incurred upon settlement of the asset retirement obligation reduce the asset retirement obligation to the extent of the liability recorded. Differences between the actual costs incurred upon settlement of the asset retirement obligation and the liability recorded are recognized in Paramount's earnings in the period in which the settlement occurs.

#### **(G) DEFERRED FINANCING CHARGES**

Deferred financing charges are included in long-term investments and other assets and are amortized using the straight-line method over the term of the related debt.

#### **(H) GOODWILL**

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

#### **(I) FOREIGN CURRENCY TRANSLATION**

Paramount's foreign operations are considered integrated and therefore, the accounts related to such operations are translated into Canadian dollars using the temporal method.

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

#### **(J) FINANCIAL INSTRUMENTS**

Paramount periodically utilizes derivative financial instrument contracts such as forwards, futures, swaps and options to manage its exposure to fluctuations in petroleum and natural gas prices, the Canadian/US dollar exchange rate and interest rates.

Financial instruments that do not qualify as hedges under Accounting Guideline 13, or are not designated as hedges, are recorded at fair value on the Paramount consolidated balance sheet, with subsequent changes in fair value recognized in net earnings. Realized gains or losses from financial instruments related to commodity prices are recognized in net earnings as the related sales occur. The estimated fair value of financial instruments is based on quoted market prices or, in their absence, third party market indicators and forecasts.

#### **(K) INCOME TAXES**

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

#### **(L) FLOW-THROUGH SHARES**

Paramount has financed a portion of its exploration activities through the issue of flow-through shares. As permitted under the Income Tax Act (Canada), the tax attributes of eligible expenditures incurred with the proceeds of a flow-through share issuance are renounced to subscribers.

On the effective date of renunciation, a future income tax liability is recognized, and shareholder's equity is reduced, for the tax effect of expenditures renounced to the subscribers.

### **(M) STOCK-BASED COMPENSATION**

Paramount has granted stock options to employees and directors, the details of which are described in Note 11 – Stock-based Compensation.

Paramount uses the intrinsic value method to recognize compensation expense associated with the Paramount Options, New Paramount Options and Holdco Options (all as defined in Note 11). Applying the intrinsic value method to account for stock-based compensation, a liability is accrued over the vesting period of the options, based on the difference between the exercise price of the options and the market price or fair value of the underlying securities. The liability is revalued at the end of each reporting period to reflect changes in the market price or fair value of the underlying securities and the net change is recognized in earnings as general and administrative expense. When options are surrendered for cash, the cash settlement paid reduces the outstanding liability to the extent the liability was accrued. The difference between the cash settlement and the accrued liability is recognized in earnings as general and administrative expense. When options are exercised for common shares, consideration paid by the option holder and the previously recognized liability associated with the options are recorded as an increase to share capital.

### **(N) PER COMMON SHARE AMOUNTS**

Paramount uses the treasury stock method to determine the dilutive effect of stock options and other dilutive instruments. This method assumes that proceeds received from the exercise of in-the-money stock options and other dilutive instruments are used to purchase common shares at the average market price during the period.

## **2. CHANGES IN ACCOUNTING POLICIES**

### **(A) VARIABLE INTEREST ENTITIES**

On January 1, 2005, Paramount adopted Accounting Guideline 15 ("AcG-15") "Consolidation of Variable Interest Entities." AcG-15 defines a variable interest entity ("VIE") as a legal entity in which either the total equity at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by other parties or the equity owners lack a controlling financial interest. The guideline requires the enterprise which absorbs the majority of a VIE's expected gains or losses, the primary beneficiary, to consolidate the VIE.

There was no effect on Paramount's Consolidated Financial Statements as a result of the adoption of AcG-15.

### **(B) ACCOUNTING FOR SUSPENDED WELL COSTS**

On July 1, 2005, Paramount adopted the guidance set out by FASB Staff Position FAS19-1 "Accounting for Suspended Well Costs" ("FSP FAS 19-1") with respect to suspended exploratory wells. FSP FAS 19-1 replaced certain provisions of FASB Statement No. 19 setting out certain criteria in continuing to capitalize drilling costs of suspended exploratory wells and exploratory-type stratigraphic wells and requiring management to apply more judgment in evaluating whether costs meet criteria for continued capitalization. No significant costs were written off as a result of the adoption of FSP FAS 19-1. Additional information on suspended wells required to be disclosed by FSP FAS 19-1 is set out in Note 6 - Property, Plant and Equipment.

### 3. TRILOGY SPINOUT

On April 1, 2005, Paramount completed a reorganization pursuant to a plan of arrangement under the *Business Corporations Act* (Alberta), resulting in the creation of Trilogy Energy Trust ("Trilogy") as a new publicly-traded energy trust (the "Trilogy Spinout").

Through the Trilogy Spinout:

- Certain properties owned by Paramount that were located in the Kaybob and Marten Creek areas of Alberta and three natural gas plants operated by Paramount became property of Trilogy (the "Spinout Assets");
- Paramount received an aggregate \$220 million in cash (including \$30 million as settlement of working capital accounts) and 79.1 million units of Trilogy (64.1 million being ultimately received by Paramount shareholders) as consideration for the Spinout Assets and related working capital adjustments; and
- Paramount's shareholders received one Class A common share of Paramount and one unit of Trilogy for each common share of Paramount previously held, resulting in Paramount's shareholders owning 64.1 million (81 percent) of the 79.1 million issued and outstanding units of Trilogy, and Paramount holding the remaining 15.0 million (19 percent) of such Trilogy units.

Upon completion of the Trilogy Spinout, shareholders of Paramount owned all of the issued and outstanding Class A common shares of Paramount.

In addition to certain assets previously owned by Paramount, the Spinout Assets included substantially all of the Kaybob properties that Paramount acquired in June 2004 as part of the \$185.1 million acquisition and all of the Marten Creek properties that Paramount acquired as part of the August 2004 acquisition for \$86.9 million (see Note 4).

During the fourth quarter of 2005, Paramount finalized the entries related to the Trilogy Spinout, the results of which are summarized below.

Paramount's transfer of the Spinout Assets to Trilogy under the Trilogy Spinout did not result in a substantive change in ownership of the Spinout Assets under GAAP. Therefore, the transaction was accounted for using the carrying value of the net assets transferred and did not give rise to a gain or loss in the Consolidated Financial Statements of Paramount. The net change to retained earnings was a \$20.3 million decrease. The carrying value in Paramount's Consolidated Financial Statements of the assets net of related liabilities transferred to Trilogy on April 1, 2005 were as follows:

Property, plant and equipment, net	\$ 637,196
Goodwill	19,400
Asset retirement obligations	(65,076)
Net working capital accounts	(50,884)
Future income tax liabilities	(142,111)
	\$ 398,525

The following table provides a summary of the impact of the Trilogy Spinout on share capital, retained earnings, and the residual value of Paramount's 19 percent interest in Trilogy immediately after the Trilogy Spinout becoming effective:

	Share Capital	Retained Earnings	Investment in Trilogy Energy Trust <sup>1</sup>	Total
Balance as at March 31, 2005	\$ 314,272	\$ 276,549	\$ –	\$ 590,821
Common share exchange (Note 10)	(157,136)	157,136	–	–
Carrying value of assets and related liabilities transferred to Trilogy	–	(322,805)	(75,720)	(398,525) <sup>(2)</sup>
Cash received per the plan of arrangement	–	153,900	36,100	190,000 <sup>(2)</sup>
Tax expense arising on reorganization	–	(3,752)	–	(3,752)
Paramount's reorganization costs related to Trilogy Spinout	–	(4,004)	–	(4,004)
Paramount's equity share of Trilogy formation costs (Note 8)	–	(756)	–	(756)
Net adjustments	(157,136)	(20,281)	(39,620)	(217,037)
Balance as at April 1, 2005	\$ 157,136	\$ 256,268	\$ (39,620)	\$ 373,784

<sup>1</sup> Amounts were credited (debited) to Investment in Trilogy Energy Trust.

<sup>2</sup> Excluding \$30 million initial cash settlement of working capital distribution accounts.

#### 4. ACQUISITION OF OIL AND GAS PROPERTIES

On June 30, 2004, Paramount closed an acquisition of petroleum and natural gas assets for an aggregate purchase price of \$185.1 million, after adjustments. Paramount assigned the entire amount of the purchase price to property, plant and equipment and recognized a \$26.8 million asset retirement obligation related to those properties.

On August 16, 2004, Paramount closed an acquisition of petroleum and natural gas assets for an aggregate purchase price of \$86.9 million, after adjustments. In accounting for this acquisition, Paramount recorded a future tax asset in the amount of \$89.0 million and recognized a \$2.1 million asset retirement obligation related to those properties.

#### 5. DISCONTINUED OPERATIONS

On July 27, 2004, a private drilling company in which Paramount owns a 50 percent equity interest, ("Drillco"), closed the sale of its drilling assets for \$32 million to a publicly traded income trust. The gross proceeds were \$19.2 million cash with the balance in exchangeable shares. The exchangeable shares were valued at the fair market value of the purchasers' shares and were redeemable for trust units in the income trust, subject to securities laws and regulations. In connection with the closing of the sale, certain indebtedness related to these operations was extinguished. The results of operations of Drillco for the period to July 27, 2004 have been presented as discontinued operations.

On September 10, 2004, Paramount completed the disposition of its 99 percent interest in a drilling partnership for approximately \$1.0 million. For reporting purposes, the drilling partnership has been accounted for as discontinued operations.

On December 13, 2004, Paramount completed the disposition of a building acquired as part of the \$185.1 million acquisition, for approximately \$10.5 million, inclusive of the mortgage assumed by the purchaser of \$6.4 million.



Selected financial information of the discontinued operations for the year ended December 31, 2004 is provided below:

	Drillco	Drilling Partnership	Building	Total
<b>Revenue</b>				
Other income	\$ 908	\$ 327	\$ –	\$ 1,235
<b>Expenses (Recovery)</b>				
Interest	250	–	367	617
General and administrative	642	384	(308)	718
Depreciation	655	6	278	939
Gain on sale of property and equipment	(6,659)	(27)	(2,569)	(9,255)
	(5,112)	363	(2,232)	(6,981)
Net earnings (loss) before income tax	6,020	(36)	2,232	8,216
Large corporation tax and other	1,857	–	(34)	1,823
Future income tax expense	94	–	20	114
Net earnings (loss) from discontinued operations	\$ 4,069	\$ (36)	\$ 2,246	\$ 6,279

## 6. PROPERTY PLANT AND EQUIPMENT

	2005			2004
	Accumulated Cost	Depletion and Depreciation	Net Book Value	Net Book Value
Petroleum and natural gas properties	\$ 913,386	\$ 307,201	\$ 606,185	\$ 901,432
Gas plants, gathering systems and production equipment	385,131	81,260	303,871	421,114
Other	16,134	11,611	4,523	23,260
Net book value	\$1,314,651	\$ 400,072	\$ 914,579	\$ 1,345,806

Included in property, plant and equipment are asset retirement costs, net of accumulated depletion and depreciation, of \$40.5 million (2004 - \$57.4 million). Capital costs associated with non-producing petroleum and natural gas properties totaling approximately \$320 million (2004 - \$300 million) are currently not subject to depletion.

For the year ended December 31, 2005, Paramount expensed \$44.9 million in dry hole costs (2004 - \$24.7 million). A portion of the dry hole costs expensed related to prior year capital projects that were determined in the current year to have no future economic value.

Additional disclosures for suspended wells are as follows:

<b>Continuity of Suspended Exploratory Well Costs</b> (millions of dollars)	2005	2004
Balance at January 1	\$ 118	\$ 46
Additions pending the determination of proved reserves	111	110
Reclassifications to proved reserves	(55)	(24)
Wells costs charged to dry hole expense	(24)	(14)
Wells sold	(7)	–
Balance at December 31	\$ 143	\$ 118

<b>Aging of Capitalized Exploratory Well Costs</b> (millions of dollars)	<b>2005</b>	2004
Capitalized exploratory well costs that have been capitalized for a period of one year or less	\$ 81	\$ 86
Capitalized exploratory well costs that have been capitalized for a period of greater than one year	62	32
Balance at December 31	\$ 143	\$ 118
Number of projects that have exploratory well costs that have been capitalized for a period greater than one year	63	23

At December 31, 2005, \$73.6 million of the capitalized costs of suspended wells related to Colville Lake in the Northwest Territories. The commerciality of the gas in Colville Lake is being evaluated in conjunction with Paramount's planned drilling program and the anticipated timing for construction of the MacKenzie Valley Gas Pipeline. The remaining capitalized costs relate to projects where infrastructure decisions are dependent upon environmental permission and production capacity, or where Paramount is continuing to assess reserves and their potential development, including those relating to oil sands.

## 7. ASSET RETIREMENT OBLIGATIONS

	<b>2005</b>	2004
Asset retirement obligations, beginning of year	\$ 101,486	\$ 61,554
Adjustment resulting from the Trilogy Spinout (Note 3)	(65,076)	-
Liabilities incurred	3,614	34,226
Revisions in estimated cost of abandonment	22,113	-
Liabilities settled	(990)	(1,214)
Accretion expense	5,056	6,920
Asset retirement obligations, end of year	\$ 66,203	\$ 101,486

The total future asset retirement obligation was estimated by management based on Paramount's net ownership in all wells and facilities, estimated work to reclaim and abandon the wells and facilities, and the estimated timing of the costs to be incurred in future periods. The undiscounted asset retirement obligations associated with Paramount's oil and gas properties at December 31, 2005 are \$138.4 million (December 31, 2004 - \$136.2 million), which have been discounted using credit-adjusted risk-free rates between 7 7/8 percent and 8 1/2 percent. The majority of these obligations are not expected to be settled for several years, or decades, in the future and will be funded from general company resources at that time.

Paramount updated the estimate of its asset retirement obligation on October 1, 2005 and made an upward revision to the asset retirement obligation of \$22.1 million due mainly to the increases in estimated cost of abandonment. This revision increased the related cost of the underlying assets.

## 8. LONG-TERM INVESTMENTS AND OTHER ASSETS

	2005	2004
Equity accounted investments:		
Trilogy Energy Trust (market value as at December 31, 2005 - \$357.8 million)	\$ 51,665	\$ -
Private oil and gas company	623	-
	<b>52,288</b>	-
Deferred financing costs net of amortization	4,179	7,709
	<b>\$ 56,467</b>	\$ 7,709

The following table provides a continuity of Paramount's equity accounted investments for the year ended December 31, 2005:

	Trilogy Energy Trust	Private Oil and Gas Company	Gas Marketing Limited Partnership	Total
Balance as at December 31, 2004	\$ -	\$ -	\$ -	\$ -
Initial carrying value of investment (Note 3)	39,620	-	-	39,620
Cost of investment	-	3,180	7,457	10,637
Return-of-capital	-	(1,931)	-	(1,931)
Equity income (loss) for the period	21,191	3,155	(1,145)	23,201
Future income tax recovery on equity income	4,217	-	-	4,217
Distributions received and receivable	(35,332)	(3,781)	-	(39,113)
Dilution gain (see below)	21,880	-	-	21,880
Provision for impairment	-	-	(1,130)	(1,130)
Reclassification to short-term investments	-	-	(5,182)	(5,182)
Stock-based compensation awards to Trilogy employees	845	-	-	845
Paramount's equity share in units issuance costs	(756)	-	-	(756)
Balance as at December 31, 2005	\$ 51,665	\$ 623	\$ -	\$ 52,288

The dilution gain relating to Trilogy Energy Trust resulted from Trilogy's issuance of additional Trust Units to third parties on December 30, 2005 decreasing Paramount's equity interest in Trilogy from 19 percent to 17.66 percent as at that date.

In March 2005, Paramount completed a transaction whereby it acquired an indirect 30 percent interest (25 percent net of non-controlling interest) in a gas marketing limited partnership for \$7.5 million (US\$6 million). The gas marketing limited partnership commenced operations on March 9, 2005 and was being accounted for using the equity method. On November 30, 2005, the gas marketing limited partnership ceased commercial operations with the intention to dissolve. In connection with such planned dissolution, Paramount has recognized a before tax provision for impairment of \$1.1 million which represents the excess of the carrying value over the net realizable value of the investment. The net realizable value of Paramount's investment has been presented as part of short-term investments at December 31, 2005.

In October 2005, Paramount received distributions, valued at \$5.7 million, in the form of common shares of a Toronto Stock Exchange listed oil and gas company, from a private oil and gas company. The distributions consisted of a return-of-capital of \$1.9 million and dividends of \$3.8 million resulting from a disposition of one of the private oil and gas company's producing properties.

## 9. LONG-TERM DEBT

	2005	2004
Credit facility – current interest rate of 4.9 percent (2004 - 3.8 percent)	\$ 105,479	\$ 201,305
7 7/8 percent US Senior Notes due 2010 (US\$133.3 million)	–	160,174
8 1/2 percent US Senior Notes due 2013 (US\$213.6 million)	248,409	–
8 7/8 percent US Senior Notes due 2014 (US\$81.3 million)	–	97,662
	\$ 353,888	\$ 459,141

### CREDIT FACILITIES

At December 31, 2005, Paramount had a \$189 million committed revolving/non-revolving term facility with a syndicate of Canadian banks. Borrowings under the facility bear interest at the lender's prime rate, bankers' acceptance rate, or LIBOR plus an applicable margin dependent on certain conditions. Advances drawn on the facility are secured by a fixed and floating charge over the assets of Paramount, excluding 12,755,845 of the Trilogy units owned by Paramount. At the end of each month, Paramount's lenders review the market value of these Trilogy units. Paramount's lenders may increase or decrease the credit facility borrowing base to the extent there is a significant increase or decrease in the value of these units. The maximum credit facility borrowing base that can be extended under the current agreement is \$200 million as at December 31, 2005. The revolving nature of Paramount's credit facility expires on March 30, 2006. Pursuant to the terms of the credit agreement, Paramount has requested an extension of one year on the revolving feature. Paramount anticipates this request will be approved and the revolving feature on the credit facility will be extended to March 29, 2007. Upon the expiry of the revolving feature of the credit agreement, amounts outstanding will have a term maturity date of one additional year.

Paramount had letters of credit totaling \$23.3 million outstanding at December 31, 2005 (December 31, 2004 - \$28.1 million). These letters of credit reduce the amount available under Paramount's credit facility.

### US SENIOR NOTES

On February 7, 2005, Paramount completed a note exchange offer and consent solicitation issuing US\$213.6 million principal amount of 8 1/2 percent Senior Notes due 2013 (the "2013 Notes") and paying aggregate cash consideration of \$45.1 million (US\$36.2 million) in exchange for approximately 99.3 percent of the outstanding 7 7/8 percent Senior Notes due 2010 (the "2010 Notes"), all of the outstanding 8 7/8 percent Senior Notes due 2014 (the "2014 Notes") and the note holders' consent for Paramount to proceed with the Trilogy Spinout. At December 31, 2005, Paramount's obligations respecting the 2010 Notes and 2014 Notes have been extinguished as a result of the note exchange and subsequent open market repurchases. Paramount has expensed \$8.0 million of deferred financing costs associated with the 2010 Notes and the 2014 Notes.

The 2013 Notes bear interest at a rate of 8 1/2 percent per year and mature on January 31, 2013. They are secured by 12,755,845 units of Trilogy Energy Trust that are owned by Paramount, which had a market value of \$303.6 million on December 31, 2005. Paramount may sell any or all of such trust units, in one or more transactions, provided it offers to redeem 2013 Notes with the net proceeds received. The redemption price associated with such an offer would be par plus a redemption premium, if applicable, of up to 4 1/4 percent, depending on when the offer is made. Paramount may, at its option, redeem all or a portion of the 2013 Notes after January 31, 2007 at a price equal to par plus a redemption premium, if applicable, of up to 4 1/4 percent depending on when the 2013 Notes are redeemed. The 2013 Notes cannot be redeemed with the proceeds of an equity offering prior to January 31, 2007. In any event of redemption, holders are entitled to receive any accrued and unpaid interest.

Holder of a majority in aggregate principal amount of the 2013 Notes had until September 30, 2005 to provide notice of their election to increase the interest rate on such notes to 10 1/2 percent per year. Had such notice been provided, Paramount could have, at its option, redeemed all of such notes at par on or prior to January 31, 2006. The required majority of holders did not provide such notice.

## 10. SHARE CAPITAL

### AUTHORIZED

Amendments to the authorized classes of Paramount's capital were approved by shareholders in March 2005 in connection with the approval of the Trilogy Spinout. Paramount's authorized capital is comprised of an unlimited number of voting Class A Common Shares, an unlimited number of non-voting redeemable / retractable Class X Preferred Shares, an unlimited number of non-voting redeemable / retractable Class Z Preferred Shares and an unlimited number of non-voting Preferred Shares issuable in series, all of such classes of authorized capital without par value. The redemption price for each Class X Preferred Share and each Class Z Preferred Share is \$15.23. The Class X Preferred Shares and Class Z Preferred Shares carry non-cumulative preferential dividends as and when declared by the Board of Directors of Paramount.

### TRILOGY SPINOUT

In connection with the Trilogy Spinout, the following transactions took place:

- 34,157,780 Common Shares held by shareholders (which exclude Common Shares held by "Substantial Shareholders" as later defined) were transferred to Paramount in exchange for the issuance to such shareholders of 34,157,780 Class A Common Shares and 34,157,780 Class X Preferred Shares, whereupon the Common Shares received by Paramount were cancelled.
- 29,940,270 Common Shares held by Substantial Shareholders (a person who either alone or together with persons that were related to that person for purposes of the Income Tax Act (Canada), beneficially owned 25 percent or more of the issued and outstanding common shares) were transferred to Paramount in exchange for the issuance to such Substantial Shareholders of 29,940,270 Class A Common Shares and 29,940,270 Class Z Preferred Shares, whereupon the Common Shares received by Paramount were cancelled.
- All of the issued and outstanding Class Z Preferred Shares were redeemed by Paramount in exchange for the issuance by Paramount of notes payable to the Substantial Shareholders (the "Redemption Notes") whereupon all of the Class Z Preferred Shares were cancelled.
- The Redemption Notes were transferred and assigned to a subsidiary of Trilogy by the Substantial Shareholders in exchange for 29,940,270 Trilogy trust units. The Redemption Notes were extinguished during the course of the Trilogy Spinout reorganization.
- All of the issued and outstanding Class X Preferred Shares were transferred by the holders of such shares to a wholly-owned subsidiary of Paramount Resources Ltd. ("Exchangeco") in exchange for Trilogy trust units. As of December 31, 2005, Exchangeco held 34,157,780 Class X Preferred Shares of Paramount Resources Ltd.

For presentation purposes, Paramount has shown the Class A Common Shares as a continuity of the Common Shares, with an adjustment to the carrying value of such shares to reflect the impact of the Trilogy Spinout.

## ISSUED AND OUTSTANDING

Common Shares/Class A Common Shares	Number	Consideration
Balance December 31, 2003	60,094,600	\$ 200,274
Shares repurchased - at carrying value	(1,629,500)	(5,322)
Stock options exercised	220,500	3,057
Common shares issued, net of issuance costs	2,500,000	54,901
Flow-through shares issued, net of issuance costs	2,000,000	57,981
Tax adjustment on share issuance costs and flow-through share renunciations	-	(7,959)
Balance December 31, 2004	63,185,600	302,932
Stock options exercised (Note 11)	1,136,075	29,126
Flow through shares issued, net of issuance costs	1,900,000	39,588
Tax adjustment on share issuance costs and flow-through share renunciations	-	(16,093)
Common share exchange adjustment due to Trilogy Spinout (Note 3)	-	(157,136)
<b>Balance December 31, 2005</b>	<b>66,221,675</b>	<b>\$ 198,417</b>

On July 14, 2005, Paramount completed the private placement of 1,900,000 Common Shares issued on a "flow-through" basis at a price of \$21.25 per share. The gross proceeds of the issue were \$40.4 million. During the year ended December 31, 2005, Paramount made renunciations of \$20.3 million.

On October 26, 2004, Paramount completed the issuance of 2,500,000 Common Shares at a price of \$23.00 per share. The gross proceeds of the issue were \$57.5 million.

On October 15, 2004, Paramount completed the private placement of 2,000,000 Common Shares issued on a "flow-through" basis at a price of \$29.50 per share. The gross proceeds of the issue were \$59.0 million. During the year ended December 31, 2005, Paramount made renunciations of \$35.3 million (2004 - \$23.7 million).

Paramount obtained approval to institute a Normal Course Issuer Bid program for the acquisition of up to five percent of its issued and outstanding common shares from May 15, 2003 to May 14, 2004. Between January 1, 2004 and May 14, 2004, Paramount repurchased and cancelled 1,629,500 Common Shares pursuant to the program at an average price of \$11.91 per share. For the year ended December 31, 2004, \$14.1 million was charged to retained earnings related to the excess of the price at which such shares were repurchased over the carrying value of the shares.

## 11. STOCK-BASED COMPENSATION

### PARAMOUNT OPTIONS

Paramount has a Stock Option Plan (the "Plan") that enables the Board of Directors or its Compensation Committee to grant to key Paramount employees and directors options to acquire Common Shares. The exercise price of an option is no lower than the closing market price of the Common Shares on the day preceding the date of grant. Upon exercise of options under the Plan, optionholders may be entitled to receive, at the election of the employee, either a share certificate for the Common Shares or a cash payment in an amount equal to the positive difference, if any, between the market price and the exercise price of the number of Common Shares in respect of which the option is exercised: the market price being the weighted average trading price of the Common Shares on the Toronto Stock Exchange for the five (5) trading days preceding the date of exercise. Paramount, however, can refuse to accept a cash surrender. Cash payments made in respect of the Plan are charged to general and administrative expenses when incurred. Options granted generally vest over four years and have a four and half year contractual life.

Under the terms of the plan of arrangement reorganization respecting the Trilogy Spinout effective April 1, 2005, each outstanding Paramount Option was replaced with one New Paramount Option and one Holdco Option. A New Paramount Option and a Holdco Option issued in replacement of a Paramount Option each related to the same number of Class A Common Shares and Holdco shares, (which derive their value from Trilogy Trust units), respectively, as the number of Common Shares issuable under the replaced Paramount Option, and had the same aggregate exercise price as the replaced

Paramount Option with the respective exercise price being determined based on the Class A Common Share weighted average trading price and the Trilogy Trust unit weighted average trading price. This was intended to preserve, but not enhance, the economic benefit to the optionholders.

### **NEW PARAMOUNT OPTIONS**

Each New Paramount Option is subject to the Plan and is identical to the Paramount option, except that, for each New Paramount Option that replaced the Paramount Options;

- a) it entitles the holder to acquire Class A Common Shares;
- b) the exercise price was determined by multiplying the exercise price of the Paramount Option it replaced by the fraction determined by dividing the Class A Common Share weighted average trading price by the sum of the Class A Common Share weighted average trading price and the Trilogy Trust unit weighted average trading price; and
- c) the provisions relating to termination in the event of ceasing to be a Paramount employee only apply in the event the optionholder is no longer employed by either Paramount or Trilogy.

The granting of Paramount Options ceased March 31, 2005. Effective April 1, 2005, only New Paramount Options are granted under the Plan.

### **HOLDCO OPTIONS**

Under the Trilogy Spinout, Paramount transferred 2,279,500 Trilogy Energy Trust units to a wholly owned, non-public subsidiary of Paramount ("Holdco"). The Holdco Options are not subject to the Plan.

Each Holdco Option entitles the holder thereof to acquire from Paramount the same number of common shares of Holdco, as the number of common shares issuable under the holder's Paramount Option. The exercise price is the exercise price of the original Paramount Option less the exercise price of the related New Paramount Option. The vesting dates and expiry dates are the same as the Paramount Option and the termination provisions are the same as for the related New Paramount Option.

Holdco's shares are not listed for trading on any stock exchange. As a result, holders of the Holdco Options have the right, alternatively, to surrender options for cancellation in return for a cash payment from Paramount. The amount of the payment in respect of each Holdco share subject to the surrendered option is the difference between the fair market value of a Holdco share at the date of surrender and the exercise price. The fair market value of a Holdco share is based on the fair market value of the Trilogy Trust units it holds and any after-tax cash and investments (resulting from distributions on the Trilogy Trust units).

As at December 31, 2005, 3,828,425 New Common Shares of Paramount were reserved for issuance under Paramount's Employee Incentive Stock Option Plan. As at December 31, 2005, 3,910,175 New Paramount Options are outstanding, exercisable to April 30, 2010 at prices ranging from \$4.33 to \$34.20 per share. The following table provides a continuity of Paramount's stock options:

<b>Paramount Options</b>	<b>Year Ended December 31, 2005</b>		<b>Year Ended December 31, 2004</b>	
	<b>Weighted Average Exercise Price</b>	<b>Options</b>	<b>Weighted Average Exercise Price</b>	<b>Options</b>
Balance, January 1	\$ 10.41	3,212,500	\$ 9.64	3,632,000
Granted	28.62	148,000	17.09	348,000
Exercised	10.50	(1,057,000)	9.97	(618,500)
Cancelled	26.90	(24,000)	9.09	(149,000)
Cancelled under the plan of arrangement reorganization	11.38	2,279,500	-	-
Balance, December 31	\$ -	-	\$ 10.41	3,212,500
Options exercisable, December 31	\$ -	-	\$ 10.26	1,282,875

<b>New Paramount Options</b>	<b>Year Ended December 31, 2005</b>	
	<b>Weighted Average Exercise Price</b>	<b>Options</b>
Balance, January 1, 2005	\$ -	-
Granted - Trilogy Spinout	5.53	2,279,500
Granted - April 1, 2005 to December 31, 2005	14.89	2,030,250
Exercised	5.91	(321,575)
Cancelled	7.22	(78,000)
Balance, December 31, 2005	\$ 10.22	3,910,175
Options exercisable, December 31, 2005	\$ 5.08	853,800

<b>Holdco Options</b>	<b>Year Ended December 31, 2005</b>	
	<b>Weighted Average Exercise Price</b>	<b>Options</b>
Balance, January 1, 2005	\$ -	-
Granted - Trilogy Spinout	5.85	2,279,500
Exercised	5.11	(253,125)
Cancelled	9.98	(41,000)
Balance, December 31, 2005	\$ 5.79	1,985,375
Options exercisable, December 31, 2005	\$ 4.92	864,250



Additional information about Paramount's stock options outstanding as at December 31, 2005 is as follows:

Exercise Price	Outstanding			Exercisable	
	Number	Weighted Average Contractual Life	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
<b>New Paramount Options</b>					
\$4.33-\$4.96	1,567,225	1.9	\$ 4.40	784,100	\$ 4.40
\$5.22-\$9.48	213,500	2.9	7.19	25,000	6.66
\$11.26-\$34.20	2,129,450	3.8	14.80	44,700	16.06
Total	3,910,175	3.0	\$ 10.22	853,800	5.08
<b>Holdco Options</b>					
\$4.58-\$5.52	1,635,375	1.9	\$ 4.67	827,250	4.67
\$6.18-\$8.60	124,000	2.9	7.12	11,500	7.28
\$10.03-\$16.37	226,000	3.5	13.18	25,500	11.99
Total	1,985,375	2.1	\$ 5.79	864,250	\$ 4.92

During the year ended December 31, 2005, 144,550 Paramount Options were surrendered in exchange for a cash payment from Paramount of \$2.7 million (2004 - 398,000 options for \$2.9 million), for which \$2.0 million of this amount (2004 - \$2.9 million) reduced the stock-based compensation liability with the balance charged to earnings during the year. In addition, 912,450 Paramount Options were exercised for shares for cash proceeds to Paramount of \$9.5 million (2004 - 220,500 Paramount Options for cash proceeds of \$1.6 million) resulting in a decrease in the related stock-based compensation liability by \$13.4 million (2004 - \$1.5 million) and an increase in share capital by \$22.9 million (2004 - \$3.1 million).

During the year ended December 31, 2005, 97,950 New Paramount Options were surrendered in exchange for a cash payment from Paramount of \$1.4 million, for which, \$0.8 million of this amount reduced the stock-based compensation liability with the balance charged to earnings during the period. In addition, 223,625 New Paramount Options were exercised for common shares for cash proceeds of \$1.4 million to Paramount resulting in a decrease in the related stock-based compensation liability by \$4.9 million and an increase in share capital by \$6.3 million.

During the year ended December 31, 2005, 253,125 Holdco Options were surrendered in exchange for a cash payment from Paramount of \$4.8 million, which reduced the stock-based compensation liability.

The current portion of stock-based compensation liability of \$27.3 million at December 31, 2005 represents the value, using the intrinsic value method, of vested Holdco options and Holdco options vesting during 2006. For exercises of New Paramount Options, Paramount has generally refused to accept a cash surrender since August 15, 2005 and has therefore required holders of New Paramount Options to exercise their vested options and acquire Class A Common Shares.

For the year ended December 31, 2005, Paramount recognized compensation costs related to the mark-to-market valuation of the Paramount Options, New Paramount Options and Holdco Options amounting to \$3.7 million, \$37.8 million and \$16.8 million, respectively. For the year ended December 31, 2004, Paramount recognized compensation costs related to the mark-to-market valuation of Paramount Options of \$41.0 million. Such compensation costs are presented as part of general and administrative expense in the consolidated statements of earnings (loss).

## 12. INCOME TAXES

The following table reconciles income taxes calculated at the Canadian statutory rate to actual income taxes:

	2005	2004
Canadian statutory income tax rate	<b>37.81%</b>	39.04%
Calculated income tax expense (recovery)	<b>\$ (39,623)</b>	\$ 32,150
Increase (decrease) resulting from:		
Non-deductible crown charges, net of Alberta Royalty Tax Credit	<b>13,894</b>	25,455
Federal resource allowance	<b>(9,380)</b>	(21,787)
Federal and provincial income tax rate adjustment	<b>(2,950)</b>	481
Attributed Canadian Royalty Income recognized	<b>(564)</b>	(1,469)
Large corporations tax and other	<b>9,763</b>	6,795
Non-taxable portion of gain on sale of investments	<b>(2,925)</b>	(4,301)
Dilution gain	<b>(8,273)</b>	–
Recognition of tax pools not previously recognized	<b>(16,649)</b>	–
Stock based compensation	<b>16,980</b>	3,205
Other	<b>(1,137)</b>	6,926
Income tax expense (recovery)	<b>\$ (40,864)</b>	\$ 47,455

### COMPONENTS OF FUTURE INCOME TAX (ASSET) LIABILITY

	2005	2004
Timing of partnership items	<b>\$ 84,412</b>	\$ 114,406
Property, plant and equipment in excess of tax value	<b>(51,481)</b>	101,177
Asset retirement obligations	<b>(22,382)</b>	(34,281)
Stock-based compensation liability	<b>(11,235)</b>	(12,405)
Other	<b>(2,237)</b>	(2,517)
	<b>\$ (2,923)</b>	\$ 166,380

The tax benefit of \$4.5 million of operating losses has not been recognized in the Consolidated Financial Statements.

## 13. FINANCIAL INSTRUMENTS

Paramount has elected not to designate any of its financial instruments as hedges under Accounting Guideline 13, Hedging Relationships ("AcG-13"). Prior to January 1, 2004, Paramount had designated its derivative financial instruments as hedges. The fair value of all outstanding financial instruments that were no longer designated as hedges under AcG-13, were recorded on the consolidated balance sheet with an offsetting net deferred gain. The net deferred loss was recognized into net earnings until December 31, 2005.

The changes in fair value associated with the financial instruments are recorded on the consolidated balance sheets with the associated unrealized gain or loss recorded in net earnings. The estimated fair value of all financial instruments is based on quoted prices or, in the absence of quoted prices, third party market indications and forecasts.

The following tables present a reconciliation of the change in the unrealized and realized gains and losses on financial instruments:

	2005			2004		
	Net Deferred Amounts on Transition	Mark-to Market Gain(Loss)	Total	Net Deferred Amounts on Transition	Mark-to Market Gain(Loss)	Total
Fair value of contracts, beginning of year	\$ -	\$ -	\$ -	\$ (1,450)	\$ 1,450	\$ -
Change in fair value of contracts recorded on transition	-	243	243	-	1,301	1,301
Amortization of deferred fair value of contracts	(1,649)	-	(1,649)	(196)	-	(196)
Net change in fair value of contracts entered into after transition	-	(22,583)	(22,583)	-	18,271	18,271
<b>Unrealized gain (loss) on financial instruments</b>			<b>(23,989)</b>	<b>(1,646)</b>	<b>21,022</b>	<b>19,376</b>
<b>Realized loss on financial instruments</b>			<b>(12,053)</b>			<b>(683)</b>
<b>Net gain (loss) on financial instruments</b>			<b>\$ (36,042)</b>			<b>\$ 18,693</b>

#### (A) COMMODITY PRICE CONTRACTS

At December 31, 2005, Paramount has entered into financial forward commodity contracts as follows:

	Amount	Price	Term
<b>Sales Contracts</b>			
AECO Fixed Price	10,000 GJ/d	\$8.730	November 2005 – March 2006
AECO Fixed Price	10,000 GJ/d	\$8.710	November 2005 – March 2006
AECO Fixed Price	20,000 GJ/d	\$8.085	November 2005 – March 2006
AECO Fixed Price	10,000 GJ/d	\$9.185	November 2005 – March 2006
AECO Fixed Price	10,000 GJ/d	\$10.600	April 2006 – October 2006
AECO Fixed Price	10,000 GJ/d	\$10.745	April 2006 – October 2006
WTI Fixed Price	1,000 Bbl/d	US\$53.430	October 2005 – March 2006
<b>Purchase Contract</b>			
AECO Fixed Price	10,000 GJ/d	\$11.220	January 2006 – March 2006
<b>Collars</b>			
AECO Costless Collar	20,000 GJ/d	\$9.000 floor	
		\$12.500 ceiling	April 2006 – October 2006
AECO Costless Collar	10,000 GJ/d	\$12.000 floor	
		\$17.650 ceiling	January 2006 – March 2006

The aggregate fair value of these contracts as at December 31, 2005 was a \$4.6 million loss.

## (B) FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES

Borrowings under bank credit facilities and the issuance of commercial paper are for short periods and are market rate based, thus, their respective carrying values in the Consolidated Financial Statements approximate fair value. Paramount's 2013 Notes were trading at approximately 102.75 percent as at December 31, 2005. Fair values for derivative instruments are determined based on the estimated cash payment or receipt necessary to settle the contract at year-end. Cash payments or receipts are based on discounted cash flow analysis using current market rates and prices available to Paramount.

## (C) CREDIT RISK

Paramount is exposed to credit risk from financial instruments to the extent of non-performance by third parties, and non-performance by counterparties to swap agreements. Paramount minimizes credit risk associated with possible non-performance by financial instrument counterparties by entering into contracts with only highly rated counterparties and by controlling third party credit risk with credit approvals, limits on exposures to any one counterparty and monitoring procedures. Paramount sells production to a variety of purchasers under normal industry sale and payment terms. Paramount's accounts receivable are with customers and joint venture partners in the petroleum and natural gas industry and are subject to normal credit risk.

## (D) INTEREST RATE RISK

Paramount is exposed to interest rate risk to the extent that changes in market interest rates will impact Paramount's credit facilities that have a floating interest rate.

## 14. NET CHANGE IN NON-CASH WORKING CAPITAL

	2005	2004
Changes in non-cash working capital:		
Short-term investments	\$ 13,362	\$ (10,532)
Accounts receivable	(32,519)	(25,480)
Distributions receivable from Trilogy Energy Trust	(12,028)	–
Financial instruments (net)	3,782	–
Prepaid expenses	(796)	(978)
Accounts payable and accrued liabilities	99,667	37,019
Due to Trilogy Energy Trust	(23,928)	–
	47,540	29
Operating activities	43,566	(27,320)
Investing activities	3,974	27,349
	\$ 47,540	\$ 29

Certain changes in working capital as a result of the plan of arrangement have been excluded from the above amounts.

Amounts paid related to interest and large corporations and other taxes were as follows:

	2005	2004
Interest paid	\$ 24,288	\$ 18,951
Large corporations and other taxes paid, including settlements	\$ 5,157	\$ 31,021

## 15. RELATED PARTY TRANSACTIONS

### TRILOGY ENERGY TRUST

At December 31, 2005, Paramount held 15,035,345 trust units of Trilogy representing 17.7 percent of the issued and outstanding trust units of Trilogy at such time. In addition to the Trilogy trust units held by Paramount, Trilogy and Paramount have certain common members of management and directors. The following transactions have been recorded at the exchange amounts:

- Paramount provided certain operational, administrative, and other services to Trilogy Energy Ltd., a wholly-owned subsidiary of Trilogy, pursuant to a services agreement dated April 1, 2005 (the "Services Agreement"). The Services Agreement had an initial term ending March 31, 2006. It is anticipated that the Services Agreement will be renewed on the same terms and conditions to March 31, 2007 prior to the expiry of its current term of March 31, 2006. Under the Services Agreement, Paramount is reimbursed for all reasonable costs (including expenses of a general and administrative nature) incurred by Paramount in providing the services. The reimbursement of expenses is not intended to provide Paramount with any financial gain or loss. Paramount billed Trilogy an aggregate \$4.2 million under the Services Agreement, which has been reflected as a reduction in Paramount's general and administrative expenses.
- In connection with the Trilogy Spinout, and in order to market Trilogy's natural gas production, Paramount and Trilogy Energy LP, entered a Call on Production Agreement which provided Paramount the right to purchase all or any portion of Trilogy Energy LP's available gas production at a price no less favourable than the price that Paramount Resources received on the resale of the natural gas to a gas marketing limited partnership (see "Gas Marketing Limited Partnership" – below). Trilogy Energy LP is a limited partnership which is indirectly wholly-owned by Trilogy.

For the year ended December 31, 2005, Paramount purchased 8,490,542 GJ of natural gas from Trilogy Energy LP for approximately \$70.3 million under the Call on Production Agreement for sale to the gas marketing limited partnership (see below). The price that Paramount paid Trilogy Energy LP for the natural gas was the same that Paramount Resources received on the resale of the natural gas to the related party gas marketing limited partnership. As a result, such amounts have been netted for financial statement presentation purposes and no revenues or expenses have been reflected in the Consolidated Financial Statements related to these activities.

- During the course of the year, payable and receivable amounts arose between Paramount and Trilogy in the normal course of business.
- At December 31, 2005 Paramount owed Trilogy \$6.4 million, which balance includes a Crown royalty deposit claim of \$5.5 million which, when refunded to Paramount, will be paid to Trilogy.
- As a result of the Trilogy Spinout, certain employees and officers of Trilogy hold Paramount Options and Holdco Options. The stock-based compensation expense relating to these options for the period April 1, 2005 to December 31, 2005 amounted to \$4.4 million, of which 81 percent (\$3.6 million) was charged to general and administration expense and 19 percent (\$0.8 million) was recognized in equity in net earnings of Trilogy.
- Paramount recorded distributions from Trilogy Energy Trust totaling \$35.3 million in 2005. Distributions receivable of \$12 million relating to distributions declared by Trilogy in December 2005 were accrued at December 31, 2005 and received in January 2006.

## **GAS MARKETING LIMITED PARTNERSHIP**

In March 2005, Paramount acquired an indirect 30 percent interest (25 percent net of non-controlling interest) in a gas marketing limited partnership for \$7.5 million (US\$6 million). In connection with this acquisition, Paramount agreed to make available for delivery an average of 150,000 GJ/d of natural gas over a five year term, to be marketed on Paramount's behalf by the gas marketing limited partnership with the expectation that prices received for such gas would be at or above market. The gas marketing limited partnership commenced operations that month.

During 2005, Paramount sold 10,380,998 GJ of its natural gas production to the gas marketing partnership for \$83.3 million. The proceeds of such sales have been reflected in petroleum and natural gas sales revenue. In addition, Paramount sold 8,490,542 GJ of natural gas purchased from Trilogy (see above) to the gas marketing limited partnership for \$70.3 million. These transactions have been recorded at the exchange amounts.

Because of market conditions, including the significant volatility of natural gas prices in the fall and the resulting margin requirements, the partners of the gas marketing limited partnership resolved to cease commercial operations in November 2005 and to dissolve the partnership in due course. Paramount recorded a \$1.1 million provision for impairment on its investment in the gas marketing limited partnership, and expects to recover approximately \$5 million on dissolution. No receivables arising from the sale of natural gas to the gas marketing limited partnership are outstanding as at December 31, 2005.

## **PRIVATE OIL AND GAS COMPANY**

At December 31, 2005, Paramount held 2,708,662 shares of a private oil and gas company representing 24.8 percent of the issued and outstanding share capital of the company at such time. A member of Paramount's management is a member of the board of directors of the private oil and gas company by virtue of such shareholdings. During the year, Paramount received dividends and a return-of-capital distribution from the private oil and gas company (the "Distributions"). The Distributions were paid in the form of common shares of a Toronto Stock Exchange listed oil and gas company. The value of such shares received by Paramount was \$5.7 million, based on the market price of the shares on the date of the Distributions. The Distributions reduced the carrying value of Paramount's investment in the private oil and gas company in the Consolidated Financial Statements, and the shares of the public oil and gas company received have been included in short-term investments.

## **OTHER**

Certain directors, officers and employees of Paramount purchased an aggregate 922,500 flow through shares issued by Paramount for gross proceeds to Paramount of \$21.1 million on July 14, 2005 as described in Note 10.

Certain directors, officers and employees of Paramount purchased an aggregate 1,016,000 flow through shares issued by Paramount for gross proceeds to Paramount of \$30.0 million on October 15, 2004 as described in Note 10.

On December 13, 2004, Paramount completed the disposition of a building to an entity under common control. The transaction has been recorded at the exchange amount. Paramount received proceeds of \$10.5 million, inclusive of the mortgage assumed by the purchaser of \$6.4 million (see Note 5).

## 16. CONTINGENCIES AND COMMITMENTS

### CONTINGENCIES

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

Paramount indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their service to Paramount to the extent permitted by law. Paramount has acquired and maintains liability insurance for its directors and officers.

The operations of Paramount are complex, and related tax and royalty legislation and regulations, and government interpretation and administration thereof, in the various jurisdictions in which Paramount operates are continually changing. As a result, there are usually some tax and royalty matters under review by relevant government authorities.

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

Crown royalties for Paramount's production from frontier lands in the Northwest Territories have been provided for in the Consolidated Financial Statements based on the Company's interpretation of the relevant legislation and regulations. At present, Paramount has not received assessments for a significant portion of its past Northwest Territories royalty filings with the Government of Canada. In addition, the Government of Canada is continuing its stakeholder and industry consultations concerning the application of and amendments to the regulations governing the computation of Crown royalties in the Northwest Territories. Although Paramount believes that its interpretation of the relevant legislation and regulations has merit, Paramount is unable to predict the ultimate outcome of future audits and/or assessments by the Government of Canada of Paramount's Northwest Territories crown royalty filings. Additional amounts could become payable and the impact on net earnings may be material.

### COMMITMENTS

At December 31, 2005, Paramount has the following commitments:

	2006	2007-2008	2009-2010	After 2010	Total
Transportation	\$ 20,137	\$ 40,188	\$ 19,285	\$ 58,221	\$ 137,831
Leases	2,565	5,358	4,447	2,706	15,076
Capital spending commitment	40,400	400	–	–	40,800
Total	\$ 63,102	\$ 45,946	\$ 23,732	\$ 60,927	\$ 193,707

Paramount also has an outstanding physical contract to sell 10,000 GJ/d of natural gas at an AECO fixed price of \$14.06/GJ from January 2006 to March 2006.

## 17. COMPARATIVE FIGURES

Certain comparative figures including transportation costs and non-controlling interest have been reclassified to conform to the current year's financial statement presentation.

## 18. SUBSEQUENT EVENTS

Subsequent to December 31, 2005, Paramount entered into the following derivative financial instruments:

	Amount	Price	Term
<b>Sales Contracts</b>			
WTI Fixed Price	1,000 Bbl/d	US \$65.64	February 2006 - December 2006
WTI Fixed Price	1,000 Bbl/d	US \$66.04	February 2006 - December 2006
AECO Fixed Price	10,000 GJ/d	\$7.80	March 2006
<b>Purchase Contract</b>			
AECO Fixed Price	10,000 GJ/d	\$7.27	March 2006

## 19. RECONCILIATION OF FINANCIAL STATEMENTS TO UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

These Consolidated Financial Statements have been prepared in accordance with Canadian GAAP, which in most respects, conform to United States generally accepted accounting principles ("US GAAP"). The significant differences between Canadian and US GAAP that impact Paramount are described below:

### NET EARNINGS

	2005	2004
<b>Net earnings (loss) from continuing operations under Canadian GAAP</b>	<b>\$ (63,932)</b>	<b>\$ 34,895</b>
<b>Adjustments under US GAAP, net of tax:</b>		
Financial instruments (a)	2,054	(1,053)
Future income taxes (b)	(12,297)	(5,633)
Depletion and depreciation expense (c)	1,546	5,385
Short-term investments (d)	(24)	929
Reorganization costs (h)	(2,969)	–
<b>Net earnings (loss) from continuing operations under US GAAP</b>	<b>\$ (75,622)</b>	<b>\$ 34,523</b>
<b>Net earnings from discontinued operations under US GAAP</b>	<b>–</b>	<b>6,279</b>
<b>Net earnings (loss) under US GAAP</b>	<b>\$ (75,622)</b>	<b>\$ 40,802</b>
<b>Net earnings (loss) from continuing operations per common share under US GAAP</b>		
Basic	\$ (1.17)	\$ 0.57
Diluted	\$ (1.17)	\$ 0.57
<b>Net earnings from discontinued operations per common share under US GAAP</b>		
Basic	\$ –	\$ 0.11
Diluted	\$ –	\$ 0.10
<b>Net earnings (loss) per common share under US GAAP</b>		
Basic	\$ (1.17)	\$ 0.68
Diluted	\$ (1.17)	\$ 0.67



## AFFECTED BALANCE SHEET ACCOUNTS

	2005		2004	
	As Reported	US GAAP	As Reported	US GAAP
<b>Assets</b>				
Short-term investments (f)	\$ 14,048	\$ 16,176	\$ 24,983	\$ 27,149
Financial instrument assets (a)	2,443	2,443	21,564	18,271
Property, plant and equipment – net (c)	914,579	911,328	1,345,806	1,350,286
Long-term investments and other assets (c)	56,467	52,316	7,709	7,709
Future income taxes (a)(b)(c)(d)	2,923	5,154	–	–
<b>Liabilities</b>				
Accounts payable and accrued liabilities (b)	155,076	155,076	147,364	152,893
Financial instrument liability (a)	7,056	7,056	2,188	542
Future income taxes (a)(b)(c)(d)	–	–	166,380	167,587
<b>Shareholders' equity</b>				
Common shares (b)	198,417	214,053	302,932	303,180
Retained earnings	\$ 238,404	\$ 217,431	\$ 322,107	\$ 324,253

## CASH FLOWS

	2005		2004	
	As Reported	US GAAP	As Reported	US GAAP
Cash flows from operating activities (e)	\$ 302,611	\$ 261,690	\$ 263,073	\$ 265,746
Cash flows from financing activities	121,678	121,678	273,647	273,647
Cash flows used in investing activities (e)	\$ (424,289)	\$ (383,368)	\$ (536,720)	\$ (539,393)

### (A) FINANCIAL INSTRUMENTS

For US GAAP purposes, Paramount has adopted Statement of Financial Accounting Standards (“SFAS”) No. 133, as amended, “Accounting for Derivative Instruments and Hedging Activities”. With the adoption of this standard, all derivative instruments are recognized on the balance sheet at fair value. The statement requires that changes in the derivative instrument’s fair value be recognized currently in earnings unless specific hedge accounting criteria are met. Paramount has currently not designated any of the financial instruments as hedges for US GAAP purposes under SFAS 133.

Prior to January 1, 2004, Paramount had designated, for Canadian GAAP purposes, its derivative financial instruments as hedges of anticipated revenue and expenses. In accordance with Canadian GAAP, payments or receipts on these contracts were recognized in income concurrently with the hedged transaction. Accordingly, the fair value of contracts deemed to be hedges was not previously reflected in the balance sheet, and changes in fair value were not reflected in earnings.

Effective January 1, 2004, Paramount has elected not to designate any of its financial instruments as hedges for Canadian GAAP purposes, thus eliminating this US/Canadian GAAP difference in future periods. During the transition, Paramount recognized a deferred financial instrument asset of \$3.4 million and a deferred financial instrument liability of \$1.8 million as at December 31, 2004 which would not be recorded for US GAAP purposes. The deferred financial instrument asset and liability was amortized to earnings until December 2005 under Canadian GAAP.

### (B) FUTURE INCOME TAXES

The Canadian liability method of accounting for income taxes is similar to the US Statement of Financial Accounting Standard (SFAS) No. 109 “Accounting for Income Taxes”, which requires the recognition of future tax assets and liabilities for the expected future tax consequences of events that have been recognized in Paramount’s financial statements or tax returns. Pursuant to US GAAP, enacted tax rates are used to calculate future taxes, whereas Canadian GAAP uses substantively enacted rates. This difference did not impact Paramount’s financial position or results of operations for the years ended December 31, 2005 and 2004.

The accounting for the issuance of flow through shares is more specifically addressed under Canadian GAAP than US GAAP. Under Canadian GAAP, when flow through shares are issued they are recorded based on proceeds received. Upon the renunciation of the tax pools, the related deferred tax liability is established for the tax effect of the difference between the tax basis and the book value of the assets and is recorded as a reduction of share capital. Under US GAAP, the proceeds from the issuance of flow through shares should be allocated between the sale of the shares and the sale of the tax benefits. The allocation is made based on the difference between the amount the investor pays for the flow through shares and the quoted market price of the existing shares. A liability is recognized for this difference which is reversed upon the renunciation of the tax benefit. The difference between this liability and the deferred tax liability is recorded as an income tax expense.

To conform with US GAAP, common share capital would have to be increased by \$20.0 million and accounts payable and accrued liabilities would have to be reduced by \$7.7 million with the difference charged to future income tax expense as at and for the year ended December 31, 2005 due to the renunciation in 2005 of tax benefits relating to the flow through shares issued on July 14, 2005 and October 14, 2004. In addition, share capital would have to be reduced by \$4.6 million and a corresponding amount of accounts payable and accrued liabilities would have to be recognized as at December 31, 2005 for the difference between the cash proceeds from the issuance of flow through shares on July 14, 2005 and the quoted market value of the shares.

As at and for the year ended December 31, 2004, share capital would have to be increased by \$0.2 million, accounts payable and accrued liabilities would have to be increased by \$5.4 million, and future income tax expense would have to be increased by \$5.6 million due to the issuance of flow through shares on October 14, 2004 and related tax benefit renunciation during 2004.

### **(C) PROPERTY, PLANT AND EQUIPMENT**

Under both US and Canadian GAAP, property, plant and equipment must be assessed for potential impairments. Under US GAAP, if the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, then an impairment loss (the amount by which the carrying amount of the asset exceeds the fair value of the asset) should be recognized. Fair value is calculated as the present value of estimated expected future cash flows. Prior to January 1, 2004, under Canadian GAAP, the impairment loss was the difference between the carrying value of the asset and its net recoverable amount (undiscounted). Effective January 1, 2004, the CICA implemented a new pronouncement on impairment of long-lived assets, which eliminated the US/Canadian GAAP difference going forward.

The resulting differences in recorded carrying values of impaired assets prior to January 1, 2004 result in differences in depreciation, depletion and amortization expense until such time that the related assets are fully depleted under Canadian GAAP. For the year ended December 31, 2005 and 2004, a reduction in depletion expense of \$2.5 million (\$1.5 million net of tax) and \$8.4 million (\$5.4 million net of tax), respectively, would have to be adjusted under US GAAP for the depletion expense recognized under Canadian GAAP on properties for which an impairment provision would have been reflected in 2002 and 2001 under US GAAP.

In 2005, Paramount transferred certain properties to Trilogy Energy Trust as part of the plan of arrangement reorganization disclosed in Note 3. The assets that became part of the Trust Spinout included certain assets that have been impaired in 2002 and 2001 under US GAAP having a total net book value of \$21.8 million as at December 31, 2005 under Canadian GAAP, of which 81 percent (or \$17.7 million) was charged to retained earnings with the remaining 19 percent (or \$4.1 million) capitalized to Investment in Trilogy Energy Trust representing the interest retained by Paramount. Under US GAAP, the full amount of the net book value of such assets should have been charged to retained earnings to recognize their impairment in 2001 and 2002.

#### **(D) SHORT-TERM INVESTMENTS**

Under US GAAP, equity securities that are bought and sold in the short-term are classified as trading securities. Unrealized holding gains and losses related to trading securities are included in earnings as incurred. Under Canadian GAAP, these gains and losses are not recognized in earnings until the security is sold. At December 31, 2005 and 2004, Paramount had unrealized holding gains of \$2.1 million (net of tax - \$1.3 million) and \$2.2 million (net of tax - \$1.4 million), respectively.

#### **(E) STATEMENTS OF CASH FLOW**

The application of US GAAP would change the amounts as reported under Canadian GAAP for cash flows provided by (used in) operating, investing or financing activities. Under Canadian GAAP, dry hole costs of \$44.9 million (2004 - \$24.7 million) are added back to net earnings in calculating cash flows from operating activities. Under US GAAP, dry hole costs represent cash flows from operating activities and therefore should not be added back to net earnings in calculating cash flows from operating activities.

Under Canadian GAAP, the consolidated statements of cash flows include, under investing activities, net changes in working capital accounts relating to property, plant and equipment, such as accrued capital expenditures payable. Under US GAAP, such changes in working capital accounts are presented as part of cash flows from operating activities. For the year ended December 31, 2005, there would be an increase of \$4.0 million (2004 - increase of \$27.3 million) to cash flows used in investing activities related to changes in investing working capital accounts, and an increase in cash flows from operating activities for the same amounts.

The presentation of funds flow from operations is a non US GAAP terminology.

#### **(F) BUY/SELL ARRANGEMENTS**

Under US GAAP, buy/sell arrangements are reported on a gross basis. For the year ended December 31, 2005, Paramount had sales of \$73.7 million (2004 - \$22.2 million) and purchases of \$73.1 million (2004 - \$22.0 million), related to buy/sell arrangements. The net gain of \$0.6 million (2004 - \$0.2 million loss) has been reflected in revenue for Canadian GAAP purposes.

#### **(G) OTHER COMPREHENSIVE INCOME**

Under US GAAP, certain items such as the unrealized gain or loss on derivative instrument contracts designated and effective as cash flow hedges are included in other comprehensive income. In these financial statements, there are no comprehensive income items other than net earnings.

#### **(H) REORGANIZATION COSTS**

In connection with the Trilogy Spinout, Paramount incurred reorganization costs totaling \$4.8 million, which were charged to retained earnings under Canadian GAAP. Under US GAAP, reorganization costs are treated as period costs.

# CORPORATE INFORMATION

## OFFICERS

### C. H. Riddell

Chairman of the Board and  
Chief Executive Officer

### B. K. Lee

Chief Financial Officer

### J. H. T. Riddell

President and Chief Operating Officer

### C. E. Morin

Corporate Secretary

### L. M. Doyle

Corporate Operating Officer

### C. G. Folden

Corporate Operating Officer

### J. S. McDougall

Corporate Operating Officer

### G. W. P. McMillan

Corporate Operating Officer

### J. B. Williams

Corporate Operating Officer

### L. A. Friesen

Assistant Corporate Secretary

## DIRECTORS

### C. H. Riddell<sup>(3)</sup>

Chairman of the Board and  
Chief Executive Officer  
Paramount Resources Ltd.  
Calgary, Alberta

### J. H. T. Riddell

President and Chief Operating Officer  
Paramount Resources Ltd.  
Calgary, Alberta

### J. C. Gorman<sup>(1) (4)</sup>

Retired  
Calgary, Alberta

### D. Jungé, C.F.A.<sup>(4)</sup>

Chairman of the Board  
Pitcairn Trust Company  
Jenkintown, Pennsylvania

### D. M. Knott

General Partner  
Knott Partners, L.P.  
Syosset, New York

### W. B. MacInnes, Q.C.<sup>(1) (2) (3) (4)</sup>

Retired  
Calgary, Alberta

### V. S. A. Riddell

Business Executive  
Calgary, Alberta

### S. L. Riddell Rose

President and Chief Executive Officer  
Paramount Energy Operating Corp.<sup>(5)</sup>  
Calgary, Alberta

### J. B. Roy<sup>(1) (2) (3) (4)</sup>

Independent Businessman  
Calgary, Alberta

### A. S. Thomson<sup>(1) (4)</sup>

President  
Touche, Thomson & Yeoman  
Investment Consultants Ltd.  
Calgary, Alberta

### B. M. Wylie<sup>(2)</sup>

Business Executive  
Calgary, Alberta

(1) Member of Audit Committee

(2) Member of Environmental, Health and  
Safety Committee

(3) Member of Compensation Committee

(4) Member of Corporate Governance Committee

(5) Paramount Energy Operating Corp. is a wholly-  
owned subsidiary of Paramount Energy Trust

## HEAD OFFICE

4700 Bankers Hall West  
888 Third Street S. W.  
Calgary, Alberta  
Canada T2P 5C5  
Telephone: (403) 290-3600  
Facsimile: (403) 262-7994  
www.paramountres.com

## CONSULTING ENGINEERS

### McDaniel & Associates

### Consultants Ltd.

Calgary, Alberta

## AUDITORS

### Ernst & Young LLP

Calgary, Alberta

## BANKERS

### Bank of Montreal

Calgary, Alberta

### The Bank of Nova Scotia

Calgary, Alberta

### Canadian Imperial Bank of Commerce

Calgary, Alberta

### ATB Financial

Calgary, Alberta

### UBS AG Canada Branch

Toronto, Ontario

## REGISTRAR AND TRANSFER AGENT

### Computershare Investor Services

Canada Calgary, Alberta  
Toronto, Ontario

## STOCK EXCHANGE LISTING

The Toronto Stock Exchange  
(‘POU’)

# ABBREVIATIONS

<b>Bbls</b>	barrels
<b>Bbl/d</b>	barrels per day
<b>Bcf</b>	billion cubic feet
<b>Bcfe</b>	billion cubic feet of gas equivalent
<b>Boe</b>	barrels of oil equivalent
<b>Mcf</b>	thousand cubic feet
<b>Mcfe</b>	thousand cubic feet of gas equivalent
<b>Mcf/d</b>	thousand cubic feet per day
<b>MMcf</b>	million cubic feet
<b>MMcf/d</b>	million cubic feet per day
<b>MBbl</b>	thousands of barrels
<b>MMbtu</b>	millions of British Thermal Units
<b>MBoe</b>	thousands of barrels of oil equivalent
<b>MMcfe/d</b>	million cubic feet of gas equivalent per day

## ANNUAL AND SPECIAL MEETING

Shareholders are cordially invited to attend the Annual and Special Meeting to be held May 10, 2006, at 3:30 p.m.  
Calgary Petroleum Club Devonian Room  
319 Fifth Avenue S. W.  
Calgary, Alberta



**Paramount**  
*resources ltd.*

4700 Bankers Hall West  
888 Third Street S.W.  
Calgary, Alberta  
Canada T2P 5C5

Telephone: (403) 290-3600

Facsimile: (403) 262-7994

[www.paramountres.com](http://www.paramountres.com)