

# **CALVALLEY PETROLEUM INC.**

## **2010 3<sup>rd</sup> Quarter Interim Report to Shareholders**

**For the three and nine months  
ended September 30, 2010**

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## ABBREVIATIONS

<b>bbls</b>	<b>barrels</b>
<b>mbbls</b>	<b>thousands of barrels</b>
<b>bopd</b>	<b>barrels of oil per day</b>
<b>mmcf</b>	<b>million cubic feet per day</b>
<b>km<sup>2</sup></b>	<b>square kilometre</b>

## CORPORATE PROFILE

Calvalley Petroleum Inc. is an international oil and gas company based in Calgary, Alberta which is focused on exploration and development of Block 9 in the Republic of Yemen and exploration of the Gimbi and Metema Blocks in Ethiopia. Calvalley is well-financed and debt-free and expects to maintain a healthy balance sheet by funding its 2010 capital program from cash generated by operating activities. Calvalley's common shares are listed on the Toronto Stock Exchange under the symbol "CVI.A."

Calvalley's principal assets and operations are related to its 50% working interest in the Production Sharing Agreement for Block 9, which consists of 2,234 km<sup>2</sup> (552,000 acres) of land within the prolific Sayun-Masila basin. Calvalley has made several significant hydrocarbon discoveries on Block 9. Calvalley declared commerciality during 2005 and started commercial production in December of that year.

Calvalley also owns a 100% working interest in a Production Sharing Contract in Ethiopia for the Metema and Gimbi blocks which cover a total area of 46,470 km<sup>2</sup> (11.5 million acres). The two blocks lie adjacent to the Sudan border, offsetting the Melut/Muglad and Blue Nile Basins, both of which are proven oil basins which form part of the Central African rift system. The Central African rift system is a series of Cretaceous to Tertiary-aged failed rifts that trend across Central Africa from the Benue Trough in Nigeria, through Chad, into Sudan. This early stage project provides Calvalley with additional opportunities to diversify its asset base.

## HIGHLIGHTS

### Financial

These key financial indicators are discussed in more detail in the following sections.

(in thousands of US dollars except per share amounts)	Three months ended September 30		Nine months ended September 30	
	2010	2009	2010	2009
Revenue (Gross)	<b>19,877</b>	12,591	<b>41,825</b>	36,703
Revenue from crude oil sales (net of royalties)	<b>12,328</b>	7,766	<b>25,813</b>	22,612
EBITDA <sup>(1)</sup>	<b>7,876</b>	5,055	<b>16,242</b>	10,559
Operating income (loss) <sup>(1)</sup>	<b>4,641</b>	3,032	<b>9,495</b>	3,142
Net income (loss)	<b>2,744</b>	2,122	<b>5,954</b>	842
Per share	<b>\$0.03</b>	\$0.02	<b>\$0.06</b>	\$0.01
Capital expenditures	<b>4,734</b>	1,781	<b>10,775</b>	6,991
Funds flow from operations <sup>(1)</sup>	<b>6,744</b>	4,453	<b>13,939</b>	8,948
Per share	<b>\$0.07</b>	\$0.04	<b>\$0.14</b>	\$0.09
Cash flow (deficiency) from operating activities	<b>1,150</b>	3,587	<b>9,729</b>	5,951

<sup>(1)</sup> See "Non-GAAP Measures"

Calvalley's revenue, royalties, depletion and operating expenses were all impacted by the timing of lifts during the second quarter which resulted in the build-up of inventory and reduced each of these components of income due to lower revenue and the inclusion of the related costs in inventory at quarter end. This trend was reversed in the third quarter when in addition to the oil produced during the quarter, a portion of the crude oil in inventory at June 30, 2010 was sold.

- Calvalley's revenue from crude oil sales was \$19.9 million (gross) and \$12.3 million (net of royalties) for the quarter ended September 30, 2010 (2009 - \$12.6 million (gross) and \$7.8 million (net of royalties)). The significant increase in revenue is primarily attributable to a 40.5% increase in sales volume which is due to the timing of lifts and is not directly correlated with production for the quarter, which was 207,574 bbls in 2010 versus 192,448 bbls in 2009.
- Net income was \$2.7 million (\$0.03 per share) for the three months ended September 30, 2010, as compared to \$2.1 (\$0.02 per share) for the same period of 2009. Net income for the six month period was \$6.0 million versus \$0.8 million during the corresponding period of 2009.
- Funds flow from operations was \$6.7 million (\$0.07/share) for the three months ended September 30, 2010, as compared to \$4.5 million (\$0.04/share) for the same period of 2009.
- Operating costs, including transportation and facilities usage fees during the third quarter of 2010 were \$3.5 million (\$13.35/bbl) as compared to \$2.1 million (\$11.52/bbl) for the three months ended September 30, 2009.

- Calvalley continues to be well financed and capitalized with no outstanding debt and working capital of \$73.3 million.

### **Operating**

The following table sets forth key operating information:

Production (barrels of oil per day)	Three months ended September 30		Nine months ended September 30	
	2010	2009	2010	2009
Total Block 9 production	4,512	4,184	4,572	4,292
Calvalley working interest (50.0%)	2,256	2,092	2,286	2,146

- Average daily production from Block 9 for the three months ended September 30, 2010 was 4,512 gross barrels per day (Calvalley working interest 2,256 bopd), a marginal decrease from the previous quarter's average of 4,606 bopd (2,303 bopd working interest share) and an increase from 2009 third quarter average production of 4,184 bopd (2,092 bopd working interest share).
- The Ras Nowmah-2 well was drilled and tested during the third quarter. Using the largest capacity pump available to the Company at the time of the test, the well flowed at a stabilized rate of approximately 3,000bbl/d of sweet crude (approximately 30° API) with no formation water and only 9.5% pressure drawdown. Independent reservoir engineers have calculated a flow rate in excess of 5,000 bbl/d with 20% pressure drawdown. The Company has commenced preparation for an appraisal well in the discovery area (Ras Nowmah-3).
- Due to the success of the Ras Nowmah-2 well, Calvalley is currently acquiring approximately 350 km of new 2D seismic data to delineate the new field discovery at the Ras Nowmah oil field for future development and to facilitate the exploration of the Qishn and Saar-Naifa in the Southern parts of Umm El Radhuma Plateau.
- Appraisal of the Qarn Qaymah structure was started by mobilizing the rig to the Qarn Qaymah-3 ("QQ-3") well site in mid-September. The drilling of the well commenced on October 2, 2010. QQ-3 is targeted to have a total depth of 4,460 meters including an openhole section of approximately 1,000 meters in the oil bearing Fractured Granitic Basement ("FGB"). The openhole section is expected to encounter seven (7) major fracture zones in the FGB. The drilling of QQ-3 is progressing well and on budget with the current depth of approximately 2,000 meters. We expect to complete the drilling by mid-December. The testing of the well will commence immediately thereafter.
- The Hiswah-34 development well was drilled and completed successfully during the third quarter and has been brought onto production. The Company is also continuing its pressure maintenance and production optimization program for the Hiswah field.
- The Company is continuing to develop the Al Roidhat field and is currently drilling the Al-Roidhat 9 development well.
- Due to the developments at Ras Nowmah, the execution of marketing agreements, and the continuing development of the Al Roidhat field, the Company is conducting preliminary technical work associated with an inter-field pipeline connecting the Al Roidhat and Ras Nowmah fields to the CPF which is located at the Hiswah field. Construction is expected to begin in the first half of 2011 with completion scheduled for the third quarter of 2011.

### **Truck Offloading Facility (TOF)**

- Construction of the TOF is underway and on schedule to be completed by year-end. The civil work is largely complete and all key equipment is either being transported to the site or nearing completion. Upon completion of the TOF, we expect to ramp up production to 10,000 bbl/d (5,000 net CVI working Interest).

### **Ethiopia**

- Based on the surface geological work, Calvalley has selected a key prospective region for acquisition of an aeromagnetic survey. The contractor for the acquisition of the aeromagnetic survey has been selected and the services have been mobilized to the region. Data acquisition is expected to commence in November 2010.

## CHAIRMAN AND CHIEF EXECUTIVE OFFICER'S REPORT

During the third quarter of 2010, Calvalley continued to make significant operational headways toward achieving several key milestones which we expect will lead to material production and reserves growth opportunities in Block 9. The geological and geophysical work program in Ethiopia has been accelerated to define the resource potentiality of our concessions in the country.

As the Company nears completion of the Truck Offloading Facilities ("TOF") at Block 51, Calvalley is entering an active phase of the development and appraisal drilling campaign at Block 9 in Yemen. Upon completion of the TOF by the end of 2010, we expect to have significant production ramp up entering 2011. In the interim, we continue to invest in facility expansion and development and appraisal drilling to increase our production capacity. Once the TOF is commissioned, Block 9 production is scheduled to reach 10,000 bbl/d (5,000 CVI working interest share) and we expect to double our cash-flow generating capability. This will further strengthen our balance sheet.

We have a rich portfolio of prospects which ensure an active exploration program through 2011 and beyond. Successful discoveries at Qarn Qaymah and Ras Nowmah have de-risked a number of prospects to be drilled. We are currently acquiring 350km of 2D seismic to high grade shallow / medium depth prospects on the Plateau area. By the end of Q1/2011, most of these prospects will be ready for drilling.

We are currently drilling the QQ-3 well which is offsetting a previous discovery well (QQ-2). QQ-3 is targeted to have a total depth of 4,460 meters including an openhole section of approximately 1,000 meters in the oil bearing Fractured Granitic Basement ("FGB"). The openhole section is expected to encounter major fracture zones in the FGB. Calvalley expects to keep the rig in the Qarn Qaymah area to drill additional deep exploration/appraisal wells. The drilling of QQ-3 is progressing well and on budget with a current depth of approximately 2,000 meters. We expect to complete the drilling by mid-December. The testing of the well will commence immediately thereafter.

Pressure maintenance at the Hiswah field has been underway for the past few months. We are currently injecting all produced water into the reservoir. In addition, we have recently drilled a prolific water source well which will provide an additional source of water for injection. Gas injection facilities, including the main compressor, have been installed and are in the commissioning phase.

Calvalley currently has two drilling rigs and one service rig on Block 9. Negotiations for a third rig have progressed well and contractual details are being finalized. Our large drilling rig is expected to continue drilling high impact deeper prospects in the greater Qarn Qaymah area. The smaller rigs will be utilized for the appraisal and development of existing discoveries and shallow exploration targets.

Calvalley continues to expand its operations in the greater Middle East and Africa region. Calvalley has established its offices in the region by opening a regional office in Sharjah Free Trade Zone in the United Arab Emirates ("UAE"). The Company continues its efforts to staff the office with technical and operational professionals to provide the necessary day-to-day support to the operation in the region. This office will alleviate the operational challenges arising from the time-zone difference between Calgary and the operational regions.

Calvalley remains debt-free with working capital of \$73 million and is well positioned to fund its capital program without further dilution to its shareholders.

***"Edmund Shimoon"***

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Edmund M. Shimoon  
Chairman and Chief Executive Officer  
*November 5, 2010*

## **OPERATIONS REPORT**

### ***Production Overview***

Average daily production from Block 9 for the three months ended September 30, 2010 was 4,512 gross barrels per day (Calvalley working interest 2,256 bopd), an marginal decrease from the previous quarter's average of 4,606 bopd (2,303 bopd working interest share) and an increase from 2009 third quarter average production of 4,184 bopd (2,092 bopd working interest share). All production came from the partially developed Hiswah oil field, which produces high-quality sweet crude oil that is sold at a price comparable to Dated Brent Crude.

Gross field production at Hiswah continues to fluctuate between 4,200 to 5,200 (2,100 to 2,600 net) bopd. While producing wells are performing as expected, production continues to be constrained due to the limitation of the volume that is accepted by the Safer Facilities at Block 18 ("Safer"). Production from the Hiswah field is restricted to an average of twenty horizontal wells due to this limitation. In addition, production at the Hiswah field has been choked back to minimize solution gas flaring. Upon full implementation of the field pressure maintenance program through water and gas injection, we expect to see a meaningful increase in well productivity as indicated by the simulation study. Our first water injection well has been performing better than expected. We have accelerated our full field water injection program and expect to have the second injection well operational prior to the year's end.

### ***Truck Offloading Facility***

As the Company nears completion of the Truck Offloading Facilities ("TOF") at Block 51, we are in position to realize the benefits of our development and appraisal drilling program at Block 9 in Yemen and to unlock the production and reserves potential of the asset. We expect that the completion of the TOF (presently scheduled for year-end 2010) will allow us to achieve significant production ramp up entering 2011.

Having established a market for all of the crude oil commercially available within Block 9, the TOF will enable Calvalley to market a blend of 26 API or better crude from Block 9 to the Masila Export Pipeline via Block 51 with pricing at an attractive price equivalent to the Masila Blend price. We have made a significant progress toward the completion of TOF. Civil work at the TOF is essentially complete. Fabrication of all key equipment including tanks, pumps, and metering systems is largely complete and the majority of the equipment is either in transit or has already arrived in Yemen. The mechanical and electrical work for the TOF is expected to commence prior to November 15, 2010. The facility is on schedule and on budget. The first delivery of blended crude from Block 9 to Block 51 is expected to commence immediately after the TOF is completed. Initially, Calvalley will be trucking oil from Block 9 to the TOF with a maximum limit of 10,000bbl/d (5,000bbl/d Calvalley working interest). In the long run, the trucking will be replaced by a main pipeline connecting Block 9 to the export line. Upon completion of the export line, the 10,000 limit will be eliminated. The initial planning for the construction of a pipeline to deliver blended oil from the Company's Central Processing Facility ("CPF") at Block 9 to the Masila system has commenced.

In summary, Calvalley has now positioned itself to increase its production of blended crude to 10,000 bopd (5,000 bopd net) upon commissioning of the TOF. The Company continues to drill development wells at its Hiswah and Al Roidhat fields to increase its production capacity.

## **DRILLING, COMPLETION, AND TESTING**

### ***Development wells at Hiswah***

Calvalley successfully completed the drilling of the Hiswah 34 producer and the well has been placed on production. Drilling operations on the Hiswah 35 producer are scheduled to commence during the fourth quarter of 2010. The Company is also continuing its pressure maintenance and production optimization program for the Hiswah field.

### ***Qarn Qaymah***

Appraisal of the Qarn Qaymah structure was started by mobilizing the rig to the Qarn Qaymah-3 ("QQ-3") well site in mid-September. The drilling of the well commenced on October 2, 2010. QQ-3 is targeted to have a total depth of 4,460 meters including an openhole section of approximately 1,000 meters in the oil bearing Fractured Granitic Basement ("FGB"). The openhole section is expected to encounter seven (7) major fracture zones in the FGB. Calvalley expects to keep this rig in the Qarn Qaymah area due to its capability to drill additional deep exploration/appraisal wells.

The drilling of QQ-3 is progressing well and on budget with the current depth of approximately 2,000 meters. We expect to complete the drilling by mid-December. The testing of the well will commence immediately thereafter.

### ***Ras Nowmah***

The Company commenced the testing of the Ras Nowmah-2 discovery well on September 13, 2010. A number of tests were conducted with two different size pumps. The final test data were obtained utilizing a larger capacity downhole pump ("ESP") which was installed by the Company for this latest phase of testing operations. The well flowed at a stabilized rate of approximately 3,000 bbl/d of sweet crude (approximately 30 degree API) and no formation water with only 9.5% pressure drawdown to the maximum operational capability of the ESP. Based on the pressure drawdown and build-up data, this 2nd phase of testing clearly indicates that the Ras Nowmah-2 well is potentially capable of producing at much higher flow rates. The test data were analyzed by an independent reservoir engineering firm in Calgary. The independent reservoir engineers calculated a flow rate in excess of 5,000bbl/d at a 20% pressure drawdown.

Given the success of the Ras Nowmah discovery, we have commenced the acquisition of 350 km of 2D seismic data which is expected to be completed by mid-December 2010. The seismic data will enable to Calvalley to further define Ras Nowmah field boundaries and high-grade the nearby prospects which are part of the 2011 drilling campaign.

Calvalley has commenced preparation for an appraisal well in the discovery area (Ras Nowmah-3). The site preparation is 90% complete. We expect to start the drilling of Ras Nowmah-3 immediately following the completion of the seismic data acquisition program.

### ***Ethiopia***

Surface geological work at the Metema and Gimbi Blocks in Ethiopia has been completed and fully evaluated. Based on the surface geological work, Calvalley has selected a key prospective region covering an area of approximately 26,000 square km for the acquisition of an aeromagnetic survey. The contractor for the acquisition of the aeromagnetic survey has been selected and the services have been mobilized to the region. The data acquisition is expected to commence in November.

## MANAGEMENT DISCUSSION & ANALYSIS

References to "Calvalley" or the "Company" refer to Calvalley Petroleum Inc. and its share of consolidated subsidiaries and joint ventures unless the context indicates otherwise. All currency references are to United States dollars unless otherwise specifically indicated. References to "C\$" are to Canadian dollars.

The purpose of this Management's Discussion and Analysis (MD&A) is to provide readers the ability to view Calvalley in much the same way as Company management. The following combination of historical and prospective information and financial and business analyses, together with the consolidated financial statements, are intended to impart useful knowledge to investors and other readers. This MD&A should be read in conjunction with the Company's unaudited consolidated financial statements and related notes for the three and nine month periods ended September 30, 2010. Additional information relating to the Company, including the Company's Annual Information Form, is available on SEDAR at [www.sedar.com](http://www.sedar.com) or on the Company's website at [www.calvalleypetroleum.com](http://www.calvalleypetroleum.com).

References in text or tables throughout this document to "2010", "2009", and "2008" refer to the years ended December 31, 2010, 2009 and 2008, respectively. References in text or tables labelled "Q4", "Q3", "Q2" and "Q1" refer to the periods ended December 31, September 30, June 30 and March 31, respectively, of the year indicated.

This MD&A contains information current to November 3, 2010.

### NON-GAAP MEASURES

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#### ***Funds flow from operations***

Funds flow from operations is a measure not recognized under Canadian generally accepted accounting principles (GAAP) that represents funds generated from operating activities before changes in non-cash working capital. Funds flow from operations should not be considered an alternative to, or more meaningful than, cash flow from operating activities. Management believes that funds flow from operations is a useful supplemental measure to analyze the Company's ability to generate cash flow to fund capital investment and working capital requirements. Funds flow from operations may not be comparable to similar measures used by other companies.

#### ***EBITDA and Operating income***

Earnings before interest, taxes, depreciation and amortization (EBITDA) and Operating income are non-GAAP measures. The Company calculates EBITDA as revenue net of royalties, operating expenses and general and administrative expenses. The Company calculates Operating income by deducting depletion, depreciation and amortization expense from EBITDA. Management believes that EBITDA and Operating income are useful supplemental measures to analyze operating performance and to provide an indication of the results generated by the Company's principal business activities prior to the consideration of other income and expenses. EBITDA and Operating income may not be comparable to similar measures used by other companies.

#### ***Netback***

Netback is a non-GAAP measure that represents oil and natural gas revenue net of royalties, operating expenses and current taxes. Management believes that netback is a useful supplemental measure to analyze operating performance and provides an indication of the results generated by the Company's principal business activities prior to the consideration of other income and expenses. Netback may not be comparable to similar measures used by other companies.

## SELECTED QUARTERLY INFORMATION

(\$000s unless otherwise noted)	2010			2009				2008
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
Avg. production volume – Calvalley share (Bopd)	<b>2,256</b>	2,303	2,299	2,202	2,092	2,082	2,266	1,995
Average sales volume (Bopd)	<b>2,839</b>	973	2,115	2,081	2,020	3,695	1,967	625
Average realized price (\$/bbl)	<b>76.10</b>	84.70	75.91	73.83	67.74	51.30	38.75	70.50
Oil Sales	<b>19,877</b>	7,499	14,449	14,136	12,591	17,252	6,860	4,060
Oil Sales, net of royalties	<b>12,328</b>	4,564	8,921	8,742	7,766	10,686	4,160	2,451
Cash flow from operating activities	<b>1,150</b>	3,457	5,122	9,271	3,587	3,325	(962)	(1,661)
Funds flow from operations <sup>(1)</sup>	<b>6,744</b>	1,926	5,269	4,652	4,453	4,644	(149)	414
Funds flow from operations per share (\$/share) <sup>(1)</sup>								
- Basic and Diluted	<b>0.07</b>	0.02	0.05	0.05	0.04	0.05	0.00	0.00
Net income (loss)	<b>2,744</b>	485	2,725	2,109	2,122	765	(2,045)	25
Net income (loss) per share (\$/share)								
- Basic and Diluted	<b>0.03</b>	0.01	0.03	0.02	0.02	0.01	(0.02)	0.00
Working Capital	<b>73,293</b>	72,650	72,182	70,705	71,278	72,059	72,599	75,775
Total Assets	<b>176,970</b>	172,390	172,378	172,991	165,178	164,193	165,683	172,406
Long-term debt	-	-	-	-	-	-	-	-

(1) See "Non-GAAP Measures".

## OVERALL PERFORMANCE

Net income for the nine month period ended September 30, 2010 was \$6.0 million versus \$0.8 million for 2009. Working capital at September 30, 2010 increased to 73.3 million from \$70.7 million at December 31, 2009. Funds flow from operations for the nine month period ended September 30, 2010 improved to \$13.9 million from \$8.9 million for the nine months ended September 30, 2009.

During the nine month period ended September 30, 2010, the Company's ability to generate positive funds flow from operations enabled it to finance its capital program and to buy back 529,528 shares at a cost of \$1.5 million representing an average cost of \$2.77/share (C\$2.87/share). The Company continues to generate cash flow from its operations at Block 9 in the Republic of Yemen.

## BUSINESS ENVIRONMENT

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The Company's financial results are significantly influenced by fluctuations in commodity prices. The following table shows selected market benchmark prices as well as the Company's realized selling price of oil for the four most recent quarters:

	2010 Q3	2010 Q2	2010 Q1	2009 Q4	2009 Q3
Dated Brent average oil price (\$/bbl)	76.86	78.24	76.37	74.53	68.08
Calvalley realized price (\$/bbl)	76.10	84.70	75.91	73.83	67.74

The price of Dated Brent oil averaged \$76.86/bbl in Q3 2010, an increase of 13% from the Q3 2009 price of \$68.08/bbl. The price of Dated Brent oil reached a record high of \$144.23/bbl in July 2008. However, financial market instability and a worldwide recession resulted in a steep decline in the price of Dated Brent oil from August to December 2008. During 2009 and into 2010, the price of oil recovered some of this decline. The closing price of Dated Brent oil at September 30, 2010 was \$80.96/bbl.

The global financial crisis has reduced liquidity in financial markets, restricted access to financing and caused significant volatility in commodity prices. Despite recent signs of a recovery, these factors may continue to impact the performance of the global economy. Calvalley, with no debt, strong cash generation from operations, and the availability of cash and cash equivalents, remains well-positioned to manage through the crisis. Furthermore, Calvalley's approach is to operate within a balanced budget and the Company does not expect to incur long-term debt in the near future.

## OUTLOOK

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As the Company nears completion of the Truck Offloading Facilities ("TOF") at Block 51, we are in position to realize the benefits of our development and appraisal drilling program at Block 9 in Yemen and to unlock the production and reserves potential of the asset. We expect that the completion of the TOF (presently scheduled for year-end 2010) will allow us to achieve significant production ramp up entering 2011.

Having established a market for all of the crude oil commercially available within Block 9, the TOF will enable Calvalley to market a blend of 26 API or better crude from Block 9 to the Masila Export Pipeline via Block 51 with pricing at an attractive price equivalent to the Masila Blend price. We have made a significant progress toward the completion of TOF. Civil work at the TOF is essentially complete. Fabrication of all key equipment including tanks, pumps, and metering systems is largely complete and the majority of the equipment is either in transit or has already arrived in Yemen. The mechanical and electrical work for the TOF is expected to commence prior to November 15, 2010. The facility is on schedule and on budget.

The first delivery of blended crude from Block 9 to Block 51 is expected to commence immediately after the TOF is completed. Initially, Block 9 crude will be trucked to the TOF with a maximum limit of 10,000bbl/d (5,000bbl/d net). In due course, trucking will be replaced by a pipeline connecting Block 9 to the export line. Upon completion of the export line, the 10,000 limit will be eliminated. The initial planning for the construction of a pipeline to deliver blended oil from the Company's Central Processing Facility ("CPF") at Block 9 to the Masila system has commenced.

With respect to drilling operations, the Company continues to drill development wells at its Hiswah and Al Roidhat fields to increase its production capacity.

Appraisal of the Qarn Qaymah structure was started by mobilizing the rig to the Qarn Qaymah-3 ("QQ-3") well site in mid-September. The drilling of the well commenced on October 2, 2010. QQ-3 is targeted to have a total depth of 4,460 meters including an openhole section of approximately 1,000 meters in the oil bearing Fractured Granitic Basement ("FGB"). The openhole section is expected to encounter seven (7) major fracture zones in the FGB. Calvalley expects to keep this rig in the Qarn Qaymah area to drill additional deep exploration/appraisal wells.

The drilling of QQ-3 is progressing well and on budget with the current depth of approximately 2,000 meters. We expect to complete drilling by mid-December. The testing of the well will commence immediately thereafter.

The Company commenced the testing of the Ras Nowmah-2 discovery well on September 13, 2010. A number of tests were conducted with two different size pumps. The final test data were obtained utilizing

a larger capacity downhole pump ("ESP") which was installed by the Company for this latest phase of testing operations. The well flowed at a stabilized rate of approximately 3,000 bbl/d of sweet crude (approximately 30 degree API) and no formation water with only 9.5% pressure drawdown to the maximum operational capability of the ESP. Based on the pressure drawdown and build-up data, this 2<sup>nd</sup> phase of testing clearly indicates that the Ras Nowmah-2 well is potentially capable of producing at much higher flow rates. The test data were analyzed by an independent reservoir engineering firm in Calgary. The independent reservoir engineers calculated a flow rate in excess of 5,000bbl/d at a 20% pressure drawdown.

Given the success of the Ras Nowmah discovery, we have commenced the acquisition of 350 km of 2D seismic data which is expected to be completed by mid-December 2010. The seismic data will enable to Calvalley to further define Ras Nowmah field boundaries and high-grade the nearby prospects which are part of the 2011 drilling campaign.

Calvalley has commenced preparation for an appraisal well in the discovery area (Ras Nowmah-3). The site preparation is 90% complete. We expect to start the drilling of Ras Nowmah-3 immediately following the completion of the seismic data acquisition program.

Calvalley has also commenced technical work associated an inter-field pipeline connecting the Al-Roidhat and Ras Nowmah fields to the CPF located at the Hiswah field. Construction is expected to commence in the first half of 2011 and to be completed in the third quarter of the same year. This pipeline will reduce inter-field transportation and operating costs.

Calvalley has started the process of bringing in a third drilling rig to Block 9, which will be dedicated to the drilling of shallow development wells. We expect the rig to be available and on location at Block 9 in January 2011.

With respect to the Company's activities in Ethiopia, surface geological work in the Metema and Gimbi Blocks has been completed and fully evaluated. Based on the surface geological work, Calvalley has selected a key prospective region covering an area of approximately 26,000 square km for the acquisition of an aeromagnetic survey. The contractor for the acquisition of the aeromagnetic survey has been selected and the services have been mobilized to the region. The data acquisition is expected to commence in November and to be completed by the end of 2010. Interpretation of the data and selection of potential drilling site will follow in the first half of 2011.

## **EXPLORATION AND DEVELOPMENT PROGRAM**

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### ***Block 9 – Republic of Yemen***

#### Joint Operating Agreement (JOA)

Substantially all of Calvalley's operations and assets are related to its 50% working interest in the Block 9 Production Sharing Agreement (PSA) with the Government of Yemen. Calvalley is the operator of the Block 9 Joint Venture (JV) pursuant to the JOA among Calvalley, HoodOil Ltd. ("HoodOil"), Reliance Industries Limited ("Reliance") and a subsidiary of the Yemen Oil and Gas General Corporation ("Yemen Co."), an entity owned by the Government of Yemen. Yemen Co.'s interest under the JOA consists of a 15% overriding royalty on the JV's allocation of profit oil under the PSA.

### Production Sharing Agreement

Oil and natural gas production from Block 9 is allocated between the JV and agencies of the Government of Yemen pursuant to the terms of the PSA. The Government of Yemen receives a 10% royalty in kind from all Block 9 production, after which the remaining oil production is shared between the JV and the Government of Yemen. The JV is first allocated up to 45% of gross production to recover capital and operating costs incurred in order to operate Block 9. To the extent that recoverable costs exceed 45% of the fair value of gross production, any excess costs are carried forward for recovery against future production. After deducting cost oil, the remaining profit oil is allocated between the Government of Yemen and the JV as follows:

- 39.23% of total profit oil to the JV (before deducting 35% income tax on JV's share of profit oil and after deducting 15% override to Yemen Co.); and
- 60.77% to the Government of Yemen (including Yemen Co.'s override and before including income tax on JV's share of profit oil).

Provided that total recoverable costs do not exceed 45% of gross production, the JV may recover operating costs during the year in which they are incurred and may deduct 50% of capital costs incurred during the year of expenditure and 50% during the following year.

As at September 30, 2010, the Company's share of capital costs to be carried forward for recovery against future production was approximately \$48 million. Until these costs have been recovered, together with future operating and capital costs that become eligible for recovery during that time period, the Company's net oil production will equal 31.33% of gross oil production (22.5% from cost oil and 8.83% from profit oil). Following full recovery of past operating costs, the Company's net oil production will range between 17.65% and 31.33% of gross oil production, which will vary depending upon prevailing crude oil selling prices and the capital and operating costs incurred by the JV. The Company's share of profit oil is subject to 35% income tax to the Government of Yemen which is paid by the Government of Yemen out of its share of profit oil.

### ***Ethiopia***

#### Production Sharing Contract

In 2008, Calvalley entered into its first Production Sharing Contract with the Ethiopian Government for the exploration, development and production of petroleum substances in the Gimbi and Metema blocks under a single contract covering a total area of over 46,470 km<sup>2</sup> (11.5 million acres).

Calvalley has a 100% operated working interest in both blocks for an exploration period of eight years, consisting of an initial period of four years followed by two subsequent option periods consisting of two years each. The option period will be activated at the discretion of Calvalley. Furthermore, subject to hydrocarbon discovery during the total eight year period, the PSC provides for an additional 25 year development period with a 10 year optional extension. The PSC gives Calvalley the rights to explore, develop, and produce hydrocarbons including oil, condensate, natural gas, and associated liquids.

Total work obligations under the PSC, during the initial 4 year exploration program amount to approximately \$8.5 million and consist of the acquisition and processing of 400 km of 2D seismic and the drilling of one exploration well.

## KEY PERFORMANCE INDICATORS

Calvalley uses key financial indicators to help assess its business performance and manage its operations. These financial indicators measure business growth (revenue and capital expenditures), cash generation (EBITDA and funds flow from operations) and profitability (operating income and net income). These key financial indicators are discussed in more detail in the following sections.

### *Production and sales information*

	2010			2009			
	Year Total	Q3	Q2	Q1	Year Total	Q4	Q3
Block 9 Oil Production (bopd)	<b>4,572</b>	<b>4,512</b>	4,606	4,597	4,320	4,404	4,184
Company working interest share (bopd)	<b>2,286</b>	<b>2,256</b>	2,303	2,299	2,160	2,202	2,092

### *Production*

Substantially all of Calvalley's crude oil production in 2010 and 2009 came from the Hiswah oil field, which produces high-quality, lighter crude oil that is sold at prices comparable to the Dated Brent crude oil reference price. All of the Company's crude oil production was trucked more than 250 kilometres to the Safer Exploration and Production Operations Co. processing facility on Block 18, where the crude oil was processed and shipped via pipeline to the Ras Isa marine terminal facility for export. During the third quarter of 2010, the Company's working interest oil production averaged 2,256 barrels of oil per day (bopd) (2009 – 2,092 bopd).

Production rates during the third quarter of 2010 improved in comparison to rates during the third quarter of 2009. Production decreased during the second quarter of 2009 because the facility through which the Company sells its oil restricted the volumes of oil it would accept from Block 9. The restriction resulted from the facility seeking to achieve target sulphur content in the oil blend exiting the facility. The facility's blended sulphur content had increased due to decreased production from other fields feeding the facility. The Company consequently shut-in certain higher-sulphur producing wells to meet the requirements of this externally imposed restriction. The restriction has been removed and the production rate has recovered.

During the first quarter of 2010 the Company finalized transportation agreements which will provide for the Company's use of alternate facilities at Block 51 and Block 14. Once shipments to Block 51 commence, the Company will begin production from the Al Roidhat field. The Company's working interest oil production for October 2010 averaged 2,264bopd.

The following table sets forth key indicators for the periods indicated:

**Selected operating information**

(\$000)	2010				2009		
	Year Total	Q3	Q2	Q1	Year Total <sup>(1)</sup>	Q4	Q3
Oil sales	<b>41,825</b>	<b>19,877</b>	7,499	14,449	50,839	14,136	12,591
Royalties	<b>(16,012)</b>	<b>(7,549)</b>	(2,935)	(5,528)	(19,485)	(5,394)	(4,825)
Operating expenses	<b>(6,569)</b>	<b>(3,487)</b>	(1,194)	(1,888)	(10,313)	(2,321)	(2,141)
Current taxes	<b>(2,578)</b>	<b>(1,229)</b>	(463)	(886)	(3,143)	(880)	(779)
Netback <sup>(2)</sup>	<b>16,666</b>	<b>7,612</b>	2,907	6,147	17,898	5,541	4,846
General and administrative expenses	<b>(3,322)</b>	<b>(1,090)</b>	(1,169)	(1,063)	(4,413)	(1,095)	(657)
EBITDA <sup>(2)</sup>	<b>16,242</b>	<b>7,876</b>	2,295	6,071	15,992	5,433	5,055
Operating income (loss) <sup>(2)</sup>	<b>9,495</b>	<b>4,641</b>	1,117	3,737	6,142	3,000	3,032
Net income (loss)	<b>5,954</b>	<b>2,744</b>	485	2,725	2,951	2,109	2,122
Capital expenditures	<b>10,775</b>	<b>4,734</b>	2,842	3,199	11,803	4,813	1,781
Funds flow from operations <sup>(2)</sup>	<b>13,939</b>	<b>6,744</b>	1,926	5,269	13,600	4,652	4,453
Cash flow (deficiency) from operating activities	<b>9,729</b>	<b>1,150</b>	3,457	5,122	13,971	9,271	3,587

(1) For the purpose of calculating netback, operating expenses for the year total of 2009 were adjusted to exclude the portion of the Facility Usage fee (FUF) which relates to deliveries of crude oil prior to January 1, 2009 in the amount of \$1,025. See discussion on Operating Expenses for further details.

(2) See "Non-GAAP Measures".

Netbacks are calculated on barrels sold as sales revenue less government royalties, taxes and operating expenses and are recognized when the underlying oil is sold. Government royalties and taxes taken in kind are attributed value at the price received by Calvalley for its production as follows:

**Netbacks**

(\$/bbl)	2010				2009		
	Year Total	Q3	Q2	Q1	Year Total <sup>(1)</sup>	Q4	Q3
Oil sales	<b>77.44</b>	<b>76.10</b>	84.70	75.91	57.08	73.83	67.74
Royalties	<b>(29.71)</b>	<b>(28.96)</b>	(33.25)	(29.09)	(21.92)	(28.28)	(26.00)
Operating expenses	<b>(12.16)</b>	<b>(13.35)</b>	(13.49)	(9.92)	(11.58)	(12.12)	(11.52)
Current taxes	<b>(4.79)</b>	<b>(4.70)</b>	(5.23)	(4.69)	(3.53)	(4.56)	(4.19)
Netback <sup>(2)</sup>	<b>30.78</b>	<b>29.09</b>	32.73	32.21	20.05	28.87	26.03

(1) For the purpose of calculating netback, operating expenses for the first quarter and year total of 2009 were adjusted to exclude the portion of the FUF which relates to deliveries of crude oil prior to January 1, 2009 in the amount of \$5.79/bbl. See "Operating Expenses".

(2) See "Non-GAAP Measures".

Netbacks for the third quarter of 2010 were \$29.09/bbl compared to \$26.03/bbl for the third quarter of 2009. Netbacks for the nine months ended September 30, 2010 were \$30.78/bbl in comparison to \$17.64/bbl for the comparable period in 2009. Fluctuations in netbacks are primarily attributable to changes in the prevailing price of crude oil. Netbacks are also impacted by fluctuations in operating costs as discussed above.

**Revenue**

During the third quarter of 2010, Calvalley recorded oil revenue of \$19.9 million as compared to \$12.6 million for the three month period ended September 30, 2009. The significant increase in revenue is attributable to a 40.5% increase in sales volume and a 12.3% increase in selling price. The Company

recognized revenue on the sale of 261,178 barrels during the three months ended September 30, 2010 compared with 185,865 barrels during the third quarter of 2009. The average selling price realized during the third quarter of 2010 was (\$76.10/bbl) in comparison to (\$67.74/bbl) during the third quarter of 2009. The increase in sales volume is attributable to the timing of lifts and is not directly correlated with production, which was 207,574 bbls in 2010 versus 192,448 bbls in 2009.

For the nine months ended September 30, 2009 oil revenues totalled \$41.8 million compared to \$36.7 million for the nine months ended September 30, 2009. The directional variance for the nine month period is attributable to the same factors as for the three month period. The decrease in sales volume from 699,179 barrels during the nine months ended September 30, 2009 to 540,062 barrels during the nine month period ended September 30, 2010 accounted for a 22.8% decline in revenue. The decrease was offset by a 47.5% increase in the average selling price which improved from \$52.49/bbl in 2009 to \$77.44/bbl in 2010.

#### ***Other Revenue***

Other revenue amounted to \$0.2 million for the three months ended September 30, 2010 (2009 - \$0.3 million) and \$0.6 million for the nine month period ended September 30, 2010 (2009 - \$0.9 million). Interest revenue resulted from maintaining significant cash reserves and guaranteed investment certificates (GICs) throughout the period. Interest income has declined from 2009 due to reduced interest rates throughout the year. Interest rates on interest-bearing deposits declined throughout 2008 and 2009, and have remained depressed during 2010 as central banks attempt to stimulate their economies by reducing borrowing rates.

#### ***Operating Expenses***

Operating expenses during the third quarter of 2010 were \$3.5 million (\$13.35/bbl) as compared to \$2.1million (11.52/bbl) in the quarter ended September 30, 2009. Operating expenses for the nine months ended September 30, 2010 were \$6.6 million (\$12.16/bbl) compared to \$9.0 million (\$11.43/bbl) for the nine month period ended September 30, 2009.

Total operating expenses were higher in the third quarter of 2010 than during the comparable period during 2009 as a result a \$0.3 million charge (\$1.14/bbl) taken by the Company in respect of processing fees associated with the sulphur content of certain oil deliveries. In addition, the Company conducted certain non-recurring maintenance projects during the quarter.

During the first quarter of 2009, the Government of Yemen charged Calvalley \$1.1 million for facilities usage. All producers of crude oil in Yemen are subject to the FUF. The charge was applied retroactively from the commencement of production at Block 9. The portion of the charge related to deliveries that occurred prior to January 1, 2009 amounted to \$1.0 million and has been excluded from operating expenses for the purpose of this MD&A to maintain comparability of operating expenses. The balance of the charge in the amount of \$81,000 (\$0.40/bbl) related to oil that was delivered to the government facility during the first quarter of 2009. The FUF is recoverable from the Company's share of cost oil in accordance with the terms of the PSA.

As a result of the global financial crisis and falling oil prices, the oil industry cut back or delayed certain capital-intensive projects, which has led to less demand and lower costs for certain goods and services. Calvalley manages operating costs through competitive bidding, long-term contracts and, recently, renegotiation of current contract terms.

Operating expenses include \$5.25 (2009 – \$5.98) per gross barrel for trucking costs, third-party processing costs, and tariffs for use of pipeline and marine terminal facilities.

#### ***General and Administrative Expenses (G&A)***

G&A, net of \$0.4 million that was capitalized into resource development costs, totalled \$1.1 million for the three month period ended September 30, 2010 as compared to \$0.7 million for the quarter ended September 30, 2009. For the nine month period ended September 30, 2010 G&A costs were \$3.3 million compared to \$3.3 million during the nine months ended September 30, 2009. G&A costs directly associated with Block 9 become recoverable costs and will be recovered from revenue associated with cost oil under the terms of the PSA.

## **EBITDA**

During the third quarter of 2010, the Company generated EBITDA of \$7.9 million compared with \$5.1 million during the three months ended September 30, 2009. For the nine months ended September 30, 2010 EBITDA was \$16.2 million compared to \$10.6 million for the corresponding period in 2009. The fluctuation in EBITDA is primarily attributable to changes in the prevailing price of crude oil. The FUF referred to above in the discussion on operating expenses was a major contributor to the decrease in EBITDA recognized in the nine months of 2009. EBITDA is also impacted by the timing of lifts by the purchaser of the Company's crude oil.

### **Depletion, Depreciation and Amortization (DD&A) Expenses**

	2010				2009		
	Year Total	Q3	Q2	Q1	Year Total	Q4	Q3
DD&A (\$000)	<b>6,747</b>	<b>3,235</b>	1,178	2,334	9,850	2,433	2,023
DD&A (\$/bbl)	<b>12.49</b>	<b>12.39</b>	13.31	12.26	11.06	12.71	10.88

Calvalley recorded DD&A expenses of \$3.2 million for the quarter ended September 30, 2010 as compared to \$2.0 million for the third quarter of 2009. For the nine months ended September 30, 2010, DD&A expenses of \$6.7 million were recorded in comparison to \$7.4 million for the nine month period ended September 30, 2009. The increase in the 2010 versus 2009 annual DD&A rate per barrel is primarily related to adjustments as reflected in the Company's December 31, 2009 reserve report. The DD&A provision is also impacted by the build up of inventory at each period end.

### **Operating Income**

During the third quarter of 2010, the Company generated operating income of \$4.6 million compared with \$3.0 million during the three month period ended September 30, 2009. During the nine month period ended September 30, 2010 the Company generated operating income of \$9.5 million in comparison with \$3.1 million for the corresponding period during 2009. Operating income was impacted by the same factors as those affecting netbacks and EBITDA.

### **Income Taxes**

Current income tax expense amounted to \$1.2 million (2009 – \$0.8 million) for the third quarter of 2010 and \$2.6 million (2009 - \$2.3 million) for the nine months ended September 30, 2010. The charge represents income taxes incurred and paid under the laws of Yemen pursuant to the PSA. The income tax is calculated as 35% of the Company's profit oil revenue in Yemen, and is paid by the Government of Yemen out of its share of profit oil.

## **CONSOLIDATED CASH FLOW**

### **Operating Activities**

	2010				2009		
	Year Total	Q3	Q2	Q1	Year Total	Q4	Q3
(\$000)							
Funds flow from operations	<b>13,939</b>	<b>6,744</b>	1,926	5,269	13,600	4,652	4,453
Change in non-cash working capital	<b>(4,210)</b>	<b>(5,594)</b>	1,531	(147)	371	3,369	(866)
Cash provided by (used in) operations	<b>9,729</b>	<b>1,150</b>	3,457	5,122	13,971	8,021	3,587

As at September 30, 2010, the Company held cash and cash equivalents of \$11.9 million compared with \$20.0 million at the end of 2009. Additionally, the Company held GICs with an initial term greater than 90 days in the amount of \$53.3 million (December 31, 2009 – \$50.4 million). The Company invests its cash reserves in GICs issued by an Alberta credit union in which deposits are guaranteed by the Province of Alberta.

Funds flow from operations of \$6.7 million during the third quarter of 2010 was sufficient to fund the additions to property, plant and equipment in the amount of \$4.7 million. During the third quarter of 2009, funds flow from operations was \$4.5 million. Funds flow from operations was \$13.9 million during the nine months ended September 30, 2010 compared to \$8.9 million for the nine months ended September 30, 2009.

### ***Investing Activities***

(\$000)	2010				2009		
	Year Total	Q3	Q2	Q1	Year Total	Q4	Q3
Additions to property, plant and equipment	<b>(10,775)</b>	<b>(4,734)</b>	(2,842)	(3,199)	(11,803)	(4,811)	(1,781)
Change in non-cash working capital	<b>(2,888)</b>	<b>(2,538)</b>	(69)	(281)	6,960	5,608	4,080
Net investment in GICs	<b>(2,896)</b>	<b>4,327</b>	1,286	(8,509)	(7,637)	(6,359)	(151)
Cash provided by (used in) investing activities	<b>(16,559)</b>	<b>(2,945)</b>	(1,625)	(11,989)	(12,480)	(5,562)	2,148

During the first three quarters of 2010, the Company made capital expenditures of \$10.8 million compared with \$7.0 million during the nine months ended September 30, 2009. The Company invested in the construction of additional facilities for water and gas injection, and the blending of crude oil. The Company also continues to invest resources to construct the truck offloading facility at Block 51 in anticipation of delivering oil to this location in accordance with the terms of the Agreements described in detail in the Outlook section of this MD&A. Finally, expenditures were incurred to prepare and complete the Al-Roidhat wells for production, to drill development wells in the Hiswah area, and to drill exploration wells in the Ras Nomah and Salmin area. The Company's funding of expenditures on behalf of its partners exceeded payments received from the Company's partners in the amount of \$2.9 million during the period. Capital expenditures related to the shortfall amounted to \$1.3 million. The Company also invested in GICs during the nine months ended September 30, 2010.

### ***Financing Activities***

(\$000)	2010				2009		
	Total Year	Q3	Q2	Q1	Year Total	Q4	Q3
Issuance of common shares	<b>210</b>	<b>41</b>	55	114	776	19	65
Common share repurchase	<b>(1,469)</b>	<b>(626)</b>	-	(843)	(3,342)	(521)	(265)
	<b>(1,259)</b>	<b>(585)</b>	55	(729)	(2,566)	(502)	(200)

During the nine months ended September 30, 2010 the Company repurchased 529,528 Class A Common Voting Shares on the open market pursuant to its normal course issuer bids at a cost of \$1.5 million representing an average cost of 2.77/share (C\$2.87/share). Proceeds from the issuance of Class A Common Voting Shares during the period were related solely to the exercise of stock options and totalled \$0.2 million.

## CONSOLIDATED FINANCIAL POSITION

Assets (\$000)	2010			2009	
	Q3	Q2	Q1	Q4	Q3
As at period-end					
Cash and cash equivalents	<b>11,937</b>	14,316	12,437	20,043	17,997
GICs	<b>53,279</b>	57,606	58,892	50,383	44,024
Accounts receivable	<b>3,910</b>	33	3,007	2,821	2,707
Due from joint venture partners	<b>12,052</b>	5,825	6,607	9,112	12,143
Oil inventory	<b>1,804</b>	2,947	428	225	266
Prepaid expenses	<b>608</b>	549	201	341	373
Property and equipment	<b>93,380</b>	91,114	90,806	90,066	87,668
<b>Total assets</b>	<b>176,970</b>	172,390	172,378	172,991	165,178

As at September 30, 2010, the Company's total assets were \$177.0 million, an increase of \$4.0 million from December 31, 2009. Cash and cash equivalents amounted to \$11.9 million compared with \$20.0 million at the beginning of the year. The decrease was partially offset by an increase of \$2.9 million in GICs.

Accounts receivable increased by \$1.1 million to \$3.9 as at September 30, 2010. The amount due from JV partners increased from \$9.1 million at the beginning of the year to \$12.1 million as at September 30, 2010.

Oil inventory increased from \$0.2 million to \$1.8 million. Oil inventory results from the timing of lifts and relates to oil production in storage at the end of a period, valued at the average cost of production. At September 30, 2010, the Company's oil inventory net of royalties and taxes amounted to 39,392 bbls compared to 5,805 bbls at December 31, 2009.

Property and equipment increased to \$93.4 million as at September 30, 2010. The movement in property and equipment resulted from capital expenditures of \$10.8 million, which was offset by DD&A expense of \$6.7 million plus \$0.7 million in net adjustments to depletion related to oil in inventory.

Liabilities and Shareholders' Equity (\$000)	2010			2009	
	Q3	Q2	Q1	Q4	Q3
As at period-end					
Accounts payable and accrued liabilities	<b>10,297</b>	8,626	9,390	12,220	6,232
Share capital	<b>116,079</b>	116,227	116,143	116,387	116,622

Accounts payable and accrued liabilities decreased to \$10.3 million as at September 30, 2010, from \$12.2 million as at December 31, 2009. The primary reason for this decrease is the increased capital spending related to heightened exploration and development activity during the last two months of 2009 and the timing of payments made to suppliers and contractors.

Share capital decreased to \$116.1 million as at September 30, 2010 from \$116.4 million as at the end of 2009 as a result of the repurchase of common shares through the Company's normal course issuer bids. The decrease was partially offset by the issuance of Class "A" Common Voting Shares from the exercise of stock options during the period.

## **LIQUIDITY AND CAPITAL RESOURCES**

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Calvalley's principal source of liquidity has been funds flow from operations. Calvalley manages its liquidity risk by regularly monitoring its cash flows from operating activities and holding adequate amounts of cash and cash equivalents. The Company does not invest its funds in speculative securities. The 2010 budget is expected to be funded from cash flow from operations and existing cash resources. Should the prevailing Dated Brent Crude price decline to lower than budgeted, Calvalley has sufficient flexibility in its capital budget to adjust capital expenditures to enable the capital program to be funded through internally generated cash flow. Fluctuations in commodity prices, product demand, foreign exchange rates and interest rates, as well as various other risks relating to factors beyond the control of Calvalley may impact capital resources.

Calvalley has no outstanding bank debt or other interest-bearing indebtedness as at September 30, 2010. The Company has not arranged any undrawn operating lines of credit with any financial institution as the Company intends to fund its near-term capital expenditure programs from available cash on hand, funds flow from operations and, if required, from the issuance of additional share capital.

As at September 30, 2010, the Company's total assets were \$177.0 million, an increase of \$4.0 million from December 31, 2009. Cash and cash equivalents amounted to \$11.9 million compared with \$20.0 million at the beginning of the year. Cash equivalents are invested with high-quality financial institutions with terms to maturity of less than three months. Additionally, the Company held GICs with an initial term greater than 90 days. Total cash and cash equivalents plus GICs decreased from \$70.4 million at December 31, 2009 to \$65.2 million at September 30, 2010.

Interest rates on interest-bearing deposits have remained depressed over the past year as central banks attempt to stimulate the economy by reducing borrowing rates. Most of Calvalley's funds are deposited at a credit union where deposits are guaranteed by the Government of Alberta.

As at September 30, 2010 the Company's working capital increased to \$73.3 million as compared to \$70.7 million as at December 31, 2009.

At December 31, 2009 the Company had Canadian tax pools of approximately \$31.3 million, of which \$13.5 million were non-capital losses, \$6.7 million were Canadian resource tax pools, \$9.8 million were undepreciated capital cost allowance and \$1.3 million were deferred financing costs. No provision has been made to record these pools as an asset because the Company is not likely to take advantage of them due to the insignificance of its Canadian operations and assets.

The Company has no long-term contractual obligations in Canada other than an operating lease for office space of approximately \$0.2 million in 2010. Its long-term commitments regarding its Yemen property include its 50% proportionate share of government allowances and bonuses payable under the terms of the PSA of \$450,000 per year, plus its 50% proportionate share of certain other bonus payments of \$2 million, \$3 million and \$4 million when and if sustainable production exceeds 25,000, 75,000 and 100,000 bopd day, respectively.

During 2008, Calvalley entered into its first Production Sharing Contract (PSC) with the government of the Federal Democratic Republic of Ethiopia. Pursuant to the PSC, the Company has entered into certain commitments to spend approximately \$8.5 million during the first four years of its work program.

Calvalley had no off-balance-sheet arrangements as at September 30, 2010 or December 31, 2009.

## **ECONOMIC SENSITIVITIES**

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The following table shows the estimated after-tax effect that changes to crude oil prices, gross crude oil production, operating costs and interest rates would have had on Calvalley's net income for the nine month period ended September 30, 2010, had these changes occurred on January 1, 2010. These calculations are based on business conditions, production and sales volumes existing for the current period. The 1,000 bopd increase assumes the increase is to gross field production and Calvalley's entitlement is calculated according to the provisions of the PSA and JOA.

	<b>Change (+)</b>	<b>Net income impact (\$ millions)</b>	<b>Net income impact (\$ per basic share)</b>
Average realized price	\$10.00/bbl	3.1	0.03
Crude oil production	1,000 bopd	1.7	0.02
Increase in operating expenses	\$1.00/bbl	(0.5)	(0.01)
Interest rate	1%	0.5	0.01

The impact of the above changes may be compounded or offset by changes to other business conditions. In addition, the table does not reflect any inter-relationships between the above factors. Changes in the foreign exchange rates have not been considered in this analysis as they do not have a significant impact on Calvalley's operations.

### **RELATED-PARTY TRANSACTIONS**

On June 10, 2009 the Company advanced \$113,000 to a member of the Board of Directors. The advance was included in accounts receivable, was non-interest-bearing, repayable within 90 days, and secured by shares of the Company. The advance was repaid in full during August 2009.

### **RISK FACTORS**

Calvalley is exposed to a number of risks inherent in exploring for, developing and producing oil and natural gas. This section describes the risks and other matters that would be most likely to influence an investor's decision to purchase securities of Calvalley.

Calvalley manages a number of risks in its business in order to achieve an acceptable level of risk without hindering the ability to maximize returns. Management has adopted procedures to identify and manage significant operational and financial risks.

#### ***Commodity Risk***

Calvalley's principal business is the production and sale of crude oil. Revenues, earnings and cash flows from the sale of crude oil are sensitive to change in market prices, over which the Company has little or no control. The Company has the ability to address its price-related exposures through the limited use of options, future and forward contracts, but generally does not enter into such arrangements.

#### ***Currency Fluctuations***

Calvalley undertakes transactions in currencies other than the United States dollar. The Company's primary foreign exchange risk is to changes in the value of the Canadian dollar relative to the United States dollar. Fluctuations in exchange rates between the United States dollar and other currencies will give rise to foreign currency exposure, either favourable or unfavourable, which may have material effects on the Company's operations and financial condition. The Company has the ability to address its currency-related exposures through the use of foreign exchange contracts. It generally does not enter into such hedging arrangements but maintains a portion of its currency in Canadian dollars to meet its Canadian dollar requirements.

#### ***Interest Rates***

The Company has no interest-bearing debt. The Company invests surplus cash balances in short-term investments with recognized Canadian financial institutions. Fluctuations in interest rates, either favourable or unfavourable, may have material effects on the Company's interest income on short-term cash investments.

#### ***Credit risk and concentration of sales risk***

In January 2007, the Company entered into a long-term crude oil marketing agreement under which the Company sells all of its crude oil production to a single purchaser for a period of 18 months. The purchaser is a subsidiary of Reliance Industries Limited, India's largest business enterprise, which is a party to the JOA for Yemen Block 9. The purchaser's obligations under the crude oil marketing agreement

are guaranteed by Reliance, which has been assigned credit ratings of Baa2 Stable Outlook by Moody's and BBB Stable Outlook by S&P (above Sovereign Rating). The contract was formally extended in April 2009 and remains in effect.

Credit risk also relates to the risk that joint venture partners may not fulfill their contractual obligations for financial contributions towards exploration, development, appraisal and production operations.

During the initial agreement negotiations and ratification, these risks are considered and incorporated into the terms of the applicable contracts. Furthermore, cash calls can be made in advance of incurring costs to help ensure costs are recovered. However, it is possible that the interest of Calvalley and its JV partners are not aligned, resulting in project delays, additional costs or disagreements, which could adversely affect business results.

### ***Insurable Risk***

Calvalley employs risk management practices to reduce and mitigate operational risks and other hazard risks and exposures, although it is impossible to completely protect its operations from all such risks. The Company places types and an amount of insurance that it considers consistent with industry practice to the extent coverage is available and cost effective. Such coverage includes third-party liability insurance and property and business interruption insurance.

The Company may become liable for damages arising from unforeseen events which it cannot insure against or chooses to self-insure. Costs incurred to repair such uninsured damage or to pay associated liabilities may have a material effect on the financial condition of the Company.

### ***Legal Contingencies***

The Company has been named in a claim filed in the Commercial Court of Yemen by a Saudi Arabian company. The claimant alleges that, pursuant to an agency agreement entered into in 1996, it is entitled to a percentage of the net profit attributable to the Company. Over the past several years this issue has been before the Commercial Court of Yemen, the Yemeni Court of Appeal and the Supreme Court of Yemen on a number of procedural issues and has now been sent back to the Supreme Court of Yemen for reassessment. Interim judgments have been issued and both parties appealed an initial ruling which limited the plaintiff's entitlement to an interest on the net profit from profit oil production prior to February, 2008. Calvalley has cross-appealed on a number of matters of substance and procedure.

The Company's legal advisors in Sana'a and Calgary are pursuing the appeal jointly. The outcome of the action in the Supreme Court of Yemen is undeterminable at this time and the Company is exploring both judicial, and extra judicial, resolution. No amounts have been accrued in the consolidated financial statements for the periods ended September 30, 2010 as the ultimate resolution is uncertain. The Company will record any amounts due, if any, once the outcome of the contingency is likely and reasonably estimated.

Between 2004 and 2007, the Company billed its Block 9 joint venture partners (JV Partners) for fees in accordance with the terms of the PSA which governs the joint venture operating activities on Block 9. The JV Partners contend that certain of these fees are not billable under the terms of the Joint Operating Agreement (JOA) between the Company and the JV Partners. Pending resolution of this matter, the Company has not charged the JV Partners for the fees in question during 2008 and 2009. The Company and its JV Partners have now agreed to enter into a binding expert determination in London, England to interpret the terms of the JOA and to obtain a ruling on whether the fees in question are billable. While management is not able to determine the likelihood of a positive or negative outcome, the maximum liability to the Company related to fees charged from 2004 to 2007 is \$1.0 million. Conversely, should the fees be deemed billable, the Company would recover fees which have not previously been recorded in the accounts in the amount of \$821,757.

### ***Concentration of Producing Assets***

Substantially all of Calvalley's production is generated from highly productive individual wells in Yemen. The production and sale of crude oil in Yemen involves the use of central production facilities, oil pipelines, and export terminals, either operated by the Company or by third parties. As significant production is generated from each of these assets, any single event causing an interruption to any one of these operations could result in the loss of production and reserves as a result.

### ***Exploration, Development and Production Risks***

Acquiring, developing and exploring for oil and natural gas involves many risks which include but are not limited to encountering unexpected formations or pressures, premature declines of reservoirs, blow-outs, well bore collapse, equipment failures and other accidents, craterings and sour gas releases, uncontrollable flows of oil, natural gas or well fluids, and environmental risks.

In many oil and natural gas producing countries, oil and natural gas properties, together with related production and transportation infrastructure, can be situated in remote areas. In addition to the operational risks described above, oil and natural gas properties in some of these countries may be vulnerable to premeditated acts of violence which have the potential to cause significant damage to oil and natural gas operations and injury or death to personnel. The Company relies on the Government of Yemen's support in providing appropriate security for crude oil operations in Block 9.

Calvalley may not be fully insured against all of these risks. Losses resulting from the occurrence of these risks could have a material impact on the Company's financial results.

### ***Reserve Additions***

Calvalley's future crude oil reserves and production, and therefore its operating cash flows and results of operations, are highly dependent upon the Company's success in exploiting its current reserve base and acquiring or discovering additional reserves. Without reserve additions through exploration, development or acquisitions, the Company's reserves and production will decline over time as reserves are produced. The business of exploring for, developing or acquiring reserves is capital-intensive. To the extent cash flows from operations are insufficient and external sources of capital become limited or unavailable, Calvalley's ability to make the necessary capital investments to maintain and expand its oil production and reserves will be impaired.

### ***Environment, Health, Safety and Regulatory Approvals***

Environmental, health and safety laws and regulations are continually evolving. Compliance with such laws and regulations can require significant expenditures which may materially affect the Company's financial condition or results of operations.

Expansion of existing operations and the development of new operating sites generally require approval of regulatory authorities. If such approvals are delayed or not achieved, the Company's ability to meet project schedule or cost objectives or to operate at expanded or existing levels could be materially impacted.

Workplace health and safety risks for workers arise from the inherent nature of the Company's operations and the jurisdictions within which it operates.

### ***Competition***

There is strong competition relating to all aspects of the oil and natural gas industry. Calvalley actively competes for skilled industry personnel who are in high demand, particularly at its Canadian headquarters, with a substantial number of other oil and natural gas companies, many of which have significantly greater financial and other resources.

### ***Changes in Legislation***

There can be no assurance that laws and regulations relating to the oil and natural gas industry will not be changed in a manner which would adversely affect the operations of the Company. Under the PSA, the Company is not obligated to comply with regulatory changes that are inconsistent with the provisions of the PSA. Further, the PSA stipulates that the interests, rights and obligations of the Government of Yemen and the Company shall be solely governed by the provisions of the PSA unless altered or amended by mutual agreement. In particular, the PSA requires that the Government of Yemen pay profit taxes on the Company's behalf, out of the Government of Yemen's share of profit oil.

## **MEASUREMENT UNCERTAINTY**

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The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and revenue and expenses during the

reporting period. Actual results, including petroleum and natural gas sales, royalties and operating expenses, can differ from these estimates.

In particular, amounts recorded for depreciation and depletion and amounts used for ceiling test calculations are based on estimates of petroleum and natural gas reserves and future costs required to develop those reserves. The Company's reserve estimates are evaluated annually by an independent engineering firm. By their nature, these estimates of reserves and the related future cash flows are subject to measurement uncertainty and the impact on the consolidated financial statements of future periods could be material.

Computations of provisions and estimates for income taxes involve management making judgments with respect to interpretation of tax regulations and related legislation which is continually changing. In addition, there are tax matters that have not yet been confirmed by taxation authorities. While management believes the provision for income taxes is adequate, these amounts are subject to measurement uncertainty. Adjustments required, if any, to these provisions will be reflected in the period when it is determined that adjustments are warranted.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which were fully tradable with no vesting restrictions. This option valuation model requires the input of highly subjective assumptions including the expected stock price volatility. Because the Company's stock options and warrants have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the calculated fair value, such value is subject to measurement uncertainty.

Amounts recorded as due from joint venture partners are based on the Company's interpretation of underlying agreements and may be subject to joint approval. The Company has recorded balances due based on costs incurred and its interpretation of allowable expenditures. Any adjustments required as a result of joint venture audits are recorded in the period of settlement with joint venture partners.

## **ADDITIONAL INFORMATION**

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As at September 30, 2010, the Company had 97,826,556 common shares outstanding. Additionally, there were 4,920,200 options outstanding which were issued pursuant to the Company's stock option plan.

## **DISCLOSURE CONTROLS AND PROCEDURES**

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Disclosure Controls and Procedures ("DC&P") are designed to provide reasonable assurance that information required to be disclosed is recorded, processed, summarized and reported within the time periods specified in applicable securities legislation, and include controls and procedures designed to ensure that information required to be disclosed is accumulated and communicated to management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

As at September 30, 2010, an evaluation of the design of the Company's DC&P was carried out under the supervision of, and with the participation of management including its certifying officers. Based on that evaluation, the Company's certifying officers concluded that the design of the Company's DC&P was effective as at September 30, 2010 and would provide reasonable assurance that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities during the period in which the interim filings were prepared, and that information required to be disclosed by the Company would be recorded, processed, summarized and reported within the time periods specified under applicable securities legislation.

## **INTERNAL CONTROLS OVER FINANCIAL REPORTING**

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Internal Controls over Financial Reporting ("ICFR") are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian GAAP. ICFR can only provide reasonable assurance and may not prevent or detect misstatements. Projections of an evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate due to changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate. As at September 30, 2010, an evaluation of the design of the Company's ICFR was carried out under the supervision of, and with the participation of management including its certifying officers. Based on that evaluation, the Company's certifying officers concluded that the design of the Company's ICFR was effective as at September 30, 2010 and would provide reasonable

assurance that material weaknesses in ICFR would be made known to them, and reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

## **EFFECT OF FUTURE CHANGES IN ACCOUNTING POLICIES**

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### ***International Financial Reporting Standards (IFRS)***

In February 2008, the CICA's Accounting Standards Board confirmed that all Canadian publicly accountable enterprises will be required to adopt IFRS for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011. Calvalley is continually assessing the impact of the convergence of Canadian GAAP with IFRS on the Company's results of operations, financial position and disclosures. Under the direction and oversight of the Board of Directors and Audit Committee, the Company has assembled a project team to manage the transition and to ensure successful implementation within the required timeframe.

The Company recognizes that the changeover to IFRS has complex implications on a combination of accounting, financial reporting, and information technology and business systems. Consequently, senior management has engaged external consultants to conduct a business impact study, to assist in the development a project plan, and to provide assistance in considering various accounting policy decisions which will be required throughout the transition period. Company personnel involved with the transition project have also received appropriate training and education.

The overall IFRS transition project consists of five phases: (i) Scope; (ii) Plan; (iii) Design and Build; (iv) Implement; (v) Review.

The Scope phase, which consisted of identifying the significant differences between Canadian GAAP and IFRS, has been completed. The Company concluded that the following key issues will have the most significant impact on Calvalley's results of operations, financial position and disclosures:

- IFRS 1 – First-time adoption of International Financial Reporting Standards;
- IFRS 6 – Exploration and Evaluation of Mineral Resources;
- International Accounting Standard (IAS) 16 – Property, Plant and Equipment; and
- IAS 36 – Impairment of Assets.

The Company has also completed the Plan phase. During this phase, the Company gathered information and financial data to assess the potential impacts of the differences identified during the Scope phase. Management established the resources that will be required to complete the transition to IFRS, assembled an IFRS transition project team, and established internal milestones and timelines. The Company is currently adhering to the timelines established in its transition project plan.

The Company continues to progress through the Design and Build phase of the transition project. The IFRS project team's development of recommendations for IFRS policy decisions is ongoing, based on appropriately documented consideration of the following factors:

- Impact on financial and key performance indicators;
- Impact on information technology and systems;
- Impact on the internal control and disclosure control frameworks;
- Transition and maintenance costs;
- Impact on communications with key stakeholders; and
- Other general business impacts.

### Accounting policies

The IFRS project team conducted a preliminary detailed analysis of all IFRSs identified during the Scope phase and has identified the impact of the available policy alternatives to the Company's financial reports. A draft IFRS transition date consolidated balance sheet has been reviewed and approved by management and by the Audit Committee. Management is currently reviewing the available policy alternatives and will present recommendations to the Audit Committee during the fourth quarter of 2010.

IFRS 1 provides the framework for the first-time adoption of IFRS and specifies that, in general, an entity shall apply the principles under IFRS retrospectively. Adjustments that arise on retrospective conversion to IFRS from other GAAP are recognized directly in retained earnings. However, certain optional exemptions and mandatory exceptions to retrospective application are provided for under IFRS 1.

Anticipated impacts to the Company of applying certain IFRS 1 exemptions and other relevant accounting differences between Canadian GAAP and IFRS on the consolidated financial statements of the Company are as follows:

<b>Financial statement item</b>	<b>Implications of IFRS</b>	<b>Expected impact on Calvalley</b>
Property, plant and equipment (PP&E)	The existing Canadian GAAP oil and gas full cost pool must be segregated into exploration and evaluation (E&E) assets and development and producing (D&P) PP&E. Per IFRS 6, assets are to be reclassified from E&E assets to D&P PP&E once technical feasibility and commercial viability have been achieved. Using the IFRS 1 deemed cost exemption the carrying value of the assets in the full cost pool under Canadian GAAP is deemed to be the opening carrying value under IFRS, subject to an impairment test.	The Company plans to use the IFRS 1 deemed cost exemption for the opening IFRS carrying value of oil and gas assets, and management has assessed that all oil and gas assets in Yemen and Canada are technically feasible and commercially viable as at January 1, 2010. As a result, exploration costs incurred in Ethiopia will be reclassified from PP&E to intangible E&E assets, and Yemen PP&E costs will be classified as D&P PP&E in the opening IFRS balance sheet.
	Canadian GAAP requires a two-step approach to impairment testing. Asset carrying values are first compared to undiscounted cash flows to determine whether impairment exists. If an impairment is indicated, the magnitude of the impairment is measured by comparing the carrying value to the fair value of discounted cash flows. IAS 36 uses a one-step approach for testing and measuring impairment. Asset carrying values are compared to the higher of fair value less costs to sell and value in use (which uses discounted future cash flows). IFRS also requires reversal of impairment losses when circumstances for previous impairment have changed, however Canadian GAAP prohibits reversal.	The Company conducted IAS 36 impairment tests on its PP&E as at January 1, 2010. None of the Company's assets were found to be impaired at the date of transition. Going forward under IFRS, the one-step impairment test approach could trigger more frequent impairment losses, and the reversal of impairments could result in greater volatility in net income and carrying values of assets.
Contributed surplus – stock-based compensation	Where the Company recorded stock-based compensation expense on a straight-line basis and forfeitures as they occurred under Canadian GAAP, IFRS 2 <i>Share-based Payment</i> requires expense recognition over the individual vesting periods of graded vesting awards and an estimation of forfeiture rates. Using the IFRS 1 share-based payment transactions exemption, IFRS 2 is retrospectively applied only to stock options issued after November 7, 2002, that had not vested as at January 1, 2010.	The Company plans to apply the IFRS 1 share-based payment transactions exemption. The opening IFRS balance sheet will reflect an increase to contributed surplus and a corresponding decrease to retained earnings for additional stock-based compensation expense. Going forward under IFRS, stock-based compensation expense will be concentrated in the earlier years of an issue of graded vesting options.

<i>Financial statement item</i>	<i>Implications of IFRS</i>	<i>Expected impact on Calvalley</i>
Accumulated other comprehensive income – cumulative translation differences	Applying the IFRS 1 cumulative translation differences exemption resets previously recognized translation differences relating to investments in foreign operations to zero.	The Company plans to elect the IFRS 1 cumulative translation differences exemption. Accumulated other comprehensive income as at January 1, 2010 will consequently be decreased with a corresponding increase to retained earnings.
	IAS 21 <i>The Effects of Changes in Foreign Exchange Rates</i> requires the Company to formally assess the functional currency of each entity in the consolidated group. Some variances in functional currency criteria exist between IFRS and Canadian GAAP.	Consistent with its assessment under Canadian GAAP, the Company determined that the US dollar is the functional currency of each entity within the consolidated group. Accounting for the Company's foreign currency transactions and balances under IFRS will remain consistent with Canadian GAAP.

While management and the Audit Committee have made preliminary decisions and approvals regarding some of the Company's IFRS accounting policies, the areas impacted by IFRS discussed above should not be regarded as a comprehensive list of changes that will result from the transition to IFRS. The Company's selected IFRS policies have not been finalized and remain subject to review by the Company's external auditors. As the Company proceeds with the Implementation and Review stages, management may find it necessary to refine its policy choices in order to accommodate developments to industry best practices and to provide more useful information in the financial statements. Further, the International Accounting Standards Board has ongoing projects that could affect IFRS prior to conversion in 2011 as well as the Company's financial statements in future years.

#### DC&P and ICFR

Implementation of the necessary changes to entity level, information technology, financial reporting, disclosure, and business process controls will be executed as policy choices are finalized. Where significant changes are identified, these changes will be mapped and tested to ensure that no material deficiencies exist as a result of the Company's conversion to IFRS.

#### Business activities

In conjunction with policy development, the Company continues to assess whether the transition to IFRS will have an impact on business activities. Management does not anticipate that IFRS will significantly affect the Company's contractual agreements, as the Company has no debt covenants, and the Yemen PSA and Ethiopian PSC stipulate particular accounting and reporting requirements. Management has not identified any instances where IFRS would have major implications on existing contractual arrangements or on other business activities.

#### Information technology and data systems

In respect of information technology systems implications, management has communicated with software suppliers to confirm that systems in place are sufficient to enable the IFRS transition. Management is in the process of developing a strategy for implementing IFRS-compliant financial reporting processes during 2010 using the existing accounting software suite and financial reporting infrastructure. Plans are also under development in preparation for go-live in early 2011 to IFRS, which will require the loading of IFRS financial information into the current accounting and reporting systems.

## **NORMAL COURSE ISSUER BIDS**

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On April 21, 2009, the Company made the necessary filings, and received the necessary approvals, to make a normal course issuer bid through the facilities of the Toronto Stock Exchange (TSX) commencing April 23, 2009 and ending April 22, 2010. A copy of the notice filed with the Toronto Stock Exchange can be obtained by any shareholder of the Company, without charge, by contacting the Company.

A total of 4,948,029 Class A Common Shares (the "Common Shares") were authorized to be acquired under the bid, representing 5% of the 98,960,580 Common Shares outstanding as of April 15, 2009. Calvalley was to acquire Common Shares under the bid at the market price at the time of purchase, and all Common Shares acquired were to be cancelled. Unless Calvalley utilized a Block Purchase Exemption as permitted by the TSX, purchases were subject to a daily purchase restriction equal to 25% of the average daily trading volume of the Common Shares over the preceding six calendar months, or a maximum of 28,824 Common Shares per trading day.

In the opinion of Calvalley's Board of Directors, Calvalley's Common Shares were, from time to time, undervalued by the market, and the cost of acquiring the shares is an expense prudently incurred by Calvalley to increase shareholder value.

A total of 1,657,688 shares were acquired under the bid at an average cost of C\$1.93/share.

On September 14, 2010, the Company made the necessary filings, and received the necessary approvals, to make a normal course issuer bid through the facilities of the Toronto Stock Exchange (TSX) commencing September 16, 2010 and ending September 15, 2011. A copy of the notice filed with the Toronto Stock Exchange can be obtained by any shareholder of the Company, without charge, by contacting the Company.

A total of 7,841,792 Class A Common Shares (the "Common Shares") were authorized to be acquired under the bid, representing 10% of the public float of Common Shares of the Company. Calvalley may acquire Common Shares under the bid at the market price at the time of purchase, and all Common Shares acquired are to be cancelled. Unless Calvalley utilized a Block Purchase Exemption as permitted by the TSX, purchases are subject to a daily purchase restriction equal to 25% of the average daily trading volume of the Common Shares over the preceding six calendar months, or a maximum of 32,134 Common Shares per trading day.

In the opinion of Calvalley's Board of Directors, Calvalley's Common Shares are, from time to time, undervalued by the market, and the cost of acquiring the shares is an expense prudently incurred by Calvalley to increase shareholder value.

As of November 3, 2010, a total of 289,936 shares have been acquired under the bid at an average cost of C\$3.61/share.

## **COMPARABILITY WITH PRIOR PERIODS**

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Revenue may fluctuate from period to period due to the timing of shipments of oil from the Ras Isa Oil Terminal. Revenue is recognized only when oil is loaded onto a tanker. Oil in storage at period-end is recorded as inventory at the average cost of production and depletion and in situations where the take-or-pay provisions of the crude marketing agreement take effect, any receivable related to those provisions is recorded in the accounts as deferred revenue. At September 30, 2010, the Company had no take-or-pay revenue and oil inventory was \$1.8 million.

In April 2009, the Government of Yemen charged Calvalley \$1.1 million for facilities usage. All producers of crude oil in Yemen are subject to the Facility Usage Fee (FUF). The charge was applied retroactively from the commencement of production at Block 9 and was accrued in the first quarter 2009 financial statements. The portion of the charge related to deliveries that occurred prior to January 1, 2009 amounted to \$1.0 million. The balance of the charge in the amount of \$81,000 (\$0.40/bbl) related to oil that was delivered to the government facility during Q1 2009. The Company will continue to incur the \$0.40/bbl FUF in future periods. The FUF is recoverable from the Company's share of cost oil in accordance with the terms of the Production Sharing Agreement.

## **FORWARD-LOOKING STATEMENTS**

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This MD&A contains certain forward-looking statements. Some of the statements contained herein including, without limitation, financial and business prospects and financial outlooks of the Company may be forward-looking statements which reflect management's expectations regarding future plans and intentions, growth, results of operations, performance and business prospects and opportunities. Words such as "may", "will", "should", "could", "anticipate", "believe", "expect", "intend", "plan", "potential", "continue", and similar expressions have been used to identify these forward-looking statements. These statements reflect management's current beliefs and are based on information currently available to management. Forward-looking statements involve significant risk and uncertainties. A number of factors could cause actual results to differ materially from the results discussed in the forward-looking statements including, but not limited to, changes in general economic, political and market conditions and other risk factors. Although the forward-looking statements contained herein are based upon what management believes to be reasonable assumptions, management cannot assure that actual results will be consistent with these forward-looking statements. Investors should not place undue reliance on forward-looking statements. These forward-looking statements are made as of the date hereof.

Forward-looking statements and other information contained herein concerning the oil and natural gas industry and Calvalley's general expectations concerning this industry are based on estimates prepared by management using data from publicly available industry sources as well as from reserve reports, market research and industry analysis and on assumptions based on data and knowledge of this industry which Calvalley believes to be reasonable. However, this data is inherently imprecise, although generally indicative of relative market positions, market shares and performance characteristics. While Calvalley is not aware of any misstatements regarding any industry data presented herein, the industry involves risks and uncertainties and is subject to change based on various factors. See "Risk Factors."

Calvalley does not undertake any obligation to update publicly or revise any forward-looking statements contained in this or in any other document filed with Canadian securities regulatory authorities, whether as a result of new information, future events or otherwise, except as required by applicable securities laws.

# Calvalley Petroleum Inc.

Unaudited Consolidated Financial Statements

For the three and nine months ended

September 30, 2010 and 2009

(Expressed in Thousands of United States Dollars)

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Calvalley Petroleum Inc.  
**CONSOLIDATED BALANCE SHEETS**  
(Unaudited - Expressed in Thousands of United States Dollars)

	September 30, 2010 \$	December 31, 2009 \$
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents (note 2)	11,937	20,043
Guaranteed investment certificates (note 3)	53,279	50,383
Accounts receivable	3,910	2,821
Oil inventory (note 4)	1,804	225
Due from joint venture partners (note 5)	12,052	9,112
Prepaid expenses	608	341
	<b>83,590</b>	<b>82,925</b>
<b>Property, plant and equipment (note 6)</b>	<b>93,380</b>	<b>90,066</b>
	<b>176,970</b>	<b>172,991</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	10,297	12,220
	<b>10,297</b>	<b>12,220</b>
<b>Commitments (note 14)</b>		
<b>Contingencies (note 15)</b>		
<b>Shareholders' equity</b>		
Share capital (note 7)	116,079	116,387
Contributed surplus (note 8)	8,242	7,146
Accumulated other comprehensive income	3,963	3,963
Retained earnings	38,389	33,275
	<b>166,673</b>	<b>160,771</b>
	<b>176,970</b>	<b>172,991</b>

*See accompanying notes*

On behalf of the Board:

*"Edmund Shimoon"*

Edmund Shimoon

*"Gary Robertson"*

Gary Robertson

Calvalley Petroleum Inc.

**CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS**  
(Unaudited - Expressed in Thousands of United States Dollars)

	Three months ended		Nine months	
	September 30		ended September 30	
	2010	2009	2010	2009
	\$	\$	\$	\$
<b>REVENUE</b>				
Oil sales	19,877	12,591	41,825	36,703
Royalties	(7,549)	(4,825)	(16,012)	(14,091)
	<b>12,328</b>	7,766	<b>25,813</b>	22,612
Management fees	125	87	320	282
Interest and other	94	188	282	663
	<b>12,547</b>	8,041	<b>26,415</b>	23,557
<b>EXPENSES</b>				
Operating	3,487	2,141	6,569	9,017
General and administrative, net of recoveries	1,090	657	3,322	3,318
Stock-based compensation	750	331	1,207	710
Depletion, depreciation and amortization	3,235	2,023	6,747	7,417
	<b>8,562</b>	5,152	<b>17,845</b>	20,462
Income before other items	3,985	2,889	8,570	3,095
Foreign exchange gain (loss)	(12)	12	(38)	10
<b>Income before income tax</b>	<b>3,973</b>	2,901	<b>8,532</b>	3,105
Income tax	1,229	779	2,578	2,263
<b>Net income and comprehensive income</b>	<b>2,744</b>	2,122	<b>5,954</b>	842
Retained earnings, beginning of period	36,060	29,200	33,275	30,480
Common share repurchases	(415)	-	(840)	-
<b>Retained earnings, end of period</b>	<b>38,389</b>	31,322	<b>38,389</b>	31,322
<b>Earnings per share (note 12)</b>				
<b>Basic</b>	<b>0.03</b>	0.02	<b>0.06</b>	0.01
<b>Diluted</b>	<b>0.03</b>	0.02	<b>0.06</b>	0.01

*See accompanying notes*

**Calvalley Petroleum Inc.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited - Expressed in thousands of United States Dollars)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2010	2009	2010	2009
	\$	\$	\$	\$
<b>OPERATING ACTIVITIES</b>				
Net income for the period	2,744	2,122	5,954	842
Add (deduct) items not affecting cash:				
Stock-based compensation	750	331	1,207	710
Depletion, depreciation and amortization	3,235	2,023	6,747	7,417
Unrealized foreign exchange gain (loss)	15	(23)	31	(21)
	<b>6,744</b>	4,453	<b>13,939</b>	8,948
Change in non-cash working capital (note 10)	<b>(5,594)</b>	(866)	<b>(4,210)</b>	(2,997)
	<b>1,150</b>	3,587	<b>9,729</b>	5,951
<b>INVESTING ACTIVITIES</b>				
Additions to property, plant and equipment	<b>(4,734)</b>	(1,781)	<b>(10,775)</b>	(6,991)
Investment in guaranteed investment certificates	<b>(33,231)</b>	(38,279)	<b>(144,912)</b>	(101,083)
Redemption of guaranteed investment certificates	<b>37,558</b>	38,128	<b>142,016</b>	99,805
Change in non-cash working capital (note 10)	<b>(2,538)</b>	4,080	<b>(2,888)</b>	1,351
	<b>(2,945)</b>	2,148	<b>(16,559)</b>	(6,918)
<b>FINANCING ACTIVITIES</b>				
Issuance of common shares (note 7)	41	65	210	757
Common share repurchases (note 7)	<b>(626)</b>	(265)	<b>(1,469)</b>	(2,821)
	<b>(585)</b>	(200)	<b>(1,259)</b>	(2,064)
Foreign exchange gain (loss) on cash and cash equivalents held in foreign currencies	1	41	<b>(17)</b>	39
Increase (decrease) in cash and cash equivalents	<b>(2,379)</b>	5,577	<b>(8,106)</b>	(2,992)
Cash and cash equivalents, beginning of period	<b>14,316</b>	12,420	<b>20,043</b>	20,989
<b>Cash and cash equivalents, end of period</b>	<b>11,937</b>	17,997	<b>11,937</b>	17,997

*See accompanying notes*

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited - Financial Figures Expressed in Thousands of United States Dollars)****September 30, 2010 and 2009****1. BASIS OF PRESENTATION**

The interim consolidated financial statements include the accounts of Calvalley Petroleum Inc. and its subsidiaries ("Calvalley" or the "Company") for the three and nine month periods ended September 30, 2010 and 2009 and are presented in accordance with Canadian generally accepted accounting principles on the same basis as the audited consolidated financial statements as at and for the year ended December 31, 2009. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto in Calvalley's annual report for the year ended December 31, 2009 as the disclosures in these interim financial statements do not conform in all respects to the requirements of generally accepted accounting principles for annual financial statements. In these interim consolidated financial statements, unless otherwise indicated, all dollars are expressed in thousands of United States (US) dollars. All references to US\$ or to \$ are US dollars and references to C\$ are to Canadian dollars.

**2. CASH AND CASH EQUIVALENTS**

Cash and cash equivalents at September 30, 2010 include various short-term deposits of \$9,038 (December 31, 2009 – \$16,664), bearing interest at 0.18% to 0.25% (December 31, 2009 – 0.20% to 0.28%) and maturing from October 6 to December 21, 2010, and \$2,899 (December 31, 2009 – \$3,379) of cash.

**3. GUARANTEED INVESTMENT CERTIFICATES**

Guaranteed investment certificates (GICs) with original maturities in excess of 90 days at September 30, 2010 are as follows:

<u>Maturity</u>	<u>Face Value</u>	<u>Interest Rate</u>
November 6, 2010	\$3,000	0.90%
November 12, 2010	\$2,548	0.90%
December 10, 2010	\$13,980	0.45%
January 11, 2011	\$5,952	0.45%
March 20, 2011	\$27,628	0.70%

The GICs are carried at cost plus interest, which approximates fair value and can be redeemed at any time without penalty.

**4. OIL INVENTORY**

Inventory sold is expensed through production and depletion expenses in the period when it is sold. During the nine months ended September 30, 2010, \$225 (2009 – \$2,995) was expensed with respect to oil which was sold. During the three months ended September 30, 2010, an expense in the amount of \$2,947 (2009 - \$379) was recorded.

**5. DUE FROM JOINT VENTURE PARTNERS**

Amounts due from joint venture partners are comprised primarily of amounts due for operating costs and capital expenditures. The balances are due under normal trade terms.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited - Financial Figures Expressed in Thousands of United States Dollars)

September 30, 2010 and 2009

## 6. PROPERTY, PLANT AND EQUIPMENT

September 30, 2010	Cost	Accumulated Depletion and Depreciation	Net Book Value
	\$	\$	\$
<b>Canada:</b>			
Oil and natural gas properties	129	87	42
Other capital assets	324	180	144
	453	267	186
<b>Yemen:</b>			
Oil and natural gas properties	136,527	44,080	92,447
<b>Ethiopia:</b>			
Oil and natural gas properties	747	-	747
	137,727	44,347	93,380

December 31, 2009	Cost	Accumulated Depletion and Depreciation	Net Book Value
	\$	\$	\$
<b>Canada:</b>			
Oil and natural gas properties	130	80	50
Other capital assets	294	153	141
	424	233	191
<b>Yemen:</b>			
Oil and natural gas properties	125,889	36,653	89,236
<b>Ethiopia:</b>			
Oil and natural gas properties	639	-	639
	126,952	36,886	90,066

**Yemen**

The Company has a 50% working interest in the Malik Block 9 Joint Venture in Yemen. The Company's right to produce crude oil under the Production Sharing Agreement (PSA) continues to 2025, with a provision for a five-year extension. The ownership of all assets, tangible and intangible, remains with the Yemen authority.

During the nine months ended September 30, 2010, the Company capitalized overhead costs relating to oil and natural gas exploration and development activities of \$1,306 (2009 – \$859). During the three months ended September 30, 2010, overhead costs of \$448 (2009 - \$233) were capitalized.

**Ethiopia**

During 2008, the Company signed a Production Sharing Contract (PSC) with the government of the Federal Democratic Republic of Ethiopia on the Metema and Gimbi Blocks covering a total area of 11.5 million acres.

Costs incurred during 2009 and 2010 related to initial exploration efforts. Costs incurred during 2008 were related to the signing of the PSC. Properties in Ethiopia are unproved and the costs incurred of \$747 (December 31, 2009 – \$639) have been excluded from costs subject to depletion and depreciation.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited - Financial Figures Expressed in Thousands of United States Dollars)

September 30, 2010 and 2009

## 7. SHARE CAPITAL

## a. Common shares

## Authorized:

Unlimited number of Class A Common Voting Shares.

## Issued:

Nine month period ended September 30, 2010	Number	Amount (\$)
<b>Class A Common Voting Shares</b>		
Shares outstanding, beginning of period	98,217,984	116,387
Issued on the exercise of options (i)	138,100	210
Contributed surplus reclassified on exercise of options (i)	-	111
Repurchased and cancelled (ii)	(529,528)	(629)
<b>Balance, end of period</b>	<b>97,826,556</b>	<b>116,079</b>

- (i) During the nine months ended September 30, 2010, the Company issued 138,100 Class A shares (2009 – 550,000) upon the exercise of options for proceeds of \$210 (2009 - \$757). An amount of \$110 (2009 – \$439) related to stock-based compensation expensed in prior periods was reclassified from contributed surplus to share capital in connection with options exercised.

During the three months ended September 30, 2010, the Company issued 25,000 Class A shares (2009 – 50,000) upon the exercise of options for proceeds of \$41 (2009 - \$65). An amount of \$21 (2009 – \$34) related to stock-based compensation expensed in prior periods was reclassified from contributed surplus to share capital in connection with options exercised.

- (ii) During the nine months ended September 30, 2010, the Company repurchased 529,528 (2009 – 2,385,194) of its common shares pursuant to its Normal Course Issuer Bid at a cost of \$1,469 (2009 - \$2,821). The cost to repurchase common shares at prices in excess of their average book value has been charged to retained earnings.

During the three months ended September 30, 2010, the Company repurchased 177,736 (2009 – 124,224) of its common shares pursuant to its Normal Course Issuer Bid at a cost of \$626 (2009 - \$265). The cost to repurchase common shares at prices in excess of their average book value has been charged to retained earnings.

Year ended December 31, 2009	Number	Amount (\$)
<b>Class A Common Voting Shares</b>		
Shares outstanding, beginning of year	100,265,602	118,243
Issued on the exercise of options (i)	563,300	776
Contributed surplus reclassified on exercise of options (i)	-	452
Repurchased and cancelled (ii)	(2,610,918)	(3,084)
<b>Balance, end of year</b>	<b>98,217,984</b>	<b>116,387</b>

- (i) The Company issued 563,300 Class A Common Voting Shares upon the exercise of options for proceeds of \$776. An amount of \$452 related to stock-based compensation expensed in prior years was reclassified from contributed surplus to share capital in connection with options exercised in 2009.

- (ii) The Company repurchased 2,610,918 of its common shares pursuant to its Normal Course Issuer Bid at a cost of \$3,342. The cost to repurchase common shares at prices in excess of their average book value has been charged to retained earnings and contributed surplus. The cost to repurchase shares at prices below their average book value has been credited to contributed surplus.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited - Financial Figures Expressed in Thousands of United States Dollars)

September 30, 2010 and 2009

## 7. SHARE CAPITAL (continued)

## b. Stock options

The Company's restated stock option plan, as approved effective May 11, 2010, provides for the issue of stock options to directors, officers, employees and consultants. Vesting terms are determined by the Board of Directors as they are granted and currently include periods ranging from immediately to evenly over three or five years. The options' maximum term is five years (10 years for options granted prior to October 1, 2001).

At September 30, 2010 a total of 9,782,656 (December 31, 2009 – 9,821,798) shares were reserved for issue under this plan. Options which are forfeited are available for reissue.

The following is a continuity of stock options outstanding:

	Nine months ended September 30, 2010		Year ended December 31, 2009	
	Options (000s)	Weighted Average Exercise Price C\$	Options (000s)	Weighted Average Exercise Price C\$
Opening balance	4,095	3.53	4,358	3.66
Granted	1,310	3.57	945	1.76
Forfeited / Expired	(347)	3.71	(645)	3.52
Exercised	(138)	1.54	(563)	1.58
<b>Ending balance</b>	<b>4,920</b>	<b>3.58</b>	<b>4,095</b>	<b>3.53</b>

Stock options outstanding at September 30, 2010 were as follows:

Number of Options (000s)		Weighted average Exercise price – C\$	Year of expiry
Granted	Exercisable		
680	680	4.13	2010
50	50	0.90	2011
75	75	6.86	2011
160	160	7.61	2012
1,475	1,283	4.29	2013
400	100	1.59	2013
570	290	1.65	2014
200	67	2.22	2014
1,310	300	3.57	2015
<b>4,920</b>	<b>3,005</b>	<b>3.58</b>	

During the nine months ended September 30, 2010, stock-based compensation costs of \$1,207 (2009 – \$710) were expensed and credited to contributed surplus. During the three months ended September 30, 2010, stock-based compensation costs amounted to \$750 (2009 - \$331). The fair value of the options granted during the third quarter was C\$2,553 (2009 – C\$910) or C\$2.11 per option (2009 – C\$0.96 per option) using the Black-Scholes option pricing model with the following assumptions:

	2010	2009
Risk-free interest rate	2.29 to 2.59%	1.6 to 2.5%
Expected hold period to exercise	5 years	5 years
Volatility in the price of the Company's shares	66 to 67%	70 - 71%
Dividend yield	Nil	Nil

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited - Financial Figures Expressed in Thousands of United States Dollars)

September 30, 2010 and 2009

## 8. CONTRIBUTED SURPLUS

	Nine months ended September 30, 2010 \$	Year ended December 31, 2009 \$
Opening balance	7,146	6,772
Stock-based compensation	1,207	928
Stock-based compensation associated with exercised options	(111)	(452)
Shares repurchased and cancelled	-	(102)
Closing balance	<b>8,242</b>	7,146

## 9. CAPITAL DISCLOSURE

The Company defines and computes its capital employed as follows:

	September 30, 2010 \$	December 31, 2009 \$
Shareholders' equity	166,673	160,771
Long-term debt	-	-
Cash and cash equivalents	(11,937)	(20,043)
GICs	(53,279)	(50,383)
Total capital	<b>101,457</b>	90,345

The Company's objectives in managing capital are to safeguard the Company's ability to continue as a going concern, so that it can continue to provide returns for shareholders and benefits for other stakeholders. The Company sets the amount of capital in proportion to risk. The Company manages the capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust the capital structure, the Company may adjust the amount of dividends paid to shareholders, return capital to shareholders, issue or repurchase shares, incur debt or sell assets to reduce debt.

The Company currently has no requirement for debt financing and has not required debt financing over the last two completed fiscal years. The objectives and strategy for utilizing capital are monitored to provide the appropriate capital structure for the risk profile of corporate objectives.

The Company has no debt and therefore has no financial covenants.

## 10. SUPPLEMENTAL CASH FLOW INFORMATION

	Three months ended September 30,		Nine months ended September 30,	
	2010 \$	2009 \$	2010 \$	2009 \$
Changes in non-cash working capital:				
Accounts receivable	(3,877)	(137)	(1,089)	586
Due from joint venture partners	(6,227)	4,694	(2,940)	3,055
Oil inventory	376	57	(865)	1,539
Prepaid expenses	(59)	(114)	(267)	(92)
Accounts payable and accrued liabilities	1,655	(1,286)	(1,937)	(3,479)
Deferred revenue	-	-	-	(3,255)
	<b>(8,132)</b>	3,214	<b>(7,098)</b>	(1,646)
Changes in non-cash working capital:				
Operating activities	(5,594)	(866)	(4,210)	(2,997)
Investing activities	(2,538)	4,080	(2,888)	1,351
	<b>(8,132)</b>	3,214	<b>(7,098)</b>	(1,646)

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited - Financial Figures Expressed in Thousands of United States Dollars)

September 30, 2010 and 2009

**10. SUPPLEMENTAL CASH FLOW INFORMATION (continued)**

During the nine and three months ended September 30, 2010, the Company incurred cash outlays of \$Nil for interest (2009 – \$Nil) and \$Nil for taxes (2009 – \$Nil). Yemen income taxes are paid to the government through its allocation of oil under the PSA.

**11. GEOGRAPHICAL INFORMATION**

The Company has defined its continuing operations as oil and natural gas operations. The majority of the Company's oil and natural gas operations are located in Yemen with lesser operations in Ethiopia and Canada.

Segmented information is as follows:

	Three months ended September 30		Nine months ended September 30	
	2010	2009	2010	2009
<b>Revenue</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Yemen	<b>19,948</b>	12,641	<b>42,025</b>	36,876
Ethiopia	-	-	-	-
Canada	<b>148</b>	225	<b>402</b>	772
Total	<b>20,096</b>	12,866	<b>42,427</b>	37,648

**12. PER SHARE AMOUNTS**

In calculating basic and diluted earnings per share, the following weighted average numbers of shares were used:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Weighted average number of shares outstanding	<b>97,985</b>	98,517	<b>98,002</b>	99,093
Dilutive effect of stock options	<b>574</b>	1,127	<b>574</b>	1,127
Weighted average number of diluted shares outstanding	<b>98,559</b>	99,644	<b>98,576</b>	100,220

A total of 3,700,000 (2009 – 2,745,000) options were not in the money and were excluded from the dilutive calculation for the nine and three months ended September 30, 2010.

**13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT****Carrying Values and Estimated Fair Values of Financial Assets and Liabilities**

The Company has classified its cash and cash equivalents and GICs as assets held for trading which are measured at fair value with changes being recognized in net income. Accounts receivable and amounts due from joint venture partners are classified as loans and receivables, which are measured at amortized cost. Accounts payable and accrued liabilities are classified as other financial liabilities and are measured at amortized cost.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited - Financial Figures Expressed in Thousands of United States Dollars)

September 30, 2010 and 2009

**13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (Continued)**

The carrying value and fair value of financial assets and liabilities are summarized as follows:

<u>Classification</u>	<u>Carrying Value (\$)</u>	<u>Fair Value (\$)</u>
Financial assets held for trading	65,216	65,216
Loans and receivables	15,962	15,962
Accounts payable and accrued liabilities	10,297	10,297

**Credit Risk**

The majority of the accounts receivable are in respect of oil and natural gas operations and are due from the Company's joint venture partners or its customer for oil sales. Management believes the risk is mitigated by the size and reputation of the companies to which the Company extends credit. The Company has not experienced any material credit loss in the collection of accounts receivable to date.

The Company is currently under contract to sell its production to one purchaser. The selling price is based on the quoted Dated Brent price on the date of shipment adjusted for the official selling price differential posted by the Government of Yemen. At September 30, 2010, \$3,852 (December 31, 2009 – \$2,771) was receivable under the contract. Payment is secured by a guarantee issued by the purchaser's parent company.

The Company funds capital and operating costs and bills joint venture partners their share of those costs. In the event that a joint venture partner was incapable of fulfilling its obligation to pay its share of the costs, the Company could, under the terms of the joint operating agreement, recover the costs from the joint venture partner's share of proceeds from crude oil sales.

Trade and other receivables from continuing operations are analyzed in the table below. With respect to the trade and other receivables that are neither impaired nor past due, there are no indications as of the reporting date that the debtors will not meet their payment obligations.

Trade and other receivables at September 30, 2010

Neither impaired nor past due	\$13,842
Impaired (net of valuation allowance)	
Not impaired and past due in the following period:	
Within 30 days	2,120
31-60 days	-
61-90 days	-
Over 90 days	-

**Interest rate risk**

The Company has exposure to interest rate risk as it relates to investments in GICs. Interest rate risk relates to the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Company incurs interest rate risk on its cash and cash equivalents, and GICs. All cash balances are current and available immediately. The Company does not hedge its exposure to interest rate risk. A 100-basis-point increase in interest rates during the three and nine months ended September 30, 2010 would have increased net income by approximately \$168 (\$0.00/share) and \$521 (\$0.01/share) respectively.

**Liquidity Risk**

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. Liquidity describes a company's ability to access cash. Companies operating in the upstream oil and natural gas industry require sufficient cash in order to fund capital programs necessary to maintain and increase production and proved reserves, to acquire strategic oil and natural gas assets, and to repay debt. The Company actively monitors its cash requirements to ensure it has sufficient available funds to meet current and foreseeable financial requirements at a reasonable cost. The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. The Company also utilizes authorizations for expenditures to further manage capital expenditures.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited - Financial Figures Expressed in Thousands of United States Dollars)****September 30, 2010 and 2009**

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**13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (Continued)**

The Company's obligations coming due in the next 12 months are accounts payable and accrued liabilities of 10,297. In addition, the Company has commitments under existing agreements as described in note 14. Given the Company's working capital position, management assesses liquidity risk as being low.

In determining the fair value of financial instruments, the Company maximizes the use of observable inputs and minimizes the use of unobservable inputs. Observable inputs reflect market-driven or market-based information obtained from independent sources, while unobservable inputs reflect the Company's estimate about market data. Based on the observability of significant inputs used, the Company classifies its fair value measurements in accordance with a three-level hierarchy. This hierarchy is based on the quality and reliability of the information used to determine fair value, as follows:

- Level 1: Valuations are based on quoted prices in active markets for identical assets or liabilities. Since the valuations are based on quoted prices that are readily available in an active market, they are not subject to significant measurement uncertainty.
- Level 2: Valuations are based on observable inputs other than quoted prices.
- Level 3: Valuations are based on at least one unobservable input that is supported by little or no market activity and is significant to the fair value measurement.

In assigning financial instruments to the appropriate levels, the Company performs detailed analysis. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. The level within which the fair value measurement is categorized is based on the lowest-level input that is significant to the fair value measurement in its entirety.

The Company's fair value measurement of held for trading financial assets was conducted using Level 1 of the hierarchy.

**Commodity Price Risk Management**

While the Company is exposed to business risk associated with fluctuations in the price of crude oil, the Company does not hold financial instruments whose fair values are susceptible to variability resulting from changes in the price of crude oil.

**Foreign Exchange Risk**

The Company holds substantially all of its cash, cash and equivalents and GICs at one financial institution in Canada. The Company invests its cash reserves in GICs issued by an Alberta credit union which deposits are guaranteed by the Province of Alberta. Approximately \$679 of the \$11,937 in cash and cash equivalents is held in Canadian-dollar-denominated accounts. As such, the Company is exposed to foreign currency risk. The impact to net income of a 10% change in the foreign exchange rates between the Canadian and United States dollars at September 30, 2010 would have been approximately \$30 (\$0.00/share).

**14. COMMITMENTS**

There have been no material changes or developments with respect to the Company's commitments as disclosed in the Company's consolidated financial statements for the year ended December 31, 2009.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited - Financial Figures Expressed in Thousands of United States Dollars)****September 30, 2010 and 2009**

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**15. CONTINGENCIES**

The Company has been named in a claim filed in the Commercial Court of Yemen by a Saudi Arabian company. The claimant alleges that, pursuant to an agency agreement entered into in 1996, it is entitled to a percentage of the net profit attributable to the Company. Over the past several years this issue has been before the Commercial Court of Yemen, the Yemeni Court of Appeal and the Supreme Court of Yemen on a number of procedural issues and has now been sent back to the Supreme Court of Yemen for reassessment. Interim judgments have been issued and both parties appealed an initial ruling which limited the plaintiff's entitlement to an interest on the net profit from profit oil production prior to February, 2008. Calvalley has cross-appealed on a number of matters of substance and procedure.

The Company's legal advisors in Sana'a and Calgary are pursuing the appeal jointly. The outcome of the action in the Supreme Court of Yemen is undeterminable at this time and the Company is exploring both judicial, and extra judicial, resolution. No amounts have been accrued in the consolidated financial statements for the periods ended September 30, 2010 as the ultimate resolution is uncertain. The Company will record any amounts due, if any, once the outcome of the contingency is likely and reasonably estimated.

Between 2004 and 2007, the Company billed its Block 9 joint venture partners (JV Partners) for fees in accordance with the terms of the PSA which governs the joint venture operating activities on Block 9. The JV Partners contend that certain of these fees are not billable under the terms of the Joint Operating Agreement (JOA) between the Company and the JV Partners. Pending resolution of this matter, the Company has not charged the JV Partners for the fees in question during 2008 and 2009. The Company and its JV Partners have now agreed to enter into a binding expert determination in London, England to interpret the terms of the JOA and to obtain a ruling on whether the fees in question are billable. While management is not able to determine the likelihood of a positive or negative outcome, the maximum liability to the Company related to fees charged from 2004 to 2007 is \$1,012. Conversely, should the fees be deemed billable, the Company would recover fees which have not previously been recorded in the accounts in the amount of \$822.



## FORWARD LOOKING STATEMENTS

Some of the statements contained herein including, without limitation, financial and business prospects and financial outlooks of the Company may be forward-looking statements which reflect management's expectations regarding future plans and intentions, growth, results of operations, performance and business prospects and opportunities. Words such as "may", "will", "should", "could", "anticipate", "believe", "expect", "intend", "plan", "potential", "continue", and similar expressions have been used to identify these forward-looking statements. These statements reflect management's current beliefs and are based on information currently available to management. Forward-looking statements involve significant risk and uncertainties. A number of factors could cause actual results to differ materially from the results discussed in the forward-looking statements including, but not limited to, changes in general economic, political and market conditions and other risk factors. Although the forward-looking statements contained herein are based upon what management believes to be reasonable assumptions, management cannot assure that actual results will be consistent with these forward-looking statements. Investors should not place undue reliance on forward-looking statements. These forward-looking statements are made as of the date hereof.

Forward-looking statements and other information contained herein concerning the oil and gas industry and Calvalley's general expectations concerning this industry are based on estimates prepared by management using data from publicly available industry sources as well as from reserve reports, market research and industry analysis and on assumptions based on data and knowledge of this industry which Calvalley believes to be reasonable. However, this data is inherently imprecise, although generally indicative of relative market positions, market shares and performance characteristics. While Calvalley is not aware of any misstatements regarding any industry data presented herein, the industry involves risks and uncertainties and is subject to change based on various factors. See "Risk Factors."

Calvalley does not undertake any obligation to update publically or revise any forward-looking statements contained in this or in any other document filed with Canadian securities regulatory authorities, whether as a result of new information, future events or otherwise, except as required by applicable securities laws.



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