PETSEC ENERGY LTD ANNUAL REPORT 2012

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PETSEC ENERGY LTD
ABN 92 000 602 700

The Company is listed on the Australian Stock Exchange (symbol: PSA) and traded over the counter in the USA in the form of ADRs (symbol: PSJEY). Its corporate office is in Sydney, Australia, and its USA operations offices are in Houston, Texas and Lafayette, Louisiana.

ANNUAL GENERAL MEETING TO BE HELD AT:

11.00 am (AEST) on Wednesday, 22 May 2013, at the Museum of Sydney, corner of Bridge and Phillip Streets, Sydney

CAPITAL STRUCTURE – AS AT 26 MARCH 2013

AUSTRALIA

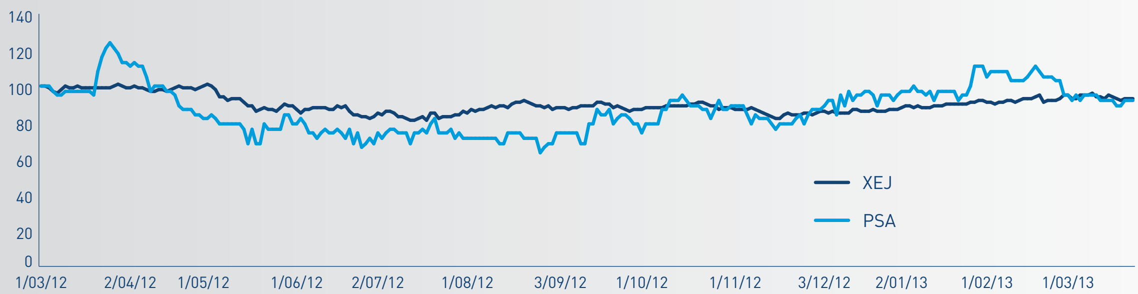
EXCHANGE	ASX
TICKER	PSA
SHARES ON ISSUE	237.7 MILLION
OPTIONS ON ISSUE	1.9 MILLION
SHARE PRICE	0.175
MARKET CAPITALISATION	$41.6 MILLION

USA

EXCHANGE	OTC PINK SHEETS
TICKER	PSJEY

SOURCE: AUSTRALIAN STOCK EXCHANGE (ASX)

PETSEC SHARE PRICE PERFORMANCE VERSUS S&P/ASX200 ENERGY INDEX



YEAR IN BRIEF 2012

FINANCIAL

- Net loss after tax: US$5.9 million.
- Oil and gas sales (net of royalties): US$8.6 million (US$3.50/Mcfe).
- EBITDAX: US$0.5 million (US$0.22/Mcfe).
- Impairment, abandonment, exploration and work-over expense: US$3.2 million.
- Acquisition, development & exploration expenditure: US$14.8 million.
- Cash at 31.12.2012: US$28.4 million.
- Ryder Scott independently estimated proved and probable (2P) oil and gas reserves at 31.12.2012: 11.1 Bcfe, PV10 US$31.8 million.

OPERATIONS

- Production: 2,364 MMcf of gas and 13,423 barrels of oil (equivalent to 2.4 Bcfe) – up 7% on 2011.
- Net daily production rates increased to 11.5 MMcfpd and 90 bopd (equivalent to 12 MMcfepd) by year end, more than double the average rate of 5.7 MMcfepd for the first nine months of the year.
- Marathon gas/condensate field, Louisiana Gulf Coast:
  - Discovered in 2010 with estimated reserves of approximately 150 to 200 Bcfe gross. Second well drilled 2011.
  - A third well was spud in March 2012 and brought into production in August 2012.
  - Marathon #4 well spud in October 2012 and brought into production in early March 2013.
  - New pipeline and production facilities were installed which increased the gross daily production rate from the field to the current 120 MMcf of gas per day and 500 barrels of oil per day from 10 MMcfepd.
  - Further expansion of production facilities for the field is underway and a fifth well is planned for third quarter 2013.
- The Main Pass 270 A-3 well recommenced production in early November 2012, having been shut-in since April 2011, following a major work-over of the well. Production from the well stabilised in excess of 7 MMcfpd and 240 bopd.

SHALE OIL

- In February 2012, the Company agreed to participate in a shale oil project in Alberta, Canada where it can earn a 24.5% working interest in leases covering 17,280 acres (4,234 net acres to Petsec Energy) in the Western Canadian Sedimentary Basin by participating in up to four wells.
- The initial vertical science well was spud in March 2012 and production testing of the well commenced in November 2012 and is ongoing.
- The Company entered into a further agreement in September 2012 to increase the size of the shale oil project area from 17,280 acres to 26,080 lease acres (6,434 net acres to Petsec Energy).
- A horizontal well was spud in November 2012 and drilled to a total measured depth of 3,754 metres (12,313 feet), including a 1,000 metre (3,280 feet) horizontal section. Multi stage hydraulic fracturing and completion of the well for potential production commenced in March 2013.

CHAIRMAN'S REPORT

In 2011, Petsec Energy announced a new three-year business plan to address declining U.S. natural gas prices and changed operating conditions in the Gulf of Mexico post the Macondo oil spill.

T N FERN
Chairman and Managing Director

Dear Shareholder,

In 2011, Petsec Energy announced a new three-year business plan to address declining U.S. natural gas prices and changed operating conditions in the Gulf of Mexico post the Macondo oil spill. The plan refocussed the Company's exploration and production business away from its traditional, predominately gas operations in the Gulf of Mexico shelf, (where it had successfully pursued small prospects with a high success rate), to deeper, large potential reserve gas and oil prospects in the Louisiana Gulf Coast region and to oil in the emerging unconventional shale oil plays onshore North America. It was considered that involvement in North American shale oil plays would provide the Company with the highest exposure to potentially large oil reserves for the least risk and capital outlay.

Our conventional exploration has been constrained by the U.S. natural gas price which declined from an average of US$9.16/Mcf in 2008 to a low of US$1.80/Mcf in April of 2012. The four year decline in gas prices appears to have been arrested and since mid 2012 the price has steadily increased to US$4/Mcf, where it appears to be stabilising in a US$3.50-US$4.00/Mcf range.

In response to this strengthening of the gas price the Company concentrated on the development of the Marathon gas/condensate field, the deep, large (150-200 Bcfe) discovery of late 2010. Two development wells were drilled in 2012 and extensive production facilities installed which increased the production rate of the field from 10 MMcfpd to over 120 MMcfpd and 500 bopd in the fourth quarter of 2012. A fifth well is expected to spud in the third quarter 2013 which has the potential to increase field production by an additional 40 MMcfpd. Also in the fourth quarter of 2012 the Main Pass 270 field A-3 well, which had been shut-in since April 2011, recommenced production following a major work-over. Production from the well stabilised in excess of the rate of 7 MMcfpd and 240 bopd produced by the well just prior to the shut-in.

The Company ended the year in a strong financial position. At 31 December 2012, the Company had no debt and held US$28.4 million in cash, and net daily production had increased to 11.5 million cubic feet of gas and 90 barrels of oil, (equivalent to 12 MMcfepd) by year end, more than doubling the average daily rate of 5.7 MMcfe achieved in the first nine months of the year. The Marathon #5 well when completed will further increase production. It is hoped that with this well and through production performance that the Company will exceed the independently assessed 2P reserves at year end of 10.5 Bcf and 93.4 Mbbl (equivalent to 11.1 Bcfe) with a NPV10 value of US$31.8 million.

This solid position will be further strengthened in 2013 as we continue to progress the 2011-13 strategy. Production from the existing Gulf of Mexico and Louisiana Gulf Coast leases is expected to be well in excess of the January 2013 production guidance of 2.9 Bcfe in the 2013 financial year, some 20% higher than 2012 production.

If gas prices stabilise around current levels of US$4.00/Mcf. I am optimistic that we can begin to test the Company's large, deep gas/oil prospect portfolio with a grossed of mapped potential 400-750 Bcfe, starting in 2014.

While our progress in U.S. shale oil plays has been slower than I would have wished, I still think that successful unconventional shale oil projects in North America will provide the Company with substantial oil reserves growth and through that, a substantial increase in shareholder value.

We have established strategic alliances with experienced shale players, and undertaken extensive studies of a number of prospective shale basins. Through these studies we have identified areas where we wish to acquire leases.

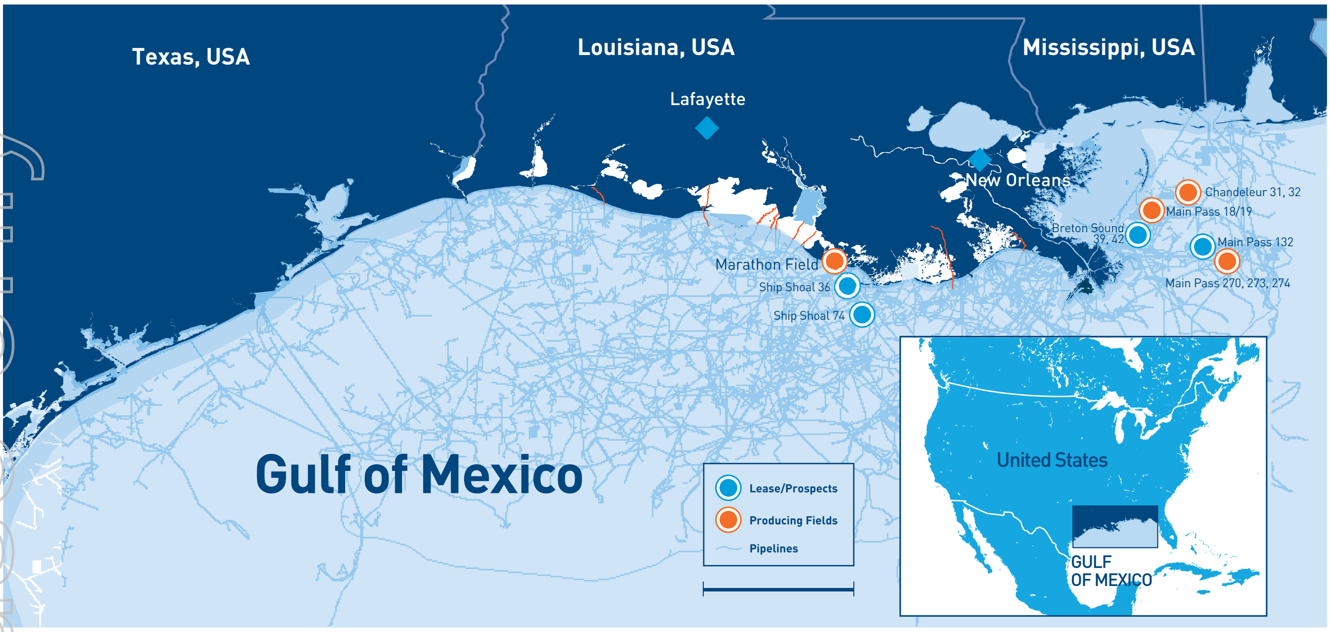
To date we have announced participation in a 26,080 acre shale oil joint venture in Alberta, Canada, with experienced shale oil partners. Our 25% share is 6,434 acres which hold potential of the order of 10-15 million barrels of recoverable oil. To date we have drilled two wells; one vertical science well and one horizontal well which has been hydraulically fractured and is in the early stage of production testing.

The Board and I would like to thank you, our shareholders, for your ongoing support and we look forward to providing further details of the Company's progress and expected success throughout the coming year.

TN Fern
Chairman and Managing Director

I still think that successful unconventional shale oil projects in North America will provide the Company with substantial reserves growth

Petsec Energy achieved net production of 2,364 million cubic feet (MMcf) of gas and 13,423 barrels of oil in 2012.



Petsec Energy Gulf of Mexico and Louisiana Gulf Coast Exploration and Production Leases

PRODUCTION

Petsec Energy achieved net production of 2,364 million cubic feet (MMcf) of gas and 13,423 barrels of oil in 2012 from the Company's four producing areas in the Gulf of Mexico and Louisiana Gulf Coast – Marathon (Atchafalaya Bay), Main Pass Block 270, Main Pass Blocks 18/19 and Chandeleur Blocks 31/32.

EXPLORATION AND DEVELOPMENT

Conventional

As U.S. natural gas prices began to rise from a 10 year low of US$1.80/Mcf in April of 2012, to its level of US$4/Mcf at the end of the first quarter 2013, the Company concentrated on the development of its existing reserves in the Marathon gas/condensate field and the Main Pass 270 gas/oil field, in order to increase production.

Production was increased from an average of 5.7 MMcfepd in the first 9 months of the 2012 year to the rate of 12 MMcfepd by year end 2012.

The Marathon gas/condensate field, located in the shallow waters of Atchafalaya Bay, Louisiana Gulf Coast, USA, was discovered in late 2010. This 150-200 Bcfe field is productive at geologic depths of 18,000 to 19,000 feet. A development well was drilled in 2011 and brought into production in November 2011. In 2012, a further two development wells were drilled and expanded production facilities, including pipelines, were completed in the second half of 2012 allowing production to increase from approximately 10-20 MMcfpd to the rate of 120 MMcfpd of gas and 500 barrels of oil per day from the four producing wells. Additional production facilities are being built which will accommodate the expected additional 40 MMcfpd of production from the fifth well which is scheduled to be spud in the third quarter of 2013 and brought into production late 2013.

The Main Pass 270 A-3 well, which had ceased producing in April 2011, was worked-over in the third quarter of 2012 and successfully recompleted for production in November. Production from the well was restored to its pre shut-in rate of in excess of 7 MMcfpd gas and 240 bopd. The well is located in 225 feet of water. A failure in the downhole production equipment had allowed sand to fill the well bore and shut-in the well's production. Operations to remove the sand, replace the damaged equipment and recommence production, involved extensive subsurface work at a measured depth of approximately 11,600 feet (3,535 metres) which required the use of a large jack-up rig.

OPERATIONS REPORT

With gas prices appearing to be stabilising in the range of US$3.50-$4/Mcf, the Company is reappraising its' portfolio of large, deep gas/oil prospects on the Gulf of Mexico shelf with a view to commence testing certain of these prospects in 2014.

The Company holds a portfolio of ten prospects, each ranging in size between 20 and 200 Bcfe, with a total gross mapped potential of 400 to 750 Bcfe.

Unconventional

Petsec Energy embarked upon its onshore shale oil strategy during 2011, to acquire a sizeable leasehold in new and emerging shale. Strategic alliances were established with experienced shale players, and detailed studies of a number of prospective shale plays were undertaken, which resulted in areas of interest where "sweetspot" areas were defined.

In Alberta, Canada the Company participated in a joint venture ("JV") in February 2012, where it could earn a 24.5% working interest in leases covering 17,280 acres by participating in up to four wells.

The initial vertical science well was drilled in March/April 2012 and the results were sufficiently encouraging for the Company to elect to participate in production testing of the well, and in acquiring additional leases, and drilling a horizontal well in a second area as discussed below. Production testing of the vertical well commenced in November 2012 and is ongoing.

Additional leases covering 8,800 acres were acquired by the JV in September 2012 in which the Company could earn 2,200 net lease acres by participating in the drilling and completion of one horizontal well to test for oil productivity in the target shale oil reservoir. The well was spud in November 2012 and in early January 2013 reached its total measured depth of 3,754 metres, which included a 1,000 metre horizontal section.

Multi stage hydraulic fracturing and completion of the well for potential production commenced in March 2013. Testing will continue through the second quarter of 2013.

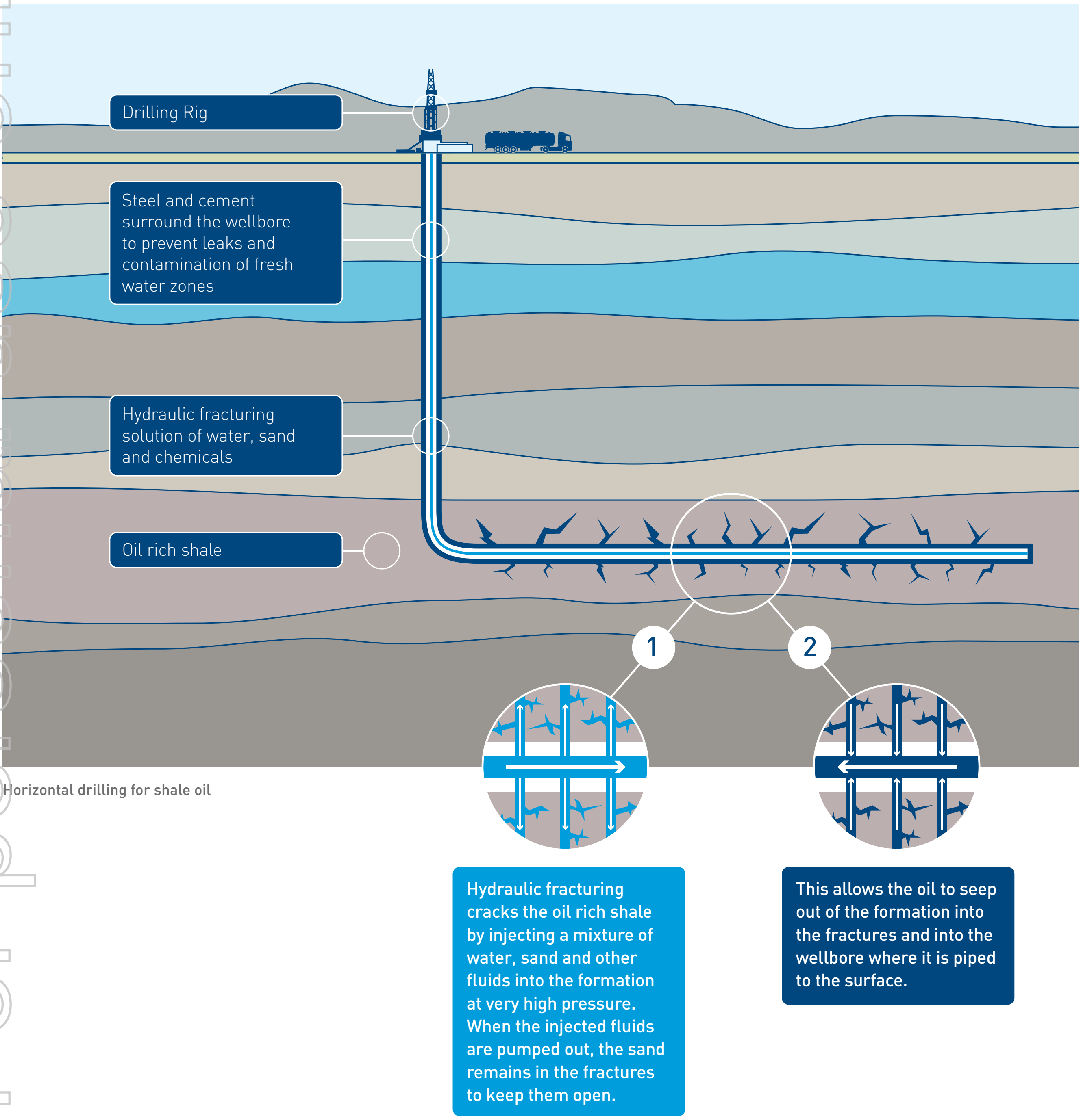
The JV now holds interests in over 26,000 acres of which Petsec Energy holds a net 6,434 acres which in turn holds the potential for 15-20 million barrels of recoverable oil. Success in the testing of the vertical and horizontal wells is expected to lead to an expansion in the lease area held by the Company.

Petsec holds a net 6,434 acres which holds the potential for 15-20 MMbbl of recoverable oil

Horizontal drilling for shale oil, Canada

HYDRAULIC FRACTURING OF HORIZONTAL WELLS

Hydraulic fracturing uses water and sand under high pressure to fracture the tight shale rock and the sand keeps the fractures open, creating artificial permeability – the pathways for the oil to flow into the well.



Horizontal drilling for shale oil

BUSINESS PLAN UPDATE

Oil rig and beam pump

PROGRESS OF THE 2011-13 BUSINESS PLAN

In 2011, Petsec Energy announced to shareholders a three year plan in response to an increasingly difficult operating environment in the Gulf of Mexico following the Macondo oil spill and the loss of economic viability of the Company's traditional 5-20 Bcfe gas prospects due to the decline of the U.S. natural gas price in 2009 to below US$4/Mcf, from an average of US$9.16 in 2008 and an average of approximately US$7.20/Mcf over the period from 2003-2008.

The 2011-13 business plan proposed to:

- Focus on North America.
- Redirect exploration away from the Gulf of Mexico, USA, to the Gulf Coast and onshore North America.
- Focus on oil rather than gas.
- Redirect exploration from small (5-20 Bcfe), high success rate (> 80%), gas prospects to large (50-200 Bcfe), deep geologic section (15,000 to 20,000 feet), gas/oil prospects.
- Pursue unconventional shale oil with large potential resources.

TARGETS: Shale Oil – Establish an oil resource of the order of 100 million barrels and a 2P reserve of 35 million barrels of oil.

TARGETS: Conventional – Target reserves of 100 Bcfe in deep geologic section.

To accomplish these targets the Company would:

- Eliminate debt.
- Sell non-core assets to fund the 2011-13 business plan.
- Focus on unconventional shale oil in onshore North America and on conventional large, deep geologic section exploration prospects on the Louisiana Gulf Coast of the USA, whilst reducing its operational exposure to the Federal waters of the Gulf of Mexico shelf.

During 2012, the Company focussed its exploration efforts entirely on advancing its unconventional shale oil project areas, having established joint ventures with parties expert in shale oil exploration, conducted detailed analyses in four shale project areas in the U.S. and Canada, acquired leases in two areas and drilled in these two areas.

In the year a vertical science well and a horizontal well, which has been hydraulically fractured and completed for potential production, were drilled in the Company's joint venture areas in Alberta, Canada, where the Company holds a 25% interest in over 26,000 acres in Alberta. Extensive testing of the wells will occur in the second quarter of 2013.

The Company is approaching this new involvement in shale oil with caution, ensuring significant data analysis is completed, taking upwards of nine months for each area, before extensive leasing commences. This inevitably led to a number of areas being rejected. Consequently progress towards the Company's desired goal of securing leases which hold the resource potential of 100 million barrels has been slower than wished.

The table below highlights the Company's progress towards achieving these objectives.

Strategy	2011 Achievements	2012 Achievements	2013 Goals
Corporate			
Eliminate debt and sell non-core assets to fund new plan.	• Eliminated US$29 million debt. • A$38 million raised from disposition of China oil interests.	• 11.1 Bcfe (2P) reserves; PV10 US$31.8 million at 31 Dec 2012. • US$28.4 million cash at 31 Dec 2012. • No debt.	
Conventional: Oil & gas/condensate; high potential prospects			
	Marathon Field		
	• Drilled two successful wells on the large gas/condensate Marathon field.	• Further two development wells drilled on the Marathon field. • Installation of new pipeline and facilities. • Estimated gross reserves of the Marathon field: 150 to 200 Bcfe with upside potential (Petsec share: 8-12 Bcfe).	• Fifth well planned for the Marathon field. • Production from four wells on the field in excess of 120 MMcf of gas per day and 500 barrels of oil per day. • Further expansion of production facilities underway.
	Gulf of Mexico Lease Prospects		
	• 10 mapped prospects with gross potential: 400 to 750 Bcfe (67 to 125 MMboe); (20 to 200 Bcfe each).		
Unconventional: Shale Oil			
Establish a net resource of 100 MMbbl (4P) recoverable; secure farm-out partners for reserves drilling and further lease acquisition; establish net 2P reserves of > 35 MMbbl; monetise.	Alberta, Canada		
		• Established joint venture with experienced shale oil partners. • Confirmation well drilled. • First horizontal well drilled. • Gross lease position of 26,080 acres. • Net lease position of 6,434 acres holds potential for 10 to 15 million barrels of oil recoverable.	• Production testing of confirmation well ongoing. • Completion of horizontal well for production. • Acquire additional lease acreage. • Drill a number of vertical and horizontal wells.
	USA		
	• Established joint ventures with experienced shale oil partners. • Regional area – 4 study areas selected. • Determination of "Sweet Spots" in 2 areas: > 2,000 bbl of oil recoverable per acre. • Lease acquisition and the seeking of farminees initiated.		

2013 EXPLORATION AND DEVELOPMENT PROGRAMME

Petsec Energy's exploration and development programme for 2013 will continue to advance the Company's shale oil objectives in North America, where it is intended to expand the current lease holding of 6,434 acres, and to increase the tempo of horizontal drilling.

The Marathon gas/condensate field will continue to be developed to increase production.

Preparation for drill testing in 2014 of a number of the Company's large, deep gas/oil prospects.

Conventional: Gas/Condensate	Marathon #5 well • Expected to spud third quarter 2013 • Production late 2013 Further expansion of production facilities to accommodate well flows of the order of 40 MMcfe/day per well
Unconventional: Shale Oil	Lease acquisition: 2-3 areas Drilling: Vertical/horizontal wells

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DIRECTORS' REPORT AND FINANCIAL REPORTS

DIRECTORS' REPORT

FOR THE YEAR ENDED 31 DECEMBER 2012

The directors present their report together with the Financial Report of Petsec Energy Ltd ("the consolidated entity"), being Petsec Energy Ltd (the Company) and its subsidiaries, for the financial year ended 31 December 2012 and the independent auditor's report thereon.

1. DIRECTORS

The names and particulars of the qualifications and experience of each director during or since the end of the financial year are:

Terrence N Fern

Chairman and Chief Executive Officer

Mr Fern has been a director since 1987 and has over 35 years of extensive international experience in petroleum and minerals exploration, development and financing. He holds a Bachelor of Science degree from the University of Sydney and has followed careers in both exploration geophysics and natural resource investment. Mr Fern was formerly a director of TSX and ASX listed company Oceana Gold Corporation from 2006 until June 2011.

David A Mortimer AO

Non-executive Director
Chairman of the Audit Committee and the Nomination and Remuneration Committee

Mr Mortimer was appointed to the Board in 1985 and has over 40 years of corporate finance experience. He was a senior executive of TNT Limited Group from 1973, serving as Finance Director and then as Chief Executive Officer until his resignation in October 1997. He is presently Chairman of Crescent Capital Partners Limited, Buildcorp Advisory Board, Defence Industry Innovation Board and University of Sydney Senate Investment and Commercialisation Committee. He is a Director of Opera Australia, Clayton Utz Foundation, the Grant Samuel Advisory Board and is on the CEDA's Board of Governors.

Mr Mortimer holds a Bachelor of Economics degree (First Class Honours) from the University of Sydney and is a Fellow of the University of Sydney Senate and the Australian Institute of Company Directors. Mr Mortimer's other roles include Governor of the Australia Israel Chamber of Commerce, and President of the Sydney University Football Club.

Mr Mortimer was formerly a non-executive director and more recently Chairman of ASX listed company Leighton Holdings Limited from 1997 until August 2011 and Chairman of Australia Post from 2006 to 2012.

Michael L Harvey

Non-executive Director
Member of the Audit Committee and the Nomination and Remuneration Committee

Mr Harvey was appointed to the Board in 2008 and is a third generation Texan oil man who brings a wealth of experience of establishment and successful growth of exploration and production (E&P) companies in South-East Asia and the Gulf of Mexico, USA. After receiving his degree from Texas A&M University in 1970, Mr Harvey served as an officer in the US Army in Vietnam.

Subsequently, he began his career in the oil industry with Shell Oil Company in their Corporate Planning and Economics department. Since 1987 to date, he has founded and been the CEO of four private US E&P companies operating in the Gulf of Mexico and the Gulf Coast of the USA. Between 1987 and 1998 he established, grew and sold Gulfstar Petroleum Corporation and Gulfstar Energy Inc. In 2000 he founded Gryphon Exploration Inc., which was acquired by Woodside Petroleum Ltd for US$285 million in 2005. In 2007 he founded Stonegate Production Company, where he is Chairman and CEO. Stonegate was an early entrant to the Eagle Ford shale oil play in Texas and is now in joint venture with Chesapeake and China National Offshore Oil Corporation. Mr Harvey was formerly a non-executive director of the listed Norwegian company Scorpion Offshore from 2006 until its sale in May 2010.

2. EXECUTIVE OFFICERS

Ross A Keogh

President of Petsec Energy Inc. ("PEI") and Group Chief Financial Officer

Mr Keogh joined the Company in 1989 and has over 30 years experience in the oil and gas industry. Between 1979 and 1989, Mr Keogh worked in the financial accounting and budgeting divisions of Total Oil Company and as Joint Venture Administrator for Bridge Oil Limited in Australia. Mr Keogh holds a Bachelor of Economics degree, with a major in Accounting, from Macquarie University in Sydney. Mr Keogh was appointed Chief Financial Officer in November 1998 until April 2002, and appointed President of PEI in April 2002. Mr Keogh took on the extended role of Group Chief Financial Officer in February 2012, in addition to his current role of President of PEI.

Ron Krenzke

Executive Vice President of Exploration of PEI

Mr. Krenzke joined the Company in November 2009 as the Executive Vice President of Exploration of Petsec Energy Inc. Mr. Krenzke has 39 years of experience in the oil and gas exploration and production industry. His career includes experience in many phases of management of oil and gas exploration and production operations. During his early career Mr. Krenzke worked in a variety of technical and management positions at major and large independent oil and gas companies including: Mobil Oil, Texas Eastern, Monsanto Oil and Amerada Hess. Since 1990 Mr. Krenzke has founded and co-founded three private E&P companies operating in the Gulf Coast region of the USA. Mr. Krenzke founded INEXS and South Coast Exploration in 1990, both of which were sold in 1997 to Xplor Energy. In 2000, he co-founded Gryphon Exploration Company, which was ultimately sold in to Woodside Petroleum in 2005 for US$285 million. From 2006 through 2009, Mr. Krenzke worked with small cap private companies primarily as a business and technical consultant. Mr. Krenzke holds a Bachelor of Science degree in Geophysics from Texas A&M University.

Patrick Webb

Vice President – Business Development and Land (PEI)

Mr. Webb joined the Company in February 2012 as Vice President Business Development and Land of Petsec Energy Inc. Mr. Webb has over 35 years of experience in the oil and gas exploration and production industry. His career includes experience in operations, business development, acquisitions and divestments, joint ventures, and other commercial transactions. In his career Mr. Webb worked for mid cap and large independent oil companies and large and small private oil companies, including Forest Oil, EOG Resources, Square Mile Energy, Saxet Petroleum, Enervest and Mariner Energy, which was acquired by Apache Corp. Mr. Webb has a Bachelor of Business Administration Degree from the University of Texas at Austin and a Masters of Business Administration – Finance from Texas A & M University in College Station, Texas.

Paul Gahdmar

Company Secretary and Group Financial Controller

Mr Gahdmar joined the Company in 1999 as the Financial Accountant of the Petsec Energy Ltd group and has since held a number of management positions within the Company. Mr Gahdmar was appointed as the Company Secretary of Petsec Energy Ltd in 2008 and has 20 years experience in corporate accounting and finance in listed companies within the resources industry. Mr Gahdmar holds a Master of Business and Technology degree from The University of New South Wales and a Diploma in Investor Relations from the Australasian Investor Relations Association. Mr Gahdmar is a Fellow of the Institute of Public Accountants and a Member of the Australian Institute of Company Directors.

DIRECTORS' REPORT *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

3. DIRECTORS' MEETINGS

The Board has a formally constituted Audit Committee and a Nomination and Remuneration Committee, of which Mr Mortimer and Mr Harvey (non-executive directors) are members. Mr Mortimer chairs both committees.

The number of directors' meetings (including meetings of committees of directors) and number of meetings attended by each of the directors of the Company during the financial year are:

	Regular Board Meetings	Additional Board Meetings	Audit Committee Meetings	Nomination & Remuneration Committee Meetings
Total number held during the year	9	–	4	3
T N Fern	9	–	4*	3*
D A Mortimer	8	–	4	3
M L Harvey	8	–	3	3

* Mr Fern attended as an invitee.

4. REMUNERATION REPORT

The Remuneration Report is set out on pages 18 to 25 and forms part of the Directors' Report for the financial year ended 31 December 2012.

5. PRINCIPAL ACTIVITIES

The principal activities of the consolidated entity during the course of the financial year were oil and gas exploration and production in the shallow waters of the Gulf of Mexico and state waters of the Louisiana Gulf Coast region of the USA, and exploration activities in shale oil projects in Canada and the USA.

There were no other significant changes in the nature of the activities of the consolidated entity during the year.

6. FINANCIAL REVIEW

Highlights

Petsec Energy generated net revenues (after royalties) from its U.S. Gulf of Mexico and onshore Louisiana operations of US$8.6 million for the twelve months to 31 December 2012, from production of 2,445 million cubic feet of gas equivalent ("MMcfe") at an average sales price of US$3.50/Mcfe. While production in 2012 was 7% higher than the prior year, net revenues in 2012 were 34% lower than the net revenues (after royalties and realised hedge gains) in 2011 of US$13.0 million (2011: Production of 2,277 MMcfe; and average gas equivalent sales price of US$5.69/Mcfe) due to the lower sales price received for the current period, reflecting the decline in U.S. natural gas prices.

Production volumes for the current period were 7% higher than the previous year due to increased production rates in the second half of 2012 from the Marathon field, following the completion of the third development well and new pipeline and production facilities; and the recommencement of production from the Main Pass 270 A-3 well in November 2012 following a successful recompletion (see section 7: *Operations Review* of this Directors Report for further details).

Net revenues in the previous corresponding period benefited significantly from higher natural gas spot prices, which averaged approximately US$4.99/Mcf for the prior period, and hedging of approximately 36% of the Company's natural gas production at an average gas collar price of approximately US$6.00/Mcf.

Lease operating expense of US$3.6 million (2011: US$4.7 million) and geological, geophysical and administrative expense of US$6.0 million (US$6.7 million) were both lower than in the previous corresponding, reflecting the reduction in the consolidated entity's U.S. Gulf of Mexico operations.

Earnings before interest, income tax, DD&A and exploration expense ("EBITDAX") of US$0.5 million for the twelve months to 31 December 2012 (2011: US$1.6 million) reflected the lower realised sales prices and net revenues for the period.

The EBITDAX (cash operating) margin for the current year was US$0.22/Mcfe (2011: US$0.72/Mcfe), representing a 5% (2011: 13%) gross operating margin.

6. FINANCIAL REVIEW *continued*

Highlights *continued*

Depreciation, depletion and amortisation ("DD&A") expense for the twelve months to 31 December 2012 decreased to US$3.9 million (US$5.2 million) largely due to the effect of the reduced carrying values of certain U.S. oil and gas properties following the recognition of impairment provisions in 2011.

The consolidated entity periodically reviews the carrying values (i.e. book values) of its oil and gas properties in accordance with accounting standards and the consolidated entity's accounting policy. Under the review, the carrying values of its properties are compared to the estimated future cash flow to be generated from the expected production from each of these properties. An impairment expense, if any, will be recognised if the carrying value of any of the properties is greater than the estimated future discounted cash flow. Impairment expense recognised in prior periods may be reversed where the carrying value of any of the properties is less than the estimated future discounted cash flow, to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation if no impairment had been previously recognised.

For the current period, the consolidated entity reversed US$4.2 million of impairment provisions previously recognised against the Main Pass 270 gas/condensate field. The reversal follows the success of the A-3 work-over which reinstituted production in the well, coupled with an increase in reserves reflecting production performance in the other wells. This reversal was partially offset by net impairments of US$2.8 million due to a reduction in the estimate of future recoverable reserves together with lower operating margins in the Main Pass 18/19 field. The net impairment and abandonment expense for the period is a reversal of US$1,349,000.

The consolidated entity also expensed the entire US$3,142,000 cost of the Main Pass 270 A-3 well work-over notwithstanding the work-over was a success and the well is producing at levels above that when the well was shut-in in April 2011. The rationale for this treatment is that the work-over is considered a repair to an existing completion and its charge to profit/(loss) is consistent with the requirements of the accounting standards and prior treatment of similar expenditure by the consolidated entity.

The consolidated entity incurred a net loss after tax for the year ended 31 December 2012 of US$5.9 million (2011: Profit of US$14.0 million) after the recognition of the abovementioned impairment and work-over expenditures. The previous corresponding period profit had benefited from the recognition of one-off accounting gains totalling US$41.2 million, relating to the discharge of debt and the disposal of the consolidated entity's China joint venture interests to cover potential plug and abandonment liabilities of the consolidated entity's operations in the Gulf of Mexico.

Financial position

At 31 December 2012, the consolidated entity had no debt and held cash deposits of US$28.4 million including US$5.4 million of cash deposits held in an escrow account (2011: US$41.6 million including US$6.6 million of cash deposits held in escrow) to fully secure operator bonds that are on issue to the Bureau of Ocean Energy Management ("BOEM").

7. OPERATIONS REVIEW

Petsec Energy Ltd is an independent oil and gas exploration and production company listed on the Australian Stock Exchange (ASX Ticker: PSA) with operations in the shallow waters of the Gulf of Mexico and state waters of the Louisiana Gulf Coast region of the United States of America ("USA"), and exploration activities in shale oil projects onshore Canada and the USA.

Production

The consolidated entity produced 2,364 million cubic feet of gas and 13,423 barrels of oil (the equivalent of 2,445 MMcfe) for the twelve months ended 31 December 2012 from its producing fields in the Gulf of Mexico shelf and the Louisiana Gulf Coast – Marathon (Atchafalaya Bay), Main Pass Block 270, Main Pass Blocks 18/19, and Chandeleur Blocks 31/32.

The net daily production rate from these fields averaged approximately 5.7 MMcf of gas and 30 barrels of oil over the first nine months of the year before increasing in the final quarter of the year to over 10 MMcf of gas and 90 barrels oil. The Marathon and Main Pass 270 fields contributed mostly to this increase, following the expansion of pipeline and production facilities servicing the three producing wells in the Marathon field and the completion of work-over operations to recommence production from the Main Pass 270 A-3 well, which had been shut-in since April 2011 due to sanding up of the well bore.

DIRECTORS' REPORT *cont.*

7. OPERATIONS REVIEW *continued*

Production *continued*

In May 2012, the Marathon field joint venture partners installed a new pipeline to an offset operator in order to alleviate the production constraints that restricted the gross daily production rate from the field to approximately 10 MMcfe per day. Following the installation of the pipeline and facilities, the combined gross production rates from the three existing wells in the field increased to in excess of 100 MMcf of gas per day and 300 barrels of oil per day. A fourth well drilled in late 2012 is expected to further increase production in 2013.

The work-over operations on the Main Pass 270 A-3 well, located in 225 feet of water, commenced 11 September 2012 and were completed on 3 November 2012. The operations involved extensive subsurface work at measured depths of approximately 11,600 feet (3,535 metres) and required the use of a large jack-up rig. The well is producing at a gross rate of approximately 8.0 MMcf of gas per day and 250 barrels of oil per day, which is slightly higher than the rates at which it was producing prior to going offline in April 2011.

Exploration/Development

During the year, Petsec Energy participated in the drilling of four wells – two further development wells on the large conventional Marathon gas/condensate field that was discovered in October 2010; and two unconventional shale oil wells in Alberta, Canada (see below for further details on these activities).

Conventional

The Marathon gas/condensate field is a significant discovery, with estimated reserves of approximately 150 to 200 Bcfe gross. The consolidated entity holds an 8% net working interest in the field (5.84% net revenue interest) and despite the small interest, the field will be a significant contributor to the reserves, production, revenues and cash flows of the consolidated entity.

Four wells have been drilled on the Marathon field to-date with the initial discovery being made in 2010. The initial well was brought into production in late 2010 and a second follow-up well was drilled on the field in 2011. A further two wells have since been drilled on the field. The third well was spud in March 2012 and brought into production in late August 2012 and the fourth well, spud on 22 October 2012, and should be in production in late February/early March 2013.

Unconventional – Canada

In February 2012, Petsec Energy entered into a shale oil joint venture in the Western Canadian Sedimentary Basin of Alberta, Canada. The Company can earn a 24.5% working interest in leases covering 17,280 acres (4,234 lease acres, net to Petsec Energy) by participating in and paying 35% of the cost of up to four horizontal wells at an estimated cost of US$5.5 million to the Company.

The initial vertical science commitment well was drilled in March 2012 and production testing of the vertical well commenced in November 2012 and is ongoing.

The Company entered into a further agreement in September 2012 to increase the size of the shale oil project area in the Western Canadian Sedimentary Basin from 17,280 acres to 26,080 lease acres. As a result of this agreement, Petsec Energy's potential net leasehold interest increased from 4,234 lease acres to 6,434 lease acres.

Petsec Energy will earn its additional 2,200 net lease acres by participating in the drilling and completion of one horizontal well to test for oil productivity in the shale oil reservoir. This well was spud on 18 November 2012 and drilled to a total measured depth of 3,754 metres (12,313 feet), which included a 1,000 metre (3,280 feet) horizontal section. The well has been temporarily suspended for future completion. Logging and core data acquired during the drilling phase is being analysed prior to fraccing, testing and completing the well for production. The well is expected to be completed for production in March 2013. The estimated cost to the Company of increasing its lease acres and of participating in the horizontal well is expected to be in the range of $4.0 – $5.0 million.

Based on the pre-drill information available, the Company's 6,434 lease acres hold the potential for a net recoverable oil resource in the order of 10 to 15 million barrels of oil.

Unconventional – U.S.A.

Technical initiatives in the Company's U.S. shale oil project areas are ongoing. For competitive reasons, the location of the projects and leasing activities remain confidential.

7. OPERATIONS REVIEW *continued*

Oil and gas reserves – USA

Independently estimated proved and probable (2P) oil and gas reserves at 31 December 2012 were 11.1 Bcfe, after net downward revisions of 1.9 Bcfe, and production of 2.4 Bcfe for the twelve months to 31 December 2012. Upward revisions were mainly at Main Pass 270 and downward revisions were at Main Pass 18/19.

The net present value at an annual discount rate of 10% (NPV10) of these 2P reserves were independently assessed to be US$31.8 million as at 31 December 2012 using the prevailing gas and oil forward strip prices on that day as shown below:

	Henry Hub Gas (US$/MMBtu)	WTI Oil (US$/Bbl)
2013	$3.55	$93.00
2014	$4.00	$92.00
2015	$4.25	$90.00
2016	$4.40	$88.00
2017 and thereafter	$4.60	$87.00

The table below provides a summary of the independently assessed reserve estimates and movements.

	Independent Assessment[1]		
Gas Equivalent (Bcfe*)	Proved Reserves	Probable Reserves	Proved and Probable Reserves
USA Reserves			
Reserves at 31 December 2011	11.1	4.3	**15.4**
Net additions/(revisions)[2]	0.8	(2.7)	**(1.9)**
Production	(2.4)	–	**(2.4)**
USA Reserves at 31 December 2012	**9.5**	**1.6**	**11.1**

* Billion cubic feet of gas equivalent using ratio of six thousand cubic feet of natural gas to one barrel of oil.

1. The independent reserve assessments at 31 December 2011 and 2012 were estimated by petroleum engineers Ryder Scott Company.
2. Net additions/(revisions) comprise reserves added, reclassified, and reduced during the period.

Competent Person Statement

The USA reserve estimates in this report are based on information provided by independent petroleum engineers – Ryder Scott Company. In accordance with ASX Listing Rules, this information has been reviewed and authorised by Competent Person Mr Ron Krenzke, Executive Vice President Exploration, a full time employee of Petsec Energy. Mr Krenzke has at least five years' relevant experience within the sector and consents to the disclosure of this information in the form and context in which it appears.

8. OBJECTIVES, STRATEGY AND FUTURE PERFORMANCE

It is the consolidated entity's objective to increase shareholder value through successful oil and gas exploration, development, and production, and through acquisitions. The consolidated entity intends to produce its current reserves, continue oil and gas exploration and development drilling activities in the Louisiana Gulf Coast region, and advance its shale oil projects in North America.

9. DIVIDENDS

Directors do not recommend the payment of a dividend for the financial year ended 31 December 2012. No dividends were paid during the financial year.

10. SIGNIFICANT CHANGES IN STATE OF AFFAIRS

There were no significant changes to the state of affairs of Petsec Energy during the financial year, other than those detailed in the "Financial review" and "Operations review" sections of this report.

11. ENVIRONMENTAL REGULATION

The consolidated entity's oil and gas exploration and production activities are subject to significant environmental regulation under U.S. Federal and State legislation.

The consolidated entity is committed to achieving a high standard of environmental performance and compliance with all lease conditions. Directors are not aware of any breach of environmental compliance requirements relating to the consolidated entity's activities during the year.

12. LIKELY DEVELOPMENTS

Petsec Energy's primary focus in 2013 will be to produce its current reserves, continue oil and gas exploration and development drilling activities in the Louisiana Gulf Coast region and to advance its shale oil projects in North America, particularly while U.S. natural gas prices remain low.

13. DIRECTORS' INTERESTS

The relevant interest of each director in the shares or options over such instruments issued by the Company, as notified by the directors to the Australian Securities Exchange in accordance with S205G (1) of the *Corporations Act 2001*, at the date of this report is as follows:

Director	Ordinary Shares	Options over Ordinary Shares
T N Fern	30,826,876	Nil
D A Mortimer	9,326,550	Nil
M L Harvey	Nil	Nil

14. SHARE OPTIONS

Options granted to directors and officers of the Company

During or since the end of the financial year, grants of 1,000,000 options were made to directors or key management personnel of the Company as part of their remuneration.

As at 31 December 2012, there were 2,007,500 options over ordinary shares in Petsec Energy Ltd on issue, all of which are employee options exercisable at prices ranging from A$0.20 to A$1.19 per share expiring at various dates between 12 February 2013 and 31 January 2017 with exercise dependent on completion of vesting period and satisfaction of share price hurdles ranging from A$0.30 to A$2.63 being achieved on the Australian Securities Exchange. During the year, 1,330,000 options were granted, 2,688,500 options were forfeited and no options were exercised.

Subsequent to 31 December 2012 through the date of this report, no employee options have been exercised.

14. SHARE OPTIONS *continued*

Unissued shares under option

At the date of this report, unissued ordinary shares of the Company under option are:

Expiry date	Exercise price	Number of shares
12 February 2013	A$1.19	75,000
31 December 2013	A$0.20	237,500
31 December 2014	A$0.23	365,000
31 January 2017	A$0.20	1,000,000
1 January 2016	A$0.20	330,000
		2,007,500

Shares issued on exercise of options

During the financial year, there were no ordinary shares issued by the Company as result of the exercise of options.

15. INDEMNIFICATION AND INSURANCE OF OFFICERS

During the year ended 31 December 2012, the Company maintained policies of insurance in respect of directors and officers liability. The policies insure persons who are directors or officers of the Company and its controlled entities against certain costs and expenses which may be incurred by them in defending proceedings and against other liabilities which may arise from their positions. The insured directors and officers are the directors, executive officers and secretaries of the Company and the directors, executive officers and secretaries of controlled entities.

The insurance contracts prohibit the disclosure of particulars of the premiums and the nature of the liabilities insured.

The Company has entered into Deeds of Indemnity and Access with directors on the terms approved by shareholders. The agreements stipulate that the Company will meet the full amount of any liabilities to another person that might arise from their position (except where the liability arises out of conduct involving a lack of good faith).

The Company has made during or since the end of the financial year no payments in relation to indemnification. The Company provides the normal indemnities to directors and officers in relation to the work carried out on behalf of or at the request of the Company.

16. NON-AUDIT SERVICES

During the year KPMG, the Company's auditor, has performed certain other services in addition to their statutory duties.

The Board has considered the non-audit services provided during the year by the auditor and in accordance with advice provided by resolution of the audit committee, is satisfied that the provision of those non-audit services during the year by the auditor is compatible with, and did not compromise, the auditor independence requirements of the *Corporations Act 2001* for the following reasons:

- All non-audit services were subject to the corporate governance procedures adopted by the Company and have been reviewed by the audit committee to ensure they do not impact the integrity and objectivity of the auditor; and
- The non-audit services provided do not undermine the general principles relating to auditor independence as set out in APES 110 *Code of Ethics for Professional Accountants*, as they did not involve reviewing or auditing the auditor's own work, acting in a management or decision-making capacity for the Company, acting as an advocate for the Company or jointly sharing risks and rewards.

Details of the amounts paid to the auditor of the Company, KPMG, and its related practices for audit and non-audit services provided during the year are set out in Note 10 of the accompanying Financial Statements.

17. LEAD AUDITOR'S INDEPENDENCE DECLARATION

The Lead Auditor's Independence Declaration is set out on page 26 and forms part of the Directors' Report for the financial year ended 31 December 2012.

18. ROUNDING OFF

The Company is of a kind referred to in ASIC Class Order 98/100 dated 10 July 1998 and in accordance with that Class Order, amounts in the Financial Report and Directors' Report have been rounded off to the nearest one thousand dollars, unless otherwise stated.

19. EVENTS SUBSEQUENT TO BALANCE DATE

Other than any matter disclosed, there has not arisen in the interval between the end of the financial year and the date of this report any item, transaction or event of a material and unusual nature likely, in the opinion of the directors of the Company, to affect significantly the operations of the consolidated entity, the results of those operations, or the state of affairs of the consolidated entity, in future years.

This report is made with a resolution of the directors:

T N Fern
Director

Sydney, 26 February 2013

20. REMUNERATION REPORT – AUDITED

20.1 Introduction

This Remuneration Report forms part of the Directors' Report. It outlines the overall remuneration strategy, framework and practices adopted by the Company and the consolidated entity ("Petsec Energy Group") for the year ended 31 December 2012 and has been prepared in accordance with Section 300A of the *Corporations Act 2001* and its regulations.

In accordance with the *Corporations Act 2001*, remuneration details are disclosed for the Petsec Energy Group's Key Management Personnel.

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Petsec Energy Group. Key management personnel comprise the directors of the Company and senior executives of the Petsec Energy Group, whose names appear in the tables in section 20.5 of this report.

20.2 Executive summary

The Board's remuneration policy is to provide fair and market competitive levels of remuneration for all employees, including directors and key management personnel in order for the Company and the Petsec Energy Group to benefit by attracting and retaining a high quality team.

The Company has a Nomination and Remuneration Committee to assist the Board in the implementation and administration of the remuneration policy – refer to *section 20.3*, below.

Key developments during the year in the implementation and administration of the remuneration policy included:

20.2.1 The appointment of Mr. Patrick Webb to the role of Vice President Land and Business Development in early February 2012. Mr. Webb had been consulting to the Company since June 2011. Mr. Webb previously worked for a number of large companies, including Forest Oil, EOG Resources and Enervest.

20.2.2 The awarding of discretionary bonuses to key management personnel in part as recognition of their personal efforts, and in part to encourage exemplary performance.

20. REMUNERATION REPORT – AUDITED *continued*

20.3 Nomination and Remuneration Committee

The Nomination and Remuneration Committee oversees the appointment and induction process for directors and committee members, and the selection, appointment and succession planning process of the Company's Chief Executive Officer. The Committee makes recommendations to the Board on the appropriate skill mix, personal qualities, expertise and diversity of each position. When a vacancy exists or there is a need for particular skills, the Committee in consultation with the Board determines the selection criteria based on the skills deemed necessary.

The Committee reviews and makes recommendations to the Board on compensation packages and policies applicable to the executive officers and directors of the Petsec Energy Group. It is also responsible for oversight of diversity, employee share and option schemes, incentive performance packages, superannuation entitlements, retirement and termination entitlements, fringe benefits policies, deeds of access and indemnity, and professional indemnity and liability insurance policies.

Executive compensation and other terms of employment are reviewed annually by the Nomination and Remuneration Committee having regard to performance against goals set at the start of the year, relevant corporate information and where appropriate independent expert advice.

The Nomination and Remuneration Committee comprised the following members during the year:

- D A Mortimer (Chairman) – Independent Non-Executive Director
- M L Harvey – Independent Non-Executive Director

The Board policy is that the Nomination and Remuneration Committee will comprise a majority of non-executive directors and a non-executive chairman.

The Nomination and Remuneration Committee meets at least twice a year and as required. The Committee met three times during the year and the Committee members' attendance record is disclosed in the table of directors' meetings.

The Nomination and Remuneration Committee's Charter is available on the Company's website www.petsec.com.au

20.4 Principles of compensation

Compensation levels for key management personnel are competitively set to attract and retain appropriately qualified and experienced directors and senior executives. The Nomination and Remuneration Committee obtains peer comparisons and/or independent advice on the appropriateness of compensation packages of the Petsec Energy Group, given trends in comparative companies both locally and internationally and the objectives of the Company's compensation strategy.

The compensation structures explained below are designed to attract suitably qualified candidates, reward the achievement of the Company's objectives, and achieve the broader outcome of creation of value for shareholders.

The compensation structures take into account:

- the capability and experience of the key management personnel; and
- the ability of key management personnel to control the relevant performance of their segment of operation.

Compensation packages include a mix of fixed compensation and performance-based incentives, including equity-based incentives as set out below.

In addition to their salaries, the Petsec Energy Group also provides non-cash benefits to its key management personnel as set out below, and contributes to several post-employment defined contribution superannuation plans in Australia and also matches contributions made by U.S.-based key management personnel to a voluntary savings plan under Section 401(k) of the U.S. tax code.

Fixed compensation

Fixed compensation consists of base compensation (which is calculated on a total cost basis and includes any FBT charges related to employee benefits), as well as employer contributions to superannuation funds in Australia and employer matching contributions to voluntary savings plans under Section 401(k) of the U.S. tax code. Non-cash benefits comprise employer payments towards U.S. health, dental and vision plans, as well as life and salary continuance insurance benefits.

The Nomination and Remuneration Committee reviews compensation levels and other terms of employment annually through a process that considers individual, segment and overall performance of the Company against goals set at the start of the year. In addition, where necessary, external consultants provide analysis and advice to ensure the directors' and senior executives' compensation is competitive in the market place.

20. REMUNERATION REPORT – AUDITED *continued*

20.4 Principles of compensation *continued*

Performance-linked compensation

Performance-linked compensation includes both short-term and long-term incentives and is designed to reward key management personnel for meeting or exceeding the Company's financial objectives and agreed individual objectives. The short-term incentive (STI) is an "at risk" bonus provided in the form of cash, while the long-term incentive (LTI) is provided as either shares or options over ordinary shares of the Company under the rules of the Employee Share and Option Plans approved by shareholders at the Annual General Meeting held on 21 May 2010 (see note 19(b) to financial statements). The maximum number of securities in aggregate that may be issued under the Employee Share and Option Plans is 15,033,435.

Short-term incentive

Short-term incentives are provided to employees through bonuses and the Company's Nomination and Remuneration Committee has the right to grant discretionary bonuses. Factors considered by the Committee when granting discretionary bonuses include personal performance, the achievement of strategic objectives, and the retention and motivation of employees.

During the year, the Company awarded discretionary bonuses to certain key management personnel in part as recognition of their personal efforts, and in part to encourage exemplary performance.

Long-term incentive

Eligible employees are also provided with long-term incentives through participation in the Company's Employee Share and Option Plans, subject to the approval of the Committee. Employees are typically offered options on an annual basis with the exercise price of the shares or options based on the weighted average market price of the Company's ordinary shares for the five trading days preceding the date of issue, subject to a minimum exercise price of 20 cents.

During the year, the Company issued 2,400,000 shares under its shareholder approved Employee Share Plan ("ESP") to two key management personnel as long term incentive compensation (refer to *note 33 – Relates Parties* of the notes to the consolidated financial statements for further details).

The shares were issued to the Trustee of the ESP on behalf of the key management personnel and under the terms of the ESP at a price of A$0.20 per share, being the minimum issue price under the terms of the ESP. The funds for the shares was provided to the key management personnel by the Company through an interest free limited recourse loan under the terms of the loan scheme under the ESP, which provides that if the borrower defaults on the loan the Company shall accept the shares issued under the ESP in full satisfaction of the loan. The term of the loans is 5 years.

The shares are unrestricted and will vest as follows:

(i) 1,000,000 shares on 1 June 2012

(ii) A further 633,334 on 1 January 2013

(iii) A further 633,333 on 1 January 2014

(iv) A further 133,333 on 1 January 2015

Consequences of performance on shareholder wealth

In considering the Group's performance and benefits for shareholder wealth, the remuneration committee have regard to the following indices in respect of the current financial year and the previous four financial years.

	2012	2011	2010	2009	2008
Profit/(loss) attributable to owners of the company	**($5,858,000)**	$14,034,000	($35,237,000)	($14,899,000)	($44,471,000)
Dividend paid	**–**	–	–	–	–
Change in share price	**$0.06**	($0.04)	($0.065)	$0.045	($1.365)

Profit is considered as one of the financial performance targets in setting the STI. Profit amounts for 2008 to 2012 have been calculated in accordance with Australian Accounting Standards (AASBs).

20. REMUNERATION REPORT – AUDITED *continued*

20.4 Principles of compensation *continued*

Service and employment agreements

Remuneration and other terms of engagement of executive employees are formalised in service agreements that are unlimited in term but capable of termination by varying periods of notice or by payment of an amount in lieu of notice. The service agreements generally outline the components of compensation paid, but do not prescribe how compensation levels are modified from year-to-year. Compensation levels are reviewed each year in light of cost-of-living changes, performance of and changes in the scope of the role performed by the executive and changes required to meet the principles of the compensation policy.

The Managing Director, Mr Fern, is engaged via a company of which Mr Fern is a director. The Company may terminate this agreement without cause by giving not less than twelve months' notice or pay an amount equal to the fees for twelve months in lieu of notice. Mr Fern may terminate the agreement with not less than six months' notice. With cause, Mr Fern may terminate the agreement by giving one month's notice and would be entitled to a payment equal to fees for a twelve-month period.

The President of Petsec Energy Inc., Mr Keogh and Executive Vice President of Exploration of Petsec Energy Inc., Mr Krenzke have employment agreements that are capable of termination without cause by the company by a lump sum payment equal to one times their annual Base Salary. Mr Keogh and/or Mr Krenzke may terminate the agreement without cause by giving the company at least 120 days notice in writing. Mr Keogh and/or Mr Krenzke may terminate their agreement for cause and in this event are entitled to receive a lump sum payment equal to one times their annual base salary at that time.

Other executives have service agreements which are capable of termination by the Company without cause by the payment of between one and three months' notice, or are "at-will" employment contracts entered into in the USA where either party may terminate the employment relationship at any time and for any reason without any further liability, except as required by law.

Non-executive directors

Directors' fees are set having regard to periodic advice from external remuneration consultants, market surveys and the level of fees paid relative to those of other comparable companies. Directors' fees for the 2012 year were unchanged from the 2011 year and comprise base fees, plus statutory superannuation for Australian directors. Directors are also entitled to reasonable travel, accommodation and other expenses incurred in attending meetings or while engaged on Company business.

Non-executive directors do not receive performance-related compensation. Directors' fees cover all main Board activities and membership of committees and are subject to the aggregate limit of A$300,000 approved by shareholders at the 1996 Annual General Meeting.

Non-executive directors appointed prior to 2003 are entitled to receive a retirement benefit equivalent to the remuneration received in the three years prior to retirement. Incoming non-executive directors are not entitled to retirement benefits.

DIRECTORS' REPORT *cont.*

20. REMUNERATION REPORT – AUDITED *continued*

20.5 Directors' and Executive Officers' Remuneration Report

Details of the nature and amount of remuneration for the key management personnel consisting of each director and executive officer of the consolidated entity are:

		Short-term benefits				Post-employment benefits		Share-based payment			
Directors[1]		Salary & fees US$	Short-term incentive cash bonus US$	Other benefits US$	Service agreements US$	Super-annuation benefits US$	Termination benefits US$	Accounting fair value US$	Total US$	Proportion of remuneration performance related %	Accounting fair value as proportion of remuneration %
Executive											
T N Fern[1] *(Note 1)* Chairman, Managing Director	**2012**	**–**	**–**	**26,554**	**746,424**	**–**	**–**	**69,709**	**842,687**	**–**	**8.3**
	2011	–	–	33,176	686,664	–	–	22,631	742,471	–	3.0
Non-executive											
D A Mortimer[1] Director	**2012**	**67,386**	**–**	**–**	**–**	**6,065**	**–**	**–**	**73,451**	**–**	**–**
	2011	67,626	–	–	–	6,086	–	–	73,712	–	–
M L Harvey Director	**2012**	**50,000**	**–**	**–**	**–**	**–**	**–**	**–**	**50,000**	**–**	**–**
	2011	50,000	–	–	–	–	–	–	50,000	–	–
Total directors remuneration	**2012**	**117,386**	**–**	**26,554**	**746,424**	**6,065**	**–**	**69,709**	**966,138**	**–**	**7.2**
	2011	117,626	–	33,176	686,664	6,086	–	22,631	866,183	–	2.6

1. Directors' remuneration amounts except for Mr Harvey are actually paid in Australian dollars and presented in US dollars at the following average FX rates i) 2012 – 1.0367 ii) 2011 – 1.0404

20. REMUNERATION REPORT – AUDITED *continued*

20.5 Directors' and Executive Officers' Remuneration Report *continued*

Details of the nature and amount of remuneration for the key management personnel consisting of each director and executive officer of the consolidated entity are:

		Short-term benefits				Post-employment benefits		Share-based payment			
Executives		Salary & fees US$ *Note 5*	Short-term incentive cash bonus US$ *Note 6*	Other benefits US$ *Note 7*	Service agreements US$	Super-annuation/ 401K benefits US$	Termination benefits US$	Accounting fair value US$ *Note 8*	Total US$	Proportion of remuneration performance related %	Accounting fair value as proportion of remuneration %
R A Keogh President, Petsec Energy Inc. (PEI) and Group Chief Financial Officer	**2012**	**280,000**	**85,000**	**28,515**	**–**	**12,500**	**–**	**4**	**406,019**	**20.9**	**–**
	2011	280,000	117,000	29,309	–	33,212	–	1,316	460,837	25.4	0.3
R Krenzke Executive Vice President Exploration, PEI	**2012**	**280,000**	**85,000**	**31,435**	**–**	**12,500**	**–**	**–**	**408,935**	**20.8**	**–**
	2011	280,000	93,000	29,309	–	34,467	–	–	436,776	21.3	–
P Webb *(Note 2)* Vice President Business Development and Land, PEI	**2012**	**206,250**	**–**	**18,536**	**–**	**–**	**–**	**45,680**	**270,466**	**–**	**16.9**
	2011	–	–	–	–	–	–	–	–	–	–
P Gahdmar[1] Company Secretary, Group Financial Controller	**2012**	**175,771**	**18,142**	**3,990**	**–**	**15,819**	**–**	**20,610**	**234,332**	**7.7**	**8.8**
	2011	167,037	27,311	6,152	–	15,033	–	667	216,200	12.6	0.3
Former											
D Swords *(Note 3)* General Counsel/ Corporate Secretary, PEI	**2012**	**52,164**	**–**	**7,658**	**–**	**2,608**	**65,690**	**11**	**128,131**	**–**	**–**
	2011	177,000	26,550	29,276	–	17,700	–	299	250,825	10.6	0.1
F Robertson[1] *(Note 4)* Chief Financial Officer (resigned 3 February 2012)	**2012**	**–**	**–**	**1,462**	**11,145**	**–**	**–**	**–**	**12,607**	**–**	**–**
	2011	–	–	18,941	142,691	–	–	–	161,632	–	–
Total executive remuneration	**2012**	**994,185**	**188,142**	**91,596**	**11,145**	**43,427**	**65,690**	**66,305**	**1,460,490**	**12.9**	**4.5**
	2011	904,037	263,861	112,987	142,691	100,412	–	2,282	1,526,270	17.3	0.1
Total directors and executive officer remuneration	**2012**	**1,111,571**	**188,142**	**118,150**	**757,569**	**49,492**	**65,690**	**136,014**	**2,426,628**	**7.8**	**5.6**
	2011	1,021,663	263,861	146,163	829,355	106,498	–	24,913	2,392,453	11.0	1.0

1. Australian-based executive officers' remuneration amounts are actually paid in Australian dollars and presented in US dollars at the following average FX rates i) 2012 – 1.0367 ii) 2011 – 1.0404.

DIRECTORS' REPORT *cont.*

20. REMUNERATION REPORT – AUDITED *continued*

20.5 Directors' and Executive Officers' Remuneration Report *continued*

Notes

(1) Included in service agreements above is an amount of US$746,424 (2011: US$686,664) which was paid or is payable to, a company of which Mr Fern is a director. During the year, a company of which Mr Fern is a director provided management services to the Company and its controlled entities. The dealings were in the ordinary course of business and on normal terms and conditions.

(2) Mr Webb was appointed Vice President Business Development and Land of Petsec Energy Inc. on 1 February 2012. Mr Webb's annualised salary is US$225,000.

(3) Mr Sword's resigned from his position of General Counsel/Corporate Secretary of Petsec Energy Inc. on 31 March 2012. Mr Swords received a termination payment of US$65,690.

(4) Included in service agreements above is an amount of US$11,145 (2011: US$142,691), which was paid, or is payable to the above company (of which Mr Fern is a director) and through which Ms Robertson provided services. Ms Robertson resigned from her position of Chief Financial Officer on 3 February 2012.

(5) Salary and fees for certain specified executives includes the movement during the reporting period of accruals for annual leave and long service leave.

(6) Short-term incentive cash bonuses represent discretionary bonus amounts granted based on a number of factors including personal performance, the achievement of strategic objectives, retention and motivation of employees.

(7) Other benefits represent amounts paid on behalf of the Managing Director and Executive Officers in respect of insurance and car parking benefits.

(8) The fair value of options is calculated at the date of the grant using the Black-Scholes model and allocated to each reporting period over the period from grant date to vesting date.

The total termination benefits or other long-term benefits paid to key management personnel for the years ended 31 December 2012 was US$65,690 (2011: nil).

The following table sets out the factors and assumptions used in determining the fair value of the options issued to the above individuals.

Grant date	Expiry date	Average fair value per option	Exercise price	Price of shares on grant date	Estimated volatility	Risk-free interest rate	Dividend yield
14/1/09	31/12/13	A$0.044	A$0.20	A$0.15	101.9%	2.90%	–
25/2/09	31/12/13	A$0.030	A$0.20	A$0.15	88.1%	3.27%	–
29/1/10	31/12/14	A$0.087	A$0.23	A$0.22	62.8%	4.66%	–
16/2/12	31/1/17	A$0.107	A$0.20	A$0.165	117.7%	3.64%	–

20.6 Analysis of short-term incentive cash bonuses included in remuneration

Amounts included in remuneration for the financial year, within the table included in note 20.5 of this Directors' Report, represent the amount that vested in the financial year based on achievement of personal goals and satisfaction of specified performance criteria.

No amounts vest in future financial years in respect of the bonus schemes for the 2012 year.

No amounts were forfeited due to the performance or service criteria not being met in relation to the current financial year.

20. REMUNERATION REPORT – AUDITED *continued*

20.7 Equity instruments

All options refer to options over ordinary shares of Petsec Energy Ltd, which are exercisable on a one-for-one basis under the Employee Option Plan.

Options over equity instruments granted as compensation

During the reporting period, 1,000,000 options over ordinary shares in the Company were granted as compensation to key management personnel (2011: Nil). Details of options that vested during the period are as follows:

Directors	Number of options granted during 2012	Grant date	Fair value per option at grant date	Exercise price per option	Expiry date	Number of options vested during 2012
T Fern	–	–	–	–	–	–
Executives						
R Keogh	–	–	–	–	–	50,000
P Webb	1,000,000	16/2/12	A$0.107	A$0.20	31/1/17	–
P Gahdmar	–	–	–	–	–	75,000

Details of options over ordinary shares that were granted as compensation to key management personnel during the previous corresponding period and details of options that vested during the previous corresponding period are as follows:

Directors	Number of options granted during 2011	Grant date	Fair value per option at grant date	Exercise price per option	Expiry date	Number of options vested during 2011
T Fern	–	–	–	–	–	525,000
Executives						
R Keogh	–	–	–	–	–	50,000
D Swords	–	–	–	–	–	86,666
P Gahdmar	–	–	–	–	–	74,999

Since the end of the financial year through the date of this report 75,000 options have been cancelled and no options have been granted.

Modification of terms of equity-settled share-based payment transactions

No terms of equity-settled share-based payment transactions (including options granted as compensation to key management personnel) have been altered or modified by the issuing entity during the reporting period or the prior period.

Exercise of options granted as compensation

No shares were issued, during the reporting period, on the exercise of options previously granted as compensation to key management personnel (previous corresponding period: Nil).

Analysis of Movement in Options

During the reporting period, 1,330,000 options were granted, 2,688,500 options were cancelled and no options were exercised.

The movement during the period, by value, of options over ordinary shares in the Company held by each director and each of the five named Company executives and relevant group executives is detailed below (2011: Nil).

2012	Value of Options		
Executives	Granted in year (A) $	Exercised in year (B) $	Total option value in year A$
P Webb	A$107,231	–	A$107,231

(A) The value of options granted in the year is the fair value of the options calculated at grant date using the Black-Scholes model. This amount is allocated to remuneration over the vesting period.

(B) The value of options exercised during the year is calculated as the market price of shares of the Company on the ASX as at the close of trading on the date the options were exercised after deducting the price paid to exercise the option.

AUDITOR'S INDEPENDENCE DECLARATION

LEAD AUDITOR'S INDEPENDENCE DECLARATION UNDER SECTION 307C OF THE CORPORATIONS ACT 2001

To: the directors of Petsec Energy Ltd

I declare that, to the best of my knowledge and belief, in relation to the audit for the financial year ended 31 December 2012 there have been:

(i) no contraventions of the auditor independence requirements as set out in the *Corporations Act 2001* in relation to the audit; and

(ii) no contraventions of any applicable code of professional conduct in relation to the audit.

KPMG

KPMG

Anthony Jones
Partner

Sydney, 26 February 2013

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 DECEMBER

	Note	2012 US$'000	2011 US$'000
Revenues from sale of oil & gas		9,702	13,569
Royalties paid		(1,144)	(2,047)
Net revenues after royalties		8,558	11,522
Other income and expenses	5	1,549	157
Lease operating expenses		(3,598)	(4,745)
Geological, geophysical and administrative expenses		(5,978)	(6,735)
Depreciation, depletion, and amortisation		(3,881)	(5,204)
Exploration expense		(1,368)	(478)
Work-over expense	7	(3,142)	–
Impairment and abandonment expense	7	1,349	(20,229)
Derivative gains/(losses)	8	1,067	(897)
Gain on discharge of debt	9	–	11,365
Financial income	11	127	103
Financial expenses	11	(541)	(632)
Net financial income/(expense)	11	(414)	(529)
Profit/(loss) before income tax		(5,858)	(15,773)
Income tax benefit/(expense)	12	–	–
Profit/(loss) from continuing operations		(5,858)	(15,773)
Profit/(loss) from discontinued operation	29	–	29,807
Profit/(loss) for the period		(5,858)	14,034
Other comprehensive income/(loss)			
Foreign exchange translation differences		(155)	(413)
Total comprehensive income/(loss) for the period		(6,013)	13,621

	Note	2012 US Cents	2011 US Cents
Earnings/(loss) per share			
Basic and diluted earnings/(loss) per share	13	(2.5)	6.1

The statement of comprehensive income is to be read in conjunction with the notes to the consolidated financial statements set out on pages 31 to 67.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER

In thousands of USD	Share capital US$'000	Translation Reserve US$'000	Cashflow hedge Reserve US$'000	Share-based compen-sation US$'000	Accumu-lated losses US$'000	Total Equity US$'000
Balance at 1 January 2011	184,783	3,311	–	224	(145,477)	42,841
Total comprehensive income for the period						
Profit/(loss)	–	–	–	–	14,034	14,034
Other comprehensive income						
Foreign exchange translation differences	–	(413)	–	–	–	(413)
Total other comprehensive income/(loss)	–	(413)	–	–	–	(413)
Total comprehensive income/(loss) for the period	–	(413)	–	–	14,034	13,621
Transactions with owners, recorded directly in equity						
Contributions by and distributions to owners						
Shares issued	813	–	–		–	813
Vesting of share options	197	–	–	(197)	–	–
Share-based payments expense	–	–	–	27	–	27
Total transactions with owners	1,010	–	–	(170)	–	840
Balance at 31 December 2011	185,793	2,898	–	54	(131,443)	57,302
Balance at 1 January 2012	**185,793**	**2,898**	**–**	**54**	**(131,443)**	**57,302**
Total comprehensive income/(loss) for the period						
Profit/(loss)	**–**	**–**	**–**		**(5,858)**	**(5,858)**
Other comprehensive income/(loss)						
Foreign exchange translation differences	**–**	**(155)**	**–**		**–**	**(155)**
Total other comprehensive income/(loss)	**–**	**(155)**	**–**		**–**	**(155)**
Total comprehensive income/(loss) for the period	**–**	**(155)**	**–**		**(5,858)**	**(6,013)**
Transactions with owners, recorded directly in equity						
Contributions by and distributions to owners						
Shares issued	**488**	**–**	**–**	**–**	**–**	**488**
Vesting of share options	**94**	**–**	**–**	**(94)**	**–**	**–**
Share-based payments expense	**–**	**–**	**–**	**151**	**–**	**151**
Total transactions with owners	**582**	**–**	**–**	**57**	**–**	**639**
Balance at 31 December 2012	**186,375**	**2,743**	**–**	**111**	**(137,301)**	**51,928**

The statement of changes in equity is to be read in conjunction with the notes to the consolidated financial statements set out on pages 31 to 67.

CONSOLIDATED BALANCE SHEETS

AS AT 31 DECEMBER

For personal use only

	Note	2012 US$'000	2011 US$'000
ASSETS			
Current assets			
Cash and cash equivalents		**23,019**	34,954
Restricted cash deposits[1]		**–**	1,200
Trade and other receivables	14	**2,558**	1,346
Prepayments		**552**	665
Total current assets		**26,129**	38,165
Non-current assets			
Restricted cash deposits[1]		**5,425**	5,425
Receivables	14	**1,350**	816
Other financial assets	15	**2,178**	662
Property, plant and equipment		**85**	92
Exploration, evaluation and development expenditure – Tangible	16(a)	**25,509**	19,272
Exploration and evaluation expenditure – Intangible	16(b)	**3,580**	1,989
Intangible assets – Software		**21**	15
Total non-current assets		**38,148**	28,271
Total assets		**64,277**	66,436
LIABILITIES			
Current liabilities			
Trade and other payables	18	**5,996**	2,980
Rehabilitation provisions	20	**147**	342
Employee benefits provisions		**203**	209
Total current liabilities		**6,346**	3,531
Non-current liabilities			
Rehabilitation provisions	20	**5,756**	5,366
Employee benefits provisions		**247**	237
Total non-current liabilities		**6,003**	5,603
Total liabilities		**12,349**	9,134
Net assets		**51,928**	57,302
EQUITY			
Issued capital		**186,375**	185,793
Reserves		**2,854**	2,952
Accumulated losses		**(137,301)**	(131,443)
Total equity		**51,928**	57,302

1. Relates to cash used to guarantee certain future rehabilitation obligations (see note 25 –Contingencies and Legal Matters for further details).

The balance sheet is to be read in conjunction with the notes to the consolidated financial statements set out on pages 31 to 67.

CONSOLIDATED STATEMENT OF CASHFLOW

FOR THE YEAR ENDED 31 DECEMBER

	Note	2012 US$'000	2011 US$'000
Cashflows from operating activities			
Cash receipts from customers		**8,305**	16,708
Cash payments for royalties		**(1,279)**	(2,718)
Cash payments to suppliers and employees		**(9,681)**	(19,697)
Interest received		**105**	103
Interest paid		**(1)**	(66)
Restricted deposits[1]		**1,200**	(925)
Net cash from operating activities	32	**(1,351)**	(6,595)
Cashflows from investing activities			
Payments for property, plant and equipment		**(76)**	(33)
Payments for exploration, evaluation and development expenditure		**(11,058)**	(3,859)
Payments for investments		**(2,194)**	–
Proceeds from sale of discontinued operation	29	**–**	40,869
Proceeds from sale of investments		**2,700**	–
Net cash from investing activities		**(10,628)**	36,977
Cashflows from financing activities			
Debt facility repayments including transaction costs		**–**	(12,833)
Net cash from financing activities		**–**	(12,833)
Net increase/(decrease) in cash and cash equivalents		**(11,979)**	17,549
Cash and cash equivalents at 1 January		**34,954**	17,373
Effects of exchange rate changes on cash held		**44**	32
Cash and cash equivalents at 31 December		**23,019**	34,954

1. Relates to cash used to guarantee certain future rehabilitation obligations (see note 25 – Contingencies and Legal Matters for further details).

The statement of cashflows is to be read in conjunction with the notes to the consolidated financial statements set out on pages 31 to 67.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 DECEMBER 2012

1. REPORTING ENTITY

Petsec Energy Ltd (the "Company") is a company domiciled in Australia. The registered office of the Company is Level 13, 1 Alfred Street Sydney NSW 2000. The consolidated financial statements of the Company as at and for the year ended 31 December 2012 comprise the Company and its subsidiaries (together referred to as the "consolidated entity").

The financial report is presented in United States dollars, which is the consolidated entity's choice of presentation currency.

The Group is a for-profit entity and is primarily involved in oil and gas exploration and production in the shallow waters of the Gulf of Mexico and state waters of the Louisiana Gulf Coast region of the USA, and exploration activities in shale oil projects in Canada and the USA.

2. BASIS OF PREPARATION

(a) Statement of compliance

The financial report is a general purpose financial report which has been prepared in accordance with Australian Accounting Standards ("AASBs") (including Australian Interpretations) adopted by the Australian Accounting Standards Board ("AASB") and the *Corporations Act 2001*. The consolidated financial report of the consolidated entity and the financial report of the Company comply with International Financial Reporting Standards ("IFRSs") and interpretations adopted by the International Accounting Standards Board (IASB).

The Board of Directors approved the financial statements on 26 February 2013.

(b) Basis of measurement

The consolidated financial statements have been prepared on the historical cost basis except for the following:

- Derivative financial instruments are measured at fair value.

The methods used to measure fair values are discussed further in note 4.

The consolidated entity is of a kind referred to in ASIC Class Order 98/100 dated 10 July 1998 (updated by CO 05/641 effective 28 July 2005 and CO 06/51 effective 31 January 2006) and in accordance with that Class Order, all financial information presented in US dollars has been rounded to the nearest thousand unless otherwise stated.

(c) Use of estimates and judgements

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

In particular, information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the financial statements are described in Note 3 (d) – Exploration, evaluation and development expenditure – Intangible and tangible, Note 3 (m) Rehabilitation provision and Note 3 (r) – Income tax.

The estimated recoverable amount of oil and gas assets is based on discounted cash flow projections which are based on estimates and assumptions that are subject to change. Key assumptions include the ultimate prices realised on the sale of oil and gas and the reserves ultimately recovered. A sustained deterioration in prices or reduction in reserves may result in further future asset impairments.

(d) Going concern basis of preparation

The financial statements of the consolidated entity have been prepared on the basis of a going concern. The going concern basis of preparation assumes that an entity will realise its assets and discharge its liabilities in the normal course of business.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

3. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements, and have been applied consistently by the Company and consolidated entity.

(a) Basis of consolidation

(i) Subsidiaries

Subsidiaries are entities controlled by the Company. Control exists when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable or convertible are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. The accounting policies of subsidiaries have been changed when necessary to align them with the policies adopted by the consolidated entity.

In the Company's financial statements, investments in subsidiaries are carried at the lower of cost and recoverable amount.

(ii) Joint operating arrangements

Joint operating arrangements are those entities over whose activities the consolidated entity has joint control, established by contractual agreement. The interest of the consolidated entity in unincorporated joint operating arrangements and jointly operated assets are brought to account by recognising in its financial statements the assets it controls, the liabilities and the expenses it incurs and its share of income that it earns from the sale of goods or services by the joint operations.

(iii) Transactions eliminated on consolidation

Intra-group balances and any unrealised gains and losses or income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

(iv) Loss of control

Upon the loss of control, the consolidated entity derecognises the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss. If the consolidated entity retains any interest in the previous subsidiary, then such interest is measured at fair value at the date that control is lost. Subsequently it is accounted for as an equity-accounted investee or as an available-for-sale financial asset depending on the level of influence retained.

(b) Foreign currency

(i) Functional and presentation currency

Items included in the financial statements of each of the consolidated entity's subsidiaries are measured using the currency of the primary economic environment in which the subsidiary operates ("the functional currency"). The functional currency of the Company and its Australian subsidiaries is Australian dollars (A$) and the functional currency of the Company's overseas subsidiaries is United States dollars (US$).

The financial statements are presented in United States dollars. The consolidated entity believes the US dollar is the best measure of performance for Petsec Energy Ltd because oil and gas, the consolidated entity's dominant sources of revenue, are priced in US dollars and the consolidated entity's main operations are based in the USA with most of the costs incurred in US dollars.

Prior to consolidation, the results and financial position of each entity within the group are translated from the functional currency into the group's presentation currency as follows:

- Assets and liabilities are translated at the closing rate at the date of that balance sheet;
- Income and expenses are translated at average exchange rates (unless this is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions);
- Components of equity are translated at the historical rates; and
- All resulting exchange differences are recognised as a separate component of equity.

3. SIGNIFICANT ACCOUNTING POLICIES *cont.*

(b) Foreign currency *cont.*

(ii) Foreign currency transactions and balances

Foreign currency transactions are translated into the functional currency at the exchange rates prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated to the respective functional currency at the foreign exchange rate ruling at that date. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the statement of comprehensive income.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction.

Foreign exchange gains and losses arising from a monetary item receivable from or payable to a foreign operation, the settlement of which is neither planned nor likely in the foreseeable future, are considered to form part of a net investment in a foreign operation and are recognised directly in equity in the foreign currency translation reserve (FCTR).

(c) Derivative financial instruments and hedging activities

The consolidated entity's revenues are exposed to changes in commodity prices. From time to time, the consolidated entity enters into derivative financial instruments to manage a portion of its oil and gas sales price risks.

The consolidated entity does not hold derivative financial instruments for speculative purposes.

Derivative financial instruments are initially recognised at fair value on the date a derivative contract is entered into and are subsequently remeasured to their fair value each reporting date. The method of recognising the resulting gain or loss depends on whether the derivative is designated as a hedging instrument, and if so, the nature of the item being hedged. The consolidated entity designates certain derivatives as hedges of highly probable forecast transactions (cash flow hedges).

The consolidated entity documents at the inception of the transaction the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The consolidated entity also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions have been and will continue to be highly effective in offsetting changes in fair values or cash flows of hedged items.

(i) Cash flow hedge

Changes in the fair value of the derivative-hedging instrument designated as a cash flow hedge are recognised directly in equity to the extent that the hedge is effective. To the extent that the hedge is ineffective, changes in fair value are recognised in the statement of comprehensive income.

If the hedging instrument no longer meets the criteria for hedge accounting, expires or is sold, terminated or exercised, then hedge accounting is discontinued prospectively. The cumulative gain or loss previously recognised in equity remains there until the forecast transaction occurs. When the hedged item is a non-financial asset, the amount recognised in equity is transferred to the carrying amount of the asset when it is recognised. In other cases the amount recognised in equity is transferred to the income statement in the same period that the hedged item affects profit or loss.

(ii) Derivative financial instruments that do not qualify for hedge accounting

Certain derivative financial instruments do not qualify for hedge accounting. Changes in the fair value of any derivative financial instrument that does not qualify for hedge accounting are recognised immediately in the statement of comprehensive income.

(iii) Other derivative financial instruments

Other derivative financial instruments are recognised initially at fair value; attributable transaction costs are recognised in profit or loss as incurred. Subsequent to initial recognition, derivatives are measured at fair value and changes therein are recognised immediately in profit or loss.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

3. SIGNIFICANT ACCOUNTING POLICIES *cont.*

(d) Exploration, evaluation and development expenditure – Intangible and tangible

Exploration, evaluation and development costs are accumulated in respect of each separate area of interest. The consolidated entity's capitalisation policy for its natural gas and crude oil exploration and development activities is to capitalise costs of productive exploratory wells, development drilling and productive wells, and costs to acquire mineral interests. Exploration costs, including personnel costs, certain geological and geophysical expenses including seismic costs where exploration rights have not been obtained for oil and natural gas leases, are charged to expense as incurred. Exploratory drilling costs are initially capitalised, but charged to expense if and when the well is determined not to have found reserves in commercial quantities.

Exploration and evaluation expenditures relating to an area of interest are capitalised as intangible deferred costs where exploration rights have been obtained. These intangible deferred costs are carried forward only to the extent that they are expected to be recouped through successful development and exploitation, or sale of the area, or where exploration and evaluation activities have not yet reached a stage which permits a reasonable assessment of the existence of economically recoverable reserves, and active and significant exploration operations are continuing. These intangible deferred costs are not subject to amortisation. Once management has determined the existence of economically recoverable reserves for an area of interest, deferred costs are reclassified from intangible to tangible assets on the balance sheet. Tangible deferred costs are amortised using a units-of-production method, as further discussed in note 3(e).

Development expenditures relating to an area of interest are capitalised as tangible deferred costs, and are carried forward to the extent that they are expected to be recouped either through the sale or successful exploitation of the area of interest.

Exploration, evaluation and development assets are assessed for impairment when facts and circumstances suggest that the carrying amount of the asset may exceed its recoverable amount. In the event that indicators of impairment are present, an impairment loss is recorded based on the higher of an asset's fair value less costs to sell and value in use (see note 3(h)). When an area of interest is abandoned or the directors decide that it is not commercial, any accumulated costs in respect of that area are written off in the financial period the decision is made.

(e) Amortisation of exploration, evaluation and development expenditure

Exploration, evaluation and development expenditure in the production phase is amortised on a units-of-production method based on the ratio of actual production to remaining proved and probable reserves (2P). Remaining 2P reserves are measured at the lower of 2P reserves estimated by external independent petroleum engineers and internal estimates.

Amortisation is not charged on costs carried forward in respect of areas of interest in the development phase until commercial production commences.

(f) Intangible assets – Software

Software acquired by the consolidated entity, which have finite useful lives, is measured at cost less accumulated amortisation.

(g) Property, plant and equipment

(i) Recognition and measurement

Items of property, plant and equipment are measured at cost less accumulated depreciation and impairment losses.

Cost includes expenditures that are directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials and direct labour, any other costs directly attributable to bringing the asset to a working condition for its intended use, and the costs of dismantling and removing the items and restoring the site on which they are located. Purchased software that is integral to the functionality of the related equipment is capitalised as part of the equipment.

When parts of an item of property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of property, plant and equipment.

Gains and losses on disposal of an item of property, plant and equipment are determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment and are recognised net within "other income" in profit and loss.

(ii) Leased assets

Leases in terms of which the consolidated entity assumes substantially all the risks and rewards of ownership are classified as finance leases. Lease payments are accounted for as described in accounting policy 3(o).

3. SIGNIFICANT ACCOUNTING POLICIES *cont.*

(g) Property, plant and equipment *cont.*

(iii) Subsequent costs

The cost of replacing part of an item of property, plant and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the consolidated entity and its costs can be measured reliably. The costs of the day-to-day servicing of property, plant and equipment are recognised in the income statement as incurred.

(iv) Depreciation and amortisation

Depreciation of property, plant and equipment is recognised in the statement of comprehensive income on a straight-line basis over the estimated useful lives of each part of an item. Leased assets are depreciated over the shorter of the lease term and their useful lives. Assets are depreciated or amortised from the date of acquisition or, in respect of internally constructed assets, from the time an asset is completed and held ready for use.

Depreciation methods, useful lives and residual values are reassessed at the reporting date. When changes are made, adjustments are reflected prospectively in current and future periods only.

The estimated useful lives or the amortisation method used for each class of asset in the current and comparative periods are as follows:

Property, plant and equipment	2012	2011
Furniture and fittings	**5 – 8 years**	5 – 8 years
Office equipment	**3 – 4 years**	3 – 4 years
Leasehold improvements	**5 – 7 years**	5 – 7 years

(h) Impairment – Non-financial assets

The carrying amounts of the consolidated entity's and the Company's non-financial assets, other than deferred tax assets (see note 3(r)), are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. For intangible assets that have indefinite lives or that are not yet available for use, recoverable amount is estimated at each reporting date.

An impairment loss is recognised if the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. A cash-generating unit is the smallest identifiable asset group that generates cash flows that largely are independent from other assets or groups. Impairment losses are recognised in the income statement. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amount of the other assets in the unit (group of units) on a *pro rata* basis.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessment of the time value of money and the risks specific to the asset.

The measurement of recoverable amount for the consolidated entity's exploration, evaluation and development expenditure requires significant estimation and judgement. Note 16 provides further details of the key assumptions adopted by the consolidated entity in measuring the recoverable amount of exploration, evaluation and development expenditure.

Impairment losses recognised in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

(i) Trade and other receivables

Trade receivables, which generally have 30-60 day terms, are recognised and carried at original invoice amount less an allowance for any uncollectible amounts.

An estimate for doubtful debts is made when collection of the full amount is no longer probable. Bad debts are written off when identified.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

3. SIGNIFICANT ACCOUNTING POLICIES *cont.*

(j) Cash and cash equivalents

Cash and cash equivalents in the balance sheet comprise cash at bank and on hand and short-term deposits with an original maturity of three months or less.

For the purposes of the Statement of Cash Flows, cash and cash equivalents consist of cash and cash equivalents as defined above, net of outstanding bank overdrafts.

(k) Interest-bearing loans and borrowings

All loans and borrowings are initially recognised at cost, being the fair value of the consideration received net of debt issue costs associated with the borrowing.

After initial recognition, interest-bearing loans and borrowings are subsequently measured at amortised cost using the effective interest method. Amortised cost is calculated by taking into account any issue costs, and any discount or premium on settlement.

(l) Borrowing costs

Borrowing costs comprise interest payable on borrowings calculated using the effective interest rate method, lease finance charges and amortisation of discounts or premiums relating to borrowings.

(m) Provisions

A provision is recognised if, as a result of a past event, the consolidated entity has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability.

Where discounting is used, the increase in the provision due to the passage of time is recognised as a finance cost.

Rehabilitation

The consolidated entity recognises a provision for the legal obligation associated with the retirement of long-lived assets that results from the acquisition, construction, development, and (or) the normal operation of oil and natural gas properties. The initial recognition of a liability for rehabilitation, which is discounted using a credit-adjusted risk-free interest rate, increases the carrying amount of the related long-lived asset by the same amount as the liability. In periods subsequent to initial measurement, period-to-period changes in the liability are recognised for the passage of time (unwinding of discount) as financial expense. Additionally, the capitalised asset retirement cost is subsequently allocated to expense on a units-of-production basis over its estimated useful life.

Changes in the estimate of the liability arising from revised timing or estimated cost-to-complete the rehabilitation are recognised with a corresponding adjustment to the relevant long-lived asset.

The rehabilitation provision requires significant estimation and judgement. These estimates include:

- Expected method of remediation;
- Forecast costs-to-complete the future remediation; and
- Anticipated timing of the remediation work.

The consolidated entity monitors the estimates and judgements involved in measuring this provision. Changes in estimated rehabilitation provisions are accounted for on a prospective basis and affect provisions.

(n) Employee benefits and director benefits

(i) Short-term employee benefits

Liabilities for employee benefits for wages, salaries, annual leave and sick leave represent present obligations resulting from employees' services provided to reporting date and are calculated at undiscounted amounts based on remuneration wage and salary rates that the consolidated entity expects to pay as at reporting date including related on-costs, such as workers' compensation insurance and payroll tax.

3. SIGNIFICANT ACCOUNTING POLICIES *cont.*

(n) Employee benefits and director benefits *cont.*

(ii) Long-term employee benefits

The provision for employee benefits for long service leave represents the present value of the estimated future cash outflows to be made resulting from employees' services provided to reporting date.

The provision is calculated using expected future increases in wage and salary rates including related on-costs and expected settlement dates based on turnover history and is discounted using the rates attaching to national government bonds at reporting date which most closely match the terms of maturity of the related liabilities.

(iii) Defined contribution pension plans

The Company and other controlled entities contribute to several defined contribution pension plans. Obligations for contributions to defined contribution pension plans are recognised as an expense in the statement of comprehensive income when they are due.

(iv) Employee incentive plans

Under the employee incentive plan, a liability may be recognised for bonuses for eligible employees based on the consolidated entity's performance for the year based on a number of pre-determined performance criteria.

(v) Share-based compensation transactions

Share-based compensation benefits are provided to employees of the consolidated entity, including directors, via the Company's Employee Option Plan and Employee Share Plan.

The grant date fair value of options granted to employees is recognised as an employee expense, with a corresponding increase in equity, over the period in which the employees become unconditionally entitled to the options.

(o) Leases

Leases in terms of which the consolidated entity assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income.

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognised as an expense in the statement of comprehensive income on a straight-line basis over the lease term. Lease incentives received are recognised as an integral part of the total lease expense, over the term of the lease.

(p) Revenue and other income recognition

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the consolidated entity and the revenue can be reliably measured. The following specific recognition criteria must also be met before revenue is recognised:

Sale of oil and gas

Revenues are recognised when the product is in the form in which it is to be delivered and an actual physical quantity has been provided or allocated to a purchaser pursuant to a contract. Revenue from oil and gas sales is measured at the fair value of the consideration receivable.

Revenue from oil and gas royalties is recognised on an accrual basis in accordance with the terms of underlying royalty agreements. Revenue from oil and gas royalties is measured at the fair value of the consideration receivable.

Sale of non-current assets

Gains or losses on sale of non-current assets are recognised as other income at the date control of the asset passes to the buyer, usually when an unconditional contract of sale is signed.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

3. SIGNIFICANT ACCOUNTING POLICIES *cont.*

(p) Revenue and other income recognition *cont.*

Dividend income

Dividend income is recognised by the Company when controlled subsidiaries declare dividends.

Interest income

Interest income is recognised as the interest accrues (using the effective interest method, which is the rate that discounts estimated future cash receipts through the expected life of the financial instrument).

(q) Earnings per share

The consolidated entity presents basic and diluted earnings per share (EPS) data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the period. Diluted EPS is determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, which comprise share options granted to employees.

(r) Income tax

Income tax expense comprises current and deferred tax. Income tax expense is recognised in the statement of comprehensive income except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognised using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognised for the following temporary differences: the initial recognition of assets or liabilities that affect neither accounting nor taxable profit nor differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

A deferred tax asset is recognised to the extent that it is probable that future taxable profits will be available against which the temporary difference or tax losses can be utilised. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Tax consolidation

The Company and its wholly owned Australian resident entities have formed a tax-consolidated group with effect from 1 July 2002 and are therefore taxed as a single entity from that date. The head entity within the tax-consolidated group is Petsec Energy Ltd.

Current tax expense/income, deferred tax liabilities and deferred tax assets arising from temporary differences of the members of the tax-consolidated group are recognised in the separate financial statements of the members of the tax-consolidated group using the 'separate taxpayer within group' approach by reference to the carrying amount of assets and liabilities in the separate financial statements of each entity and the tax values applying under tax consolidation.

Any current tax liabilities (or assets) and deferred tax assets arising from unused Australian tax losses of the subsidiaries are assumed by the head entity in the tax-consolidated group and are recognised by the Company as amounts payable (receivable) to/(from) other entities in the tax-consolidated group in conjunction with any tax funding arrangement amounts (refer below). Any difference between these amounts is recognised by the Company as an equity contribution or distribution.

The Company recognises deferred tax assets arising from unused tax losses of the tax-consolidated group to the extent that it is probable that future taxable profits of the tax-consolidated group will be available against which the asset can be utilised.

Any subsequent period adjustments to deferred tax assets arising from unused tax losses as a result of revised assessments of the probability of recoverability are recognised by the head entity only.

3. SIGNIFICANT ACCOUNTING POLICIES *cont.*

(r) Income tax *cont.*

Nature of tax funding arrangements and tax sharing arrangements

The head entity, in conjunction with other members of the Australian tax-consolidated group, has entered into a tax funding arrangement, which sets out the funding obligations of members of the tax-consolidated group in respect of tax amounts. The tax funding arrangements require payments to/from the head entity equal to the current tax liability/(asset) assumed by the head entity and any tax-loss deferred tax asset assumed by the head entity, resulting in the head entity recognising an inter-entity receivable/(payable) equal in amount to the tax liability/(asset) assumed. The inter-entity receivable/(payable) is at call.

The head entity in conjunction with other members of the Australian tax-consolidated group has also entered into a tax sharing agreement. The tax sharing agreement provides for the determination of the allocation of income tax liabilities between the entities should the head entity default on its tax payment obligations. No amounts have been recognised in the financial statements in respect of this agreement, as payment of any amounts under the tax sharing agreement is considered remote.

(s) Goods and services tax

Revenues, expenses and assets are recognised net of the amount of goods and services tax (GST), except where the amount of GST incurred is not recoverable from the taxation authority. In these circumstances, the GST is recognised as part of the cost of acquisition of the asset or as part of the expense.

Receivables and payables are stated with the amount of GST included. The net amount of GST recoverable from, or payable to, the taxation authority is included as a current asset or liability in the balance sheet.

Cash flows are included in the Statement of Cash Flows on a gross basis. The GST components of cash flows arising from investing and financing activities, which are recoverable from or payable to the taxation authority, are classified as operating cash flows.

(t) Segment reporting

An operating segment is a distinguishable component of the consolidated entity whose information is reviewed regularly by the CEO, the Group's chief decision making officer who is engaged in providing related products or services which are subject to risk and rewards that are different to other segments.

(u) New standards and interpretations not yet adopted

A number of new standards, amendments to standards and interpretations are effective for annual periods beginning after 1 January 2013, and have not been applied in preparing these consolidated financial statements. None of these is expected to have a significant effect on the consolidated financial statements of the consolidated entity.

4. DETERMINATION OF FAIR VALUES

A number of the consolidated entity's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. Where applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

Commodity derivatives

The fair values of commodity derivative hedging instruments are based on the relationship between the agreed contracted fixed and floor prices and quoted market prices at period end.

Equity securities

The fair value of equity securities is determined using the Black-Scholes formula. Measurement inputs include the share price on the measurement date, the exercise price of the instrument, expected volatility, expected term of the instruments, expected dividends, and the risk-free interest rate (based on government bonds).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

5. REVENUE AND OTHER INCOME AND EXPENSES

	2012 US$'000	2011 US$'000
Other income and expenses		
Production and project overhead income	**109**	185
Net foreign exchange gains (losses)	**205**	(33)
Net gain on disposal of property, plant and equipment	**266**	5
Net loss on disposal of investments	**(84)**	–
Change in fair value of investments	**1,053**	–
	1,549	157

6. PERSONNEL EXPENSES

	2012 US$'000	2011 US$'000
Wages and salaries	**1,791**	2,792
Service agreements for executives	**758**	830
Contract labour	**170**	247
Superannuation & 401(k) plans	**73**	111
Share-based payment compensation	**151**	28
Other employee-related expenses	**1**	10
	2,944	4,018

7. PROFIT/(LOSS) FOR THE PERIOD

Profit/(loss) for the period includes the following items that are significant because of their nature, size or incidence:

	2012 US$'000	2011 US$'000
Expenses		
Work-over expense	**(3,142)**	–
Impairment and abandonment expense	**1,349**	(20,229)

Work-over expense

In accordance with accounting standards and Company policy, the consolidated entity expensed the entire US$3,142,000 cost of the Main Pass 270 A-3 well work-over as it was a repair to an existing completion. Work-over or recompletions to new production zones are generally capitalised.

Impairment and abandonment expense

The estimated recoverable amount of all oil and gas assets is based on discounted cash flow projections that are based on a range of estimates and assumptions that are subject to change. Key assumptions include the ultimate prices realised on the sale of oil and gas and the reserves ultimately recovered. A sustained deterioration in prices or reduction in reserves may result in further future asset impairments.

For the year ended 31 December 2012, the consolidated entity reversed a total of US$1,349,000 of net impairment and abandonment expense. This amount comprised a US$4.2 million reversal of an impairment provision previously recognised against the Main Pass 270 gas/condensate field, following the success of the A-3 well work-over and the restitution of production in the well, coupled with an increase in reserves reflecting the production performance of the other wells. The benefit of the Main Pass 270 reversal of impairment was partially offset by net impairments of US$2.8 million due to a reduction in the estimate of recoverable reserves by the independent petroleum engineers, coupled with lower operating margins the Main Pass 18/19 fields.

In the previous corresponding period, the consolidated entity recognised total impairment and abandonment expense of US$20,229,000 primarily due to the effect of lower U.S. natural gas prices in combination with downward reserve revisions on certain fields.

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8. DERIVATIVE GAINS/(LOSSES)

The following table presents details of the change in fair value recognised in the current and comparative period:

	2012 US$'000	2011 US$'000
Change in fair value of collar hedge contracts	–	186
Change in fair value of securities held in unrelated entities	**1,067**	(1,083)
	1,067	(897)

In the previous corresponding period, the consolidated entity held gas collar derivative contracts to hedge the price risk associated with selling a portion of its 2011 gas production. Whilst these instruments represented an economic hedge, the consolidated entity did not apply hedge accounting, and accordingly all changes in the fair value of these contracts were recognised in profit or loss immediately in the period incurred.

Whilst changes in fair value are recognised over the life of the natural gas collars, for internal reporting, management monitors the price realised for production during the period. The price realised on production represents the aggregation of the spot selling price, net of royalties, plus the impact of the gain that is realised on the settlement of the instrument. In the previous corresponding period, the proceeds realised upon settlement of the collar hedge contracts were US$1,433,000.

The consolidated entity has share options as part consideration for the 2011 sale of Petsec Petroleum LLC – refer to *note 29 Discontinued Operations* for further details. The options are measured at fair value and changes therein are recognised immediately in profit or loss.

9. GAIN ON DISCHARGE OF DEBT

In the previous corresponding period, the consolidated entity became debt free following the settlement of the term loan of US$29.2 million owed to a third party by its US subsidiary, Petsec Energy Inc. ("PEI"). The term loan was extinguished by the payment of US$12 million in cash, and conveyance of a 2.5% working interest in Petsec Energy's Main Pass 270 producing wells, a 2% working interest in Petsec Energy's lease in the Atchafalaya Bay area (Marathon discovery), Louisiana, and 25% of Petsec Energy's working interest in ten non-producing leases in the Gulf of Mexico, USA and the exploration area of Main Pass 270.

As a result of a difference between the book value of the interest in the respective properties compared to the value of the liability extinguished, the settlement and extinguishment of the term loan generated a gain. The following table presents details of the gain on settlement and extinguishment of this liability.

	Twelve months to 31 December 2011 US$'000
Borrowings extinguished	29,175
Less: Cash paid/payable	(12,139)
Carrying value of interest in properties transferred	(4,702)
Transaction costs associated with loan settlement	(693)
Unamortised borrowing costs	(276)
Gain on term loan settlement	11,365

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

10. AUDITOR'S REMUNERATION

	2012 US$	2011 US$
Audit services:		
Auditors of the Company		
KPMG Australia		
Audit and review of financial reports	**79,750**	86,000
Overseas KPMG Firms		
Audit and review of financial reports	**26,250**	25,000
Other services:		
Auditors of the Company		
KPMG Australia		
Corporate, tax and compliance services	**–**	10,200
	106,000	121,200

11. FINANCE INCOME AND EXPENSE

	2012 US$'000	2011 US$'000
Interest income – Other parties	**127**	103
Financial income	**127**	103
Interest expense	**(1)**	(66)
Unwinding of discount	**(540)**	(566)
Financial expense	**(541)**	(632)
Net financial income	**(414)**	(529)

12. INCOME TAX EXPENSE

Recognised in the statement of comprehensive income	2012 US$'000	2011 US$'000
Deferred tax expense		
Origination and reversal of temporary differences	**–**	–
Total income tax benefit/(expense) in the statement of comprehensive income	**–**	–
Numerical reconciliation between tax expense and pre-tax net profit/(loss)		
Profit/(loss) before tax	**(5,858)**	14,034
Income tax expense/(benefit) using the Australian corporation tax rate of 30% (2011: 30%)	**(1,757)**	4,210
Increase/(decrease) in income tax expense due to:		
Non-deductible expenses	**379**	379
U.S. income taxes assessed at different rate	**(297)**	(671)
Canadian income taxes assessed at different rate	**100**	–
Deferred tax movements not brought to account in current year	**1,575**	(3,809)
Under/(over) provided in prior years	**–**	(109)
Income tax expense/(benefit) on pre-tax net profit/(loss)	**–**	–

13. EARNINGS PER SHARE

The Company has only one type of security, being ordinary shares, included in the basic earnings per share calculation.

In addition to the ordinary shares, the Company has 2,007,500 (2011: 3,366,000) options outstanding under the Employee Option Plan. In determining potential ordinary shares, 2,007,500 (2011: 3,366,000) are not dilutive.

During the year, 1,330,000 options were granted and 2,688,500 were forfeited. No options were exercised and converted to ordinary shares.

Basic earnings/(loss) per share

The calculation of basic earnings/(loss) per share at 31 December 2012 was based on the loss attributable to ordinary shareholders of US$5,858,000 (2011: Profit of US$14,034,000) and a weighted average number of ordinary shares outstanding during the year ended 31 December 2012 of 236,044,278 (2011: 231,404,170), calculated as follows:

Profit/(loss) attributable to ordinary shareholders	2012 US$'000	2011 US$'000
Profit/(loss) for the period	**(5,858)**	14,034

Weighted average number of shares (basic) *In thousands of shares*	2012	2011
Issued ordinary shares at 1 January	**235,284**	231,284
Effect of shares issued in 2012 and 2011, respectively	**760**	120
Weighted average number of ordinary shares at 31 December	**236,044**	231,404

Earnings/(loss) per share *In USD cents*	2012	2011
Basic and diluted earnings/(loss) per share	**(2.5)**	6.1

14. TRADE AND OTHER RECEIVABLES

	2012 US$'000	2011 US$'000
Current		
Trade receivables	**2,546**	1,333
Other receivables	**12**	13
	2,558	1,346
Non-current		
Loan receivable from related parties	**1,350**	816
	1,350	816

15. OTHER FINANCIAL ASSETS

	2012 US$'000	2011 US$'000
Investments in unrelated entities	**2,178**	662
	2,178	662

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

16. EXPLORATION, EVALUATION AND DEVELOPMENT EXPENDITURE

(a) Tangible	2012 US$'000	2011 US$'000
Costs carried forward in respect of areas of interest in the following phases:		
Production phase – at WDV		
Balance at 1 January	**19,129**	41,816
Additions	**5,297**	2,949
Sales, disposals and assignments	**–**	(2,894)
Impairment reversal/(expense)	**1,439**	(17,686)
Current year amortisation expense	**(3,804)**	(5,056)
Balance at 31 December	**22,061**	19,129
Exploration and/or evaluation phase – at cost		
Balance at 1 January	**143**	12,568
Additions	**3,449**	–
Impairment expense	**(144)**	–
Sales, disposals and assignments	**–**	(12,425)
Balance at 31 December	**3,448**	143
Total costs carried forward	**25,509**	19,272
(b) Intangible		
Costs carried forward in respect of areas of interest in the following phase:		
Exploration and/or evaluation phase – at cost		
Balance at 1 January	**1,989**	7,344
Additions	**1,591**	556
Disposals, assignments and lease relinquishments	**–**	(3,097)
Impairment expense	**–**	(2,814)
Balance at 31 December	**3,580**	1,989

Recoverable amount

The ultimate recoupment of costs carried forward for exploration and evaluation phases is dependent on the successful development and commercial exploitation or sale of the respective areas.

The estimated recoverable amount of all cash generating units in the development and production phases is determined by discounting the estimated future cash flows to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the assets. The consolidated entity utilises discounted future cash flows as estimated by independent petroleum engineers for this assessment. The key assumptions used include:

- Estimated proved and probable reserves (2P reserves);
- For wells now in production – initial production rates based on current producing rates for those wells;
- For wells not currently in production – initial production rates based on test data and other related information;
- Estimated rates of production decline based on current trends;
- Hydrocarbon prices that the consolidated entity estimates to be reasonable taking into account historical prices, current prices, and prices used in making its exploration and development decisions;
- Operating costs directly applicable to the leases or wells;
- Development costs based on authorisations for expenditure for the proposed work or actual costs for similar projects;
- Pre-tax discount rate of 10%.

16. EXPLORATION, EVALUATION AND DEVELOPMENT EXPENDITURE *cont.*

Risk of future impairments

The determination of the estimated recoverable amount of Petsec's producing oil and gas properties is highly sensitive to a change in estimated recoverable reserves and oil and gas prices.

As a result of historical impairments, certain properties are carried at recoverable amounts. Consequently any reduction in recoverable reserves or a reduction in the oil or gas price may trigger the need for further impairment on these specific properties.

17. DEFERRED TAX ASSETS

Recognised deferred tax assets and liabilities

	Assets		Liabilities		Net	
	2012 US$'000	2011 US$'000	2012 US$'000	2011 US$'000	2012 US$'000	2011 US$'000
Exploration, evaluation and development expenditure	**2,436**	5,105	**–**	–	**2,436**	5,105
Other items	**302**	124	**–**	–	**302**	124
Deferred tax balances not brought to account	**(2,738)**	(5,229)	**–**	–	**(2,738)**	(5,229)
Deferred tax assets/(liabilities)	**–**	–	**–**	–	**–**	–

Unrecognised deferred tax assets

Deferred tax assets have not been recognised in respect of the following items:

	2012 US$'000	2011 US$'000
Deductible temporary differences in USA (net)	**2,738**	5,229
Tax operating loss carry-forwards in USA (net)	**31,351**	27,109
Tax operating loss carry-forwards in Canada (net)	**166**	–
Deductible temporary differences in Australia (net)	**214**	276
Tax operating loss carry-forwards in Australia (net)	**3,209**	2,765
	37,678	35,379

Under Australian Accounting Standards, the consolidated entity is required to assess at each reporting period, the extent to which deferred tax assets in respect of the carry-forward of unused tax losses and temporary differences qualify for recognition on the balance sheet based on current facts and circumstances, including projected future taxable profits.

Historically, no deferred tax assets have been recognised in relation to the Australian operations as they do not qualify for recognition of deferred tax assets until such time that it is probable that future taxable profits will be available against which unused tax losses and temporary differences in the relevant tax jurisdictions can be utilised.

The deductible temporary differences and tax losses in Australia do not expire under current tax legislation though these losses are subject to testing under loss recoupment rules, in order for them to be utilised. USA and Canada loss carry forwards expire in 2021 and later.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

17. DEFERRED TAX ASSETS *cont.*

Movement in temporary differences during the year

	Balance 1 Jan 11 US$'000	Recognised in income US$'000	Recognised in equity US$000	Reclassified to other balance sheet account US$000	Balance 31 Dec 11 US$'000
Exploration, evaluation and development expenditure	7,366	(2,261)	–	–	5,105
Other items	(162)	286	–	–	124
Deferred tax balances in USA not brought to account	(7,204)	1,975	–	–	(5,229)
	–	–	–	–	–

	Balance 1 Jan 12 US$'000	Recognised in income US$'000	Recognised in equity US$000	Reclassified to other balance sheet account US$000	Balance 31 Dec 12 US$'000
Exploration, evaluation and development expenditure	**5,105**	**(2,669)**	**–**	**–**	**2,436**
Other items	**124**	**178**	**–**	**–**	**302**
Deferred tax balances in USA not brought to account	**(5,229)**	**2,491**	**–**	**–**	**(2,738)**
	–	**–**	**–**	**–**	**–**

18. TRADE AND OTHER PAYABLES

Current	2012 US$'000	2011 US$'000
Trade and other payables, stated at cost		
Trade payables	**2,037**	1,218
Exploration and development accruals	**2,346**	341
Operational and administration accruals	**1,613**	1,378
Related party payables	**–**	43
	5,996	2,980

19. EMPLOYEE BENEFITS

(a) Superannuation/pension plans

The consolidated entity contributes to several defined contribution employee superannuation plans in Australia. Employer contributions are based on various percentages of their gross salaries. The consolidated entity is under no legal obligation to make contributions in excess of those specified in Superannuation Industry (Supervision) legislation. The amount recognised, as expense was US$25,000 for the year ended 31 December 2012 (2011: US$29,000).

U.S. based employees are eligible to participate in a voluntary retirement savings plan under Section 401(k) of the US tax code ("401(k) plan"). Employer matching contributions under the 401(k) plan recognised as an expense was US$48,000 for the year ended 31 December 2012 (2011: US$82,000).

19. EMPLOYEE BENEFITS *cont.*

(b) Share-based payments

The Employee Share and Employee Option Plans, established by shareholder resolutions on 29 November 1994, provide for employees, executives and directors to be granted ordinary shares or options over ordinary shares at the discretion of the Nomination and Remuneration Committee.

Employee Share Plan

During the year, the Company issued 2,400,000 shares under its Employee Share Plan ("ESP") to two key management personnel as long term incentive compensation.

The shares were issued to the Trustee of the ESP on behalf of the key management personnel and under the terms of the ESP at a price of A$0.20 per share, being the minimum issue price under the terms of the ESP. The funds for the shares was provided to the key management personnel by the Company through an interest free limited recourse loan under the terms of the loan scheme under the ESP, which provides that if the borrower defaults on the loan the Company shall accept the shares issued under the ESP in full satisfaction of the loan. The term of the loans is 5 years.

The shares are unrestricted and vest on various dates from 1 June 2012 through to 1 January 2015.

Employee Option Plan

The following sets forth the share-based compensation transactions under the Company's Employee Option Plan.

The number and weighted average exercise prices of share options, is as follows:

In thousands of options	Weighted average exercise price 2012	Number of options 2012	Weighted average exercise price 2011	Number of options 2011
Outstanding at the beginning of the period	**A$1.68**	**3,366**	A$1.51	5,272
Granted during the period	**A$0.20**	**1,330**	–	–
Exercised during the period	**–**	**–**	–	–
Forfeited during the period	**A$2.02**	**2,689**	A$1.23	(1,906)
Outstanding at the end of the period	**A$0.24**	**2,007**	A$1.68	3,366
Exercisable at the end of the period	**A$0.35**	**556**	A$2.06	2,654

The options outstanding at 31 December 2012 have an exercise price in the range of A$0.20 to A$1.19 and a weighted average contractual life of 3.0 years. During the year, no share options were exercised (2011: Nil).

Each option is convertible to one ordinary share. The exercise prices of the options, determined in accordance with the Rules of the plan, are based on the ruling market prices when the options are issued.

All options expire on the earlier of their expiry date or when the holder's employment ceases unless otherwise approved by the Remuneration Committee. Options may not be exercised until they are vested and thereafter exercise is conditional on satisfaction of share price hurdles and the terms of issue. The vesting periods range from six months to four years after granting. The plan does not represent remuneration for past services.

19. EMPLOYEE BENEFITS *cont.*

(b) Share-based payments *cont.*

The terms and conditions of the option grants are as follows, whereby all options are settled by physical delivery of shares:

Grant date/employees entitled	Number of instruments	Contractual life of options
Option grant to other personnel at 27 February 2008	90,000	4.46 years
Option grant to key management personnel at 14 January 2009	60,000	3.52 years
Option grant to other personnel at 14 January 2009	395,500	3.52 years
Option grant to key management personnel at 25 February 2009	175,000	3.35 years
Option grant to other personnel at 25 February 2009	206,000	3.35 years
Option grant to key management personnel at 29 January 2010	600,000	3.54 years
Option grant to other personnel at 29 January 2010	1,546,000	3.54 years
Option grant to key management personnel at 8 February 2012	1,000,000	4.45 years
Option grant to other personnel at 22 March 2012	300,000	3.26 years
Option grant to other personnel at 31 July 2012	30,000	2.92 years
Total share option schemes with all or a portion of options outstanding at 31 December 2012	**4,402,500**	

The fair value of services received in return for share options granted are measured by reference to the fair value of share options granted. The estimate of the fair value of the services received is measured based on a Black-Scholes model. The contractual life of the option is used as an input into this model.

Share and option grants to key management personnel

During the year ended 31 December 2012, share grants of 2,400,000 and option grants of 1,000,000 were made to key management personnel (2011: Nil).

The following table summarises the fair value assumptions of shares and options granted to key management personnel during the years ended 31 December 2012 and 2011.

	Key management personnel 2012	Key management personnel 2011
Weighted average fair value at measurement date	**$0.07**	–
Weighted average share price	**$0.16**	–
Weighted average exercise price	**$0.20**	–
Expected volatility (expressed as weighted average used in the modelling under Black-Scholes model)	**105.45%**	–
Expected option life (expressed as weighted average used in the modelling under Black-Scholes model)	**2.9**	–
Expected dividends	**–**	–
Risk-free interest rate (based on national government bonds)	**2.39% – 3.64%**	–

The expected volatility is based on historic volatility (calculated based on the weighted average remaining life of the shares and options), adjusted for any expected changes to future volatility due to publicly available information.

Shares and options are granted under a service condition and minimum share price hurdles. Such conditions are not taken into account in the grant date fair value measurement of the services received, however, are considered in assumptions about the number of shares and options that are expected to become exercisable.

20. REHABILITATION PROVISIONS

Current	2012 US$'000	2011 US$'000
Balance at 1 January	**342**	8,571
Provisions made during the year	**–**	–
Assignment/conveyance of interests	**(93)**	–
Provisions reclassed from non-current classification	**–**	318
Provisions used during the year	**(48)**	(8,412)
Provisions revised during the year	**(54)**	(206)
Unwind of discount	**–**	71
Balance at 31 December	**147**	342
Non-current		
Balance at 1 January	**5,366**	5,182
Provisions made during the year	**18**	–
Assignment/conveyance of interests	**(168)**	(35)
Provisions reclassed to current classification	**–**	(318)
Provisions used during the year	**–**	–
Provisions revised during the year	**–**	44
Unwind of discount	**540**	493
Balance at 31 December	**5,756**	5,366
	5,903	5,708

21. CAPITAL AND RESERVES

Share capital

	Ordinary Shares	
In thousands of shares	2012	2011
On issue at 1 January	**235,284**	231,284
Shares issued	**2,400**	4,000
On issue at 31 December – fully paid	**237,684**	235,284

The Company does not have authorised capital or par value in respect of its issued shares.

The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the Company.

Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of operations where their functional currency is different to the presentation currency of the reporting entity.

Cash flow hedge reserve

Historically, the hedging reserve comprised the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that had not yet transpired.

Share-based compensation

The share-based compensation represents the value of unvested shares and options issued under the Company's Employee Share and Option Plans.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

21. CAPITAL AND RESERVES *cont.*

Capital management

The Board's policy is to maintain an appropriate capital base to sustain future development of the consolidated entity. This capital base may comprise equity and borrowings.

Neither the Company nor any of its subsidiaries are subject to externally imposed capital requirements.

22. FINANCING ARRANGEMENTS AND ADDITIONAL FINANCIAL INSTRUMENTS DISCLOSURES

Financing arrangements

At 31 December 2012, the consolidated entity had no debt outstanding (2011: Nil).

Additional financial instruments disclosures

Overview

The consolidated entity has exposure to the following risks from its use of financial instruments:

- Credit risk;
- Liquidity risk; and
- Market risk.

This note presents information about the consolidated entity's exposure to each of the above risks, their objectives, policies and processes for measuring and managing risk, and the management of capital. Further quantitative disclosures are included throughout this financial report.

Risk Management Framework

The Board of Directors has overall responsibility for the establishment and oversight of the risk management framework. There is no separate risk management committee.

Risk management policies are established to identify and analyse the risks faced by the consolidated entity, to set appropriate risk limits and controls, and to monitor risks and adherence to limits. Risk management policies and systems are reviewed regularly to reflect changes in market conditions and the consolidated entity's activities. The consolidated entity, through their training and management standards and procedures, aim to develop a disciplined and constructive control environment in which all employees understand their roles and obligations.

The forecast financial position of the consolidated entity is continually monitored and derivative financial instruments can be used to hedge exposure to fluctuations in commodity prices (refer to *Commodity Price Risk* below for further details).

The Board oversees how management monitors compliance with the consolidated entity's risk management policies and procedures and reviews the adequacy of the risk management framework in relation to the risks faced by the consolidated entity.

Credit risk

Credit risk represents the loss that would be recognised if counterparties failed to perform as contracted. The credit risk on financial assets of the consolidated entity that have been recognised is the carrying amount, net of any provision for doubtful debts. The consolidated entity has assessed that the counterparties credit ratings determined by a recognised ratings agency remains acceptable.

Exposure to credit risk

The carrying amount of the consolidated entity's financial assets represents the maximum credit exposure. The consolidated entity's maximum exposure to credit risk at the reporting date was:

	Consolidated	
	2012 US$'000	2011 US$'000
Cash and restricted cash deposits	**28,444**	41,579
Trade and other receivables	**2,558**	1,346
	31,002	42,925

As at 31 December 2012, there was no material exposure to credit risk in relation to cash held by banks as $18.5 million was held with Australian financial institutions rated AA with the remaining balances held in the USA with institutions rated A or higher.

22. FINANCING ARRANGEMENTS AND ADDITIONAL FINANCIAL INSTRUMENTS DISCLOSURES *cont.*

Additional financial instruments disclosures *cont.*

Credit risk *cont.*

Where possible, the consolidated entity manages its credit risk on trade receivables by dealing with only large reputable customers for its oil and gas sales. At balance date, approximately 34% of trade and other receivables were due from four such customers. The remainder of the receivables were due mainly from a number of joint owners of the jointly owned properties. The consolidated entity does not consider there to be any impairment indicators associated with these debtors. The consolidated entity's credit risk is limited to the carrying value of its financial assets. None of the consolidated entity's receivables are materially past due (2011: is consistent with 2012).

Liquidity risk

Liquidity risk is the risk that the consolidated entity and companies within the consolidated entity will not be able to meet their financial obligations as they fall due. The consolidated entity's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the consolidated entity's reputation.

Ultimate responsibility for liquidity risk management rests with the Board of Directors. The consolidated entity manages liquidity risk by monitoring of future rolling cash flow forecasts. These reflect management's expectations of the settlement of financial assets and liabilities.

The following are the contractual maturities of financial liabilities, including estimated interest payments.

	Contractual cashflows					
31 December 2012	Carrying amount US$000	6 mths or less US$000	6 – 12 mths US$000	1 – 2 years US$000	2 – 5 years US$000	5 years or more US$000
Trade and other payables	**5,996**	**5,996**	**–**	**–**	**–**	**–**
Total	**5,996**	**5,996**	**–**	**–**	**–**	**–**

	Contractual cashflows					
31 December 2011	Carrying amount US$000	6 mths or less US$000	6 – 12 mths US$000	1 – 2 years US$000	2 – 5 years US$000	5 years or more US$000
Trade and other payables	2,980	2,980	–	–	–	–
Total	2,980	2,980	–	–	–	–

Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices, interest rates will affect the consolidated entity's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return.

Foreign exchange risk

During 2011 and 2012, operating costs were incurred in Australian, Canadian and US dollars.

Throughout 2011 and 2012, the consolidated entity held the majority of its liquid funds in US dollars.

Fluctuations in the Australian dollar/US dollar exchange rate have impacted the underlying performance of the consolidated entity. The consolidated entity's policy is not to hedge the Australian dollar/US dollar exchange rate risk as income (cash inflows) and expenses (cash outflows), are predominantly denominated in US dollars, with the exception of Australian dollar denominated equity funding, consequently surplus funds are primarily held in US dollars.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

22. FINANCING ARRANGEMENTS AND ADDITIONAL FINANCIAL INSTRUMENTS DISCLOSURES *cont.*

Additional financial instruments disclosures *cont.*

Commodity price risk

As at 31 December 2012 the consolidated entity does not have any outstanding commodity price derivative instruments nor did it enter into any commodity price derivative instruments during 2012.

The revenue and income of the consolidated entity are affected by changes in natural gas and crude oil prices, and from time to time various financial transactions (swap contracts and collar contracts involving NYMEX commodity prices for natural gas and crude oil) may be undertaken to reduce the effect of these changes. The consolidated entity ensures that it has sufficient proved reserves of these commodities to cover all these transactions and it only enters into such derivatives to match its anticipated underlying physical production and reserves. The consolidated entity also limits the term of the transactions and the percentage of the Company's expected aggregate oil and natural gas production that may be hedged at any time.

Swaps

In a natural gas swap agreement the consolidated entity receives from the counterparty the difference between the agreed contracted fixed price and the quoted or published reference settlement price if the latter is lower than the fixed price. If the reference settlement price is higher than the agreed fixed price, the consolidated entity will pay the difference to the counterparty.

Collars

In a collar agreement, a floor price and a ceiling price are established. If there is no cash outlay upon entering a collar arrangement, it is called a "costless" or "cashless" collar. If quoted reference prices at the specified date (expiration date) are lower than the floor price, then the counterparty pays the price difference multiplied by the notional quantity to the consolidated entity. If the quoted reference prices at the specified date are higher than the ceiling price, then the consolidated entity pays the price difference multiplied by the notional quantity to the counterparty.

Interest rate risk

The consolidated entity's exposure to market interest rates primarily relates to the consolidated entity's cash holdings (2011: cash holdings and secured bank loan).

The financial instruments exposed to interest rate risk are as follows:

Financial assets	2012 US$'000	2011 US$'000
Cash and restricted cash deposits	**28,444**	41,579

Sensitivity analysis

In managing commodity price and interest rate risks the consolidated entity aims to reduce the impact of short-term fluctuations on the consolidated entity's earnings. However, credit considerations limit the amount of hedging with derivative instruments that the consolidated entity can enter into. The consolidated entity and the Company do not use derivative instruments to manage foreign exchange rate risk. Over the longer-term, permanent changes in commodity prices, interest rates and exchange rates will have an impact on profit.

The estimated impact of a 10 per cent change in the average commodity price for the year ended 31 December 2012 would have increased or decreased the consolidated entity's profit or loss by US$856,000 (2011: US$765,000) excluding potential impact of impairments. The estimated impact of a change of 100 basis points in interest rates would have increased or decreased the consolidated entity's profit or loss by US$13,000 (2011: US$4,000). The estimated impact of a 10 per cent change in the USD/AUD and USD/CAD exchange rates would have increased or decreased the consolidated entity's and the Company's profit or loss by a total of US$323,000 (2011: US$209,000).

22. FINANCING ARRANGEMENTS AND ADDITIONAL FINANCIAL INSTRUMENTS DISCLOSURES *cont.*

Fair values of financial assets and liabilities

The fair values of financial assets and liabilities, together with the carrying amounts shown in the balance sheet, are as follows:

	2012		2011	
	Carrying amount US$'000	Fair value US$'000	Carrying amount US$'000	Fair value US$'000
Trade and other receivables	**2,558**	**2,558**	1,346	1,346
Cash and restricted cash deposits	**28,444**	**28,444**	41,579	41,579
Trade and other payables	**(5,996)**	**(5,996)**	(2,980)	(2,980)
	25,006	**25,006**	39,945	39,945

The carrying values of all other financial assets and liabilities are estimated to approximate fair value because of their short maturity.

The carrying amounts shown in the balance sheet of the Company are equal to fair value.

The following tables detail the consolidated entity's fair values of financial instruments categorised by the following levels:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities

Level 2: Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices)

Level 3: Inputs for the asset or liability that are not based on observable market data (unobservable inputs)

2012	Level 1 US$000	Level 2 US$000	Level 3 US$000	Total US$000
Asset				
Other financial assets	**589**	**1,589**	**–**	**2,178**
Total assets	**589**	**1,589**	**–**	**2,178**

2011	Level 1 US$000	Level 2 US$000	Level 3 US$000	Total US$000
Asset				
Other financial assets	–	662	–	662
Total assets	–	662	–	662

Unless otherwise stated, the carrying amounts of financial instruments reflect their fair value.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

23. OPERATING LEASES

Leases as lessee

Non-cancellable operating lease rentals are payable as follows:

	2012 US$'000	2011 US$'000
Less than one year	**257**	489
Between one and five years	**105**	195
	362	684

The consolidated entity leases office space in Australia and the USA under operating leases. The leases typically run for a period of 3 years. None of the leases includes contingent rentals.

One of the leased properties was sublet by the consolidated entity. The lease and sublease expired in 2012.

During the year ended 31 December 2012, US$993,000 was recognised as an expense in the statement of comprehensive income in respect of operating leases including month-to-month leases (2011: US$1,002,000). US$8,000 (2011: US$27,000) was recognised as income in the statement of comprehensive income in respect of sub-leases.

24. CAPITAL AND OTHER COMMITMENTS

Capital expenditure commitments	2012 US$'000	2011 US$'000
Exploration, evaluation and development expenditure		
Contracted but not provided for and payable:		
Within one year	**1,986**	1,151
One year or later and no later than five years	**122**	278
	2,108	1,429

25. CONTINGENCIES AND LEGAL MATTERS

The consolidated entity is a defendant from time to time in legal proceedings. Where appropriate the consolidated entity engages legal counsel.

The production, handling, storage, transportation and disposal of oil and natural gas, by-products thereof and other substances and materials produced or used in connection with oil and natural gas operations were subject to regulation under U.S. federal, state and local laws and regulations primarily relating to protection of human health and environment. To date, expenditure related to complying with these laws and for remediation of existing environmental contamination has not been significant in relation to the results of operations of the Company.

The Company's U.S. subsidiary, Petsec Energy Inc. ("PEI") is required to provide bonding or security for the benefit of U.S. regulatory authorities and lease owners in relation to its obligations to pay lease rentals and royalties, the plugging and abandonment of oil and natural gas wells, and the removal of related facilities. As of 31 December 2012, the consolidated entity was contingently liable for US$5,300,000 of surety and supplemental bonds (2011: US$7,425,000) issued through a surety company to secure those obligations. At balance date US$5,300,000 of these bonds were collateralised by cash (2011: US$6,625,000).

26. DEED OF CROSS GUARANTEE

Pursuant to an ASIC Class Order 98/1418 dated 13 August 1998, relief is granted to certain wholly owned Australian subsidiaries of the Company from the Corporations Act requirements for preparation, audit, and publication of Financial Reports and Directors' Reports.

It is a condition of the Class Order that the Company and each of its subsidiaries enter into a Deed of Cross Guarantee Indemnity. The effect of the deed is that the Company guarantees to each creditor payment in full of any debt in the event of winding up of any of the subsidiaries under certain provisions of the Corporations Act. If a winding-up occurs under other provisions of the Act, the Company will only be liable in the event that after six months any creditor has not been paid in full. The subsidiaries have also given similar guarantees in the event that the Company is wound up.

The subsidiaries subject to the Deed are:

- Petsec Investments Pty. Limited
- Petroleum Securities Pty. Limited
- Najedo Pty. Ltd
- Petroleum Securities Share Plan Pty Limited
- Laurel Bay Petroleum Limited
- Ginida Pty. Limited
- Western Medical Products Pty. Limited

A consolidated statement of comprehensive income and consolidated balance sheet, comprising the Company and subsidiaries which are a party to the Deed, after eliminating all transactions between parties to the Deed of Cross Guarantee, as at 31 December 2012 and 2011, is set out as follows:

Summarised statement of comprehensive income and retained earnings/(accumulated losses)

	2012 US$000	2011 US$000
Other income and expenses	**4,833**	8,752
Operating expenses	**(2,433)**	(2,094)
Finance income	**126**	101
Net movement in provisions against loans and investments in controlled entities	**(12,161)**	(26,435)
Profit before tax	**(9,635)**	(19,676)
Income tax benefit/(expense)	**–**	–
Profit/(loss) after tax	**(9,635)**	(19,676)
Other comprehensive income	**–**	–
Total comprehensive income for the period	**(9,635)**	(19,676)
Retained earnings/(accumulated losses) at beginning of year	**(150,578)**	(130,902)
Retained earnings/(accumulated losses) at end of year	**(160,213)**	(150,578)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

26. DEED OF CROSS GUARANTEE *cont.*

Balance sheet

	2012 US$000	2011 US$000
Assets		
Cash and cash equivalents	18,530	31,367
Other receivables	4,982	9,927
Prepayments	111	108
Total current assets	23,623	41,402
Loans receivable from related parties	1,350	817
Other financial assets	14,502	11,000
Other investments	29,884	27,920
Property, plant and equipment	29	31
Total non-current assets	45,765	39,768
Total assets	69,388	81,170
Liabilities		
Trade and other payables	143	281
Employee benefits provision	38	45
Total current liabilities	181	326
Loans payable to controlled entities	4,087	8,042
Employee benefits provision	247	237
Total non-current liabilities	4,334	8,279
Total liabilities	4,515	8,605
Net assets	64,873	72,565
Equity		
Issued capital	186,375	185,793
Reserves	38,711	37,350
Retained earnings/(accumulated losses)	(160,213)	(150,578)
Total equity	64,873	72,565

27. CONSOLIDATED ENTITIES

		Ownership interest	
	Country of Incorporation	2012 %	2011 %
Parent entity			
Petsec Energy Ltd			
Significant subsidiaries			
Petsec Investments Pty. Limited	Australia	**100**	100
Petroleum Securities Pty. Limited	Australia	**100**	100
Najedo Pty. Limited	Australia	**100**	100
Petroleum Securities Share Plan Pty. Limited	Australia	**100**	100
Petsec America Pty. Limited	Australia	**100**	100
Petsec (U.S.A.) Inc.	USA	**100**	100
Petsec Energy Inc.	USA	**100**	100
Petsec Exploration and Production LLC	USA	**100**	100
Petsec Energy Canada Ltd[1]	Canada	**100**	–
Laurel Bay Petroleum Limited	Australia	**100**	100
Ginida Pty. Limited	Australia	**100**	100
Western Medical Products Pty. Limited	Australia	**100**	100

1. Petsec Energy Canada Ltd was incorporated on 6 February 2012 and holds the consolidated entity's shale oil interests in Alberta, Canada.

All entities carry on business in the country where they were incorporated.

28. SEGMENT REPORTING

The consolidated entity operates in the oil and gas industry.

Segment information is presented in the consolidated financial statements in respect of the consolidated entity's geographic segments, which reflects the presentation of information to the chief operating decision maker and may differ from the information required to be disclosed in accordance with the Accounting Standards.

Segment results include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. Segment acquisition of property, plant and equipment, intangibles and exploration, evaluation and development assets is the total cost incurred during the period to acquire segment assets that are expected to be utilised for more than one period.

In presenting information on the basis of geographical segments, segment revenue and assets are based on the geographical location of operations. 2011 segment net revenues after royalties include the effect of realised hedge gains of US$1,433,000. The realised hedge gain is not revenue under Accounting Standards (refer to *note 8 Derivative Gains* for further details).

In February 2012, the Company commenced shale oil exploratory activities in Alberta, Canada.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

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28. SEGMENT REPORTING *cont.*

	Australia		USA		Canada		Consolidated	
	2012 US$'000	2011 US$'000	2012 US$'000	2011 US$'000	2012 US$'000	2011 US$'000	2012 US$'000	2011 US$'000
Oil and gas sales and royalties	–	–	9,702	15,002	–	–	9,702	15,002
Royalties paid	–	–	(1,144)	(2,047)	–	–	(1,144)	(2,047)
Net revenues after royalties*	–	–	8,558	12,955	–	–	8,558	12,955
Segment net profit/(loss) before tax	(191)	26,524	(5,000)	(12,490)	(667)	–	(5,858)	14,034
Income tax expense							–	–
Profit/(loss) after tax							(5,858)	14,034
Depreciation, depletion and amortisation	9	12	3,872	5,192	–	–	3,881	5,204
Dry hole, impairment and abandonment expense	–	–	(1,349)	20,229	–	–	(1,349)	20,229
Exploration and work-over expense	–	–	3,888	478	622	–	4,510	478
Segment assets	22,209	32,997	37,795	33,439	4,273	–	64,277	66,436
Acquisition of property, plant and equipment and exploration, evaluation and development assets	6	4	6,917	3,888	4,211	–	11,134	3,892

* There are no inter-segment sales

	Australia		USA		Canada		Consolidated	
	2012 US$'000	2011 US$'000	2012 US$'000	2011 US$'000	2012 US$'000	2011 US$'000	2012 US$'000	2011 US$'000
Segment liabilities	562	563	11,120	8,571	667	–	12,349	9,134
Cash flows from operating activities	(2,193)	(2,059)	887	(4,536)	(45)	–	(1,351)	(6,595)
Cash flows from investing activities	500	40,865	(6,917)	(3,888)	(4,211)	–	(10,628)	36,977
Cash flows from financing activities	–	–	–	(12,833)	–	–	–	(12,833)

29. DISCONTINUED OPERATION

During the previous corresponding period, the consolidated entity sold its wholly owned subsidiary, Petsec Petroleum LLC that held the consolidated entity's interest in Block 22/12 Beibu Gulf, China resulting in the recognition of an accounting gain of US$29.8 million on disposal.

The effective sale date was 1 January 2011 and the total consideration comprised A$38 million cash and 15,000,000 options over Horizon Oil Limited ordinary shares with a three year term and exercise price of A$0.37 cents per share.

29. DISCONTINUED OPERATION *cont.*

The Block 22/12 Beibu Gulf interest represented the consolidated entity's China segment. The following table presents details of the contribution of this discontinued operation and the gain on sale.

	2011 US$'000
Results from discontinued operation	
GG&A expense	–
Tax expense	–
Result from operating activities, net of income tax	–
Net gain on sale of discontinued operation	29,807
Tax expense on net gain on sale of discontinued operations	–
Profit/(loss) for the period	29,807
Cash flows from discontinued operations	
Net cash from (used in) operating activities	–
Net cash from (used in) investing activities	–
Net cash from (used in) financing activities	–

The net gain on the sale of Block 22/12 Beibu Gulf has been calculated using the prevailing USD/AUD exchange rates on the date of the transaction, as follows:

	2011 US$'000
Sale proceeds	
– Cash	40,869
– Receivable	683
– Fair value of options in Horizon Oil Limited*	1,817
Total sales proceeds	43,369
Carrying value of net assets disposed	(13,562)
Net gain on sale of discontinued operations	29,807

* The options have an exercise price of A$0.37 per share, and can be exercised at any time up until 30 June 2014. The options are unlisted. There are no restrictions on Petsec selling the unexercised options to a third party. At the grant date, the options had a fair value of A$0.1126 per option.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

30. INTERESTS IN UNINCORPORATED JOINT OPERATING ARRANGEMENTS

Included in the assets of the consolidated entity are the following items which represent the consolidated entity's interest in the assets and liabilities in joint operating arrangements:

Assets	2012 US$'000	2011 US$'000
Exploration, evaluation and development expenditure – Tangible:		
Leases now in production		
Producing leases – at cost	**88,817**	86,859
Less: accumulated amortisation and impairment	**(63,977)**	(69,634)
	24,840	17,225
Represented by the following lease carrying values:		
– Main Pass 270	**12,769**	10,261
– Main Pass 19	**1,033**	2,920
– Onshore and coastal Louisiana	**7,589**	4,044
– Onshore Canada	**3,449**	–
Total exploration, evaluation and development expenditure – Tangible	**24,840**	17,225
Exploration and evaluation expenditure – Intangible:		
Not in production		
– Onshore Canada	**805**	–
– Other Gulf of Mexico leases	**1,695**	1,573
Total exploration, evaluation and development expenditure – Intangible	**2,500**	1,573

Liabilities	2012 US$'000	2011 US$'000
Rehabilitation provision:		
– Main Pass 19	**1,662**	1,510
– Main Pass 270	**377**	338
– Onshore and coastal Louisiana	**177**	522
	2,216	2,370

The contribution of the consolidated entity's joint operating arrangements to EBIT (including exploration write-offs and impairments; and excluding the effects of hedging):	2012 US$'000	2011 US$'000
– Main Pass 19	**(2,681)**	(5,973)
– Mobile Bay Area	**–**	(624)
– Main Pass 270	**1,174**	(9,088)
– Onshore and coastal Louisiana	**1,987**	(1,152)
– Other Gulf of Mexico leases	**–**	28
	480	(16,809)

30. INTERESTS IN UNINCORPORATED JOINT OPERATING ARRANGEMENTS *cont.*

The principal activity of all the joint operating arrangements is oil & gas exploration. Listed below is the name of each of the joint operating arrangements and the percentage working interest held in the joint operating arrangement by the consolidated entity as at and during the year ended 31 December:

	Interest held 2012	Interest held 2011
– Main Pass 19	**55.00%**	55.00%
– Main Pass 270	**22.50%**	22.50%
– Onshore and coastal Louisiana	**8.00%**	8.00% to 80.00%
– Other Gulf of Mexico leases[2]	**37.50% to 75.00%**	37.50% to 75.00%

31. WHOLLY OWNED AREAS OF INTEREST

Included in the assets and liabilities of the consolidated entity are the following items which represent the consolidated entity's wholly owned areas of interest:

Assets	2012 US$'000	2011 US$'000
Exploration, evaluation and development expenditure – Tangible:		
Leases now in production		
Producing leases – at cost	**48,429**	47,998
Less: accumulated amortisation and impairments	**(47,759)**	(46,094)
	670	1,904
Represented by the following lease carrying values:		
– Main Pass 18	**670**	1,904
– Chandeleur 31/32	**–**	–
	670	1,904
Not in production		
– Spare equipment	**–**	143
	–	143
Total exploration, evaluation and development expenditure – Tangible	**670**	2,047
Exploration and evaluation expenditure – Intangible:		
Not in production		
– Onshore Texas	**1,080**	416
Total exploration and evaluation expenditure – Intangible	**1,080**	416

Liabilities	2012 US$'000	2011 US$'000
Rehabilitation provision:		
– Main Pass 18	**162**	152
– Chandeleur 31/32	**3,525**	3,186
	3,687	3,338

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

31. WHOLLY OWNED AREAS OF INTEREST *cont.*

The contribution of the consolidated entity's areas of interest to EBIT (including exploration write-offs and impairments; and excluding the effects of hedging):	2012 US$'000	2011 US$'000
– Chandeleur 31/32	(23)	587
– Main Pass 18	(820)	(2,792)
– Main Pass 20	–	677
	(843)	(1,528)

32. RECONCILIATION OF CASH FLOWS FROM OPERATING ACTIVITIES

	2012 US$'000	2011 US$'000
Cash flows from operating activities		
Profit/(loss) for the period	(5,858)	14,034
Adjustments for:		
Depreciation, depletion and amortisation	3,881	5,204
Dry-hole, impairment and abandonment expense	(1,349)	20,229
Work-over expense	3,142	–
Net movement in fair value of investments	(1,219)	1,083
Profit/(loss) from discontinued operation	–	(29,807)
Gain on discharge of debt	–	(11,365)
Net foreign exchange losses/(gains)	(205)	33
Net loss/(gain) on property, plant and equipment	(266)	(5)
Net loss/(gain) on investments	(854)	–
Share-based payment expenses	151	28
Operating profit before changes in working capital and provisions	(2,577)	(566)
Decrease/(increase) in restricted cash deposits	1,200	(925)
Decrease/(Increase) in receivables and prepayments	(1,099)	1,798
(Decrease)/Increase in payables and provisions	1,125	(6,902)
Net cash from operating activities	(1,351)	(6,595)

33. RELATED PARTIES

The following were key management personnel of the consolidated entity at any time during the reporting period and unless otherwise indicated were key management personnel for the entire period:

Non-executive director

D A Mortimer
M L Harvey

Executive director

T N Fern (Chairman and Managing Director)

Executives

R A Keogh (President, Petsec Energy Inc.)
R Krenzke (Executive Vice President Exploration, Petsec Energy Inc.)
P Webb (Vice President Business Development and Land, Petsec Energy Inc.) – Joined on 1 February 2012
P Gahdmar (Company Secretary and Group Financial Controller, Petsec Energy Ltd)

Former executives

D Swords (General Counsel/Corporate Secretary, Petsec Energy Inc.) – Resigned from the Company on 31 March 2012
F Robertson (Chief Financial Officer, Petsec Energy Ltd) – Resigned on 3 February 2012

Key management personnel compensation

The key management personnel compensation included in personnel expenses (see note 6) is as follows:

	2012 US$	2011 US$
Wages and salaries	**1,111,571**	1,021,663
Service agreements	**757,569**	829,355
Superannuation & 401(k) plans	**49,492**	106,498
Bonuses	**188,142**	263,861
Termination benefits	**65,690**	–
Share-based payment compensation	**136,014**	24,913
Other benefits	**118,150**	146,163
	2,426,628	2,392,453

Individual directors and executives compensation disclosures

Information regarding individual directors' and executives' compensation and some equity instruments disclosures as permitted by Corporations Regulations 2M.3.03 and 2M.6.04 are provided in the Remuneration Report section of the Directors' Report on pages 18 to 25.

Apart from the details disclosed in this note, no director has entered into a material contract with the Company or consolidated entity since the end of the previous financial year and there were no material contracts involving directors' interests existing at year-end.

Non-executive directors appointed prior to 2003 are entitled to receive a retirement benefit that is equivalent to the remuneration received in the three years prior to retirement. Incoming non-executive directors appointed thereafter are not entitled to receive retirement benefits in accordance with the recommendations made by the ASX Corporate Governance Council. Directors' retirement obligations are presently US$203,000 in total (2011: US$199,000).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

33. RELATED PARTIES *cont.*

Transactions with key management personnel

Key management personnel of the Company and their immediate relatives control approximately 17.4 percent of the voting shares of the Company.

During the year, the Company issued 2,400,000 shares under its shareholder approved Employee Share Plan ("ESP") to two key management personnel as long term incentive compensation.

The shares were issued to the Trustee of the ESP on behalf of the key management personnel and under the terms of the ESP at a price of A$0.20 per share, being the minimum issue price under the terms of the ESP. The funds for the shares was provided to the key management personnel by the Company through an interest free limited recourse loan under the terms of the loan scheme under the ESP, which provides that if the borrower defaults on the loan the Company shall accept the shares issued under the ESP in full satisfaction of the loan. The term of the loans is 5 years.

The shares are unrestricted and will vest as follows:

(i) 1,000,000 shares on 1 June 2012

(ii) A further 633,334 on 1 January 2013

(iii) A further 633,333 on 1 January 2014

(iv) A further 133,333 on 1 January 2015

The aggregate amounts recognised during the year relating to key management personnel and their personally related entities, were a total expense of US$758,000 (2011: US$830,000). Refer to Remuneration Report for further details.

Assets and liabilities arising from the above related party transactions

	2012 US$'000	2011 US$'000
Non-current assets		
Related party receivables	1,350	816
Current liabilities		
Related party payables	–	56

Other related party disclosures

Information relating to subsidiaries is set out in note 28.

33. RELATED PARTIES *cont.*

Options and rights over equity instruments

The movement during the reporting period in the number of options over ordinary shares in Petsec Energy Ltd held, directly, indirectly or beneficially, by each key management person, including their related parties, is as follows:

	Held at 1 January 2012	Granted as compensation	Exercised	Other changes[1]	Held at 31 December 2012	Vested during the year	Vested and exercisable at 31 December 2012
Directors							
T Fern	2,000,000	–	–	(2,000,000)	–	–	–
Executives							
R Keogh	150,000	–	–	–	150,000	50,000	–
R Krenzke	–	–	–	–	–	–	–
P Webb[2]	–	1,000,000	–	–	1,000,000	–	–
D Swords[3]	260,000	–	–	(260,000)	–	–	–
P Gahdmar	225,000	–	–	–	225,000	75,000	–

	Held at 1 January 2011	Granted as compensation	Exercised	Other changes[1]	Held at 31 December 2010	Vested during the year	Vested and exercisable at 31 December 2011
Directors							
T Fern	2,000,000	–	–	–	2,000,000	525,000	–
Executives							
R Keogh	150,000	–	–	–	150,000	50,000	–
R Krenzke	–	–	–	–	–	–	–
D Swords[3]	260,000	–	–	–	260,000	86,666	–
P Gahdmar	225,000	–	–	–	225,000	74,999	–

1. Other changes represent options that expired or were forfeited during the year.
2. Mr Webb joined the Company on 1 February 2012.
3. Mr Swords resigned from the Company on 31 March 2012.

Key management personnel related parties held no options.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS *cont.*

33. RELATED PARTIES *cont.*

Movements in shares

The movement during the reporting period in the number of ordinary shares in Petsec Energy Ltd held, directly, indirectly or beneficially, by each key management person, including their related parties, is as follows:

	Held at 1 January 2012	Granted as compensation	Purchases	Received on exercise of options	Sales/ Disposal of relevant interest	Held at 31 December 2012
Directors						
T Fern	**28,826,876**	**2,000,000**	–	–	–	**30,826,876**
D Mortimer	**9,326,550**	–	–	–	–	**9,326,550**
M Harvey	–	–	–	–	–	–
Executives						
R Keogh	**3,612,500**	–	–	–	–	**3,612,500**
R Krenzke	**2,250,000**	–	–	–	–	**2,250,000**
P Webb[1]	–	–	–	–	–	–
D Swords[2]	–	–	–	–	–	–
P Gahdmar	**120,000**	**400,000**	–	–	–	**520,000**

	Held at 1 January 2011	Granted as compensation	Purchases	Received on exercise of options	Sales/ Disposal of relevant interest	Held at 31 December 2011
Directors						
T Fern	28,826,876	–	–	–	–	28,826,876
D Mortimer	9,326,550	–	–	–	–	9,326,550
M Harvey	–	–	–	–	–	–
Executives						
R Keogh	1,612,500	2,000,000	–	–	–	3,612,500
R Krenzke	250,000	2,000,000	–	–	–	2,250,000
D Swords[2]	–	–	–	–	–	–
P Gahdmar	120,000	–	–	–	–	120,000

1. Mr Webb joined the Company on 1 February 2012.
2. Mr Swords resigned from the Company on 31 March 2012.

34. PARENT ENTITY DISCLOSURES

As at, and throughout, the financial year ending 31 December 2012 the parent entity of the consolidated group was Petsec Energy Ltd.

	2012 US$'000	2011 US$'000
Result of parent entity		
Profit/(loss) for the period	(10,622)	(19,674)
Other comprehensive income	1,301	772
Total comprehensive income/(loss) for the period	(9,321)	(18,902)
Financial position of parent entity at year end		
Current assets	23,623	41,402
Total assets	77,167	89,388
Current liabilities	181	326
Total liabilities	13,274	16,814
Total equity of the parent entity comprising of:		
Share capital	186,375	185,793
Share-based payment compensation reserve	111	54
Foreign currency translation reserve	38,568	37,267
Accumulated losses	(161,162)	(150,540)
Total equity	63,893	72,574

Parent entity guarantees in respect of the debts of its subsidiaries

The parent entity has entered into a Deed of Cross Guarantee with the effect that the Company guarantees debts in respect of its subsidiaries. Further details of the Deed of Cross Guarantee and the subsidiaries subject to the deed are disclosed in note 26.

Parent entity contingencies and capital commitments

The parent entity had no contingent liabilities and capital commitments outstanding at 31 December 2012.

35. EVENTS SUBSEQUENT TO BALANCE DATE

There have been no events subsequent to balance date that would have a material effect on the consolidated entity's financial statements at 31 December 2012.

DIRECTORS' DECLARATION

1. In the opinion of the directors of Petsec Energy Ltd ("the Company"):
   (a) the financial statements and notes and the Remuneration report in the Directors' Report, set out on pages 18 to 67, are in accordance with the *Corporations Act 2001* including:
      (i) giving a true and fair view of the financial position of the Company and the consolidated entity as at 31 December 2012 and of their performance, as represented by the results of their operations and their cash flows, for the year ended on that date; and
      (ii) complying with Australian Accounting Standards and the Corporations Regulation 2001; and
   (b) the financial report also complies with International Financial Reporting Standards as disclosed in note 2; and
   (c) there are reasonable grounds to believe that the Company will be able to pay its debts as and when they become due and payable.
2. There are reasonable grounds to believe that the Company and the controlled entities identified in Note 26 will be able to meet any obligations or liabilities to which they are or may become subject to by virtue of the Deed of Cross Guarantee between the Company and those controlled entities pursuant to ASIC Class Order 98/1418.
3. The directors have been given the declarations required by Section 295A of the *Corporations Act 2001* from the chief executive officer and chief financial officer for the financial year ended 31 December 2012.

Signed in accordance with a resolution of the directors:

Terrence N. Fern
Director

Sydney, 26 February 2013

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF PETSEC ENERGY LTD

KPMG

Independent auditor's report to the members of Petsec Energy Ltd

Report on the financial report

We have audited the accompanying financial report of Petsec Energy Ltd (the company), which comprises the consolidated balance sheet as at 31 December 2012, and consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year ended on that date, notes 1 to 35 comprising a summary of significant accounting policies and other explanatory information and the directors' declaration of the Group comprising the company and the entities it controlled at the year's end or from time to time during the financial year.

Directors' responsibility for the financial report

The directors of the company are responsible for the preparation of the financial report that gives a true and fair view in accordance with Australian Accounting Standards and the *Corporations Act 2001* and for such internal control as the directors determine is necessary to enable the preparation of the financial report that is free from material misstatement whether due to fraud or error. In note 2(a), the directors also state, in accordance with Australian Accounting Standard AASB 101 *Presentation of Financial Statements*, that the financial statements of the Group comply with International Financial Reporting Standards.

Auditor's responsibility

Our responsibility is to express an opinion on the financial report based on our audit. We conducted our audit in accordance with Australian Auditing Standards. These Auditing Standards require that we comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance whether the financial report is free from material misstatement.

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

We performed the procedures to assess whether in all material respects the financial report presents fairly, in accordance with the *Corporations Act 2001* and Australian Accounting Standards, a true and fair view which is consistent with our understanding of the Group's financial position and of its performance.

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

Independence

In conducting our audit, we have complied with the independence requirements of the *Corporations Act 2001*.

INDEPENDENT AUDITOR'S REPORT *cont.*

TO THE MEMBERS OF PETSEC ENERGY LTD

KPMG

Auditor's opinion

In our opinion:

(a) the financial report of the Group is in accordance with the *Corporations Act 2001*, including:

(i) giving a true and fair view of the Group's financial position as at 31 December 2012 and of its performance for the year ended on that date; and

(ii) complying with Australian Accounting Standards and the Corporations Regulations 2001.

(b) the financial report also complies with International Financial Reporting Standards as disclosed in note 2(a).

Report on the remuneration report

We have audited the Remuneration Report included in pages 18 to 25 of the directors' report for the year ended 31 December 2012. The directors of the company are responsible for the preparation and presentation of the remuneration report in accordance with Section 300A of the *Corporations Act 2001*. Our responsibility is to express an opinion on the remuneration report, based on our audit conducted in accordance with auditing standards.

Auditor's opinion

In our opinion, the remuneration report of Petsec Energy Ltd for the year ended 31 December 2012, complies with Section 300A of the *Corporations Act 2001*.

KPMG

KPMG

Anthony Jones
Partner

Sydney

26 February 2013

CORPORATE GOVERNANCE STATEMENT

The Board of Petsec Energy Ltd ("Petsec") is committed to good corporate governance.

This statement sets out the main corporate governance practices adopted by the Company in the format of the Corporate Governance Principles and Recommendations (2nd Edition) (**Recommendations**) issued by the ASX Corporate Governance Council.

Unless otherwise stated, the Company's corporate governance practices were in place throughout the 2012 year and comply with the Recommendations. In a limited number of instances there are departures from the Recommendations, with the details and reasons for the departures stated below in italics.

1. LAYING SOLID FOUNDATIONS FOR MANAGEMENT AND OVERSIGHT

The Board operates within the requirements of the Company's Constitution and Board Charter which sets out the functions and responsibilities reserved for the Board and the matters which have been delegated to executive management. The Board Charter is posted on the Company's website.

The performance of the CEO and senior executives is reviewed annually by the Nomination and Remuneration Committee and is reported to and confirmed by the full Board.

2. STRUCTURE THE BOARD TO ADD VALUE

Board Composition and Director Independence

A majority of the Board are independent Directors. Currently the Board comprises three Directors, being one executive Director and two non-executive Directors. The non-executive Directors are considered by the Board to be independent, based on the criteria in the Recommendations.

Mr T N Fern acts in the roles of both Chairman and Managing Director. *Although Recommendations 2.2 and 2.3 provide that the Chairman should be an independent director and the roles of Chairman and Managing Director should not be exercised by the same individual, Directors consider that the current composition of the Board is appropriate for the Company at its current stage of development.*

To ensure that independent judgment is achieved and maintained in respect of its decision-making processes, the Board has adopted a number of measures which include the following:

- Directors are entitled to seek independent professional advice at the Company's expense,
- Directors having a conflict of interest in relation to a particular item of business must declare their interest and not vote on that item of business and absent themselves from the Board Meeting if required by the Board before commencement of discussion on the topic; and
- Non-executive Directors confer on a needs basis without management in attendance.

The Board is balanced in its composition with each Director bringing a range of complementary skills and experience to the Company as set out in the Directors' Report.

Board Committees

To assist the Board in discharging its responsibilities, the Board has a Nomination and Remuneration Committee and an Audit Committee. Each of these committees has its own written charter which has been approved by the Board.

Both Committees comprise two independent Directors and are chaired by Mr D A Mortimer. *The Company does not comply with Recommendations 4.2 and 8.2, as the Audit Committee and the Nomination and Remuneration Committee do not have three members, as the size of the Board does not allow for this.*

It is the Board's policy that Board Committees should:

- be chaired by a non-executive Director;
- should comprise a majority of non-executive Directors;
- be entitled to obtain independent professional or other advice at the cost of the Company; and
- be entitled to obtain such resources and information from the Company, including direct access to employees of and advisors to the Company, as they may require.

The qualifications and experience of Directors and Committee Members are included in the Directors' Report, as are details of the number of Board and Committee meetings held during the year.

CORPORATE GOVERNANCE STATEMENT *cont.*

2. STRUCTURE THE BOARD TO ADD VALUE *cont.*

Evaluation of performance of the Board, its Committees and individual Directors

A review of the Board's own performance is conducted annually, together with reviews of the performance of Board Committees and individual Directors. Each Director completes a questionnaire, with the collective responses being discussed by the Board to identify actions and goals to guide performance improvement. The questionnaire covers general and governance issues, overall Board performance and performance of individual Directors. Each of these evaluations has been performed during the past year.

Further details of the Company's performance evaluation processes are detailed in the Board Charter and Nomination and Remuneration Committee Charter, which are posted on the Company's website.

3. PROMOTING ETHICAL AND RESPONSIBLE DECISION MAKING

Code of Corporate Conduct

Petsec has always placed great importance on the maintenance of high ethical standards. The Board has adopted a Code of Corporate Conduct which is contained within the Board Charter posted on the Company's website. A similar document has been issued to all employees setting out the principles and standards with which they are expected to comply. Petsec participates in a "whistle-blower" programme with an independent third party which provides a means for staff to report any violation of the Company's Code of Ethics and Corporate Conduct or other wrongdoing.

The Company also has a Share Trading Policy, which is posted on the website.

Diversity

The Company adopted a Diversity Policy in August 2011, which is posted on the website. *Notwithstanding the requirements of Recommendations 2.6, 3.2, 3.3 and 3.4 to establish and disclose measurable objectives and results for achieving gender diversity, the Board has not adopted any numerical benchmarks or targets, and has not made the relevant disclosure as required by Recommendation 3.4, given the small size of the Company's board and workforce.* The Company will reconsider the need for measurable objectives as it grows.

4. SAFEGUARDING INTEGRITY IN FINANCIAL REPORTING

The Audit Committee is comprised of two independent Directors, each with relevant financial and technical experience, and is chaired by Mr D A Mortimer. Details of the qualifications of the Audit Committee members are set out in the Directors' Report.

The responsibilities of the Audit Committee include the monitoring and review of the external audit function, management reporting and internal controls, integrity of financial reporting and risk management. The Committee's Charter is posted on the Company's website.

The Audit Committee also appoints the auditor and monitors the 5-year auditor rotation policy, as set out in the Company's Auditor Appointment Policy posted on the website.

5. MAKING TIMELY AND BALANCED DISCLOSURE

The Company has policies and procedures in place to ensure the timely and appropriate release of all information required to be disclosed to shareholders in accordance with the ASX Continuous Disclosure regime. The Company Secretary has been appointed as the Continuous Disclosure Officer and with the approval of the Managing Director is responsible for ensuring compliance by overseeing and coordinating the release of information to the ASX, brokers, shareholders, the media and the public. The Continuous Disclosure Policy is posted on the Company's website.

6. RESPECTING THE RIGHTS OF SHAREHOLDERS

In addition to market disclosure through the ASX, Directors ensure that shareholders and other interested parties are informed through a range of other means including the Company's website at www.petsec.com.au which contains copies of all key disclosure information including announcements to the market, periodic reports, broker and analyst briefings and notices of meetings. The website also contains corporate governance information and general information regarding the Company's activities.

Shareholders and other interested parties are also able to register their email address with the Company to receive announcements made to the ASX.

It is the Company's policy that its external auditors attend each Annual General Meeting and be available to respond to questions from shareholders.

The Communications Policy is posted on the Company's website.

7. RECOGNISING AND MANAGING RISK

The Company recognises that an effective system of risk oversight, management and internal control is critical for its success.

A brief summary of the Company's processes are set out below. A more detailed summary is posted in the Corporate Governance section of the Company's website.

(a) Control Environment

The Board oversees the overall risk management and control framework of the Company to ensure an appropriate control environment is established and maintained spanning Petsec's operations, financial reporting and compliance activities.

The Audit Committee assists the Board in fulfilling its responsibilities in this regard by reviewing and monitoring financial and reporting matters, and the Company's risk management and internal control processes.

(b) Risk Assessment

Petsec runs two parallel risk management processes, one to identify and manage business and operational risk and the other to manage the financial reporting risks and underlying internal controls.

Identification and evaluation of key business and operational risks is conducted through:

(i) the annual risk management review, a formal process which is based on the approach prescribed in Australian Standard AS/NZS ISO 31000:2009 and carried out in the fourth quarter each year in conjunction with the preparation of the budget and strategic plan; and

(ii) assessment of risk as part of all business proposals for management or Board approval.

Key financial statement and financial reporting risks are reviewed and assessed, prior to the commencement of the internal and external audit programmes each year.

(c) Mitigation and Control

Petsec employs a range of techniques to mitigate and control risk including insurance, oil and gas price hedging, establishment of management accountabilities, and compliance with policies and procedures documented in the Company's Internal Control Policy manual and supporting documents.

(d) Information and Communication

Monthly management reports to the Board, which draw from both structured management information systems and management input, provide a regular and formal channel of communication within Petsec.

CORPORATE GOVERNANCE STATEMENT *cont.*

7. RECOGNISING AND MANAGING RISK *cont.*

(e) Monitoring

Formal monitoring of risk and controls at senior management and Board level is achieved by means of:

(i) the monthly management report to the Board;

(ii) detailed audit questionnaires and management sign-offs, which form part of the semi-annual audit process, and

(iii) an internal audit programme to evaluate and test the key controls over financial reporting that is conducted over the course of each year.

Petsec's Managing Director and Chief Financial Officer have provided a written statement to the Audit Committee in relation to each recent six-month reporting period in accordance with section 295A of the Corporations Act stating that, to the best of their knowledge and belief:

- the declaration given is founded on a sound system of risk management and internal compliance and control which implements the policies adopted by the Board; and
- the Company's risk management and internal compliance and control framework is operating efficiently and effectively in all material respects.

8. REMUNERATE FAIRLY AND RESPONSIBLY

The objective of the Company's remuneration policies is to provide fair and competitive remuneration to its Board, executives and staff in order for the Company to benefit by attracting and retaining a high quality team. The level and composition of Directors' and senior executives' remuneration is set out in the Remuneration Report in the Directors' Report together with further information on the structure and basis of remuneration paid.

The Nomination and Remuneration Committee is responsible for reviewing and making recommendations on remuneration policies for Directors and senior executives based on assessment of relevant market conditions, and linking remuneration to the Company's financial and operational performance. The Nomination and Remuneration Committee consists of two independent Directors, and is chaired by Mr D A Mortimer.

Executive remuneration may comprise salary, short term bonuses and share participation. All equity-based remuneration is made in accordance with thresholds approved by shareholders.

Non-executive Directors are remunerated by fees which are not performance-based. Non-executive Directors appointed prior to 2003 are entitled to receive a retirement allowance which is equivalent to the remuneration received in the three years prior to retirement. Incoming non-executive Directors are not entitled to receive retirement benefits, in accordance with the Recommendations.

EXPLORATION AND PRODUCTION INTERESTS – USA

Lease/Project		Wells	Lease Date	Term (Years)	Operator	Status	Working Interest	Net Revenue Interest
Onshore Louisiana, USA								
Marathon Prospect	SL 20221	SL 20221 No. 1 Well SL 20221 No. 2 Well	9/12/09	3	Castex Energy	HBP	0.080000	0.058400
	SL 20367		9/06/10	3	Castex Energy	Part HBP	0.080000	0.058400
	SL 20368		9/06/10	3	Castex Energy	HBP	0.080000	0.058400
	SL 20369	SL 20369 No. 1 Well SL 20369 No.2 Well (drilling)	9/06/10	3	Castex Energy	HBP	0.080000	0.058400
	SL 20528		12/01/11	3	Castex Energy	Part HBP	0.080000	0.058400
	SL 20529		12/01/11	3	Castex Energy	Part HBP	0.080000	0.058400
	SL 20530		12/01/11	3	Castex Energy	Part HBP	0.080000	0.058400
	SL 20753		14/09/11	3	Castex Energy	Part HBP	0.080000	0.058400
Gulf of Mexico, USA								
Chandeleur 31	OCS-G 27215	A 001 Well Serial No. 1772840870	1/06/05	5	Petsec Energy	HBP	1.00000	0.81833
		A 002 ST 1 Well Serial No. 1772840871					1.00000	0.81833
Chandeleur 32	OCS-G 27214	A 001/1D Well Serial No. 1772840872	1/06/05	5	Petsec Energy	HBP	1.00000	0.81833
Main Pass 18	OCS-G 27194	G-6 Well API No. 17-725-40815-00	1/07/05	5	Petsec Energy	HBP	1.00000	0.83333
Main Pass 19	OCS-G 26146	G-1 Well API No. 17-725-40800-00	1/07/04	5	Petsec Energy	HBP	0.55000	0.45833
		G-2 Well API No. 17-725-40801-00					0.55000	0.45833
		G-3 Well API No. 17-725-40802-00					0.55000	0.45833
		G-4 Well API No. 17-725-40813-00					0.55000	0.45833
		G-5 Well API No. 17-725-40814-00					0.55000	0.45833
		G-7 Well API No. 17-725-40817-00					0.55000	0.45833
Main Pass 270	OCS-G 22812	A 001 Well Serial No. 1772440889	1/07/01	5	ENI US Operating	HBP	0.22500	0.18750
		A 002 Well Serial No. 1772440890					0.22500	0.18750
		A 003 Well Serial No. 1772440906					0.22500	0.18750
Breton Sound 39	OCS-G 33683		1/07/10	5	Petsec Energy	Primary	0.56250	0.45703125
Breton Sound 42	OCS-G 33684		1/07/10	5	Phoenix Energy	Primary	0.37500	0.3046875
Main Pass 132	OCS-G 33682		1/07/10	5	Petsec Energy	Primary	0.75000	0.60938
Main Pass 273	OCS-G 33690		1/07/10	5	Petsec Energy	Primary	0.37500	0.3046875
Main Pass 274	OCS-G 33691		1/07/10	5	Petsec Energy	Primary	0.37500	0.2990625
Ship Shoal 36	OCS-G 33637		1/05/10	5	Petsec Energy	Primary	0.75000	0.60938
Ship Shoal 74	OCS-G 33638		1/05/10	5	Petsec Energy	Primary	0.75000	0.60938

SHAREHOLDER INFORMATION

AS AT 26 MARCH 2013

NUMBER OF SHAREHOLDERS

Issued capital was 237,683,622 ordinary shares held by 4,641 shareholders.
All issued shares carry equal voting rights on a one for one basis.

DISTRIBUTION OF SHAREHOLDERS

Size of Holding	No of Holders
1-1,000	1,376
1,001-5,000	1,413
5,001-10,000	633
10,001-100,000	986
100,001 and over	233
Total number of shareholders	**4,641**
Number holding less than a marketable parcel	2,122

LARGEST TWENTY SHAREHOLDERS

The largest twenty shareholders held 128,022,021 ordinary shares being 53.86% of the issued ordinary capital.

Name of Holder	No of Shares	%
CANNING OIL PTY LTD	25,709,116	10.82
MARTIN PLACE SECURITIES NOMINEES PTY LTD	24,426,981	10.28
LIPPO SECURITIES NOMINEES (BVI) LTD <CLIENT A/C>	11,332,500	4.77
HSBC CUSTODY NOMINEES (AUSTRALIA) LIMITED	9,585,631	4.03
MR DAVID A MORTIMER & MRS BARBARA L MORTIMER <WALLAROY PROVIDENT FUND A/C>	8,636,448	3.63
NATIONAL NOMINEES LIMITED	6,385,627	2.69
CITICORP NOMINEES PTY LIMITED	5,445,826	2.29
HESTIAN PTY LTD	4,281,950	1.80
BNP PARIBAS NOMS PTY LTD <DRP>	4,070,000	1.71
HUMBOLDT CAPITAL CORPORATION	3,674,532	1.55
MR ROSS ADRIAN KEOGH	3,112,500	1.31
DEN DUYTS CORPORATION PTY LTD	3,057,635	1.29
CALVESTON WORLDWIDE LTD	2,460,000	1.03
SINO CHAMPION DEVELOPMENT LIMITED	2,459,579	1.03
PIAT CORP PTY LTD	2,400,498	1.01
PETROLEUM SECURITIES SHARE PLAN PTY LIMITED	2,400,000	1.01
MRS ELIZABETH HEATH	2,270,000	0.96
ASIAN CORPORATE ADVISERS (BVI) LIMITED	2,250,000	0.95
EVELIND PTY LTD <THE ALPHA A/C>	2,063,198	0.87
IRONSIDE PTY LTD <IRONSIDE FAMILY A/C>	2,000,000	0.84

Substantial shareholders disclosed in substantial shareholder notices given to the Company are as follows:

CANNING OIL PTY LTD including its associates	30,826,876	12.97

FIVE YEAR COMPARATIVE DATA SUMMARY

For personal use only

		2008	2009	2010	2011	2012	% change
Financial Performance							
Net Production (Bcfe)[1]		12.1	7.1	3.9	2.3	**2.4**	7%
Average Gas Price Received	(US$/Mcfe)	$8.70	$7.36	$6.98	$5.69	**$3.50**	(38%)
US$ millions							
Net Revenue	(US$m)	$105.3	$52.0	$27.1	$13.0	**$8.6**	(34%)
Net Profit/(Loss) after Tax		$(44.5)	$(14.9)	$(35.2)	$14.0	**$(5.9)**	n/a
Realised hedge gains[2]	(US$m)	$0.0	$0.0	$0.0	$1.5	**$0.0**	n/a
Depreciation, depletion & amortisation	(US$m)	$57.3	$21.0	$12.5	$5.2	**$3.9**	(25%)
Exploration Writeoffs, Impairments, abandonment and work-over expenses	(US$m)	$75.1	$11.9	$20.0	$20.6	**$3.2**	(84%)
Derivative (gains)/losses	(US$m)	$0.0	$0.0	($1.2)	$0.9	**($1.1)**	n/a
Gain on discharge of debt	(US$m)	$0.0	$0.0	$0.0	($11.3)	**$0.0**	n/a
Net financial expense	(US$m)	$7.1	$5.5	$3.0	$0.5	**$0.4**	(20%)
Income tax (benefit)/expense	(US$m)	($15.4)	$7.8	$13.6	$0.0	**$0.0**	n/a
(Profit)/Loss from discontinued operation[3]	(US$m)	$0.0	$0.0	$0.4	($29.8)	**$0.0**	n/a
EBITDAX[4]	(US$m)	$79.6	$31.3	$13.1	$1.6	**$0.5**	(69%)
EBITDAX Margin /Mcfe	(US$/Mcfe)	$6.58	$4.43	$3.36	$0.72	**$0.22**	(69%)
Operating Cashflow after Tax	(US$m)	$85.2	$28.0	$1.8	($6.6)	**($1.4)**	(80%)
Balance Sheet							
Total Assets	(US$m)	$161.7	$130.7	$90.1	$66.4	**$64.3**	(3%)
Cash[5]	(US$m)	$13.7	$25.4	$23.1	$41.6	**$28.4**	(32%)
Debt[6]	(US$m)	$48.8	$28.4	$28.9	$0.0	**$0.0**	n/a
Shareholders Equity	(US$m)	$85.9	$80.0	$42.8	$57.3	**$51.9**	(9%)
Cashflow and Capital Expenditures							
Net Cashflow from:							
Operations	(US$m)	$85.2	$28.0	$1.8	($6.6)	**($1.4)**	(80%)
Investing	(US$m)	($43.5)	($10.2)	($11.9)	$37.0	**($10.6)**	n/a
Financing	(US$m)	($53.7)	($7.4)	($0.2)	($12.8)	**$0.0**	n/a
		($12.0)	$10.4	($10.3)	$17.6	**($12.0)**	
Capital Expenditures[7]							
Exploration	(US$m)	$30.8	$1.5	$7.7	$0.6	**$4.9**	724%
Development	(US$m)	$11.4	$3.5	$1.2	$2.8	**$8.4**	200%
Acquisition	(US$m)	$1.1	$0.2	$1.7	$0.5	**$1.5**	194%
		$43.3	$5.2	$10.6	$3.9	**$14.8**	

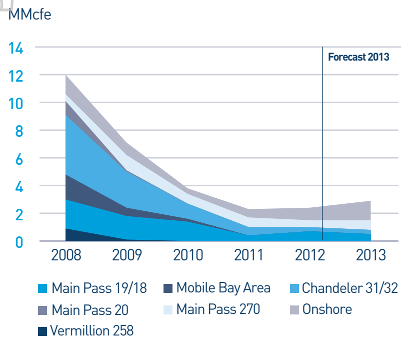
FIVE YEAR COMPARATIVE DATA SUMMARY *cont.*

FOR THE YEAR ENDED 31 DECEMBER 2012

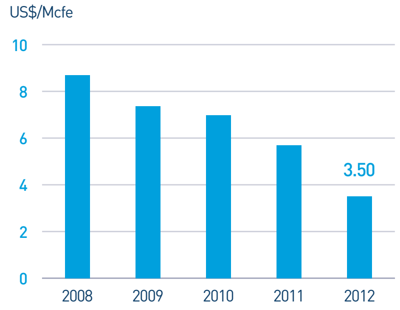
		2008	2009	2010	2011	2012	% change
A$ million							
EBITDAX[4]	(A$m)	$93.0	$39.6	$14.3	$1.5	**$0.5**	(69%)
Net Profit/(Loss) after Tax	(A$m)	($52.0)	($18.9)	($38.3)	$13.5	**($5.7)**	n/a
Operating Cashflow after Tax	(A$m)	$99.6	$35.5	$2.0	($6.3)	**($1.3)**	(79%)
(US$/A$ exchange rate)		$0.86	$0.79	$0.92	$1.04	**$1.04**	0%
Operating Margins & Costs							
Average Gas Price Received	(US$/Mcfe)	$8.70	$7.36	$6.98	$5.69	**$3.50**	(38%)
+ Other Income	(US$/Mcfe)	($0.06)	$0.00	$0.27	$0.07	**$0.63**	n/a
– Operating Costs (GG&A + LOE)	(US$/Mcfe)	$2.06	$2.93	$3.99	$5.04	**$3.92**	(22%)
= EBITDAX[4]	(US$/Mcfe)	$6.58	$4.43	$3.26	$0.72	**$0.22**	(70%)
Depreciation, Depletion & Amortisation	(US$/Mcfe)	$4.73	$2.97	$3.22	$2.29	**$1.59**	(31%)
Finding and Development Costs (three year average 2P)[8]	(US$/Mcfe)	$6.20	$24.38	n/a	n/a	**n/a**	n/a
Reserves							
Proved and Probable Reserves (2P)[9]	(Bcfe)	51.9	40.4	34.3	15.4	**11.1**	(28%)
Reserves Replacement Ratio (%)		(46%)	(62%)	(55%)	n/a	**n/a**	

1. Bcfe = billion cubic feet of gas equivalent. Mcfe = thousand cubic feet of gas equivalent.
2. Realised hedge gains in FY2011 relate to derivative natural gas collar contracts which settled during the period. The Company had included the impact of the realised hedge gains, in the reported Net Revenue and EBITDAX amounts in the above table and elsewhere in the comparative Full Year Financial Statements to better reflect the commercial impact and rationale for holding these derivative instruments.
3. Profit from discontinued operation in FY2011 reflects the accounting gain recognised on the disposal of the wholly owned subsidiary which held the China oil interests.
4. EBITDAX = earnings before interest (financial income and expense), income tax, depreciation, depletion, amortisation, rehabilitation and exploration (including dry hole, impairment and abandonment expense, seismic and repair expense) and realised hedge gains. EBITDAX is a non-IFRS number and is unaudited.
5. FY2012 includes US$5.4m of cash deposits held in an escrow account to secure operator bonds that are on issue to the Bureau of Ocean Energy Management ("BOEM").
6. FY2008 through FY2010 debt is shown net of original issue discount and transaction costs.
7. Excludes minor (non oil & gas) property, plant & equipment expenditure and investments.
8. Finding & Development (F&D) costs include all exploration writeoffs. 2008 through 2009 includes the cost of acquiring interests in producing assets in 2007.
9. FY2008 through FY2010 2P reserve estimates are based on Petsec Energy assessment and include previously booked China oil reserves (disposed in June 2011). FY2011 and FY2012 2P reserve estimates are based on independent assessment.

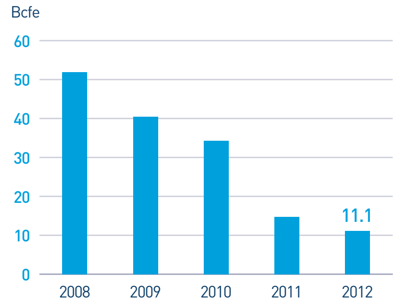
Production History by Field



Average Gas Equivalent Price Received per Mcfe

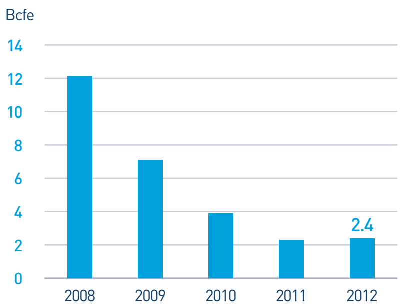


Proved and Probable Reserves* at Year End

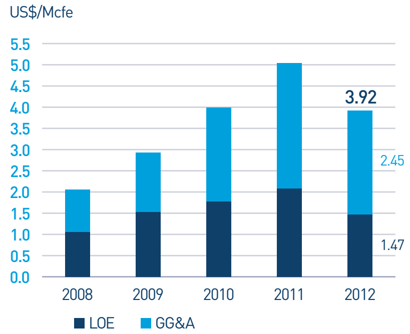


*Petsec Internal Estimate FY2008 – FY2010
* Independent assessment FY2011 – FY2012

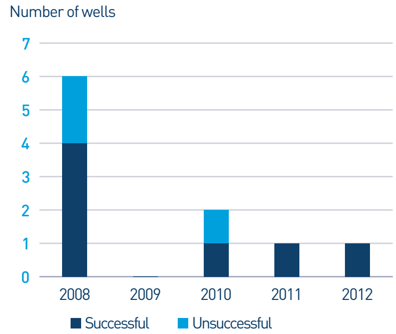
Production



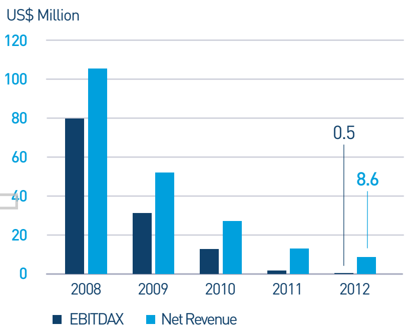
Total Operating Expense (LOE & GG&A) per Mcfe



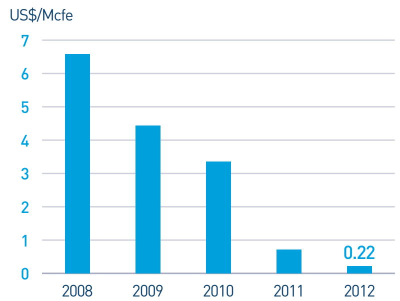
Wells Drilled/Successful – USA/China (50% success rate – 5 years to 2012)



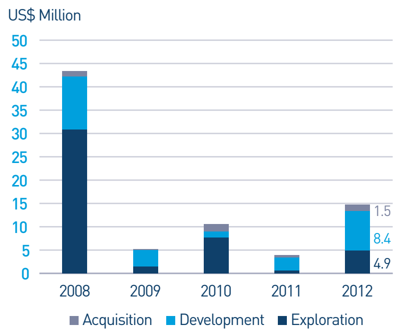
EBITDAX and Net Revenue



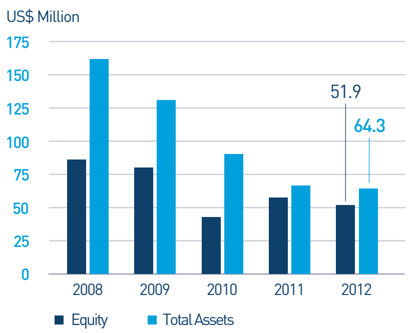
Cash Operating Margins



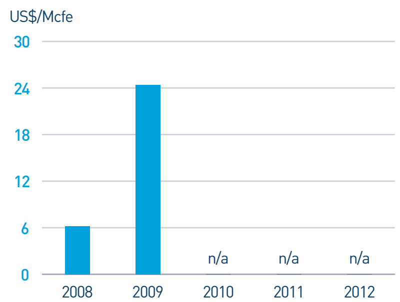
Exploration, Development and Acquisition Expenditure



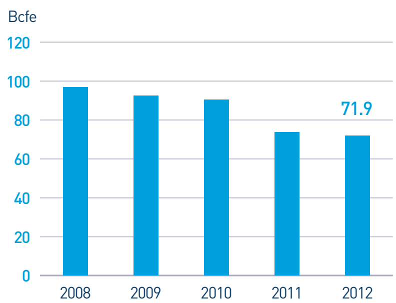
Balance Sheet Equity and Total Assets



Finding & Development Costs 3 yr Average on Petsec 2P Reserves



Cumulative 2P Reserve Additions



CORPORATE DIRECTORY

Board of Directors

Terrence N Fern – Chairman
David A Mortimer – Non-executive Director
Michael L Harvey – Non-executive Director

Company Secretary

Paul Gahdmar

USA Management

Ross A Keogh – President of Petsec Energy Inc. and Group Chief Financial Officer

Ron A Krenzke – Executive Vice President – Exploration

Patrick Webb – Vice President Business Development and Land

Australian Management

Terrence N Fern – Chairman & Managing Director

Paul Gahdmar – Company Secretary & Group Financial Controller

Registered Office and Principal Business Office

Level 13, 1 Alfred Street
Sydney NSW 2000 Australia
Telephone: +61 2 9247 4605
Facsimile: +61 2 9251 2410

USA Offices

1000 Louisiana
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Houston, TX 77002
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Facsimile: +1 713 457 5838

301 E. Kaliste Saloom Road
Suite 300, Lafayette
LA 70503 USA
Telephone: +1 337 989 1942
Facsimile: +1 337 989 7271

Share Register

Boardroom Pty Limited
Office: Level 7, 207 Kent Street, Sydney NSW 2000 Australia
Postal: GPO Box 3993, Sydney NSW 2001
Telephone: 1300 737 760
International: + 61 2 9290 9600
Facsimile: 1300 653 459
International: + 61 2 9279 0664
Email: enquiries@boardroomlimited.com.au

Depositary Receipts Register

The Bank of New York
6th Floor, 620 Avenue of the Americas
New York NY 10011 USA
Telephone: +1 646 885 3300
Facsimile: +1 646 885 3043

Auditors

KPMG Chartered Accountants
King Street Wharf
10 Shelley Street
Sydney NSW 2000 Australia

Stock Exchange

Listed on the Australian Stock Exchange, Symbol: PSA
Traded in USA on ADRs, Symbol: PSJEY

For further information

Web: www.petsec.com.au

www.colliercreative.com.au #PET0004

Petsec Energy

PETSEC ENERGY LTD
ABN 92 000 602 700

Certain statements in this report regarding future expectations and plans of the Company may be regarded as 'forward-looking statements.' Although the Company believes that its expectations and plans are based upon reasonable assumptions, it can give no assurance that its goals will be met. Actual results may vary significantly from those anticipated due to many factors, including oil and gas prices, operating hazards, drilling risks, environmental risks and uncertainties in interpreting engineering and other data relating to oil and gas reservoirs, as well as other risks.