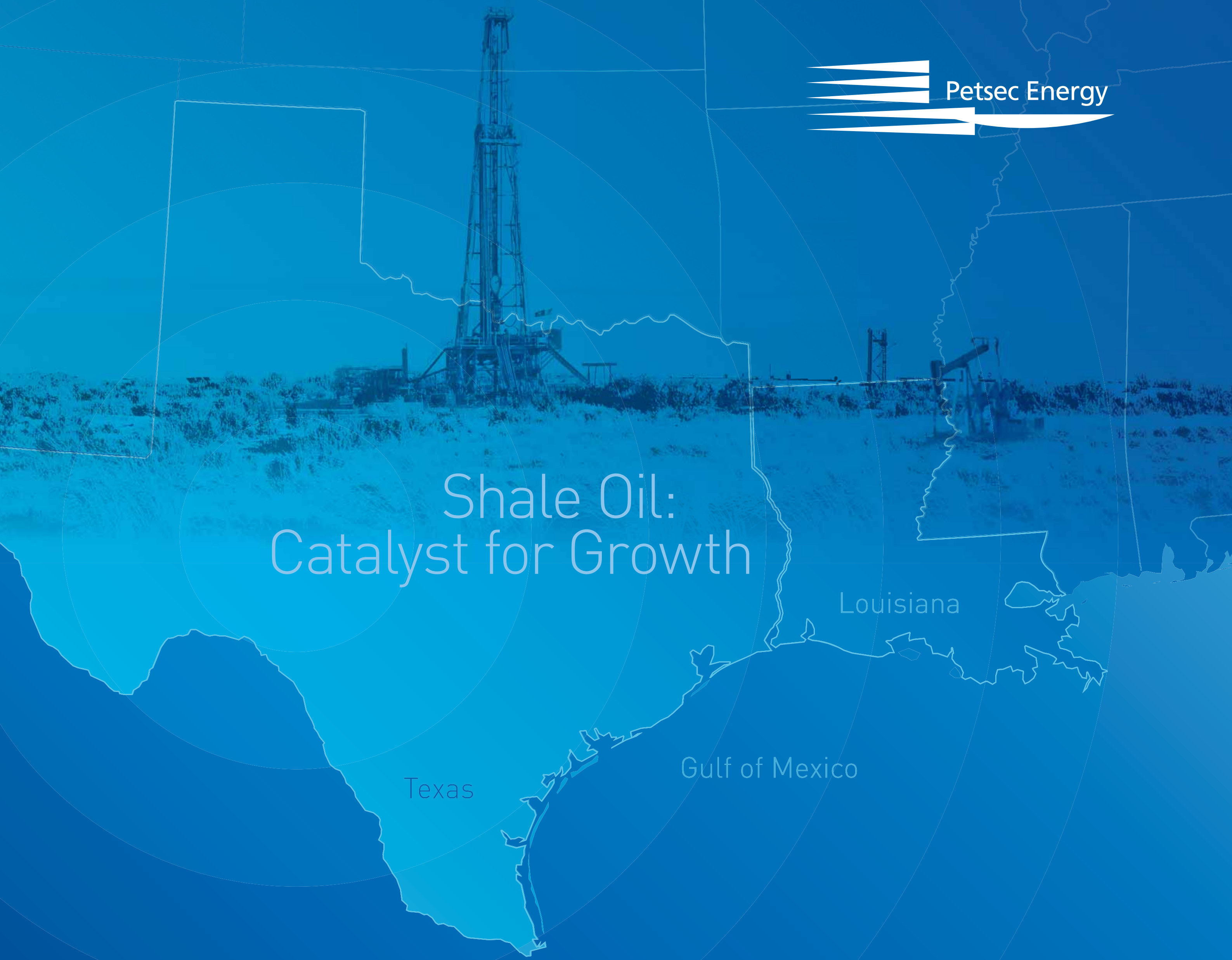
Petsec Energy

Shale Oil: Catalyst for Growth



PETSEC ENERGY LTD ANNUAL REPORT 2011

CAPITAL STRUCTURE – AS AT 26 MARCH 2012

AUSTRALIA

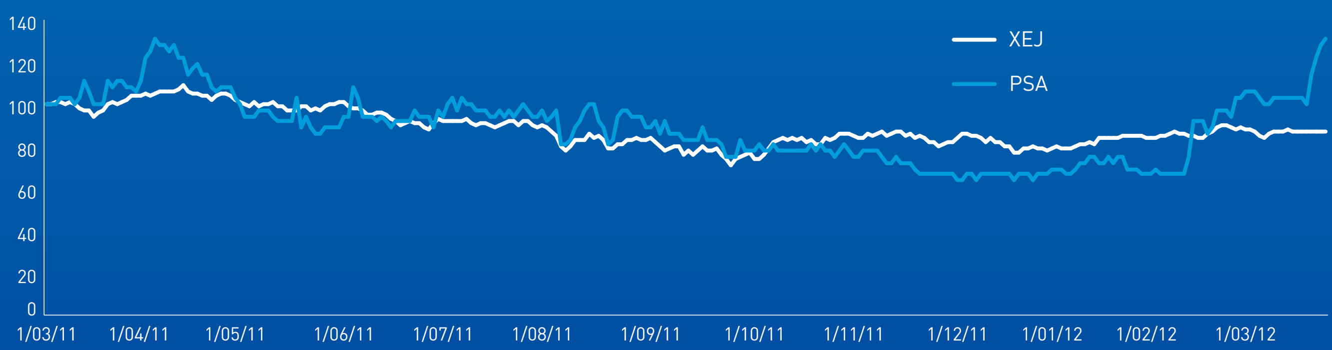
EXCHANGE	ASX
TICKER	PSA
SHARES ON ISSUE	235.7 MILLION
OPTIONS ON ISSUE	4.3 MILLION
SHARE PRICE	0.235
MARKET CAPITALISATION	$55.4 MILLION

SOURCE: AUSTRALIAN STOCK EXCHANGE (ASX)

USA

EXCHANGE	OTC PINK SHEETS
TICKER	PSJEY

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



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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,
23 May 2012, at the Museum of Sydney,
corner of Bridge and Phillip Streets, Sydney.

YEAR IN BRIEF 2011

FINANCIAL

Net profit after tax: US$14.0 million.

Oil & gas sales (net of royalties): US$13.0 million (US$5.69/Mcfe).

EBITDAX: US$1.6 million (US$0.72/Mcfe).

US$29.2 million term debt settled in May 2011 – Company now debt free; gain of US$11.4 million.

China oil interests sold in June 2011 – cash consideration of A$38 million; gain of US$29.8 million.

Dry hole, impairment and abandonment expense of US$20.2 million.

Acquisition, development & exploration expenditure: US$3.9 million.

Plug and abandonment expenditure: US$8.4 million.

Cash at 31.12.2011: US$41.6 million.

Ryder Scott independently estimated proved and probable (2P) oil and gas reserves at 31.12.2011 were 15.4 Bcfe, PV10 US$39 million.

OPERATIONS

Production: 2.3 Bcfe – down 41% on 2010; due to the effect of natural decline coupled with shut ins and curtailments at a number of the Company's main producing fields.

Main Pass 270 A-3 well ceased producing in April 2011 due to influx of sand and remains shut in until a work-over can be undertaken to restore production from the well.

Marathon Field production constrained by limited sales pipeline capacity.

Marathon gas/condensate Field development, Louisiana Gulf Coast:

- The Marathon #2 well in August 2011 confirmed the productive reservoirs found in the first well and extended the known pays across the structure. Production of the well commenced in November 2011.
- A third Marathon well with a target depth of 19,000 feet was spud in early March 2012 to serve as a further development well for the field.
- New pipeline options for the Marathon Field are currently being evaluated to allow for increased production from the existing two wells, the third well being drilled, and further development wells.

Plug and abandonment work completed for the Mobile Bay and Main Pass Block 20 fields.

SHALE OIL

Established a number of strategic alliances to capture shale oil expertise, commenced regional studies and technical evaluation in four areas in North America. Leasing was initiated in two areas and drilling in one.

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 by participating in up to four wells. First well was spud in March 2012.

CHAIRMAN'S REPORT

T N FERN
Chairman and
Managing Director

2011 was a year of significant change in direction for the Company in response to continuing low natural gas prices in the USA and a difficult operating environment in the Gulf of Mexico following the Macondo well blow out and oil spill in early 2010.

Over the year, Petsec Energy refocussed its exploration and production business away from its traditional, predominantly gas operations on the Gulf of Mexico shelf, towards deeper prospects that hold large potential reserves in the Louisiana Gulf Coast region and the emerging unconventional shale oil plays onshore North America.

Exploration of deeper, large potential reserve prospects in the Gulf Coast successfully began in late 2010 with participation in the discovery of the substantial gas/condensate Marathon Field, followed by an equally successful second well completed in September 2011.

A third well to develop the Marathon Field was spud in March 2012.

New sales pipeline facilities are scheduled to be completed midyear to allow increased production from the existing two wells, this third well, and further development wells.

Progress has been made in the Company's participation in emerging North American shale oil plays, with a number of strategic alliances formed, several prospective areas identified, and recently the initiation of lease acquisition in two play areas. The first test well was spud in early March 2012 in a project located in Alberta, Canada.

We believe shale oil offers Petsec Energy the highest exposure to potentially large oil reserves for the least risk and capital. We believe shale oil will be the catalyst for the Company's growth.

To financially position the Company for this change in business direction, debt of US$29.2 million was cleared, and the China oil interests were divested, resulting in Petsec Energy holding no debt and sufficient working capital to pursue its new business plan.

At 31 December 2011, the Company had no debt, US$41.6 million in cash, independently estimated proved and probable (2P) oil and gas reserves of 15.4 Bcfe with an estimated present value (PV10) of US$39 million, which should produce in the order of 2 Bcfe in the 2012 financial year, a strong portfolio of large oil and gas prospects with mapped potential of 400 to 750 Bcfe and two advancing shale oil projects in North America.

The Company believes it is well positioned to achieve significant growth over the next few years.

The Board and I would like to thank you, our shareholders, for your continued support and look forward to sharing with you the next exciting chapter in the Petsec Energy story.

T N Fern
Chairman and Managing Director

WE BELIEVE SHALE OIL WILL BE THE CATALYST FOR THE COMPANY'S GROWTH

OPERATIONS REPORT

PRODUCTION

Petsec Energy achieved net production of 2.2 billion cubic feet (Bcf) of gas and 21,516 barrels of oil in the 2011 year from the Company's five producing fields in the Gulf of Mexico and Louisiana Gulf Coast – Main Pass 270, Marathon, Main Pass 18/19 and Chandeleur 31/32.

PETSEC ENERGY GULF OF MEXICO EXPLORATION AND PRODUCTION LEASES

EXPLORATION

In response to the significant decline in U.S. natural gas prices due to the oversupply of natural gas from shale gas plays, the Company has moved its focus away from small gas prospects on the Gulf of Mexico shelf to large, deeper oil and gas/condensate prospects in the Gulf Coast and to unconventional shale oil, onshore North America.

Conventional

This change in strategy to explore large, deeper oil and gas/condensate prospects in the Gulf Coast led to participation in the 18,000 foot well to test the Marathon Prospect which resulted in a large gas/condensate discovery in October 2010. The well was brought into production in late December 2010, producing at 25 MMcfpd.

EACH WELL HAS THE PRODUCTIVE CAPACITY OF 25MMCFE/DAY

MARATHON GAS/CONDENSATE FIELD PRODUCTION FACILITIES, GULF COAST LOUISIANA, USA
PHOTOGRAPHY: GEORGE PAYNE © 2010

In April 2011, a second well was drilled, which confirmed the productive reservoirs found in the first well, and extended the known field pays across the structure. Proved and probable (2P) reserves are now estimated to be 150 to 200 Bcfe for the field. The second well was brought into production in November 2011 at a restricted rate of 10 million cubic feet of gas equivalent (MMcfe) per day due to pipeline capacity constraints which also required the shut-in of the initial producing well. Each well has the productive capacity of 25MMcfe/day. In mid 2012 new pipeline facilities are expected to be completed to allow maximum production rates for the current and future development wells. The third well on the field was spud in March 2012.

The Company has a portfolio of ten large deep prospects each ranging in size between 20 and 200 Bcfe, with a total mapped potential of 400 to 750 Bcfe. We do not expect to test these prospects before 2013, while gas prices are so low. Instead the Company will concentrate on developing unconventional shale oil in onshore North America.

Unconventional

In the 2011 year, the Company embarked on its onshore shale oil strategy in North America.

The Company established a number of strategic alliances with parties who possess shale oil expertise in North America and commenced regional studies and technical evaluation in four areas where it is expected large leaseholds can be acquired at reasonable lease and royalty costs. In two areas the technical evaluation has located areas of high potential ('Sweet Spots') and leasing has been initiated. The Company aims to secure a sufficiently large lease area during 2012, which can hold the potential for a 100 MMbbl resource within which through further drilling a 2P reserve of 35 MMbbl could be established.

In February 2012, the Company farmed-in to a shale oil project in Alberta, Canada where it can earn a 24.5% working interest in leases covering 17,280 acres by participating in up to four wells. The first well was spud on 9 March 2012 and reached target depth in late March 2012. The well was extensively logged and cored to provide the necessary data to allow correlation with previously drilled wells and to confirm the viability of the shale oil play and the areas which should next be leased. Full evaluation will take three to four months, and further drilling is contemplated in the fourth quarter of 2012.

IN THE 2011 YEAR, THE COMPANY EMBARKED ON ITS ONSHORE SHALE OIL STRATEGY IN NORTH AMERICA

STRATEGY FOR FUTURE GROWTH

2011–2013 BUSINESS PLAN

Major changes in trading conditions in the Gulf of Mexico (GoM) over the last few years due to the global financial crisis, the repercussions of the Macondo well oil spill, and a 75% decline in the U.S. natural gas prices, has caused the Company to change its business plan which had served it well over the years from 2002 to 2007. The Company's historic operations of drilling small (5 to 10 Bcfe) gas prospects, with a record of 80% drilling success, high returns and payback within a year, is no longer viable under the current gas price and operating conditions in the GoM.

The 75% decline of U.S. natural gas prices from an average of US$9.16/Mcf in 2008 to US$2.30/Mcf in March 2012 has been caused by an oversupply of natural gas due to the success of shale gas horizontal wells and fracking in the U.S. The U.S. natural gas storage level of 2.4 Tcf on 23 March 2012 was 59% above the five year average which has impacted the NYMEX 12 and 36 month forward strip prices which at 4 April 2012 were US$2.86/Mcf and US$3.58/Mcf, respectively. U.S. shale gas production has risen from 1% of total U.S. natural gas production in 2005 to 28% in 2010 with estimates by the U.S. Energy Information Administration estimating it could reach 49% of total annual U.S. gas production of 27 Tcf by 2035. This increase in gas supply is likely to keep U.S. gas prices at these low levels for the next few years.

The Company's new business plan is to operate in North America, focus on oil rather than gas, and on large resources rather than small, with an objective within the 2011-2013 timeframe to establish an oil resource of the order of 100 million barrels and a 2P reserve of 35 million barrels of oil in unconventional shale oil, and 100 Bcfe in conventional deep geologic section.

To accomplish this objective the Company would eliminate debt, sell non-core assets to fund the new 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, while reducing our operational exposure to the Federal waters of the Gulf of Mexico shelf.

In 2011 the Company's US$29.4 million of debt was eliminated, some US$40 million was raised through the disposition of the China oil interests,

ESTABLISH AN OIL RESOURCE OF THE ORDER OF 100 MILLION BARRELS OF OIL

HORIZONTAL DRILLING FOR SHALE OIL, USA

offshore leases were significantly culled to those which held large prospects only – 10 prospects with a combined mapped gross potential of 400 to 750 Bcfe, the large, deep section Marathon gas/condensate Field was discovered in late 2010 and further developed in 2011 with estimated reserves of 150 to 200 Bcfe, and strategic alliances were forged with experienced shale oil players, regional studies were completed resulting in the selection of four study areas, two of which were evaluated in detail and on which leasing has proceeded.

SHALE OIL – CATALYST FOR GROWTH

Unconventional shale oil plays will be Petsec Energy's primary focus of exploration in 2012/2013 while U.S. natural gas prices remain low.

Why Shale Oil?

Petsec Energy believes that shale oil offers the Company the highest exposure to large potential oil reserves for the least risk and capital because: Recent advances in horizontal drilling and multi-stage fracking of horizontal wells in the U.S. have made extraction of oil from shale commercially viable:

- The shale oil play is emerging – large areas of open land are available to lease at modest prices;
- Potential to acquire large oil resources (>100 MMbbl recoverable) within the bounds of Petsec Energy's current working capital;
- Potential to increase investment value by an order of magnitude with a modest drilling programme;
- The Company has valuable shale oil expertise relationships in the U.S. through its 22 year North American operations history; these include Mike Harvey, Petsec director and an early and successful participant in the Eagle Ford shale oil play.

Why Shale Oil in North America?

Petsec Energy has operated in the U.S. since 1989 and has explored offshore in the Gulf of Mexico and onshore in Louisiana, Texas, California, Utah, Colorado, Wyoming, Montana and North Dakota. North America is at the forefront of shale oil extraction technology, has vast remaining oil reserves, large oil demand and extensive infrastructure to develop and sell oil. Importantly North America has:

- Large shale oil reserves potential: USGS estimates greater than 3 trillion barrels of oil recoverable from shale;
- Extensive lease availability:
  – Many shale basins;
  – Private mineral ownership;

WORKING BEAM OIL PUMP, TEXAS, USA

- Largest market for oil:
  – Net imports of 9.6 MMbbl per day;
- Forefront of shale oil technology:
  – Exploration, drilling, fracking and development;
- Best oil and gas infrastructure:
  – Extensive network of pipelines;
- Highly liquid transaction market for funding and exit.

Petsec Energy Shale Oil Objectives

The Company's objectives within its 2011-2013 business plan is to:

- Establish a net resource of 100 MMbbl (4P) recoverable;
- Secure farm-out partners for reserves drilling and further lease acquisition;
- Establish net reserves of >35 MMbbl – demonstrate flow rates from horizontal fracked wells that provide 12 month pay back of development wells;
- Monetise.

Petsec Energy Shale Oil Strategy

The Company's strategy to achieve its shale oil objectives is to:

- Work with our shale expertise partners to identify areas with appropriate resource play characteristics – porosity, permeability, TOC, brittleness, containment etc;
- Focus on historic producing areas that are relatively inactive and where the source rocks are oil-prone, thick, rich and at appropriate drilling depths;
- Utilise existing well log data and geological data to recognise and quantify the potential of source rocks as resource play targets;
- Determine the core areas of the new plays ('Sweet Spots'), and acquire key acreage at low royalty level and costs per acre before the play is actively developed;
- Drill test wells to calibrate logs to geology and for 'proof of concept';
- Expand leasehold to significant acreage position that indicates a sufficiently large resource (>100 MMbbl recoverable) to be attractive to a large E&P company;
- Farm-out or sell all or a portion of the acreage to a large E&P with the financial capacity and drilling technology capability to fully exploit the play.

SOURCE: US ENERGY INFORMATION ADMINISTRATION BASED ON DATA FROM VARIOUS PUBLISHED STUDIES. CANADA AND MEXICO PLAYS FROM ARI. UPDATED MAY 9, 2011.

ACHIEVEMENTS TO DATE OF THE 2011-2013 BUSINESS PLAN

Corporate

- Eliminated US$29 million debt in May 2011 – now debt free;
- A$38 million raised from disposition of China oil interests in June 2011;
- 15.4 Bcfe (2P) reserves; PV10: US$39 million at 31/12/11.

Conventional: Oil & gas/condensate; high potential prospects

- Drilled 2 successful wells to-date on the large gas/condensate Marathon Field – a third well is currently being drilled and further wells planned;
- Estimated gross reserves of the Marathon Field: 150 to 200 Bcfe (Petsec share: 8 to 12 Bcfe);
- 10 mapped prospects with gross potential: 400 to 750 Bcfe (67 to 125 MMboe); (20 to 200 Bcfe each).

Unconventional: Shale Oil

- Established joint ventures with experienced shale oil partners;
- Regional studies – 4 study areas selected;
- Determination of 'Sweet Spots' in 2 areas: potential > 2,000 bbl of oil recoverable per acre;
- Leasing commenced in 2 areas;
- Confirmation drilling in Alberta, Canada.

WHY WILL THE COMPANY SUCCEED WITH ITS SHALE OIL OBJECTIVE?

Petsec Energy has operated successfully in the U.S. since 1989 creating substantial value from limited capital through drilling success. It has many valuable relationships in the North American oil and gas industry which will be brought to bear in our pursuit of shale oil.

The extraction of oil from shale with fracked, horizontal wells will see oil reserve growth in North America not seen since the 1970's and affords the small independent E&P company the opportunity to acquire and determine substantial resources far and above that which could be achieved normally from conventional drilling.

Petsec Energy has the U.S. operational knowledge, shale oil expertise alliances, funding and determination to succeed and in so doing the ability to increase the value of the Company by an order of magnitude within the 2011–2013 plan.

2012 EXPLORATION AND DEVELOPMENT PROGRAMME

Conventional: Gas/Condensate	Marathon #3 well: • Spud 4th March 2012 TD 19,000 feet • Estimated 107 days to drill, log & case Facilities to accommodate well flows of the order of 25 MMcfe/day per well
Unconventional: Shale Oil	Lease acquisition: 2–3 areas Drilling: • Vertical: 1–3 wells • Horizontal: 1–2 wells

Petsec Energy

DIRECTORS' REPORT AND FINANCIAL REPORTS

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DIRECTORS' REPORT

For the year ended 31 December 2011

The directors present their report together with the Financial Report of Petsec Energy Ltd ("the Company") and of the consolidated entity, being the Company and its subsidiaries, for the financial year ended 31 December 2011 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 Australia Post, Crescent Capital Partners Limited and Buildcorp Advisory Board and is a Director of the Defence Strategic Reform Advisory Board, Clayton Utz Foundation and the Grant Samuel Advisory Board. In 2011, Mr Mortimer was appointed as Chairman of the Defence Industry Innovation Board.

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, President of the Sydney University Football Club, and Director of the Australian Schoolboys Rugby Foundation.

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

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 37 years of experience in the oil and gas exploration and production industry. His career includes experience in management and growth, exploration program development, prospect generation and acquisition, joint ventures, and corporate divestiture. In his early career Mr. Krenzke worked for major and large independent oil 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 co-founded Gryphon Exploration Company which was formed in 2000 and was ultimately sold in 2005 for US$285 million. From 2006 through 2008, Mr. Krenzke worked as a consultant in business development and evaluation of exploration and producing properties in the Gulf Coast, Gulf of Mexico and North Sea regions. In 2008 he joined Saxet Petroleum as Executive Vice President of Exploration, leaving in 2009 to join Petsec. Mr. Krenzke holds a Bachelor of Science degree in Geophysics from Texas A&M University.

Denis Swords

General Counsel and Corporate Secretary of PEI

Mr Swords joined the Company in 2005 as the General Counsel and Corporate Secretary of Petsec Energy Inc. Mr Swords has over 29 years of experience working in and with the oil and gas industry. He earned a Master of Science degree in Geology from the University of New Orleans and worked as an exploration geologist for Tenneco Exploration and Production Company and Sandefer Offshore from 1982 until he enrolled in the Louisiana State University Law School in 1989. After receiving his Juris Doctor Degree in 1992, Mr Swords became a partner in a mid-sized law firm where he counselled numerous oil and gas clients, until joining Petsec.

Fiona A Robertson

Chief Financial Officer

Ms Robertson joined the Company in 2002 as the Chief Financial Officer of the Petsec Energy Ltd group. Ms Robertson has over 30 years of corporate finance experience including more than 20 in the resources industry. She spent 14 years working for The Chase Manhattan Bank in London, New York and Sydney, and eight years with Delta Gold Ltd as General Manager, Finance/Chief Financial Officer. In October 2011, Ms Robertson became a Non-Executive Director of One Asia Resources Limited. Ms Robertson is also a Non-Executive Director of Drillsearch Energy Limited. Ms Robertson holds a Master of Arts degree in geology from Oxford University, is a Fellow of the Australian Institute of Company Directors and a Member of the Australasian Institute of Mining and Metallurgy. Ms Robertson resigned her position of Chief Financial Officer on 3 February 2012 to devote more time to her non-executive roles with other companies.

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 over 15 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.

3. Directors' meetings

The Board has a formally constituted Audit Committee and a Nomination and Remuneration Committee, of which each director is a member. A non-executive director 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	**11**	**–**	**4**	**3**
T N Fern	11	–	4*	3*
D A Mortimer	11	–	4	3
M L Harvey	10	–	4	3

* Mr Fern attended as an invitee.

4. Remuneration report

The Remuneration Report is set out on pages 18 to 26 and forms part of the Directors' Report for the financial year ended 31 December 2011.

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 USA within the shallow waters of the Gulf of Mexico and onshore Louisiana and Texas, and oil exploration in the shallow waters of the Beibu Gulf off the south coast of China.

In June 2011, Petsec Energy sold its wholly owned subsidiary which held the Company's entire interest in Block 22/12 Beibu Gulf, China, a separate reportable segment (see *notes 28 Segment Reporting* and *29 Discontinued Operation* of the notes of the consolidated financial statements for further details).

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 revenues (after royalties and realised hedge gains) of US$13.0 million for the twelve months to 31 December 2011, representing a decrease of 52% on the previous corresponding period (2010: US$27.1 million) due to the combined effect of lower production volumes and lower average gas equivalent sales prices received for the year – 2,277 MMcfe and US$5.69/Mcfe, respectively (2010: 3,882 MMcfe and US$6.98/Mcfe).

The lower production volumes for the current period resulted from natural decline in field production, production shut ins and curtailments at various times during the year due to sales pipeline issues, and the shut in of the Main Pass 270 A-3 well in April 2011 due to an influx of sand in the well bore.

Lease operating expense of US$4.7 million (2010: US$6.9 million) and geological, geophysical and administrative expense of US$6.7 million (2010: US$8.2 million) for the full year were both lower than in the previous corresponding period, reflecting lower production and the reduction and streamlining of the consolidated entity's U.S. Gulf of Mexico operations.

Earnings before interest, income tax, DD&A and exploration expense and including realised hedge gains ("EBITDAX") for the twelve months to 31 December 2011 of US$1.6 million (2010: US$13.1 million) reflected the lower net revenues generated for the period.

The EBITDAX (cash operating) margin for the current period was US$0.72/Mcfe (2010: US$3.36/Mcfe), representing a 13% (2010: 48%) gross operating margin.

6. Financial review cont.

Highlights *cont.*

Depreciation, depletion, and amortisation ("DD&A") expense for the current period decreased 58% to US$5.2 million (2010: US$12.5 million) as a result of the lower production for the year and the reduction in the carrying values of certain U.S. oil and gas properties resulting from impairments recognised in 2010.

Financial expenses of US$0.6 million (2010: US$3.5 million) were lower, reflecting the settlement of the U.S. subordinated term loan during the current period.

The consolidated entity periodically reviews the carrying values (i.e. book value) of its oil and gas properties and, in accordance with accounting standards and the consolidated entity's policy, is required to demonstrate that the carrying value of its properties are no less than, the estimated future discounted cash flow to be generated from the expected production from these properties.

For the current period, the consolidated entity recognised dry hole, impairment and abandonment expense of US$20.2 million (2010: US$19.5 million) mainly comprised of impairment provisions against certain producing properties due to lower than anticipated future performance of certain of the wells coupled with the continued softening of natural gas prices since the beginning of the year (see *note 7 – Profit/(loss) for the Period* of the notes to the consolidated financial statements for further details).

The consolidated entity recorded a net profit after tax for the twelve months to 31 December 2011 of US$14.0 million (2010: loss of US$35.2 million) after one-off accounting gains recognised on the discharge of the subordinated term loan (US$11.4 million) and the disposal of the wholly owned subsidiary which held the China joint venture interests (US$29.8 million) – see *note 29 Discontinued Operations* of the notes to the consolidated financial statements for further details. The net impact of the one-off accounting gains were offset to some extent by the recognition of dry hole, impairment and abandonment expense of US$20.2 million in the current period (see *note 7: Profit/(loss) for the Period* of the notes to the consolidated financial statements for further details).

Financial position

During the year, all outstanding amounts under the subordinated term loan owed by the U.S. subsidiary Petsec Energy Inc. ("PEI") were settled. The amount of the term loan of US$29.2 million was fully extinguished in exchange for US$12 million in cash plus, the conveyance of a part interest in some of the Company's US properties, these being a 2.5% working interest in the three Main Pass 270 producing wells, a 2.0% working interest in Petsec Energy's leases over the Marathon gas/condensate discovery, and 25% of PEI's working interest in ten non-producing leases in the Gulf of Mexico and the exploration area of Main Pass 270 (see *note 18 Borrowings* of the notes to the consolidated financial statements for further details). The consolidated entity is now debt free.

In June 2011, the Company sold its wholly owned subsidiary, Petsec Petroleum LLC, which held its interest in Block 22/12 in the Beibu Gulf, China, to Horizon Oil Limited for cash consideration of A$38 million, plus 15 million share options with a three year term and an exercise price of A$0.37 (see *note 29 Discontinued Operations* of the notes to the consolidated financial statements for further details).

The proceeds received from the sale of the China interests together with the settlement of the U.S. subordinated term loan considerably strengthened the balance sheet and cash position of the consolidated entity.

At 31 December 2011, the consolidated entity had no debt and held total cash deposits of US$41.6 million including US$6.6 million of cash deposits held in an escrow account to partially secure US$7.4 million of operator bonds that are on issue to the Bureau of Ocean Energy Management, Regulation and Enforcement ("BOEMRE"). In the previous corresponding period the consolidated entity had secured bank loans of US$29.2 million (before US$0.3 million of unamortised debt issue costs) and held total cash deposits of US$23.1 million including US$5.7 million of restricted cash deposits.

7. Operations review

USA, Gulf of Mexico/Onshore Louisiana

Gulf of Mexico

Operating conditions in the Gulf of Mexico continue to be negatively impacted by low gas prices, and a more difficult operating environment post the 2010 Macondo well blowout. The Company responded to these difficult operating conditions by eliminating debt, raising capital through the disposition of its China oil interests and redirecting its exploration focus away from the Gulf of Mexico shelf, to deep large potential reserve prospects in the Louisiana Gulf Coast region, and to the emerging North American unconventional shale oil resource plays (see Shale Oil section below for further details).

Operations

Petsec Energy currently produces oil and gas in the offshore shallow waters of the Gulf of Mexico and the Gulf Coast of Louisiana in five producing fields. The main oil and gas fields are Main Pass 270, Marathon (Atchafalaya Bay), Main Pass 18/19, and Chandeleur Area 31/32.

The Company experienced a number of curtailments of production at its larger fields, particularly Main Pass 270 and the Marathon Field throughout the year, mainly due to third party sales pipeline shut-ins, resulting in a 23% reduction to the expected production for the year of 3 Bcfe. In addition to the pipeline issues, the Main Pass 270 A-3 well ceased producing in April 2011 due to an influx of sand, and remains shut in until a work-over can be undertaken to restore production from the well. The Company is currently waiting on a proposal from the operator regarding the timing of future well operations.

Production from the Marathon Field had been restricted since mid July 2011 because of third party sales pipeline capacity issues. Currently, pipeline capacity for Marathon production is restricted to 10 MMcfpd, resulting in the Marathon #1 well being shut-in and the Marathon #2 well which was brought into production in November 2011, restricted to 10 MMcfpd. The Marathon #1 well was producing at a gross daily rate of 24 MMcfpd prior to the pipeline restrictions. The Marathon #2 well is expected to be capable of similar rates.

New facilities are scheduled to be built mid 2012 to allow optimal production from the existing two wells, the third well due to spud in March 2012, and further development wells (see Exploration/Development section below for further details).

Exploration/Development

In April 2011, the Company participated in the drilling of the Marathon #2 well – the second well drilled in the Marathon gas/condensate Field, Louisiana Gulf Coast.

The Marathon #2 well, located approximately 2,950 feet (900 metres) from the successful Marathon #1 well, reached target depth of 21,160 feet (6,450 metres) in August 2011 confirming the productive reservoirs found in the #1 well and extended the known field pays across the structure. The #2 well commenced production in November 2011. While the well is capable of producing at 24 MMcfe per day similar to the #1 well it is currently restricted to a gross production rate of 10 MMcfe per day due to the third party pipeline constraints.

Shale Oil

In response to continuing low US natural gas prices, the Company has redirected itself to oil prospects, particularly the emerging unconventional shale oil plays, onshore North America, where it believes the Company can achieve the highest return on its capital invested. During the year, the Company made a number of strategic alliances and conducted regional reviews to identify areas of shale oil potential which are not being actively explored. The Company expects to be an "early mover" in areas where the shale source rocks are liquid rich and to acquire a sizeable holding of high quality acreage before it becomes competitive and costly to lease.

For competitive reasons, the location of the projects and leasing activities will remain confidential until the desired lease acquisition has been completed.

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. To earn its interest in the leases, the Company will pay 35% of the costs to drill one initial commitment well and 35% of the costs of drilling up to three optional wells.

The initial commitment well is expected to spud in early March 2012. The results of the well will be extensively evaluated over a 3 – 4 month period after which the Company can elect to participate in the drilling of the first optional well.

7. Operations review cont.

USA, Gulf of Mexico/Onshore Louisiana *cont.*

Plug and abandonment

During the year, the Company plugged and abandoned the Mobile Bay Area and Main Pass Block 20 fields, completing the work in October 2011. In addition, the plug and abandonment of the Company's South Sunrise onshore field was substantially complete as of 31 December 2011. The Company has no immediate plans to plug and abandon any of the other producing fields.

Oil and gas reserves – USA

Independently estimated proved and probable (2P) oil and gas reserves at 31 December 2011 were 15.4 Bcfe, after reductions in reserves of 1.3 Bcfe for the conveyance of certain working interests as part of the settlement of the subordinated term loan (refer to *note 18 Borrowings* of the notes to the consolidated financial statements for further details), net additions of 2.1 Bcfe, and production of 2.3 Bcfe for the twelve months to 31 December 2011. The table below provides a summary of both the independently assessed and the Company's reserve estimates and movements.

	Independent Assessment[1]			Petsec Energy
Gas Equivalent (Bcfe *)	Proved Reserves	Probable Reserves	Proved and Probable Reserves	Estimated Recoverable Proved and Probable Reserves
USA Reserves				
Reserves at 31 December 2010	13.1	3.8	**16.9**	**16.7**
Conveyance of working interests	(0.9)	(0.4)	**(1.3)**	**(1.3)**
Net additions[2]	1.2	0.9	**2.1**	**1.6**
Production	(2.3)	–	**(2.3)**	**(2.3)**
USA Reserves at 31 December 2011	**11.1**	**4.3**	**15.4**	**14.7**

* 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 were estimated by petroleum engineers Ryder Scott Company.
2 Net additions comprise reserves added during the period and the effect of downward reserve adjustments made for the period.

Competent Person Statement

In accordance with ASX Listing Rules, the Petsec Energy Inc. internal reserve estimates information in this report is based upon information compiled, reviewed and signed off by Mr Ron Krenzke, Executive Vice President Exploration, a full-time employee of Petsec Energy Inc. 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 2011. 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 focus in 2012 will be on shale oil exploration due to the anticipated soft U.S. natural gas prices over the next twelve months and the increased regulatory burden for operating in the Gulf of Mexico. In 2012, the consolidated entity expects to acquire a number of lease positions and commence drilling.

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	28,826,876	2,000,000
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, no grants of options were made to directors or the five most highly remunerated officers of the Company as part of their remuneration.

As at 31 December 2011, there were 3,366,000 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$3.11 per share expiring at various dates between 23 January 2012 and 31 December 2014 with exercise dependent on completion of vesting period and satisfaction of share price hurdles ranging from A$0.30 to A$6.84 being achieved on the Australian Securities Exchange. During the year, no options were granted or exercised and 1,906,000 options were forfeited.

Subsequent to 31 December 2011 through the date of this report, no employee options have been exercised.

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
23 January 2012	A$2.27	35,000
14 June 2012	A$2.40	1,500,000
14 June 2012	A$3.11	500,000
17 July 2012	A$1.48	30,000
12 February 2013	A$1.19	75,000
31 December 2013	A$0.20	373,500
31 December 2014	A$0.23	852,500
		3,366,000

14. Share options cont.

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 2011, 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 *Corporation 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 9 of the accompanying Financial Statements.

17. Lead auditor's independence declaration

The Lead Auditor's Independence Declaration is set out on page 27 and forms part of the Directors' Report for the financial year ended 31 December 2011.

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

On 15 February 2012, Petsec Energy announced that it had 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. To earn its interest in the leases, the Company will pay 35% of the costs to drill one initial commitment well and 35% of the costs of drilling up to three optional wells.

The Company's share of the drilling costs for the initial commitment well, which is expected to spud in early March 2012, is approximately US$0.7 million.

Further details relating to the farm-in to the shale oil project are contained within the media release made to ASX on 15 February 2012.

This report is made with a resolution of the directors:

T N Fern
Director

Sydney, 28 February 2012

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 2011 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, which includes the five most highly remunerated executives.

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 were:

20.2.1 The Board reviewed the form of the executive employment agreements offered to key management personnel and amended its terms to standardise the agreements and ensure that termination payments payable to key management personnel would not exceed 12 months of base salary. This amendment ensures alignment with the *Corporations Act 2001*. The Board negotiated and entered into the new form of agreement with Mr Keogh, President of Petsec Energy Inc. ("PEI") and Group Chief Financial Officer, to reflect the changes outlined above.

20.2 Executive summary *cont.*

20.2.2 The Board determined that Mr Keogh, President of PEI and Group Chief Financial Officer and Mr Krenzke, Executive Vice President of Petsec Energy Inc. would receive an increase in annual base salary, taking into account the scope and added responsibilities associated with each of the positions, their skills and experience, and to ensure that such remuneration remains competitive and in line with market conditions.

20.2.3 In 2011, key management personnel were awarded discretionary bonuses in recognition of their personal efforts, particularly in relation to the achievement of the settlement of the US term debt, and the Marathon discovery.

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 key management personnel's ability to control the relevant performance of their segment of operation.

20. Remuneration Report – Audited cont.

20.4 Principles of compensation *cont.*

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.

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(c)* 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 recognition of their personal efforts, particularly in relation to the achievement of the settlement of the US term debt, and Marathon discovery (see section 20.5 of this Directors' Report).

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 reporting period, two senior executives were each issued 2,000,000 shares, Mr Keogh (President of Petsec Energy Inc. and Group Chief Financial Officer) and Mr Krenzke (Vice President of Exploration of Petsec Energy Inc.), as long-term incentive compensation (2010: nil). The shares were issued at a price of A$0.20 per share and funded by a loan from the Company, repayable on or before 1 January 2016 and secured by a full recourse promissory note bearing interest at the rate of 2.26% per annum (U.S. based interest rate as the executives are U.S. residents).

20. Remuneration Report – Audited cont.

20.4 Principles of compensation *cont.*

Long-term incentive *cont.*

The shares are subject to a holding lock which prevents them from being sold or assigned. For each of the two executives 1,000,000 shares were released from the holding lock on 1 January 2012, and unless there is a prior change of control of the Company or involuntary cessation of employment of the key management personnel, further shares will be released to each of the executives from the holding lock as follows:

i) 500,000 shares on 1 January 2013

ii) 500,000 shares on 1 January 2014

The shares were issued outside the Employee Share Plan as the executives are based in the U.S. and the plan was designed specifically to comply with Australian regulatory and taxation requirements. The progressive release of shares from the holding lock is designed to assist with the retention of the executives.

Service 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. and Group Chief Financial Officer, 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 2011 year were unchanged from the 2010 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.

20. Remuneration Report – Audited cont.

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 Company and the consolidated entity are:

		Short-term benefits				Post-employment benefits		Share-based payment			
		Salary & fees US$	Short-term incentive cash bonus US$	Other benefits US$	Service agree-ments US$	Super-annuation /401k benefits US$	Retire-ment benefits US$	Accounting fair value of options US$	Total US$	Proportion of remun-eration perfor-mance related %	Value of options as proportion of remun-eration %
Directors[1]											
Executive											
T N Fern[1] *(Note 1)*	**2011**	**–**	**–**	**33,176**	**686,664**	**–**	**–**	**22,631**	**742,471**	**–**	**3.0**
Chairman, Managing Director	2010	–	–	23,355	606,012	–	–	63,843	693,210	–	9.2
Non-executive											
D A Mortimer[1]	**2011**	**67,626**	**–**	**–**	**–**	**6,086**	**–**	**–**	**73,712**	**–**	**–**
Director	2010	59,683	–	–	–	5,371	–	–	65,054	–	–
M L Harvey	**2011**	**50,000**	**–**	**–**	**–**	**–**	**–**	**–**	**50,000**	**–**	**–**
Director	2010	50,000	–	–	–	–	–	–	50,000	–	–
Former											
P E Power[1]	**2011**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Director (Retired 21 May 2010)	2010	23,283	–	–	–	–	179,049	–	202,332	–	–
Total directors remuneration	**2011**	**117,626**	**–**	**33,176**	**686,664**	**6,086**	**–**	**22,631**	**866,183**	**–**	**2.6**
	2010	132,966	–	23,355	606,012	5,371	179,049	63,843	1,010,596	–	6.3

[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) 2011 – 1.0404 ii) 2010 – 0.9182

20. Remuneration Report – Audited cont.

20.5 Directors' and Executive Officers' Remuneration Report *cont.*

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

		Short-term benefits				Post-employment benefits		Share-based payment			
		Salary & fees US$	Short-term incentive cash bonus US$	Other benefits US$	Service agree-ments US$	Super-annuation /401k benefits US$	Retire-ment benefits US$	Accounting fair value of options US$	Total US$	Proportion of remun-eration perfor-mance related %	Value of options as proportion of remun-eration %
Executives											
R A Keogh *President, Petsec Energy Inc. (PEI) and Group Chief Financial Officer*	**2011**	**280,000**	**117,000**	**29,309**	**–**	**33,212**	**–**	**1,316**	**460,837**	**25.4**	**0.3**
	2010	234,000	–	27,917	–	33,212	–	55,222	350,351	–	15.8
R Krenzke *Executive Vice President Exploration, PEI*	**2011**	**280,000**	**93,000**	**29,309**	**–**	**34,467**	**–**	**–**	**436,776**	**21.3**	**–**
	2010	234,000	–	27,917	–	24,300	–	–	286,217	–	–
D Swords *General Counsel/ Corporate Secretary, PEI*	**2011**	**177,000**	**26,550**	**29,276**	**–**	**17,700**	**–**	**299**	**250,825**	**10.6**	**0.1**
	2010	177,000	–	27,884	–	17,700	–	10,221	232,805	–	4.4
F Robertson[1] *(Note 2)* *Chief Financial Officer (resigned 3 February 2012)*	**2011**	**–**	**–**	**18,941**	**142,691**	**–**	**–**	**–**	**161,632**	**–**	**–**
	2010	–	–	7,374	217,687	–	–	25,602	250,663	–	10.2
P Gahdmar[1] *Company Secretary,* Group Financial Controller	**2011**	**167,037**	**27,311**	**6,152**	**–**	**15,033**	**–**	**667**	**216,200**	**12.6**	**0.3**
	2010	147,417	–	2,230	–	13,268	–	8,945	171,860	–	5.2
Former											
F Steele *Vice President Land, PEI (resigned 26 July 2010)*	**2011**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
	2010	109,320	–	16,285	–	10,932	–	839	137,376	–	0.6
Total executive remuneration	**2011**	**904,037**	**263,861**	**112,987**	**142,691**	**100,412**	**–**	**2,282**	**1,526,270**	**17.3**	**0.1**
	2010	901,737	–	109,607	217,687	99,412	–	100,829	1,429,272	–	7.1
Total directors and executive officer remuneration (Consolidated)	**2011**	**1,021,663**	**263,861**	**146,163**	**829,355**	**106,498**	**–**	**24,913**	**2,392,453**	**11.0**	**1.0**
	2010	1,034,703	–	132,962	823,699	104,783	179,049	164,672	2,439,868	–	6.7
Total directors and executive officer remuneration (Company)	**2011**	**234,663**	**27,311**	**58,269**	**829,355**	**21,119**	**–**	**23,298**	**1,194,015**	**2.3**	**2.0**
	2010	230,383	–	32,959	823,699	18,639	179,049	98,390	1,383,119	–	7.1

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) 2011 – 1.0404 ii) 2010 – 0.9182.

20. Remuneration Report – Audited cont.

20.5 Directors' and Executive Officers' Remuneration Report *cont.*

Notes

1) Included in service agreements above is an amount of US$686,664 (2010: US$606,012) 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) Included in service agreements above is an amount of US$142,691 (2010: US$217,687), 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.

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

4) 2011 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.

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

6) 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.

No termination benefits or other long-term benefits were paid to key management personnel for the years ended 31 December 2011 and 2010.

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
2/03/07	30/01/12	A$0.509	A$2.38	A$1.95	46.5%	5.91%	–
2/03/07	12/02/12	A$0.497	A$2.40	A$1.95	46.5%	5.91%	–
2/03/07	12/02/12	A$0.373	A$3.11	A$1.95	46.5%	5.91%	–
1/06/07	14/06/12	A$0.214	A$2.40	A$1.49	40.5%	6.23%	–
1/06/07	14/06/12	A$0.141	A$3.11	A$1.49	40.5%	6.23%	–
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%	–

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 section 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 2011 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 cont.

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

No options over ordinary shares in the Company were granted as compensation to key management personnel during the reporting period (2010: 600,000). Details of options that vested during the previous corresponding period are as follows:

	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
Directors						
T Fern	–	–	–	–	–	525,000
Executives						
R Keogh	–	–	–	–	–	50,000
D Swords	–	–	–	–	–	86,666
P Gahdmar	–	–	–	–	–	74,999

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:

	Number of options granted during 2010	Grant date	Fair value per option at grant date	Exercise price per option	Expiry date	Number of options vested during 2010
Directors						
T Fern	–	–	–	–	–	500,000
Executives						
R Keogh	–	–	–	–	–	50,000
F Robertson	–	–	–	–	–	56,250
F Steele	200,000	29/01/10	A$0.087	A$0.23	31/12/14	–
D Swords	200,000	29/01/10	A$0.087	A$0.23	31/12/14	20,000
P Gahdmar	200,000	29/01/10	A$0.087	A$0.23	31/12/14	8,333

No options have been granted or cancelled since the end of the financial year through the date of this report.

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).

20. Remuneration Report – Audited cont.

20.7 Equity instruments *cont.*

Analysis of Movement in Options

During the reporting period, 1,906,000 options were cancelled and no options were granted or exercised.

The movement during the previous corresponding 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.

	Value of Options		
2010	Granted in year[A] $	Exercised in year[B] $	Total option value in year A$
Executives			
F Steele	A$17,492	–	A$17,492
D Swords	A$17,492	–	A$17,492
P Gahdmar	A$17,492	–	A$17,492

[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 2011 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

David Sinclair
Partner

Sydney, 28 February 2012

STATEMENTS OF COMPREHENSIVE INCOME

For the year ended 31 December 2011

	Note	Consolidated		The Company	
		2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Revenues from sale of oil & gas and royalties	5	**13,569**	31,061	**–**	–
Royalties paid		**(2,047)**	(3,981)	**–**	–
Net revenues after royalties		**11,522**	27,080	**–**	–
Other income and expenses	5	**157**	1,062	**8,752**	1,899
Lease operating expenses		**(4,745)**	(6,915)	**–**	–
Geological, geophysical and administrative expenses		**(6,735)**	(8,173)	**(2,080)**	(2,181)
Depreciation, depletion, and amortisation		**(5,204)**	(12,496)	**(12)**	(13)
Seismic and repair expense		**(478)**	(533)	**–**	–
Dry hole, impairment and abandonment expense	7	**(20,229)**	(19,456)	**–**	–
Net movement in provisions against loans to investments in controlled entities	7	**–**	–	**(26,435)**	(52,086)
EBIT [1]		**(25,712)**	(19,431)	**(19,775)**	(52,381)
Derivative gains/(losses)	8	**(897)**	1,178	**–**	–
Gain on discharge of debt	18	**11,365**	–	**–**	–
Financial income	10	**103**	531	**101**	525
Financial expenses	10	**(632)**	(3,522)	**–**	–
Net financial income/(expense)	10	**(529)**	(2,991)	**101**	525
Profit/(loss) before income tax		**(15,773)**	(21,244)	**(19,674)**	(51,856)
Income tax benefit/(expense)	11	**–**	(13,589)	**–**	–
Profit/(loss) from continuing operations		**(15,773)**	(34,833)	**(19,674)**	(51,856)
Profit/(loss) from discontinued operation	29	**29,807**	(404)	**–**	–
Profit/(loss) for the period		**14,034**	(35,237)	**(19,674)**	(51,856)
Other comprehensive income/(loss)					
Foreign exchange translation differences		**(413)**	679	**772**	12,178
Cash flow hedges, net of tax		**–**	(2,744)	**–**	–
Total comprehensive income/(loss) for the period		**13,621**	(37,302)	**(18,902)**	(39,678)

	Note	Consolidated US Cents	
		2011	2010
Earnings/(loss) per share			
Basic and diluted earnings/(loss) per share	12	**6.1**	(15.2)

[1] Earnings before interest (financial income and expense), unrealised derivative gains and income tax.

The statement of comprehensive income is to be read in conjunction with the notes to the consolidated financial statements set out on pages 33 to 72.

STATEMENTS OF CHANGES IN EQUITY

For the year ended 31 December 2011

Consolidated *In thousands of USD*	Share capital US$'000	Translation reserve US$'000	Cashflow hedge Reserve US$'000	Share-based compensation US$'000	Accumulated losses US$'000	Total Equity US$'000
Balance at 1 January 2010	184,027	2,632	2,744	789	(110,240)	79,952
Total comprehensive income for the period						
Profit/(loss)	–	–	–	–	(35,237)	(35,237)
Other comprehensive income						
Foreign exchange translation differences	–	679	–	–	–	679
Cash flow hedges, net of tax	–	–	(2,744)	–	–	(2,744)
Total other comprehensive income/(loss)	–	679	(2,744)	–	–	(2,065)
Total comprehensive income/(loss) for the period	–	679	(2,744)	–	(35,237)	(37,302)
Transactions with owners, recorded directly in equity						
Contributions by and distributions to owners						
Vesting of share options	756	–	–	(756)	–	–
Share-based payments expense	–	–	–	191	–	191
Total transactions with owners	756	–	–	(565)	–	191
Balance at 31 December 2010	184,783	3,311	–	224	(145,477)	42,841
Balance at 1 January 2011	**184,783**	**3,311**	**–**	**224**	**(145,477)**	**42,841**
Total comprehensive income/(loss) for the period						
Profit/(loss)	**–**	**–**	**–**	**–**	**14,034**	**14,034**
Other comprehensive income/(loss)						
Foreign exchange translation differences	**–**	**(413)**	**–**	**–**	**–**	**(413)**
Cash flow hedges, net of tax	–	**–**	–	**–**	–	**–**
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**

The statement of changes in equity is to be read in conjunction with the notes to the consolidated financial statements set out on pages 33 to 72.

STATEMENTS OF CHANGES IN EQUITY

For the year ended 31 December 2011

The Company *In thousands of USD*	Share capital US$'000	Translation reserve US$'000	Cashflow hedge Reserve US$'000	Share-based compensation US$'000	Accumulated losses US$'000	Total Equity US$'000
Balance at 1 January 2010	184,027	24,317	–	789	(79,010)	130,123
Total comprehensive income for the period						
Profit/(loss)	–	–	–	–	(51,856)	(51,856)
Other comprehensive income						
Foreign exchange translation differences	–	12,178	–	–	–	12,178
Total other comprehensive income/(loss)	–	12,178	–	–	–	12,178
Total comprehensive income/(loss) for the period	–	12,178	–	–	(51,856)	(39,678)
Transactions with owners, recorded directly in equity						
Contributions by and distributions to owners						
Vesting of share options	756	–	–	(756)	–	–
Share-based payments expense	–	–	–	191	–	191
Total transactions with owners	756	–	–	(565)	–	191
Balance at 31 December 2010	184,783	36,495	–	224	(130,866)	90,636
Balance at 1 January 2011	**184,783**	**36,495**	**–**	**224**	**(130,866)**	**90,636**
Total comprehensive income/(loss) for the period						
Profit/(loss)	–	**–**	–	**–**	**(19,674)**	**(19,674)**
Other comprehensive income/(loss)						
Foreign exchange translation differences	**–**	**772**	**–**	**–**	**–**	**772**
Total other comprehensive income/(loss)	**–**	**772**	**–**	**–**	**–**	**772**
Total comprehensive income/(loss) for the period	**–**	**772**	**–**	**–**	**(19,674)**	**(18,902)**
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**	**37,267**	**–**	**54**	**(150,540)**	**72,574**

The statement of changes in equity is to be read in conjunction with the notes to the consolidated financial statements set out on pages 33 to 72.

BALANCE SHEETS

As at 31 December 2011

	Note	Consolidated		The Company	
		2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
ASSETS					
Current assets					
Cash and cash equivalents		**34,954**	17,373	**31,367**	12,817
Restricted cash deposits[1]		**1,200**	4,487	**–**	–
Trade and other receivables	13	**1,346**	2,816	**9,927**	3,969
Fair value of derivative financial instruments	22	**–**	1,247	**–**	–
Prepayments		**665**	993	**108**	116
Total current assets		**38,165**	26,916	**41,402**	16,902
Non-current assets					
Restricted cash deposits[1]		**5,425**	1,213	**–**	–
Receivables	13	**816**	–	**15,117**	38,054
Investments	14	**662**	–	**32,838**	44,405
Property, plant and equipment		**92**	209	**31**	38
Exploration, evaluation and development expenditure – Tangible	15(a)	**19,272**	54,384	**–**	–
Exploration and evaluation expenditure – Intangible	15(b)	**1,989**	7,344	**–**	–
Intangible assets – Software		**15**	13	**–**	–
Total non-current assets		**28,271**	63,163	**47,986**	82,497
Total assets		**66,436**	90,079	**89,388**	99,399
LIABILITIES					
Current liabilities					
Trade and other payables	17	**2,980**	4,157	**281**	321
Borrowings	18	**–**	28,919	**–**	–
Rehabilitation provisions	20	**342**	8,571	**–**	–
Employee benefits provisions		**209**	176	**45**	35
Total current liabilities		**3,531**	41,823	**326**	356
Non-current liabilities					
Trade and other payables	17	**–**	–	**16,251**	8,174
Rehabilitation provisions	20	**5,366**	5,182	**–**	–
Employee benefits provisions		**237**	233	**237**	233
Total non-current liabilities		**5,603**	5,415	**16,488**	8,407
Total liabilities		**9,134**	47,238	**16,814**	8,763
Net assets		**57,302**	42,841	**72,574**	90,636
EQUITY					
Issued capital		**185,793**	184,783	**185,793**	184,783
Reserves		**2,952**	3,535	**37,321**	36,719
Accumulated losses		**(131,443)**	(145,477)	**(150,540)**	(130,866)
Total equity		**57,302**	42,841	**72,574**	90,636

[1] Relates to cash used to guarantee certain future rehabilitation obligations (see *note 18 –Borrowings* for further details).

The balance sheet is to be read in conjunction with the notes to the consolidated financial statements set out on pages 33 to 72.

CONSOLIDATED STATEMENT OF CASHFLOWS

For the year ended 31 December 2011

	Note	Consolidated		The Company	
		2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Cashflows from operating activities					
Cash receipts from customers		**16,708**	33,163	**–**	–
Cash payments for royalties		**(2,718)**	(3,958)	**–**	–
Cash payments to suppliers and employees		**(19,697)**	(20,091)	**(2,160)**	(2,232)
Interest received		**103**	531	**101**	525
Management fees received – related parties		**–**	–	**4,707**	978
Taxes refunded		**–**	480	**–**	–
Interest paid		**(66)**	(2,584)	**–**	–
Restricted deposits[1]		**(925)**	(5,700)	**–**	–
Net cash from operating activities	32	**(6,595)**	1,841	**2,648**	(729)
Cashflows from investing activities					
Payments for property, plant and equipment		**(33)**	(124)	**(4)**	(10)
Payments for exploration, evaluation and development expenditure		**(3,859)**	(11,815)	**–**	–
Loans from/(to) controlled entities		**–**	–	**15,874**	(5,954)
Proceeds from sale of investments	29	**40,869**	–	**–**	–
Proceeds from sale of assets		**–**	12	**–**	–
Net cash from investing activities		**36,977**	(11,927)	**15,870**	(5,964)
Cashflows from financing activities					
Debt facility repayments including transaction costs	18	**(12,833)**	(225)	**–**	–
Net cash from financing activities		**(12,833)**	(225)	**–**	–
Net increase/(decrease) in cash and cash equivalents		**17,549**	(10,311)	**18,518**	(6,693)
Cash and cash equivalents at 1 January		**17,373**	25,356	**12,817**	17,182
Effects of exchange rate changes on cash held		**32**	2,328	**32**	2,328
Cash and cash equivalents at 31 December		**34,954**	17,373	**31,367**	12,817

[1] Relates to cash used to guarantee certain future rehabilitation obligations (see *note 18 – Borrowings* 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 33 to 72.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the year ended 31 December 2011

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 2011 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.

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 28 February 2012.

(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.

3. Significant accounting policies cont.

(a) Basis of consolidation

(i) Subsidiaries

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.

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's interest expense is exposed to changes in short-term interest rates. From time to time, the consolidated entity enters into derivative financial instruments to manage a portion of its interest rate 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.

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. Borrowing costs related to the acquisition or construction of qualifying assets are recognised in profit and loss as incurred.

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.

3. Significant accounting policies cont.

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

(i) Recognition and measurement *cont.*

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).

(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:

	2011	2010
Property, plant and equipment		
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 15 provides further details of the key assumptions adopted by the consolidated entity in measuring the recoverable amount of exploration, evaluation and development expenditure.

3. Significant accounting policies cont.

(h) Impairment – Non-financial assets *cont.*

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.

(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. Borrowing costs are expensed as incurred unless they relate to qualifying assets.

(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.

3. Significant accounting policies cont.

(m) Provisions *cont.*

Rehabilitation *cont.*

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.

(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.

3. Significant accounting policies cont.

(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.

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.

3. Significant accounting policies cont.

(r) Income tax *cont.*

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.

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.

3. Significant accounting policies cont.

(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 2011, 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 value 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).

5. Revenue and other income and expenses

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Revenue				
Revenues from sale of oil and gas	**13,569**	24,311	**–**	–
Derivative hedging gains/(losses)	**–**	6,750	**–**	–
	13,569	31,061	**–**	–
Other income and expenses				
Drilling, production and prospect overhead income	**185**	699	**–**	–
Management fee income	**–**	–	**4,758**	857
Dividend income	**–**	–	**2,686**	2,787
Net foreign exchange gains (losses)	**(33)**	368	**1,308**	(1,741)
Net profit/(loss) on disposal of property, plant and equipment	**5**	(5)	**–**	(4)
	157	1,062	**8,752**	1,899

6. Personnel expenses

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Wages and salaries	**2,792**	2,536	**295**	232
Service agreements for executives	**830**	824	**830**	824
Contract labour	**247**	670	**–**	–
Superannuation & 401(k) plans	**111**	121	**29**	23
Share-based payment compensation	**28**	173	**24**	76
Other employee-related expenses	**10**	9	**10**	9
	4,018	4,333	**1,188**	1,164

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:

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Expenses				
Dry hole, impairment and abandonment expense	**(20,229)**	(19,456)	**–**	–
Net movements in provisions against loans to and investments in controlled entities	**–**	–	**(26,435)**	(52,086)

Dry hole, 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 2011, the consolidated entity recognised total impairment and abandonment expense of US$20,229,000 primarily due to the effect of low gas prices at year end in combination with downward reserve adjustments on certain fields.

In 2010, the consolidated entity recognised total dry hole, impairment and abandonment expense of US$19,456,000 comprising US$2,873,000 of dry hole costs mainly in relation to the Main Pass Block 20 #4 exploration well; US$16,462,000 of net impairment provisions against certain oil & gas properties; and US$115,000 increase in the Company's rehabilitation provision due to the reassessment of future plug and abandonment cost estimates.

Net movement in provisions against loans to and investments in controlled entities

During the year ended 31 December 2011, the Company recognised a further provision of US$26,435,000 against the carrying amount of its investment in controlled entities (2010: US$52,086,000). This additional provision reflects the cumulative effect of reserve revisions and the impact of lower commodity prices on estimates of recoverable amounts of oil and gas properties. Refer to Note 15 for further discussion of the factors that influence the estimation uncertainty associated with the underlying oil and gas properties.

8. Derivative gains/(losses)

The consolidated entity had entered into natural gas collar derivative contracts to hedge the price risk associated with selling a portion of its 2011 gas production. Whilst these instruments represent an economic hedge, the consolidated entity does not use hedge accounting. Accordingly all changes in the fair value of these contracts are 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. The proceeds realised upon settlement of the collar hedge contracts were $1,433,000 for the year ended 31 December 2011 (2010: nil).

The consolidated entity acquired 15 million options as part consideration for the 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.

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

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Change in fair value of collar hedge contracts	**186**	1,178	**–**	–
Change in fair value of options held in unrelated entities	**(1,083)**	–	**–**	–
	(897)	1,178	**–**	–

9. Auditor's remuneration

	Consolidated		The Company	
	2011 US$	2010 US$	2011 US$	2010 US$
Audit services:				
Auditors of the Company				
KPMG Australia				
Audit and review of financial reports	**86,000**	105,000	**86,000**	105,000
Overseas KPMG Firms				
Audit and review of financial reports	**25,000**	20,000	**–**	20,000
Other services:				
Auditors of the Company				
KPMG Australia				
Corporate, tax and compliance services	**10,200**	–	**10,200**	–
Overseas KPMG Firms				
Audit and review of financial reports	**–**	15,800	**–**	–
	121,200	140,800	**96,200**	125,000

10. Finance income and expense

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Interest income – Other parties	**103**	531	**101**	525
Financial income	**103**	531	**101**	525
Interest expense	**(66)**	(2,583)	**–**	–
Unwinding of discount	**(566)**	(939)	**–**	–
Financial expense	**(632)**	(3,522)	**–**	–
Net financial income	**(529)**	(2,991)	**101**	525

11. Income tax expense

Recognised in the statement of comprehensive income

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Deferred tax expense				
Origination and reversal of temporary differences	**–**	13,589	**–**	–
Total income tax benefit/(expense) in the statement of comprehensive income	**–**	13,589	**–**	–

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Numerical reconciliation between tax expense and pre-tax net profit/(loss)				
Profit/(loss) before tax	**14,034**	(21,648)	**(19,674)**	(51,856)
Income tax expense/(benefit) using the Australian corporation tax rate of 30% (2010: 30%)	**4,210**	(6,494)	**(5,902)**	(15,557)
Increase/(decrease) in income tax expense due to:				
Non-assessable income	**–**	–	**(1,576)**	(911)
Non-deductible expenses	**379**	216	**7,944**	15,652
U.S. income taxes assessed at different rate	**(671)**	(1,043)	**–**	–
Australian tax losses utilised	**–**	–	**–**	–
Deferred tax movements not brought to account in current year	**(3,809)**	8,798	**(466)**	816
Provisions against deferred tax assets recognised in prior years	**–**	12,513	**–**	–
Under/(over) provided in prior years	**(109)**	(401)	**–**	–
Income tax expense/(benefit) on pre-tax net profit/(loss)	**–**	13,589	**–**	–

In the previous corresponding period, the consolidated entity's tax expense included a provision of US$12,513,000 to reduce the overall carrying value of the recognised deferred tax asset to nil. This provision reflected the impact of revised estimates of probable future US taxable income made by management at that time. Refer to Note 15 for further discussion of the factors that influence the estimation uncertainty associated with the recoverability of oil and gas properties, and consequently the probability of generation of US taxable income in future periods.

12. 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 3,366,000 (2010: 5,272,000) options outstanding under the Employee Option Plan. In determining potential ordinary shares, 3,366,000 (2010: 4,667,500) are not dilutive.

During the year, no options were granted and 1,906,000 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 2011 was based on the profit attributable to ordinary shareholders of US$14,034,000 (2010: Loss of US$35,237,000) and a weighted average number of ordinary shares outstanding during the year ended 31 December 2011 of 231,404,170 (2010: 231,283,622), calculated as follows:

	Consolidated	
	2011 US$'000	2010 US$'000
Profit/(loss) attributable to ordinary shareholders		
Profit/(loss) for the period	**14,034**	(35,237)

	Consolidated	
in thousands of shares	2011	2010
Weighted average number of shares (basic)		
Issued ordinary shares at 1 January	**231,284**	231,284
Effect of shares issued in 2011 and 2010, respectively	**120**	–
Weighted average number of ordinary shares at 31 December	**231,404**	231,284

	Consolidated	
in USD cents	2011	2010
Earnings/(loss) per share		
Basic and diluted earnings/(loss) per share	**6.1**	(15.2)

13. Trade and other receivables

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Current				
Trade receivables	**1,333**	2,792	**–**	–
Other receivables	**13**	24	**13**	23
Loans receivable from controlled entities	**–**	–	**9,914**	3,946
	1,346	2,816	**9,927**	3,969
Non-current				
Dividend receivable from controlled entities	**–**	–	**11,001**	8,178
Loans receivable from controlled entities	**–**	–	**3,300**	29,876
Loans receivable from related parties	**816**	–	**816**	–
	816	–	**15,117**	38,054

14. Other investments

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Investments in unrelated entities	**662**	–	**–**	–
Investments in controlled entities – at recoverable amount [1]	**–**	–	**32,838**	44,405
	662	–	**32,838**	44,405

[1] The Company reassesses its estimate of recoverable amount for its investment in controlled entities annually.

15. Exploration, evaluation and development expenditure

(a) Tangible

	Consolidated	
	2011 US$'000	2010 US$'000
Costs carried forward in respect of areas of interest in the following phases:		
Production phase – at WDV		
Balance at 1 January	**41,816**	63,121
Additions	**2,949**	1,625
Reclassification from development phase	**–**	281
Reclassification from tangible exploration phase	**–**	2,071
Reclassification from intangible exploration phase	**–**	71
Sales, disposals and assignments	**(2,894)**	–
Impairment and abandonment expense	**(17,686)**	(13,121)
Current year amortisation expense	**(5,056)**	(12,232)
Balance at 31 December	**19,129**	41,816
Development phase – at cost		
Balance at 1 January	**–**	–
Additions	**–**	281
Reclassification to production phase	**–**	(281)
Balance at 31 December	**–**	–
Exploration and/or evaluation phase – at cost		
Balance at 1 January	**12,568**	12,151
Additions	**–**	5,664
Reclassification to production phase	**–**	(2,071)
Sales, disposals and assignments	**(12,425)**	(7)
Dry hole and impairment expense	**–**	(3,169)
Balance at 31 December	**143**	12,568
Total costs carried forward	**19,272**	54,384

15. Exploration, evaluation and development expenditure cont.

(b) Intangible

	Consolidated	
	2011 US$'000	2010 US$'000
Costs carried forward in respect of areas of interest in the following phase:		
Exploration and/or evaluation phase – at cost		
Balance at 1 January	**7,344**	6,917
Additions	**556**	3,420
Disposals, assignments and lease relinquishments	**(3,097)**	(314)
Reclassification to tangible production phase	**–**	(71)
Impairment expense	**(2,814)**	(2,608)
Balance at 31 December	**1,989**	7,344

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%.

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.

16. Deferred tax assets

Recognised deferred tax assets and liabilities

	Assets		Liabilities		Net	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Consolidated						
Exploration, evaluation and development expenditure	**5,105**	7,366	**–**	–	**5,105**	7,366
Other items	**124**	–	**–**	(162)	**124**	(162)
Deferred tax balances not brought to account	**(5,229)**	(7,366)	**–**	162	**(5,229)**	(7,204)
Deferred tax assets/(liabilities)	**–**	–	**–**	–	**–**	–

	Assets		Liabilities		Net	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
The Company						
Provisions	**135**	154	**–**	–	**135**	154
Equity issue costs	**141**	161	**–**	–	**141**	161
Deferred tax balances not brought to account	**(276)**	(315)	**–**	–	**(276)**	(315)
Deferred tax assets/(liabilities)	**–**	–	**–**	–	**–**	–

Unrecognised deferred tax assets

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

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Deductible temporary differences in USA (net)	**5,229**	7,204	**–**	–
Tax operating loss carry-forwards in USA (net)	**27,109**	23,193	**–**	–
Deductible temporary differences in Australia (net)	**276**	315	**276**	315
Tax operating loss carry-forwards in Australia (net)	**2,765**	2,718	**2,765**	2,718
	35,379	33,430	**3,041**	3,033

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.

In the previous corresponding period, the consolidated entity recognised a provision of US$12,513,000 against the entire USA deferred tax balance previously brought to account until such time as the USA operations can regain sustained profitability sufficient to make it probable that the tax losses 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 loss carry forwards expire in 2021 and later.

16. Deferred tax assets cont.

Movement in temporary differences during the year *cont.*

	Consolidated				
	Balance 1 Jan 10 US$'000	Recognised in income US$'000	Recognised in equity US$000	Reclassified to other balance sheet account US$000	Balance 31 Dec 10 US$'000
Exploration, evaluation and development expenditure	5,415	1,951	–	–	7,366
Cash flow hedges	(1,478)	1,478	–	–	–
Other items	600	(360)	–	(402)	(162)
U.S. operating loss carry-forwards	7,976	(7,976)	–	–	–
Deferred tax balances in USA not brought to account	–	(7,204)	–	–	(7,204)
	12,513	(12,111)	–	(402)	–

	Consolidated				
	Balance 1 Jan 11 US$'000	Recognised in income US$'000	Recognised in equity US$000	Reclassified from 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)**
	–	**–**	**–**	**–**	**–**

	The Company				
	Balance 1 Jan 10 US$'000	Recognised in income US$'000	Recognised in equity US$000	Reclassified from other balance sheet account US$000	Balance 31 Dec 10 US$'000
Provisions	169	(15)	–	–	154
Equity issue costs	145	16	–	–	161
Deferred tax balances in Australia not brought to account	(314)	(1)	–	–	(315)
	–	–	–	–	–

	The Company				
	Balance 1 Jan 11 US$'000	Recognised in income US$'000	Recognised in equity US$000	Reclassified from other balance sheet account US$000	Balance 31 Dec 11 US$'000
Provisions	**154**	**(19)**	**–**	**–**	**135**
Equity issue costs	**161**	**(20)**	**–**	**–**	**141**
Deferred tax balances in Australia not brought to account	**(315)**	**39**	**–**	**–**	**(276)**
	–	**–**	**–**	**–**	**–**

17. Trade and other payables

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Current				
Trade and other payables, stated at cost				
Trade payables	**1,218**	746	**96**	62
Exploration and development accruals	**341**	633	**–**	–
Operational and administration accruals	**1,378**	2,727	**142**	208
Related party payables	**43**	51	**43**	51
	2,980	4,157	**281**	321
Non-current				
Loans payable to controlled entities	**–**	–	**16,251**	8,174
	–	–	**16,251**	8,174

18. Borrowings

(a) Term loan settlement

At 31 December 2011, the consolidated entity had no borrowings (31 December 2010: US$29.2 million of borrowings, before US$0.3 million of unamortised debt issue costs).

As detailed in the financial statements for the year ended 31 December 2010, the consolidated entity had a term loan owed to a third party by its US subsidiary, Petsec Energy Inc ("PEI"). In December 2010, PEI and the lender entered into a memorandum of understanding in relation to the settlement and extinguishment of amounts outstanding under this facility.

On 25 May 2011, the consolidated entity completed the settlement of the US$29.2 million term loan owed by PEI. As a result of this settlement, the security over PEI's assets associated with this loan has been released.

The term loan was extinguished by the payment of US$12 million in cash, and conveyance of a 2.5% working interest in the Company's Main Pass 270 producing wells, a 2% working interest in the Company's lease in the Atchafalaya Bay area (Marathon discovery), Louisiana, and 25% of the Company's working interest in 10 non-producing leases in the Gulf of Mexico, USA and the exploration area of Main Pass 270.

The following table presents details of the gain on settlement and extinguishment of this liability.

	Consolidated
	US$'000
Borrowings extinguished	29,175
Less: Cash paid	(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**

18. Borrowings cont.

(b) Revolving facility

At 31 December 2011, the consolidated entity had no borrowings following the maturity of PEI's revolving facility on 15 August 2011 (December 2010: US$6.6 million of letters of credit were on issue of which US$3.4 million was secured by the borrowing base under the PEI revolving facility, and US$3.2 million was secured by restricted cash).

During 2011, the outstanding letters of credit were terminated and the cash that secured the letters of credit was transferred to an escrow account with a bonds underwriter. The letters of credit that were on issue secured BOEMRE (Bureau of Ocean Energy Management, Regulation and Enforcement) bonding for potential plug and abandonment and contingent environmental liabilities in connection with PEI's oil and natural gas operations. As at 31 December 2011, US$6.6 million of restricted cash is deposited in the escrow account partially securing US$7.4 million of bonding.

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$29,000 for the year ended 31 December 2011 (2010: US$23,000).

U.S. based employees are eligible to participate in a voluntary savings plan under Section 401(k) of the US tax code ("401(k) plan"). The employer matching contributions recognised as an expense was US$82,000 for the year ended 31 December 2011 (2010: US$98,000).

(b) Share-based payments

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 2011	Number of options 2011	Weighted average exercise price 2010	Number of options 2010
Outstanding at the beginning of the period	**A$1.51**	**5,272**	A$2.10	5,700
Granted during the period	**–**	**–**	A$0.23	2,146
Exercised during the period	**–**	**–**	–	–
Forfeited during the period	**A$1.23**	**(1,906)**	A$1.75	(2,574)
Outstanding at the end of the period	**A$1.68**	**3,366**	A$1.51	5,272
Exercisable at the end of the period	**A$2.06**	**2,654**	A$2.31	2,531

The options outstanding at 31 December 2011 have an exercise price in the range of A$0.20 to A$3.11 and a weighted average contractual life of 1.3 years.

During the year, no share options were exercised (2010: Nil).

The Employee option plan provides for employees, executives and directors to be granted options over ordinary shares at the discretion of the Nomination and Remuneration Committee.

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 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 2 March 2007	80,000	4.40 years
Option grant to key management personnel at 1 June 2007	1,500,000	4.54 years
Option grant to key management personnel at 1 June 2007	500,000	4.54 years
Option grant to other personnel at 10 September 2007	30,000	4.35 years
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
Total share option schemes with all or a portion of options outstanding at 31 December 2011		**5,182,500**

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. During the year ended 31 December 2011, no grants of options were made to key management personnel (2010: 600,000).

The following table summarises the fair value assumptions of share options granted to key management personnel during the years ended 31 December 2011 and 2010.

	Key management personnel 2011	Key management personnel 2010
Weighted average fair value at measurement date	–	A$0.09
Weighted average share price	–	A$0.22
Weighted average exercise price	–	A$0.23
Expected volatility (expressed as weighted average used in the modelling under Black-Scholes model)	–	62.83%
Expected option life (expressed as weighted average used in the modelling under Black-Scholes model)	–	3.5 years
Expected dividends	–	–
Risk-free interest rate (based on national government bonds)	–	4.66%

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

Share 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 options that are expected to become exercisable.

20. Rehabilitation provisions

	Consolidated	
	2011 US$'000	2010 US$'000
Current		
Balance at 1 January	**8,571**	3,624
Provisions made during the year	**–**	156
Provisions reclassed from non-current classification	**318**	8,186
Provisions used during the year	**(8,412)**	(3,630)
Provisions revised during the year	**(206)**	(51)
Unwind of discount	**71**	286
Balance at 31 December	**342**	8,571
Non-current		
Balance at 1 January	**5,182**	11,808
Provisions made during the year	**–**	11
Assignment/conveyance of interests	**(35)**	–
Provisions reclassed to current classification	**(318)**	(8,186)
Provisions used during the year	**–**	(4)
Provisions revised during the year	**44**	900
Unwind of discount	**493**	653
Balance at 31 December	**5,366**	5,182
	5,708	13,753

21. Capital and reserves

Share capital

	The Company	
In thousands of shares	2011	2010
On issue at 1 January	**231,284**	231,284
Shares issued	**4,000**	–
On issue at 31 December – fully paid	**235,284**	231,284

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 options issued under the Company's Employee Option Plan.

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.

At 31 December 2011, the consolidated entity had no outstanding borrowings following the completion during the year of the settlement of the term loan owed to a third party by its US subsidiary, PEI (see *note 18 Borrowings* for further details).

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

22. Additional financial instruments disclosures

Overview

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

- Credit risk
- Liquidity risk
- 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	
	2011 US$'000	2010 US$'000
Cash and restricted cash deposits	**41,579**	23,073
Trade and other receivables	**1,346**	2,816
	42,925	25,889

22. Additional financial instruments disclosures cont.

Exposure to credit risk *cont.*

As at 31 December 2011, there was no material exposure to credit risk in relation to cash held by banks as $31 million was held with Australian financial institutions rated AA with the remaining balances held in the USA with institutions rated A or higher. In addition, U.S. demand deposits are fully insured by the Federal Deposit Insurance Corporation (FDIC).

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 50% 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 (2010: is consistent with 2011).

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.

31 December 2011

	Contractual cashflows					
Consolidated	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**	–	–	–	–

31 December 2010

	Contractual cashflows					
Consolidated	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	4,157	4,157	–	–	–	–
Borrowings	28,919	28,919	–	–	–	–
Total	33,076	33,076	–	–	–	–

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 2010 and 2011, operating costs were incurred in both Australian and US dollars.

Throughout 2010 and 2011, 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.

22. Additional financial instruments disclosures cont.

Commodity price risk

The revenue and income of the consolidated entity are affected by changes in natural gas and crude oil prices, and various financial transactions have been undertaken (purchased put options and swaps involving commodity prices for natural gas) to reduce the effect of these changes. The consolidated entity has proved reserves of these commodities sufficient to cover all these transactions and it only enters into such derivatives to match its anticipated underlying physical production and reserves. The consolidated entity has limited 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. The consolidated entity had no outstanding swaps at 31 December 2011.

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.

At 31 December 2011, the consolidated entity had no outstanding natural gas hedges in place.

In the previous corresponding period, the consolidated entity had the following outstanding natural gas hedges in place:

Production period	Hedge type	Daily volume	Weighted average USD Price *
2011	Collars	2,162 MMBtu	6.00 – 7.56

* Fixed price for swaps and floor and ceiling prices for collars.

The consolidated entity did not use hedge accounting treatment for its collar contracts. Accordingly, changes in the fair value of the collars were recognised in income immediately.

At 31 December 2011, the consolidated entity did not record any derivative assets or liabilities as it had no outstanding derivative instruments. At 31 December 2010, the consolidated entity recorded derivative assets of US$1.2 million and derivative liabilities of nil representing the fair value of the commodity hedge instruments at that date of which US$1.2 million of associated net unrealised gains were recognised income in 2010. Refer to accounting policy *note 3(c)*.

The fair values for commodity hedge agreements will vary with movements in market prices until the contracts settle.

Interest rate risk

The consolidated entity's exposure to market interest rates primarily relates to the consolidated entity's cash holdings (2010: cash holdings and secured bank loan).

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

	Consolidated	
	2011 US$'000	2010 US$'000
Financial assets		
Cash and restricted cash deposits	**41,579**	23,073
Financial liabilities		
Secured bank loans	–	28,919

22. Additional financial instruments disclosures cont.

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 2011 would have increased or decreased the consolidated entity's profit or loss by US$765,000 (2010: US$800,000) 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$4,000 (2010: US$145,000). The estimated impact of a 10 per cent change in the USD/AUD exchange rates would have increased or decreased the consolidated entity's and the Company's profit or loss by US$209,000 (2010: US$223,000).

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:

	Consolidated			
	2011		2010	
	Carrying amount US$'000	Fair value US$'000	Carrying amount US$'000	Fair value US$'000
Trade and other receivables	**1,346**	**1,346**	2,816	2,816
Cash and restricted cash deposits	**41,579**	**41,579**	23,073	23,073
Secured bank loans	**–**	**–**	(28,919)	(29,175)
Trade and other payables	**(2,980)**	**(2,980)**	(4,157)	(4,157)
	39,945	**39,945**	(7,187)	(7,443)
Unrecognised loss		**–**		(256)

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)

Consolidated – 2011	Level 1 US$000	Level 2 US$000	Level 3 US$000	Total US$000
Asset				
Derivative financial instruments	**–**	**662**	**–**	**662**
Total assets	**–**	**662**	**–**	**662**

22. Additional financial instruments disclosures cont.

Consolidated – 2010	Level 1 US$000	Level 2 US$000	Level 3 US$000	Total US$000
Asset				
Derivative financial instruments	–	1,247	–	1,247
Total assets	–	1,247	–	1,247

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

23. Operating leases

Leases as lessee

Non-cancellable operating lease rentals are payable as follows:

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Less than one year	**489**	418	**177**	172
Between one and five years	**195**	329	**–**	177
	684	747	**177**	349

The consolidated entity leases office space in Australia and the USA under operating leases. The leases typically run for a period of 3 to 5 years. None of the leases includes contingent rentals.

One of the leased properties has been sublet by the consolidated entity. The lease and subleases expire in 2012. Sub-lease payments of A$15,000 are expected to be received during the following financial year.

During the year ended 31 December 2011, US$1,002,000 was recognised as an expense in the statement of comprehensive income in respect of operating leases (2010: US$1,197,000). US$27,000 (2010: US$25,000) was recognised as income in the statement of comprehensive income in respect of sub-leases.

24. Capital and other commitments

	Consolidated	
	2011 US$'000	2010 US$'000
Capital expenditure commitments		
Exploration, evaluation and development expenditure		
Contracted but not provided for and payable:		
Within one year	**1,151**	1,216
One year or later and no later than five years	**278**	624
	1,429	1,840

	Consolidated	
	2011 US$'000	2010 US$'000
Joint operating arrangements commitments		
Share of capital commitments of the joint operating arrangements:		
Within one year	**–**	1,356

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 2011, the consolidated entity was contingently liable for US$7,425,000 of surety and supplemental bonds (2010: US$10,075,000) issued through a surety company to secure those obligations. At balance date US$6,625,000 of these bonds were collateralised by cash (2010: US$6,625,000 by cash and letters of credit).

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 2011 and 2010, is set out as follows:

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

	Consolidated	
	2011 US$'000	2010 US$'000
Retained earnings/(accumulated losses) at beginning of year	**(130,902)**	(79,044)
Profit/(loss) after related income tax expense	**(19,676)**	(51,858)
Retained earnings/(accumulated losses) at end of year	**(150,578)**	(130,902)

26. Deed of cross guarantee

Balance sheet

	Consolidated 2011 US$'000	Consolidated 2010 US$'000
Assets		
Cash and cash equivalents	31,367	12,817
Other receivables	9,927	3,969
Prepayments	108	116
Total current assets	41,402	16,902
Loans receivable from controlled entities	–	26,592
Loans receivable from related parties	817	–
Other financial assets	11,000	8,178
Other investments	27,920	39,509
Property, plant and equipment	31	38
Total non-current assets	39,768	74,317
Total assets	81,170	91,219
Liabilities		
Trade and other payables	281	322
Employee benefits provision	45	35
Total current liabilities	326	357
Loans payable to controlled entities	8,042	–
Employee benefits provision	237	233
Total non-current liabilities	8,279	233
Total liabilities	8,605	590
Net assets	72,565	90,629
Equity		
Issued capital	185,793	184,783
Reserves	37,350	36,748
Retained earnings/(accumulated losses)	(150,578)	(130,902)
Total equity	72,565	90,629

27. Consolidated entities

	Country of Incorporation	Ownership interest 2011 %	Ownership interest 2010 %
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 Petroleum LLC[1]	USA	**–**	100
Petsec Energy Inc.	USA	**100**	100
Petsec Exploration and Production LLC	USA	**100**	100
Laurel Bay Petroleum Limited	Australia	**100**	100
Ginida Pty. Limited	Australia	**100**	100
Western Medical Products Pty. Limited	Australia	**100**	100

1 Petsec Petroleum LLC was sold to Horizon Oil in June 2011 (refer to *note 29 Discontinued Operations* for further details).

All entities carry on business in the country where they were incorporated with the exception of Petsec Petroleum LLC, which held the consolidated entity's interests in the Beibu Gulf, China.

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. 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).

28. Segment reporting cont.

During the current period, Petsec Energy sold the subsidiary through which it conducted its China operations (refer to *note 29 Discontinued Operations* for further details). The effective date of the sale was 1 January 2011.

	Australia		USA		China		Consolidated	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Oil and gas sales and royalties	**–**	–	**15,002**	31,061	**–**	–	**15,002**	31,061
Royalties paid	**–**	–	**(2,047)**	(3,981)	**–**	–	**(2,047)**	(3,981)
Net revenues after royalties*	**–**	–	**12,955**	27,080	**–**	–	**12,955**	27,080
Segment net profit/(loss) before tax	**26,524**	(1,342)	**(12,490)**	(19,902)	**–**	(404)	**14,034**	(21,648)
Income tax expense							**–**	(13,589)
Profit/(loss) after tax							**14,034**	(35,237)
Depreciation, depletion and amortisation	**12**	13	**5,192**	12,483	**–**	–	**5,204**	12,496
Dry hole, impairment and abandonment expense	**–**	–	**20,229**	19,456	**–**	–	**20,229**	19,456
Seismic and repair expense	**–**	–	**478**	533	**–**	–	**478**	533
Segment assets	**32,997**	12,993	**33,439**	63,424	**–**	13,662	**66,436**	90,079
Acquisition of property, plant and equipment and exploration, evaluation and development assets	**4**	10	**3,888**	11,323	**–**	606	**3,892**	11,939

* There are no inter-segment sales

	Australia		USA		China		Consolidated	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Segment liabilities	**563**	589	**8,571**	45,963	**–**	686	**9,134**	47,238
Cash flows from operating activities	**(2,059)**	(1,707)	**(4,536)**	3,942	**–**	(394)	**(6,595)**	1,841
Cash flows from investing activities	**40,865**	(10)	**(3,888)**	(11,198)	**–**	(719)	**36,977**	(11,927)
Cash flows from financing activities	**–**	–	**(12,833)**	(225)	**–**	–	**(12,833)**	(225)

29. Discontinued operation

On 2 June 2011, the Company entered into an agreement with Horizon Oil Limited for the sale of Petsec Energy's wholly owned subsidiary, Petsec Petroleum LLC, which held Petsec Energy's entire interest in Block 22/12 Beibu Gulf, China. 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. Following approval from the Chinese National Offshore Oil Corporation, this transaction completed in June 2011 resulting in the recognition of an accounting gain of US$29.8 million on disposal.

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

	Consolidated	
	2011 US$'000	2010 US$'000
Results from discontinued operation		
GG&A expense	–	(404)
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	(404)
Cash flows from discontinued operations		
Net cash from (used in) operating activities	–	(394)
Net cash from (used in) investing activities	–	(719)
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:

	Consolidated
	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.

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:

	Consolidated	
	2011 US$'000	2010 US$'000
Assets		
Exploration, evaluation and development expenditure – Tangible:		
Leases now in production		
Producing leases – at cost	**86,859**	138,230
Less: accumulated amortisation and impairment	**(69,634)**	(102,391)
	17,225	35,839
Represented by the following lease carrying values:		
– Main Pass 270	**10,261**	24,691
– Main Pass 19	**2,920**	8,724
– Onshore Louisiana	**4,044**	2,424
	17,225	35,839
Leases not yet in production		
– Block 22/12 Beibu Gulf, China[1]	**–**	12,315
– Other Gulf of Mexico leases	**–**	110
	–	12,425
Total exploration, evaluation and development expenditure – Tangible	**17,225**	**48,264**
Exploration and evaluation expenditure – Intangible:		
Not in production		
– Block 22/12 Beibu Gulf, China[1]	**–**	1,338
– Onshore Louisiana	**–**	2,814
– Other Gulf of Mexico leases	**1,573**	2,640
Total exploration, evaluation and development expenditure – Intangible	**1,573**	6,792

[1] Interest in Block 22/12 Beibu Gulf, China sold in June 2011.

	Consolidated	
	2011 US$'000	2010 US$'000
Liabilities		
Rehabilitation provision:		
– Main Pass 19	**1,510**	1,340
– Mobile Bay Area[2]	**–**	4,836
– Main Pass 270	**338**	336
– Onshore Louisiana	**522**	711
	2,370	7,223

[2] Mobile Bay Area field ceased production during the first half 2010. Plug and abandonment operations commenced during the current period and the work was completed by October 2011.

30. Interests in unincorporated joint operating arrangements cont.

The contribution of the consolidated entity's joint operating arrangements to EBIT (including exploration write-offs and impairments; and excluding the effects of hedging):

	Consolidated	
	2011 US$'000	2010 US$'000
– Main Pass 19	**(5,973)**	(5,215)
– Mobile Bay Area	**(624)**	(1,317)
– Main Pass 270	**(9,088)**	(6,882)
– Main Pass 20 Deep #4 well	**–**	(2,860)
– Block 22/12 Beibu Gulf, China[1]	**–**	(404)
– Onshore Louisiana	**(1,152)**	1,357
– Other Gulf of Mexico leases	**28**	230
	(16,809)	(15,091)

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:

	Consolidated	
	Interest held 2011	Interest held 2010
– Main Pass 19	**55.00%**	55.00%
– Mobile Bay Area	**–**	40.00% to 50.00%
– Main Pass 270	**18.75% to 22.50%**	25.00%
– Block 22/12 Beibu Gulf, China[1]	**–**	12.25% to 25.00%
– Onshore Louisiana	**46.21% to 80.00%**	10.00% to 80.00%
– Other Gulf of Mexico leases[2]	**37.50% to 75.00%**	25.00% to 50.00%

1 Interest in Block 22/12 Beibu Gulf, China sold in June 2011.
2 Reflects interest held following conveyance of minority interests as part of the terms of the settlement of the subordinated term debt in May 2011.

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:

	Consolidated	
	2011 US$'000	2010 US$'000
Assets		
Exploration, evaluation and development expenditure – Tangible:		
Leases now in production		
Producing leases – at cost	**47,998**	47,778
Less: accumulated amortisation and impairments	**(46,094)**	(41,801)
	1,904	5,977
Represented by the following lease carrying values:		
– Main Pass 18	**1,904**	5,348
– Chandeleur 31/32	**–**	629
	1,904	5,977
Not in production		
– Spare equipment	**143**	143
	143	143
Total exploration, evaluation and development expenditure – Tangible	**2,047**	**6,120**
Exploration and evaluation expenditure – Intangible:		
Not in production		
– Onshore Texas	**416**	–
– Other Gulf of Mexico leases	**–**	552
Total exploration and evaluation expenditure – Intangible	**416**	552

	Consolidated	
	2011 US$'000	2010 US$'000
Liabilities		
Rehabilitation provision:		
– Main Pass 18	**152**	134
– Main Pass 20[1]	**–**	3,516
– Chandeleur 31/32	**3,186**	2,880
	3,338	6,530

[1] The Main Pass 20 field ceased production in August 2009. Plug and abandonment operations commenced during the current period and the work was completed by October 2011.

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):

	Consolidated	
	2011 US$'000	2010 US$'000
– Chandeleur 31/32	**587**	786
– Main Pass 18	**(2,792)**	(965)
– Main Pass 20	**677**	(245)
– Other Gulf of Mexico leases	**–**	(2,745)
– Spare equipment	**–**	(359)
	(1,528)	(3,528)

32. Reconciliation of cash flows from operating activities

	Consolidated		The Company	
	2011 US$'000	2010 US$'000	2011 US$'000	2010 US$'000
Cash flows from operating activities				
Profit/(loss) for the period	**14,034**	(35,237)	**(19,674)**	(51,856)
Adjustments for:				
Depreciation, depletion and amortisation	**5,204**	12,496	**12**	13
Dry-hole, impairment and abandonment expense	**20,229**	19,456	**–**	–
Repair expense	**–**	142	**–**	–
Net movement in fair value of investments	**1,083**	–	**–**	–
Net movement in provisions against investments and loans to controlled entities	**–**	–	**26,435**	52,086
Management fee income	**–**	–	**(4,758)**	(857)
Dividend income	**–**	–	**(2,686)**	(2,787)
Profit/(loss) from discontinued operation	**(29,807)**	404	**–**	–
Gain on discharge of debt	**(11,365)**	–	**–**	–
Net foreign exchange losses/(gains)	**33**	(368)	**(1,308)**	1,741
Net loss/(gain) on property, plant and equipment	**(5)**	5	**–**	4
Share-based payment expenses	**28**	173	**24**	76
Operating profit before changes in working capital and provisions	**(566)**	(2,929)	**(1,955)**	(1,580)
Decrease/(increase) in restricted cash deposits	**(925)**	(5,700)	**–**	–
Decrease/(Increase) in receivables and prepayments	**1,798**	2,123	**(5,967)**	(2,681)
Decrease/(Increase) in deferred tax assets	**–**	12,513	**–**	–
(Decrease)/Increase in payables and provisions	**(6,902)**	(4,166)	**10,570**	3,532
Net cash from operating activities	**(6,595)**	1,841	**2,648**	(729)

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.)
D Swords (General Counsel/Corporate Secretary, Petsec Energy Inc.)
F Robertson (Chief Financial Officer, Petsec Energy Ltd) – Resigned on 3 February 2012
P Gahdmar (Company Secretary and Group Financial Controller, Petsec Energy Ltd)

Key management personnel compensation

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

	Consolidated	
	2011 US$	2010 US$
Wages and salaries	**1,021,663**	1,034,703
Service agreements for executives	**829,355**	823,699
Superannuation & 401(k) plans	**106,498**	104,783
Bonuses	**263,861**	–
Retirement benefits	**–**	179,049
Share-based payment compensation	**24,913**	164,672
Other benefits	**146,163**	132,962
	2,392,453	2,439,868

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 26.

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$199,000 in total (2010: US$198,000).

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, two key US management personnel were each issued 2,000,000 shares as long term incentive compensation. The shares were issued at a price of A$0.20 per share and funded by a loan from the Company, repayable on or before 1 January 2016 and secured by a recourse promissory note bearing interest at the rate of 2.26% (U.S. based rate as the key management personnel are U.S. residents). The shares are subject to a holding lock which prevents them from being sold or assigned. For each of the two executives 1,000,000 shares were released from the holding lock on 1 January 2012, and unless there is a prior change of control of the Company or involuntary cessation of employment of the key management personnel, the shares will be released to each of the executives from the holding lock as follows:

i. 500,000 shares on 1 January 2013

ii. 500,000 shares on 1 January 2014

The shares were issued outside the Employee Share Plan as the executives are based in the U.S. and the plan was designed specifically to meet Australian regulatory and taxation requirements. The progressive release of shares from the holding lock is designed to assist with retention of the executives.

The aggregate amounts recognised during the year relating to key management personnel and their personally related entities, were a total expense of US$830,000 (2010: US$824,000). Refer to Remuneration Report for further details.

Assets and liabilities arising from the above related party transactions

	The Company	
	2011 US$'000	2010 US$'000
Non-current assets		
Related party receivables	**816**	–
Current liabilities		
Related party payables	**56**	3

Other related party disclosures

Information relating to subsidiaries is set out in *note 27*.

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 2011	Granted as compensation	Exercised	Other changes[1]	Held at 31 December 2011	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	**260,000**	**–**	**–**	**–**	**260,000**	**86,666**	**–**
F Robertson[2]	**225,000**	**–**	**–**	**(225,000)**	**–**	**–**	**–**
P Gahdmar	**225,000**	**–**	**–**	**–**	**225,000**	**74,999**	**–**

	Held at 1 January 2010	Granted as compensation	Exercised	Other changes[1]	Held at 31 December 2010	Vested during the year	Vested and exercisable at 31 December 2010
Directors							
T Fern	2,000,000	–	–	–	2,000,000	500,000	–
Executives							
R Keogh	1,150,000	–	–	(1,000,000)	150,000	50,000	50,000
R Krenzke	–	–	–	–	–	–	–
D Swords	310,000	200,000	–	(250,000)	260,000	20,000	20,000
F Steele[3]	200,000	200,000	–	(400,000)	–	–	–
F Robertson[2]	225,000	–	–	–	225,000	56,250	–
P Gahdmar	100,000	200,000	–	(75,000)	225,000	8,333	8,333

1 Other changes represent options that expired or were forfeited during the year.
2 Ms Robertson resigned on 3 February 2012.
3 Mr F Steele resigned on 26 July 2010.

Key management personnel related parties held no options.

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 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	–	–	–	–	–	–
F Robertson[1]	**172,625**	–	–	–	–	**172,625**
P Gahdmar	**120,000**	–	–	–	–	**120,000**

	Held at 1 January 2010	Granted as compensation	Purchases	Received on exercise of options	Sales/ Disposal of relevant interest	Held at 31 December 2010
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	–	–	–	–	1,612,500
R Krenzke	–	–	250,000	–	–	250,000
D Swords	–	–	–	–	–	–
F Robertson[1]	172,625	–	–	–	–	172,625
P Gahdmar	120,000	–	–	–	–	120,000

[1] Ms Robertson resigned on 3 February 2012.

34. Events subsequent to balance date

On 15 February 2012, Petsec Energy announced that it had 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. To earn its interest in the leases, the Company will pay 35% of the costs to drill one initial commitment well and 35% of the costs of drilling up to three optional wells.

The Company's share of the drilling costs for the initial commitment well, which is expected to spud in early March 2012, is approximately US$0.7 million.

Further details relating to the farm-in to the shale oil project are contained within the media release made to ASX on 15 February 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 72, 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 2011 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 2011.

Signed in accordance with a resolution of the directors:

T N Fern
Director

Sydney, 28 February 2012

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 balance sheets as at 31 December 2011, and statements of comprehensive income, statements of changes in equity and statements of cash flows for the year ended on that date, notes 1 to 34 comprising a summary of significant accounting policies and other explanatory information and the directors' declaration of the company and 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, 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 Company's and the Group's financial position and of their 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*.

Auditor's opinion

In our opinion:

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

(i) giving a true and fair view of the Company's and the Group's financial position as at 31 December 2011 and of their performance for the year ended on that date; and

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

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

Report on the remuneration report

We have audited the Remuneration Report included in pages 18 to 26 of the directors' report for the year ended 31 December 2011. 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 2011, complies with Section 300A of the *Corporations Act 2001*.

KPMG

KPMG

David Sinclair
Partner

Sydney

28 February 2012

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 2011 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.

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, 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.

(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 Moonshine Project					Petsec Energy	HBP	0.50000 – 0.80000	0.36000 – 0.60000
		E. Laurent No. 1 Well					0.80000	.60000 (est.)
		W.P. Miles Timber No. 1 Well					0.62000	.45000 (est.)
Marathon Prospect	SL 20221	SL 20221 No. 1 Well SL 20221 No. 2 Well (drilling)	9/12/09	3	Castex Energy	Primary	0.080000	0.058400
	SL 20367		9/06/10	3	Castex Energy	Primary	0.080000	0.058400
	SL 20368		9/06/10	3	Castex Energy	Primary	0.080000	0.058400
	SL 20369	SL 20369 No. 1 Well	9/06/10	3	Castex Energy	Primary	0.080000	0.058400
	SL 20528		12/01/11	3	Castex Energy	Primary	0.080000	0.058400
	SL 20529		12/01/11	3	Castex Energy	Primary	0.080000	0.058400
	SL 20530		12/01/11	3	Castex Energy	Primary	0.080000	0.058400
	SL 20753		14/09/11	3	Castex Energy	Primary	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	0.81330
		A 002 ST 1 Well Serial No. 1772840871					1.00000	0.81333
Chandeleur 32	OCS-G 27214	A 001/1D Well Serial No. 1772840872	1/06/05	5	Petsec Energy	HBP	1.00000	0.81333
Main Pass 18	OCS-G 27194	G-6 Well API No. 17-725-40815-00	1/07/05	5	Petsec Energy	HBP	1.00000	0.83330
Main Pass 19	OCS-G 26146	G-1 Well API No. 17-725-40800-00	1/07/04	5	Petsec Energy	HBP	0.55000	0.45830
		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					0.25000	0.18750
		A 003 Well Serial No. 1772440906					0.22500	0.18750
North Padre Island 929	OCS-G 32720		1/10/08	5	Petsec Energy	Primary	0.37500	0.28845
North Padre Island 934	OCS-G 32721		1/10/08	5	Petsec Energy	Primary	0.37500	0.28845
Breton Sound 39	OCS-G 33683		1/07/10	5	Petsec Energy	Primary	0.56250	0.4570313
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	0.59813
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	0.3046875
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 2012

Number of Shareholders

Issued capital was 235,683,622 ordinary shares held by 4,899 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	1,399
1,001-5,000	1,511
5,001-10,000	670
10,001-100,000	1,091
100,001 and over	228
Total number of shareholders	**4,899**
Number holding less than a marketable parcel	1,994

Largest Twenty Shareholders

The largest twenty shareholders held 127,561,890 ordinary shares being 54.12% of the issued ordinary capital.

Name of Holder	No of Shares	%
CANNING OIL PTY LTD	25,709,116	10.91
MARTIN PLACE SECURITIES NOMINEES PTY LTD	24,426,981	10.36
HSBC CUSTODY NOMINEES (AUSTRALIA) LIMITED	13,659,727	5.80
LIPPO SECURITIES NOMINEES (BVI) LTD <CLIENT A/C>	11,332,500	4.81
MR DAVID A MORTIMER & MRS BARBARA L MORTIMER <WALLAROY PROVIDENT FUND A/C>	8,636,448	3.66
NATIONAL NOMINEES LIMITED	6,547,754	2.78
CITICORP NOMINEES PTY LIMITED	4,863,507	2.06
HESTIAN PTY LTD	4,281,950	1.82
HUMBOLDT CAPITAL CORPORATION	3,674,532	1.56
DEN DUYTS CORPORATION PTY LTD	3,057,635	1.30
PIAT CORP PTY LTD	2,487,000	1.06
CALVESTON WORLDWIDE LTD	2,460,000	1.04
SINO CHAMPION DEVELOPMENT LIMITED	2,459,579	1.04
MRS ELIZABETH HEATH	2,426,000	1.03
ASIAN CORPORATE ADVISERS (BVI) LIMITED	2,250,000	0.96
EVELIND PTY LTD <THE ALPHA A/C>	2,063,198	0.88
IRONSIDE PTY LTD <IRONSIDE FAMILY A/C>	2,000,000	0.85
SCINTILLA STRATEGIC INVESTMENTS LIMITED	1,800,000	0.76
KEY RESOURCE ANALYSTS LTD	1,754,824	0.75
MARTIN PLACE SECURITIES NOMINEES PTY LTD <GULF STREAM A/C>	1,671,139	0.71

Substantial shareholders disclosed in substantial shareholder notices given to the Company are as follows:		
CANNING OIL PTY LTD including its associates	28,826,876	12.46

FIVE YEAR COMPARATIVE DATA SUMMARY

Financial Performance		2007	2008	2009	2010	2011	% change
Net Production (Bcfe)[1]		8.1	12.1	7.1	3.9	**2.3**	(42%)
Average Gas Price Received	(US$/Mcfe)	$7.93	$8.70	$7.36	$6.98	**$5.69**	(18%)
US$ millions							
Net Revenue	(US$m)	$64.0	$105.3	$52.0	$27.1	**$13.0**	(52%)
EBITDAX[2]	(US$m)	$45.9	$79.6	$31.3	$13.1	**$1.6**	(88%)
Realised hedge gains[3]	(US$m)	$0.0	$0.0	$0.0	$0.0	**$(1.5)**	n/a
Depreciation, depletion & amortisation	(US$m)	$(27.7)	$(57.3)	$(21.0)	$(12.5)	**$(5.2)**	(58%)
Exploration Writeoffs, Provisions & seismic and repair expenses	(US$m)	$(20.1)	$(75.1)	$(11.9)	$(20.0)	**$(20.6)**	3%
EBIT		$(1.9)	$(52.8)	$(1.6)	$(19.4)	**$(25.7)**	32%
Derivative gains/(losses)	(US$m)	$0.0	$0.0	$0.0	$1.2	**$(0.9)**	n/a
Gain on discharge of debt	(US$m)	$0.0	$0.0	$0.0	$0.0	**$11.3**	n/a
Net financial income (expense)	(US$m)	$(0.9)	$(7.1)	$(5.5)	$(3.0)	**$(0.5)**	(83%)
Income tax benefit/(expense)	(US$m)	$0.8	$15.4	$(7.8)	$(13.6)	**$0.0**	(100%)
Profit from discontinued operation[4]	(US$m)	$0.0	$0.0	$0.0	$(0.4)	**$29.8**	n/a
Net Profit/(Loss) after Tax	(US$m)	$(2.0)	$(44.5)	$(14.9)	$(35.2)	**$14.0**	n/a
EBITDAX Margin/Mcfe	(US$/Mcfe)	$5.69	$6.58	$4.43	$3.36	**$0.72**	(79%)
Operating Cashflow after Tax	(US$m)	$35.1	$85.2	$28.0	$1.8	**$(6.6)**	n/a
Balance Sheet							
Total Assets	(US$m)	$254.7	$161.7	$130.7	$90.1	**$66.4**	(26%)
Cash[5]	(US$m)	$27.2	$13.7	$25.4	$23.1	**$41.6**	80%
Debt[6]	(US$m)	$101.8	$48.8	$28.4	$28.9	**$0.0**	(100%)
Shareholders Equity	(US$m)	$123.3	$85.9	$80.0	$42.8	**$57.3**	34%
Cashflow and Capital Expenditures							
Net Cashflow from:							
Operations	(US$m)	$35.1	$85.2	$28.0	$1.8	**$(6.6)**	(467%)
Investing	(US$m)	$(146.5)	$(43.5)	$(10.2)	$(11.9)	**$37.0**	n/a
Financing	(US$m)	$110.7	$(53.7)	$(7.4)	$(0.2)	**$(12.8)**	n/a
		$(0.7)	$(12.0)	$10.4	$(10.3)	**$17.6**	
Capital Expenditures[7]							
Exploration	(US$m)	$22.1	$30.8	$1.5	$7.7	**$0.6**	(92%)
Development	(US$m)	$20.0	$11.4	$3.5	$1.2	**$2.8**	133%
Acquisition	(US$m)	$103.8	$1.1	$0.2	$1.7	**$0.5**	(71%)
		$145.9	$43.3	$5.2	$10.6	**$3.9**	
A$ million							
EBITDAX[2]	(A$m)	$54.8	$93.0	$39.6	$14.3	**$1.5**	(89%)
Net Profit after Tax	(A$m)	$(2.4)	$(52.0)	$(18.9)	$(38.3)	**$13.5**	n/a
Operating Cashflow after Tax	(A$m)	$41.9	$99.6	$35.5	$2.0	**$(6.3)**	(424%)
(US$/A$ exchange rate)		$0.84	$0.86	$0.79	$0.92	**$1.04**	13%
Operating Margins & Costs							
Average Gas Price Received	(US$/Mcfe)	$7.93	$8.70	$7.36	$6.98	**$5.69**	(18%)
+ Other Income	(US$/Mcfe)	$0.04	$(0.06)	$0.00	$0.27	**$0.07**	n/a
- Operating Costs (GG&A + LOE)	(US$/Mcfe)	$2.28	$2.06	$2.93	$3.99	**$5.04**	26%
= EBITDAX[2]	(US$/Mcfe)	$5.69	$6.58	$4.43	$3.26	**$0.72**	(78%)
Depreciation, Depletion & Amort.	(US$/Mcfe)	$3.44	$4.73	$2.97	$3.22	**$2.29**	(29%)
Finding and Development Costs (three year average 2P)[8]	(US$/Mcfe)	$4.10	$6.20	$24.38	n/a	**n/a**	n/a
Reserves							
Proved and Probable Reserves (2P)[9]	(Bcfe)	69.6	51.9	40.4	34.3	**14.7**	(57%)
Reserves Replacement Ratio (%)		222%	(46%)	(62%)	(55%)	**n/a**	

[1] Bcfe = billion cubic feet of gas equivalent. Mcfe = thousand cubic feet of gas equivalent.

[2] 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.

[3] Realised hedge gains relate to derivative natural gas collar contracts which settled during the period. The Company has included the impact of the realised hedge gains, in the reported Net Revenue and EBITDAX amounts in the above table and elsewhere in the Directors' Report and Full Year Financial Statements to better reflect the commercial impact and rationale for holding these derivative instruments.

[4] Profit from discontinued operation reflects the accounting gain recognised on the disposal of the wholly owned subsidairy which held the China oil interests.

[5] Includes US$6.6m of cash deposits held in an escrow account to partially secure US$7.4 million of operator bonds that are on issue to the Bureau of Ocean Energy Management, restricted cash deposits used to collaterise letter of credit amounts in excess of the Company's bank borrowing base facility and amounts held in escrow to Regulation and Enforcement ("BOEMRE").

[6] 2007 through 2010 debt is shown net of original issue discount and transaction costs (refer *note 18 – Borrowings* of the notes to the consolidated financial statements).

[7] Excludes minor (non oil & gas) property, plant & equipment expenditure and investments.

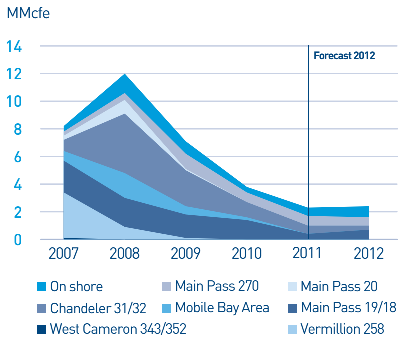
[8] Finding & Development (F&D) costs include all exploration writeoffs. 2007 through 2009 includes the cost of acquiring interests in producing assets in 2007.

[9] Petsec Energy – estimated recoverable proved and probable (2P) reserves. Current period decrease reflects disposal of previously booked China oil reserves in June 2011.

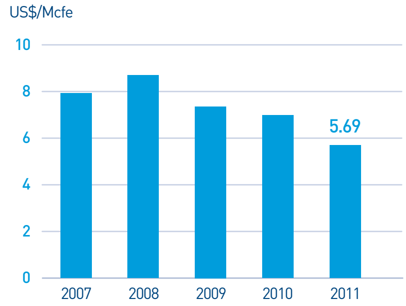
FIVE YEAR COMPARATIVE DATA SUMMARY CONT.

For the year ended 31 December 2011

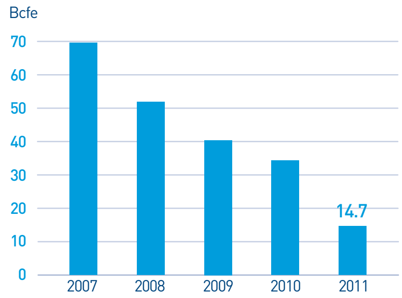
Production History by Field



Average Gas Equivalent Price Received per Mcfe

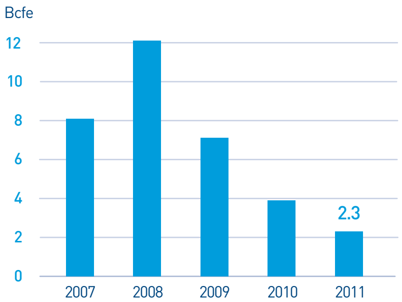


Proved and Probable Reserves* at Year End

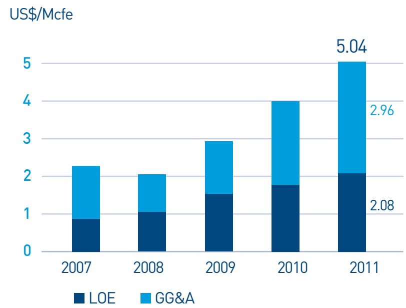


*Petsec Internal Estimate

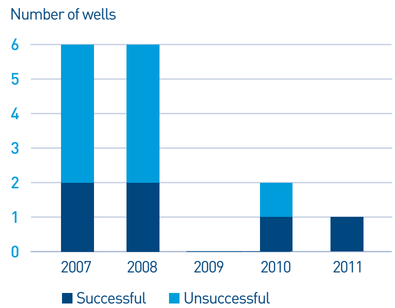
Production



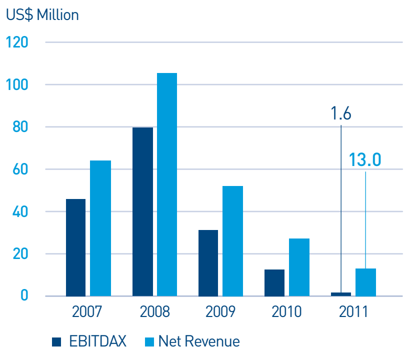
Total Operating Expense (LOE & GG&A) per Mcfe



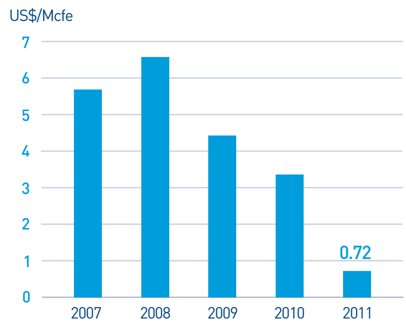
Wells Drilled/Successful – USA/China [40% success rate - 5 years to 2011]



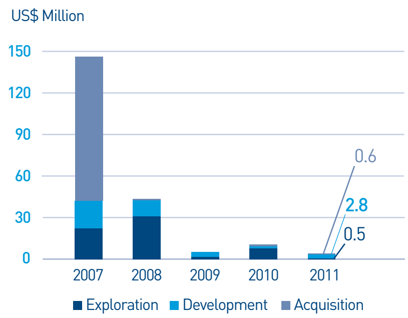
EBITDAX and Net Revenue



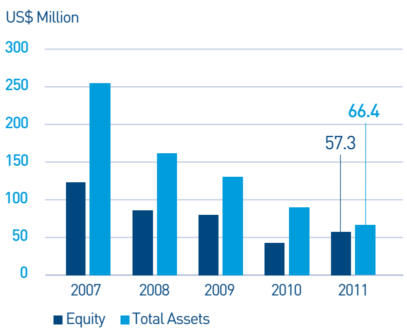
Cash Operating Margins



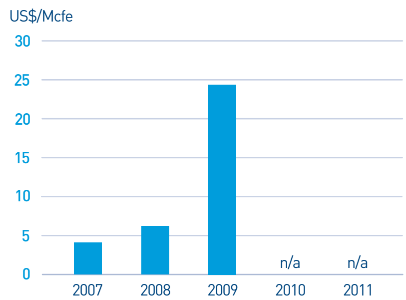
Exploration, Development and Acquisition Expenditure



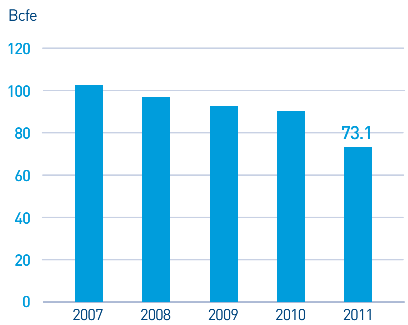
Balance Sheet Equity and Total Assets



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



Cumulative 2P Reserve Additions



PETSEC ENERGY LTD CORPORATE DIRECTORY

Board of Directors
Terry N Fern – Chairman & Managing Director
Mike L Harvey – Non-executive Director
David A Mortimer – Non-executive Director

Company Secretary
Paul Gahdmar

Australian Management
Paul Gahdmar – Company Secretary & Group Financial Controller

USA Management
Ross A Keogh – President, Petsec Energy Inc. and Group Chief Financial Officer
Ron A Krenzke – Executive Vice President – Exploration
Patrick Webb – Vice President Business Development and Land

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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

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