



Underground Energy Corporation

Unaudited Condensed Interim Consolidated Financial Statements
For the Three Months Ended March 31, 2012 and 2011

UNDERGROUND ENERGY CORPORATION

Condensed Interim Consolidated Balance Sheets

(in US dollars) | (unaudited)

	Note	March 31, 2012	December 31, 2011
Assets			
Cash and cash equivalents		\$ 11,208,820	\$ 14,646,951
Restricted cash	4	800,279	1,077,260
Accounts receivable		536,585	302,422
Prepaid expenses and deposits		726,485	653,370
Loans receivable		175,083	167,970
Total current assets		13,447,252	16,847,973
Investments		146,757	155,374
Property, plant and equipment	5	7,621,170	5,138,369
Exploration and evaluation assets	6	6,019,011	5,377,653
Total non-current assets		13,786,938	10,671,396
Total assets		\$ 27,234,190	\$ 27,519,369
Liabilities			
Accounts payable and accrued liabilities	7	\$ 3,944,986	\$ 3,144,624
Warrant liability		704,000	448,000
Total current liabilities		4,648,986	3,592,624
Decommissioning obligations provision		119,817	99,012
Total liabilities		4,768,803	3,691,636
Equity			
Share capital		38,029,080	37,590,330
Share-based payment reserve	8	2,073,892	1,324,286
Deficit		(17,637,585)	(15,086,883)
Total equity		22,465,387	23,827,733
Subsequent events (notes 8 and 11)			
Total equity and liabilities		\$ 27,234,190	\$ 27,519,369

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

UNDERGROUND ENERGY CORPORATION

Condensed Interim Consolidated Statements of Comprehensive Loss

(in US dollars) | (unaudited)

	Three Months Ended March 31	
	2012	2011
Revenues		
Oil and natural gas revenue	\$ 163,538	\$ –
Other income	–	47,925
	163,538	47,925
Expenses		
Production and operating	411,593	–
Exploration and evaluation	570,099	279,904
Administrative	1,723,183	470,949
	2,704,875	750,853
Operating Loss	2,541,337	702,928
Finance income	6,704	779
Finance expense	7,452	12,101
Net finance expense (income)	748	11,322
Loss Before Loss of Equity Accounted Investments	2,542,085	714,250
Share of loss of equity accounted investments	8,617	–
Loss and comprehensive loss for the period	\$ 2,550,702	\$ 714,250
Loss per share:		
Basic and diluted	\$ (0.01)	\$ (0.01)

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

UNDERGROUND ENERGY CORPORATION

Condensed Interim Consolidated Statements of Changes in Equity
(in US dollars) | (unaudited)

	Number of ordinary shares	Share capital	Share- based payment reserve	Deficit	Total equity
Balance at December 31, 2010	56,334,336	\$ 5,028,198	\$ 433,625	\$ (4,919,052)	\$ 542,771
Issue of ordinary shares	46,212,798	6,678,150	—	—	6,678,150
Share issuance costs, net of tax of \$nil	—	(9,976)	—	—	(9,976)
Share-based payments	—	—	95,093	—	95,093
Non-cash dividends paid	—	—	—	(2,853)	(2,853)
Loss for the period	—	—	—	(714,250)	(714,250)
Balance at March 31, 2011	102,547,134	\$ 11,696,372	\$ 528,718	\$ (5,636,155)	\$ 6,588,935

Number of shares has been adjusted to reflect the corporate merger, which is described in note 13 of the Audited Consolidated Financial Statements for the year ended December 31, 2011.

	Number of ordinary shares	Share capital	Share- based payment reserve	Deficit	Total equity
Balance at December 31, 2011	202,152,379	\$ 37,590,330	\$ 1,324,286	\$ (15,086,883)	\$ 23,827,733
Warrants exercised	2,024,100	438,750	—	—	438,750
Share-based payments	—	—	749,606	—	749,606
Loss for the period	—	—	—	(2,550,702)	(2,550,702)
Balance at March 31, 2012	204,176,479	\$ 38,029,080	\$ 2,073,892	\$ (17,637,585)	\$ 22,465,387

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

UNDERGROUND ENERGY CORPORATION

Condensed Interim Consolidated Statements of Cash Flows

(in US dollars) | (unaudited)

	Note	Three Months Ended March 31	
		2012	2011
Cash flows from operating activities:			
Loss for the period		\$ (2,550,702)	\$ (714,250)
Adjustments for:			
Share of loss of equity accounted investments		8,617	–
Depletion, depreciation and amortization	5	40,555	5,620
Impairment losses on exploration and evaluation assets	6	385,348	–
Gain on sale of exploration and evaluation assets		–	(47,925)
Accretion of decommissioning obligations		195	–
Share-based compensation	8	749,606	95,093
Warrant liability, mark-to-market adjustment		256,000	–
Change in non-cash working capital, operating activities	9	485,971	(442,619)
Net cash used in operating activities		(624,410)	(1,104,081)
Cash flows from investing activities:			
Additions to property, plant and equipment	5	(2,502,746)	(7,785)
Additions to exploration and evaluation assets	6	(1,026,706)	(519,593)
Proceeds from sale of exploration and evaluation assets	6	–	50,000
Investment in Careaga Sand and Asphalt Company		–	(2,853)
Investment in EQ Energy LLC		–	(500)
Reduction in restricted cash		276,981	–
Net cash used in investing activities		(3,252,471)	(480,731)
Cash flows from financing activities:			
Proceeds from issue of share capital		–	6,678,150
Share issuance costs		–	(9,976)
Proceeds upon exercise of warrants		438,750	–
Net cash from financing activities		438,750	6,668,174
Change in cash and cash equivalents		(3,438,131)	5,083,362
Cash and cash equivalents beginning of period		14,646,951	427,730
Cash and cash equivalents end of period		\$11,208,820	\$ 5,511,092

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

UNDERGROUND ENERGY CORPORATION

Notes to Condensed Interim Consolidated Financial Statements

For the three months ended March 31, 2012 and 2011
(all amounts are in US dollars, unless otherwise stated) | (unaudited)

1. Reporting Entity

Underground Energy Corporation ("Underground", "the Company" or "we") is an energy company in the business of locating and gaining access to hydrocarbon deposits that are known but have not been completely recovered, and applying advanced exploration, drilling and completion techniques and production stimulation methods to extract the hydrocarbons. The Company is incorporated and domiciled in the British Virgin Islands.

2. Basis of Preparation

A) Statement of Compliance

These condensed interim consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as adopted by the IASB. Specifically they have been prepared in accordance with International Accounting Standard ("IAS") 34, "Interim Financial Reporting". These interim consolidated financial statements do not include all of the information required for full annual consolidated financial statements.

These interim consolidated financial statements were authorized for issue by the Board of Directors on May 23, 2012.

B) Basis of Preparation

The basis of preparation that we follow is described in note 2 of the Audited Consolidated Financial Statements for the year ended December 31, 2011. There have been no changes to our basis of preparation since December 31, 2011.

3. Accounting Policies

The accounting policies we follow are described in note 3 of the Audited Consolidated Financial Statements for the year ended December 31, 2011. There have been no changes to our accounting policies since December 31, 2011.

4. Restricted Cash

Restricted cash is comprised of \$750,279 in a US bank account under an escrow agreement to fund a liability for payments under a gas pipeline agreement that is included in accounts payable (note 7); and a \$50,000 certificate of deposit at a US bank as a compensating balance under a credit arrangement.

UNDERGROUND ENERGY CORPORATION

Notes to Condensed Interim Consolidated Financial Statements

For the three months ended March 31, 2012 and 2011

(all amounts are in US dollars, unless otherwise stated) | (unaudited)

5. Property, Plant and Equipment

Cost

	Oil and Natural Gas Interests	Corporate	Total
Balance at December 31, 2011	\$ 4,793,409	\$ 520,051	\$ 5,313,460
Additions	2,471,796	30,950	2,502,746
Decommissioning obligations	20,610	—	20,610
Balance at March 31, 2012	\$ 7,285,815	\$ 551,001	\$ 7,836,816

Accumulated depletion and depreciation

	Oil and Natural Gas Interests	Corporate	Total
Balance at December 31, 2011	\$ 15,031	\$ 160,060	\$ 175,091
Depletion and depreciation	13,724	26,831	40,555
Balance at March 31, 2012	\$ 28,755	\$ 186,891	\$ 215,646

Net book value

	Oil and Natural Gas Interests	Corporate	Total
At December 31, 2011	\$ 4,778,378	\$ 359,991	\$ 5,138,369
At March 31, 2012	\$ 7,257,060	\$ 364,110	\$ 7,621,170

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Notes to Condensed Interim Consolidated Financial Statements

For the three months ended March 31, 2012 and 2011
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6. Exploration and Evaluation Assets

The Company has working interests ranging from 70% to 100% in various oil and gas leaseholds in the states of California and Nevada in the Western United States. Exploration and evaluation assets consist of the Company's exploration projects which are pending the determination of proven or probable reserves.

The Company's share of expenditures on E&E assets which were capitalized during the period are:

	Three months ended March 31, 2012
Acquisitions and lease rental payments	\$ 164,060
Geology and seismic	862,646
Additions to E&E assets	1,026,706
Impairments	(385,348)
Change to E&E assets	641,358
E&E assets beginning of period	5,377,653
Balance at end of period	\$ 6,019,011

A) Acquisition and Lease Rental Payments

During the three months ended March 31, 2012, the Company made annual lease payments totaling \$71,495.

During the three months ended March 31, 2012, the Company acquired a 75% working interest in properties in the San Joaquin Valley in California covering an area of 804 net acres at an aggregate cost of \$92,565.

B) Geology and Seismic

During the three months ended March 31, 2012, the Company incurred \$608,180 on geologic investigation and seismic surveys of the Devil's Den prospect; the balance of the \$862,646 in exploration and evaluation assets of geology and seismic additions was incurred on various other projects.

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Notes to Condensed Interim Consolidated Financial Statements

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6. Exploration and Evaluation Assets (continued)

C) Impairments

During Q1 of 2012 management decided that it would allow certain leases on gas properties to lapse at the Challenger prospect in the San Joaquin Valley. As a result, the Company wrote off \$371,808 of costs capitalized in respect of those properties in the statement of comprehensive loss.

During Q1 of 2012 the Company allowed its seismic option in respect of its Mustang Flats project in Nevada to lapse. As a result, the Company wrote off in the statement of comprehensive loss \$13,540 of costs capitalized during Q1 in respect of the property.

7. Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities are comprised of:

	March 31, 2012	December 31 2011
Trade accounts payable	\$ 2,011,128	\$ 834,785
Accrued liabilities	1,197,000	1,257,185
Gas pipeline liability	736,858	1,052,654
	<u>\$ 3,944,986</u>	<u>\$ 3,144,624</u>

8. Share-Based Payment Reserve

During Q1 of 2012, the Company issued 1,550,000 time-based options to a senior officer and a new employee. Each option entitles the holder to acquire one common share at an exercise price of \$0.284 for up to ten years.

Subsequent to March 31, 2012, the Company issued 2,665,658 time-based options; 2,390,658 with a three year term to employees who selected options rather than a cash incentive bonus and 275,000 with a ten year term to new employees. Each option entitles the holder to acquire one common share at an exercise price of \$0.284.

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9. Supplemental Cash Flow Information

Changes in non-cash working capital is comprised of:

	Period Ended March 31	
	2012	2011
Source (use) of cash:		
Accounts receivable	\$ (234,163)	\$ 3,926
Prepaid expenses and deposits	(73,115)	(67,790)
Loans receivable	(7,113)	(98,706)
Trade accounts payable	800,362	(280,049)
Related to operating activities	\$ 485,971	\$ (442,619)

10. Related Party Disclosures

The only payments made to directors and officers during the three month period ending March 31, 2012 were for compensation and expense reimbursement. Current liabilities as at March 31, 2012 included \$1,021,249 payable to directors and officers of the Company.

The Company's relationship with its former subsidiary, Careaga Sand and Asphalt Company, is described in note 6 of the Audited Consolidated Financial Statements for the year ended December 31, 2011. There have been no changes in that relationship since December 31, 2011.

The Company's relationships with EQ Energy LLC and Subset Energy, LLC ("Subset") are described in note 7 of the Audited Consolidated Financial Statements for the year ended December 31, 2011. There have been no changes in those relationships since December 31, 2011. During Q1 of 2012 the investment in Subset was adjusted to reflect the results of Subset's operations.

11. Subsequent Event

Subsequent to March 31, 2012, investors exercised 475,173 warrants, resulting in the issuance of 475,173 common shares and the receipt of \$103,000 by the Company.