

Gastar Exploration Ltd.
Interim Consolidated Financial Statements
For the six months ended June 30, 2005
(Unaudited – Prepared by Management)

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Gastar Exploration Ltd.
(United States Dollars)
Interim Consolidated Balance Sheets
(Unaudited – Prepared by Management)

As at	June 30, 2005 (unaudited) (in thousands)	December 31, 2004 (audited)
Assets		
Current		
Cash	\$ 13,313	\$ 15,841
Revenue receivable	3,962	1,693
Accounts receivable	25	39
Due from related party (Note 14(c))	858	-
Prepaid expenses	131	307
Current portion of deferred charges (Note 6)	101	238
	18,390	18,118
Deferred charges (Note 6)	19,769	5,297
Cash call receivable (Note 4)	2,822	6,318
Property and equipment (Note 5)	163,352	64,563
	\$ 204,333	\$ 94,296
Liabilities and Shareholders' Equity		
Current		
Accounts payable and accrued liabilities	\$ 12,216	\$ 1,197
Accounts payable – joint venture partner (Note 14(a))	-	601
Note payable (Note 3 and 20)	7,500	-
	19,716	1,798
Long Term		
Accrued liability	77	77
Drilling advances liability	-	1,002
Senior notes (Note 8)	-	26,483
Subordinated, unsecured notes payable	3,250	3,250
Note payable (Note 3 and 20)	7,500	-
Senior secured notes (Note 9)	63,000	-
Convertible notes	29,754	29,725
Asset retirement obligation (Note 7)	3,111	1,711
	126,408	64,046
Liability to be Settled by the Issuance of Shares		
Note payable (Note 3 and 20)	17,000	-
Senior secured notes (Note 9)	10,930	-
	27,930	-
Shareholders' Equity		
Convertible notes	284	284
Share capital (Note 11(b))	75,045	48,305
Contributed surplus (Note 12)	2,914	1,374
Share purchase warrants (Note 11(f))	2,847	2,847
Translation loss	(83)	(83)
Deficit	(31,012)	(22,477)
	49,995	30,250
	\$ 204,333	\$ 94,296

Commitments and Contingencies (Note 16)

On behalf of the Board:

"Abby Badwi " Director
 Abby Badwi

"Richard Kapuscinski " Director
 Richard Kapuscinski

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

Gastar Exploration Ltd
(United States Dollars)
Interim Consolidated Statements of Operations
(Unaudited – Prepared by Management)

	For the three month period ended June 30,		For the six month period ended June 30,	
	2005	2004	2005	2004
	(in thousands, except per share data)			
Revenues	\$ 4,942	\$ 517	\$ 9,674	\$ 873
Expenses				
Depletion, depreciation and amortization	(2,805)	(243)	(5,905)	(448)
Interest and debt related items (Note 10)	(4,969)	(219)	(7,136)	(586)
Accretion on asset retirement obligation (Note 7)	(24)	(11)	(43)	(25)
Lease operating, transportation and selling	(478)	(227)	(1,792)	(438)
General and administrative	(1,771)	(680)	(3,537)	(847)
Net loss before other items	<u>(5,105)</u>	<u>(863)</u>	<u>(8,739)</u>	<u>(1,471)</u>
Other items				
Investment income and other	23	4	62	8
Foreign exchange gain	167	55	142	42
	<u>190</u>	<u>59</u>	<u>204</u>	<u>50</u>
Net loss before income taxes	<u>(4,915)</u>	<u>(804)</u>	<u>(8,535)</u>	<u>(1,421)</u>
Provision for income taxes (Note 15)	-	-	-	-
Net loss for the period	<u>\$ (4,915)</u>	<u>\$ (804)</u>	<u>\$ (8,535)</u>	<u>\$ (1,421)</u>
Loss per share (Note 13)				
Net loss per share (basic and diluted)	\$ (0.042)	\$ (0.007)	\$ (0.074)	\$ (0.013)

Interim Consolidated Statements of Deficit

	For the six month period ended June 30,	
	2005	2004
	(in thousands)	
Balance, beginning of period	\$ (22,477)	\$ (15,039)
Current loss	(8,535)	(1,421)
Purchase price of common shares repurchased in excess of carrying value	-	(627)
Balance, end of period	<u>\$ (31,012)</u>	<u>\$ (17,087)</u>

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Gastar Exploration Ltd.
(United States Dollars)
Interim Consolidated Statements of Cash Flows
(Unaudited – Prepared by Management)

	For the three month period ended		For the six month period ended	
	June 30, 2004	June 30, 2004	June 30, 2004	June 30, 2004
	(in thousands)			
Cash from operating activities				
Net loss for the period	\$ (4,915)	\$ (804)	\$ (8,535)	\$ (1,421)
Adjustments for:				
Depletion and amortization	5,243	360	8,858	641
Compensation expense	748	55	1,540	55
Other income	-	-	(2)	-
Accretion expense on convertible notes	14	20	28	134
Accretion expense on asset retirement obligation (Note 7)	24	11	43	25
	<u>1,114</u>	<u>(358)</u>	<u>1,932</u>	<u>(566)</u>
Changes in non-cash working capital balances				
Accounts receivable	(763)	142	(2,255)	(20)
Foreign exchange	2	10	-	3
Prepaid expenses	47	(168)	177	(161)
Accounts payable	10,072	590	11,019	323
	<u>10,472</u>	<u>216</u>	<u>10,873</u>	<u>(421)</u>
Cash from investing activities				
Cash call receivable (Note 4)	2,517	(2,572)	3,496	(1,352)
Purchase of oil and gas properties - other (Note 5)	(15,127)	(3,196)	(23,393)	(4,510)
Purchase of oil and gas properties from related party (Note 3)	(30,900)	-	(30,900)	-
Sale of oil and gas properties (Note 5)	1	(17)	2	3,296
Purchase of furniture, fixtures and equipment	(2)	(2)	(93)	(2)
Development of mineral properties (Note 5)	(6)	1	(33)	(31)
Bonds and deposits	-	263	-	263
Foreign exchange	-	(1)	-	(1)
	<u>(43,517)</u>	<u>(5,524)</u>	<u>(50,921)</u>	<u>(2,337)</u>
Cash from financing activities				
Payments on debt	(26,483)	(742)	(26,483)	(1,742)
Accounts payable – joint venture partner	(9,059)	(4,720)	(13,377)	(4,720)
Issue costs of debenture	(2,717)	(603)	(2,717)	(603)
Share issuance, net of share issue costs	17,073	-	17,097	-
Proceeds from debt	63,000	18,750	63,000	18,750
Foreign exchange	(1)	-	-	-
Share cancellation costs	-	(2)	-	(5)
Repurchase of shares	-	(333)	-	(733)
	<u>41,813</u>	<u>12,350</u>	<u>37,520</u>	<u>10,947</u>
Increase (decrease) in cash	8,768	7,042	(2,528)	8,189
Foreign exchange gain (loss) on cash held in foreign currency	-	(2)	-	(2)
Cash, beginning of period	4,545	1,828	15,841	681
Cash, end of period	\$ 13,313	\$ 8,868	\$ 13,313	\$ 8,868

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

June 30, 2005

1. Business and Basis of Presentation

These unaudited interim consolidated financial statements should be read in conjunction with the most recent audited annual consolidated financial statements. The significant policies and methods of computation follow that of the most recently reported annual consolidated financial statements. The disclosures provided below are incremental to those included with the annual audited consolidated financial statements. All amounts other than per share amounts are shown in thousands of dollars.

2. Significant Accounting Policies

The consolidated financial statements of the Company (in United States (“US”) dollars unless otherwise noted) have been prepared by management in accordance with generally accepted accounting principles (“GAAP”) in Canada. The preparation of consolidated financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The consolidated financial statements have, in management’s opinion, been properly prepared using careful judgment with reasonable limits of materiality. The accounting policies used in these financial statements are consistent with those used in the Company’s annual audited financial statements.

3. Asset Acquisition

On June 17, 2005 the Company, acquired certain oil and gas properties from Geostar Corporation, a significant shareholder of the Company, in consideration for cash, notes payable and shares. The acquisition has been accounted for using the purchase method, with results of operations included from the date of acquisition as the Company has acquired all of the remaining working interests in certain properties in East Texas and the Powder River Basin. Details of the acquisition are as follows (in thousands):

Fair values of net assets acquired:	
Oil and gas properties	\$ 72,579
Asset retirement obligation	(953)
	<u>\$ 71,626</u>
 Consideration given:	
Cash	\$ 30,500
Note payable (Note 20)	32,000
Shares	6,000
Post closing adjustments	2,726
Acquisition costs	400
	<u>\$ 71,626</u>

Gastar paid a total of \$68.5 million for the interest acquired from Geostar consisting of \$30.5 million in cash, 1.65 million common shares (\$6 million in Common Shares valued at CDN \$4.50 per share) and \$32.0 million in unsecured subordinated notes expiring on January 31, 2006, bearing interest at 3.42% per annum. Subsequent to June 30, 2005, the Company has re-negotiated the terms of the \$32.0 million note (Note 20).

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3. Asset Acquisition - continued

The purchase price allocation is based on management's best estimate of what the fair values were at June 17, 2005. If events determine the allocation to be different, the difference will be treated as a purchase price adjustment in such subsequent period. In addition, the asset purchase agreement provides for certain post closing adjustments relating to additional expenditures incurred on the acquired properties. These adjustments are to be finalized by September 15, 2005. Any discrepancy between the amounts provided for by management and the agreed to ending adjustment will be treated as a purchase price adjustment when finalized.

Additional purchase price may be payable on certain properties using the look back provisions detailed in the purchase and sale agreements (Note 16).

4. Cash Calls Receivable

	Opening balance		Cash Call Advances		Amounts Spent/Refunded (in thousands)		Cash Calls, ending balance
Fridkin Kaufman #1 well	\$ 1,220	\$	-	\$	1,220	\$	-
Cheney #1 well	-		9,015		9,015		-
Lone Oak Ranch #1 well	-		8,397		6,053		2,344
Greer #1 well	-		4,122		148		3,974
Balance as of December 31, 2004	<u>\$ 1,220</u>	\$	<u>21,534</u>	\$	<u>16,436</u>	\$	<u>6,318</u>
Lone Oak Ranch #1 well	\$ 2,344	\$	-	\$	2,344	\$	-
Greer #1 well	3,974		1,460		5,434		-
Fridkin Kaufman #2 well	-		5,680		5,680		-
Burong #2	-		535		383		152
Burong #3	-		535		251		284
Other prepaid cash calls	-		4,541		2,155		2,386
Balance as of June 30, 2005	<u>\$ 6,318</u>	\$	<u>12,751</u>	\$	<u>16,247</u>	\$	<u>2,822</u>

Of the total cash calls paid, \$8.2 million were paid to Geostar and the remainder was paid to other outside parties. Geostar invoices the Company for their proportionate share of planned authorized expenditures upon the execution of the final drilling AFE by Gastar.

In the second quarter of 2005, Geostar refunded to the Company \$2.1 million of unused cash call balances pursuant to the acquisition of additional properties and working interest properties in East Texas (Note 3).

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5. Property and Equipment

The amount capitalized as oil and gas properties was incurred for the purchase and development of various properties in the states of Wyoming, Montana, Texas, California, Pennsylvania and West Virginia in the US and in New South Wales and Victoria in Australia.

The following schedule represents costs distributed by country (in thousands):

Oil and gas properties				
From Inception to June 30, 2005:	US	Australia	Canada	Total
Cost	\$ 170,375	\$ 3,374	\$ -	\$ 173,749
Asset retirement	2,780	80	-	2,860
Impairment/Ceiling test allowance	(2,605)	(519)	-	(3,124)
Accumulated Depletion	(10,339)	-	-	(10,339)
Net Book Value at June 30, 2005	160,211	2,935	-	163,146
Capital assets	86	6	-	92
Mineral resource properties	-	95	19	114
Total property and equipment	\$ 160,297	\$ 3,036	\$ 19	\$ 163,352

Oil and gas properties				
From Inception to December 31, 2004:	US	Australia	Canada	Total
Cost	\$ 67,912	\$ 2,629	\$ -	\$ 70,541
Asset retirement	1,423	80	-	1,503
Impairment/Ceiling test allowance	(2,606)	(519)	-	(3,125)
Accumulated Depletion	(4,442)	-	-	(4,442)
Net Book Value at December 31, 2004	62,287	2,190	-	64,477
Capital assets	-	8	-	8
Mineral resource properties	-	61	17	78
Total property and equipment	\$ 62,287	\$ 2,259	\$ 17	\$ 64,563

Excluded from the depletion base are unproved property costs of \$93.3 million (\$29.8 million - December 31, 2004), which consists primarily of drilling in progress costs of approximately \$21.2 million (\$13.9 million - December 31, 2004) and acreage acquisition costs of approximately \$72.1 million (\$15.9 million - December 31, 2004).

As part of the Company's quarterly procedures, management conducts an internal ceiling test to evaluate and compare the carrying value of its oil and gas properties, excluding the \$93.3 million as detailed above, to its estimated future net revenue. At June 30, 2005, the result of management's evaluation requires no writedown.

The prices used for the benchmark for purposes of the impairment test are as follows:

	Oil Price (\$/Barrel)	Gas Price - Wyoming (\$/MMBTU)	Gas Price - Texas (\$/MMBTU)
2005	53.46	7.00	6.65
2006	55.85	7.76	7.41
2007	51.42	7.05	6.70
2008	43.92	6.27	5.92
2009	42.45	6.10	5.75
2010	43.09	6.14	5.79
2011	43.74	6.23	5.88
2012	44.39	6.33	5.98
2013	45.06	6.42	6.07
2014	45.74	6.52	6.17
2015	46.42	6.62	6.27
2016	47.12	6.71	6.36
Thereafter	+1.5%	+1.5%	+1.5%

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5. Property and Equipment – continued

Of the total expenditures incurred on oil and gas properties in the amount of \$103.2 million, \$11.9 million were pursuant to the terms of the JOA with Geostar, \$32.0 million were related to notes payable issuance, and \$6 million was paid in shares. Oil and gas properties were reduced by \$1 million upon reclassification of drilling advances and \$2,000 upon sale of acreage.

Included in oil and gas properties are direct travel and supplies expense capitalized in the amount of \$105,000 (2004 - \$105,000).

The carrying value of mineral resource properties is as follows (in thousands):

	June 30, 2005	December 31, 2004
Gippsland Basin Mineral property	\$ 95	\$ 61
Mokoman (Knife) Lake Area, Saskatchewan	16	17
Other	3	-
	<u>\$ 114</u>	<u>\$ 78</u>

The recovery of the costs associated with these claims is dependent upon their future sale or commercial development.

6. Deferred Charges

Deferred Financing Costs	Cost	Accumulated Amortization (in thousands)	Net Book Value
Balance as of December 31, 2004	\$ 6,386	\$ (1,360)	\$ 5,026
Additions in the period	17,290	-	17,290
Amortization for the period	-	(2,818)	(2,818)
Balance as of June 30, 2005	<u>\$ 23,676</u>	<u>\$ (4,178)</u>	<u>\$ 19,498</u>
Deferred Lease Costs			
Balance – December 31, 2004, net	\$ 509		
Amortization expense	(137)		
Reclass to current portion	(101)		
Balance as of June 30, 2005	<u>\$ 271</u>		
Total Deferred Charges – June 30, 2005	<u>\$ 19,769</u>		
Total Deferred Charges – December 31, 2004	\$ 5,297		

The additions in the period related to \$14.5 million (CDN - \$18 million) committed pursuant to the Senior Note financing (Note 9) and is non-cash as it will be settled by the issuance of shares. An additional \$2.7 million was incurred for related financing costs.

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7. Asset Retirement Obligation

The undiscounted amount of expected cash flows required to settle the asset retirement obligations is estimated at \$4.0 million. Of these payments, 86.2% are expected to be made over the next 5 years, 12.7% is expected to be made in years 6-10, with the remainder being paid in years 11-19.

The schedule below is a reconciliation of the Company's liability discounted at 6.8% (in thousands):

	June 30, 2005	December 31, 2004
Asset retirement obligation, beginning of year	\$ 1,711	\$ 984
Liabilities incurred	404	166
Accretion expense	43	52
Increase (reduction) due to acquisition (sale) of working interest	953	(57)
Revision in estimated cash flows	-	566
Asset retirement obligation, end of year	\$ 3,111	\$ 1,711

8. Senior Notes

During the second quarter, the Company paid the Senior Note balance of \$26.5 million plus accrued interest of \$1.9 million and a call premium of \$662,000.

9. Senior Secured Notes

On June 17, 2005, the Company issued senior secured notes totaling \$63.0 million in principal amount, together with the issuance of 1,217,269 common shares in a private placement transaction. The notes are secured by substantially all of the Company's assets, bear interest at the sum of the three-month LIBOR rate plus 6%, payable quarterly, and mature on June 18, 2010. Additionally, the Company agreed to issue the purchasers of the senior secured notes for no additional consideration, additional shares in increments valued at CDN \$4.5 million on each of the six, twelve, and eighteen month anniversaries of the closing.

Pursuant to the senior secured notes, the Company has the right, on a quarterly basis during the period from two months after closing of the initial notes to 24 months after the same date, to require the note holders to purchase up to an aggregate additional \$20.0 million principal amount of additional notes. The issuance of the additional notes is contingent upon compliance with a proved plus probable reserve discounted at 10% ("2P PV(10)") to net senior secured debt coverage ratio of 2.0:1 and other covenants. Under the senior secured note agreement, the PV(10) valuation is to be based on a third party independent reserve report utilizing constant pricing based on the lower of current natural gas and oil prices, adjusted for area basis differentials, or \$6.00 per Mcf of natural gas and \$40.00 per barrel of oil. From the first anniversary of issuance up to the second anniversary of issuance of the notes, proved reserves discounted at 10% ("1P PV(10)") to net debt must be a minimum of 1.0:1. On the second anniversary date of the notes, the 1P PV(10) reserve ratio covenant increases to a minimum of 1.5:1 and it increases to 2.0:1 on the third anniversary date and for all test periods thereafter until maturity. Utilizing the same reserve pricing criteria above, the 2P PV (10) to net debt reserve maintenance ratio covenant must be a minimum of 1.5:1 from date of issuance of the notes up to the first anniversary date. On the first anniversary date of the note, the 2P PV(10) reserve ratio

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9. Senior Secured Notes - continued

covenant increases to a minimum of 2.5:1, on the second anniversary to 3.0:1 and on the third anniversary and for all test periods thereafter until maturity to 3.5:1. The Company must maintain compliance with the reserve ratio covenant at all future quarterly and annual covenant determination dates or be subject to mandatory principal redemptions under certain conditions.

The Company has recorded a deferred charge of \$14.5 million (CDN \$18 million) to be amortized over the term of the notes. Of this amount, \$3.6 million (CDN \$4.5 million) was recorded for the issuance of 1,217,269 shares issued and the remainder \$10.9 million will be settled by the issue of shares as detailed above. For the quarter ended June 30, 2005, the Company recorded amortization expense of \$109,000 relating to the debt discount.

The Company recorded an estimated \$2.7 million of direct financing costs for legal fees and fees paid to an agent and will amortize over the term of the notes. For the quarter ended June 30, 2005, the Company recorded amortization expense of \$23,000 relating to these costs.

The Company has provided the purchasers of the notes an undertaking to file a registration statement with the US Securities and Exchange Commission to register the shares issued (and to be issued) in conjunction with this financing in order that the shares are freely tradable in the US by December 15, 2005. In the event that the Company does not file a registration statement within 90 days that is declared effective within 180 days of closing of the financing, the Company will incur penalties equal to 0.50% per month of the value of the shares as of December 15, 2005. In addition, the Company has agreed to a potential make-whole payment to the holders of the shares for any decline in price between the price as of December 15, 2005 and the date that the registration statement is declared effective of the shares become freely tradable otherwise.

10. Interest Expense

The following table summarizes interest expense components (in thousands):

	For the three month period ended June 30,		For the six month period ended June 30,	
	2005	2004	2005	2004
Cash and accrued	\$ 1,922	\$ 82	\$ 3,628	\$ 259
Call premium	662	-	662	-
Deferred financing cost amortization	2,385	137	2,846	327
Total	\$ 4,969	\$ 219	\$ 7,136	\$ 586

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11. Share Capital

(a) Authorized
 Unlimited number of common shares without par value.

(b) Issued

	Number of Shares	CDN\$ Amount (in thousands)	USD\$ Amount
Balance, December 31, 2004	113,390	\$ 71,529	\$ 48,305
Stock options exercised, cash (12)	3,721	1,116	707
Stock options exercised, non-cash (12)	2,670	2,058	1,327
Stock options cancelled in lieu of non-cash exercise (12)	(455)	(2,058)	(1,327)
Issuance of shares (11 (c, d and e))	9,485	33,831	27,192
Share issue costs	-	(1,429)	(1,159)
Balance June 30, 2005	128,811	\$ 105,047	\$ 75,045

(c) During the quarter, the Company issued 1.65 million common shares (\$6 million) valued at CDN \$4.50 per share (CDN \$7.4 million) pursuant to the acquisition of additional leasehold and working interest properties in East Texas and the Powder River basin from Geostar Corporation (Note 3).

(d) During the quarter, the Company issued 1.2 million common shares (an aggregate of CDN \$4.5 million (US - \$3.6 million) based upon a five day weighted average trading price of CDN \$3.69 per share) pursuant to the private placement of \$63.0 million Senior Secured Notes (Note 9).

(e) During the quarter, the Company closed a private placement of common shares at CDN \$3.31 per share. The Company received and accepted subscriptions for a total of 6.6 million shares. The proceeds from this private placement were \$17.5 million (CDN \$21.9 million). The Company recorded an estimated \$1.2 million of share issuance costs.

(f) At June 30, 2005, the Company has 5 million warrants outstanding. There was no change in the warrants outstanding from December 31, 2004.

(g) At June 30, 2005, the Company has reserved 29.2 million shares to be issued pursuant to the conversion of convertible debt up to (6.9 million), exercise of options (17.3 million), and the exercise of warrants (5 million).

12. Stock-Based Compensation

The Company has a stock-based compensation plan that allows employees to purchase common shares of the Company. Option exercise prices approximate the market price for the common shares on the date the options were issued. Options granted under the plan are generally fully exercisable after four years and expire five years after the grant date. The Company can issue up to 25% of the issued and outstanding shares under this plan.

The Company permits option holders to exercise their options on a "cash-less" basis by reducing the number of shares issued under the option exercise by the option price due to the Company. The reduction in the number of shares to be issued is based on trading prices prevailing on date of exercise.

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12. Stock-Based Compensation - continued

The Company recorded \$1.5 million in stock-based compensation expense for stock options granted to employees and directors in the second quarter of 2005 and 2004 using the fair-value method with the following assumptions: volatility – 30% to 55%; risk-free interest rate – 5%; dividend yield - nil and expected life of 4 years. The 5.5 million options issued in 2004 had a fair value on grant date ranging from \$0.47 to \$1.42 per option. The 395,000 options issued in 2005 had a fair value on grant date ranging from \$0.59 to \$1.50 per option.

The table below details contributed surplus recorded (in thousands):

	June 30, 2005
Contributed Surplus, December 31, 2004	\$ 1,374
Contributed surplus recorded for the period	1,540
Contributed Surplus, June 30, 2005	\$ 2,914

The following is a summary of options to purchase common shares outstanding:

	Number of Options (in thousands)	Option Price per Share Range in CDN\$	Option Price per Share Range in USD\$	WA ⁽¹⁾ Remaining Life in Years	WA ⁽¹⁾ Exercise Price in CDN\$	WA ⁽¹⁾ Exercise Price in USD\$
Options outstanding, Dec. 31, 2004	24,369	0.30 - 3.70	0.19 - 2.75	-	2.26	1.52
Options exercised 2005:						
Feb. 4, 2005 – May 26, 2005	(5,492)	0.30	0.19	-	0.30	0.19
Feb. 9, 2005	(700)	0.30 - 2.76	0.19 - 1.74	-	1.35	0.85
March 2, 2005	(200)	1.66	1.09	-	1.66	1.09
Options cancelled/expired:	(1,042)	0.30 - 3.41	0.19 - 2.59	-	1.19	0.84
Options granted, June 24, 2005	345	3.50	2.84	5 years	3.50	2.84
Options granted, June 28, 2005	50	3.40	2.76	5 years	3.40	2.84
Options outstanding, June 30, 2005	17,330	2.76 - 3.70	1.74 - 2.84	2.05 years	2.99	2.03

⁽¹⁾WA – weighted average

To June 2005, 6.4 million stock options were exercised with exercise prices ranging from \$0.19 - \$1.74 (CDN \$0.30 - \$2.76). A portion of the stock options exercised were via a non-cash basis. The Company issued a net of 5.9 million shares upon exercise of these options and cancelled the 455,000 shares reserved for shares exercised on a non cash basis.

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12. Stock-Based Compensation - continued

Of the total options outstanding, 8.9 million options have vested as of June 30, 2005 which have a weighted average exercise price of \$1.77 and a weighted average life of 1.11 years. The expiry dates for the issued 17.3 million options outstanding are as detailed below:

Number of Options (in thousands)	Option Price per Share Range in CDN\$	Option Price per Share Range in USD\$	Expiry date
10,975	2.76	1.74	July 13, 2006
700	2.81	1.79	April 26, 2007
825	3.70	2.75	April 20, 2009
4,435	3.41	2.59	August 4, 2009
345	3.50	2.84	June 24, 2010
50	3.40	2.76	June 28, 2010
17,330	2.76 - 3.70	1.74 - 2.84	

Compensation expense has not been recorded for stock options granted prior to 2003. Pro-forma amounts for 2005 and 2004 are disclosed below for options issued prior to January 1, 2003:

	For the three month period ended June 30, 2005		For the six month period ended June 30, 2005	
		2004 (in thousands)		2004
Net loss, as reported	\$ (4,915)	\$ (804)	\$ (8,535)	\$ (1,421)
Cost of compensation expense using fair value	(8)	(18)	(22)	(47)
Net loss, pro forma	\$ (4,923)	\$ (822)	\$ (8,557)	\$ (1,468)
Loss per share, as reported	\$ (0.042)	\$ (0.007)	\$ (0.074)	\$ (0.013)
Loss per share, pro forma	\$ (0.042)	\$ (0.007)	\$ (0.074)	\$ (0.013)

The fair value of the options granted prior to January 1, 2003 is estimated on the date of grant using the Black-Scholes option-pricing model with weighted average assumptions for grants as follows:

Risk-free interest rate	5%
Expected lives (years)	4
Expected volatility	40%
Dividend yield	Nil

13. Loss per Share

The weighted average number of shares outstanding is 115,547,122 (123,329,734 diluted) for the six month period ended June 30, 2005; 117,286,718 (124,472,990 diluted) for the three month period ended June 30, 2005; 109,733,128 (121,303,972 diluted) for the six month period ended June 30, 2004 and 112,200,762 (124,264,765 diluted) for the three month period ended June 30, 2004.

June 30, 2005

14. Related Party Transactions

Except as disclosed elsewhere in these financial statements, the Company had the following related party transactions:

- (a) In 2001, the Company entered into a Participation and Operating Agreement (“POA”) with Geostar. For the East Texas properties, the POA was replaced effective January 1, 2005 with a Joint Operating Agreement (“JOA”) (Note 14(c)). Pursuant to the terms of the original POA, which still governs West Virginia and certain of the Company’s Australian assets, the Company has the option to participate as a working interest partner in properties in which Geostar and its subsidiaries have interest in on an “at cost” basis, subject to our full due diligence review prior to our participation election. Upon agreeing to participate, the Company is responsible for its proportionate share of actual costs expended by Geostar and its subsidiaries to third parties on an “at cost” basis. The balance of \$601,000 at December 31, 2004 represented amounts owed to Geostar and its subsidiaries for natural gas and oil property development.
- (b) The consolidated statements also include approximately \$1,000 (2004 - \$40,000) in seismic reprocessing and other administrative fees to a subsidiary of Geostar, based on current, independent, third-party industry billing rates. The seismic reprocessing fees were capitalized to oil and gas properties.
- (c) Effective January 1, 2005, the Company, First Sourcenergy Wyoming (“FSW”), and Geostar entered into a JOA covering an Area of Mutual Interest (“AMI”) in the East Texas Basin, with Gastar as a non operator and Geostar as Operator. Under the terms of the JOA, Geostar will receive overhead reimbursement equal to 12.5% of development costs for the first 10 wells drilled after the effective date, 10% of the development costs for the 11th through 20th wells and 8.5% of the developments costs for all subsequent wells. As a result, Geostar will no longer charge Gastar a proportionate amount of direct salary and shared premises rent expense for Geostar employees providing administrative and technical support services to Gastar. During the first quarter of 2005 Geostar billed FSW \$1.4 million which was equal to 12.5% of development costs for the Greer #1 and F-K #2 wells. These have been capitalized to property and equipment (Note 5). These amounts were paid in the second quarter. In conjunction with the execution of the JOA, the Company terminated the convertible debenture arrangement with Geostar and commenced operating the East Texas properties. Under the new arrangement, the Company is required to find financing for Gastar’s share of future joint venture costs.

There is a balance of \$858,000 receivable from Geostar at June 30, 2005, related to the revenue earned from the properties net of capitalized expenditures incurred during the period and net of the estimated post closing adjustments (Note 3). This amount, along with the final post-closing purchase price adjustments, will be settled as provided for in the Purchase and Sale Agreements between Geostar and the Company.

- (d) Effective January 1, 2005 the Company has agreed to hire and employ directly certain Geostar employees as members of the management team. The Company will invoice Geostar for their share of common costs, if applicable.

All related party transactions in the normal course of operations have been measured at the agreed to exchange amounts, which is the amount of consideration established and agreed to by the related parties and which is similar to those negotiated with third parties.

June 30, 2005

15. Income Taxes

There has been no future tax recovery recorded in these interim statements as the ultimate utilization of future tax assets is currently uncertain.

16. Commitments and Contingencies

There were no material changes in commitments and contingencies from those disclosed in the audited annual consolidated financial statements for the year ended December 31, 2004 except for the following:

The Company has a letter of credit in the amount of \$127,000 bearing interest at a rate of 2.71%, with a maturity date of January 15, 2006 issued as security under our current office lease.

On May 3, 2005 Western Gas Resources, Lance Oil and Gas Company, Inc and Williams Production RMT Company filed a lawsuit against First Sourcenergy Wyoming, Inc., First Sourcenergy Group, Inc. (the Company's subsidiaries) and others over a dispute that has arisen concerning a June 2002 Lease Exchange and Purchase Agreement between certain of the parties. The issue involves a certain gas gathering agreement and its applicability to some of the properties exchanged under the June 2002 Agreement. A formal response to the Complaint was filed in June 2005. Discovery on this matter is just beginning, and as such it is premature to assess a probability of success in defense of this action or of the Company's exposure if liability were to be found. The Company believes that it has multiple strong defenses to this action and intends to vigorously advance its positions. Further, at this very preliminary stage, it would appear that the Company's exposure is significantly lower than that of the other defendants. While the Company does not anticipate that this action will result in a material loss to the Company, such determination is subject to measurement uncertainty. Losses, if any, will be recognized in the period of settlement.

The contingency regarding the 1,989,475 warrants issued in conjunction with the \$10 million Senior Note financing price discrepancy has been resolved and the warrants are now issued at the correct price of \$3.63.

The Company has committed to issue additional shares pursuant to a note financing completed in the second quarter of 2005 (Note 9).

In addition, the Company has agreed to meet certain registration requirements for these shares by December 15, 2005. If the Company does not meet the requirements, the Company will be required to pay additional interest and bear the market risk on downward price fluctuations between December 15, 2005 and the date the registration statement goes final.

All of the Company's operating subsidiaries have provided a guarantee of the Company's borrowings under the Senior Secured Notes.

FSW has entered into an employment agreement with a certain executive officer. In addition to defining the terms of employment, the agreement entitles the executive to termination payments, equal to two times his most recent annual compensation (exclusive of bonuses received or other non-cash compensation) if notice is received after May 17, 2006. If notice is received prior to May 17, 2006, the severance amount equals one times his most recent annual compensation (exclusive of bonuses or other non-cash compensation). Severance benefits will be payable over the "Severance Pay Period", as set forth in the employment agreement for any reason other than "reasonable cause".

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16. Commitments and Contingencies - continued

Pursuant to the Geostar property acquisition completed on June 17, 2005, Geostar may receive additional common shares based on look-backs at June 30, 2006 and June 30, 2007 on the East Texas assets, based on a required number of drilled wells, and net reserve additions valued at \$1.50 per Mcf less attributable capital expenditures to Geostar's former ownership position in the East Texas development costs.

17. Financial Instruments

The Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to interest rate risk, credit risk and fair value risk. The Company manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

(a) Concentration risk

Approximately 77% of the Company's 2005 revenues are from the production at the Gastar Fridkin-Kaufman #1 ("F-K #1"), Cheney #1 ("Cheney") and Lone Oak Ranch ("LOR") wells in Texas. The F-K #1 well commenced production on September 28, 2004, the Cheney well commenced production on February 9, 2005 and the LOR well commenced production in May 2005.

18. Statement of Cash Flows

Non-cash transactions have been disclosed in Notes 4, 6, 8, 10 and 11. The Company paid, in cash, interest of \$3.5 million (2004-\$432,000).

19. Comparative Presentation

The Company now reflects production taxes as lease operating expenses. The prior period comparatives were reclassified as follows:

	For the three month period ended June 30, 2004	For the six month period ended June 30, 2004
	(in thousands)	
Revenue	\$ 52	87
Lease operating expense, transportation and selling	(52)	(87)
Net income	\$ -	\$ -

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20. Subsequent Event

On August 11, 2005, the Company executed an agreement with Geostar whereby the Geostar \$32.0 million unsecured subordinated note was cancelled. In conjunction with the note cancellation, the Company agreed to issue Geostar \$17.0 million of common shares issued at a value of CDN \$3.25 and a new unsecured subordinated note for \$15.0 million. The new Geostar note bears interest, payable monthly commencing February 15, 2006, at three-month LIBOR plus 4.5% and matures November 15, 2006. The note requires monthly principal payments of \$1.5 million commencing February 15, 2006 and continuing for nine months thereafter with a final principal payment of \$1.5 million due on November 15, 2006. The Company may elect to pay interest in kind through the issuance of additional notes with such notes maturing on January 15, 2007.

21. Differences Between Canadian and US Generally Accepted Accounting Principles

The Consolidated Financial Statements have been prepared in accordance with generally accepted accounting principles in Canada. Canadian principles differ from US principles as follows:

(a) Reconciliation of Net Loss Under Canadian GAAP to US GAAP

Consolidated Statement of Operations – US GAAP

	For the three month period ended June 30,		For the six month period ended June 30,	
	2005	2004	2005	2004
(in thousands, except per share amounts)				
Net loss as reported in accordance with Canadian principles	\$ (4,915)	\$ (804)	\$ (8,535)	\$ (1,421)
Impact of US principles:				
Depreciation, depletion and amortization ¹	531	35	940	65
Natural gas and oil property impairment ⁵	(4,288)	-	(8,698)	-
Mineral resource property expenditures ⁴	(6)	-	(34)	(32)
Accretion expense on convertible notes ²	14	20	28	(32)
Net adjustments	(3,749)	55	(7,764)	1
Net loss in accordance with US principles	\$ (8,664)	\$ (749)	(16,299)	(1,420)
Loss per common share in accordance with US principles				
Basic and diluted	\$ (0.074)	\$ (0.007)	\$ (0.141)	\$ (0.013)

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21. Differences Between Canadian and US Generally Accepted Accounting Principles - continued

	For the three month period ended June 30,		For the six month period ended June 30,	
	2005	2004	2005	2004
	(in thousands, except per share amounts)			
Revenues	\$ 4,942	\$ 517	\$ 9,674	\$ 873
Expenses				
Depreciation, depletion and amortization ¹	(2,274)	(208)	(4,965)	(383)
Natural gas and oil property impairment ⁵	(4,288)	-	(8,698)	-
Mineral resource property expenditures ⁴	(6)	-	(34)	(32)
Interest and debt related items ^{2,6}	(4,955)	(199)	(7,108)	(618)
Accretion on asset retirement obligation	(24)	(11)	(43)	(25)
Lease operating, transportation and selling	(478)	(227)	(1,792)	(438)
General and administrative	(1,771)	(680)	(3,537)	(847)
Net loss before other items	(8,854)	(808)	(16,503)	(1,470)
Other Items				
Investment income and other	23	4	62	8
Foreign exchange gain (loss)	167	55	142	42
	190	59	204	50
Net loss before income taxes	(8,664)	(749)	(16,299)	(1,420)
Provision for income taxes ⁷	-	-	-	-
Net loss	\$ (8,664)	\$ (749)	\$ (16,299)	\$ (1,420)
Loss per share – US GAAP	\$ (0.074)	\$ (0.007)	\$ (0.141)	\$ (0.013)

Statement of Comprehensive Income (Loss)

	For the three month period ended		For the six month period ended	
	June 30, 2005	June 30, 2004	June 30, 2005	June 30, 2004
	(in thousands)			
Net loss – US GAAP	\$ (8,664)	\$ (749)	\$ (16,299)	\$ (1,420)
Foreign currency translation adjustment ³	-	(9)	-	1
Comprehensive income (loss)	\$ (8,664)	\$ (758)	\$ (16,299)	\$ (1,419)

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21. Differences Between Canadian and US Generally Accepted Accounting Principles - continued

(b) Condensed Consolidated Balance Sheet

	Canadian Principles at June 30, 2005	US Principles at June 30, 2005	Canadian Principles at December 31, 2004	US Principles at December 31, 2004
	(in thousands)			
Assets				
Current assets	\$ 18,390	\$ 18,390	\$ 18,118	\$ 18,118
Deferred Charges ⁶	19,769	5,117	5,297	3,442
Cash call receivable	2,822	2,822	6,318	6,318
Property, plant and equipment ^{1, 4, 5}	163,352	147,559	64,563	56,564
	<u>\$ 204,333</u>	<u>\$ 173,888</u>	<u>\$ 94,296</u>	<u>\$ 84,442</u>
Liabilities				
Accounts payable and accrued liabilities	\$ 12,216	\$ 12,216	\$ 1,197	\$ 1,197
Accounts payable – joint venture partner	-	-	601	601
Current portion of note payable	7,500	7,500	-	-
Note payable	7,500	7,500	-	-
Drilling advances	-	-	1,002	1,002
Accrued liability	77	77	77	77
Senior notes	-	-	26,483	24,840
Convertible notes ²	29,754	30,000	29,725	30,000
Senior secured notes	63,000	48,536	-	-
Subordinated, unsecured notes payable	3,250	3,062	3,250	3,038
Site restoration	3,111	3,111	1,711	1,711
	<u>126,408</u>	<u>112,002</u>	<u>64,046</u>	<u>62,466</u>
Liability to be settled by the issuance of shares	27,930	27,930	-	-
Shareholders' Equity	<u>49,995</u>	<u>33,956</u>	<u>30,250</u>	<u>21,976</u>
	<u>\$ 204,333</u>	<u>\$ 173,888</u>	<u>\$ 94,296</u>	<u>\$ 84,442</u>

Reconciliation of Shareholders' Equity under Canadian GAAP to US GAAP:

	June 30, 2005	December 31, 2004
	(in thousands)	
Shareholder's Equity as reported with Canadian principles	\$ 49,995	\$ 30,250
Convertible notes, beneficial conversion feature ²	(246)	(275)
Mineral resource properties ⁴	(113)	(78)
Oil and gas properties ^{1,5}	(15,680)	(7,921)
Shareholders' Equity in accordance with US Principles	<u>\$ 33,956</u>	<u>\$ 21,976</u>

June 30, 2005

**21. Differences Between Canadian and US Generally Accepted Accounting Principles -
continued**

¹ In accordance with Canadian principles, companies that have not reached commercial levels of production are considered to be in the pre-production stage. While in the pre-production stage, entities net their oil and gas revenue and lease operating expenses against oil and gas properties on the balance sheet. For US principles, entities must recognize revenue and expenses on the income statement without regard to levels of commercial production. In addition, while in the pre-production stage under Canadian principles, entities do not record depletion on their oil and gas properties. Once again, under US principles, depletion is calculated and reported on the income statement. The Company was in the pre-production stage until June 30, 2002.

² In accordance with Canadian principles, these convertible notes are considered to be compound financial instruments and the liability component and the equity component must be presented separately as determined at initial recognition. For US principles, the total amount of convertible notes is recognized as debt and is offset by the value attributable to the beneficial conversion feature. The value of the warrants attached to debt as well as the value of the conversion feature of the convertible debt is recognized as paid in capital in Shareholders' Equity. The amortization of the beneficial conversion feature is to be amortized over the term of the related convertible notes.

³ In accordance with Canadian principles, the Company records foreign currency translation adjustments in Shareholders' Equity. For US principles, gains or losses arising from the translation of self-sustaining foreign operations are to be included in other comprehensive income.

U.S. GAAP requires the disclosure, as other comprehensive income, of changes in equity during the period from transactions and other events from non-owner sources. Canadian GAAP does not require similar disclosure.

⁴ In accordance with Canadian principles, the Company capitalizes expenditures on mineral resource properties. For US principles, expenditures on mineral resource properties must be expensed.

⁵ In 2003, the Company adopted the new Canadian guideline AcG-16 which restricts the capitalized costs less accumulated depletion from exceeding an amount equal to the estimated undiscounted value of future net revenues from proved oil and gas reserves, as determined by independent engineers, based on sales prices achievable under existing contracts and posted average reference prices in effect between the end of the year and the finalization of the year end audit and current costs, and after deducting estimated production related expenses, abandonment and reclamation costs, and applicable taxes. When the carrying value of the cost center exceeds the undiscounted value of future net revenues from proved oil and gas reserves, the Company is required to determine the fair value of proved and probable reserves and a writedown, if any is recorded. Unproved properties are tested separately for impairment. For US principles, entities are required to use discounted future net revenues (discounted at 10%)

In computing its consolidated net earnings for U.S. GAAP purposes, the Company recorded a write down of properties in years 2000-2004 as a result of the application of the US ceiling test. At June 30, 2005, the result of management's evaluation showed a write-down of \$8.7 million currently, and the Company will further evaluate its reserves and ceiling limitation at future quarters and at year end.

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21. Differences Between Canadian and US Generally Accepted Accounting Principles - continued

⁶ In Accordance with Canadian principles, the Company records the fair value of the warrants as a deferred charge and amortizes over the life of the note. For US principles, the value of the warrants is allocated based on relative fair values and is netted against the debt and not deferred as a financing cost. The debt discount is amortized as interest expense.

⁷ There are no tax effects to the US GAAP adjustments as the Company currently is not taxable and a valuation allowance has been recorded for the entire balance of the future tax asset.

The Company operates in one industry segment, which is the exploration, development and production of natural gas and crude oil. The Company's operational activities are conducted in the United States and Australia with only the United States currently having revenue generating operating results. The identifiable assets for each country have been disclosed in Note 5.

(c) Additional Disclosure Based on US principles

Had the Company provided financial data in accordance with US principles in prior quarters, the following additional stock based compensation amounts would have been disclosed on a pro-forma basis as outlined in the table below:

Quarter ended	Stock based compensation expense	Risk-free Interest rate (\$ in thousands)	Expected lives (years)	Expected volatility
March 31, 2004	\$ 678	5%	4	40%
June 30, 2004	657	5%	4	40%
September 30, 2004	262	5%	4	40%
December 31, 2004	286	5%	4	40%
2004 Total	<u>\$ 1,883</u>			
March 31, 2005	\$ 270	5%	4	40%
June 30, 2005	274	5%	4	40%
2005 Total	\$ 544			

	For the three month period ended June 30,		For the six month period ended June 30,	
	2005	2004	2005	2004
	(in thousands, except per share amounts)			
Net loss – US GAAP, as reported	\$ (8,664)	\$ (749)	\$ (16,299)	\$ (1,420)
Cost of Compensation expense using fair value	(274)	(657)	(544)	(1,335)
Net loss – US GAAP, pro forma	<u>\$ (8,938)</u>	<u>\$ (1,406)</u>	<u>\$ (16,843)</u>	<u>\$ (2,755)</u>
Loss per share – US GAAP, as reported	\$ (0.074)	\$ (0.007)	\$ (0.141)	\$ (0.013)
Loss per share – US GAAP, pro forma	<u>\$ (0.076)</u>	<u>\$ (0.013)</u>	<u>\$ (0.146)</u>	<u>\$ (0.025)</u>

The differences between the pro-forma compensation expenses listed above disclosed under US principles and those in Note 10 under Canadian principles result from options issued prior to January 1, 2002, which had not been fully vested at January 1, 2002.