CHINA NORTH EAST PETROLEUM HOLDINGS LTD
Form 10-K
March 16, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

x ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2010

o TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________ to _________

Commission File Number: 000-49846

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
(Exact Name of Registrant as specified in its charter)

Nevada (State or other jurisdiction of Incorporation or organization)	87-0638750 (I.R.S. Employer Identification Number)

445 Park Avenue
New York, NY 10022
(Address of principal executive office)

Registrant’s telephone number, including area code: (212) 307-3568

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Stock, $0.001 par value	NYSE Amex

Securities registered under Section 12(g) of the Exchange Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	o	Accelerated filer	x
Non-accelerated filer	o	Smaller reporting company	o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x

The aggregate market value of the voting and non-voting stock held by non-affiliates of the registrant, as of the last business day of the registrant's most recently completed second fiscal quarter, was approximately $162,276,730. All executive officers and directors of the registrant have been deemed, solely for the purpose of the foregoing calculation, to be "affiliates" of the registrant.

As of March 3, 2011, there were 29,604,860 shares of the issuer's common stock, $0.001 par value, issued and outstanding.

Documents Incorporated by Reference

None

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2010

TABLE OF CONTENTS

Information Regarding Forward-Looking Statements

In addition to historical information, this report contains predictions, estimates and other forward-looking statements that relate to future events or our future financial performance. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by the forward-looking statements. These risks and other factors include those listed under “Risk Factors” and elsewhere in this report, and some of which we may not know. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expects,” “plans,” “anticipates,” “believes,” “estimates,” “predicts,” “potential,” the negative of these terms or other comparable terminology.

Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. We discuss many of these risks in this report in greater detail under the heading “Risk Factors.” Given these uncertainties, you should not place undue reliance on these forward-looking statements. Also, forward-looking statements represent our management’s beliefs and assumptions only as of the date of this report. You should read this annual report on Form 10-K and the documents that we have filed as exhibits to this annual report completely and with the understanding that our actual future results may be materially different from what we expect.

Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

PART I

ITEM 1. BUSINESS

Overview

We are engaged in the exploration and production of crude oil in Northern China. We have an arrangement with the Jilin Refinery of PetroChina Group to sell our crude oil production for use in the China marketplace. As of December 31, 2010, we operated 295 producing wells located in four oilfields in Northern China and have plans for additional drilling projects.

In particular, through two of our subsidiaries, Song Yuan City Yu Qiao Oil and Gas Development Ltd. Corp. ("Yu Qiao") and Longde Oil and Gas Development Co. Ltd. ("LongDe"), we have entered into binding sales agreements with the PetroChina Group, whereby we sell our crude oil production for use in the China marketplace.

We currently operate 4 oilfields located in Northern China, which include:

Field	Acreage Gross (developed and undeveloped) at 12/31/2010	Producing Oil Wells at 12/31/2010	Proved Reserves (Bbls) at 12/31/2010
Qian'an 112	5,115	250	5,440,900
Daan 34	2,298	12	2,500
Gudian 31	1,779	12	16,500
Hetingbao 301	2,471	21	16,300

Financial Information about Segments

The Company operates in two reportable segments; exploration and production of crude oil ("Crude oil") and contract land drilling of oil wells ("Contract drilling"). The accounting policies of the segments are the same as described in the summary of significant accounting policies. The Company evaluates segment performance based on income from operations. All inter-company transactions between segments have been eliminated. As a result, the components of operating income for one segment may not be comparable to another segment. The following is a summary of the Company's segment information for the last three fiscal years ended December 31, 2010, 2009 and 2008 (restated) (in thousands):

Year	2010	2009	2008 (restated)
Revenue:			
Crude oil	$ 54,672	$ 51,081	$ 58,572
Contract drilling	44,876	13,577	-
Total revenue	$ 99,548	$ 64,658	$ 58,572
Gross profit:			
Crude oil	$ 35,393	$ 33,778	$ 34,998
Contract drilling	25,363	8,342	-
Total gross profit	$ 60,756	$ 42,120	$ 34,998

Income from operations:			
Crude oil	$ 27,989	$ 24,212	$ 18,177
Contract drilling	24,964	176	-
Total income from operations	52,953	24,388	18,177
Corporate and other	25,506	(37,579)	(797)
Net income (loss) before income taxes	$ 78,459	$ (13,191)	$ 17,380

1

The flowing chart illustrates our company's organizational structure:

2

Organizational History

We were incorporated in the State of Nevada on August 20, 1999 under the name Draco Holding Corporation. On March 29, 2004, we executed an Agreement for Share Exchange with Hong Xiang Petroleum Group Limited, a corporation organized and existing under the laws of the British Virgin Islands (“Hong Xiang”), and the individual shareholders owning 100% of the outstanding common shares of Hong Xiang (the “Hong Xiang Shareholders”).

Pursuant to the Agreement for Share Exchange, we issued 18,700,000 shares of our common stock to the Hong Xiang Shareholders in exchange for all of the shares of capital stock of Hong Xiang owned by the Hong Xiang Shareholders at closing, and Hong Xiang became our wholly-owned subsidiary. On June 28, 2004, we changed our name to China North East Petroleum Holdings Ltd.

During 2004, we acquired a 100% ownership in Song Yuan City Hong Xiang Petroleum Technical Services Co., Ltd. (“Hong Xiang Technical”), and Hong Xiang Technical in turn acquired a 100% interest in Song Yuan City Yu Qiao Qianan Hong Xiang Oil and Gas Development Co., Ltd. (“Hong Xiang Oil Development”), which was engaged in the exploration and production of crude oil in the Jilin region of the PRC.

As a result of the Yu Qiao acquisition discussed below, all operations, assets and liabilities of the Company’s subsidiary Hong Xiang Oil Development were transferred to Yu Qiao on March 19, 2007. Since Hong Xiang Oil Development and Hong Xiang Technical were no longer necessary elements of the Company’s corporate structure, and they were liquidated and dissolved.

PetroChina Oil Leases

Pursuant to a 20-year exclusive Cooperative Oil Lease (the “Oil Lease”), entered into among PetroChina Group, Yu Qiao and the Company in May 2002, the Company has the right to explore, develop and produce oil at Qian’an 112 Oilfield. Pursuant to the Oil Lease, (i) PetroChina is entitled to 20% of the Company’s oil production for the first ten years of the Oil Lease term and 40% of the Company’s oil production for the remaining ten years of the Oil Lease term; and (ii) Yu Qiao is entitled to 2% of the Company’s oil production as a management fee. The payment of management fee was stopped following the acquisition of Yu Qiao by the Company in 2007.

In May 2003, LongDe entered into a 20-year contract with PetroChina Group. Pursuant to the contract, LongDe has the right to explore, develop and produce oil at the Hetingbao 301 oilfield in the PRC. In addition, pursuant to the contract between PetroChina and LongDe, PetroChina is entitled to 20% of LongDe’s output in the first ten years and 40% of LongDe’s output thereafter until the end of the contract.

As the controlling shareholder of Yu Qiao, the Company has the rights to extract and develop Qian’an 112 and other oil fields under the contracts that Yu Qiao has entered into with PetroChina. These oilfields include the Daan 34 oilfield and Gudian 31 oilfield in Jilin Province.

Song Yuan Technical Joint Venture

On July 26, 2006, the Company entered into a joint venture agreement with Wang Hongjun (“Mr. Wang”), the president and a stockholder of the Company and Ju Guizhi (“Ms. Ju”), mother of Mr. Wang, to contribute to the increased registered capital of Song Yuan North East Petroleum Technical Service Co. Ltd. (“Song Yuan Technical”). The purpose of Song Yuan Technical is to acquire oil and gas properties and to engage in the exploration of crude oil in the PRC. On December 20, 2006, Mr. Wang transferred his interest (4.5%) in Song Yuan Technical to Ms. Ju and as result, the Company owns a 90% equity interest in Song Yuan Technical, and Ms. Ju owns the remaining 10% equity interest in Song Yuan Technical.

Acquisition of LongDe

In order to comply with certain PRC laws relating to foreign entities' ownership of oil and gas companies in the PRC, prior to March 17, 2008, Song Yuan Technical directly owned a 70% equity interest in LongDe, while Sun Peng and Ai Chang Shan, respectively, owned 10% and 20% of the equity interests in LongDe in trust for Song Yuan Technical. On March 17, 2008, Song Yuan Technical acquired an additional 20% equity interest in LongDe, 10% of the equity interest in LongDe from Sun Peng, and 10% of the equity interest in LongDe from Ai Chang Shan. Accordingly, Song Yuan Technical now owns directly 90% of the equity interests in LongDe, with Ai ChangShan holding the remaining 10% in trust for Song Yuan Technical. The acquisition of LongDe was made pursuant to the laws of the PRC. As a 90% owner of Song Yuan Technical, the Company effectively controls LongDe.

This beneficial ownership structure is governed by two trust agreements: (i) Trust Agreement dated October 8, 2006 by and between Song Yuan Technical and Ai Chang Shan; and (ii) Trust Agreement dated April 18, 2008 by and between Song Yuan Technical and Wang Hongjun. Pursuant to the October 8, 2006 agreement, Ai Chang Shan holds 20% of the equity interest in LongDe in trust for the benefit of Song Yuan Technical. On March 17, 2008, Ai Chang Shan entered into a transfer agreement whereby Ai Chang Shan transferred 10% of the equity interest of LongDe held in trust pursuant to this trust agreement to Song Yuan Technical. Currently under the trust agreement dated October 8, 2006, Ai Chang Shan holds 10% of the total equity interest of LongDe in trust for the benefit of Song Yuan Technical. Pursuant to the April 18, 2008 trust agreement, Wang Hongjun holds 10% of the total outstanding equity interest in Yu Qiao in trust for the benefit of Song Yuan Technical.

Acquisition of Yu Qiao

The Company acquired 100% beneficial interest of Yu Qiao from Yu Qiao's former shareholders: Ms. Ju (70%), Meng Xiangyun (20%) and Wang Pingwu (10%) on January 26, 2007. In order to comply with PRC laws which restrict ownership of oil and gas companies by foreign entities, following the acquisition, 20% and 10% of the equity interest, respectively, was transferred to Meng Xiangyun and Wang Pingwu to be held in trust for the benefit of Song Yuan Technical pursuant to a trust agreement.

On March 17, 2008, the trust agreement with Meng Xiangyun was cancelled and the 20% equity interest in Yu Qiao held in trust by Meng Xiangyun was transferred to Song Yuan Technical. On April 18, 2008, the 10% equity interest in Yu Qiao held by Wang Pingwu in trust was transferred to the Company's President and Chairman, Wang Hongjun to hold in trust for the benefit of Song Yuan Technical.

Currently, Song Yuan Technical directly holds 90% of Yu Qiao and 10% is held in trust by Wang Hongjun for the benefit of Song Yuan Technical.

Acquisition of Tiancheng

On September 27, 2009, we acquired, through Song Yuan Technical, beneficial ownership of all of the equity interest in Song Yuan Tiancheng Drilling Engineering Co., Ltd. or "Tiancheng." In order to comply with certain PRC laws, 5% of the equity interest in Tiancheng was initially held in trust by Lou Yunhui, one of the former Tiancheng stockholders, for the benefit of Song Yuan Technical, while the remaining 95% of the equity interest in Tiancheng was held directly by Song Yuan Technical.

On November 13, 2009, the 5% equity interest in Tiancheng held by Lou Yunhui in trust was transferred to the Company's President and Chairman, Wang Hongjun to hold in trust for the benefit of Songyuan Technical.

Tiancheng provides contract drilling services. Tiancheng currently has eight drilling teams with the same number of rigs in house, which include two 4,000 meter rigs, (approximately 13,000 feet depth), three 3,000 meter rigs (approximately 9,800 feet depth) and three 2,000 meter rigs (approximately 6,500 feet depth), respectively. All of its drilling teams have received approvals issued by the Qualification Administrative Committee of China National Petroleum Corporation (PetroChina). Tiancheng has existing contracts with PetroChina and other private oil companies to provide contract drilling and other oilfield services.

The acquisition of Tiancheng was accounted for as a purchase under ASC Topic 805 Business Combinations. Accordingly, the operating results of Tiancheng have been included in the consolidated statements of operations and comprehensive income after September 25, 2009, the effective date of the acquisition.

4

Proposed Acquisition of Sunite Right Banner

On January 19, 2011, the Company through its subsidiary, Songyuan Technical, entered into a Share Transfer Agreement with the shareholders of Sunite Right Banner Shengyuan Oil and Gas Technology Development Co., Ltd. to acquire 100% of the equity interests in Shengyuan.Shengyuan, a limited liability company incorporated in Sunite Right Banner, Inner Mongolia in the People’s Republic of China with exclusive oilfield exploration and drilling rights to the Durimu oilfield in Inner Mongolia.

The total purchase price for Shengyuan is valued at approximately $43.4 million consisting of RMB 70 million (approximately US$10.6 million) in cash and 5,800,000 shares of the Company’s common stock.

The Durimu oilfield belongs to Yanchang Petroleum Group ("Yanchang"), the fourth largest and qualified state owned organization (SOE) for oil and gas exploration in China. Shengyuan is qualified by Yanchang to manage the oil exploration and production activities in the Durimu oilfield. In 2010, Shengyuan signed a 25 year exclusive exploration agreement with Sunite Right Banner Jiangyuan Mining Co. Ltd. ("Jiangyuan"), a state-owned enterprise of the local government to drill in the Durimu oilfield in Inner Mongolia.We will benefit from the 24 years remaining on an exclusive exploration and drilling agreement to operate in the Durimu oilfield and Shengyuan has the first right of refusal to renew the lease at the end of its 25 year term.

According to the terms of the 25 year lease, Shengyuan is entitled to 75% of all production revenue while 25% will be allocated to Yanchang as a royalty payment. Shengyuan will only be liable for income tax on its 75% of oil production revenue. All oil produced by Shengyuan is required to be sold to refineries and other buyers already qualified by Yanchang.

After the consummation of this acquisition, we intend to gradually shift our drilling efforts from the Jilin oilfield to the Durimu oilfield. After the closing of this acquisition, we intend to conduct further seismic tests in the oilfield to gather more geo-data, and begin drilling exploration wells to test productivity within the oilfield. As part of this effort, we plan to utilize 2-3 of our in-house drilling rigs to conduct the initial work. This initial stage is expected to last approximately 12-18 months. As we completed our first stage of testing in Durimu, we intend to shift into a second stage which is to aggressively drill in Durimu and increase overall production. This will be done while maintaining current production levels within our four existing oilfields.

Listing on NYSE Amex LLC

On June 15, 2009, the Company’s common stock commenced trading on the NYSE Amex LLC (“AMEX”). Upon trading on AMEX, the Company changed its ticker symbol from “CNEH.OB” to “NEP.”

Available Information

The Company files or furnishes Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, registration statements and other items with the Securities and Exchange Commission (SEC). The Company provides access free of charge to all of these SEC filings, as soon as reasonably practicable after filing or furnishing, on its Internet site located at http://cneh.irpage.net/SEC_Filings.html. The Company will also make available to any stockholder, without charge, copies of its Annual Report on Form 10-K as filed with the SEC. For copies of this report, or any other filing, please contact China North East Petroleum Holdings, 445 Park Avenue, 10th Floor, New York, NY 10022, Tel: (212) 307-3568 or email: info@cnepetroleum.com.

The public may read and copy any materials the Company files with the SEC at the SEC’s Public Reference Room at 100 F Street, N.E., Washington, DC 20549. The public may obtain information on the operation of the Public

Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site (www.sec.gov) that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC.

Oil Properties and Activities

As of December 31, 2010, the Company had a total of 295 producing wells, including 250 producing wells at the Qian'an 112 oilfield, 21 producing wells at the Hetingbao 301 oilfield, 12 producing wells at the Daan 34 oilfield and 12 producing wells at the Gudian 31 oilfield.

All of the Company's crude oil production is sold to the Jilin Refinery of PetroChina Group. The approximate distance of each of the Company's oil fields from the Jilin Refinery is as follows: the Qian'an 112 oilfield is four kilometers away, the Hetingbao 301 oilfield is three kilometers away, the Daan 34 oilfield is fifteen kilometers away and the Gudian Oilfield 31 is thirty kilometers away.

PetroChina pays the Company a price per barrel equal to the monthly mean price calculated from the Mean of Platts Singapore ("MOPS") daily price for sour, heavy Indonesian crude, as measured during the previous month. Platts is a leading global provider of energy and metals information that collects and publishes pricing data on a wide range of petroleum and non-petroleum commodity types. An independent provider, Platts serves the oil, natural gas, electricity, emissions, nuclear power, coal, petrochemical, shipping, and metals markets from 17 offices worldwide. Price paid to the Company is FOB at the local Jilin Province PetroChina oil storage depot. The oil grade produced in China is lower than the grade of light and sweet oil quoted as West Texas Intermediate ("WTI") and Brent, therefore, the oil price we receive from PetroChina generally is slightly discounted to the WTI or Brent price.

The following table shows the difference between the WTI and MOPS China monthly oil prices.

	Oil Sale Price $	
Month	WTI	MOPS-China
January 2010	78	73
February 2010	76	76
March 2010	81	71
April 2010	84	75
May 2010	74	80
June 2010	75	76
July 2010	76	72
August 2010	77	72
September 2010	75	73
October 2010	82	74
November 2010	84	78
December 2010	89	80

(Note: data references to Wall Street Journal, and MOPS China price is exchanged from RMB to USD at the exchange rate of 6.7695 for 12 months moving average)

As noted in the table above, compared with WTI prices, the MOPS China price generally is slightly discounted due to lower oil quality. In addition, there is a one-month time lag between the two prices.

PetroChina pays the Company monthly in arrears, on approximately the 15th day after the end of each month. The amount paid to the Company in the first two months of each calendar quarter is decreased by the amount of oil surcharge tax the Company will owe to the PRC government at the end of that calendar quarter. PetroChina holds those amounts back from the Company until the end of each calendar quarter, and then pays those amounts to the Company with the balance due for oil deliveries in the final month of the quarter. For this reason, the Accounts Receivable balance at the end of each quarter is larger than the prior month's oil sales revenue, because it includes the oil surcharge tax amounts the Company owes for the first two months of the quarter.

Sales Volumes and Prices

The following table shows the Company's annual sales volumes of crude oil for the last two fiscal years.

	2010	2009
China	(Bbls)	(Bbls)
Crude Oil	723,774	908,126

6

Proved Reserves

As of December 31, 2010, total proven reserves were 5,476,200 barrels of crude oil. The Qian'an 112 Oilfield had proven reserves of 5,440,900 barrels. The Hetingbao 301 Oilfield had proven reserves of 16,300 barrels. The Gudian 31 Oilfield had proven reserves of 16,500 barrels, and the Daan 34 Oilfield had proven reserve of 2,500 barrels.

Proved reserve estimates were made as of December 31, 2010 by Ralph E. Davis Associates Inc., an independent worldwide petroleum consultant based in Houston, Texas. Ralph E. Davis Associates Inc. conducted a study of each of the aforementioned oilfields in accordance with generally accepted petroleum engineering and evaluation principles in conformity with SEC definitions and guidelines.

The Company's estimates of proved reserves, proved developed reserves and proved undeveloped reserves at December 31, 2010 and 2009 are listed as of following:

	2010 Proved			2009 Proved		
	Producing	Undeveloped	Total	Producing	Undeveloped	Total
Oil/condensate-Barrels	3,389,900	2,086,300	5,476,200	4,331,000	1,801,000	6,132,000

Also contained in the above table are the Company's estimates of future net cash flows and discounted future net cash flows from proved reserves. See Operating Results and Critical Accounting Policies and Estimates for additional information on the Company's proved reserves.

The following table shows the Company's annual average sales prices and average production costs. Production costs are costs incurred to operate and maintain the Company's wells and related equipment and include cost of labor, well service and repair, location maintenance, power and fuel, transportation, cost of product, property taxes, production and severance taxes and production related general and administrative costs. Additional detail of production costs is contained in the Supplemental Information.

Qian'an 112 Oilfield	2010	2009
Average annual sales price per barrel	$ 75.54	$ 55.97
Aggregate annual sales	$ 53,631,300	$ 50,142,897
Average annual production cost per barrel equivalent	$ 18	$ 2.94

Hetingbao 301 Oilfield	2010	2009
Average annual sales price per barrel	$ 75.54	$ 55.97
Aggregate annual sales	$ 511,216	$ 555,449
Average annual production cost per barrel equivalent	$ 102	$ 25.70

Daan 34 Oilfield	2010	2009
Average annual sales price per barrel	$ 75.54	$ 55.97
Aggregate annual sales	$ 146,947	$ 153,823
Average annual production cost per barrel equivalent	$ 25	$ 3.96

Gudian 31 Oilfield	2010	2009
Average annual sales price per barrel	$ 75.54	$ 55.97
Aggregate annual sales	$ 382,694	$ 228,606
Average annual production cost per barrel equivalent	$ 17	$ 3.96

Due to flooding in July 2010, the Company was forced to suspend oil extraction for a week. However, oil extraction machinery needs continuous operation, in order to be kept in good condition. Therefore, before extraction could be resumed, the Company was forced to perform additional repair and maintenance work, which increased its production costs significantly.

Drilling Programs

During 2010, the Company drilled 3 new productive wells at the Qian'an 112 oilfield, 3 new productive wells at the Hetingbao 301oilfield, 0 new productive wells at the Daan 34 oilfield, and 0 new productive wells at the Gudian 31 oilfield.

Drilling Statistics

The following table shows the results of the oil wells drilled and tested as of December 31, 2010 and 2009:

	Net Exploratory			Net Development			
	Productive	Dry Holes	Total	Productive	Dry Holes	Total	Total
2010	0	0	0	295	0	295	295

2009	0	0	0	289	0	289	289

Properties and Leases

The following schedule shows the number of developed leases, undeveloped leases and fee mineral acres in which the Company held interests at December 31, 2010:

	Developed Lease (1)		Undeveloped Lease (2)	
Property	Gross	Net	Gross	Net
Qian'an 112	5,227	4,182	281	225
Hetingbao 301	756	605	0	0
Daan 34	281	225	0	0
Gudian 31	281	225	0	0

(1) Developed Proved Acres means the acres assigned to each productive well. Total proved producing wells as of December 31, 2010 were 295.

(2) Undeveloped Proved Acres means the acres assigned to each undeveloped location under lease that contains proved oil reserves.

Present Activities

Production, Average Sales Prices, Production Costs, Drilling Depth and Drilling Wells Count

Our business operations are characterized by frequent, and sometimes significant, changes in the price we receive for the crude oil we produce and in the volumes of crude oil we produce. The following table shows selected operating data for the fiscal years ended December 31, 2010 and 2009.

	Fiscal year ended December 31	
	2010	2009
Oil Output (Bbl)	723,774	908,126
Avg. Sale Price ($/bbl)	$ 75.54	$ 55.97
Tiancheng Drilling Depth (m)	374,413	99,161
Avg. Drilling Price ($/m)	$ 120	$ 137
Tiancheng Drilling Wells	191	60
Oil Sales Revenue	$ 54,672,157	$ 51,080,775
Drilling Revenue	44,875,757	13,577,310
Cost of Revenue:		
Production Costs	4,113,237	2,868,895
Drilling Cost	17,555,255	4,861,488
Depreciation, depletion and amortization of oil properties	6,570,965	9,795,312
Depreciation of drilling equipment	1,925,895	373.437
Amortization of land use rights	31,754	19,792
Oil Surcharge	8,594,481	4,618,789
Gross Profit	$ 60,756,327	$ 42,120,372

As shown in the above table, the appreciation of oil prices in 2010 compared with 2009 caused our revenues to increase substantially, even though the production of oil decreased slightly due to flooding that occurred in the second quarter.

The following table reflects the significant oil sale price fluctuation in China in the past 12 months.

Month	Oil Sale Price	
	RMB/Ton	USD/Bbl
January 2010	3,670	73
February 2010	3,820	76
March 2010	3,586	71
April 2010	3,761	75
May 2010	4,054	80
June 2010	3,837	76
July 2010	3,615	72
August 2010	3,599	72
September 2010	3,660	73
October 2010	3,693	74
November 2010	3,909	78
December 2010	4,019	80

(Note: 1 Ton = 7.38 Bbls, Exchange rate 1 USD = 6.7695 RMB for 12 months moving average)

Marketing and Sales

Currently, all of the Company’s crude oil production is sold to PetroChina’s Jilin Refinery. We do not expect the Company to have any other customers during the next twelve months. As restricted by contract with PetroChina, we may not sell any crude oil to any other customer. PetroChina pays the Company a price per barrel equal to the monthly mean price calculated from the Mean of Platts Singapore (“MOPS”) daily price for sour, heavy Indonesian crude, as measured during the previous month. Platts is an international commodity and trading company that collects and publishes pricing data on a wide range of petroleum and non-petroleum commodity types. The price paid to the Company is FOB at the local Jilin Province PetroChina oil storage depot.

Contract Drilling Services

Our subsidiary, Song Yuan Tiancheng Drilling Engineering Co. Ltd (“Tiancheng”), founded in December 2007 and acquired by the Company on September 27, 2009, provides contract drilling and other oilfield services for state-owned and non-state-owned oil companies in Northern China.

Tiancheng is one of four private contract drilling and service companies that has been qualified and licensed to operate in PetroChina’s Jilin oilfield. Tiancheng has also been granted contracts to drill for PetroChina. Compared to the other three drilling companies operating in the Jilin oilfield, Tiancheng is the largest, in terms of the number of drilling rigs owned in house. Tiancheng was started with only two rigs at the end of 2007, and now has eight drilling teams with the same number of rigs, which include two 4,000 meters rig (capable of drilling down to a depth of approximately 13,000 feet), three 3,000 meters rigs (approximately 9,800 feet) and three 2,000 meters rigs (approximately 6,500 feet), respectively. All of its eight drilling teams received approvals issued by the Qualification Administrative Committee of China National Petroleum Corporation (PetroChina).

Tiancheng enters into drilling contracts with PetroChina and other private oil companies to provide oilfield drilling services, and generates revenue based on the depth of each well drilled. Clients typically pay 30% of the total projected drilling costs as a down payment to start the drilling process, and pay the remaining balance within 12 months according to the specific contract terms.

In 2010, Tiancheng completed contracts to drill 191 shallow wells, which include 146 wells for state-owned PetroChina Jilin Branch and 45 wells for non-state-owned Daqing Shunwei Energy Development Co. Ltd. Tiancheng drilled a total of 374,413 meters (approximately 1,228,889 feet) in 2010, earned revenue of $44,875,757 and net income of $18,420,154.

Employees

At December 31, 2010, we employed 715 people, of which 75 are in management and 640 are site workers. This figure represents an increase in the number of employees reported last year. While we continue to work towards more efficient labor utilization at our oil well locations, we added employees in conjunction with our new oil wells in 2010.

Regulations

Restrictions on Foreign Ownership in the Oil and Gas Industry

The principal regulation governing foreign ownership of oil and gas companies in China is the "Regulations on Mergers and Acquisitions of Domestic Enterprises by the Foreign Investors" issued by Ministry of Commerce, Foreign Investment Administration, Stock Exchange Committee (September 2006). Currently, qualified foreign investors cannot own 100% of an oil and gas company in China. The foreign investors' equity holding ratios are subject to the approval of relevant government authorities.

Foreign investment in China is generally subject to the approval of the Ministry of Commerce and approvals of other federal and local authorities.

As a result of the rules and regulations described above, we conduct our businesses in China through Yu Qiao and Wang Hongjun, who hold the equity interests of Yu Qiao in trust for the Company, and LongDe and Ai ChangShan, who hold the equity interests of LongDe in trust for the Company. We have entered into contractual arrangements with Wang Hongjun and Ai ChangShan pursuant to which we believe, based on the advice of PRC legal counsel that:

- we are able to exert effective control over Yu Qiao and LongDe;
- substantially all of the economic benefits of Yu Qiao and LongDe will be transferred to us; and
- our 90% owned joint venture, Song Yuan Technical, has an exclusive option to purchase all or part of the equity interests in Yu Qiao and LongDe to the extent permitted by PRC law.

The Company further believes, based on the advice of PRC legal counsel, that:

- the ownership structure of Yu Qiao and LongDe are in compliance with existing PRC laws and regulations;
- the contractual arrangements among Song Yuan Technical, Yu Qiao, Wang Hongjun, LongDe and Ai ChangShan are valid, binding and enforceable, and will not result in any violation of PRC laws or regulations currently in effect; and
- the PRC business operations of Song Yuan Technical and Yu Qiao and LongDe as described in this annual report, are in compliance with existing PRC laws and regulations in all material respects.

We have been further advised, however, that there are substantial uncertainties regarding the interpretation and application of current and future PRC laws and regulations. Accordingly, there can be no assurance that the PRC regulatory authorities will not in the future take a view that is contrary to the above position.

Environmental Regulations

We are subject to the environmental laws and regulations of the jurisdictions in which we carry on our business. Existing or future laws and regulations could have a significant impact on the exploration and development of natural resources by us. However, to date, we have not been required to spend any material amounts for environmental control facilities. The Chinese government strictly monitors compliance with these laws but compliance therewith has not had any adverse impact on our operations or our financial resources.

Special Oil Fees

In June 2006, the PRC government imposed a new regulation on all oil and gas producers. Under this new regulation, all oil and gas producers are subject to a mandatory special oil fee. The fee is calculated based on the per barrel selling price of crude oil received by the producer and is paid by the Company on a quarterly basis, following the end of each quarter. This special oil surcharge is essentially a progressive windfall profits tax. This fee is not related to the Company's oil field lease operating expenses or to the underlying production sharing lease payment arrangement we have with PetroChina. We pay this special oil surcharge directly to the PRC government on a quarterly basis, in arrears. The following table shows the calculation methodology for the special oil fees:

Crude Price $/Bbl	Surcharge Rate
$40-45	20%
$45-50	25%
$50-55	30%
$55-60	35%
Above $60	40%

For example, if the MOPS oil price is $57.00 per barrel, the oil surcharge is $4.45 per barrel ($1.00 + $1.25 + $1.50 + $0.70); if the oil price is $75.00 per barrel, the oil surcharge is $11.50 per barrel ($1.00 + $1.25 + $1.50 + $1.75 + $6.00).

As a result of this new regulation, the Company paid additional special oil fees of $8,594,481 during 2010 and $4,618,789 during 2009 to the PRC government. The Company will be required to continue to pay these special oil fees to the PRC government if the selling price of crude oil remains above $40.00 per barrel, and these special oil fees will increase to the extent that crude oil prices rise.

Competition

By virtue of our binding contractual agreements with PetroChina Group as described above, we have no competitor with respect to the extraction and production of crude oil from the oilfields in which we operate.

ITEM 1A. RISK FACTORS

Our business is subject to certain risks, and we want you to review these risks while you are evaluating our business and our historical results. Please keep in mind that any of the following risks discussed below and elsewhere in this Annual Report could materially and adversely affect us, our operating results, our financial condition and our projections and beliefs as to our future performance. As such, our results could differ materially from those projected in our forward-looking statements. Additional risks and uncertainties not currently known to us or those we currently deem to be immaterial may also materially and adversely affect our business.

Risks Related To Our Business

Oil prices fluctuate significantly, and lower prices for an extended period of time are likely to have a material adverse impact on our business.

Our revenues, profitability and future growth depend substantially on prevailing prices for crude oil. We sell to one customer, PetroChina, and PetroChina pays the Company a price per barrel equal to the monthly mean price calculated from the Mean of Platts Singapore ("MOPS") daily price for sour, heavy Indonesian crude, as measured during the previous month. Platts is an international commodity and trading company that collects and publishes pricing data on a wide range of petroleum and non-petroleum commodity types. The price paid to the Company is FOB at the local Jilin Province PetroChina oil storage depot. These prices also affect the amount of cash flow available for capital expenditures and our ability to borrow and raise additional capital. The lower prices may reduce the amount of crude oil that we can economically produce.

Among the factors that can cause fluctuations are:

- The price and availability of alternative fuels;
- disruptions in supply and changes in demand caused by weather conditions;
- changes in demand as a result of changes in price;
- political conditions in oil and gas producing regions; and
- domestic governmental regulations.

Our future success depends on our ability to find, develop and acquire oil and gas reserves.

To maintain production levels, we must locate and develop or acquire new crude oil reserves to replace those depleted by production. Without successful exploration or acquisition activities, our reserves, production and revenues will decline rapidly. We may be unable to find and develop or acquire additional reserves at an acceptable cost. In addition, substantial capital is required to replace and grow reserves. If lower crude oil price or operating constraints or production difficulties result in our cash flow from operations being less than expected, we may be unable to expend the capital necessary to locate and develop or acquire new crude oil reserves.

We may need to raise substantial additional capital, which may result in substantial dilution to existing stockholders.

Although the Company currently has no plans to raise additional capital, the Company may need to raise additional capital to fully deploy wells onto its oilfields or to make acquisitions. There can be no assurance that we will be able to raise sufficient capital at all or on terms favorable to our stockholders or us. If we issue equity securities in order to raise additional capital in the amounts currently contemplated, the stockholders will experience immediate and substantial dilution in their ownership percentage of the combined company. In addition, to raise the capital we need, we may need to issue additional shares at a discount to the current market price. If the terms of such financing are unfavorable to us or our stockholders, the stockholders may experience substantial dilution in the net tangible book value of their stock. In addition, any new equity securities may have rights, preferences or privileges senior to those of existing holders of common stock. If we cannot raise funds on acceptable terms, we may not be able to fully develop or exploit our existing oil reserves, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements all of which could have a material adverse effect on us.

Environmental and regulatory factors

The oil drilling industry in China to date has not been subject to the type and scope of regulation seen in Europe and the United States. However, the possibility exists that new legislation or regulations may be adopted or that the enforcement of existing laws could become more stringent, either of which may have a significant impact on our mining operations or our customers' ability to use oil and may require us or our customers to significantly change operations or to incur substantial costs. We believe that our operations in China are in compliance with China's applicable legal and regulatory requirements. However, there can be no assurance that China's central or local governments will not impose new, stricter regulations or interpretations of existing regulations that would require additional expenditures.

Compliance and enforcement of environmental laws and regulations related to climate change

Future international, national, regional and local environmental laws and regulations in China and other Pacific Rim countries related to climate change may have a significant impact on the Company’s operations. These laws and regulations may provide for user fees, penalties and other liabilities for the violation of these standards. As new environmental laws and regulations are enacted and existing laws are repealed, interpretation, application and enforcement of the laws may become inconsistent. Compliance with applicable climate change regulation in the future may require significant expenditures, which may adversely affect the Company’s operations. The enactment of any such laws, rules or regulations in the future may have a negative impact on the Company’s projected growth, which could in turn decrease its projected revenues or increase its cost of doing business.

Reserve degradation and depletion

Our profitability depends substantially on our ability to exploit our oil reserves at competitive costs. Replacement reserves may not be available when required or, if available, may not be capable of being drilled at costs comparable to those characteristics of the depleting oil field. We may in the future acquire oil reserves from third parties. We may not be able to accurately assess the geological characteristics of any reserves that we acquire, which may adversely affect our profitability and financial condition. Exhaustion of reserves at our existing oil fields and at oil fields that we may acquire in the future can also have an adverse effect on operating results that is disproportionate to the percentage of overall production represented by such mines.

Reserves – title; leasehold interests

Our proved reserves are estimates. Any material inaccuracies in our reserve estimates or assumptions underlying our reserve estimates could cause the quantities and net present value of our reserves to be overstated or understated. There are numerous uncertainties inherent in estimating quantities of proved reserves, including many factors beyond our control that could cause the quantities and net present value of our reserves to be overstated. The reserve information included or incorporated by reference in this report represents estimates prepared by our internal engineers and examined by independent petroleum consultants. Estimation of reserves is not an exact science. Estimates of economically recoverable oil and natural gas reserves and of future net cash flows necessarily depend upon a number of variable factors and assumptions, any of which may cause these estimates to vary considerably from actual results, such as:

- historical production from an area compared with production from similar producing areas;
- assumed effects of regulation by governmental agencies;
- assumptions concerning future oil and natural gas prices, future operating costs and capital
- expenditures; and
- estimates of future severance and excise taxes, workover and remedial costs.

Estimates of reserves based on risk of recovery and estimates of expected future net cash flows prepared or audited by different engineers, or by the same engineers at different times, may vary substantially. Actual production, revenues and expenditures with respect to our reserves will likely vary from estimates, and the variance may be material. The net present values referred to in this report should not be construed as the current market value of the estimated oil reserves attributable to our properties. In accordance with SEC requirements, the estimated discounted net cash flows from proved reserves are generally based on prices and costs as of the date of the estimate, whereas actual future prices and costs may be materially higher or lower.

Acquisitions

We are seeking to expand our operations and oil reserves in the regions in which we operate through acquisitions of businesses and assets, including leases of oil reserves. Acquisition transactions involve inherent risks, such as:

15

- uncertainties in assessing the value, strengths, weaknesses, contingent and other liabilities and potential profitability of acquisition or other transaction candidates;
- the potential loss of key personnel of an acquired business;
- the ability to achieve identified operating and financial synergies anticipated to result from an acquisition or other transaction;
- problems that could arise from the integration of the acquired business;
- unanticipated changes in business, industry or general economic conditions that affect the assumptions underlying the acquisition or other transaction rationale; and
- Unexpected development costs that adversely affects our profitability.

Any one or more of these factors could cause us not to realize the benefits anticipated to result from the acquisition of businesses or assets.

Risks Related To Doing Business In China

Our operations are primarily located in China and may be adversely affected by changes in the policies of the Chinese government.

The political environment in the PRC may adversely affect the Company's business operations. The PRC has operated as a socialist state since 1949 and is controlled by the Communist Party of China. In recent years, however, the government has introduced reforms aimed at creating a "socialist market economy" and policies have been implemented to allow business enterprises greater autonomy in their operations. Changes in the political leadership of the PRC may have a significant effect on laws and policies related to the current economic reforms program, other policies affecting business and the general political, economic and social environment in the PRC, including the introduction of measures to control inflation, changes in the rate or method of taxation, the imposition of additional restrictions on currency conversion and remittances abroad, and foreign investment. These effects could substantially impair the Company's business, profits or prospects in China. Moreover, economic reforms and growth in the PRC have been more successful in certain provinces than in others, and the continuation or increases of such disparities could affect the political or social stability of the PRC.

The PRC's economic, political and social conditions, as well as governmental policies, could affect the financial markets in China and our liquidity and access to capital and our ability to operate our business.

The PRC economy differs from the economies of most developed countries in many respects, including the amount of government involvement, level of development, growth rate, control of foreign exchange and allocation of resources. While the PRC economy has experienced significant growth over the past, growth has been uneven, both geographically and among various sectors of the economy. The PRC government has implemented various measures to encourage economic growth and guide the allocation of resources. Some of these measures benefit the overall PRC economy, but may also have a negative effect on us. The PRC economy has been transitioning from a planned economy to a more market-oriented economy. Although the PRC government has implemented measures since the late 1970s emphasizing the utilization of market forces for economic reform, the reduction of state ownership of productive assets and the establishment of improved corporate governance in business enterprises, a substantial portion of productive assets in China is still owned by the PRC government. In addition, the PRC government continues to play a significant role in regulating industry development by imposing industrial policies. The PRC government also exercises significant control over China's economic growth through the allocation of resources, controlling payment of foreign currency- denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies. Since late 2003, the PRC government implemented a number of measures, such as raising bank reserves against deposit rates to place additional limitations on the ability of commercial banks to make loans and raise interest rates, in order to slow down specific segments of China's economy which it believed to be overheating. These actions, as well as future actions and policies of the PRC government, could materially affect our liquidity and access to capital and our ability to operate our business.

The Chinese government exerts substantial influence over the manner in which the Company must conduct its business activities.

The PRC only recently has permitted greater provincial and local economic autonomy and private economic activities. The government of the PRC has exercised and continues to exercise substantial control over virtually every sector of the Chinese economy through regulation and state ownership. Accordingly, government actions in the future, including any decision not to continue to support recent economic reforms and to return to a more centrally planned economy or regional or local variations in the implementation of economic policies, could have a significant effect on economic conditions in the PRC or particular regions thereof, and could require the Company to divest the interests it then holds in Chinese properties or joint ventures. Any such developments could have a material adverse effect on the business, operations, financial condition and prospects of the Company.

Future inflation in China may inhibit economic activity and adversely affect the Company's operations.

In recent years, the Chinese economy has experienced periods of rapid expansion and within which some years with high rates of inflation and deflation, which have led to the adoption by the PRC government, from time to time, of various corrective measures designed to restrict the availability of credit or regulate growth and contain inflation. While inflation has moderated since 1995, high inflation may in the future cause the PRC government to impose controls on credit and/or prices, or to take other action, which could inhibit economic activity in China, and thereby adversely affect the Company's business operations and prospects in the PRC.

We may be restricted from freely converting the Renminbi ("RMB") to other currencies in a timely manner.

The RMB is not a freely convertible currency at present. The Company receives all of its revenue in RMB, which may need to be converted to other currencies, primarily U.S. dollars, and remitted outside of the PRC. Effective July 1, 1996, foreign currency "current account" transactions by foreign investment enterprises, including Sino-foreign joint ventures, are no longer subject to the approval of State Administration of Foreign Exchange ("SAFE," formerly, "State Administration of Exchange Control"), but need only a ministerial review, according to the Administration of the Settlement, Sale and Payment of Foreign Exchange Provisions promulgated in 1996 (the "FX regulations"). "Current account" items include international commercial transactions, which occur on a regular basis, such as those relating to trade and provision of services. Distributions to joint venture parties also are considered a "current account transaction." Other non-current account items, known as "capital account" items, remain subject to SAFE approval. Under current regulations, the Company can obtain foreign currency in exchange for RMB from swap centers authorized by the government. The Company does not anticipate problems in obtaining foreign currency to satisfy its requirements; however, there is no assurance that foreign currency shortages or changes in currency exchange laws and regulations by the Chinese government will not restrict the Company from freely converting RMB in a timely manner. If such shortages or change in laws and regulations occur, the Company may accept RMB, which can be held or re-invested in other projects.

We may suffer from exchange rate risks that could result in foreign currency exchange loss.

Because our business transactions are denominated in RMB and our funding and result of operations will be denominated in USD, fluctuations in exchange rates between USD and RMB will affect our balance sheet and financial results. Since July 2005, RMB is no longer solely pegged with USD but is pegged against a basket of currencies as a whole in order to keep a more stable exchange rate for international trading. With the very strong economic growth in China in the last few years, RMB is facing a very high pressure to appreciate against USD. Such pressure would result more fluctuations in exchange rates and in turn our business would be suffered from higher exchange rate risk.

There are very limited hedging tools available in China to hedge our exposure in exchange rate fluctuations. They are also ineffective in the sense that these hedges cannot be freely preformed in the PRC financial market, and more important, the frequent changes in PRC exchange control regulations would limit our hedging ability for RMB.

We may be unable to enforce our rights due to policies regarding the regulation of foreign investments in China.

The PRC's legal system is a civil law system based on written statutes in which decided legal cases have little value as precedents, unlike the common law system prevalent in the United States. The PRC does not have a well-developed, consolidated body of laws governing foreign investment enterprises. As a result, the administration of laws and regulations by government agencies may be subject to considerable discretion and variation, and may be subject to influence by external forces unrelated to the legal merits of a particular matter. China's regulations and policies with respect to foreign investments are evolving. Definitive regulations and policies with respect to such matters as the permissible percentage of foreign investment and permissible rates of equity returns have not yet been published. Statements regarding these evolving policies have been conflicting and any such policies, as administered, are likely to be subject to broad interpretation and discretion and to be modified, perhaps on a case-by-case basis. The uncertainties regarding such regulations and policies present risks that the Company will not be able to achieve its business objectives. There can be no assurance that the Company will be able to enforce any legal rights it may have under its contracts or otherwise.

Because our assets are located overseas, stockholders may not receive distributions that they would otherwise be entitled to if we were declared bankrupt or insolvent.

Our assets are, for the most part, located in the PRC. Because the Company's assets are located overseas, the assets of the Company may be outside of the jurisdiction of U.S. courts to administer if the Company was the subject of an insolvency or bankruptcy proceeding. As a result, if the Company was declared bankrupt or insolvent, the Company's stockholders may not receive the distributions on liquidation that they are otherwise entitled to under U.S. bankruptcy law.

Our acquisitions of LongDe and Yu Qiao were structured to attempt to fully comply with PRC rules and regulations. However, such arrangements may be adjudicated by relevant PRC government agencies as not being in compliance with PRC governmental regulations on foreign investment in oil and gas industries and such structures may limit our control with respect to such entities.

PRC rules and regulations do not allow foreign investors to directly own 100% of a domestic oil and gas business. As such, we are ineligible to own directly 100% a domestic oil and gas business in China. We acquired Hong Xiang Oil Development through Hong Xiang Technical, our 100% owned subsidiary. We acquired a majority interest of LongDe and Yu Qiao through Song Yuan Technical, our 90% owned joint venture incorporated in the PRC. Our acquisition of Yu Qiao is currently provided through a trust arrangement with a PRC citizen designated by PetroChina, a government owned entity; pursuant to which they agree to hold 10% securities of Yu Qiao for the benefit of Song Yuan Technical in compliance with the applicable law of the PRC. However, pursuant to the trust agreement, they agree, among other things, to (i) vote the securities as directed by Song Yuan technical, (ii) deliver all payments, distributions and other economic benefits received with respect to the securities to Song Yuan Technical, (iii) not transfer or encumber the securities without the consent of Song Yuan Technical and (iv) to transfer the securities to Song Yuan Technical as soon as permissible under the laws of the PRC.

Although we have been advised by our PRC counsel that our arrangements with our affiliated Chinese entities are valid under current PRC laws and regulations, we cannot assure you that we will not be required to restructure our organization structure and operations in China to comply with changing and new PRC laws and regulations. Restructuring of our operations may result in disruption of our business, diversion of management attention and the incurrence of substantial costs.

Recent PRC regulations relating to offshore investment activities by PRC residents may increase our administrative burden and restrict our overseas and cross-border investment activities. If our shareholders who are PRC residents fail to make any required applications and filings under such regulations, we may be unable to distribute profits and may become subject to liability under PRC laws.

The PRC National Development and Reform Commission, or NDRC, and SAFE recently promulgated regulations that require PRC residents and PRC corporate entities to register with and obtain approvals from relevant PRC government authorities in connection with their direct or indirect offshore investment activities. These regulations apply to our shareholders who are PRC residents and may apply to any offshore acquisitions that we make in the future.

Under the SAFE regulations, PRC residents who make, or have previously made, direct or indirect investments in offshore companies will be required to register those investments. In addition, any PRC resident who is a direct or indirect shareholder of an offshore company is required to file with the local branch of SAFE, with respect to that offshore company, any material change involving capital variation, such as an increase or decrease in capital, transfer or swap of shares, merger, division, long-term equity or debt investment or creation of any security interest over the assets located in China. If any PRC shareholder fails to make the required SAFE registration, the PRC subsidiaries of that offshore parent company may be prohibited from distributing their profits and the proceeds from any reduction in capital, share transfer or liquidation, to their offshore parent company, and the offshore parent company may also be prohibited from injecting additional capital into their PRC subsidiaries. Moreover, failure to comply with the various SAFE registration requirements described above could result in liability under PRC laws for evasion of applicable foreign exchange restrictions.

We cannot assure you that all of our shareholders who are PRC residents will comply with our request to make or obtain any registrations or approvals required under these regulations or other related legislation. Furthermore, as the regulations are relatively new, the PRC government has yet to publish implementing rules, and much uncertainty remains concerning the reconciliation of the new regulations with other approval requirements. It is unclear how these regulations, and any future legislation concerning offshore or cross-border transactions, will be interpreted, amended and implemented by the relevant government authorities. The failure or inability of our PRC resident shareholders to comply with these regulations may subject us to fines and legal sanctions, restrict our overseas or cross-border investment activities, limit our ability to inject additional capital into our PRC subsidiaries, and the ability of our PRC subsidiaries to make distributions or pay dividends, or materially and adversely affect our ownership structure. If any of the foregoing events occur, our acquisition strategy, business operations and ability to distribute profits to you could be materially and adversely affected.

PRC regulation of loans and direct investment by offshore holding companies to PRC entities may delay or prevent us from raising finance to make loans or additional capital contributions to our PRC operating subsidiaries and affiliates.

As an offshore holding company of our PRC operating subsidiaries and affiliates, we may make loans to our PRC subsidiaries and consolidated PRC affiliated entities, or we may make additional capital contributions to our PRC subsidiaries. Any loans to our PRC subsidiaries or consolidated PRC affiliated entities are subject to PRC regulations and approvals.

We may also determine to finance Song Yuan Technical, by means of capital contributions. These capital contributions to Song Yuan Technical must be approved by the PRC Ministry of Commerce or its local counterpart. We cannot assure you that we can obtain these government registrations or approvals on a timely basis, if at all, with respect to future loans or capital contributions by us to our operating subsidiaries. If we fail to receive such registrations or approvals, our ability to capitalize our PRC operations would be negatively affected which would adversely and materially affect our liquidity and our ability to expand our business.

Risks Related to Corporate and Stock Matters

Our authorized preferred stock exposes stockholders to certain risks.

Our Articles of Incorporation authorizes the issuance of up to 150,000,000 shares of preferred stock, par value $.001 per share. To date, no shares of preferred stock have been issued. The authorized preferred stock constitutes what is commonly referred to as “blank check” preferred stock. This type of preferred stock allows the Board of Directors to divide the preferred stock into series, to designate each series, to fix and determine separately for each series any one or more relative rights and preferences and to issue shares of any series without further stockholder approval. Preferred stock authorized in series allows our Board of Directors to hinder or discourage an attempt to gain control of us by a merger, tender offer at a control premium price, proxy contest or otherwise. Consequently, the preferred stock could entrench our management. In addition, the market price of our common stock could be materially and adversely affected by the existence of the preferred stock.

The market for the Company’s common stock is illiquid.

It is thinly traded compared to larger more widely known companies in its industry. Thinly traded common stock can be more volatile than stock trading in an active public market. The Company cannot predict the extent to which an active public market for its common stock will develop or be sustained.

National Association of Securities Dealers (“NASD”) sales practice requirements may also limit a stockholder’s ability to buy and sell our stock.

The NASD has adopted rules that require that in recommending an investment to a customer, a broker-dealer must have reasonable grounds for believing that the investment is suitable for that customer. Prior to recommending speculative low priced securities to their non-institutional customers, broker-dealers must make reasonable efforts to obtain information about the customer’s financial status, tax status, investment objectives and other information. Under interpretations of these rules, the NASD believes that there is a high probability that speculative low priced securities will not be suitable for at least some customers. The NASD requirements make it more difficult for broker-dealers to recommend that their customers buy our common stock, which may limit your ability to buy and sell our stock and have an adverse effect on the market for our shares.

Our common stock has experienced, and may continue to experience, price volatility and a low trading volume

The trading price of our common stock has been and may continue to be subject to large fluctuations, which may result in losses to investors. Our stock price may increase or decrease in response to a number of events and factors, including:

- trends in our industry and the markets in which we operate;
- changes in the market price of the commodities we sell;
- changes in financial estimates and recommendations by securities analysts;
- acquisitions and financings;
- quarterly variations in operating results;
- the operating and stock price performance of other companies that investors may deem comparable to us; and
- issuances, purchases or sales of blocks of our common stock.

This volatility may adversely affect the price of our common stock regardless of our operating performance. See “Item 4 — Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” for further discussion.

20

Stockholders should have no expectation of any dividends.

The holders of our common stock are entitled to receive dividends when, as and if declared by the board of directors out of funds legally available therefore. To date, we have not declared nor paid any cash dividends. The board of directors does not intend to declare any dividends in the foreseeable future, but instead intends to retain all earnings, if any, for use in our business operations.

A majority of our directors and officers are located outside the United States, with the result that it may be difficult for investors to enforce within the United States any judgments obtained against us or any of our overseas-based directors or officers.

A majority of our directors and officers are nationals and/or residents of countries other than the United States, and all or a substantial portion of such persons' assets are located outside the United States. As a result, it may be difficult for investors to effect service of process on our overseas-based directors or officers, or enforce within the United States or Canada any judgments obtained against us or our overseas-based officers or directors, including judgments predicated upon the civil liability provisions of the securities laws of the United States or any state thereof. Consequently, you may be effectively prevented from pursuing remedies under U.S. federal securities laws against them. In addition, investors may not be able to commence an action in a Canadian court predicated upon the civil liability provisions of the securities laws of the United States.

If we or our independent registered public accountants cannot attest our adequacy in the internal control measures over our financial reporting, as required by Section404 of the U.S. Sarbanes-Oxley Act, for the fiscal year ending December31, 2010, we may be adversely affected.

As a public company, we are subject to report our internal control structure and procedures for financial reporting in our annual reports on Form 10-K, as a requirement of Section 404 of the U.S. Sarbanes-Oxley Act of 2002 by the U.S. Securities and Exchange Commission (the "SEC"). The report must contain an assessment by management about the effectiveness of our internal controls over financial reporting. Moreover, the independent registered public accountants of our company must attest to and report on management's assessment of the same. Our management attests that our internal control measures are not effective, our independent registered public accountants also may not be satisfied with our internal control structure and procedures. The conclusion of the report could result in an adverse impact on us in the financial marketplace due to the loss of investor confidence in the reliability of our financial statements, which could negatively impact our stock market price.

ITEM 1B. UNRESOLVED STAFF COMMENTS

The Company received a comment letter from the SEC Division of Corporate Finance on December 31, 2009 which raised a number of questions regarding the Company's previously filed Annual Report on Form 10-K for the year ended December 31, 2008 (the "Comment Letter"). In the process of preparing a response to the Comment Letter, on February 23, 2010 the Company determined that the Company's financial statements as of December 31, 2008 and for the year then ended, and for the quarters ended March 31, 2008, June 30, 2008, September 30, 2008, March 31, 2009, June 30, 2009 and September 30, 2009, should no longer be relied upon and should be restated as a result of certain non-cash errors contained therein regarding the accounting for: (i) warrants issued in conjunction with a secured debenture on February 28, 2008, which warrants should have been classified according to EITF 00-19 as liability instruments rather than equity instruments; (ii) the change in the fair value of those warrants from the date of issuance through the end of the reporting period; (iii) effective interest expense arising from amortization of the discount to the carrying value of the secured debenture; (iv) the recording of warrants issued to investment consultants in connection with the secured debenture as deferred financing costs instead of consulting fees; (v) the amount of amortization of deferred financing costs associated with the issuance of that secured debenture; (vi) amounts payable to a consultant included in accrued liabilities; (vii) compensation issued to employees in the form of stock; (viii) depreciation, depletion and amortization of oil properties; (ix) ceiling test reduction of the net carrying value of oil properties; (x) income tax expense for the above items; and (xi) noncontrolling interest for certain of the above items. The amended and restated financial reports for those periods were filed with the SEC on August 31 and September 1, 2010, along with the Company's response to the Comment Letter. As of the filing date of this Annual Report on Form 10-K for the year ended December 31, 2010, the Company has not received a response from the SEC that resolves the comments raised in the Comment Letter. It is possible that the SEC will have additional comments or questions related to our response to the Comment Letter.

ITEM 2. PROPERTIES

China North East Petroleum's principal headquarters are located in Song Yuan City, in the People's Republic of China. The Company leases an approximately 7,747 square foot facility for approximately $14,519 per year that expires in June 30, 2015. These headquarters house all of our PRC administrative and clerical staff. The Company also leases an approximately 26,910 square foot facility as its production base for $189 per year that expires in September 20, 2023. We also have offices in Harbin City, China, Los Angeles and New York City, United States.

The Company's crude oil exploration and production operations are conducted on property which is located in the Jilin Oil Region.

The Company also has an office located at the Qian'an 112 Oilfield. The Company owns the buildings although the land is leased pursuant to the Oil Lease. Actual oil exploration and production operations are controlled from this office and housing is provided for up to 60 workers. The Company pays no rent for use of this space. In addition, the Company has no written agreement or formal arrangement pertaining to the use of this space. No other businesses operate from this office.

The Company also has an office located at the Northern River Industry Zone, Song Yuan city. The office houses all of our administrative and clerical staff for our drilling company. The Company owns the buildings. The land area totals approximately 20,500 square meters.

The Company does not have an office located in the Hetingbao 301, Daan 34 or Gudian 31 Oilfields.

The Company leases an office located at 445 Park Avenue, 10th Floor, New York, NY for $4,438 per year that expires in February 2012 and an office located at 21688 Gateway Center Drive, Suite 165, Diamond Bar, CA for $32,788 per year that expires in October 2013. These offices house the Company's U.S. administrative and clerical staff.

The Company has no current plans to occupy any additional office space.

ITEM 3. LEGAL PROCEEDINGS

The Company was recently involved in six legal actions, three of which are securities class actions and three of which are shareholder derivative actions, in the U.S. District Court for the Southern District of New York against the Company and certain officers and directors. The three class actions assert claims under the federal securities laws and the three derivative actions assert common law claims based on breach of duty.

The six actions are: (1) Rosado v. China North East Petroleum Holdings Limited, et al., 10 CV 4577 (MGC), filed June 11, 2010; (2) Weissmann v. China North East Petroleum Holdings Limited, et al. , 10 CV 4775 (MGC), filed June 18, 2010; (3) Moore v. China North East Petroleum Holdings Limited, et al., 10 CV 5263 (MGC), filed July 9, 2010; (4) Strickland v. Hongjun, et al., 10 CV 5445 (RMB), filed July 19, 2010; (5) Drobner v. Hongjun, et al., 10 CV 6193 (No Judge has been assigned at this time), filed August 23, 2010; and (6) Nicoln v. Hongjun, et al., 10 CV 6344 (No Judge has been assigned at this time), filed August 24, 2010.

The time for the Company to respond formally to these lawsuits has not come. In addition, the complaints do not specify an amount of damages that plaintiffs seek. Because these matters are in very early stages, we cannot comment on whether an adverse outcome is probable or otherwise. While we believe we have meritorious defenses to each of these actions and intend to defend them vigorously, an adverse outcome in one or more of these matters could have a material adverse effect on its business, financial condition, results of operations or liquidity.

22

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Market Information

Prior to June 15, 2009, the Company's common stock was quoted on the Over-the-Counter Bulletin Board ("OCTBB") under the symbol "CNEH.OB." On June 15, 2009, we terminated our listing on OTCBB and listed our common stock on NYSE Amex LLC ("AMEX") under the symbol "NEP." The following table sets forth, for the indicated periods, the high low prices for our common stock as reported on AMEX, and prior to June 15, 2009, as reported on OTCBB. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

	NEP / CNEH COMMON STOCK HIGH		NEP / CNEH COMMON STOCK LOW	
FISCAL YEAR ENDING DECEMBER 31, 2010:				
First Quarter	$	11.35	$	7.82
Second Quarter	$	9.85	$	5.20
Third Quarter	$	6.08	$	4.42
Fourth Quarter	$	7.95	$	5.31
FISCAL YEAR ENDING DECEMBER 31, 2009:				
First Quarter	$	2.00	$	1.30
Second Quarter	$	5.82	$	1.44
Third Quarter	$	6.28	$	3.80
Fourth Quarter	$	9.25	$	4.38

Holders

As of March 3, 2011, the Company had approximately 92 holders of record.

Equity Compensation Plan Information

The following table sets forth certain information as of March 3, 2011 about our equity compensation plans under which our equity securities are authorized for issuance.

Equity Compensation Plan Information Table

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))

Equity compensation plans approved by security holders	180,000	$2.94 - $5.50	220,000
Equity compensation plans not approved by security holders	-	-	-
Total	180,000		220,000

During 2010, the Company granted its employees, 80,000 common stock options under the Company's 2006 Stock Option/Stock Issuance Plan (the "2006 Plan"). As of December 31, 2010, stock options granted under the 2006 Plan to purchase 180,000 shares of its Common Stock (the "Options") at an exercise price from $2.94 to $5.50 per share were outstanding. The stock options outstanding, 180,000 vest as follows: 25% of the stock options vest upon grant and 25% vest every three months thereafter, and these stock options expire ten years after the grant date if unexercised at that time. The remaining 310,000 stock options vest as follows: 50% of the 310,000 stock options vest upon grant and 50% vest on the first anniversary of the grant date.

The 2006 Plan authorizes the issuance of up to 2,500,000 common stock equivalents (stock options, restricted stock, stock grants). As of December 31, 2010, the Company had 220,000 remaining share equivalents available for grant under the 2006 Plan. The Company settles employee stock option exercises with newly issued common shares.
The fair value of stock options granted was estimated at the date of grant using the Black-Scholes option-pricing model with the following assumptions:

Expected Life	Expected Volatility	Dividend Yield	Risk Free Interest Rate	Grant Date Fair Value
5 years	258% - 316%	0%	1.47% - 3.42%	$2.94 - $5.50

- Dividend Yield: The expected dividend yield is zero. The Company has not paid a dividend and does not anticipate paying dividends in the foreseeable future.
- Risk Free Rate: Risk-free interest rate of 1.47% - 3.42% was used. The risk-free interest rate was based on U.S. Treasury yields with a remaining term that corresponded to the expected term of the option calculated on the grant date.
- Expected Life: Because the Company has no historical share option exercise experience to estimate future exercise patterns, the expected life was determined using the simplified method as these awards meet the definition of "plain-vanilla."

Stock compensation expense is recognized based on awards expected to vest. There was no estimated forfeiture as the Company has a short history of issuing options. ASC 718-10 requires forfeiture to be estimated at the time of grant and revised in subsequent periods, if necessary, if actual forfeitures differ from those estimates.

On January 28, 2010, 250,000 stock options previously granted to one senior management member were exercised at $4.50 per share, with an aggregate fair value of $1,125,000 paid to the Company.

On March 29, 2010, 400,000 shares of common stock with a fair value of approximately $3,232,000 were granted to key members of the management team of Tiancheng, and the Company recognized stock compensation expenses of $1,219,372 which was included in selling, general and administrative expenses for the year ended December 31, 2010.

As of December 31, 2010, the total compensation cost related to stock options not yet recognized was $1,843,792 and will be recognized over the next three years.

The following is a summary of the stock option activity:

	Number of Options Outstanding	Weighted-Average Exercise Price
Balance, December 31, 2009	350,000	$4.18
Granted	80,000	$5.50
Forfeited	-	-
Exercised	(250,000)	$4.50
Balance, December 31, 2010	180,000	$4.32
Exercisable at December 31, 2010	100,000	$3.38

The following is a summary of the status of options outstanding at December 31, 2010:

Outstanding	Average	Average	Exercisable	Weighted

Exercise Price	Options Number	Remaining Contractual Life	Exercise Price	Options Number	Average Exercise Price
$4.05	40,000	7.42 years	$4.05	40,000	$4.05
$2.94	60,000	8.42 years	$2.94	60,000	$2.94
$5.50	80,000	9.48 years	$5.50	-	$5.50
	180,000			100,000	

The Company's outstanding warrants as of December 31, 2010 are as follows:

	Date of issue	Expiration date		Exercise price	Outstanding Warrants
Warrant 1	February 28, 2008	February 28, 2013	$	2.35	2,100,000
Warrant 2	March 5, 2009	March 5, 2013	$	2.00	250,000
Warrant 3	March 5, 2009	March 5, 2013	$	2.35	250,000
Warrant 4	April 29, 2009	April 29, 2013	$	2.65	50,000
Warrant 5	September 15, 2009	September 15, 2014	$	6.00	698,263
Warrant 6	September 10, 2009	September 10, 2014	$	6.00	80,000
Warrant 7	December 11, 2009	September 9, 2014	$	8.10	58,910
Warrant 8	December 17, 2009	June 17, 2011	$	8.10	392,728
					3,879,899

The Company treats these warrants as liabilities under ASC 815-40 and accordingly records the warrants at fair value with changes in fair values recorded in the profit or loss until such time as the warrants are exercised or expired. The fair values were $39,528,261 at December 31, 2009 and $12,376,301 at December 31, 2010. As of December 31, 2010, included in the warrant liabilities, there was an accrued penalty imposed by an investor on late filing of registration statement of $1,163,333. For the fiscal years ended December 31, 2010 and 2009, the Company recorded a gain of $26,555,889, a loss of $27,398,967, respectively, in changes in the fair value of the warrants in profit or loss.

On March 12, 2011, the Company entered into an agreement with Lotusbox Investments Ltd., the purchaser of the Company's Secured Debenture, pursuant to which the parties released each other from all claims and liabilities based on or arising out of the Company's failure to register shares of the Company's common stock underlying warrants issued to the purchaser in connection with the purchase of the Secured Debenture. In addition, the purchaser released the Company from any further obligations to register the warrant shares. In return, the Company agreed to reduce the exercise prices of 500,000 warrants issued to the purchaser in 2009 from $2.00 and $2.35 to $0.01; and to reduce the exercise price of 100,000 warrants to the purchaser in 2008 from $2.35 to $0.01. The Company also agreed to allow the purchaser to purchase the warrant shares by means of a cashless exercise.

The Company estimates the fair value of these warrants using the Black-Scholes option pricing model using the following assumptions:

	December 31, 2010
Market price and estimated fair value of common stock:	$5.76
Exercise price:	$2.00 - $8.10
Remaining contractual life (years):	0.21 - 3.67
Dividend yield:	–
Expected volatility:	24% - 213%
Risk-free interest rate:	

0.12% -
2.01%

Stock issuance

(1) In January 2010, Series B Warrants issued with the secured debenture were exercised by one investor to purchase 867,438 shares of common stock at the exercise price of $2.35 per share.
(2) On March 23, 2010, an investor exercised warrants and purchased 21,739 shares of common stock at exercise price of $6.00 per share. The Company received $130,434 proceeds in connection with this transaction.
(3) In April 2010, one investor exercised warrants to purchase 29,865 shares of common stock at the exercise price of $6.00 per share.

Dividend Policy

We have not declared any dividends since incorporation and do not anticipate that we will do so in the foreseeable future. Although there are no restrictions that limit the ability to pay dividends on our common shares, our intention is to retain future earnings for use in our operations and the expansion of our business.

ITEM 7. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The following discussion and analysis of financial condition and results of operations should be read in conjunction with our financial statements and related notes included elsewhere in this report. This discussion contains forward-looking statements that involve risks, uncertainties and assumptions. Forward-looking statements can be identified by the fact that they do not relate strictly to historic or current facts. They use words such as “anticipate,” “estimate,” “project,” “intend,” “plan,” “believe” and other words and terms of similar meaning in connection with any discussion of future operating or financial performance. In particular, these include statements relating to:

- Our expectation of continued growth in the demand for our oil;
- Our expectation that we will continue to have adequate liquidity from cash flows from operations;
- A variety of market, operational, geologic, permitting, labor and weather related factors; and
- The other risks and uncertainties which are described below under “RISK FACTORS”, including, but not limited to, the following:
- Unanticipated conditions may cause profitability to fluctuate.
- Decreases in purchases of oil by our customer will adversely affect our revenues.

Overview

We are engaged in the exploration and production of crude oil in Northern China. We have an arrangement with the Jilin Refinery of PetroChina Group to sell our crude oil production for use in the China marketplace. We currently operate 295 producing wells located in four oilfields in Northern China and have plans for additional drilling projects.

In particular, through two of our subsidiaries, Yu Qiao and LongDe, we have entered into binding sales agreements with the PetroChina Group, whereby we sell our crude oil production for use in the China marketplace.

In addition, on September 25, 2009, we acquired Tiancheng which provides contract drilling and other oilfield services for state-owned and non-state-owned oil companies in Northern China.

Entry into a Material Definitive Agreement

On January 19, 2011, the Company through its subsidiary, Songyuan Technical, entered into a Share Transfer Agreement with the shareholders (the “Shareholders”) of Sunite Right Banner Shengyuan Oil and Gas Technology Development Co., Ltd. (“Shengyuan”), dated January 19, 2011 (the “Share Transfer Agreement), to acquire 100% of the equity interests in Shengyuan (the “Acquisition”). Shengyuan is a limited liability company incorporated in Sunite Right Banner, Inner Mongolia in the People’s Republic of China with exclusive oilfield exploration and drilling rights to the Durimu oilfield in Inner Mongolia.

The total purchase price for Shengyuan is valued at approximately $43.4 million consisting of RMB 70 million (approximately US$10.6 million) in cash and 5,800,000 shares of the Company’s common stock (the “Acquisition Shares”). The Acquisition Shares will be issued pursuant to a Share Issuance Agreement by and among the Company, Bellini Holdings Management Ltd., a company organized by the Shareholders under the laws of the British Virgin Islands (“Bellini”), and the Shareholders dated January 19, 2011 (the “Share Issuance Agreement”). The cash consideration will be paid to the Shareholders at closing. Bellini is an entity fully controlled by the Shareholders and designated by the Shareholders to receive the Acquisition Shares.

Completion of the Acquisition is subject to certain terms and closing conditions set forth in the Share Transfer Agreement and the Share Issuance Agreement, including that Shengyuan obtain approval of the transfer of the

Shareholders’ equity interest in Shengyuan to Songyuan Technical from all relevant governmental authorities, and other customary closing conditions.

On January 20, 2011, the Company issued a press release announcing the Acquisition.

CONSOLIDATED RESULTS OF OPERATIONS

The Company's crude oil sales is paid by PetroChina based on the crude oil price in the international commodity market. Prices in 2010 averaged RMB 3,772 per ton or approximately $75.49 per barrel, which represents an increase of 35% from the 2009 average price received of $55.97 per barrel.

In 2010, our contract drilling subsidiary, Tiancheng, completed contracts to drill 191 shallow wells, which include 146 wells for state-owned PetroChina Jilin Branch and 45 wells for non-state-owned Daqing Shunwei Energy Development Co. Ltd. The total drilling depth accomplished this year was 374,413 meters (approximately 1,228,389 feet), with drilling revenues of $44,875,757 and income from operations of $18,420,154.

Our cost of net revenues consists of cost of labor, well service and repair, location maintenance, power and fuel, transportation, cost of product, property taxes, production and severance taxes and production related general and administrative costs.

General and administrative expenses consist primarily of salaries and related expenses for executive, finance, accounting, information technology, facilities and human resources personnel, recruiting expenses, professional fees and costs associated with expanding our information systems.

Comparing Fiscal Years Ended December 31, 2010 and 2009:

The following table presents certain consolidated statement of operations information. Financial information is presented for the 12-month period ended as of December 31, 2010 and December 31, 2009.

	2010	2009
Revenues, net	$ 99,547,914	$ 64,658,085
Operating Expenses	$ 7,802,930	$ 17,732,379
Income from Operations	$ 52,953,397	$ 24,387,993

Revenues. Revenues for 2010 increased 54% to $99,547,914 from $64,658,085 in 2009 as a result of an increase in oil prices and revenue generated by our newly acquired contract drilling entity, Tiancheng. During the year, the Company drilled six new oil wells in our four oilfields. The total number of producing wells increased from 289 in 2009 to 295 in 2010, a total increase of 2%. However, total oil production for 2010 was 723,154 barrels, or approximately a 20% decrease, as compared with 908,126 barrels in 2009 due to severe flooding that occurred in the region in the third quarter that impacted oil production. Oil prices in 2010 averaged RMB 3,772 per ton or approximately $75.49 per barrel, which represents an increase of 35% over 2009 levels of RMB 2,824 per ton or approximately $55.97 per barrel.

Oilfield	2010 wells	2009 wells	2010 Production	2009 Production
Qian’an112	250	247	710,027	892,404
Hetingbao 301	21	18	6,689	9,482
Gudian31	12	12	5,063	3,796
Daan 34	12	12	1,995	2,444
Total	295	289	723,792	908,126

Company	2010 wells	2009 wells	2010 Production	2009 Production
Yu Qiao	274	271	717,085	898,644
LongDe	21	18	6,689	9,482

Cost of Revenue. Cost of revenue increased by 72.1% from $22,537,713 for the year ended December 31, 2009 to $38,791,587 for the year ended December 31, 2010. The increase was due to an increase in the number of wells drilled by Tiancheng which led to a significant increase in drilling costs. In addition, higher oil prices in 2010 led to an increase in government oil surcharge. During 2010, our total number of producing wells increased to 295, an increase of 2%. The Company paid a special oil surcharge of $8,594,481 to the PRC government in 2010, compared to $4,618,789 paid to the PRC government for the same period in 2009. Depreciation, depletion and amortization of oil properties decreased by 33% from $9,795,312 in 2009, to $6,570,965 in the same period in 2010 due to a decrease in production .

Total drilling costs in 2010 were $17,555,255 associated with 191 wells drilled during fiscal 2010.

Operating Expenses. In 2010 operating expenses decreased by 56% from $17,732,379 for the year ended December 31, 2009 to $7,802,930 for the year ended December 31, 2010. The decrease was mainly due to the fact that the Company recorded impairment to oil properties of $13,837,108 in 2009 compared to zero impairment in 2010.

General and Administrative Expenses. General and administrative expenses increased slightly by 2% to $2,989,913 for the year ended December 31, 2010 compared to $2,942,381 for the year ended December 31, 2009.

Net Income (Loss) Attributable to NEP Common Stockholders. The Company realized net income attributable to NEP stockholders of $58,369,471 for the year ended December 31, 2010 compared to a net loss of $22,109,514 for the year ended December 31, 2009. The increase in net income was primarily a result of an increase in the number of wells drilled by Tiancheng, oil prices surge and non cash gain in the fair value of warrants, as well as lower operating expenses.

LIQUIDITY AND CAPITAL RESOURCES

We are financing our operations and capital expenditures through cash flows from operations and the issuance of new shares of our common stock. Our capital resources consist primarily of cash flows from our oil producing properties and oilfield drilling services operation. Earnings and cash flows of the Company depend upon many factors, such as the price we receive for crude oil we produce.

As of December 31, 2010, the Company had cash and cash equivalents of $60,974,007, total current assets of $80,550,863 and current liabilities of $14,011,449. For the year ended December 31, 2010, our primary source of liquidity was $35,046,468 in net cash provided by operations.

As of December 31, 2010, the Company's current liabilities were $14,011,449, consisting of $4,156,349 in accounts payable primarily comprised of costs related to the drilling of wells in previous years and $5,076,074 in income and other taxes payable

Net cash provided by operating activities was $35,046,468 for the year ended December 31, 2010 compared to $15,885,573 for the same period in 2009. This is primarily related to an increase in net income to $62,690,631 in 2010, due to an increase in the number of wells drilled by Tiancheng and oil prices and non cash gains in fair value of warrants as well as lower operating expenses.

Net cash used in investing activities was $1,279,470 for the year ended December 31, 2010 compared to $29,912,139 for the same period in 2009 primarily because of the acquisition of Tiancheng in 2009 and fewer wells were drilled.

Net cash used in financing activities was $3,712,856 for the year ended December 31, 2010 compared to net cash provided by financing activities of $29,512,312 for the same period in 2009. This is because the Company raised a significant amount of capital in 2009, which was deployed in 2010.

The Company has paid for the construction of its oil wells under production and construction, along with its acquisition of an oil well drilling and servicing company, with cash from operations as well as by funds raised through the issuance of secured debt, common stock and warrants to purchase the Company's common stock. The Company is continually evaluating opportunities to expand the Company's production and operations. The Company may need additional resources to fully implement the Company's business plan and growth strategy. Our ability to obtain additional capital to achieve these expansion goals will depend on market conditions, national and global economies, and other factors beyond our control. We cannot assure you that the Company will be able to implement or capitalize on various financing alternatives or otherwise obtain required capital, the need for which could be substantial given the Company's business and development goals. However, the Company anticipates that cash flows from operations will be sufficient to fund continued development at the four oil fields it currently operates and to fund continued operations at its oil well drilling and servicing subsidiary.

Registration Rights Penalties

In conjunction with the March 5, 2009 modification of the Company's secured debenture issued on February 28, 2008 (See Note 9, "Secured Debenture," of the Notes to the Consolidated Financial Statements) and the original issuance of the secured debenture, the Company entered into two Registration Rights Agreements, which cover stock to be issued upon excercise of warrants issued in connection with both the modification and the issuance of the secured debenture. These Registration Rights Agreements provide for financial penalties in certain circumstances, including (i) if the registration statement covering the shares of common stock underlying the Original Warrants is not declared effective within 180 days of the date of the Registration Rights Agreement or (ii) after effectiveness, the registration statement ceases to remain continuously effective for more than 10 consecutive calendar days or more than 30 calendar days in any 30 calendar day period. The financial penalty equals 1% of the aggregate purchase price paid for the Original Warrants subject to the registration rights up to a maximum of 10% of the principal amount of the debenture. The Company analyzes these registration rights agreements to determine if penalties triggered for late filing should be accrued under ASC 825-20.

On March 12, 2011, the Company entered into an agreement with Lotusbox Investments Ltd., the purchaser of the Company's Secured Debenture, pursuant to which the parties released each other from all claims and liabilities based on or arising out of the Company's failure to register shares of the Company's common stock underlying warrants issued to the purchaser in connection with the purchase of the Secured Debenture. In addition, the purchaser released the Company from any further obligations to register the warrant shares. In return, the Company agreed to reduce the exercise prices of 500,000 warrants issued to the purchaser in 2009 from $2.00 and $2.35 to $0.01; and to reduce the exercise price of 100,000 warrants to the purchaser in 2008 from $2.35 to $0.01. The Company also agreed to allow the purchaser to purchase the warrant shares by means of a cashless exercise.

Inflation

Inflation did not have a material impact on our business in 2010.

29

Crude Oil Price Trends

Changes in crude oil prices significantly affect our revenues, financial condition and cash flows. Markets for crude oil have historically been volatile and we expect this trend to continue. Prices for crude oil typically fluctuate in response to relatively minor changes in supply and demand, market uncertainty, seasonal, economic, political and other factors beyond our control. Although we are unable to predict accurately the prices we receive for our oil, any significant or sustained decline in oil prices may materially adversely affect our financial condition, liquidity, ability to obtain future debt or equity financing and operating results.

Production Trends

Like all other oil exploration and production companies, we experience natural production declines at existing wells. We recognize that oil production from a given well naturally decreases over time and that a downward trend in our overall production could occur unless the natural declines are offset by additional production from new wells, investment in measures to increase the production from existing wells (such as CO_2 and water injection), or acquisitions of producing properties. If any production declines we experience are not a temporary trend, and if we cannot economically replace our reserves, our results may be adversely affected and our stock price may decline. Our future growth will depend upon our ability to continue to add oil reserves in excess of our production at a reasonable cost.

We have achieved an increased production and revenue from our four oilfields as a result of our significant investments in these areas. As of December 31, 2010, we have drilled 295 wells out of the 650 wells that can be drilled in our four oilfields. We anticipate that we will continue to drill new wells and increase production in these areas. We are also actively seeking additional oil fields that we can lease and operate.

Operating Expense Trends

Costs associated with oil well drilling, improvement (e.g. fracturing and water injection), and maintenance in the northeastern Chinese oil fields where we operate have remained relatively constant over the past few years. Similarly, service rates charged by oil field service companies have remained relatively constant over the past few years. We are also generally somewhat buffered from changes in the world oil prices due to the impact of the government oil surcharge tax. When the prices rise, the amount of oil surcharge tax that we are required to pay increases; conversely, price declines it would lead to a reduction in the amount of oil surcharge tax. For the year ended December 31, 2010, the approximate amount of oil surcharge tax we paid was $8,594,481, as compared to $4,618,789 for the year ended December 31, 2009.

CRITICAL ACCOUNTING POLICIES

Proved Reserves.

Proved oil and gas reserves, as defined by SEC Regulation S-X Rule 4-10(a) (2)(i), (2)(ii), (2)(iii), (3) and (4), are the estimated quantities of crude oil that geological and engineering data demonstrate with reasonable certainty to be recoverable in the future years from known reservoirs under existing economic and operating conditions, i.e., prices and costs as of the date the estimate is made. Prices include consideration of changes in the existing prices provided only by contractual arrangements, but not on escalations based upon future conditions.

The Company's estimates of proved reserves are made using available geological and reservoir data as well as production performance data. These estimates, made by the Company's engineers, are reviewed annually and revised, either upward or downward, as warranted by additional data. Revisions are necessary due to changes in, among other things, reservoir performance, prices, economic conditions and governmental restrictions. Decreases in prices, for example, may cause a reduction in some proved reserves due to reaching economic limits sooner.

Properties and Equipment.

The Company uses the full cost method of accounting for exploration and development activities as defined by the SEC. Under this method of accounting, the costs of unsuccessful, as well as successful, exploration and development activities are capitalized as properties and equipment. This includes any internal costs that is directly related to exploration and development activities but does not include any costs related to production, general corporate overhead or similar activities. Gain or loss on the sale or other disposition of oil properties is not recognized, unless the gain or loss would significantly alter the relationship between capitalized costs and proved reserves of oil and natural gas attributable to a country. The application of the full cost method of accounting for oil properties generally results in higher capitalized costs and higher depreciation, depletion and amortization rates compared to the successful efforts method of accounting for oil properties.

Principles of consolidation

The accompanying audited consolidated financial statements as of December 31, 2010 and 2009 include the audited financial statements of North East Petroleum and its wholly owned subsidiary, Hong Xiang Petroleum Group and 90% owned subsidiaries, Song Yuan Technical, LongDe, Yu Qiao and Tiancheng. The noncontrolling interests represent the minority shareholders' 10% share of the results of Song Yuan Technical, LongDe, Yu Qiao and Tiancheng.

All significant inter-company accounts and transactions have been eliminated in consolidation.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates include the value of the Company's oil reserve quantities which are the basis for the calculation of the depletion, depreciation and amortization of oil properties and impairments of oil properties and estimates of the fair value of warrants. Actual results could differ from those estimates.

Revenue recognition

Our oil production business records revenue from the sales of oil on a net basis when delivery to the customer (PetroChina) has occurred and title has transferred. This occurs when oil has been delivered to a PetroChina depot.

Pursuant to the Oil Leases entered into in 2002 and 2003 with PetroChina, each with twenty year terms, the Company is entitled to 80% of its oil production for the first ten years and 60% of its oil production for the remaining ten years. The Company receives payment for the net physical volume of oil delivered (either 80% or 60% by volume, depending upon the lease terms that are current at that point in time). The Company only records revenue for the production that it is entitled to.

Our oilfield drilling business (Tiancheng) records revenue from the sales of services that are generally sold based upon purchase orders or contracts with the customer that include fixed or determinable prices and that do not include right of return or other similar provisions or other significant post-delivery obligations. Revenue for services is recognized as the services are rendered and when collectibility is reasonably assured. Rates for services are typically priced on a per day, per meter, per man hour or similar basis. In certain situations, revenue is generated from transactions that may include multiple services under one contract or agreement. Revenue from these arrangements is recognized as each service is delivered based on their relative fair values.

Major customers

Our oil production business has only one customer – PetroChina's Jilin Refinery branch, located in Song Yuan City, Jilin Province, the PRC. Pursuant to our lease agreements with PetroChina we are prohibited from selling our oil production to any other customer.

Our oilfield services business has one primary customer–PetroChina, but also serves other independent oil production companies located in Jilin and Heilongjiang provinces in the PRC.

Accounts receivables and allowance for doubtful accounts

Our oil production business bills PetroChina on a monthly basis, at the month-end, for the oil that we delivered to PetroChina during that month. We receive payment from PetroChina approximately 10 to 20 days following the end of each month. We receive payment in full for the prior month, less a holdback in the first and second months of each calendar quarter for the amount of oil surcharge tax (if any) due to the PRC government for the respective month's oil sales. These oil surcharge tax holdbacks are paid to the Company with the normal monthly payment in the third month of each quarter, and therefore are timed to be received by us shortly before we are responsible for remitting the quarterly oil surcharge tax to the PRC government. Therefore, the amount we show as accounts receivable at the end of each reporting period will include the amounts due to us for sales in the prior month, as well as amounts of oil surcharge due for the two preceding months. We do not recognize any allowance for doubtful accounts, as PetroChina paid our invoices on a correct, consistent and timely basis.

Our oilfield services business bills customers according to the terms of each service contract. These contracts generally require downpayments of 30% of the drilling contract sum at the initiation of drilling services and payment of the remaining 70% of the drilling contract sum in twelve monthly installments following the completion of drilling services.

Long-lived assets

The Company evaluates at least annually, and more often when circumstances require, the carrying value of long-lived assets to be held and used. Impairment losses to be recorded on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amounts. In that event, a loss in recognized based on the amount by which the carrying amount exceeds the fair market value of the long-lived assets. No impairment was made for the year ended December 31, 2010 and 2009.

Financial instruments

The Company analyzes all financial instruments with features of both liabilities and equity under ASC 480-10 (formerly Statement of Financial Accounting Standards ("SFAS") No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity"), ASC 815-10 (formerly SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities") and ASC 815-40 (formerly EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"). The warrants issued in conjunction with the issuance of the secured debenture in February 2008 are treated as liability instruments and will be marked to the fair value as of each reporting date. Additionally, the Company analyzes registration rights agreements associated with any equity instruments issued to determine if penalties triggered for late filing should be accrued under ASC 825-20 (formerly FSP EITF 00-19-2, "Accounting for Registration Payment Arrangements"). (See Note 9, Registration Payment Arrangements Below).

Fair value of financial instruments

On January 1, 2008, the Company adopted ASC 820-10 (formerly SFAS No. 157, "Fair Value Measurements"), which defines fair value, establishes a three-level valuation hierarchy for disclosures of fair value measurement and enhances disclosures requirements for fair value measures. The three levels are defined as follows:

- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the assets or liability, either directly or indirectly, for substantially the full term of the financial instruments.
- Level 3 inputs to the valuation methodology are unobservable and significant to the fair value.

The financial assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular in