



Together, creating pure
oil, gas and water.

Management Discussion and Analysis

March 9, 2011

For the year ended December 31, 2010

This Management Discussion and Analysis ("MD&A") should be read in conjunction with the Annual Audited Consolidated Financial Statements of ProSep Inc. ("ProSep" or the "Company") for the year ended December 31, 2010. For additional information on the business, products and services or industry, please refer to the 2010 Annual Information Form.

Regulatory Filings

The Company's continuous disclosure material including interim filings, annual MD&A and Audited Consolidated Financial Statements, Annual Information Form and Notice of Annual Shareholder Meeting and Proxy Circular are available at www.sedar.com and on the Company's website at www.prosep.com.

Caution Regarding Forward-Looking Statements

This Management Discussion and Analysis may contain forward-looking statements, including statements regarding the business and anticipated financial performance of ProSep Inc. These statements are based on, among other things, management's current assumptions, expectations, estimates, objectives, plans and intentions regarding projected revenues and expenses, the economic and industry environments in which the Company operates or which could affect its activities, and the Company's ability to attract new clients and consumers, as well as its operating costs and cost of raw materials and energy supply, which are subject to a number of risks and uncertainties. Forward-looking statements can generally be identified by the use of the conditional tense, the words "may", "should", "would", "believe", "plan", "expect", "intend", "anticipate", "estimate", "foresee", "objective" or "continue" or the negative of these terms or variations of them or words and expressions of similar nature. Actual results could differ materially from the conclusions, forecasts or projections stated in such forward-looking information. These statements are subject to a number of risks and uncertainties that may cause actual results to differ materially from those contemplated by the forward-looking statements. Some of the factors that could cause such differences include but are not limited to the Company's ability to develop, manufacture, and successfully commercialize value added equipment and services, the availability of funds and resources to continue its operations and pursue its projects, legislative or regulatory developments, competition, technological change, changes in government and economic policy, inflation and general political and economic conditions in geographic areas where ProSep Inc. operates. These and other factors should be considered carefully, and undue reliance should not be placed on the forward-looking statements.

Use of Estimates

In the course of the preparation of financial statements in accordance with Canadian generally accepted accounting principles, management must make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses for the period. Actual results could differ from these estimates.

All amounts are in Canadian dollars unless otherwise specified

Non-GAAP Measurements

This MD&A contains the terms "Earnings Before Interest, Taxes, Depreciation and Amortization" ("EBITDA") and "Net Invested Working Capital" ("NIWC"), which should not be considered as an alternative to, or more meaningful than, net earnings or cash flow from operating activities as determined in accordance with GAAP, as an indicator of the Company's performance. These terms do not have standardized meanings prescribed by GAAP. ProSep's determination of EBITDA and NIWC may not be comparable to that reported by other companies.

Management uses EBITDA, among other measures, to assess the operating performance of the ongoing businesses without the effects of depreciation expenses. The Company excludes depreciation expenses because they largely depend on the accounting methods and assumptions a company uses, as well as on non-operating factors such as the historical cost of capital assets. The following table reconciles EBITDA with net income.

	Year ended December 31		Three months ended December 31	
	2010 \$	2009 \$	2010 \$	2009 \$
Net loss (a)	(4,402,198)	(13,878,383)	(1,247,824)	(1,305,757)
Future tax provision (recovery)	(870,115)	550,158	(157,959)	450,147
Current tax provision (recovery)	(192,772)	(76,066)	158,984	(187,104)
Disposal on property and equipment	25,468	-	-	-
Amortization	1,760,179	1,578,540	653,518	397,724
Net financial charges	2,120,099	5,866,130	424,911	1,092,305
Increase in fair value of long- term investments	(375,000)	(400,000)	-	-
Impairment of goodwill	-	6,500,000	-	-
Total (b)	2,467,859	14,018,762	1,079,454	1,753,072
EBITDA (a plus b)	(1,934,339)	140,379	(168,370)	447,315

NIWC is also used by management to analyze the total amount invested to support outstanding contracts, and is defined as the sum of restricted cash related to letters of guarantee, receivables, inventories and prepaid expenses, less the sum of accounts payable, accrued liabilities and deferred revenue.

The following table shows the calculation of this non-GAAP measure.

	December 31, 2010	December 31, 2009
	\$	\$
Restricted cash	226,046	2,022,940
Receivables	12,938,294	12,807,205
Inventories	282,346	392,709
Prepaid expenses	585,068	665,162
Total (a)	14,031,754	15,888,016
Less		
Accounts payable and accrued liabilities	8,055,157	12,836,057
Deferred revenue	71,164	71,796
Total (b)	8,126,321	12,907,853
Net Invested Working Capital (a minus b)	5,905,433	2,980,163

Comparative Figures

Comparative figures for the financial information related to the year ended December 31, 2009, have been reclassified to be consistent with the December 31, 2010, presentation.

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1. OVERALL PERFORMANCE

1.1. Highlights of the Year

Financial:

- Revenues of \$34.7 million, a decrease of 16% when compared to \$41.4 million for the corresponding period of 2009.
- Gross margin of \$10.3 million (30% of revenues) compared to \$13.3 million (32%) for the corresponding period of 2009.
- EBITDA was negative \$1.9 million compared to \$0.140 million for the year ended December 31, 2009.
- Net loss of \$4.4 million compared with a net loss of \$13.9 million for the previous year ended December 31, 2009. Included in the 2009 year-to date net losses were a \$6.5 million goodwill impairment and debt conversion and settlement cost amounting to \$2.1 million.
- Concluded a \$3.7 million equity financing to support working capital requirements with existing and new shareholders.
- Concluded a \$1.0 million subordinated convertible debenture to fund the ProSep-Kolon venture.

Commercial

- Announced approximately \$23 million in new contracts during the year. Current backlog stands at \$19.4 million up from \$7.8 million at year-end.
- Concluded a joint venture agreement with the chairman and controlling shareholder of Kolon Group, a large integrated commercial group and Korea's largest water treatment company. This partnership will allow ProSep to leverage Kolon Group's vast network and strong reputation to promote ProSep's offering to the growing Floating Production Storage and Offloading (FPSO) shipbuilding industry and Oil & Gas Engineering Procurement and Construction (O&G EPC) firms.
- Signed a collaboration agreement with Bandariyah International Group, a leading supplier to the Saudi Arabian oil & gas and petrochemical industries, to accelerate commercialization of ProSep's offering in the Kingdom.
- Successfully introduced the Company's produced water treatment offering in the Gulf of Mexico and in South East Asia. The later represents a key growth market for ProSep.
- Concluded a significant agreement to supply a proprietary CTour® produced water treatment system to a super major operating in the North Sea for an important redevelopment project. This contract is for an amount of \$3.6 million.
- Concluded ProSep's first significant sale in the Canadian oil sands, to provide process engineering and internals for a crude treatment system. This contract is for an amount of \$2 million.
- Successfully completed the ProDry's development phase with industry partners Total, Statoil and ConocoPhillips. Results showed high performance and robustness.
- Announced its proprietary technology will be used at an important large-scale carbon capture testing facility owned by Statoil, Norske Shell and Gassnova.
- Achieved promising results from field trials of the Sorbloc, a revolutionary biodegradable flocculant to treat produced water, capable of removing a full spectrum of harmful components including heavy metals.

Corporate:

- Appointed two highly regarded directors to the Company's Board.
 - Mr. Claude Fontaine Q.C., F.I.C.D, a retired senior partner at Ogilvy Renault LLP.
 - Mr. Joseph Wilson, recently retired after serving as Senior Vice President — Global Ventures for NATCO Group until its acquisition by Cameron International Corporation, a leading equipment supplier with over \$5 billion in sales.
- Initiated a global integration plan to improve reach and ensure best practices across all business units. Appointed to the executive committee and to lead this initiative are two industry veterans:
 - Douglas A. Campbell, P. Eng., M.B.A. was appointed Executive Vice President of Sales and Business Development. Mr. Campbell was previously Vice President Marketing and Business Development at NATCO where he was intimately involved in the group's international success.
 - Parag P. Jhonsa was promoted to Executive Vice President Operations. Mr Jhonsa previously led the American business unit's engineering and operations teams.
- Ranked for a second consecutive year among the Deloitte Technology Fast 50TM, received a third Green Fifteen award and ranked fourteenth fastest growing company in Deloitte's North American Fast 500 edition based on percentage of revenue growth over the last 5 years.

1.2 Material Events and Important Subsequent Events

All material events and commitments for the year 2010 are presented in this section, including information on important subsequent events, up to the date of this MD&A.

On the date of this MD&A, ProSep announced that it elected to exercise the put option related to the ABCP Credit Facility. In accordance with the Credit Agreement entered into with National Bank of Canada with respect to the Class 2 Restructured Notes, the Company exercised its right to transfer to National Bank of Canada on March 10, 2011, the ownership of the Class 2 Restructured Notes and any proceeds in payment of the principal amount owing under the Asset Backed Commercial Paper (ABCP) Credit Facility of \$ 2.5 million.

On February 21, 2011, ProSep announced that it had been awarded a contract worth \$2.6 million for the supply of spare parts (gas membranes) to an existing customer, a large independent North American oil and gas company.

On February 14, 2011, ProSep announced that it had been awarded a US \$5.5 million contract to provide a gas dehydration system to a super major international oil and gas producer operating in the South China Sea.

On February 3, 2011, ProSep announced that it had been awarded a US \$9 million contract to provide an additional gas membrane system to a large independent North-American customer.

On December 23, 2010, ProSep announced that it had been awarded additional funding to pursue the development of its "ProDry" proprietary gas dehydration technology under a Joint Industry Project (JIP) being carried-out with Total, Statoil and ConocoPhillips.

On December 8, 2010, ProSep announced that it was expecting to enter into a joint venture agreement with the chairman and controlling shareholder of Kolon Group, a large South-Korean-based integrated construction, chemical and advanced materials company and Korea's largest water treatment group. The joint venture agreement was signed in early January 2011. To fund this initiative, ProSep concluded a private placement subscription agreement with Kolon Glotech Inc. ("Kolon Glotech"), a wholly-owned subsidiary of Kolon Group Inc. The private placement consists of a five-year convertible unsecured subordinated debenture in the principal amount of \$1,009,300 (the equivalent of US\$1 million) bearing interest at a rate of 5% per annum. The debenture will mature on December 7, 2015, and will be convertible at the holder's option into common shares of ProSep at any time prior to the maturity date at a conversion price of \$0.13 per share.

On November 29, 2010, ProSep announced that it had signed a collaboration agreement with Bandariyah International Group, a leading supplier to the Saudi Arabian oil & gas and petrochemical industries.

On November 4, 2010, ProSep announced the appointment of two new executives, Douglas A. Campbell, P. Eng., M.B.A., as Executive Vice President of Sales and Business Development, and Parag P. Jhonsa as Executive Vice President, Operations.

On October 7, 2010, ProSep announced that it had been awarded a US\$1.5 million supply contract to provide additional equipment associated with a CO₂ gas membrane treatment plant to be delivered to a South American customer. Additional equipment includes the supply of spare gas membranes.

On September 27, 2010, the Company announced that it would supply after-market services and spare parts valued at \$2 million to clients located in Kuwait and the United States for produced water and gas treatment systems.

On September 23, 2010, the Company announced that for a second consecutive year, it had ranked among the Deloitte Technology Fast 50TM, a ranking of the 50 fastest-growing technology companies in Canada, based on the percentage of revenue growth over the last five years. ProSep ranked seventh, with a 10,203% revenue growth from 2005 to 2009. The Company also received for the third consecutive year, a Technology Green 15TM Award, created in 2007 to showcase 15 Canadian companies that are leading the way to create major breakthroughs in the field of green technology. ProSep also ranked as the fourteenth fastest growing company according to revenue growth over the last five years in the North American Fast 500 edition.

On August 24, 2010, the Company received new contracts in the United States, South America and Asia Pacific for a total of US\$2.4 million. Under a contract valued at US\$1.5 million, ProSep was to supply CO₂ gas separation membrane and hydrocarbon dew point packages for installation at an onshore gas plant in South America. The Company also announced a second supply agreement had been concluded for the delivery of a nitrogen generator package valued at US\$0.5 million to be installed on a Floating Production Storage and Offloading ("FPSO") facility expected to operate in the South China Sea. Under a contract valued at US\$0.4 million, ProSep will supply a pitless air drilling de-duster skid for a large international oil services company.

On August 9, 2010, the Company was awarded a US\$4.1 million contract to supply a gas dehydration system for a natural gas development project located in the South China Sea. On the same day, the Company announced that it had received a contract valued at US\$0.5 million to supply a chemical injection package for a leading engineering and construction services provider.

On July 8, 2010, ProSep announced that it had been awarded a US\$2.0 million contract to provide process engineering and specialized internals for a crude separation solution to be installed at a super major oil and gas producer's steam-assisted gravity drainage ("SAGD") facility located in Alberta's oil sands.

On May 19, 2010 ProSep announced the appointment of two new highly regarded directors. Claude Fontaine, Q.C., F.I.C.D., is a retired senior partner from Ogilvy Renault LLP and one of Canada's most recognized lawyers in corporate law, commercial law, and mergers and acquisitions. Mr. Fontaine served on many boards of directors including Petro-Canada until its merger with Suncor Energy Inc. Also joining ProSep's board is Joseph Wilson, recently retired after serving as Senior Vice President — Global Ventures for NATCO, a worldwide leader in process solutions to the oil and gas industry acquired by Cameron International Corporation. Mr. Wilson is a member of IPAA, NOIA, PESA, SPE and API.

On May 18, 2010, ProSep closed a private placement for aggregate gross proceeds of \$3,700,501, for which it has issued a total of 28,465,385 common shares at a purchase price of \$0.13. Initially announced on May 6, 2010, the private placement was closed in two tranches, the first tranche, announced on May 7, 2010, for gross proceeds of \$2,650,001 and the second and final tranche announced on May 18, 2010 for an additional \$1,050,500. Gross proceeds from the private placement were used for working capital purposes. ProSep also announced that it had obtained an advance income tax ruling confirming it is a qualified issuing corporation and that the common shares issued in the second tranche of the private placement qualify under the Québec Stock Savings Plan II (QSSP II).

On May 17, 2010 ProSep announced it had been awarded a US \$2.2 million contract to supply a 75,000 barrel-per-day produced-water treatment package for installation on an offshore facility in the South China Sea.

On May 3, 2010 ProSep announced it had been awarded a contract to supply a water treatment system to Dragados Offshore for a Pemex platform located in the Gulf of Mexico. Designed to treat 800 barrels of water per day, the system will remove free oil from the storm water/wash water drain system.

On March 25, 2010, ProSep announced that its proprietary technology was to be used as an important process component for carbon capture technologies to be tested by Statoil, Norske Shell and Gassnova at their European CO₂ Technology Center at Mongstad, in Norway. The \$0.4 million skid was delivered in September 2010.

On January 27, 2010 ProSep announced it had been awarded a \$3.6 million contract to supply a 35,000 barrels-per-day proprietary CTour® produced water treatment system for an offshore redevelopment project located in the Norwegian Continental Shelf.

On January 18, 2010 ProSep announced that it had been awarded a US \$3.5 million contract to provide gas membrane equipment to a large independent North-American oil and gas company. This system will be used for enhanced oil recovery (EOR) in Texas.

On January 12, 2010 ProSep announced that it had been awarded a contract to supply a 13,000 barrel-per-day proprietary produced-water treatment system to a major oil and gas producer, for installation on an offshore processing platform in South East Asia.

2. COMPANY OVERVIEW

ProSep designs, develops, manufactures, and commercializes technology-based process solutions to treat, separate and purify oil, gas and water for the upstream oil and gas (“O&G”) industry. ProSep offers a wide range of process equipment sold in units or in packages to O&G producers and engineering procurement and construction firms (“EPC”) with or without process warranties. ProSep has over 60 patents and has developed one of the industry’s most comprehensive suite of produced-water treatment solutions, including best-in-class polishing equipment. ProSep provides in-house engineering from process to details and is actively involved in project management and execution, including fabrication, assembly, commissioning and value-added services.

ProSep operates around the world in the most important O&G service hubs with operations in Houston (USA), Bergen (Norway), Fusa (Norway), Kuala Lumpur (Malaysia), Manama (Bahrain) and Seoul (South Korea). Its head office is located in Montreal (Canada).

ProSep had approximately 110 employees at the end of 2010, mainly process engineers, product engineers, technical sales people, project managers and workers (at the fabrication shop located in Houston, Texas).

2.1. Corporate Model and Sales Network

ProSep has three diversified business units and a commercial joint venture (ProSep Kolon Company Ltd.) that promote the Company’s solutions across their respective markets. Each operation has developed its own specific expertise and reputation by tailoring the Company’s solutions to the markets it serves. Each business unit has its own team of engineers and experienced sales people including a select network of agents. The joint venture with Kolon Group, ProSep Kolon, was recently concluded and will aim to reproduce the same business model but tailored to the specificities of the Korean upstream oil and gas market.



(Head office located in Montreal, Canada)

<p>America (Houston, USA) Engineering Project management Manufacturing Assembly Commissioning</p>	<p>Europe + Middle East (Bergen, Norway) + (Bahrain) Engineering Sales office Project management Commissioning (Fusa, Norway) Product development</p>	<p>Asia Pacific (Kuala Lumpur, Malaysia) Engineering Project management Manufacturing Assembly Commissioning</p>	<p>ProSep KOLON Far East (Seoul, Republic of Korea) Engineering Project management Commissioning</p>
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2.1.1. American Operations

ProSep’s Houston (Texas) based operation is the Company’s center of excellence for gas membranes, primary separation, heavy crude oil treatment and conventional produced-water treatment systems and packages. To support an increase in the level of activity, plans were made in 2009 to double production capacity by relocating the Company’s only fabrication and assembly facility to a new 55,000 square feet shop. This is where manufacturing and assembly of internals, process vessels, skid-mounted packages and complete process systems is done for a significant portion of the Company’s offering. Most of the systems or packages assembled in Houston are for shipment to the Americas and the Middle-East.

2.1.2. Europe and Middle-East Operations

ProSep’s Bergen (Norway) based operation is the center of excellence for the development and commercialization of the Company’s proprietary products. It is here that the ProMix technology was developed and that various applications using the Company’s patented in-line multiphase injection-mixer process continue to be developed and commercialized. This business unit is also ProSep’s commercial gateway to Europe and the Middle-East, where an office was opened in Manama (Bahrain) in 2008.

2.1.3. South-East Asia Operations

ProSep’s Kuala Lumpur (Malaysia) based operation offers the Company’s entire line of process solutions to the East Asian market, with an emphasis on offshore gas and produced-water treatment systems. It has developed strategic partnerships with local suppliers to build and assemble its process solutions and has concluded a non-exclusive agreement with an engineering firm for detailed engineering work.

2.1.4. Far East Operations

ProSep concluded a joint venture agreement with one of South Korea's largest diversified groups to commercialize the Company's process solutions. By leveraging Kolon Group's reputation, this new venture intends to quickly become Korea's first technology-focused process solutions provider for upstream O&G market. By early 2011, the joint venture already employed five full-time personnel, mostly engineers, and started representing ProSep's offering to Floating Production Storage and Offloading ("FPSO") shipbuilders Hyundai Heavy Industries, Samsung Heavy Industries and Daewoo Shipbuilding & Marine Industries.

2.1.5. Global Network of Agents

ProSep also uses a global network of agents to access markets where the Company does not have an office or employees and/or when the end-users, mostly National Oil Companies, require local representation. Agents are individuals or organisations with a good knowledge of potential customers, business practices and market needs in a specific region. Typically, they are remunerated on a success fee basis. Currently, agents cover several regions such as South America, Middle-East and South-East Asia.

2.2. Business Environment

Demand is expected to grow on non-OECD growth:

In 2010, the upstream oil and gas industry is back to growth after almost two years of decline. Barclays Capital¹ forecasts an increase in Exploration and Production spending of 11% in 2011 to \$490 million up from \$442 million in 2010. Before the financial crisis and low levels in the price of oil affected the industry, upstream capital expenditures had quadrupled between 2000 and 2008.

Global oil demand declined for two consecutive years in 2008-2009 before reaching a bottom in mid 2009 at 84 million barrels per day ("mbpd" or "mp/d"). According to the International Energy Agency's 2010 World Energy Outlook, oil demand is expected to reach 99 mb/d by 2035 representing an annual increase of less than 1% if new energy policies are put in place and could grow up to 1.5% per year if current conditions remain (no energy security or environmental policy changes). Demand growth will come from non-OECD countries such as China (57% of demand growth) and other emerging Asian economies such as India and the Middle-East. The proportion of global oil demand stemming from OECD countries is expected drop from 54% in 2009 to 39% in 2035.

In its February 10, 2011 Short-Term Energy Outlook, the IEA estimated oil demand at 87.8 mb/d in 2010, and expects demand to reach 89.3 mb/d in 2011. It anticipates that non-OECD countries will continue to lead demand, helped by improved economic prospects for OECD countries.

¹Barclay's Original E&P Spending Survey, Wednesday December 15, 2010

Supply challenges:

A significant share of projected long-term increases in supply is expected to come from OPEC conventional oil reserves. The IEA predicts that global output from OPEC producers, who own the bulk of global proven and recoverable reserves, will rise from 41% in 2007 to 52% of total production in 2035. Lower development costs and easier recovery of OPEC reserves should allow for faster relative output growth. Non-conventional oil production is expected to continue to grow steadily as it needs to make up for declining rates of production observed in non-OPEC regions such as in the Gulf of Mexico, the North Sea and as of 2009, Russia, which accounted for 70% of non-OPEC supply over the past decade.

According to the IEA, more than half of the oil discovered are offshore since the turn of the century many of which are in deep water and most new discoveries are offshore. To face future demand in the context of declining rates of production and lack of new discoveries of major fields, future production growth will have to come from enhanced oil recovery (EOR) techniques and other technological advances. These new techniques increase recovery of oil at mature sites and allow production from new reservoirs located in challenging environments and from unconventional hydrocarbons. These new techniques will be associated with higher production costs and sometimes lower quality of oil. In order to cope with these challenges, the oil and gas industry is likely to seek better production process equipment and new technologies associated with more efficient performance and lower operational costs.

2.3. New Global Strategy and Integration Plan

Since concluding the acquisition of Pure Group in October 2007, ProSep diversified its offering and successfully reorganized the Company's structure and activities. From a "one-product" company it quickly grew to a globally diversified provider of process solutions to treat oil, gas and water. Favourable industry conditions, a new global footprint and a wider product portfolio lead to strong revenue growth and increased market recognition. In 2008, ProSep's revenues reached \$52 million, which earned it recognition as Canada's fastest growing technology company according to Deloitte's Technology Fast 50TM program in 2009.

During this fast growth period, ProSep operated with a decentralized business model where each operating unit was encouraged to focus on its dedicated market and develop its offering accordingly. This strategy nurtured a strong entrepreneurial culture, allowed the further development of the Company's engineering expertise and laid strong foundations on which ProSep could build.

Towards the end of 2008, the global recession, shrinking demand and low levels in the price of oil led to two years of industry downturn and reduced investments in oil and gas equipment. During this period, ProSep's order intake was reduced, consolidated revenues declined by 20% and tight competition affected gross margins, however unequally across all regions. While its US operations were feeling the brunt of the recession, ProSep's Asia Pacific operations grew quickly. The Company's geographical diversification and proprietary offering allowed it to weather this storm and preserve capital and key human resources. The Company also took this time to further develop its offering, by furthering the development of the ProDry and completing its produced-water treatment line, giving it one of the industry's most comprehensive offering in the field.

During the industry downturn, many equipment and service suppliers were severely affected and consolidation among the two largest process equipment providers in the fourth quarter of 2009 changed the competitive landscape. NATCO, the process industry's leading independent technology provider was acquired by Cameron International Corporation, one of the oil and gas industry's largest equipment manufacturers.

With the global recovery and expected increase in energy demand from developing countries, the price of oil recovered and oil and gas companies revived their capital investment plans. To meet expected demand and replace declining production capacity, oil and gas producers around the world are now looking to increase output at existing fields or develop new fields. Subsequently, ProSep's bidding activity started reaching levels not seen since before the recession. Since delays between the initiation of a tender process and the conclusion of a supply agreement can be from 6 to 18 months, ProSep's backlog recently started improving, with significant contract announcements in the early part of the first quarter of 2011.

In order to benefit from positive market conditions and a favourable competitive landscape, ProSep implemented the first phase of a global integration plan with the objective of achieving stronger revenue growth and profitability. By leveraging its customer base, improving global reach and ensuring the highest level of execution across all business units, ProSep believes it can become the next leading independent technology-focused process solutions provider. This new strategic direction is articulated around an integrated sales and engineering model and will be supported by a global marketing strategy.

2.3.1. New Strategic Direction

During the fourth quarter of 2010, ProSep started hiring key industry figures and promoted its best personnel to implement best-practices across all its business units and lead the new sales and business development initiatives. The ultimate objective is to quickly gain market share, increase revenues and profitability. The new strategic plan is focused on these important cornerstones:

- Integrate proprietary technologies in conventional processes
- Raise the competitiveness of ProSep's conventional offering: this would allow ProSep to offer a more efficient and compact conventional offering at competitive prices;
- Reduce risk perception of proprietary technologies: conventional solutions are seen as less risky because of their wide acceptance and installation base. Even when performance of conventional technology is known to be inferior and overall costs are higher when considering initial capital investment and future operating expenses, the industry's path to adopting new technologies can still be long;
- Build references: by integrating proprietary elements to conventional equipment, these solutions will no longer be seen as new technologies but rather as improved, widely used conventional equipment. This will make them easier to commercialize and help build additional references for proprietary technologies in an effort to accelerate their validation cycle;
- Create maintenance and service offerings;
- Leveraging customer base: By working closely with O&G companies, ProSep's engineers have an intimate understanding of customer's production environments and technical challenges, an ideal repeat customer base for these services;
- Create value added services: Offering services such as maintenance and process optimization will improve ProSep's competitive advantage and help attract and retain key relationships in a highly competitive environment;
- Improve profitability: Value added services create a stronger relationship with customers and provide for additional, less volatile revenue streams;

- Develop local content;
- Favorably position the Company in the eyes of National Oil Companies and other stakeholders by supporting local economic development strategies, help create employment and build the foundations of a more competitive national oil and gas supply industry. In some countries such as Brazil, official guidelines exist as to minimum local content requirements;
- Facilitate customer's procurement relationships: The joint-venture between ProSep and Kolon Group is the first concrete result of this strategy. Customers want to deal in their own language and time zone and be close to their suppliers. By opening a presence near the FPSO builders in South Korea and employing local engineers, this improves project management and execution for the customers and reinforces relationships;
- Reduce costs associated with transport when a capable local supply infrastructure is available;
- Move from a decentralized, divisional structure to a matrix organization
- ProSep's international presence is key to building and maintaining strong customer relationships. This requires a network of business units and agents around the world that are close to their respective markets. However, by having multiple centers of execution, there is the risk of an uneven customer experience and operational redundancy. By implementing a matrix organizational structure and grouping employees around their business functions such as sales, operations and marketing, the Company can leverage its best resources and ensure even execution across all business units;
- ProSep has an ambitious plan to become the next leading independent technology-focused process solutions provider. This new strategic plan should clearly position the Company as such, and provide a growth platform to achieve revenue growth objectives and deliver profitability;

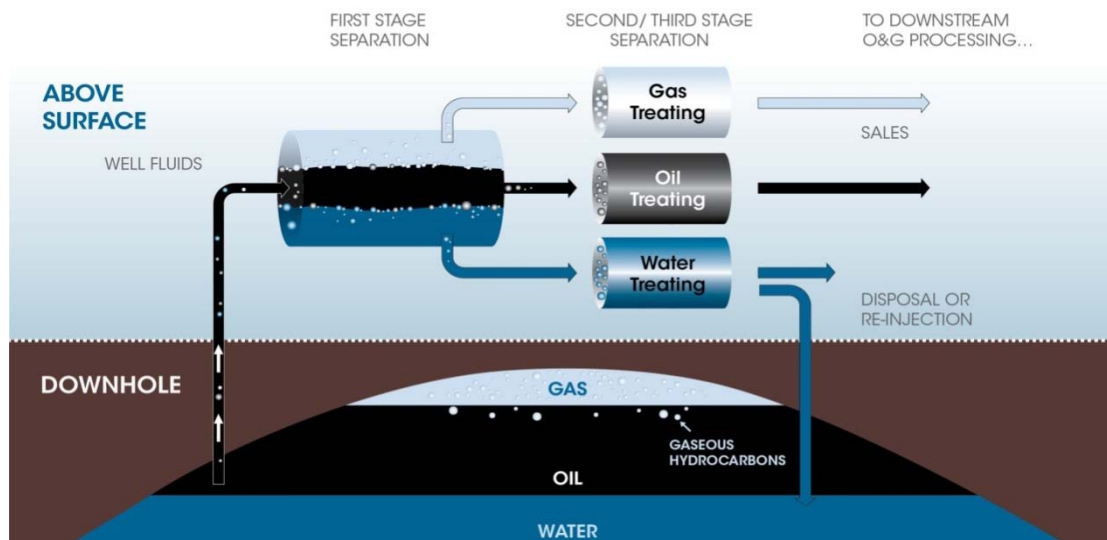
3. PRODUCTS

ProSep's international team of engineers has developed extensive knowledge of process solutions for the upstream O&G treatment market. The Company's expertise lies in the development of technically advanced separation solutions designed to treat gas, oil and produced-water for upstream production activities.

3.1.1. Upstream oil and gas production activities and market:

Upstream oil and gas activities consist of exploration, development and production of oil and gas assets, a market estimated by the International Energy Agency to reach US\$470 billion in 2010. Hydrocarbons, natural gas, water and solids are recovered from geological formations (downhole) and treated at topside facilities before sellable commodities (hydrocarbons and natural gas) can be transported downstream for further refining.

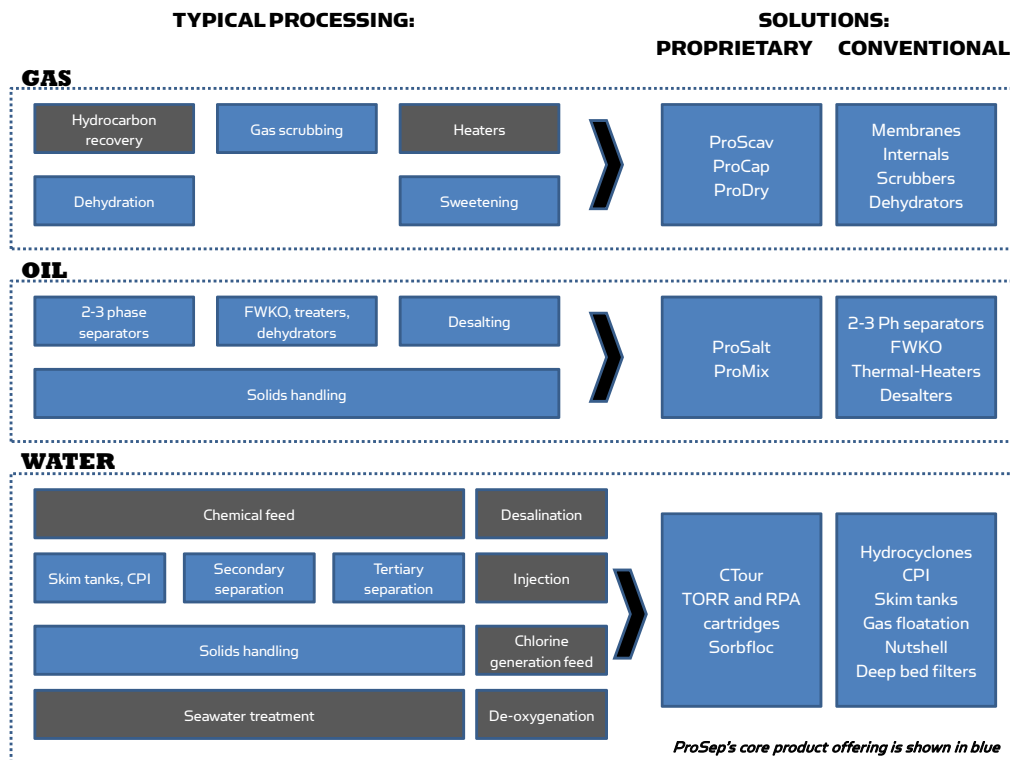
Representation of Upstream Oil and Gas Processing



Topside Oil and Gas Separation

When recovering oil and gas from onshore or offshore production facilities, the extracted hydrocarbon stream (oil, gas, water and solids) is brought to the surface (topside) to be processed and separated. Oil must be cleaned of salt, dissolved gas and other components, gas must be stabilized and cleaned of all liquids and unwanted components such as hydrogen sulphide and carbon dioxide before being commercialized. Produced-water needs to be treated to remove all dissolved components, organic materials and solids before being disposed of or used for re-injection.

ProSep designs customer specific solutions by utilizing its wide range of equipment to separate, treat and polish well fluids and gas before they can be sent downstream for further refining, disposed of or used for re-injection. The following is a diagram of the Company’s core product offering/penetration:



Process Design Experts:

Complete portfolio:

ProSep’s process engineers have developed a wide range of complementary branded proprietary and conventional technologies. Offered as individual equipment or complete custom-designed packages, ProSep’s technically advanced process solutions are used by O&G producers around the world to optimize separation and treatment of produced-water, oil and gas. ProSep’s solutions offer environmental and economic efficiencies, allowing oil and gas producers to meet industry and regulatory requirements while optimizing profitability. The Company believes this is an important and unique value-added proposition as the industry faces increasing production challenges such as diminishing production at older wells, difficult production environments, unconventional resources and increasing use and co-production of water.

Technology-focused:

ProSep has also developed innovative proprietary offering to address growing production challenges facing the onshore and offshore oil and gas industry. These solutions are designed to improve processing efficiencies, are compact, lightweight and robust. They are often an environmentally-sound, cost-effective alternative to older, widely used processes. These systems are designed to use less energy and chemicals, reduce fresh water consumption and efficiently treat larger volumes of oil, gas and produced-water in challenging operating conditions.

Hybrid fabrication model:

ProSep's systems are designed for optimal performance by highly experienced process engineers. These systems are custom designed to each client's specifications. By using a hybrid fabrication model, using in-house fabrication capacity and a network of selected local suppliers, the Company can reach the optimal balance between quality and cost control with local content requirement. Control over the design and fabrication process ensures timely delivery, better cost efficiencies and quality control, important differentiation factors in the oil and gas industry. These products are either offered as individual components or as "industrial packages" which are customized packages of equipment consisting of custom-built or assembled vessels, pumps, valves, instrumentation and other specialized equipment.

For a complete list and description of the Company's conventional and proprietary offering, refer to the most recent Annual Information Form document available at www.sedar.com and www.prosep.com.

4. RESULTS OF OPERATIONS

4.1. Contracts

Sales originate from a number of contracts for the supply of conventional and proprietary oil, gas and water treatment systems to both large international oil and gas companies (“IOC”) and national oil and gas companies (“NOC”). ProSep’s systems have been delivered and installed on onshore and offshore oil and gas fields around the world.

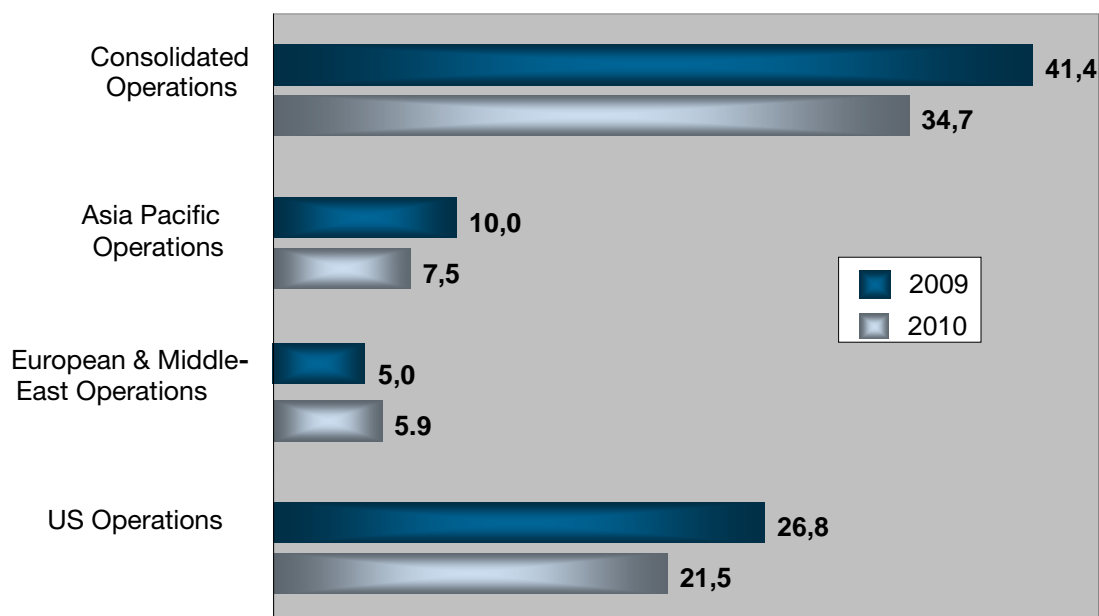
Table of Contracts Announced over the last 24 months

Date	Value	Product	Customer	End User
January 2009	US\$3.7 M	Fuel gas package	Major EPC firm*	*: Asia Offshore IOC
February 2009	US\$1.2 M	Separator	Worley Parsons	BP Exploration
February 2009	US\$0.3 M	ProMix Test Unit	Saudi Aramco	Saudi Aramco
March 2009	US\$2.0 M	Fuel gas package	Powertium/MMHE	Petronas
March 2009	US\$2.1 M	Gas membrane units	Whiting Petroleum	Whiting Petroleum
May 2009	\$1.4 M	ProDry “JIP”	Total, Statoil, Con.Phil.	-
July 2009	\$1 M	ProSalt, ProDry	BP, Con.Phil, Maersk	BP, Con.Phil, Maersk
October 2009	US\$12.9 M	Gas separation	Ecopetrol	Ecopetrol
January 2010	\$1 M	Water treatment (TORR™)	*	*: Asia Offshore NOC
January 2010	US\$3.5 M	Gas membrane	*	*: US Onshore producer
January 2010	\$3.6 M	Water treatment (CTour®)	*	*: Offshore super major
March 2010	\$0.4 M	Proprietary mixer for CO ₂ capture project	Statoil, Norske Shell, Gassnova	Statoil, Norske Shell, Gassnova
May 2010	n/a	Water treatment	Dragados	Dragados-Pemex
May 2010	US\$2.2 M	Water treatment	*	*: Asia Offshore
July 2010	US\$2.0 M	Engineering and specialized internals for crude separation	*	*: Super major producer in Canadian Oil Sand market
August 2010	US\$0.5M	Chemical injection package	*	*: Asia Pacific
August 2010	US\$4.1 M	Gas dehydration	*	*: Asia Pacific
August 2010	US\$1.5 M	CO ₂ gas separation membrane and hydrocarbon dew point packages	*	*: South America
August 2010	US\$0.5 M	Nitrogen generator package	*	*: South China Sea
August 2010	US\$0.4 M	Pitless air drilling de-duster skid	*	*: United States
September 2010	\$2.0 M	After-market services and spare parts	*	*: Kuwait & United States
October 2010	\$1.5 M	Additional equipment (including spare gas membranes)	*	*: South America
February 2011	\$9.0M	Gas membrane units	*	*: US Onshore producer
February 2011	\$5.5M	Gas dehydration	*	*: South China Sea
February 2011	\$2.6 M	Gas membranes	*	North America

*: Information could not be revealed for competitive reasons.

4.2. Revenues

Year ended December 31 (\$ millions)



ProSep reported consolidated revenues of \$34.7 million during the year ended December 31, 2010, down 16% from \$41.4 million generated during 2009. Growth of close to 18% at the *European and Middle-East operations* was offset by decreased revenue at the *US and Asia Pacific operations*. Overall, lower order intake related to residual weakness in upstream capital expenditure spending, increased competition, delays in contract completion at the Asian operations and unfavourable USD/CAD exchange rates explain most of the variance which is further discussed in segmented comments below. With a total of \$17.1 million in announced contracts since the end of the year, ProSep significantly increased its backlog level. These contracts will mostly be executed within a twelve-month period. Please refer to Section 2.2 of this MD&A for an update on the current business environment.

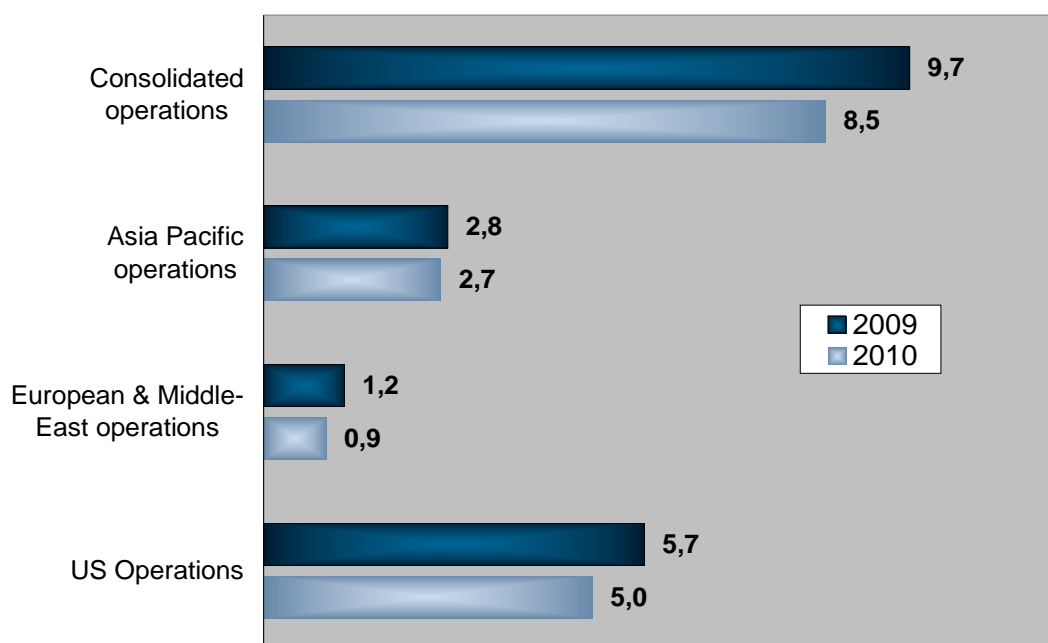
Segment Comments

ProSep's US operations generated 62% of the consolidated revenues, with sales of \$21.5 million, down 20% from \$26.8 million reported in 2009. Large part of the decrease is related to unfavourable exchange rates, which negatively affected reported sales by approximately \$2.7 million. Tighter market conditions resulting from the industry downturn explains the remaining variance. The 2010 revenues were mostly derived from contracts for gas membrane skids, crude separation internals, as well as various orders for spare parts. These contracts included the US\$12.9 million gas separation skid to Ecopetrol which was delivered during the year. This contract confirms the good reputation and high gas treatment expertise of these operations which led to the award of the US\$ 9 million gas membrane skid contract announced in February 2011.

The *European and Middle-East operations* reported revenues of \$5.9 million, up 18% from \$5.0 million in 2009. The sale of a large proprietary produced-water treatment system valued at \$3.6 million for a super major producer operating in the North Sea, contributed most to the increase in revenue. This operation’s offering is based on a relatively new and promising suite of proprietary solutions to treat oil, gas and water. During the year, this business unit was awarded funding to further pursue the development of proprietary gas dehydration technology “ProDry” under a Joint Industry Project carried-out with Total, Statoil and ConocoPhillips, which contributed approximately \$0.5 million to revenues. A \$0.4 million contract for the supply of proprietary technology to be used as an important process component for carbon capture technology was also awarded during the year. This large scale carbon capture testing program is currently being undertaken by Statoil, Norske Shell and Gassnova at their European CO₂ Technology Center in Mongstad, Norway.

The *Asia Pacific operations* recorded revenues of \$7.5 million in 2010, 25% lower than the \$10.0 million reported in 2009. Most of the revenue decrease is related to timing contract awards as these operations are entering 2011 with a list of signed contracts that is 60% higher than a year before. Moreover, in February 2011, these operations were awarded a \$5.5 million order for gas dehydration. The 2010 revenues were also affected by a stronger Malaysian Ringgit against the US dollar. On average, the MYR/USD currency exchange was 3.2 compared to 3.6 during 2009. The value of certain contracts signed in USD was negatively affected by the appreciating value of the Ringgit, and impacted revenues by approximately \$0.5 million in 2010. Management has since developed a hedging strategy to reduce the impact of such currency fluctuations. The 2010 revenues of these operations were mostly derived from gas dehydration, produced-water and chemical injection skids.

Three-month period ended December 31 (\$ millions)



ProSep reported consolidated revenues of \$8.5 million during the last quarter of 2010, down 12% from \$9.7 million generated during the same quarter in 2009. Revenues for the *US* and *European &*

Middle-East operations were affected by lower order intake. As mentioned above, there was a significant increase in the total value of signed contracts since the end of the year, which should contribute to revenue growth in the upcoming quarters.

Segment comments

ProSep's *US operations* generated revenues of \$5.0 million in the last quarter of 2010 compared to \$5.7 million a year before. Unfavourable exchange rates negatively affected sales by approximately \$0.3 million.

The remaining variance is mostly explained by contract advancement and residual weakness creating delays in contract awards won during the first quarter of 2011. Fourth quarter revenues were mostly derived from engineering work for crude separation as well as sales of parts.

The *European and Middle-East operations* reported revenues of \$0.9 million for the fourth quarter of 2010, down from \$1.2 million reported for the corresponding period of 2009. The decrease of \$0.3 million is also related to delays in contract awards.

The *Asia Pacific operations* reported revenues of \$2.7 million for the last three months of 2010, in line with the \$2.8 million generated during the same period in 2009. Since the end of the second quarter, these operations have announced US\$5.5 million in new orders confirming strong CAPEX programs in this region as National Oil Companies look to mitigate overall declining oil production and bolster gas reserves and production.

4.3. Cost of Goods Sold and Gross Margin

Year ended December 31

		US Operations	European & Middle-East operations	Asia Pacific operations	Consolidation & Inter segment eliminations	Consolidated operations
		\$ millions	\$ millions	\$ millions	\$ millions	\$ millions
2010	Cost of goods sold	15.7	2.3	6.5	(0.2)	24.3
	Gross margin	5.8	3.6	1.0	-	10.3
		27%	61%	13%	-	30%
2009	Cost of goods sold	18.7	2.0	7.8	(0.4)	28.1
	Gross margin	8.1	3.1	2.2	-	13.3
		30%	61%	22%	-	32%

The *US* and *European and Middle-East Operations* were the largest contributors to consolidated gross margin in 2010. Gross margins for the year were \$10.3 million, or 30% of revenues, compared to \$13.3 million or 32% of revenues generated in 2009. The contribution to gross margins from the *European and Middle-East Operations*, where most of the Company's proprietary expertise resides, is significant compared to its contribution to total revenues. Expanding this knowhow and engineering expertise to other operations will improve their ability to efficiently promote the solutions across their respective markets. This will be key in achieving higher levels of consolidated gross margins in a competitive environment.

Segment Comments

US operations generated \$5.8 million or 27% of revenues down from \$8.1 million or 30% in 2009. The gross margin for both 2010 and 2009 benefited from strict controls over engineering as well as negotiation efforts in procurement leading to costs savings in project completion and commissioning. Excluding these savings, margins for both years would have been in the 25-27% range. ProSep accounts for costs using the percentage of completion approach. Under this method, contract costs are accrued for using the best estimates of the total expected costs to complete a project. In certain cases, such costs may differ from initial estimates leading to higher than planned gross margin.

Gross margins at the *European & Middle-East operations* were \$3.6 million, (61% of revenues) compared with the 2009 \$3.1 million (also 61% of revenues). The high gross margin levels generated by these operations confirm the incremental value of ProSep's technology driven and proprietary offering. In 2010 most of the gross margin was derived from the produced-water CTour[®] contract concluded in January 2010, as well as the delivery of several TORR[™] RPA cartridges.

Gross margins at the *Asia Pacific operations* stood at \$1.0 million or 13% of revenues compared to \$2.2 million or 22% of revenues during the same period last year. This year's unusually low gross margin was partly caused by contracts signed in USD which were negatively affected by the appreciating value of the Ringgit. Also, change orders and unplanned extra costs in the completion of a glycol regeneration package contributed to this year's lower margin. Rapid growth experienced by this operation led to challenges executing this contract. The appointment of Parag P. Jhonsa, as Executive Vice President Operations, who is responsible to oversee project executions, should ensure these operations have access to required resources, allowing them to reach the same level of seamless execution and cost controls as other operations. Moreover, these operations succeeded in negotiating, in the fourth quarter, additional change orders.

Three-month period ended December 31

		US Operations	European & Middle-East operations	Asia Pacific operations	Consolidation & Inter segment eliminations	Consolidated operations
		\$ millions	\$ millions	\$ millions	\$ millions	\$ millions
2010	Cost of goods sold	3.2	0.1	2.1	(0.1)	5.3
	Gross margin	1.8	0.8	0.6	-	3.2
		36%	86%	23%	-	38%
2009	Cost of goods sold	3.6	0.1	2.3	-	6.0
	Gross margin	2.1	1.1	0.5	-	3.7
		37%	90%	18%	-	38%

For the quarter ended December 31, 2010, consolidated gross margin was \$3.2 million or 38% of revenues compared to \$3.7 million or also 38% of revenues for the same period in 2009. High levels of gross margins in both last quarters of 2010 and 2009 were caused by costs savings in project completion, contract mix as well as the capitalization of test skids and technology development costs. These costs were accounted for as part of cost of goods sold in the previous quarters.

Segment comments

ProSep's *US Operations* reported a gross margin of \$1.8 million or 36% of revenues, in line with \$2.1 million or 37% during the last quarter of 2009. The relatively high margin level generated in the fourth quarter of 2010 is explained by contract mix, comprised of engineering work for crude separation as well as parts orders, and costs savings in project completion resulting from improved negotiation with suppliers. The 2009 margin was also inclusive of cost savings in project completion and commissioning.

The *European and Middle-East operations* reported a gross margin of \$0.8 million or 86% of revenues, slightly lower on a percentage basis than the \$1.1 million or 90% of revenues reported for the same quarter of 2009. The relatively high margin levels reported in both the 2010 and 2009 fourth quarters are explained by the capitalization of test skids and technology development costs that were accounted for as part of direct costs in the previous quarters. As such, a total of \$0.5 million in costs were reversed in the fourth quarter of 2010. In 2009, the total capitalized cost was also \$0.5 million. Please refer to the Note on capitalized costs related to development activities in section 4.4

The *Asia Pacific operations* reported a gross margin of \$0.6 million or 23% of revenues during the fourth quarter of 2010, compared to \$0.5 million or 18% for the corresponding period of 2009. Successful negotiations to increase contract value in relation to change orders accounted for in previous quarters, explain the increase in margin level over the last year.

4.4. Expenses and EBITDA

Expenses and EBITDA* for the year ended December 31

	2010 \$ millions	2009 \$ millions
Revenue	34.7	41.4
Sales and marketing	2.1	2.2
Research and development	0.2	0.1
General and administrative	10.0	10.9
	12.3	13.2
EBITDA (loss)	(1.9)	0.1

Expenses and EBITDA* for the three-month period ended December 31

	2010 \$ millions	2009 \$ millions
Revenue	8.5	9.7
Sales and marketing	0.6	0.5
Research and development	-	(0.3)
General and administrative	2.8	3.1
	3.4	3.3
EBITDA (loss)	(0.2)	0.4

*EBITDA is a non-GAAP measure. Please refer to the section called non-GAAP measures for detailed calculations.

Despite the Company's ability to control contract costs and expenses, lower order intake explained by residual weakness in the industry, execution issues at the *Asia Pacific operations* and unfavourable currency exchange rates led to a \$1.9 million EBITDA for 2010. This compares to a positive \$0.1 million for the same period in 2009. For the quarter ended December 31, 2010 EBITDA loss was \$0.2 million compared to a positive \$0.4 million a year before.

Sales and Marketing Expenses

Sales and marketing expenses were stable at \$2.1 million or 6.1% of revenues for the year ended December 31, 2010 compared with \$2.2 million or 5.2% in 2009. For the last quarter of 2010, sales and marketing expenses were \$0.6 million or 7% of revenues compared to \$0.5 million or 5% for the same period of 2009. The small increase over the last quarter reflects the new strategy to promote a global business development approach. In line with this new approach was the appointment in November 2010 of Douglas A. Campbell as Executive Vice President of Sales and Business Development. Mr. Campbell brings over 33 years of experience in the engineering and construction fields for the upstream oil & gas industry. Sales and marketing expenses are mostly comprised of salaries, marketing, promotional and travel activities.

Research and Development Expenses

Research and development expenses were \$0.18 million for the year ended December 31, 2010 compared to \$0.13 million in 2009. There were very few R&D expenses for the fourth quarter of 2010 compared to a negative \$0.3 million for the corresponding period of 2009. The negative amount of last year is the result of the capitalization, in the fourth quarter, of expenses incurred during the year totalling \$0.3 million in relation to Phase III of the development of the ProDry (see below, for the Note on capitalized costs related to development activities). Since 2009, R&D expenses have represented an increasingly smaller portion of total operating expenses as all the Company's technology is developed with industry partners. These partners are usually industry super majors such as Total, Chevron and ConocoPhillips, which contribute most of the cost of developing ProSep's proprietary technologies under Joint Industry Partnerships.

General and Administrative Expenses

General and administrative expenses were \$9.9 million for the year 2010 compared with \$10.9 million for 2009. For the fourth quarter these expenses were \$2.8 million, slightly below the \$3.1 million a year before. Tight cost control within all operations helped reduce these expenses, in line with lower levels of revenues experienced during the year. The USD/CAD exchange rates also contributed approximately \$0.4 million to the reduction. The 2009 G&A expenses were positively impacted by the capitalization of certain administrative costs incurred in the first three quarters of 2009, totalling \$0.4 million in relation to the successful development of Phase III of the ProDry.

Note on capitalized costs related to development activities:

During the year, the Company incurred costs to test and fabricate test skids for both the development of Phase IV of ProDry*, a proprietary in-line gas dehydration system, and the development of Sorbfloc, a bio-degradable flocculent. Following a thorough analysis, conclusive results from tests performed and discussions with the auditors, management concluded that these costs and test skids should be capitalized. As such, \$0.6 million of direct costs were capitalized in the fourth quarter. In 2009, the Company also incurred costs in relation to another phase (Phase III) of the development of ProDry. As such, \$0.5 million in direct product development costs, \$0.3 million in research and development expenses and \$0.4 million in general and administrative expenses were capitalized, for a total of \$1.2 million in the fourth quarter of 2009.

See also Balance Sheet Items – Assets in Section 6 of this MD&A for further information.

* See press release issued December 23rd, 2010 “ProSep pursues joint development of proprietary gas dehydration technology”.

4.5. Goodwill Impairment

The Company performed its annual goodwill impairment test at December 31, 2010 and determined that no goodwill impairment charges was required for the year ended December 31, 2010. In the second quarter of 2009, the Company performed a goodwill valuation test in light of the anticipated impact of the balance sheet restructuring initiative that took place in the second quarter of that year. As such, the Company determined that the anticipated value of ProSep was below its carrying value. Accordingly, an impairment charge of \$6.5 million was recorded in June of 2009.

4.6. Change in Fair Value of Long-term Investments

During the year ended December 31 2010, the Company recognized a \$375,000 increase in the value of its investment in notes held since January 2009 following the restructuring of the asset-backed commercial paper. The current value reflects the effect of market indicators as of December 31, 2010, on the valuation technique used by the Company.

4.7. Financial Charges and Loss on Debt Settlement

The decrease is largely related to the \$0.9 million difference in foreign exchange gain and loss, offset by interest savings on long-term debt in line with reduced overall levels of debt as a result of the balance sheet restructuring. The foreign exchange gains and losses are mostly the consequence of the conversion of the U.S. and Europe & Middle-East Operations’ transactions in foreign currency.

The total variation in financial charges for the year ended December 31, 2010, reflects the positive impact of the balance sheet restructuring initiative* whereby close to \$8 million in indebtedness was converted to equity in July 2009. The reconsideration of the functional currency of each of the Company's domestic and foreign operations (see Section 4.11 below) also had a positive impact on the financial charges, as the underlying changes related to currency conversion of the balance sheet items of the foreign subsidiaries are now accounted for as part of the currency translation adjustment.

Total financial charges were \$2.1 million for the year ended December 31, 2010 compared to \$3.8 million the same period of 2009.

In December 2009, results included a \$2.1 million loss related to the induced conversion and settlement of debt recorded in Q3-2009. This non-cash loss is a direct consequence of the balance sheet restructuring done in 2009*.

* Please refer to section 8.3 of the 2009 annual MD&A for more details.

4.8. Amortization

The total depreciation expense was \$1.8 million, a 13% increase over the 2009 expense of \$1.6 million. The increase is mostly related to the amortization of the capitalized ProDry development costs.

4.9. Income Tax

Current year tax recovery arose from the net loss reported at our *US operations*, compared to a net profit from these operations in 2009. The Company's operating revenues and expenses are reported by various operations located around the world and are subject to various fiscal jurisdictions. Some of the subsidiaries are profitable, while others have yet to generate net income and some have accumulated tax losses.

4.10. Net Loss

During the year ended December 31, 2010, the Company reported a net loss of \$4.4 million (\$0.02 per share), compared to a net loss of \$13.9 million (\$0.13 per share) in 2009. Included in the 2009 net loss were \$6.5 million goodwill impairment and \$2.1 million debt conversion and settlement costs resulting from the balance sheet restructuring initiative concluded in the third quarter of 2009. Excluding these non-cash items, the 2009 net loss would have stood at \$5.3 million. In spite of lower revenues and a lower gross margin, the reduction in net loss in 2010 is mostly explained by tighter control of direct and administrative costs, lower financial expenses resulting from the 2009 balance sheet restructuring and tax recoveries due to the net loss reported at our *US operations*.

For the quarter ended December 31, 2010, the Company reported a net loss of \$1.2 million, in comparison to a net loss of \$1.3 million for the same period in 2009. In spite of lower revenues that generated a \$0.5 million lower gross margin, the improvement in net loss quarter-over-quarter is mostly explained by lower losses on foreign exchange.

4.11. Foreign Currency Translation Adjustment (part of comprehensive loss)

During the year ended December 31, 2010, the Company recorded a foreign currency translation adjustment of \$0.1 million resulting from the conversion of the balance sheet of the foreign subsidiaries into the Canadian currency. The conversion of the inter-company advances and bank debts denominated in Norwegian Kroner, which depreciated in relation to the Canadian dollar, predominantly accounted for this amount. In addition, the conversion of the *US operations'* goodwill denominated in US dollars, which depreciated in relation to the Canadian dollar, also contributed to the negative year-to-date currency translation.

In the fourth quarter of 2009, following several significant changes, the Company reconsidered the functional currency of each of its domestic and foreign operations and concluded that all of the foreign subsidiaries were self-sustaining. The underlying changes in measurement currencies of the foreign subsidiaries were accounted for prospectively; effective October 2009, with no change to previously-reported results or balances. As such, no amount was accounted for in relation to the foreign currency translation adjustment for the first three quarters of 2009.

4.12. Legal Proceedings

The Company was the defendant in a claim made by Westend Enviro Consultants in the Supreme Court of British Columbia on March 31, 2006, for damages relating to breach of contract and fraudulent misrepresentation in an amount totaling \$280,000. This claim was settled in the first quarter of 2010 for a total amount of \$102,000 (plus interest). As a provision covering substantially all this amount had been recorded in the previous years, this settlement had no significant impact on the Company's 2010 results.

5. SUMMARY OF QUARTERLY RESULTS

Selected Quarterly Financial Performance

	Year Ending December 31, 2010				Year Ending December 31, 2009			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Revenue (\$ millions)	8.5	8.1	8.7	9.4	9.7	9.2	9.3	13.2
Net income (loss) (\$ millions)	(1.2)	(1.5)	(0.3)	(1.3)	(1.3)	(3.4)	(7.1)	(2.0)
Basic EPS* (loss) (\$)	(0.01)	(0.01)	(0.00)	(0.01)	(0.01)	(0.02)	(0.11)	(0.03)
Diluted EPS (\$)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

*EPS: Earnings per share

At this stage of the Company's life, interim operating results are still considered volatile.

5.1. Selected Annual Financial Performance

(\$ millions) (except for EPS)	December 31 2010	December 31 2009	December 31 2008
Revenue	34.7	41.4	51.6
Net loss	4.4	13.9	1.6
Net loss per share (basic & diluted)	\$0.02	\$0.13	\$0.03
Total assets	46.5	53.4	69.5
Long-term debt	10.4	11.7	12.1
Other long-term liabilities	1.8	2.2	1.4
Cash dividend per share	Nil	Nil	Nil

5.2. Discussion of Historical Financial Performance

Over the year ended December 31, 2008, ProSep:

- Concluded a \$5.1 million convertible debenture leading to increased debt level;
- Reversed warranty provision of \$2,561,841 (\$1.3 million in Q3 2008 and \$1.3 million in Q4 2008) representing the total provision taken in relation to the delivery of the seven TORR™ water treatment systems sold to SKEC
- Benefited from the PureGroup AS acquisition with important sales growth to more than \$51 million;
- Reported its first ever positive EBITDA of \$3 million.

In the year ended December 31, 2009, ProSep:

- Reported revenues of \$41.4 million;
- Recorded non-cash goodwill impairment of \$6.5 million;
- Strengthened its financial position and provided additional liquidities by converting \$8 million in principal amount of indebtedness into equity, and subsequently completed a \$5 million rights offering to shareholders;
- Reported second consecutive annual positive EBITDA at \$0.14 million;
- Reported a net loss of \$13.9 million. Excluding non-cash goodwill impairment and debt conversion and settlement costs, the 2009 loss would have stood at \$5.3 million.

5.3. Previous Financings and Use of Proceeds

On April 24, 2008, ProSep concluded a \$5.1 million private placement consisting of convertible unsecured subordinated debentures and share purchase warrants. Proceeds were used for general working capital in order to finance growth and issue performance and warranty bonds.

In July and August 2009, ProSep completely restructured its balance sheet by converting \$7.8 million principal amount of indebtedness into equity followed by a \$5 million rights offering.

On May 18, 2010, ProSep concluded a \$3.7 million equity financing via private placement. Proceeds were used for general working capital in order to finance ongoing contracts.

In December 2010, ProSep concluded a \$1 million subordinated convertible debt facility with Kolon Glotech Inc. to finance the investment in Prosep-Kolon.

Following table summarizes use of proceeds of the financings:

Category of Usage	Year ended Dec 31 2010	Year ended Dec 31 2009	Year ended Dec 31 2008	Total
	\$ millions	\$ millions	\$ millions	\$ millions
Proceeds Unused at Year-End (cash)	1.0	-	-	1.0
Business Acquisition & Capital Expenditures	-	1.5	0.6	2.1
Research & Development	-	-	1.0	1.0
Operations and Working Capital	3.7	3.5	3.5	10.7

6. BALANCE SHEET ITEMS

6.1. Assets

Total short-term assets at December 31, 2010 were \$18.8 million, representing a \$3.5 million decrease from the December 31, 2009 amount of \$22.3 million. Most of this decrease is related to cash levels to finance operations and working capital. At the end of December 2010, the Company had \$3.7 million in cash and cash equivalents compared to \$7.7 million at December 31, 2009. Current year cash level is inclusive of approximately \$1.0 million coming from the proceeds of the private placement completed in December. This amount was used in January to fund the acquisition of a 51% interest in ProSep Kolon, a joint stock company incorporated under the laws of the Republic of Korea.

At December 31, 2010, the Company had \$0.2 million in restricted cash compared to \$2 million at December 31, 2009. Restricted cash is necessary to support the issuance of letters of guarantee (“LGs”) required to receive advance payments on contracts. The decrease from 2009 is related to the Ecopetrol contract, which was delivered during the year allowing the release of the cash.

The Company’s receivables stood at \$12.9 million at December 31, 2010, in line with \$12.8 million at December 31, 2009. The receivables consisted of billed and unbilled receivables. The latter category represents costs related to contracts that have not yet reached certain milestones, allowing the Company to invoice the customer. The Company did not experience major bad debt in both 2009 and 2010. No material changes have occurred in other current assets accounts since the beginning of 2010.

Total long-term investments were \$3.7 million at December 31, 2010, reflecting a \$0.375 million increase in the estimated market value of the notes issued by Master Asset Vehicle II (“MAV 2”) recorded in the second quarter of 2010. For more details, see Section 11 of this MD&A and Note 8 to the annual financial statements.

Capital assets climbed from \$1.5 million at the end of 2009 to \$2.5 million at the end of 2010. The increase is mostly attributable to the transfer of the ProDry and Sorbfloc development costs from intangible assets. These costs include of both testing costs and test skid cost, and are amortized over the expected life of the test skids. See “Note on capitalized costs related to development activities” in Section 4.4.

Goodwill totalled \$14.6 million at December 31, 2010 compared to \$15.2 million at December 31, 2009. The variation is due to changes in foreign exchange conversion rates as goodwill is recorded in the local currency of each operating unit. Total intangible assets were \$6.9 million at December 31, 2010 compared to \$8.9 million in December 2009. This decrease relates to the transfer of capitalized development costs into capital assets (see above comment on capital assets), amortization and changes in foreign exchange conversion rates.

6.2. Liabilities

Total liabilities at December 31, 2010 were \$26.7 million, a decrease of \$6.7 million from the December 31, 2009 amount of \$33.4 million. The variance is predominantly caused by both a decrease of the accounts payable and accrued liabilities related to advancement and completion of major contracts. Additionally, the Company repaid capital on its long term debt with DnB Nor for a total of \$1.5 million. This decrease in debt was partially offset by a new \$1.0 million debenture issued through a private placement to fund the acquisition of a 51% interest in ProSep Kolon. Please refer to Section 1.1.4 and 6.1 of this MD&A for more details.

For more information on the Company’s debt structure refer to Section 8.3 below and to Note 11 of the annual financial statements.

6.3. Equity

The Company’s net equity as at December 31, 2010, was \$19.8 million compared to \$20 million at December 31, 2009. The variation is explained by the 2010 net loss, offset by the \$3.7 million private placement concluded in the second quarter of 2010.

As of December 31, 2010, ProSep had 191,798,008 common shares issued and outstanding, compared to 163,255,910 on December 31, 2009.

7. OFF BALANCE SHEET ARRANGEMENTS

The Company did not enter into material off-balance-sheet arrangements during the year ended December 31, 2010. Most of the current lease obligations are related to rental of office space as well as the Houston, TX fabrication facility.

ProSep’s annual commercial lease obligations on December 31, 2010, are as follows:

\$ millions

2011	2012	2013	2014	2015	Cumulative
0.8	0.7	0.8	0.7	0.6	2.2

In the normal course of business, the company also provides letters of guarantee in relation to contracts with customers. Please see Section 8.2 below

8. LIQUIDITY AND CAPITAL RESOURCES

8.1. Cash Flows

Operating Activities

Despite a lower net loss, the Company used \$7.5 million in cash for operations during the year ended December 31, 2010, compared to \$3.5 million used the year before. The difference between the two years is predominantly related to higher investment in the operating working capital items required to support ongoing contracts. Please refer to Section 8.2 for more details.

Investing Activities

Investing activities during 2010 mainly involved the release of the restricted cash required for the issuance of LGs on the Ecopetrol contract, which was delivered during the third quarter. Investing activities also included a total of \$1.0 million for both shop equipment for the Houston fabrication facility and capitalized test skid costs in relation of the development of ProDry and Sorbfloc.

Financing activities

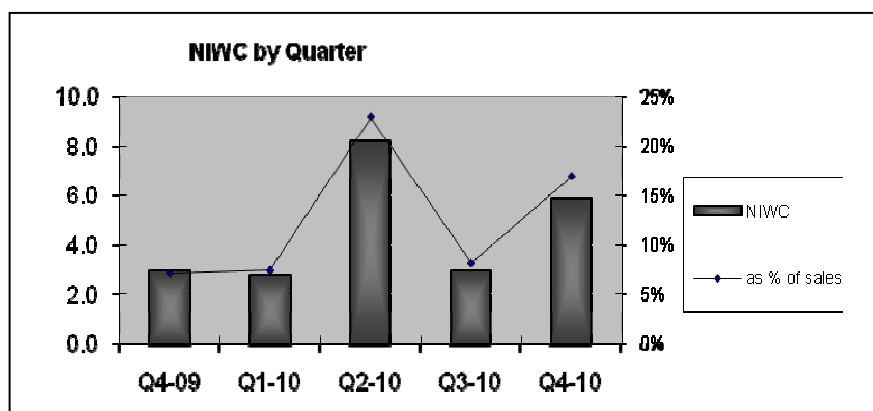
The 2010 financing activities consisted mainly of \$1.0 million inflow related to the new debenture issued to fund the ProSep-Kolon investment, \$3.6 million from the equity issuance completed in May 2010 and the scheduled payments on the DnB Nor term debt for \$1.6 million.

In 2009, financing activities included the proceeds of the offering concluded in August 2009 and the release of restricted cash required under the credit facility with DnB NOR. On April 29, 2009, the Company agreed to a new covenant structure on this credit facility allowing for the release of the restricted amounts. Financing activities in 2009 also included an increase in the bank credit facility required to fund the operations and scheduled payments on the long-term debt in the amount of \$1.9 million.

8.2. Liquidity, Working Capital and Credit Facility

At December 31, 2010, the Company had net cash (defined for the purpose of this section as being cash less bank credit facilities) of negative \$1 million compared to \$2.7 million at December 31, 2009.

At December 31, 2010, the Company had net invested working capital (NIWC – see definition on page 2) of \$5.9 million or 17% of annual sales, representing an increase of \$2.9 million from the \$3.0 million it had at December 31, 2009 (7.2% of annual sales). This increase in NIWC is purely related to timing between collection of receivables and payment to suppliers and shows the high volatility of amounts required to support outstanding contracts. Management actively monitors NIWC to ensure it is as low as possible.



As shown above, the level of NIWC can be quite volatile depending on the structure and progress of contracts. NIWC is financed through cash on hand and a bank line of credit, and is reduced by customer advances or progress payments on contracts. In some cases, such advances or payments require the issuance of LGs using the DnB NOR 15 million NOK credit facility (approximately \$2.5 million at December 31, 2010), assistance provided by Export Development Canada (“EDC”), or simply the pledging of cash to secure the issuance of such LGs. At December 31, 2010, the total outstanding LGs (DnB, EDC and LGs secured by restricted cash) amounted to \$2.5 million (\$5.6 million at December 31, 2009). As sales are migrating to countries where the Company does not have a physical presence, it is anticipated that increased levels of NIWC and LGs will be required. ProSep Inc. is a company with limited business operations, sources of income or operating assets other than the shares of its subsidiaries, operating companies and TORR technology. ProSep's cash flow and, consequently, its ability to meet its debt service obligations is highly dependent upon the receipt of funds from its subsidiaries in the form of loans, dividends, advances or otherwise. Under the current debt agreement with DNB, ProSep is subject to certain financial and negative covenants including limitations from the operating subsidiaries of the Company to transfer funds in the form of dividends, loans or otherwise to the Company in excess of \$3.7 million for each fiscal year. The Company intends to finance its operations and NIWC using cash on hand, cash flow from operating activities, bank credit lines, assistance from EDC and funds from external sources.

8.3. Bank Overdraft Facilities and Obligations under Financial Liabilities

ProSep’s Bank Credit Facility at December 31, 2010

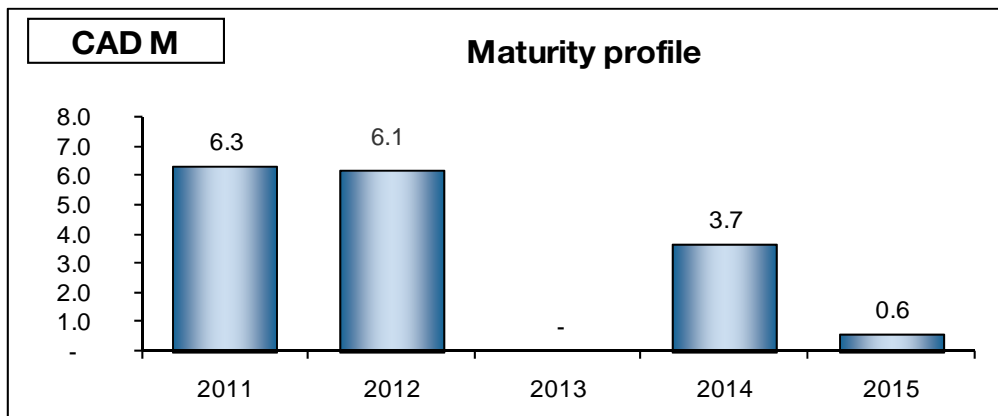
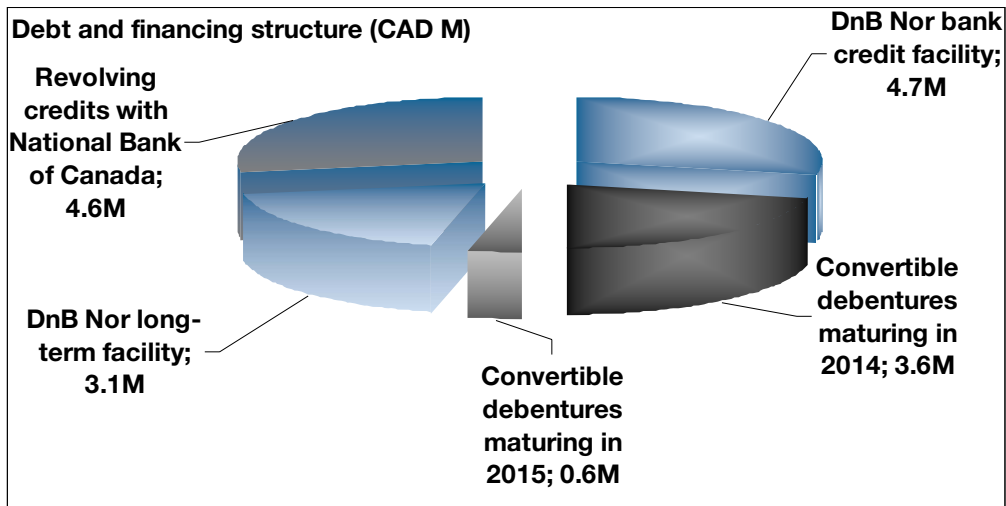
Lender	Description	Currency	Capacity	Drawn	Available
			\$ millions	\$ millions	\$ millions
DnB NOR	Overdraft	NOK/USD	5.1	4.7	0.4
	Guarantee facility	NOK	2.6	2.1	0.5

8.3.1 Financial Covenants

The Company is in full compliance with its financial covenants.

8.3.2 Obligations under Financial Liabilities

ProSep's Debt and Credit Facility Repayment Schedule at December 31, 2010



	Carrying Amount	One to nine months	Nine to twelve months	One to five years	More than five years
	\$ millions	\$ millions	\$ millions	\$ millions	\$ millions
DnB bank credit facility	4.7	-	4.7	-	-
DNB NOR long-term credit facility	3.1	0.7	0.7	1.7	-
Convertible unsecured debenture maturing in 2014	3.6	-	-	3.6	-
Convertible unsecured debenture maturing in 2015	0.6	-	-	0.6	-
Revolving credits with National Bank	4.6	0.1	-	4.5	-
Other	0.1	0.1	-	-	-
Total	16.7	0.9	5.4	10.4	-

9. TRANSACTIONS WITH RELATED PARTIES

ProSep did not enter into any related-party transactions during the year ended December 31, 2010.

10. DESCRIPTION OF CAPITAL STRUCTURE

ProSep's authorized share capital consists of an unlimited number of common shares, of which 191,798,008 common shares were issued and outstanding as of December 31, 2010. The Company is authorized to issue an unlimited number of common shares without par value. The holders of the common shares are entitled to receive notice of and to attend all annual and special meetings of shareholders and to one vote in respect of each common share held at all such meetings. The holders of the common shares are entitled, at the discretion of the Company's Board of Directors, to receive any or all of profits or surplus properly available for the payment of dividends, as well as any dividend declared by the Board of Directors and payable by the Company on the common shares. The holders of the common shares will participate rateably in any distribution of the Company's assets upon liquidation, dissolution or winding-up or other distribution of assets among shareholders for the purpose of winding-up the Company's affairs. Such participation will be subject to the rights, privileges, restrictions and conditions attached to any securities issued and outstanding at such time ranking in priority to the common shares upon liquidation, dissolution or winding-up.

At December 31, 2010, options to purchase 420,000 common shares of the Company issued pursuant to ProSep's stock option plan were outstanding.

The Company grants restricted share units to attract, retain and motivate key personnel and reward officers and employees for significant performance and distributable cash flow growth. Each restricted share unit is equal in value to one common share of the Company. The shares will be issued from the treasury of the Company. The number of shares reserved at any time must not

exceed, when combined with all other security-based compensation arrangements, 10% of the aggregate number of shares.

At December 31, 2010, 7,190,000 restricted share units were issued and outstanding.

At December 31, 2010, warrants to purchase 4,460,242 common shares of the Company were outstanding.

11. CRITICAL ACCOUNTING ESTIMATES

The accompanying financial statements have been prepared using Canadian generally accepted accounting principles applicable to a going concern. These principles assume that ProSep will be able to realize the carrying value of its assets and discharge its liabilities in the normal course of operations.

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. These estimates include those related to revenue recognition, the relative fair value of long-term debt and equity instruments, the fair value of intangible assets, the useful lives of assets and intangible assets, the establishment of warranty provisions, the impairment of goodwill and intangible assets, the determination of pension costs, future taxes, manufacturing contracts as well as fair value estimates of stock options, restricted share units and values of long-term investment. All the estimates are based on management's knowledge of current events and actions that the Company might take in the future. Actual results could differ from these estimates. The following areas are considered to be those that require the exercise of the most critical judgements.

11.1. Long-term Investments

At January 1, 2009, the Company held asset-backed commercial paper ("ABCP") acquired on July 12, 2007, with a nominal value of \$9,000,000. During the month of August 2007, the ABCP market experienced liquidity problems. The maturity date of the ABCP held by the Company was August 14, 2007, and the amount due was not repaid.

The restructuring efforts of the Pan Canadian Restructuring Committee under the Companies' Creditors Arrangement Act led to a final restructuring, the closing of which occurred on January 21, 2009. The restructuring plan led to the replacement of the ABCP held by the Company by new floating rate notes that have maturities based on the maturities of the underlying assets. The key elements of the plan relevant to the Company are as follows:

- Creation of a new trust named "Master Asset Vehicle II" ("MAV 2"):
- MAV 2 regroups the so-called 100% synthetic transactions, which is a combination of assets provided as collateral, credit default swaps and hybrid transactions, comprised of a combination of synthetic and traditional assets.
- MAV 2 also includes the ineligible (subprime) assets originally associated with these transactions.
- Creation of five categories of notes for MAV 2 (A-1, A-2, B, C and IA).
- The IA notes are subdivided in multiple series of tracking notes that pass through to the holders the cash flows generated by the underlying assets.

According to the restructuring plan, the Company has received in January 2009 long-term floating rate MAV 2 notes (the “Notes”). The nominal amount of the Notes initially received by the Company and held as of December 31, 2009 and 2010 are as follows:

	December 31, 2010	December 31, 2009	January 21, 2009
	\$	\$	\$
Class A-1 Notes:	370,745	370,970	371,936
Class A-2 Notes:	4,291,318	4,291,318	4,291,318
Class B Notes:	778,993	778,993	778,993
Class C Notes:	168,316	168,316	168,316
Class IA, series 1 and 2 Notes:	-	1,869,479	3,365,062
Total	5,609,372	7,479,076	8,975,625

The MAV 2 A-1, A-2, B and C Notes legally mature in 2056, however, the expected repayment date is in 2016. The Class A-1 and A-2 Notes were originally rated A(sf) by DBRS. The Class A-2 Notes have, however, been downgraded to BBB (low)(sf) and placed under review with negative implications by DBRS on August 11, 2009. On February 9, 2010, DBRS confirmed the BBB (low) (sf) rating and removed the Under Review with Negative Implications status, citing the passage of time and the stability in the credit environment. On September 21, 2010, DBRS upgraded the Class A-1 Notes to A (high) (sf) and confirmed the BBB (low) (sf) rating of the Class A-2 Notes. The Class B and C Notes have not been rated nor have the Class IA Notes received by the Company. Further to credit events that have occurred in the underlying assets, the outstanding principal amount Class IA Series 1 and 2 Notes was reduced to zero during 2010 and 2009, respectively. However, they remain eligible for the sales mechanism described under Credit facility related to IA notes described below.

The Replacement Notes are considered as new financial instruments, have been designated as held for trading and are classified as long-term investments.

In 2009, the Company has received cash payments totalling \$425,678 representing accrued interest on the ABCP for the period from August 2007 to January 2009, net of the estimated restructuring costs incurred by the Pan-Canadian Restructuring Committee. Interest and principal payments received on the Notes amounted to \$8,561 and \$225 in 2010 (\$17,292 and \$966 in 2009).

In connection with the restructuring of the ABCP, the Company arranged two credit facilities with the National Bank of Canada (“National Bank”) in March 2009.

Credit facility related to IA Notes

This credit agreement provides for a \$2,523,797 revolving credit facility agreement representing an amount equal to 75% of the original nominal amount of such Notes. This credit facility expires on March 10, 2011 and bears interest at the prime rate less 1%. The agreement also grants the Company the right to transfer to National Bank the IA Notes on March 10, 2011, in full payment of the loan. In January 2011, the Company advised the National Bank that it was exercising such right. The settlement of the transaction is scheduled to occur on March 10, 2011 without any cash disbursement by the Company.

Credit Facility related to Eligible Notes

This credit agreement provides for a \$4,656,767 revolving credit facility representing an amount equal to 83% of the total nominal amount of the MAV II Class A- 1, A-2, B and C Notes (collectively the "Eligible Notes"). This credit facility expires in March 2012 and also bears interest at the prime rate less 1%. The agreement provides for borrowings to be made in two tranches: a first tranche representing 45% of the nominal amount of the Eligible Notes and a second tranche representing 38% of the nominal amount of the Eligible Notes. It also grants the Company the right to sell to National Bank the Eligible Notes in March 2012 at their fair market value. The proceeds from the sale of the Eligible Notes must be used to settle the first tranche and then the second tranche of the credit facility.

Any remaining balance under the first tranche of the credit facility is without recourse to the Company, thus providing indirectly the Company with a guaranteed minimum sales price of 45% of the nominal amount of such Eligible Notes.

The Company has granted a first ranking hypothecation to National Bank on the Notes. Subsequent to the decision to exercise the right to sell to the National Bank the Ineligible Notes in settlement of the IA Notes credit facility, the Eligible Notes credit facility continues to provide the Company with \$4,656,542 in long term financing facilities in replacement of the previous term loan that was secured with the ABCP which matured on April 30, 2009. As mentioned above, except for the second tranche of the Eligible Notes facility, the bank's recourse with respect to these new credit facilities will be limited to the Notes.

The repayment arrangements of the two credit facilities are considered embedded derivatives representing put options held by the Company. These put options are classified as assets held for trading, are recorded at fair value and are presented in reduction of the related credit facility under long-term debt.

Estimation of fair value

During 2010, increased trading of the MAV 2 notes was observed on the secondary market allowing for more liquidity than during the previous year, even though the notes held by the Company have not traded in an active market since the restructuring.

The fair value of the Notes as of December 31, 2010, was determined based on management's judgment using available information and assumptions market participants would use in pricing such Notes at the balance sheet date. In considering the fair value of the investment, the Company reviewed information provided by DBRS and BlackRock, the administrator of MAV 2, including current and anticipated credit ratings, composition and valuation estimates of the underlying assets, the estimate of the extent of leverage in the transactions underlying the MAV 2 Notes and general economic conditions.

The Company estimated the fair value of the Notes using the discounted cash flow evaluation technique based on observable market assumptions to the extent possible. The main assumptions are comprised of the anticipated interest coupons, anticipated maturity of the Notes and an appropriate discount rate considering the underlying risks. The estimated discount rate was determined based on observable market assumptions for similar securities. The Company used the following discount factors to evaluate the Notes:

Replacement Notes	Expected Yield	Market Related Discount Factors
Class A-1	186 basis points*	Canada bond rate plus 480 basis points
Class A-2	186 basis points*	Canada bond rate plus 570 basis points
Class B	0 basis points*	Canada bond rate plus 1,080 basis points
Class C	0 basis points*	Canada bond rate plus 3,580 basis points
Ineligible	0 basis points	Canada bond rate plus 135 basis points

*December 31, 2010 Bankers' Acceptance swap rate of 2.36% minus 50 basis points

The risk premiums added to the Canadian government bond rates reflect the liquidity, credit and other risks.

The fair value of the put options at December 31, 2010 was estimated using a valuation technique that incorporates a probability-weighted approach, applied to discounted future cash flows of the underlying IA and Eligible Notes while considering: (i) the fair value of such Notes, (ii) the maximum amount that can be drawn under the respective credit facilities, (iii) the recourse features of such drawings, and (iv) the discount rate relating to National Bank.

At December 31, 2010, the fair values of the embedded derivatives were established based on the following significant assumptions:

	Embedded Put Option	
	IA Notes	Eligible Notes
Maturity	March 2011	March 2012
Fair value of underlying Notes	Nil	\$ 3,729,775
Discount rate	2.75%	3.5%
Estimated fair value of put option	\$ 2,470,000	Nil

At December 31, 2008, the implicit value of the put option was considered in the estimation of the value of the ABCP that was anticipated to be converted into IA Notes.

Based on its assessment of fair values of the Notes and the embedded put option, the Company recognized an increase in fair value of its investment in ABCP and Notes of \$375,000 during the year ended December 31, 2010 (an increase in value of \$400,000 for the year ended December 31, 2009). The cumulative impairment charge represents \$2,800,225 since the acquisition of the original ABCP (31.1% of the nominal value).

The above estimated fair values may not be indicative of the ultimate net realizable value or the future fair value. Because of the uncertainty in the market, numerous reasonable assumptions exist. While management believes that its valuation technique is appropriate under the circumstances, changes in significant assumptions, especially those relating to the probability of the scenarios, returns, credit risk and liquidity risk could significantly affect the value ascribed to the replacement notes in the future. Following the analysis, the Company identified that the discount rate related to Classes A-1 and A-2 of MAV 2, and the embedded put option on the IA Notes generate the vast majority of the volatility in the valuation model of the Notes and embedded put options fair value. For example, a 50 basis point increase or decrease in the discount rate for A-1 and A-2 notes and the IA Notes put option would result in a \$94,313 change in the aggregate fair value.

11.2. Impairment of Long Lived Assets and Goodwill

Long lived assets are tested for recoverability whenever events or changes in circumstances indicate that their carrying value may not be recoverable. An impairment loss is recognized when their carrying value exceeds the total estimated undiscounted cash flows expected from their use and eventual disposal. The amount of the impairment loss is measured as the excess of the asset's carrying value over its fair value. Management believes that the accounting estimate related to these impairment assessments are critical accounting estimates because: a) it is highly susceptible to change from period to period as it requires management to make assumptions about future sales, margins and market conditions over the long-term life of the assets; and b) the impact that recognizing an impairment would have on ProSep's financial position and results of operations could be material.

Goodwill is not amortized, but is assessed for impairment at the reporting unit level annually, or sooner if events or changes in circumstances indicate that the carrying amount could exceed fair value. Goodwill is assessed for impairment using a two-step approach. The first step is to assess whether the fair value of the reporting unit to which the goodwill is associated is less than its carrying value. If this is the case, a second impairment test is performed which requires a comparison of the fair value of the reporting unit's goodwill to its carrying value. If fair value is less than carrying value, goodwill is considered impaired and an impairment charge must be recorded immediately. Management believes that the accounting estimate related to these impairment assessments are critical accounting estimates because of two major factors. First, the estimates are highly susceptible to change from period to period as the methodology used by management to estimate a reporting unit's fair value is based on internally developed valuation models that require management to estimate various factors such as earnings, demand for its products, selling prices, foreign exchange rates, operating costs, future capital expenditures, present value of future cash flows and weighted average cost of capital; all these variables remain highly subjective and will evolve over time as the conditions in the worldwide energy and financial markets develop and will depend on how the Company will responds to those market conditions. It is likely that estimates will change over time as a result of changes in the global economy. The second contributing factor is the potential material impact on the Company's financial position and results of recognizing an impairment. There is a risk that actual results may be materially different from estimates used in the assessment.

11.3. Revenue recognition

The Company's revenues are derived from various sources: (i) Manufacturing contracts and (ii) field trials and (iii) spare parts orders.

The Company offers complete and integrated solutions to meet customer needs. These solutions may involve the delivery of multiple services and products occurring at different points in time and/or over different periods of time. As appropriate, these multiple element arrangements are separated into their units of accounting based upon their relative fair values when the delivered item has value to the customer on a stand-alone basis and there is objective and reliable evidence of the fair value of each deliverable. Each element is accounted for in accordance with the Company's revenue recognition policies.

i) Manufacturing contracts

Revenue related to long-term manufacturing contracts is recognized based on the degree of completion. Under this method, revenue is recognized over the duration of the contract. Completion is measured on the value of tasks completed. Cost of goods sold is also based on the degree of completion. Any excess of the cost of goods sold over cost incurred to date is reported as liability on the balance sheet under accrued liabilities (see note 10 to financial statements). If the degree of completion of a project cannot be established reliably, only revenue corresponding to expenses incurred will be recognized. Any loss on projects is fully recognized when it is ascertained that the project will incur a loss. Recognized revenues and margins are subject to revisions as the contracts progress to completion. Management conducts monthly reviews of its estimated costs to complete, percentage-of-completion estimates and revenues and margins recognized, on a contract-by-contract basis. The impact of any revisions in cost and earnings estimates is reflected in the period in which the need for a revision becomes known.

Warranty provision

A warranty provision is accounted for in cost of goods sold when the product is delivered and in accordance with the terms of the contract. When relevant, the provision is calculated based on the contract terms and/or based on the data available during field trials and is reversed progressively when relevant data is available and when the guarantee period ends.

ii) Field trials

Field trials are services rendered by technicians and/or engineers operating a demonstration unit of the Company's various products at the client's site, with the ultimate objective of selling such a product. The duration of these demonstrations can range from days to months. Revenue derived from these services is recognized on the basis of services rendered in line with agreements with clients. Revenue derived from the rental of demonstration related equipment is recognized on the basis of services rendered.

iii) Spare parts

Revenues derived from spare parts orders are accounted for at shipment.

11.4. Future Accounting Standards

The Company will cease to prepare its financial statements in accordance with Canadian GAAP as set out in Part V of the CICA Handbook - Accounting ("Canadian GAAP") for the periods beginning on January 1, 2011, when it will start to apply International Financial Reporting Standards as published by the International Accounting Standards Board as set out in Part I of the CICA Handbook – Accounting as its primary basis of accounting. Consequently, future accounting changes to Canadian GAAP are not discussed in this Management Discussion and Analysis as they will never be applied by the Company.

11.5. International Financial Reporting Standards (“IFRS”) - Changeover Plan

The CICA Handbook – Accounting requires that Canadian publicly accountable enterprises, such as the Company, report in accordance with IFRS for years beginning on or after January 1, 2011.

We established a changeover plan to adopt IFRS by 2011. An implementation team has been created to plan for and achieve a smooth transition to IFRS. External resources have also been engaged to assist, under the direction of Company management, with certain aspects of the project. The audit committee of the Board of Directors regularly receives progress report on the status of the IFRS implementation project. The implementation project consists of three primary phases: (1) the scoping and diagnostic phase; (2) the impact analysis, evaluation and design phase; and (3) the implementation and review phase.

The Company completed the scoping and diagnostic phase in the spring of 2009. The following summarizes the key elements of the Company’s changeover plan for transitioning to IFRS for which progress has been made:

1. Accounting policies and procedures
2. Financial statement preparation
3. Training and communication
4. Business impacts
5. IT systems
6. Control environment

Based on the work performed to date, the differences identified between IFRS and Canadian GAAP are not expected to have a material impact on ProSep’s reported results and financial position. In addition, the effects on the Company’s commercial activities in terms of financial covenants, contractual agreements, incentive plans, budgeting and financial risk management strategies, for example, have been assessed as relatively minor to date. Accordingly, efforts with respect to the areas of training and internal and external communications are expected to be minor. During the second quarter of 2010, the Company reviewed its existing accounting systems and procedures along with its internal control over financial reporting and disclosure control processes, concluding that they would not need significant modification because of the Company’s conversion to IFRS. During the third quarter, further progress was made in the conversion analysis. The review indicated that it is likely that there will be no material differences to the majority of line items appearing in the Company’s consolidated balance sheet and income statement from what was reported under Canadian GAAP in terms of recognition and measurement. The key focus during the fourth quarter was the completion of the IFRS January 1, 2010 opening balance sheet, the 2010 quarterly comparative financial statements and the model annual and interim IFRS financial statements.

Most adjustments required with the transition to IFRS will be made retrospectively against the opening deficit as of January 1, 2010, based on standards that will be applicable as at December 31, 2011.

Initial Adoption of International Financial Reporting Standards

IFRS 1 “First-time Adoption of International Financial Reporting Standards” sets forth guidance for the initial adoption of IFRS. Under IFRS 1, the standards are applied retrospectively at the transition date with all adjustments to assets and liabilities taken to retained earnings, unless certain exemptions are applied. To date, the Company has decided to take advantage of the following optional exemptions provided by IFRS 1. All other available exemptions are currently considered either not applicable or not significant for the Company.

Business combinations

The Company will elect to not apply IFRS 3(R) “Business Combinations” retrospectively to business combinations that occurred prior to January 1, 2010. Accordingly, such business combinations will not be restated.

Employee benefits

The Company will elect to not apply IAS 19 “Employee Benefits” retrospectively to its defined benefit plan. It will therefore charge to the opening deficit the \$177,404 balance of the actuarial gain on its plan at January 1, 2011.

Cumulative translation adjustment (CTA)

The Company will elect to use the option to reset its cumulative foreign currency translation adjustment account to nil at January 1, 2010, with the balance of \$1,900,511 being charged to the opening deficit.

Share-based payment transactions

The Company will elect to apply the requirements of IFRS 2 “Share-Based Payments” to all equity instruments granted since July 1, 2002 which was the date when similar requirements were adopted under Canadian GAAP.

Compound financial instruments

The Company will elect to use the exemption whereby it does not need to separate the two portions of a compound instrument in accordance with IAS 32 Financial Instruments: Presentation, when the liability component is no longer outstanding at January 1, 2010.

Expected Areas of Significant Impact

Set out below are the key areas where changes in accounting policies may have a significant impact on the Company's consolidated financial statements.

Impairment of assets

Canadian GAAP generally uses a two-step approach to impairment testing: first comparing asset carrying values with undiscounted future cash flows to determine whether impairment exists; and then measuring any impairment by comparing asset carrying values with fair values. IAS 36, "Impairment of Assets", uses a one-step approach for both testing for and measurement of impairment, with asset carrying values compared directly with the higher of fair value less costs to sell and value in use (which uses discounted future cash flows). This may potentially result in more write downs where carrying values of assets were previously supported under Canadian GAAP on an undiscounted cash flow basis but could not be supported on a discounted cash flow basis. However, the extent of any new write downs (other than on goodwill) may be partially offset by the requirement under IAS 36 to reverse any previous impairment losses where circumstances have changed such that the impairments have been reduced. Canadian GAAP prohibits reversal of impairment losses. Effective January 1, 2010, the Company performed an impairment testing for its long lived assets including goodwill. There were no significant differences between the carrying value and the recoverable amounts of the Company's cash generating units under IFRS.

Future income taxes on convertible debt instruments

Canadian GAAP does not require that future income tax liabilities be recognized for the taxable temporary difference arising from the excess of the tax base of the liability component over its carrying amount. IFRS specifically requires that a deferred income tax liability be recorded for such taxable temporary difference with the offset recorded against the equity component of the convertible instrument. Due to the existence of sufficient unrecognized deferred income tax assets, this difference will not have an effect on net shareholders' equity at the transition date.

Stock based compensation

Canadian GAAP allows the compensation cost related to "graded vesting" awards to be recognized using the straight line basis over the vesting period of the longest award. IFRS requires that each tranche of an award be recognized over its own vesting period, thus leading to faster recognition of compensation costs. Furthermore, IFRS requires that forfeitures be estimated at the time of grant to eliminate distortion of remuneration expense recognized during the vesting period. The estimate should be revised if subsequent information indicates that actual forfeitures are likely to differ from previous estimates. These differences will result in an increase of \$195,440 of contributed surplus and of deficit with no effect on net shareholders' equity on transition date.

The above comments should not be regarded as a complete list of changes that will result from the transition to IFRS. They are intended to highlight those areas the Company believes to be most significant. It should be noted that the Company's analysis of possible changes is still underway, especially for 2010 figures, and that not all decisions have been made where choices of accounting policies are available. Until its analyses and choices are finalized, the Company cannot reliably quantify the expected impact on its consolidated financial statements for these differences.

It should also be noted that the standard-setting bodies that promulgate IFRS have significant ongoing projects. While many new final IFRS standards are expected to be published in 2011, none are expected to have a mandatory effective date before December 31, 2011. Such projects that will likely be relevant for the Company include Liabilities, Employee Future Benefits, Revenue Recognition, Leases and Presentation of Financial Statements. Depending on the timing of publication of the final standards that may arise from those projects and their impact on the Company, opportunities to early-adopt any such new standard will be assessed during 2011. The Company has processes in place to ensure that such potential changes are monitored and evaluated. The future impacts of IFRS will also depend on the particular circumstances prevailing in those years. The differences described are those existing based on Canadian GAAP and IFRS today.

The Company's IFRS project continues to be on target to meet the changeover date.

11.6. Income Taxes

The Company recognizes a current tax liability or asset for current taxes payable or receivable. A future tax liability or asset is recognized for the estimated future tax effects of temporary differences between the carrying value of assets and liabilities for financial reporting purposes and their tax bases. Future income tax assets relating to tax losses carried forward and other deductible temporary differences are recognized to the extent they are more likely than not to be realized. The determination of whether or not a future income tax asset warrants recognition requires the exercise of significant judgement related to the extent and timing of future taxable income for each of the relevant legal entities within the group.

12. INTERNAL CONTROLS

In order to comply with the Canadian Securities Administrator's Multilateral Instrument 52-109 ("MI 52-109"), the Company has conducted an evaluation of its disclosure controls and procedures and internal controls. The implementation of MI 52-109 involves a continuous improvement process, which has led the Company to ensure that all relevant processes and controls are documented.

12.1. Disclosure Controls and Procedures

Our disclosure controls and procedures are designed to provide reasonable assurance that material information required to be disclosed is recorded, processed, summarized and reported within the time periods specified under Canadian securities laws, and include controls and procedures that are designed to ensure that information is accumulated and communicated to the management committee members, including the President & CEO and the CFO, to allow timely decisions regarding required disclosure.

An evaluation of the effectiveness of the disclosure controls and procedures as defined under MI 52-109 was carried out as of December 31, 2010, under the supervision and with the participation of management, including the President & CEO, the CFO and the Treasury Director. This evaluation took into consideration the Company's disclosure policy, a cascading certification process and the presence of the disclosure committee. Based on that evaluation, the President & CEO and the CFO concluded that the design and operation of disclosure controls and procedures were effective at December 31, 2010.

12.2. Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

Internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions; provide reasonable assurance that transactions are recorded as necessary, thereby permitting preparation of consolidated financial statements in accordance with determined authorizations; and provide reasonable assurance regarding prevention or timely detection of unauthorized use of assets that could have a material effect on the Company's consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of internal control over financial reporting to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies and procedures may deteriorate.

As of December 31, 2010, management assessed the design of internal control over financial reporting as defined in MI 52-109, and based on that evaluation determined that certain aspects of internal control over financial reporting were not designed effectively but were mitigated by additional compensating procedures. As part of the assessment, the Company has continued to implement entity-level controls, which are now in accordance with the COSO control framework. This results in a much greater level of confidence in the mitigating controls to compensate for the identified deficiencies. The control deficiencies identified by the Company did not result in adjustments to its consolidated financial statements for 2010. Management's assessment identified the following significant deficiencies along with related remediation:

Entity Level Controls

During the course of 2010, the Company ensured its entity-level controls were maintained in accordance with the COSO control framework. The entity-level controls evolved continuously during the financial year as the Company finished implementing the previously-identified entity-level controls. The Company now regularly reviews and updates policies on a quarterly basis to ensure that they remain relevant and up to date. Amended policies are communicated to appropriate employees of the Company.

In order to mitigate the risks on entity level controls inherent to the continuously changing business, management has maintained the following activities:

- Communication to employees and management of their roles and responsibilities with regard to internal control over financial reporting;
- Production of bi-weekly management reports;
- Weekly management committee meetings;
- Weekly disclosure committee meetings (included in management committee meetings);
- Full-time availability of all policies and procedures to employees, managers, and directors;

- Evaluation of the design of the internal controls and continuous implementation of additional controls to ensure an increased level of confidence;
- Monthly financial statements are established by the corporate controller, and reviewed and analyzed by all vice-presidents and the President and CEO. An analytic review is provided with the financial statements in order to explain variances between actual and budget.
- Quarterly financial statements are reviewed and annual financial statements are audited by external auditors. These statements, along with all related documents, are reviewed by members of the audit committee and approved by the Board of Directors.

In conclusion, the Company implemented a number of controls during the year ended December 31, 2010. To ensure an optimal control environment, the Company will be testing the implemented controls to validate their effectiveness and performance.

Segregation of Duties

The Company had deficient controls within its accounting and finance department relating to segregation of duties inherent to its size. As a result of the limited number of personnel in the accounting and finance department, certain financial personnel had incompatible duties that allowed for the creation, review and processing of certain financial data without independent review and authorization.

To mitigate this risk, ProSep continues to implement improved monitoring systems and other procedures to prevent potential fraud, properly assign roles and responsibilities to employees to maximize segregation of duties within the limited environment, and rely on procedures and controls as described in the previous section (see “Entity level controls”).

It should be noted that some of the deficiencies mentioned above are related to the size of the Company. Management is nevertheless committed to establishing effective internal controls over financial reporting and as such will continue to assess existing controls and implement additional controls as deemed necessary.

13. SELECTED RISKS

Please refer to ProSep’s 2010 Annual Information Form for a complete list of selected risks.



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