



Annual Report

For the Year Ended December 31, 2008

Message to Shareholders

Mahalo Energy Ltd. (“Mahalo” or the “Company”) announces its results for the twelve months ended December 31, 2008.

SUMMARY OF RESULTS	2008	2007
		<i>(Restated)</i>
Financial (\$000's except per share)		
Continuing operations:		
Petroleum and natural gas revenue	37,551	28,569
Operating netback	19,399	15,370
Loss from continuing operations	(13,451)	(204)
Per share - basic & diluted	(0.23)	0.00
Loss from discontinued operations	(53,910)	(3,513)
Per share - basic & diluted	(0.91)	(0.06)
Net loss	(67,361)	(3,717)
Per share - basic & diluted	(1.14)	(0.06)
Funds from continuing operations	11,096	9,960
Per share - basic	0.19	0.17
Funds from discontinued operations	5,445	3,577
Per share - basic	0.09	0.06
Funds from operations	16,541	13,537
Per share - basic	0.28	0.23
Net debt	98,499	53,313
Operational		
Average daily sales volumes (<i>boe</i>)		
Continuing operations	2,147	1,993
Discontinued operations	917	1,105
Total	3,064	3,098
Continuing operations:		
Average selling price (\$/ <i>boe</i>)	47.78	39.27
Operating netback (\$/ <i>boe</i>)	24.69	21.12

(1) Refer to special advisories regarding use of Non-GAAP financial measures and barrel of oil ("*boe*") equivalents.

(2) Restated to reflect "discontinued operations" accounting.

Financial

In 2008, Mahalo committed to dispose of all of its Canadian resource assets. Since the assets encompass Mahalo's entire Canadian business segment or cost centre under full cost accounting, the Company has accounted for these assets as "discontinued operations". Financial information for the prior year has been restated to reflect this change.

The Company generated funds from continuing operations of \$11.1 million on related sales of \$37.6 million in 2008. During this same period, the Company recorded a loss from continuing operations of \$13.5 million. Results of discontinued operations for 2008 include a loss of \$54.6 million on the disposition of Canadian resource assets. The loss was non-cash and did not affect funds from discontinued operations.

Additional information regarding the Company's results of operations and financial condition is included in the Management's Discussion and Analysis attached hereto. The reader is also specifically referred to Note 1 accompanying the audited consolidated financial statements as at December 31, 2008 regarding "basis of presentation and going concern issues".

Operations

Mahalo has seen dramatic changes in its operating environment with the steep drop in North American natural gas prices and significant business and economic uncertainty created by the current global financial crisis.

In looking back, 2008 was a year of dramatic events which would, in turn, have a profound impact on the Company. The early part of 2008 saw Mahalo tighten its focus on its core United States coal bed methane (“CBM”) and shale gas assets, all of which are located in eastern Oklahoma. Mahalo decided to sell its remaining Canadian oil and gas assets and operations, aggressively exploit its US CBM assets and staff a team to pursue development of its potentially significant US shale gas resource.

These decisions were made in an environment of rapidly increasing commodity prices with many oil and gas companies ramping up activity to record or near record levels. At this same time, interest in shale gas was becoming unparalleled with record prices being paid for shale gas mineral rights.

To fund this aggressive plan, Mahalo initiated a formal process to expedite the sale of its Canadian assets; it also entered into a new credit facility at the end of June which provided increased borrowing, albeit with stricter covenants. One such covenant involved the attainment of certain minimum production levels.

While the Company’s aggressive capital spending plan targeting increased CBM production was very successful and achieved expected results on a well by well basis, overall oil and gas production levels did not meet the Company’s targets or that required under the credit facility covenant. As a result, the Company found itself in default of the production and certain other covenants under its credit facility agreement at September 30, 2008.

The inability to achieve the targeted production levels was mainly due to two factors; the rapid decline of certain high volume conventional gas wells in Canada and operational issues with CBM production in the United States. While the individual CBM wells drilled in 2008 performed according to plan, very high ambient temperatures affected gathering and compression performance and the new wells, in some cases, temporarily backed out production from older wells.

The impact on Mahalo’s cash flow was further exacerbated by operational issues with a major interstate gas transmission line that transports gas out of the area of the Company’s US CBM operations. This caused price differentials to increase dramatically, reducing Mahalo’s realized prices and cash flows from affected production for a number of months. Production from the Company’s US CBM assets has, in the interim, stabilized and continues to remain stable.

The second half of 2008 saw a major and rapid collapse in commodity prices and a significant deterioration in global financial markets. These events have taken a significant toll on our industry. The impact to Mahalo of lower commodity prices was mitigated by an aggressive hedging program implemented in July 2008 when commodity prices were close to the highest point of the year. The weakened global economic situation has, however, resulted in restricted access to capital markets and virtually no flexibility as to alternate sources of credit for the Company.

On November 28, 2008, the Company accepted an amendment to its credit facility agreement that waived the previous events of default; the amendment included an additional advance of US \$5.0 million (repayable on March 31, 2009) to meet short-term funding requirements; revised terms, conditions and covenants; and the imposition of an additional loan fee of US \$10 million. The amendment also included a requirement that Mahalo seek a sale of the assets of the Company; a sale or merger of the Company; or a financial restructuring of the Company, including raising new equity. The ultimate loan fee could be reduced by up to US \$5 million, dependent upon the result of such initiatives. Mahalo subsequently engaged a financial advisor to assist in the process.

Outlook

Although the Company did complete the sale of most of its Canadian assets by the latter part of 2008, the prices received were disappointing in comparison to what was expected when commodity prices were at higher levels earlier in the year. In fourth quarter 2008, the Company suspended its capital spending program in an effort to improve its financial situation.

Under the amended credit agreement, the Company was required to have reached the “letter of intent” stage with respect to an asset sale or other corporate/financial restructuring initiative by March 1, 2009; this was not achieved. On March 5, 2009, the Company announced that it had received notice from its lenders that it was in default under

the credit agreement. The lenders also advised that until resolved, future loans would be made in the sole discretion of the lender. To date the lender has not exercised its default-related rights or demanded repayment of the loan.

Although several proposals have resulted from the sale/merger/restructuring process, no proposal has been accepted by Mahalo and there is no reasonable expectation that an acceptable proposal will be received.

Since the Company has been unsuccessful in its attempts to sell its assets and/or achieve a financial restructuring, the US \$10 million fee will become payable on March 31, 2009. The US \$5 million advance is also repayable on this date. The Company does not expect to meet either payment. At this point the Company has limited flexibility and is working with its lenders to determine a course of action.

On behalf of the Board of Directors
"Signed"

James Burns
President and Chief Executive Officer

MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis ("MD&A") of the results of operations and changes in financial condition of Mahalo Energy Ltd. ("Mahalo" or the "Company") should be read in conjunction with the Company's audited consolidated financial statements for the years ended December 31, 2008 and 2007 and the accompanying notes contained therein. This MD&A has been prepared taking into consideration information available up to and including March 31, 2009.

BASIS OF PRESENTATION AND GOING CONCERN ISSUES

The audited consolidated financial statements have been prepared using generally accepted accounting principles (GAAP) on the basis that the Company will be able to discharge its obligations and realize its assets in the normal course of business at the values at which they are carried in the financial statements, and that the Company will be able to continue its business activities. If this assumption is not appropriate, adjustments to the carrying amounts of the assets and liabilities, revenues and expenses and the balance sheet classifications used may be necessary.

In accordance with Canadian GAAP appropriate for a going concern, property and equipment is carried at cost less accumulated amortization and any impairment losses and they are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. There can be no assurance that expected future cash flows will be realized or will be sufficient to recover the carrying amount of property and equipment.

At December 31, 2008, the Company had a working capital deficiency of \$91.9 million and an accumulated deficit of \$121.2 million. The Company's ability to continue as a going concern is dependent upon its ability to achieve profitable operations, obtain waivers or amendments relative to defaults, obtain the necessary financing to meet its obligations, repay its liabilities arising from normal business operations when they become due, successfully raise capital and receive the continued financial support from its Lenders. However, significant conditions and events exist that cast doubt on the validity of this assumption.

At September 30, 2008, the Company was in breach of certain covenants under its bank credit facility agreement with Ableco Finance LLC ("Ableco" or the "Lender"); the breaches constituted "Events of Default". In November 2008, the Company signed an amended credit facility agreement that included a waiver of the previous Events of Default and provided for an additional advance of US \$5 million that is repayable on March 31, 2009. The amendment also requires the Company to pay a loan fee of between US \$5 million and US \$10 million on March 31, 2009, dependent upon achieving certain restructuring and/or refinancing initiatives. In conjunction therewith, the Company engaged GMP Securities L.P. to assist in seeking a sale of the assets of the Company, a sale or merger of the Company or a financial restructuring of the Company, including raising new equity.

The Company is in default under its bank credit facility. As announced on March 5, 2008, Mahalo received a reservation of rights letter from its Lender notifying the Company that it is in default under its loan agreement for failure to comply with certain covenants. As a result of the default, the Lender advised Mahalo that until resolved, future loans would be made in the sole discretion of the lender. To date, the Lender has not exercised its default-related rights or demanded repayment of the loan.

If the Lender were to call the debt, the Company would require an alternate credit facility and/or additional capital to discharge its obligations and continue its activities. The outcome of these matters is dependent on factors outside of the Company's control. Under current conditions, there can be no assurance that the Company has sufficient assets or will be able to raise sufficient capital to make a full repayment to its Lenders if such an event were to occur. In addition, any financial restructuring plan ultimately agreed on by Mahalo and its Lenders may involve bankruptcy or similar filings by Mahalo and/or its subsidiary, Mahalo Energy (USA) Inc.

Although several proposals have resulted from the GMP Securities L.P. led asset sale/merger/restructuring process, no proposal was satisfactory to Mahalo or its lenders and there is no reasonable expectation that an acceptable proposal will be received.

The Company does not expect to be in a position to repay the additional advance of US \$5 million and pay the loan fee, currently estimated at US \$10 million, both of which are due on March 31, 2009. The Company is currently working with its lenders to rectify this issue. If an acceptable solution is not achieved and the debt is called, the Company will require additional capital to continue its activities and discharge its obligations. The outcome of these matters is dependant on factors outside of the Company's control. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

READER GUIDANCE

The reader is advised that this MD&A contains forward-looking information and statements, refers to and discusses certain non-GAAP financial measures, aggregates certain oil and gas information in terms of barrels of oil equivalent and summarizes certain information contained in the Netherland, Sewell and Associates, Inc. reserves report effective as at December 31, 2008. The reader is specifically referred to and encouraged to read the section entitled "Special Cautionary Advisories" concerning "Forward-looking statements", "Non-GAAP financial measures", "Barrel of oil equivalent volumetric measures" and "Reserves information" at the end of this MD&A.

The financial data presented in this MD&A has been prepared in accordance with Canadian GAAP, unless otherwise indicated. Unless otherwise noted, production, sales and reserves volumes referred to in this MD&A reflect the Company's working interest before deduction of royalties paid to others. The reporting and measurement currency is the Canadian dollar, unless otherwise specified. References to "US\$" are to United States dollars. Certain columns in tables may not add due to rounding.

Readers should be aware that historical results are not necessarily indicative of future performance. Additional information relating to the Company, including the Company's Information Circular and Annual Information Form ("AIF"), is available on the System for Electronic Document Analysis and Retrieval ("SEDAR") at www.sedar.com or from the Company's web-site at www.mahaloenergy.com.

PRIMARY BUSINESS

Mahalo Energy Ltd. was incorporated on April 21, 2004 under the *Business Corporations Act (Alberta)*. On July 29, 2005, Mahalo completed its initial public offering and began trading its common shares through the facilities of The Toronto Stock Exchange (TSX) under the trading symbol "CBM". The Company's head office is in Calgary, Alberta, Canada.

At December 31, 2008, Mahalo had one wholly-owned subsidiary, Mahalo Energy (USA) Inc., a company incorporated under the laws of Delaware. Unless the context otherwise requires, references herein to "Mahalo" or the "Company" include Mahalo Energy Ltd. and Mahalo Energy (USA) Inc.

Mahalo is focused on acquisition, exploration, development and production of unconventional natural gas, principally coalbed methane ("CBM") and shale gas in the Arkoma Basin in the state of Oklahoma, U.S.A.

In 2008, Mahalo committed to dispose of its Canadian resource assets with an agent being engaged to facilitate the process. The majority of the Canadian resource assets were sold by December 31, 2008; as of the date of this MD&A, a small number of minor properties remain to be disposed of. Since the assets encompass the entire Canadian business segment or cost centre under full cost accounting, the Company has accounted for these assets as "discontinued operations". This has resulted in various changes to how financial information is presented. Assets and liabilities held for sale are segregated on the consolidated balance sheet. The net loss and funds from the operation of the Canadian resource assets are segregated and reported as being from "discontinued operations" on the consolidated statements of operations and consolidated statements of cash flows and throughout this MD&A. Results for comparative periods have been "restated" to conform to current period presentation; any reference within this MD&A to amounts being "restated" refers to "discontinued operations" accounting.

OVERVIEW

Inception to December 31, 2008

The Company has actively pursued growth in unconventional resource assets, production and reserves through farm-ins, corporate and property acquisitions and exploration and development activity in the United States and Canada. In 2006, the Company added Canadian conventional oil and gas assets, production and reserves.

The Company's United States CBM program benefitted from the introduction of multi-lateral horizontal wells to more rapidly and efficiently desorb and dewater the coal. Mahalo also continued to work diligently along side other United States exploration and development companies to further develop, test and prove various concepts related to successful exploitation of the Woodford and Caney shale. In addition to conducting 3D seismic, the Company drilled a number of vertical and horizontal shale wells and continued to assess the potential of this higher risk/higher reward resource.

Although having applied similar horizontal drilling and other techniques in Canada, Mahalo determined that targeted Mannville coals possess significantly different characteristics than United States Hartshorne coals; as a result, in 2006, the Company shifted its Canadian unconventional focus towards research and development on one CBM property. On the conventional oil and gas front, the Company continued to conduct selective exploration and development on certain of the properties while actively pursuing the sale of others; sales proceeds were directed principally towards unconventional resource activity and reduction of bank debt.

Although Mahalo did experience some success in further developing its Canadian unconventional and conventional oil and gas interests, a majority of its success was still coming from within its United States Hartshorne CBM development program. In addition, the Company's US prospect inventory still included a significant number of Hartshorne CBM drilling locations and a number of shale prospects which deserved funding priority. In 2008, Mahalo decided to monetize its Canadian oil and gas property interests and apply proceeds to reduce debt.

During the first half of 2008, North American oil and gas prices were reaching for new highs, fuelling renewed optimism within the industry. At this same time, the Company was confident that with the sale of its Canadian operations, operational and financial flexibility should increase to better allow the Company to focus on its United States Hartshorne CBM and Woodford and Caney Shale assets and opportunities. In conjunction therewith, the Company added a number of key individuals to lead and further strengthen the team in its Tulsa, Oklahoma office.

On June 30, 2008, the Company closed a new, four year US \$105 million credit facility (the "Facility") with Ableco Finance LLC, (together with participating lenders referred to as "Ableco"), replacing a Cdn \$75 million facility which was due to expire in early 2009. The Facility included a US \$65 million revolving credit facility (with an initial borrowing base set at US \$50 million), a US \$25 million term facility (fully funded at closing), and a US \$15 million delay draw term facility (for future acquisitions and capital expenditures, subject to the satisfaction of certain pre-conditions).

By early July, the price for West Texas Intermediate (WTI) crude oil on NYMEX had reached US \$147 per barrel while natural gas prices as measured by the NYMEX Henry Hub were over US \$13 per Mcf. With the significant improvement in commodity prices, the Company elected to accelerate its remaining 2008 CBM drilling program and the re-entering of certain existing CBM wells to add horizontal laterals.

The optimism driven by the significant and rapid improvement in commodity prices was, unfortunately, short-lived. World financial markets began to reflect significant weakness in second half 2008; commodity prices retreated as well. By the end of the third quarter, WTI crude oil had declined to US \$100 per barrel and Henry Hub natural gas was back around US \$7.00 per Mcf. Many companies, including Mahalo, began to re-assess their capital spending activity levels. By year-end 2008, the world-wide financial crisis had escalated; the aforementioned oil and gas reference prices were down to US \$44.60 per barrel for crude oil and US \$5.62 per Mcf for natural gas. Crude oil and natural gas prices continued to retreat to even lower levels and reflect increased volatility and economic uncertainty following the year-end.

Although the Company's 2008 CBM drilling program was successful, production from a number of existing wells did not hold up as expected. Production levels that were anticipated and committed to during earlier credit facility negotiations were not achieved. The lower than anticipated production also affected the Company's cash flows. As a result, the Company breached certain of its September 30, 2008 covenants under its bank credit facility agreement; the breaches constituted "Events of Default".

Effective November 28, 2008, the Company reached an agreement with the Lenders to amend the Facility (the "Facility Amendment") resulting in a waiver of the Events of Default. The Facility Amendment included new minimum production and hedging requirements and revised current ratio covenants for the period October 31, 2008 through December 31, 2009. The Company also agreed to engage an advisor to assist with financial and accounting matters.

Under the Facility Amendment, an additional US \$5.0 million revolving loan advance was made to the Company to meet ongoing cash requirements. The advance is short term and repayable on March 31, 2009. The Facility Amendment also required the Company to pay a Loan Fee of between US \$5.0 million and US \$10.0 million, dependent upon achieving certain specific restructuring and/or refinancing initiatives by March 31, 2009; the ultimate fee is payable on March 31, 2009. Additional information regarding the Facility Amendment is available at www.sedar.com and elsewhere in this MD&A.

Subsequent to the completing the Facility Amendment, Mahalo engaged GMP Securities L.P. to assist in seeking a sale of the assets of the Company, a sale or merger of the Company or a financial restructuring of the Company including raising new equity.

Effective December 1, 2008, the Company adopted the US dollar as its functional currency. Prior to December 1, 2008, the functional currency of the Company was the Canadian dollar. The change in functional currency of the Company is due to the increased exposure to the US dollar as a result of discontinuing Canadian operations.

At December 31, 2008, the Company had a working capital deficit of \$91.9 million, including \$75.1 million (US \$61.3 million) of loans outstanding under the Ableco credit facility. In addition, the Company has accrued an estimated liability of \$12.2 million (US \$10.0 million) related to the Ableco Loan Fee. At December 31, 2008, the Company was in compliance with respect to all covenants under the amended facility agreement.

As a result of a covenant breach which occurred on March 1, 2009, the Ableco bank debt has been classified as a current liability at December 31, 2008.

During December 2008, production of natural gas from continuing operations was approximately 2,280 boe per day. The Company's interest in proved and probable oil and gas reserves, before deduction of royalties, as at December 31, 2008, based on an independent engineering report prepared by Netherland, Sewell and Associates, Inc., amounted to 11.7 million boe of unconventional natural gas in the United States. A majority of the Company's Canadian resource properties were sold in 2008 with only minor properties remaining for sale at December 31, 2008. Additional information regarding estimated oil and gas reserves is included in the Company's Annual Information Form which is available at www.sedar.com.

Subsequent to December 31, 2008

On March 5, 2009, Mahalo announced that it had received proposals from several qualified parties as a result of the process to seek strategic or refinancing alternatives. On the same date, Mahalo announced that it had received a reservation of rights letter from the Lenders notifying the Company that it is in default under its loan agreement for failure to comply with certain covenants relating to obtaining a letter of intent ("LOI") for the sale or recapitalization of the Company by March 1, 2009. As a result of the default, the Lenders advised Mahalo that until resolved, future loans would be made in the sole discretion of the lender. To date, the Lender has not exercised its default-related rights or demanded repayment of the loan.

Additional information regarding these matters is included under "basis of presentation and going concern issues", "outlook", and elsewhere in this MD&A.

RESULTS OF OPERATIONS

Selected Financial Information	2008	2007	2006
		<i>(Restated)</i>	<i>(Restated)</i>
<i>(\$000's except share and per share)</i>			
Continuing operations:			
Petroleum and natural gas revenue	37,551	28,569	27,932
Operating netback	19,399	15,370	15,556
Gain on derivative natural gas contracts	10,856	-	-
Foreign exchange loss (gain)	16,944	(3,416)	1,480
Future income tax expense (recovery)	3,237	(759)	950
Loss from continuing operations	(13,451)	(204)	(4,082)
Per share - basic & diluted	(0.23)	0.00	(0.08)
Loss from discontinued operations	(53,910)	(3,513)	(44,485)
Per share - basic & diluted	(0.91)	(0.06)	(0.86)
Net loss	(67,361)	(3,717)	(48,567)
Per share - basic & diluted	(1.14)	(0.06)	(0.94)
Funds from continuing operations	11,096	9,960	9,804
Per share - basic	0.19	0.17	0.19
Funds from discontinued operations	5,445	3,577	3,089
Per share - basic	0.09	0.06	0.06
Funds from operations	16,541	13,537	12,893
Per share - basic	0.28	0.23	0.25
Total assets	183,857	193,647	199,614
Net debt	98,499	53,313	52,804
Shareholders' equity	61,394	115,249	116,763
Common shares (000's)	59,298	59,298	58,386
Weighted average - basic and diluted	59,298	59,243	51,980

A number of major factors affected the comparability of results from continuing operations when comparing 2008 with 2007. In 2008, the Company generated an additional \$4.0 million in operating netback on petroleum and natural gas sales and recorded \$10.9 million of gains on derivative natural gas contracts. These items were more than offset by a significant negative shift in foreign exchange and higher future income tax expense.

Funds from continuing operations in 2008 remained relatively unchanged when compared with 2007. Virtually all of the gains on derivative natural gas contracts and the loss on foreign exchange in 2008 were unrealized at the year end. Future income tax expense does not impact funds from operations.

The major factors resulting in the improvement in earnings from continuing operations when comparing 2007 with 2006 were a positive shift in foreign exchange and in future income taxes in the 2007 year. Funds from continuing operations were relatively unchanged during the two periods.

The loss from discontinued operations of \$53.9 million in 2008 included losses on disposition of Canadian property and equipment of \$54.6 million; the loss from discontinued operations of \$44.5 million in 2006 included write downs of goodwill of \$12.7 million and Canadian property and equipment of \$36.3 million. The loss on disposition and the write-downs were non-cash in nature and did not impact the computation of funds from discontinued operations.

Petroleum and natural gas revenue

	2008	2007
		<i>(Restated)</i>
Average daily sales volumes (boe)		
Continuing operations	2,147	1,993
Discontinued operations	917	1,105
	3,064	3,098
Continuing operations:		
Petroleum and natural gas revenue (\$000s)	37,551	28,569
Average realized selling price (\$/Mcf)	7.96	6.55
Average realized selling price (\$/boe)	47.78	39.27

The Company's petroleum and natural gas sales volumes and revenues from continuing operations consist solely of natural gas produced and sold from properties in Oklahoma; the gas is delivered for sale into the Oklahoma Gas Transmission and Centre Point East pipeline system. Sales revenues grew by approximately 31 per cent to \$37.6 million in 2008 from \$28.6 million in 2007. The \$9.0 million increase was driven primarily by realized sales prices which were 24 per cent higher in 2008, contributing an additional \$7.3 million to sales revenue; sales volumes (on a boe basis) increased by 6 per cent in 2008, providing a positive volume variance of \$1.7 million to revenues.

The average natural gas price in 2008, as measured by the NYMEX Henry Hub, was 25 per cent above 2007. In the first half of 2008, world crude oil prices reached levels never seen before. During this same period, North American natural gas prices strengthened considerably, approaching a two year high around mid-year. Factors included a reduction in natural gas storage levels from record highs entering the previous winter heating season, and a general resurgence in various commodity prices. In second half 2008, crude oil prices weakened dramatically; natural gas prices also dropped.

In compliance with its credit facility entered into mid-year 2008, Mahalo sold a substantial portion of its natural gas under fixed price physical forward contracts in the latter half of 2008; this helped to reduce the impact of market volatility, resulting in an average realized natural gas sales price of \$7.96 per Mcf in 2008 compared with \$6.55 per Mcf in 2007.

Although the Company utilizes financial derivative instruments from time to time to protect its cash flow, related gains or losses do not impact the reported average sales price; gains and losses from financial instruments are reflected separately on the consolidated statements of operations.

North American natural gas prices reflected a further decline during first quarter 2009 and are expected to remain volatile and unpredictable as markets react rapidly to news events, weather forecasts and natural gas inventory reports. Mahalo will continue to take measures to protect its cash flow from commodity price volatility, principally by entering into fixed price physical sales contracts and hedging arrangements when considered prudent.

Royalty expense

Royalties are paid to government entities and other land and mineral rights owners. Oklahoma government royalty assessments are generally based on the price realized for the underlying petroleum product.

	2008	2007
		<i>(Restated)</i>
Continuing operations:		
Royalty expense (\$000s)	9,457	7,043
Royalty expense (\$/boe)	12.03	9.68
Royalty expense (% of revenue)	25%	25%

Operating expense

Operating expense includes various costs, the most significant of which are contractor labour, compression, chemicals and treating supplies, water disposal, equipment rental, minor well workovers and operator overhead.

	2008	2007
		<i>(Restated)</i>
Continuing operations:		
Operating expense (\$000s)	6,409	4,442
Operating expense (\$/boe)	8.15	6.11

Operating expense and per unit operating costs from continuing operations were higher in the current year as a result of additional contract labour and supervision, consulting services and compression costs along with increased costs for these services.

Transportation expense

Transportation expense includes costs to move saleable oil and gas from the crude oil wellhead or natural gas plant outlet to its ultimate point of sale.

	2008	2007
		<i>(Restated)</i>
Continuing operations:		
Transportation expense (\$000s)	2,286	1,714
Transportation expense (\$/boe)	2.91	2.36

Operating netback

Operating netback is a measure of net oil and gas revenue commonly used in the oil and gas industry. The Company uses this non-GAAP measure, in conjunction with a barrel of oil equivalent volumetric measure, to aggregate oil and gas volumes and assess comparability of petroleum sales and related costs between periods. The Company cautions that operating netback should not be considered as an alternative to, or more meaningful than net earnings or cash from operating activities as determined in accordance with Canadian GAAP, as an indicator of the Company's performance or liquidity. Additional information regarding non-GAAP financial measures and other advisories are set out at the end of this MD&A.

The following table reflects natural gas sales volumes and the components of operating netback from continuing operations for 2008 and 2007.

	2008	\$/boe	2007	\$/boe
			<i>(Restated)</i>	<i>(Restated)</i>
Continuing operations:				
Average daily sales volume (boe)	2,147		1,993	
<i>(\$000s, except \$/boe)</i>				
Petroleum and natural gas revenue	37,551	47.78	28,569	39.27
Royalties	9,457	12.03	7,043	9.68
Operating and transportation	8,695	11.06	6,156	8.47
Operating netback	19,399	24.69	15,370	21.12

Operating netback from continuing operations increased by \$4.0 million or \$3.57 per boe when comparing 2008 with 2007. The increase included a positive sales price variance of \$6.7 million and a positive volume variance of \$1.2 million. The benefit of the higher sales price and volumes and was partially offset by the effects of a higher per unit royalty cost and a higher per unit operating and transportation cost, which, in turn, reduced operating netback by \$1.8 million and \$2.1 million, respectively in 2008.

Gain on derivative natural gas contracts

During 2008, the Company entered into a contract to purchase 2,000 GJ of natural gas per day at Cdn \$7.80 per GJ to offset an existing physical fixed price contract to sell 2,000 GJ per day at Cdn \$7.43 per GJ. The term of the offsetting arrangement was September 1, 2008 to December 31, 2008. The arrangement resulted in a loss of approximately \$90,000.

At December 31, 2008, the Company recorded an unrealized mark-to-market gain of \$6.8 million relating to a participating natural gas swap contract covering the period July 1, 2009 to May 31, 2010. Under this swap arrangement, the Company will receive a floor price of US \$10 per Mmbtu for 5,000 Mmbtu of natural gas per day and 31 per cent of the price in excess of US \$10 per Mmbtu. In addition, the Company had a number of other derivative natural gas contracts outstanding at December 31, 2008 which reflect an unrealized net mark-to-market gain of \$3.9 million.

General and administrative expense

General and administrative expense from continuing operations amounted to \$5.2 million in 2008 compared with \$4.6 million in 2007. In 2008, the Company incurred additional costs to strengthen the management team in the Company's Tulsa, Oklahoma office.

Stock-based compensation expense

Stock-based compensation reflects the amortization of the aggregate fair value of stock options over their related vesting period. The amount is primarily determined by the number of options granted, the vesting period and the estimated fair value of the options.

In 2008, stock-based compensation amounted to \$1.7 million (2007 - \$2.1 million) of which \$0.2 million (2007 - \$0.2 million) was capitalized as costs related to discontinued operations and \$1.5 million (2007 - \$1.9 million) was reflected as an expense related to continuing operations. During 2008, the Company granted 912,000 (2007 - 757,000) stock options.

Foreign exchange gains and losses

Shifts in currency rates result in foreign exchange gains and losses when account balances in a currency other than the reporting currency are settled during the period or translated at the period end. A significant portion of the Company's monetary assets and liabilities and revenues and expenses are denominated in United States dollars; they are translated to Canadian dollars for financial reporting purposes.

During 2008, the Company recorded a net foreign exchange loss from continuing operations of \$16.9 million of which \$16.6 million was unrealized at December 31, 2008. The majority of the unrealized loss results from translation of the Company's long term debt which is denominated in US dollars. The Canadian/US dollar exchange rate declined to \$0.8080 at December 31, 2008 from \$1.009 at December 31, 2007. A majority of the decline occurred in the October/November 2008 period.

On December 1, 2008 the Company evaluated its changed economic circumstances, in particular its disposal of substantially all of its Canadian operations and its use of exclusively US dollar debt financing, and concluded that the US dollar is the most appropriate functional currency for all of its operations. Prior to December 1, 2008, the Company's functional currency was the Canadian dollar. The Company has retained the Canadian dollar as its reporting currency.

As a result at December 1, 2008 the Company's non-monetary assets and liabilities were re-measured at the spot US dollar to Canadian dollar exchange rate. The change in functional currency increased comprehensive income by \$11.8 million and resulted mainly from translation of property and equipment balances.

In 2007, the Company recorded a net foreign exchange gain from continuing operations of \$3.4 million of which \$1.9 million was unrealized at December 31, 2007. During this period, Mahalo elected to convert \$37.8 million of U.S. dollar denominated bank debt to a Canadian dollar obligation and repaid \$6.9 million of U.S. dollar denominated bank debt; these transactions resulting in realized foreign exchange gains aggregating \$1.5 million.

Interest and financing expense

On June 30, 2008, the Company replaced a Cdn \$75.0 million Union Bank of California credit facility with a US \$105 million four year, committed revolving and term loan facility with Ableco Finance LLC (together with participating lenders referred to as "Ableco"). The Union Bank facility was due to expire in early 2009. Fees and other costs of approximately \$3.4 million were paid to Ableco to establish the new facility; such costs are being deferred and amortized to interest and financing expense from continuing operations over the term of the credit facility.

In November 2008, the Ableco credit facility was amended. The amendment requires the Company to pay a Loan Fee of between US \$5.0 million and US \$10.0 million on March 31, 2009; the amount of the fee is dependent upon Mahalo achieving certain specific restructuring and/or refinancing initiatives by March 31, 2009. The Company has recognized an estimated liability of \$12.2 million (US \$10.0 million) related to the Loan Fee in its accounts payable and accrued liabilities at December 31, 2008; the amount is being deferred and amortized to interest and financing expense over the expected remaining term of the credit facility.

Interest and financing expense relating to continuing operations amounted to \$4.7 million in 2008 compared with \$2.3 million in 2007. The weighted average effective interest rate on borrowings outstanding under the Facility at December 31, 2008 was 9.53 per cent (2007 – 7.40 per cent). A majority of the change in interest and financing expense resulted from a higher level of borrowings and increased fees on refinancing during the 2008 period. No interest and financing expense was capitalized during the periods under comparison.

Depletion, depreciation and accretion expense

Depletion, depreciation and accretion expense from continuing operations is reflected in the following table.

	2008	2007
<i>(\$000s, except per boe)</i>		<i>(Restated)</i>
Continuing operations:		
Depletion and depreciation expense	12,142	10,941
Accretion expense	82	72
Depletion, depreciation and accretion expense	12,224	11,013
Depletion and depreciation <i>(\$/boe)</i>	15.45	15.04

Depletion and depreciation expense is computed on a unit of production basis. Such expense, on a boe basis, fluctuates primarily as a result of changes in the underlying proved reserves base and in the amount of costs subject to depletion and depreciation.

The Company records an asset retirement obligation which reflects the present value of the estimated clean-up and restoration costs of wells, well sites, gathering lines and processing facilities at the time they are acquired or constructed and put into use. The liability is also adjusted when properties and related asset retirement obligations are disposed of. The asset retirement liability is increased each reporting period due to the passage of time and the related amount, referred to as "accretion", is charged to earnings in the period. The Company's asset retirement obligation related to continuing operations amounted to \$1.4 million and \$0.9 million at December 31, 2008 and 2007, respectively. Asset retirement obligations related to assets held for sale amounted to \$1.8 million and \$3.2 million at December 31, 2008 and 2007, respectively.

Future income taxes

Future income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes (book value) and the amounts used for income tax purposes (tax basis). Future income tax assets, which result when the tax basis of assets exceed the book basis, are only recognized to the extent that their realization is considered more likely than not based upon projections of operating results and tax planning strategies available to the Company.

During 2008, the Company recorded future United States income tax expense of \$3.2 million compared with a future United States income tax recovery of \$0.8 million in 2007. During these same periods, the Company recorded pre-tax losses from continuing operations of \$10.2 million and \$0.9 million, respectively. Although all of the Company's continuing resource operations are physically located in the United States, the computation of results from continuing operations include items such as certain general and administrative expenses, stock-based compensation expense and foreign exchange gains and losses incurred in Canada. Such latter items did not impact the calculation of future income taxes.

In Canada, the Company had an income tax asset of \$16.7 million (2007 - \$3.0 million) at December 31, 2008 that was fully offset by a valuation allowance. The Company has Canadian non-capital loss carry-forwards of \$26.8 million (2007 - \$18.4 million); approximately 20 per cent of the losses expire in 2015; the balance expire in the 2026 and 2027 periods.

At December 31, 2008, the Company had a future United States income tax liability of \$6.0 million (2007 - \$2.1 million). Non-capital loss carry-forwards in the United States were US \$53.2 million (2007- US \$30.6 million); they expire in the 2025 to 2028 period.

LIQUIDITY AND CAPITAL RESOURCES

The Company's strategy has been to focus on resource projects that offer the greatest opportunity to maximize funds flow generation and shareholder value. The Company's capital resources consist primarily of funds from operations, existing credit facilities and access to debt and capital markets. In addition, the Company has realized cash proceeds from the sale of certain non-core oil and gas assets in its on-going rationalization of its resource asset base and more recently, as a result of its decision to dispose of its Canadian resource assets.

Funds from operations, which represent net earnings adjusted for non-cash items, is a non-GAAP measure used by Mahalo to assess its operating results and its ability to generate funds to finance future capital investment and service debt. The Company considers net income (loss) and cash provided by operating activities to be the most directly comparable GAAP measures to the non-GAAP measure, funds from operations.

The following table illustrates the relationship between these measures. The table also reflects cash provided by (used in) operating, financing and investing activities and the aggregate change in cash during the respective periods.

	2008	2007
<i>(\$ 000s)</i>		<i>(Restated)</i>
Net loss from continuing operations	(13,451)	(204)
Net loss from discontinued operations	(53,910)	(3,513)
Net loss	(67,361)	(3,717)
Non-cash items	83,902	17,254
Funds from operations	16,541	13,537
Change in non-cash working capital related to operating activities	3,548	336
Cash provided by operating activities	20,089	13,873
Cash provided by financing activities	6,402	1,932
Cash used in investing activities	(28,391)	(13,119)
Increase (decrease) in cash	(1,900)	2,686

Cash provided by operating activities takes into account earnings adjusted for non-cash items, and includes a further adjustment for the change in operating-related, non-cash working capital that occurred during the respective periods. The majority of the change in non-cash working capital relating to operating activities involved shifts in accounts receivable and accounts payable and the timing of cash receipts and payments.

Operating activities

The Company generated funds from continuing operations of \$11.0 million and \$10.0 million in 2008 and 2007, respectively. The major factors that accounted for the change in funds from continuing operations between these two periods were as follows:

<i>(\$ 000s)</i>		
Funds from continuing operations in 2007		9,960
Change during 2008 as a result of:		
Higher operating netback		
Higher sales volumes	1,236	
Higher per unit realized sales prices	6,684	
Higher per unit royalties expense	(1,847)	
Higher per unit operating and transportation expense	(2,042)	4,031
Higher general and administrative expense		(634)
Higher interest and financing costs		(1,775)
Higher realized foreign exchange loss		(750)
Other		264
Funds from continuing operations in 2008		11,096

Management believes that funds from operations represent a useful measure to assess its operating results and its ability to finance operations and service debt. Management refers the reader to a special advisory at the end of this MD&A which discusses the calculation of and use of this and other non-GAAP financial measures in more detail.

Financing activities

On June 30, 2008, the Company replaced its \$75 million Union Bank credit facility with a new US \$105 million credit facility (the "Facility") with Ableco Finance LLC (the "Lender"). The Facility is a four year committed facility comprised of a US \$65 million revolving loan (with an initial borrowing base set at US \$50 million), a US \$25 million term loan (fully funded at closing) and a US \$15 million delay draw loan (for future acquisitions and capital expenditures, subject to the satisfaction of certain pre-conditions). All borrowings under the Facility are denominated in US dollars.

The Facility is secured by a first floating charge on the Company's Canadian assets and a first lien on its United States assets. Included in the terms and conditions are requirements to meet certain financial covenants and ratios, to

achieve specified monthly minimum production levels and to maintain contracts to fix the price on a specified minimum percentage of projected sales volumes. The Company paid fees and expenses to the Lender of approximately US \$3.4 million to establish the Facility; such costs are being deferred and amortized over the life of the Facility.

Under the initial Facility, the revolving loan bore interest at the Lender's Base Rate or Lender's Base Eurodollar Rate (with effective floors of 5.25 to 5.75 per cent for the Base Rate and 3.00 to 3.50 per cent for the Base Eurodollar Rate) plus a margin spread of 1.75 to 2.75 per cent per annum while the term loan and the delay draw loan bore interest at a margin spread of 7.50 to 9.50 per cent per annum. The percentage margin spread was, in each case, dependent upon Mahalo's choice of utilizing a Base Rate or Eurodollar Rate borrowing option and, with respect to the term loan and delay draw loans, was also dependent upon the Company's asset coverage ratio.

As at September 30, 2008, the Company was in breach of certain covenants; the breaches constituted "Events of Default". Effective November 28, 2008, the Company reached an agreement with the Lender to amend the Facility (the "Amendment") resulting in a waiver of the Events of Default. The Amendment included new production, hedging and current ratio covenants for the period October 31, 2008 through December 31, 2009. The margin spread on certain of the borrowings was increased between 1.00 and 3.00 per cent.

An additional US \$5 million short-term, revolving loan advance was made to the Company upon signing of the Amendment to meet ongoing cash requirements. The advance bears interest at a margin spread of 12.50 per cent (under both the Base Rate and Base Eurodollar Rate borrowing options) and is repayable on March 31, 2009. The Company also agreed to engage an advisor to assist with financial and accounting matters.

In addition, the Company will be required to pay certain additional loan fees, the amount of which is dependent on achievement of specific steps to restructure and/or re-finance the Company. More specifically, under the terms of the amendment; Mahalo must pay the Lender a "Loan Fee" of US \$10.0 million on March 31, 2009, subject to reduction in certain events. If, on or before March 31, 2009, the Company: (i) is able to sell its United States assets, the Loan Fee will be reduced to US \$5.0 million; (ii) is able to raise a minimum of US \$11.0 million through an equity or subordinated debt offering, the Loan Fee will be reduced to US \$6.0 million; or (iii) is able to raise a minimum of US \$15.0 million, through an equity or subordinated debt offering, the Loan Fee will be reduced to US \$5.0 million. In addition the Company must dispose of its remaining Canadian assets on or before March 31, 2009; otherwise the amounts required to be raised in the financings referred to in (ii) and (iii) above increase to US \$14.2 million and US \$18.2 million, respectively.

As at December 31, 2008, US \$39.9 million (Cdn \$48.9 million) was drawn on the revolver loan and US \$21.4 million (Cdn \$26.2 million) was drawn on the term loan. At December 31, 2008, irrevocable standby letters of credit were issued for a total of Cdn \$145,000 and US \$20,000 (2007 - Cdn \$125,000 and US \$20,000). These letters of credit reduce the amount available under the facility.

The average effective interest rate on borrowings outstanding under the Facility at December 31, 2008 was 9.53 per cent. Of the revolver loan, US \$5.0 million (Cdn \$6.1 million) is repayable on March 31, 2009. The Company has recorded an accrued liability of US \$10.0 million (Cdn \$12.2 million) as at December 31, 2008, being the estimated Loan Fee payable on March 31, 2009.

At December 31, 2008 and as at the date of this MD&A, the Company had 59,298,035 common shares, 1,440,000 common share purchase warrants and 292,800 performance warrants issued and outstanding. Contributed surplus at December 31, 2008 amounted to \$9.8 million, reflective of aggregate stock-based compensation costs incurred since inception of the Company in 2004.

Dividends

The Company has not declared or paid any dividends on its outstanding common shares. Any decision to pay dividends will be made by the Board of Directors on the basis of the Company's earnings, financial requirements

and other conditions existing at the time. At present, the Company does not anticipate declaring and paying dividends in the near future.

Investing activities

The Company has since its inception expanded its oil and gas asset and production base through farm-ins, corporate and property acquisitions and exploration and development activity. During 2008, Mahalo committed to dispose of its Canadian resource assets with an agent being engaged to facilitate the process. Since the assets to be sold encompass the entire Canadian business segment or cost centre under full cost accounting, the cost center has been accounted for as a “discontinued operation” as required under Canadian GAAP. A majority of the assets were sold by December 31, 2008. The Company has determined that there is a significant probability that the remaining assets held for sale will be sold within the next year.

The following table reflects cash expenditures on property and equipment (net of proceeds from dispositions) for continuing and discontinued operations during the periods under comparison.

	2008	2007
(\$000s)		<i>(Restated)</i>
Continuing operations:		
Land and seismic	6,901	5,405
Drilling and completions	27,022	21,061
Facilities and equipment	8,203	1,453
Property divestures	-	(8,335)
	42,126	19,584
Discontinued operations	(11,994)	(5,738)
Cash expenditures on property and equipment, net	30,132	13,846

The Company did not dispose of any of its United States resource assets in 2008. In 2007, it sold approximately 6,700 net acres of oil, gas and deep mineral rights below the base of the Hartshorne formation in its Island, Oklahoma property. In Canada, the Company realized proceeds of \$18.7 million and \$22.4 million in 2008 and 2007, respectively, from the sale of resource assets.

At March 31, 2009, the Company had approximately US \$8.3 million of mechanics liens filed against several of its properties.

Contractual obligations

As at the date of this MD&A, the Company has committed to certain payments as follows:

Years ended December 31,	2009	2010	2011	2012	2013	Total
(\$000s)						
Office lease	639	668	529	105	44	1,985
Equipment usage	73	2,376	-	-	-	2,449
	712	3,044	529	105	44	4,434

The equipment usage obligation results from a drilling rig lease contract with a drilling company entered into on January 27, 2006. The terms of the contract include a commitment to utilize a specific drilling rig for a minimum of 250 days per year for three years, with the contract taking effect upon release of the rig to Mahalo in 2007. The terms of the agreement specify that the Company is obligated to pay a minimum standby rate of \$9,504 per day.

The Company attempts to minimize the impact of natural gas price volatility by entering into physical fixed price sales contracts and derivative natural gas contracts for at least 80 per cent of expected daily sales volumes, as required by the Company’s credit facility agreement.

The physical fixed price sales contracts had an estimated fair value of \$8.9 million at December 31, 2008. The fair value for these contracts was provided by the financial intermediary with whom the transactions were completed; they were tested by the Company for reasonableness based on comparing current market price and the fixed price of the contracts. Because of the nature of the sales contracts, the related fair value is not reflected in the accounts of the Company at December 31, 2008 in accordance with GAAP.

The following is a summary of the commodity physical fixed price sale commitments outstanding at December 31, 2008.

Transaction	Daily Volume (MMBtu)	Contract Price	Term
Sell	1,500	US \$7.185/Mmbtu	February 2008 - January 2009
Sell	3,000	US \$10.22/MMbtu	November 2008 - June 2009
Sell	2,750	US \$10.35/MMbtu	November 2008 - June 2009
Sell	1,000	US \$10.26/MMbtu	November 2008 - July 2009
Sell	2,000	Pan Index + US \$0.01/MMbtu	January 2009 - June 2009
Sell	5,000	Pan Index + US \$0.05/MMbtu	July 2009 - May 2010
Sell	3,000	Pan Index + US \$0.01/MMbtu	January 2009 - December 2009
Sell	2,000	Pan Index Flat	July 2009 - December 2009

At the date of this MD&A, the Company had the following derivative natural gas contracts outstanding.

Transaction	Daily Volume (MMBtu)	Contract Price	Term	Mark to Market (\$000's)
Sell - NYMEX Financial Fixed	5,000	US \$7.44/MMbtu	January 2009 - December 2009	2,955
Sell - NYMEX Financial Fixed	2,500	US \$8.10/MMbtu	January 2010 - December 2010	1,067
Sell - Financial Panhandle Basis	5,000	HH minus US \$1.12/MMBtu	July 2009 - May 2010	(108)
Sell - Financial Panhandle Basis	5,000	HH minus US \$1.27/MMBtu	January 2009 - December 2009	(49)
Sell - Financial Panhandle Basis	2,500	HH minus US \$0.98/MMBtu	January 2010 - December 2010	16
Sell - Financial Panhandle Basis	2,500	HH minus US \$1.00/MMBtu	January 2010 - December 2010	(6)

In addition to the above, the Company entered into a participating natural gas financial derivative natural gas swap contract whereby the Company will receive a floor price of US \$10 per MMBtu for 5,000 Mmbtu per day and will participate for 31 per cent of the price in excess of US \$10 per MMBtu. The term is July 2009 to May 2010. The December 31, 2008 mark-to-market of this derivative is \$6.8 million.

The combined mark-to-market on the derivative natural gas contracts was an asset of \$10.7 million at December 31, 2008 and is reflected in the Company's accounts as an asset. The fair value for these contracts was provided by the financial intermediary with whom the transactions were completed; they were tested by the Company for reasonableness based on comparing current market price and the fixed price of the contracts.

Taking into account the derivative natural gas contracts listed above, the impact of a Cdn \$1 change per MMBtu results in an estimated \$4.4 million impact on pre-tax income for the year ended December 31, 2008.

The Company indemnifies its directors and officers against all claims and losses reasonably incurred in the performance of their duties to the extent permitted by law. The Company maintains Directors and Officers insurance in amounts deemed adequate.

Liquidity

The following table illustrates the Company's working capital deficiency, net debt and shareholders' equity balances as at December 31, 2008 and 2007.

As at December 31,	2008	2007
<i>(\$ 000s)</i>		<i>(Restated)</i>
Current assets	21,309	18,945
Accounts payable and accrued liabilities	38,118	20,924
Current portion of long-term debt	75,097	-
Working capital deficiency	(91,906)	(1,979)
Adjust for unrealized financial derivative gains (losses) included above	6,593	-
Long term debt	-	51,334
Net debt	(98,499)	(53,313)
Shareholders' equity	61,394	115,249

As of March 1, 2009, the Company was in breach of certain covenants under its bank credit agreement and does not expect to have the default remedied or waived. Under the terms of the bank credit agreement, if any Event of Default occurs and is continuing, the administrative agent shall, at the request of, or may, with the consent of, the Lender, take any or all of the following actions:

- Terminate any commitment to make loans and any other credit extensions.
- Declare the unpaid principal amount of all outstanding loans, all interest accrued and unpaid thereon, and all other amounts owing or payable to be immediately due and payable.
- Require that the borrower cash collateralize any letters of credit.
- Exercise all rights and remedies available to the Lender under the loan documents.

Consequently, and as long as the default continues, Management considers the credit facility to no longer be a four year commitment but instead have the same characteristics as a demand loan; therefore, it has been classified as a current liability at December 31, 2008. Additionally, should the loan be called earlier than December 31, 2009, any unamortized balance of deferred financing costs, which at December 31, 2008 amounted to \$15.6 million, would be expensed in its entirety at that time.

The Company, as at the date of this MD&A, is not in a position to repay the additional advance of US \$5 million or pay the estimated loan fee of US \$10 million, both of which are due on March 31, 2009. The Company is currently working with its lenders to rectify this situation. If an acceptable solution is not achieved and the debt is called, the Company will require additional capital to continue its activities and discharge its obligations. The outcome of these matters is dependant on factors outside of the Company's control and cannot be predicted at this time.

As a result of the weakened global economic situation, the Company is experiencing restricted access to debt and equity markets and increased borrowing costs. The lending capacity of all financial institutions is reported to have diminished and risk premiums have increased independent of the Company's business and asset base. Future capital expenditures must be financed with cash from operations, debt and/or equity. The Company's ability to obtain further debt/equity funding is dependent upon, among other factors, the overall state of debt markets and investor appetite for equity investments in the energy industry and the Company's securities in particular.

The Company has engaged GMP Securities L.P. to assist in seeking a sale of the assets of the Company, a sale or merger of the Company or a financial restructuring of the Company including raising new equity. No decision on any particular alternative has been reached at this time and there can be no assurance that the process will result in any change in the Company's current operations, that the Company will pursue any particular transaction or that any transaction will be concluded.

The Company's ability to continue as a going concern is dependent upon its ability to achieve profitable operations, obtain waivers or amendments relative to defaults, obtain the necessary financing to meet its obligations, repay its liabilities arising from normal business operations when they become due, successfully raise capital and receive the continued financial support from its Lenders.

OFF-BALANCE SHEET ARRANGEMENTS

The Company did not enter into any material off-balance sheet arrangements, except for certain office leases and equipment usage contracts as discussed under the sub-section "Contractual obligations" in this MD&A.

RELATED PARTY TRANSACTIONS

The Company is related to Avenir Capital Corporation and Avenir Operating Corp. ("Avenir") by virtue of certain directors in common. The Company conducts joint operating activities with these companies in the normal course of business.

During 2008, the Company sold certain non-core properties to Avenir for \$4.0 million. The sale was consummated through a public process and the transaction value was compared with current market sales metrics from an independent public source. The asset sale transaction was a cash transaction and did not include any ongoing contractual or other commitments.

In 2007, the Company sold certain non-core properties to Avenir for \$7.2 million. The measurement basis used for the transaction was an independent reserves valuation as at December 31, 2006. The transaction value was also compared with current market sales metrics from an independent public source. The asset sale transaction was a cash transaction and did not include any ongoing contractual or other commitments.

COMPARATIVE AMOUNTS

The Company is in the process of disposing of its Canadian assets and operations. As a result, the Company is considered to have only one geographical reporting unit; the United States. Prior period amounts have been restated to reflect the discontinued operations. Certain other prior period amounts have been reclassified to conform to the presentation adopted in 2008.

SUMMARY OF QUARTERLY FINANCIAL RESULTS (Unaudited)

The following table presents a summary of unaudited consolidated operating results for the eight quarters ended December 31, 2008. Information as presented reflects the application of "Discontinued Operations Accounting" as previously discussed herein.

Selected quarterly information	Q4 2008	Q3 2008	Q2 2008	Q1 2008	Q4 2007	Q3 2007	Q2 2007	Q1 2007
		(1)	(1)	(1)	(1)	(1)	(1)	(1)
Financial (\$000s, except per share)								
Continuing operations:								
Petroleum and natural gas revenue	11,081	9,477	9,213	7,780	6,689	7,410	7,474	6,996
Operating netback	5,591	4,527	4,836	4,445	3,343	3,870	3,874	4,280
Gain on derivative contracts	7,913	2,943	-	-	-	-	-	-
General and administrative	1,771	1,390	1,242	791	1,031	975	1,523	1,030
Stock-based compensation	73	445	510	468	577	514	324	445
Foreign exchange loss (gain)	13,172	3,284	319	169	(612)	(450)	(1,877)	(476)
Interest and financing expense	2,491	1,011	697	543	677	603	439	575
Depletion, depreciation, accretion	3,891	3,219	2,661	2,453	2,476	2,879	3,088	2,571
Future income taxes (recovery)	1,922	617	290	408	(1,293)	271	(31)	293
Net income (loss):								
Continuing operations	(9,671)	(2,501)	(887)	(392)	485	(929)	402	(165)
Per share: basic and diluted	(0.16)	(0.04)	(0.01)	(0.01)	0.01	(0.02)	0.01	0.00
Discontinued operations	(7,390)	(15,802)	(30,616)	(102)	(1,182)	(884)	(573)	(871)
Per share: basic and diluted	(0.13)	(0.27)	(0.52)	0.00	(0.02)	(0.01)	(0.01)	(0.01)
Net income (loss)								
Per share: basic and diluted	(0.29)	(0.31)	(0.53)	(0.01)	(0.01)	(0.03)	0.00	(0.02)
Funds from continuing operations								
Per share: basic	0.04	0.04	0.05	0.05	0.03	0.04	0.05	0.05
Funds from discontinued operations								
Per share: basic	(0.02)	0.01	0.06	0.04	0.02	0.02	0.01	0.01
Funds from operations								
Per share: basic	0.02	0.06	0.11	0.09	0.05	0.06	0.06	0.06
Reconciliation:								
Funds from operations	1,382	3,420	6,368	5,371	3,166	3,333	3,545	3,494
Changes in non-cash working capital related to operating activities	6,881	(550)	50	(2,833)	3,923	482	(3,314)	(531)
Cash provided by (used in)								
operating activities	8,263	2,870	6,418	2,538	7,089	3,815	231	2,963
Operational								
Average daily sales volume (boe/day)								
Continuing operations	2,320	2,191	2,029	2,048	2,152	2,107	1,952	1,755
Discontinued operations	200	870	1,254	1,354	1,390	1,300	853	869
	2,520	3,061	3,283	3,402	3,542	3,407	2,805	2,624
Continuing operations:								
Average realized selling prices								
Natural gas (\$/Mcf)	8.65	7.83	8.32	6.96	5.63	6.37	7.01	7.38
Barrel of oil equivalent (\$/boe)	51.92	47.01	49.90	41.74	33.78	38.23	42.07	44.30
Average operating netback (\$/boe)	26.20	22.46	26.19	23.85	16.89	19.97	21.80	27.11
Cdn\$/US\$ exchange rate								
Average for period	0.820	0.960	0.990	0.998	1.019	0.957	0.911	0.854
End of period	0.817	0.944	0.981	0.974	1.009	0.995	0.940	0.867

(1) Restated to reflect "discontinued operations" accounting.

Fourth quarter 2008 compared with third quarter 2008 and fourth quarter 2007

The Company generated \$2.6 million in funds from continuing operations on related sales of \$11.1 million and recorded a net loss from continuing operations of \$9.7 million in fourth quarter 2008. This compares with funds from continuing operations of \$2.5 million on related sales of \$9.5 million and a net loss from continuing operations of \$2.5 million in third quarter 2008.

In fourth quarter 2007, Mahalo had funds from continuing operations of \$1.9 million, related sales of \$6.7 million and a net profit from continuing operations of \$0.5 million.

The following tables provide a comparison of the components of operating netback from continuing operations for the three quarterly periods under comparison.

	Fourth Quarter 2008		Third Quarter 2008		Fourth Quarter 2007	
		\$/boe		\$/boe	(Restated)	(Restated)
Continuing operations:						
Average daily sales volume (boe)	2,320		2,191		2,152	
<i>(\$000s, except per boe)</i>						
Petroleum and natural gas revenue	11,081	51.92	9,477	47.01	6,689	33.78
Royalties	2,798	13.11	2,327	11.54	1,674	8.45
Operating and transportation	2,692	12.61	2,623	13.01	1,672	8.44
Operating netback	5,591	26.20	4,527	22.46	3,344	16.89

Average daily sales volumes increased by approximately 6 per cent over third quarter 2008. Operating netback was \$26.20 per boe compared with \$22.46 per boe in the immediately preceding quarter. The improvement was primarily due to the higher average realized price. Per unit royalty expense increased in tandem with the higher realized sales price; operating and transportation expense remained relatively unchanged during these periods.

Although average daily sales volumes were 8 per cent higher when compared with fourth quarter 2007, the significantly improved average realized sales price in the 2008 period was primarily responsible for a 66 per cent increase in sales revenues and a 67 per cent increase in operating netback over the 2007 period.

After having gained significant strength against its US counterpart in 2007, the relative value of the Canadian dollar declined rapidly in the latter two months of 2008. This resulted in a large foreign exchange loss in fourth quarter 2008, principally related to conversion, for financial reporting purposes, of the Company's US dollar denominated debt. The related loss was unrealized and did not impact funds from operations.

Effective December 1, 2008, the Company adopted the US dollar as its functional currency. Prior to December 1, 2008, the functional currency of the Company was the Canadian dollar. The change in functional currency of the Company is due to the increased exposure to the US dollar as a result of discontinuing Canadian operations.

The results of discontinued operations for the fourth and third quarters of 2008 include the impact of loss on disposition of property and equipment of \$6.0 million and \$48.6 million, respectively.

Further details in respect of historical quarterly results can be found in the Company's quarterly and annual reports filed on SEDAR at www.sedar.com or on the Company's web-site at www.mahaloenergy.com.

OUTLOOK

On March 5, 2009, Mahalo announced that it had received proposals from several qualified parties as a result of the process to seek strategic or refinancing alternatives. Mahalo also announced that it has received a reservation of rights letter from Ableco ("the Lenders") notifying the Company that it is in default under its loan agreement for failure to comply with certain covenants relating to obtaining a letter of intent ("LOI") for the sale or recapitalization of the Company by March 1, 2009. As a result of the default, the Lenders advised Mahalo that until resolved, future loans would be made in the sole discretion of the Lenders. To date, the Lenders have not exercised their default-related rights or demanded repayment of the loan.

The Company has not executed an LOI with any party or made a decision on any particular alternative; in the opinion of management, there can be no assurance that the process will result in any change in the Company's current operations, that the Company will pursue any particular transaction or that any transaction will be concluded.

Although several proposals have resulted from the GMP Securities L.P. led process, no proposal was satisfactory to Mahalo or its lenders and there is no reasonable expectation that an acceptable proposal will be received.

In the interim, although the Company's does have certain financial hedges and fixed price forward sales agreements in place to protect a portion of its cash flows from price erosion, it has curtailed virtually all capital spending in an effort to improve its financial position.

The Company continues to be in breach of certain covenants under its bank credit agreement and does not expect to be in a position to repay the short-term, revolving loan of US \$5 million and pay the estimated loan fee of US \$10 million, both of which are due on March 31, 2009. The Company is currently working with its lenders to rectify this issue.

If an acceptable solution is not achieved and the debt is called, the Company will require additional capital to continue its activities and discharge its obligations. The outcome of these matters is dependant on factors outside of the Company's control and cannot be predicted at this time. Additional information regarding this matter is set forth under "basis of presentation and going concern issues" and elsewhere in this MD&A.

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires the Company to make assumptions, judgments and estimates that may have a significant impact on the financial statements. Estimates are reviewed periodically and as adjustments become necessary, they are reported in earnings in the periods in which they become known. A summary of the Company's significant accounting policies can be found in Note 2 to the Consolidated Financial Statements.

The following is a discussion of the critical accounting estimates that are inherent in the preparation of the Company's consolidated financial statements and related notes.

Reserve estimates

The process of estimating petroleum and natural gas reserves is critical to several accounting estimates including unit-of-production depletion, the determination of asset retirement obligations and the application of an impairment test.

The Company's petroleum and natural gas reserves are evaluated by independent engineering firms. By their nature, estimates of reserves and related future cash flows are subject to measurement uncertainty. Forecasts are based on geological, geophysical and engineering data, projected future rates of production, estimated commodity price forecasts and the timing of future expenditures, all of which are subject to a number of uncertainties and various interpretations. The Company expects that over time its reserve estimates will be revised upward or downward based on updated information such as results of drilling, testing, production levels and economics of recovery based on cash flow forecasts.

The calculation of unit-of-production depletion is based on estimated proved oil and gas reserves. A revision to the reserve estimates could result in higher or lower depletion charges to earnings. The Company's ceiling test calculations are based on estimates of reserves, commodity prices, expected royalty burdens, foreign exchange rates, production expenses and the capital costs required to develop and produce those reserves. Downward revisions to reserve estimates could result in a write-down of petroleum and natural gas properties under the ceiling test.

The Company's lender uses reserve estimates to assess the borrowing base under the revolving bank credit facility. Changes to reserve estimates can result in borrowing base increases or decreases, which impact the Company's financial position.

Asset retirement obligations

The calculation of asset retirement obligations requires estimates of future outlays to settle the obligation, the timing of related cash flows, future inflation rates and the cost of capital. Determination of the original undiscounted cost is based on estimates using current costs and technology in accordance with existing legislation and industry practice. The estimation of these costs can be further affected by factors such as the number of wells drilled, well depth and area specific environmental legislation. On recognition of the liability, there is a corresponding increase in the carrying amount of the related asset. The impact of differences between actual and estimated asset retirement obligation amounts on the consolidated financial statements of future periods could be material.

Stock-based compensation

Compensation costs resulting from the grant of stock options by the Company are charged to earnings over the vesting period of the related options. The Company utilizes the Black-Scholes model which requires management to estimate the expected life of the options and the volatility of the Company's common share price over the life of the options. The actual life and volatility may differ from the estimates used in computing stock-based compensation costs.

Future income taxes

Income taxes are calculated using the liability method of accounting for income taxes. The liability method requires the Company to schedule out all existing temporary differences and to recalculate the future income tax balance using tax rates in effect when temporary differences are expected to reverse. Forecasts of estimated net revenue streams are utilized to calculate the future tax provision and, as such, are subject to revisions, both upwards and downwards. In addition to these revisions, future capital activities can impact the timing of the reversal of any temporary differences. These differences can have an impact on the amount of future taxes determined at a point in time, and to the extent that these differences are created, they can impact the charge against earnings for future taxes.

FINANCIAL INSTRUMENT RISK

Carrying values and estimated fair values of financial assets and liabilities

The Company's financial instruments as at December 31, 2008 consist of cash, accounts receivable, unrealized gain on derivative natural gas contracts, accounts payable and accrued liabilities, and long-term debt.

The Company classifies its cash and unrealized gain on derivative natural gas contracts as held-for-trading, its accounts receivable as loans and receivables, and its accounts payable and accrued liabilities and long term debt as other financial liabilities.

The carrying value of the Company's cash, accounts receivable and accounts payable and accrued liabilities approximates fair value due to their immediate or short-terms to maturity. The fair value of the derivative contracts is recognized on the balance sheet. The carrying value of long-term debt approximates fair value as it bears interest at market rate.

The Company's primary financial risks include credit, foreign currency, commodity price and market, interest rate and liquidity risk. Additional discussion regarding such risks is included in note 14 accompanying the December 31, 2008 consolidated financial statements.

Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. The Company's credit risk can be directly impacted by a decline in economic conditions, which in turn may impair the customer or counterparty's ability to satisfy their obligations to the Company. Cash is maintained at major financial institutions. Credit risk arises principally from the Company's accounts receivable.

A substantial portion of the Company's accounts receivable are with petroleum and natural gas marketers, joint venture partners and others in the energy industry and are subject to normal industry credit risk. The Company's policy to mitigate credit risk is to establish marketing relationships with large purchasers.

Joint venture receivables are typically collected within one to three months of the joint venture bills being issued to the partner. Joint venture receivables are typically from participants in the petroleum and natural gas sector; collection of outstanding balances is dependent on industry factors such as commodity price fluctuations, escalating costs, the risk of unsuccessful drilling and occasional disagreement between parties. The Company attempts to mitigate this risk by obtaining partner approval of significant capital expenditures prior to performance of the project.

The Company does not typically obtain collateral from joint venture partners; however, in certain circumstances a cash call may be requested in advance of the expenditure. In some cases, the Company has the ability to withhold production from joint venture partners in the event of their non-payment of amounts outstanding. Mahalo generally grants unsecured credit to its other customers but routinely assesses their financial strength.

The Company considers its accounts receivable to be aged as follows:

As at December 31, <i>(\$000's)</i>	2008
Not past due (90 days or less)	10,291
Past due (greater than 90 days)	1,353
	11,644

The carrying amount of accounts receivable generally represent the maximum credit exposure faced by the Company. The Company does not have an allowance for doubtful accounts and has not written off any receivables. The Company does not believe that any of its accounts receivable are impaired and believes that the counterparties are of high credit quality.

Mahalo has not experienced collection issues with either petroleum and natural gas marketers or joint venture partners; however, given the size of balances outstanding from its petroleum and natural gas marketers and in light of current market conditions, the Company has obtained collateral of US \$3.0 million in the form of a letter of credit. The Company's derivative contracts are with Wells Fargo who is also a participant in the Company's credit facility.

Market Risk

Market risk is the risk or uncertainty arising from possible market price movements and their impact on the future performance of a business. The market price movements that the Company is exposed to include petroleum and natural gas commodity prices, interest rates and foreign currency exchange rates, all of which could adversely affect the value of the Company's financial assets, liabilities and its financial results.

(a) Commodity price risk

The price the Company receives for its petroleum and natural gas fluctuates continuously. Commodity prices and demand are generally impacted by local markets and, to an extent, world economic events. The Company has not experienced any difficulty with respect to demand for its product; it does take steps to minimize the impact of commodity price volatility by entering into physical fixed price sales contracts and financial derivative contracts as considered prudent. At present, the Company's credit facility agreement requires that at least 80 per cent of expected daily gas sales volumes are hedged. All hedging transactions are conducted in accordance with the risk management policy that has been approved by the Board of Directors. A summary of outstanding physical fixed price sales contracts and derivative natural gas sales contracts is set forth under the sub-section "Contractual obligations" in this MD&A.

(b) Interest rate risk

The Company is exposed to interest rate fluctuations on its bank debt which bears a floating rate of interest. The Company is sensitive to fluctuations in interest rate risk such that if interest rates on its long-term debt changed by 1.0 per cent, with all other variables held constant, net earnings for the year ended December 31, 2008 would change by an estimated \$0.7 million. The Company has not deemed it necessary to enter into interest rate swaps or derivative financial instruments to reduce exposure to interest rate risk.

(c) Foreign currency risk

Foreign currency exchange risk is the risk that future cash flows will fluctuate as a result of changes in foreign exchange rates. The Company's foreign exchange translation exposure principally reflects the impact of fluctuations in the Canadian/United States exchange rate on monetary and non-monetary assets and liabilities and revenues and expenses of the Company. In addition, the underlying market prices for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar.

In 2008, the Company discontinued its resource operations in Canada; all continuing resource operations are located in the United States. As a result, a majority the Company's revenues and directly related expenses are now denominated in United States dollars. The Company's most significant liability, being amounts outstanding under its credit facility, are repayable in United States dollars. Certain cash expenses, primarily general and administrative costs incurred at head office, will continue to be incurred in Canadian dollars.

Since the Company reports in Canadian dollars, foreign exchange gains and losses will occur as Canadian/US dollar exchange rates shift. If foreign exchange rates had changed by \$0.01, with all other variables held constant, net comprehensive loss for the year ended December 31, 2008 would change by an estimated \$0.1 million. The Company does not deem it necessary to utilize financial instruments to mitigate the risks arising from changes in foreign currency rates.

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. Liquidity is a reflection of a company's ability to access cash. Companies in the upstream oil and gas industry require sufficient cash in order to fund capital programs necessary to maintain and increase production and proved reserves, to acquire strategic oil and gas assets and to repay debt.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. In addition, Mahalo utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. The Company actively maintains credit facilities to facilitate its capital expenditure program.

The financial obligations on the balance sheet at December 31, 2008 were as follows:

Financial liability	Less than one year	Total
<i>(\$000s)</i>		
Accounts payable and accrued liabilities	38,118	38,118
Bank debt	75,097	75,097
	<u>113,215</u>	<u>113,215</u>

At March 1, 2009, the Company was in default under its bank credit agreement and does not expect to have the default remedied or waived; consequently, the bank debt has been classified as a current liability at December 31, 2008. The Company does not expect to be in a position to repay a US \$5.0 million revolving loan payment and an estimated US \$10.0 million loan fee, discussed elsewhere herein, both of which are due on March 31, 2009.

The Company is currently in discussion with its lenders regarding this situation. If an acceptable solution is not achieved and the debt is called, the Company will require additional capital to continue its activities and discharge its obligations. The outcome of these matters is dependant on factors outside of the Company's control and cannot be predicted at this time.

OTHER BUSINESS RISKS AND UNCERTAINTIES

The Company's operations are subject to many factors that are beyond its control. Exploring for, developing and producing oil and gas reserves is inherently risky from financial, operational and other aspects. There is a risk that the sale of the Company's reserves may be delayed indefinitely due to process constraints, lack of pipeline capacity or lack of markets. The Company is also subject to the risks associated with oil and gas properties, including exploration, development and production risks, and environmental risks such as the pollution of air, land and water. In all areas of the Company's business, it competes against entities that have greater technical and financial resources. The Company's growth is dependent upon external sources of financing which may not be available on acceptable terms.

The reader is specifically referred to the Company's Annual Information Form dated March 31, 2009 at www.sedar.com for additional information regarding risks and uncertainties, Such information is set forth under the heading "Risk Factors".

ADOPTION OF NEW ACCOUNTING STANDARDS

Effective January 1, 2008, the Company adopted CICA Handbook Section 1400 - General Standards of Financial Statement Presentation, 1535 - Capital Disclosures, 3031- Inventories, 3862 - Financial Instruments - Disclosures and 3863 - Financial Instruments - Presentation. The new standards were adopted prospectively.

Section 1400 requires management to assess an entity's ability to continue as a going concern and to provide disclosure of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. When financial statements are not prepared on a going concern basis, that fact must be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern. The adoption of this standard did not have an impact on the Company's consolidated financial statements for the twelve months ended December 31, 2008.

Section 1535 establishes standards for disclosing information regarding an entity's capital and how it is managed. The section specifies the disclosure of i) objectives, policies, and processes for managing capital; ii) quantitative data about what the entity regards as capital; iii) whether the entity has complied with any capital requirements; and iv) if it has not complied, the consequences of such non-compliance. The adoption of this standard did not impact the Company's financial results but did require additional disclosure as set forth in note 9 to the Company's consolidated financial statements for the twelve months ended December 31, 2008.

Section 3031 provides enhanced guidance for the measurement, costing, and disclosures of inventories. The standard provides that inventories be measured at the lower of cost and net realizable value, permits write-ups of subsequent increases in net realizable value of previously impaired inventories, and prohibits the use of the LIFO costing method. The adoption of this standard did not have an impact on the Company's financial statements.

Sections 3862 and 3863 replace section 3861 - Financial Instruments – Disclosure and Presentation. Under section 3862, the Company is required to disclose the significance of financial instruments to an entity's financial statements, the risks associated with the financial instruments and how those risks are managed. Section 3863 provides further guidance on the classification of financial liabilities vs. equity, and when netting of financial assets and financial liabilities is appropriate. The adoption of these standards did not impact the Company's financial results but did result in additional disclosures as set forth in note 14 to the Company's consolidated financial statements for the for the twelve months ended December 31, 2008.

Recent accounting pronouncements not yet adopted

On January 20, 2009, the CICA issued EIC-173 Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. Under this EIC, an entity's own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and liabilities, including derivative instruments. The Company will adopt the requirements of EIC-173 effective January 1, 2009. The impact of this EIC upon the Company's financial statements is currently being assessed.

On January 1, 2011, the Company will be required to adopt CICA Handbook Section 1582 – Business Combinations which establishes revised standards for accounting for business combinations, which in turn are aligned with International Financial reporting Standards (“IFRS”) on business combinations. The Section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. Earlier application is permitted.

On February 13, 2008, the Canadian Accounting Standards Board confirmed the use of International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board. The changeover date for Canadian publicly accountable enterprises is January 1, 2011 and will require restatement of comparative figures. IFRS will replace the current CICA Handbook as Canadian GAAP. Significantly increased disclosure will be required under IFRS, especially for interim reporting. While IFRS uses a conceptual framework similar to Canadian GAAP, there are significant differences in accounting policies which must be addressed.

The Company has undertaken a preliminary review of its current accounting policies under Canadian GAAP in an effort to identify key differences and options with respect to acceptable accounting standards under IFRS. Changes in accounting policy are likely and may materially impact the financial statements. Due to anticipated changes in IFRS prior to the conversion date, the final impact of the conversion on the Company's financial statements is not measurable at this time. The Company will, in 2009, proceed to make a more detailed determination of the impact of the transition to IFRS on its financial statements and systems. The active transition phase to IFRS is currently planned for 2010 in order to meet the required implementation date of January 1, 2011.

CORPORATE GOVERNANCE

This MD&A has been prepared by the management of Mahalo Energy Ltd. It has been reviewed and approved by the Audit Committee and the Board of Directors of the Company. Additional information related to the Company's Corporate Governance can be found in the Company's Annual Information Form (“AIF”) and Information Circular, both of which are filed on SEDAR at www.sedar.com.

DISCLOSURE AND INTERNAL CONTROLS

Management is responsible for establishing and maintaining disclosure controls and procedures (DC&P) and internal controls over financial reporting (ICFR), as those terms are defined in National Instrument 52-109 “Certification of Disclosure in Issuers' Annual and Interim Filings”. The objective of this instrument is to improve the quality, reliability and transparency of information that is filed or submitted under securities legislation.

The Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”) have designed, or caused to be designed under their supervision, ICFR and DC&P to provide reasonable assurance that material information related to the issuer is made known to them and is reported on a timely basis, that financial reporting is reliable, and that financial statements prepared for external purposes are in accordance with Canadian generally accepted accounting principles.

The CEO and the CFO have evaluated, or caused to be evaluated under their supervision, the effectiveness of DC&P and ICFR and have concluded that the DC&P and ICFR were effective on December 31, 2008. There have been no changes in the Company's ICFR since the most recent interim period that have materially affected, or are reasonably likely to materially affect ICFR.

It should be noted that while the CEO and CFO believe that the DC&P and ICFR are effective and provide a reasonable level of assurance, they do not expect that they will prevent all errors, misstatements or fraud. Because of the Company's smaller size, adequate segregation of duties may not always be achievable in which case the

Company relies on compensating controls. In addition, in-house expertise may not always be sufficient to deal with complex accounting, taxation and reporting matters; the Company must periodically rely upon outside assistance and advice to effectively deal with such matters. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

SPECIAL CAUTIONARY ADVISORIES

Forward-looking Statements

Except for historical financial information contained herein, the matters discussed in this document may be considered forward-looking statements. Such statements include declarations regarding management's intent, belief or current expectations. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties; actual results could differ materially from those indicated by such forward-looking statements. Among the important factors that could cause actual results to differ materially from those indicated by such forward-looking statements are: (i) that the information is of a preliminary nature and may be subject to further adjustment, (ii) the possible unavailability of financing, (iii) risks related to the exploration and development of oil and gas properties, (iv) the impact of price fluctuations and the demand and pricing for oil and natural gas, (v) the seasonal nature of the business, (vi) start-up risks, (vii) general operating risks, (viii) dependence on third parties, (ix) changes in government regulation, (x) the effects of competition, (xi) dependence on senior management, (xii) impact of economic conditions, and (xiii) fluctuations in currency exchange rates and interest rates. The forward-looking statements contained in this document are made as of the date hereof and Mahalo undertakes no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless so required by law.

Non-GAAP Financial Measures

The Company uses and makes reference to certain performance measures throughout this MD&A that do not have any standardized meaning and are not defined under Canadian Generally Accepted Accounting Principles ("GAAP"; they are therefore referred to as non-GAAP financial measures. These performance measures include "funds from operations", "funds from operations per share", "operating netback" and "net debt". The non-GAAP financial measures, as calculated and used by the Company, may not be comparable to similarly titled measures reported by other companies.

Management considers these non-GAAP measures as useful supplemental measures to analyze operations, compare performance between periods and provide shareholders and potential investors with additional information. These non-GAAP measures are also used by research analysts to value and compare oil and gas exploration and production companies, and are frequently included in published research when providing investment recommendations.

Funds from operations and funds from operations per share should not be considered as an alternative to, or more meaningful than net earnings, cash provided by operating, financing and investing activities or other measures of financial performance or liquidity calculated in accordance with Canadian GAAP. Funds from operations represent cash from operating activities before change in related non-cash working capital. Funds from operations per share are calculated using the weighted average shares outstanding, consistent with the calculation of earnings per share. These measures are used by Mahalo to assess its operating results and its ability to generate funds to finance future capital investments and to service debt.

Operating netback should not be considered an alternative to, or more meaningful than, net earnings or other measures of performance or liquidity calculated in accordance with Canadian GAAP. Operating netback presents a measure of net oil and gas revenue relative to realized commodity prices by deducting royalties and operating and transportation costs from oil and gas sales revenues. This non-GAAP measure

is also used by the Company to assess comparability of petroleum sales and directly related costs between periods.

Net debt as calculated by the Company represents long-term debt less working capital (excluding unrealized gain or loss on financial instruments) and is used by the Company to assess financial strength.

Barrel of oil equivalent ("boe") volumetric measures

The oil and gas industry commonly expresses production, sales and reserves volumes on a barrel of oil equivalent ("boe") basis whereby natural gas volumes are converted at a ratio of six thousand cubic feet ("Mcf") to one barrel ("bbl") of crude oil. The boe measure is used by the Company to aggregate oil and gas volumes. The measure is also considered to be useful for comparisons with other industry participants. The conversion ratio is based on an approximate energy equivalency of these commodities at the burner tip and does not represent a value equivalency at the well head. This conversion may therefore be misleading, particularly if used in isolation.

Reserves information

Some of the information in this MD&A summarizes information contained in the Netherland Sewell & Associates, Inc. 2008 reserves report. The Company will provide additional information regarding reserves in its Annual Information Form and other filings. The Company's oil and gas reserves volumes provided herein are estimates only and there is no guarantee that the estimated reserves will be recovered. The actual oil and gas volumes eventually recovered may be greater than or less than the reserves estimates provided herein.

ADDITIONAL INFORMATION

Additional information relating to the Company and its business and operations is available on the System for Electronic Document Analysis and Retrieval ("SEDAR") at www.sedar.com or at the Company's web-site at www.mahaloenergy.com.