



Audited Consolidated Financial Statements

For the Years Ended December 31, 2008 and 2007

MANAGEMENT'S REPORT

To the Shareholders of Mahalo Energy Ltd.:

Management is responsible for the preparation of the financial statements in accordance with Canadian generally accepted accounting principles and for ensuring that all other financial and operating information presented in this report is consistent with those financial statements. In the preparation of these financial statements, estimates are sometimes necessary to make a determination of future values for certain assets or liabilities. Management believes such estimates have been based on careful judgments and have been properly reflected. The information contained elsewhere in this year-end report has been reviewed, and is consistent in all respects with the financial statements.

The Company maintains appropriate systems of internal control designed to provide reasonable assurance that transactions are properly authorized, assets are safeguarded from loss or unauthorized use and financial records are properly maintained to provide reliable information for the preparation of financial statements.

Ernst and Young, LLP, independent auditors appointed by the shareholders, have been engaged to examine the consolidated financial statements in accordance with generally accepted auditing standards in Canada and provide an independent professional opinion. Their report is presented with the consolidated financial statements.

The Board of Directors ("the Board") is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises these responsibilities through the Corporate Governance and Audit Committee. This committee, which is comprised entirely of non-management directors, has met with management and the external auditors to satisfy it that the management responsibilities are being properly discharged, and to review the consolidated financial statements before they are presented to the board for approval. The financial statements have been approved by the Board on the recommendation of the Corporate Governance and Audit Committee.

"Signed"

James Burns
President & Chief Executive Officer

"Signed"

William Dawidowski
Chief Financial Officer

AUDITORS' REPORT

To the Shareholders of Mahalo Energy Ltd.:

We have audited the consolidated balance sheets of Mahalo Energy Ltd. as at December 31, 2008 and 2007 and the consolidated statements of loss, comprehensive loss, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Ernst + Young LLP

Chartered Accountants

Calgary, Alberta
March 31, 2009

MAHALO ENERGY LTD.

CONSOLIDATED BALANCE SHEETS

(See basis of presentation - note 1)

As at December 31,	2008	2007
<i>(\$000'S)</i>		<i>(restated - notes 2 & 4)</i>
Assets (note 6)		
Current		
Cash	2,073	3,973
Accounts receivable	11,644	13,995
Prepaid and deposits	999	977
Current portion of unrealized gain on derivative natural gas contracts (note 14)	6,593	-
	21,309	18,945
Deferred financing costs (note 6)	15,607	-
Unrealized gain on derivative natural gas contracts (note 14)	4,151	-
Property and equipment (notes 4 and 5)	139,321	98,924
Assets held for sale (note 4)	3,469	75,778
	183,857	193,647
Liabilities		
Current		
Accounts payable and accrued liabilities	38,118	20,924
Current portion of long-term debt (note 6)	75,097	-
	113,215	20,924
Long-term debt (note 6)	-	51,334
Asset retirement obligations (note 7)	1,385	871
Asset retirement obligations related to assets held for sale (note 4)	1,848	3,219
Future income taxes (note 10)	6,015	2,050
	122,463	78,398
Commitments (notes 13 & 14)		
Shareholders' equity		
Share capital (note 8)	158,979	158,979
Warrants (note 8)	1,990	1,990
Contributed surplus (note 8)	9,848	8,117
Deficit	(121,198)	(53,837)
Accumulated other comprehensive income	11,775	-
	61,394	115,249
	183,857	193,647

See accompanying notes to the consolidated financial statements

On behalf of the Board:
"Signed"

James Burns
President and CEO

"Signed"

Gary Dundas
Director

MAHALO ENERGY LTD.

CONSOLIDATED STATEMENTS OF LOSS

Year ended December 31, <i>(\$000's, except per share)</i>	2008	2007 <i>(restated - notes 2 & 4)</i>
Revenues		
Petroleum and natural gas revenue	37,551	28,569
Royalty expense	(9,457)	(7,043)
	28,094	21,526
Gain on derivative natural gas contracts (note 14)	10,856	-
Interest and other income	152	-
	39,102	21,526
Expenses		
Operating	6,409	4,442
Transportation	2,286	1,714
General and administrative (note 5)	5,194	4,560
Stock-based compensation (note 9)	1,496	1,860
Foreign exchange (gain) loss (note 11)	16,944	(3,416)
Interest and financing costs (note 6)	4,742	2,294
Depletion, depreciation and accretion	12,224	11,013
	49,295	22,467
Loss from continuing operations, before income taxes	10,193	941
Current income tax expense (note 10)	21	22
Future income tax expense (recovery) (note 10)	3,237	(759)
Loss from continuing operations	13,451	204
Loss from discontinued operations (note 4)	53,910	3,513
Net loss	67,361	3,717
Net loss per share from continuing operations (note 8)		
Basic and diluted	(0.23)	-
Net loss per share from discontinued operations (note 8)		
Basic and diluted	(0.91)	(0.06)
Net loss per share (note 8)		
Basic and diluted	(1.14)	(0.06)

See accompanying notes to the consolidated financial statements

MAHALO ENERGY LTD.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

Year ended December 31,	2008	2007
<i>(\$000's)</i>		<i>(restated - notes 2 & 4)</i>
Net loss	(67,361)	(3,717)
Increase due to change in functional currency (note 2(j))	12,419	-
Translation of US dollar results to Canadian dollar reporting currency	(644)	-
Other comprehensive income	11,775	-
Comprehensive loss	(55,586)	(3,717)

See accompanying notes to the consolidated financial statements

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDER S' EQUITY

Year ended December 31,	2008	2007
<i>(\$000's)</i>		<i>(restated - notes 2 & 4)</i>
Share Capital		
Balance, beginning of year	158,979	157,983
Exercise of share purchase warrants	-	954
Exercise of stock options	-	42
Balance, end of year	158,979	158,979
Warrants		
Balance, beginning of year	1,990	2,494
Exercise of warrants	-	(504)
Balance, end of year	1,990	1,990
Contributed Surplus		
Balance, beginning of year	8,117	6,035
Stock-based compensation costs	1,731	2,082
Balance, end of year	9,848	8,117
Deficit		
Balance, beginning of year	(53,837)	(49,749)
Net loss	(67,361)	(3,717)
Adoption of accounting policy	-	(371)
Balance, end of year	(121,198)	(53,837)
Accumulated Other Comprehensive Income		
Balance, beginning of year	-	-
Change in functional currency	12,419	-
Foreign exchange	(644)	-
Balance, end of year	11,775	-

See accompanying notes to the consolidated financial statements

MAHALO ENERGY LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year ended December 31,	2008	2007
<i>(\$000's)</i>		<i>(restated - notes 2 & 4)</i>
Operating activities		
Net loss from continuing operations	(13,451)	(204)
Non-cash items:		
Stock-based compensation	1,496	1,860
Depletion, depreciation and accretion	12,224	11,013
Unrealized financial derivative gain (note 14)	(10,744)	-
Unrealized foreign exchange loss (gain) (note 11)	16,636	(1,949)
Amortization of deferred financing costs	1,698	-
Future income tax expense (recovery) (note 10)	3,237	(759)
Cash flow from continuing operations	11,096	9,960
Change in non-cash working capital (note 12)	3,548	336
Cash flow from discontinued operations	5,445	3,577
	20,089	13,873
Financing activities		
Issue of common shares (note 8)	-	450
Exercise of stock options (note 8)	-	42
Long-term debt	11,449	1,440
Deferred financing costs (note 6)	(5,047)	-
	6,402	1,932
Investing activities		
Expenditure on property and equipment	(42,126)	(27,919)
Proceeds on sale of oil and gas properties	-	8,335
(Increase) decrease in assets held for sale	11,994	5,738
Change in non-cash working capital (note 12)	1,741	727
	(28,391)	(13,119)
Increase (decrease) in cash	(1,900)	2,686
Cash, beginning of year	3,973	1,287
Cash, end of year	2,073	3,973

See accompanying notes to the consolidated financial statements

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the years ended December 31, 2008 and 2007

All amounts are expressed in Canadian dollars unless otherwise stated

1. BASIS OF PRESENTATION AND GOING CONCERN ISSUES

These 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 these financial statements, and that the Company will be able to continue its business activities.

In accordance with Canadian GAAP appropriate for a going concern, property and equipment is carried at cost less accumulated amortization and any impairment losses. 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.

The future operation of the Company is dependant on its ability to successfully raise capital and receive the continued financial support from its lenders (see note 6). As 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 requires additional funds to maintain operations and discharge liabilities as they become due, as further discussed below. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

In November 2008, the Company signed an amended bank credit agreement that resulted in an additional advance of US \$5 million that is repayable on March 31, 2009. The amendment also requires the Company to pay an estimated US \$10 million loan fee on March 31, 2009 (see Note 6).

As of March 1, 2009, the Company was in breach of certain covenants under its bank credit agreement and does not expect to be in a position to repay the additional advance and pay the loan fee 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, it is unlikely that the Company will be able 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.

Management believes that the going concern assumption is appropriate for these financial statements. 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.

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.

Mahalo Energy Ltd. ("Mahalo" or the "Company") was incorporated under the *Business Corporations Act (Alberta)* on April 21, 2004. Mahalo completed its initial public offering and was listed on the Toronto Stock Exchange on July 29, 2005. Mahalo has one wholly-owned subsidiary, Mahalo Energy (USA) Inc. The Company's primary business is the acquisition of, exploration for and development and production of coal bed methane and shale gas in the United States.

2. SIGNIFICANT ACCOUNTING POLICIES

These consolidated financial statements have been prepared by management using generally accepted accounting principles (GAAP) within the framework of the accounting policies summarized below.

(a) Measurement Uncertainty

The timely preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, actual results could differ from estimated amounts due to factors such as fluctuations in commodity prices, interest rates and legislative changes.

The amounts recorded for depletion and depreciation of petroleum and natural gas interests and for asset retirement obligations are based on estimates of petroleum and natural gas reserves and future costs. Proved reserves also provide the basis for determining whether the carrying value of petroleum and natural gas interest is impaired. The determination of stock-based compensation involves estimates of the volatility of the Company's common shares for future rates and expected life. Future income tax expense is calculated using tax rates based on the estimated timing of reversal of temporary differences between accounting and tax values of certain assets and liabilities and involves forecasting the amount of the future income tax asset that will be realized. The fair values of financial instruments are estimated based upon market or third party information. These estimates are subject to change with fluctuations in commodity prices, interest rates, foreign currency exchange rates and estimates of non-performance risk.

By their nature, these estimates and assumptions are subject to measurement uncertainty and the impact on the consolidated financial statements of future periods could be material.

(b) Basis of Presentation

These consolidated financial statements reflect the activities of the Company and its wholly-owned subsidiary, Mahalo Energy (USA) Inc. Inter-company transactions and balances are eliminated upon consolidation.

Substantially all of Mahalo's activities are conducted jointly with others and, accordingly, the Company reflects its proportionate interest in such activities.

(c) Petroleum and Natural Gas Operations

The Company follows the full cost method of accounting whereby all costs associated with the acquisition of, exploration for and development and production of petroleum and natural gas reserves, whether productive or nonproductive, are capitalized in separate Canadian and United States cost centers and charged to income as set out below. Such costs include costs to acquire and lease land, retain non-producing properties, conduct geological and geophysical activity, drill productive and nonproductive wells and equip productive wells. Such costs also include overhead expense directly related to exploration and development activities.

Mahalo performs a detailed impairment calculation annually or when events or circumstances indicate a potential impairment of the carrying amount of petroleum and natural gas assets may have occurred. An impairment loss is recognized if the carrying amount of a cost centre is not recoverable and exceeds its fair value. The carrying amount is assessed to be recoverable when the sum of undiscounted cash flows expected from proved reserves plus the cost of unproved interests, net of impairments, exceeds the carrying amount of the cost centre. When the carrying amount is assessed not to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted cash flows from proved and probable reserves plus the cost of unproved interests, net of impairments, of the cost centre. The cash flows are estimated using expected future commodity prices and costs and discounted using a risk-free interest rate.

Proceeds from the sale of properties are applied against capitalized costs, without recognizing any gain or loss, unless crediting the proceeds would alter the rate of depletion by more than 20 percent.

(d) Depletion and Depreciation

Petroleum and natural gas interests are depleted using the unit of production method, based upon proved reserves, before royalties, as determined by the Company's independent reserve engineers. Estimated costs to develop proved reserves are included in the depletion base whereas costs of acquiring and evaluating unproven properties are excluded until it is determined that proved reserves exist or impairment of such costs has occurred.

The Company records other assets at cost and provides depreciation on the declining balance method using a rate of 20 to 100 percent per annum. The rates are designed to amortize the cost of the assets over their estimated useful lives.

(e) Asset Retirement Obligations

The Company recognizes the estimated fair value of statutory, contractual and legal obligations associated with the retirement of long-lived assets in the period in which it incurs a legal obligation associated with the retirement of long-lived assets that result from the acquisition, development, and normal use of the assets. The fair value of the asset retirement obligation ("ARO") is determined through a review of engineering studies, industry guidelines and management's estimate on a site-by-site basis and is recorded as a liability, with a corresponding increase in the carrying amount of the related asset. The capitalized costs are amortized to earnings in a manner consistent with the depletion and depreciation of the underlying asset. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is included in depreciation, depletion and accretion expense. Actual costs incurred upon settlement of the ARO are charged against the liability.

(f) Financial Instruments

The Company may periodically utilize derivative financial instrument contracts such as forwards, futures, swaps and options to manage its exposure to fluctuations in petroleum and natural gas prices, the Canadian/US dollar exchange rate and interest rates. The Company classifies its financial instruments into one of the following categories: held-for-trading (assets and liabilities), assets available-for-sale, loans and receivables, assets held-to-maturity and other financial liabilities. All financial instruments are measured at fair value on initial recognition. Transaction costs related to financial instruments are expensed as incurred. Measurement in subsequent periods depends on the classification of the financial instrument. Financial assets and liabilities held-for-trading are subsequently measured at fair value with changes in fair value recognized in net income. Financial assets available-for-sale are subsequently measured at fair value with changes in fair value recognized in other comprehensive income, net of tax. Financial assets held-to-maturity, loans and receivables, and other financial liabilities are subsequently measured at amortized cost.

(g) Other Comprehensive Income

Other comprehensive income is comprised of an adjustment as a result of the December 1, 2008 change in the functional currency (see note 2(j)) from Canadian dollars to US dollars and the effect of translating the Consolidated Financial Statements from the Company's functional currency of US dollars into its presentation currency of Canadian dollars is recorded in other comprehensive income using the current rate method.

(h) Future Income Taxes

The Company uses the liability method to account for income taxes. Under this method, future tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities, and measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. The effect of a change in these income tax rates on future income tax liabilities and assets is recognized in income during the period that the change occurs. A valuation allowance is recognized against any future income tax assets if it is considered more likely than not that the asset will not be realized.

(i) Revenue Recognition

Revenue from the sale of petroleum and natural gas is recognized when physical delivery is made and title passes to an external party.

(j) Foreign Currency Translation

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. This resulted in a \$12,419,000 increase to net assets and to other comprehensive income.

The Company's accounting policy for foreign currency translation is unchanged, and it is applied to these changed circumstances as follows:

Non-monetary assets and liabilities denominated in foreign currencies are translated to the functional currency at rates in effect on the dates the assets were acquired or liabilities were assumed. Revenues and expenses are translated at rates of exchange prevailing on the transaction dates. Gains and losses on translation are reflected in income when incurred.

The Company has translated its US dollar results into the Canadian dollar reporting currency as follows: assets and liabilities at the rate of exchange in effect at the applicable balance sheet date and revenues and expenses at the monthly average exchange rates. The Company's share capital accounts, including its common shares and contributed surplus, are translated at rates in effect at the time of issuance. Unrealized gains and losses resulting from the translation to Canadian dollars are included in accumulated other comprehensive income (loss).

(k) Stock-Based Compensation

The Company uses the fair-value method of accounting for stock options and warrants granted under its stock compensation plan. The fair value of an option is estimated at the date of grant using the Black-Scholes valuation model and is amortized against earnings over the vesting period of the option with a corresponding amount reflected in contributed surplus. Amounts related directly to exploration and development activities are capitalized. Consideration received upon the exercise of the stock option, together with the amount previously credited to contributed surplus, is recorded as an increase to share capital. In the event that vested options or warrants expire without being exercised, previously recognized compensation costs associated with such stock options are not reversed. The Company has not incorporated an estimated forfeiture rate for stock options that will not vest; rather, the Company accounts for forfeitures as they occur.

(l) Earnings Per Share

Basic earnings per share are computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. The Company computes diluted earnings per share using the treasury stock method. This method assumes that the proceeds on exercise of in-the-money stock options and share purchase warrants are used to repurchase common shares of the Company at the average market price during the relevant period.

(m) Restated and 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.

3. 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.

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.

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 consolidated 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.

Accounting Pronouncements

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.

4. ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

During 2008, Mahalo committed to dispose of its Canadian resource assets with an agent being engaged to facilitate the process. 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.

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 value of \$3.5 million, representing the estimated fair value less costs to sell, has been assigned to the petroleum and natural gas assets remaining to be sold as at December 31, 2008 (2007 - \$75.8 million). These assets have been reclassified from "property and equipment" to "assets held for sale" on the consolidated balance sheets. A liability of \$1.8 million (2007 - \$3.2 million), being the asset retirement obligations associated with the assets held for sale, has also been set out separately on the consolidated balance sheets.

The results of operations, including net loss on disposition of property and equipment, related to the Canadian cost center are as follows:

<i>(\$000's)</i>	2008	2007
Revenues		
Petroleum and natural gas revenue	18,280	15,577
Royalty expense	(3,360)	(3,376)
Loss on financial derivative natural gas contracts	(90)	-
Other	30	271
	14,860	12,472
Expenses		
Operating and transportation	5,096	4,841
General & administrative	1,647	1,974
Interest	2,672	1,730
Depletion, depreciation and accretion	4,720	7,440
Net loss on the disposition of property and equipment	54,635	-
	68,770	15,985
Loss from discontinued operations	(53,910)	(3,513)

Interest expense was allocated to discontinued operations based on asset values.

The carrying value of the Company's petroleum and natural gas properties and related facilities is limited to the fair value less costs of sale, which in turn was based on the AECO Gas benchmark reference price adjusted for quality and price differentials, specific to the Company's assets, and discounted at an interest rate of 10 percent over the estimated reserve life.

During 2008, the Company sold Canadian oil and gas assets, facilities, and seismic for \$18,689,033 (2007 - \$22,363,405). During 2007, the Company purchased working interests in certain petroleum and producing assets in the Corbett Creek area of Alberta, Canada for \$2,800,000.

The Company capitalized \$158,047 (2007 - \$222,908) of direct general and administrative costs related to petroleum and natural gas properties. The Company also capitalized \$234,539 (2007 - \$220,706) of stock based compensation costs. These costs relate to discontinued operations.

5. PROPERTY AND EQUIPMENT

<i>(\$000's)</i>	Cost	Accumulated Depletion and Depreciation	Net Book Value
December 31, 2008:			
Petroleum and natural gas properties and equipment	174,198	34,930	139,268
Other	539	486	53
	<u>174,737</u>	<u>35,416</u>	<u>139,321</u>
December 31, 2007:			
Petroleum and natural gas properties and equipment	121,888	23,259	98,629
Other	562	267	295
	<u>122,450</u>	<u>23,525</u>	<u>98,924</u>

Costs associated with unproven properties excluded from costs subject to depletion amounted to \$21,633,089 (2007 - \$22,477,723). Future development costs of \$33,049,200 (2007 - \$30,773,400) have been included in the costs subject to depletion.

The carrying value of the Company's petroleum and natural gas properties and related facilities is limited to the amount calculated under the ceiling test at the balance sheet date. At December 31, 2008, the Company applied a ceiling test to its petroleum and natural gas properties and equipment using expected market prices of:

Year	Henry Hub Gas (US \$/MMbtu)
2009	7.80
2010	6.89
2011	7.56
2012	8.49
2013	9.74
Escalate thereafter	2.0 % per year

Prices used in valuing the Company's United States gas reserves were based on the Henry Hub benchmark price adjusted for existing forward sales prices and transportation and quality differentials specific to the Company's operations.

6. BANK DEBT

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 which is available for future acquisitions and capital expenditures, subject to the satisfaction of certain pre-conditions. At expiry, outstanding borrowings become due and payable.

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 agreement, the revolving loan bore interest at the Lender's Base Rate/Eurodollar Rate (each as specifically defined and calculated within the credit agreement) plus a margin spread of 1.75 to 2.75 percent per annum while the term loan and the delay draw loan bore interest at a margin spread of 7.50 to 9.50 percent per annum. The percentage 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 temporary waiver of the Events of Default. The margin spread on the revolving loan was increased to 3.75 percent (under both the Base Rate and Eurodollar Rate borrowing options). The margin spread on US \$5 million of amounts outstanding under the term loan portion of the facility was increased to 10.50 percent through to March 31, 2009. The Lender advanced an additional US \$5 million under the revolving loan portion of the facility, upon signing of the amendment, to assist the Company in meeting its ongoing cash requirements. The additional advance bears interest at a margin spread of 12.50 percent (under both the Base Rate and Eurodollar Rate borrowing options) and is repayable on March 31, 2009.

The Amendment revised the production, hedging and current ratio covenants for the period October 31, 2008 through December 31, 2009. The Amendment requires the Company to pay an estimated US \$10 million loan fee on March 31, 2009. At December 31, 2008, US \$10 million (Cdn \$12.2 million), being the maximum fee, has been reflected as an accrued liability. The Company also agreed to engage an advisor to assist with financial and accounting matters.

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. Of the revolver loan, US \$5.0 million (Cdn \$6.1 million) is repayable on March 31, 2009. The weighted average effective interest rate on borrowings outstanding under the Facility was 9.53 percent (2007 – 7.40 percent) at December 31, 2008.

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.

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

As of March 1, 2009, the Company was in breach of certain covenants under its bank credit agreement and does not expect to be in a position to repay the additional advance and pay the loan fee 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. Consequently, and as long as the default continues, Management knows that the credit facility is no longer a four year commitment but instead has the same characteristics as a demand loan; therefore, it must be classified as a current liability. Additionally, should the loan be called earlier than December 31, 2009, any unamortized balance of deferred financing costs would be expensed in its entirety at that time.

Under the terms of the Facility and the Amendment, 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:

- a) Terminate any commitment to make loans and any other credit extensions.

- b) 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.
- c) Require that the borrower cash collateralize any letters of credit.
- d) Exercise all rights and remedies available to the Lender under the loan documents.

7. ASSET RETIREMENT OBLIGATIONS

The Company's asset retirement obligations result from net ownership interests in petroleum and natural gas properties and equipment including well sites, gathering systems and processing facilities.

At December 31, 2008, the estimated total undiscounted amount required to settle the asset retirement obligations related to continuing operations, adjusted for inflation of 2 percent, is approximately \$4.5 million (December 31, 2007 - \$3.1 million). This amount has been discounted using a credit adjusted risk free interest rate of 8.5 percent. The expected period until settlement is dependent upon the useful lives of the underlying assets, which currently extend up to 50 years.

A reconciliation of the asset retirement obligation related to continuing operations is provided below:

(\$000's)	2008	2007
Balance, beginning of year	871	907
Liabilities incurred	209	33
Revision to assumptions	205	(136)
Accretion expense	100	67
Balance, end of year	1,385	871

The asset retirement obligation related to assets held for sale and discontinued operations are discussed in note 4.

8. SHARE CAPITAL

(a) Authorized

Unlimited number of voting common shares with no par value.
 Unlimited number of non-preferred shares issuable in series.

(b) Issued

Common shares	Number of Shares	Amount (\$000's)
Balance, December 31, 2006	58,386,035	157,983
Exercise of share purchase warrants (i)	900,000	954
Exercise of stock options	12,000	42
Balance, December 31, 2007 and 2008	59,298,035	158,979

- (i) During 2007, the remaining 900,000 of an original 1,000,000 share purchase warrants were exercised to purchase an equivalent number of common shares at \$0.50 per share. Each warrant was assigned a value of \$0.56 based on a net asset value of the Company at the date of issue.

(c) Share Purchase Warrants

At December 31, 2008, the Company had outstanding 292,800 performance warrants at a strike price of \$4.92 per share. The warrants will become 100 percent vested when the Company's stock price is \$8.33 per share on a 45 day weighted average trading basis. The warrants expire July 29, 2010. The warrants carry a "Put Right" whereby the warrant holders, at their option, may receive cash in an amount equal to the excess of the market

price at the time of exercise over the strike price. The warrants will be valued by the changes in the market price of the common shares at the end of each accounting period and will be amortized into earnings over their expected life once the performance condition becomes likely. No value has been assigned to these warrants.

In addition at December 31, 2008 and 2007, the Company had warrants which enable the warrant holder to acquire 1,440,000 common shares at \$4.17 per share. The value assigned to these warrants was \$1,990,412 using the Black-Scholes option-pricing model. These warrants expire November 30, 2009.

(d) Stock Options

The Company has a stock option plan whereby options may be granted to the Company's directors, officers, employees and consultants for up to 10 percent of the Company's outstanding common shares. The exercised price of the options is determined by the five day weighted average price of the stock on the five trading days immediately preceding the relevant date. Each stock option granted permits the holder to purchase one common share of the Company at the stated exercise price. Options currently outstanding have a term of five years and vest equally over three years commencing one year after the date of grant of the option.

The following table provides a continuity of stock options outstanding and the weighted average share prices for which shares have been reserved.

	Number of Options	Weighted Average Exercise Price (\$)
Outstanding, December 31, 2006	4,967,700	4.15
Granted	757,000	3.77
Exercised	(12,000)	3.54
Forfeited	(990,667)	3.87
Outstanding, December 31, 2007	4,722,033	4.18
Granted	912,000	2.46
Forfeited	(1,634,302)	4.13
Outstanding, December 31, 2008	3,999,731	3.51
Exercisable, December 31, 2008	2,514,981	3.96

The following summarizes information about stock options outstanding at December 31, 2008:

Range of Exercise Price	Options Outstanding	Weighted Average Exercise Price (\$)	Weighted Average Remaining Term (Years)	Options Exercisable	Weighted Average Exercise Price (\$)	Weighted Average Remaining Term (Years)
\$2.12 to \$3.95	2,468,931	2.83	3.3	984,181	2.93	2.4
\$4.19 to \$4.77	1,402,400	4.57	1.6	1,402,400	4.57	1.6
\$5.00 to \$7.40	128,400	5.23	1.2	128,400	5.23	1.2
	3,999,731	3.51	2.6	2,514,981	3.96	1.9

(e) Stock-Based Compensation

The Company accounts for its stock-based compensation using the fair value method. Under this method, the fair value of stock options granted is recognized as a charge to earnings with a corresponding increase to contributed surplus over the vesting period.

The fair value of stock options granted during the year was estimated using the Black-Scholes option-pricing model, using the following weighted average assumptions:

	2008	2007
Risk free interest rate (%)	3.1	3.5
Expected life (years)	5.0	5.0
Expected volatility (%)	94	45
Weighted average fair value per share (\$)	1.68	1.75

In 2008, stock-based compensation amounted to \$1,731,128 (2007 - \$2,081,125), of which \$1,496,489 (2007 - \$1,860,419) was recognized as an expense and \$234,539 (2007 - \$220,706) was capitalized to property and equipment.

(f) Stock Option Modification

During 2008, the Company re-priced 557,000 options (none of which were held by officers, directors or senior management). These options had original exercise prices ranging from \$3.01 to \$7.38 and were re-priced to have an exercise price of \$2.29 (the stock price at the date the re-pricing took place). This re-pricing resulted in the recognition of approximately \$130,000 of additional stock based compensation.

(g) Contributed Surplus

The following table reconciles Mahalo's contributed surplus:

<i>(\$000's)</i>	
Balance, December 31, 2006	6,035
Stock-based compensation costs	2,082
Balance, December 31, 2007	8,117
Stock-based compensation costs	1,731
Balance, December 31, 2008	9,848

(h) Per Share Amounts

The weighted average number of shares outstanding is as follows:

	2008	2007
Weighted average basic	59,298,035	59,242,901
Weighted average diluted	59,298,035	59,242,901

For the years ended December 31, 2008 and 2007, the share purchase warrants and the stock options were anti-dilutive.

9. Management of Capital Structure

The Company considers its capital structure to include working capital, long-term debt and shareholders' equity. Mahalo may from time to time make adjustments to its capital expenditure program and sell assets or issue new debt or equity; however, there is no assurance that debt or equity financing will be available on terms acceptable to the Company.

The Company manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying petroleum and natural gas assets. The Company prepares annual capital expenditure budgets, which are updated at least quarterly to reflect results of operations and capital deployment, changes to forecasted prices and costs, general industry conditions and other factors. The annual and updated budgets are approved by the Board of Directors.

Mahalo's capital structure at December 31, 2008 is set forth in the following table.

(\$000's)	December 31, 2008
Current assets	21,309
Accounts payable and accrued liabilities	38,118
Current portion of long-term debt	75,097
Working capital deficiency	(91,906)
Shareholders' equity	61,394

Working capital and long-term debt fluctuate primarily as a result of normal operational activity and the timing and level of capital expenditures. Mahalo's share capital is not subject to external restrictions; the approved borrowing base under the revolving bank credit facility is, however, based to a significant extent on the estimated value of the Company's petroleum and natural gas reserves. In addition, the Company must comply with the following debt covenants under the bank credit facility; interest rate coverage ratio, consolidated leverage ratio, current ratio, minimum liquidity, asset coverage ratio, minimum production, minimum hedging positions and maximum capital expenditures.

In November 2008, the Company's bank credit facility agreement was amended as set forth in note 6. At December 31, 2008, the Company was in compliance with respect to all covenants under the amended facility agreement.

As of March 1, 2009, the Company was in breach of certain covenants under its bank credit agreement and does not expect to be in a position to repay certain amounts that 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.

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.

10. INCOME TAXES

Income taxes vary from the amount that would be computed by applying the Canadian statutory tax rate of 29.5% for the year ended December 31, 2008 (2007 – 32.13%) to income from continuing operations as follows:

(\$000's)	2008	2007
Tax Rate (%)	29.5%	32.13%
Income (loss) from continuing operations before taxes	(10,193)	(941)
Expected income tax expense (recovery)	(3,007)	(302)
Increase (decrease) in income taxes resulting from:		
Foreign exchange adjustment	6,381	(1,309)
Higher foreign taxes	(740)	97
Non taxable expenses	713	755
Other	(110)	-
Income tax expense (recovery)	3,237	(759)
Capital taxes	21	22
Total taxes	3,258	(737)

The figures in the tables below represent the differences between the accounting and tax basis of assets and liabilities at the tax rates expected to apply upon reversal of the differences.

At December 31,	2008	2007
<i>(\$000's)</i>		
Canada		
Net book value of property and equipment less than (in excess of) tax basis	9,365	(6,665)
Asset retirement obligation	380	805
Non-capital loss carry forward	6,707	8,381
Share issue costs	222	521
Valuation allowance	(16,674)	(3,042)
Future income tax asset	-	-
United States		
Net book value of property and equipment less than (in excess of) tax basis	(27,791)	(13,305)
Unrealized derivative gain	(4,190)	-
Asset retirement obligation	540	338
Non-capital loss carry forward	25,426	10,917
Future income tax liability	(6,015)	(2,050)

At December 31, 2008, the Company had Canadian non-capital losses (included in the tax pools table above) available to offset future income of \$26.8 million (2007 - \$18.4 million). The losses expire as follows:

Canada	2008
<i>(\$000's)</i>	
2015	5,381
2026	13,000
2027	8,447
	26,828

At December 31, 2008, the Company had United States non-capital losses (included in the tax pools table above) available to offset future income of US \$53.2 million (2007 – US \$30.6 million). The losses expire as follows:

United States	2008
<i>(\$000's US)</i>	
2025	7,235
2026	8,866
2027	14,477
2028	22,659
Total	53,237

11. FOREIGN EXCHANGE

During 2008, the Company recorded a net foreign exchange loss of \$16,944,000 (2007 – gain of \$3,416,000), of which \$16,636,000 (2007 – gain of \$1,949,000) was unrealized at the year end. The amounts reflect the impact of fluctuations in the Canadian/United States exchange rate on monetary assets and liabilities and revenues and expenses of the Company that were denominated in United States dollars prior to the change in functional currency at December 1, 2008 (see note 2 (j)). The Canadian/US dollar exchange

rate declined to \$0.8080 at December 1, 2008 from \$1.009 at December 31, 2007. A majority of the decline occurred in the October/November 2008 period.

As disclosed in note 2(j) above, 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 Canadian and US operations are considered integrated and have the US dollar as their functional currency.

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 change in functional currency increased comprehensive income for the year by \$12.4 million due to foreign exchange gains.

12. SUPPLEMENTAL CASH FLOW INFORMATION

Changes in non-cash working capital were as follows:

<i>(\$000's)</i>	2008	2007
Increase (decrease) in non-cash working capital		
Accounts receivable	1,709	832
Prepaid and deposits	(16)	302
Accounts payable and accrued liabilities	3,596	(71)
Net change in non-cash working capital	5,289	1,063
Relating to:		
Operating activities	3,548	336
Investing activities	1,741	727
Net change in non-cash working capital	5,289	1,063

Cash taxes paid in 2008 was US\$20,000. Cash interest paid in 2008 was \$3.1 million.

13. COMMITMENTS

The Company has committed to certain payments over the next five years as follows:

	2009	2010	2011	2012	2013	Total
<i>(\$000's)</i>						
Office lease	639	668	529	105	44	1,985
Equipment usage	76	2,376	-	-	-	2,452
	715	3,044	529	-	-	4,437

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 (or 750 days in total), 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.

14. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

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 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.

Credit Risk

Credit risk is the risk of loss if customers or counterparties do not fulfill their contractual obligations. 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 and joint venture partners and are subject to normal energy industry credit risk. It is the Company's policy to establish marketing relationships with large customers to help mitigate credit risk. Mahalo generally grants unsecured credit but routinely assesses the financial strength of such parties.

The Company enters into physical fixed price forward sales contracts with its gas marketers and financial derivative contracts with large banking institutions.

Joint venture receivables are typically from participants in the petroleum and natural gas sector and collection of the 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 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 start of a project. In some cases, the Company does have the ability to withhold production from joint venture partners in the event of non-payment. Joint venture receivables are typically collected within one to three months of the joint venture bills being issued to the partner.

The Company considers its accounts receivable to be aged as follow as at December 31, 2008.

<i>(\$000's)</i>	December 31, 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 prices (commodity price risk), foreign currency exchange rates and interest 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 Company's operational results and financial condition are impacted by the price it receives for its petroleum and natural gas production. Commodity prices have fluctuated significantly this year. The Company takes 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 percent of expected daily gas sales volumes be pre sold. All such transactions are conducted in accordance with the risk management policy that has been approved by the Board of Directors.

The Company has sales contracts outstanding with respect to the physical delivery and sale of natural gas at a fixed price. The estimated fair value of the fixed price physical sales contracts was \$8.9 million at December 31, 2008. The following is a summary of the physical fixed forward sales commitments.

Daily Volume	Contract Price	Term
Mmbtu		
1500	US \$7.185/MMbtu	February 2008 - January 2009
3000	US \$10.22/MMbtu	November 2008 - June 2009
2750	US \$10.35/MMbtu	November 2008 - June 2009
1000	US \$10.26/MMbtu	November 2008 - July 2009
2000	Pan Index + US \$0.01/MMbtu	January 2009 - June 2009
5000	Pan Index + US \$0.05/MMbtu	July 2009 - May 2010
3000	Pan Index + US \$0.01/MMbtu	January 2009 - December 2009
2000	Pan Index Flat	July 2009 - December 2009

Taking into account the physical fixed forward sales contracts in 2008, the impact of a Cdn \$1 change per MMBtu on remaining volumes results in an estimated \$0.4 million impact on pre-tax income for the year ended December 31, 2008.

At December 31, 2008, the Company also had derivative natural gas contacts outstanding as follows:

Transaction Type	Daily Volume	Contract Price	Term	Mark to Market
	MMBtu			(\$000's)
NYMEX Financial Fixed	5000	US \$7.44/MMbtu	Jan 2009 - Dec 2009	2,955
NYMEX Financial Fixed	2500	US \$8.10/MMbtu	Jan 2010 - Dec 2010	1,067
Financial Panhandle Basis	5000	HH minus US \$1.12/MMbtu	July 2009 - May 2010	(108)
Financial Panhandle Basis	5000	HH minus US \$1.27/MMbtu	Jan 2009 - Dec 2009	(49)
Financial Panhandle Basis	2500	HH minus US \$0.98/MMbtu	Jan 2010 - Dec 2010	16
Financial Panhandle Basis	2500	HH minus US \$1.00/MMbtu	Jan 2010 - Dec 2010	(6)

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

The mark-to-market of all derivative natural gas contracts was an asset of \$10.7 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.

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.

(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 percent, 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 Exchange 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. This results in a natural hedge which significantly reduces the Company's foreign currency risk. 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 financial obligations on the balance sheet are as follows:

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

As of March 1, 2009, the Company was in breach of certain covenants under its bank credit agreement and does not expect to be in a position to repay certain amounts that are due on March 31, 2009 as discussed in note 6.

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.

15. RELATED PARTY TRANSACTIONS

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

In 2008, the Company sold certain non-core properties to Avenir Operating Corp. for \$4.0 million. The measurement basis used for the transaction was an independent reserves valuation as at December 31, 2007. 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.

During 2007, the Company sold certain non-core properties to Avenir Operating Corp 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.