*Unaudited Interim Consolidated Financial Statements of*

# Iteration Energy Ltd.

*September 30, 2008*

# Iteration Energy Ltd.

## Consolidated Balance Sheets (unaudited)

| **As at**<br>*(in thousands of dollars)* | **September 30, 2008** | December 31, 2007 |
|---|---|---|
| **ASSETS** (Note 5) | | |
| Current | | |
| Cash | **$21,857** | $1,230 |
| Accounts receivable (Note 11(f)) | **49,698** | 15,942 |
| Prepaids and other current assets | **9,332** | 2,640 |
| | **80,887** | 19,812 |
| Property, plant and equipment (Notes 3 and 4) | **935,601** | 285,354 |
| Goodwill (Note 3) | **241,761** | 33,899 |
| | **$1,258,249** | $339,065 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current | | |
| Bank indebtedness (Note 5) | **$234,000** | $50,370 |
| Accounts payable and accrued liabilities (Note 6) | **79,354** | 30,454 |
| Stock based compensation payable (Notes 8(d) and (e)) | **2,252** | 7,520 |
| | **315,606** | 88,344 |
| Future income taxes (Notes 3 and 9) | **94,625** | 7,510 |
| Leasehold inducements | **229** | 199 |
| Asset retirement obligation (Note 7) | **41,553** | 18,897 |
| | **452,013** | 114,950 |
| Commitments and contingencies (Notes 10, 11, and 12) | | |
| Subsequent event (Note 16) | | |
| Shareholders' equity | | |
| Share capital (Note 8) | **805,302** | 238,586 |
| Warrants outstanding (Note 8(e)) | **-** | 3,934 |
| Retained earnings (deficit) | **934** | (18,405) |
| | **806,236** | 224,115 |
| | **$1,258,249** | $339,065 |

See accompanying notes to the unaudited interim consolidated financial statements.

# Iteration Energy Ltd.

## Consolidated Statements of Earnings (Loss), Comprehensive Earnings (Loss) and Retained Earnings (Deficit) (unaudited)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| *(in thousands of dollars, except per share amounts)* | **2008** | 2007 | **2008** | 2007 |
| Revenue | | | | |
| Production revenue | **$108,444** | $22,161 | **$291,183** | $72,711 |
| Royalties | **(23,115)** | (5,387) | **(61,993)** | (14,806) |
| | **85,329** | 16,774 | **229,190** | 57,905 |
| Other production revenue | **950** | 107 | **1,908** | 102 |
| | **86,279** | 16,881 | **231,098** | 58,007 |
| Expenses | | | | |
| Production | **18,535** | 3,786 | **49,022** | 12,884 |
| Transportation | **1,290** | 747 | **4,741** | 2,324 |
| General and administrative | **2,752** | 1,269 | **8,224** | 3,720 |
| Stock based compensation expense (recovery) (Notes 8(d) and (e)) | **(16,496)** | (1,486) | **4,412** | 3,722 |
| Interest on current debt | **2,526** | 398 | **6,705** | 1,259 |
| Depletion, depreciation and accretion | **40,639** | 15,117 | **101,239** | 43,109 |
| | **49,246** | 19,831 | **174,343** | 67,018 |
| Earnings (loss) before the following | **37,033** | (2,950) | **56,755** | (9,011) |
| Non-cash charge related to warrants (Note 8(e)) | **-** | - | **(3,547)** | - |
| Provision for bankruptcy: SemGroup LP (Note 11(f)) | **(1,650)** | - | **(10,998)** | - |
| Recovery of investment tax credits | **-** | - | **1,820** | |
| Earnings (loss) before income taxes | **35,383** | (2,950) | **44,030** | (9,011) |
| Income taxes (Note 9) | | | | |
| Current income tax expense | **-** | - | **671** | 197 |
| Future income tax expense (recovery) | **8,687** | (965) | **14,301** | (2,915) |
| | **8,687** | (965) | **14,972** | (2,718) |
| Net earnings (loss) and comprehensive earnings (loss) | **26,696** | (1,985) | **29,058** | (6,293) |
| Deficit, beginning of period | **(26,072)** | (13,271) | **(18,405)** | (8,963) |
| Credit (charge) on modification of warrant terms (Note 8(e)) | **310** | - | **(9,719)** | - |
| Retained earnings (deficit), end of period | **$934** | $(15,256) | **$934** | $(15,256) |
| Earnings (loss) per basic common share (Note 8(f)) | **$0.16** | $(0.03) | **$0.21** | $(0.10) |
| Earnings (loss) per diluted common share (Note 8(f)) | **$0.16** | $(0.03) | **$0.20** | $(0.10) |

See accompanying notes to the unaudited interim consolidated financial statements

# Iteration Energy Ltd.

## Consolidated Statements of Cash Flows (unaudited)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| *(in thousands of dollars)* | **2008** | 2007 | **2008** | 2007 |
| **OPERATING ACTIVITIES** | | | | |
| Net earnings (loss) | **$26,696** | $(1,985) | **$29,058** | $(6,293) |
| Add (deduct) non-cash items: | | | | |
| Depletion, depreciation and accretion | **40,639** | 15,117 | **101,239** | 43,109 |
| Recovery of investment tax credits | **-** | - | **(1,820)** | - |
| Future income tax expense (recovery) | **8,687** | (965) | **14,301** | (2,915) |
| Amortization of leasehold inducements | **(41)** | (33) | **(136)** | (99) |
| Stock-based compensation expense (recovery) (Note 8 (d) and (e)) | **(16,496)** | (1,486) | **(5,256)** | 3,722 |
| Non-cash charge related to warrants Note 8(e) | **-** | - | **3,547** | - |
| Asset retirement expenditures | **(147)** | (87) | **(257)** | (121) |
| | **59,338** | 10,561 | **140,676** | 37,403 |
| Net change in non-cash operating working capital (Note 13) | **(13,563)** | 682 | **(13,664)** | (5,326) |
| | **45,775** | 11,243 | **127,012** | 32,077 |
| **INVESTING ACTIVITIES** | | | | |
| Proceeds on sale of property plant and equipment | **-** | - | **646** | 122 |
| Acquisition of subsidiary | **-** | - | **(778)** | - |
| Acquisition of oil and gas properties | **(36,930)** | (52,695) | **(41,344)** | (55,068) |
| Additions to oil and gas properties | **(31,907)** | (18,621) | **(100,542)** | (71,572) |
| Additions to other capital assets | **(507)** | (44) | **(1,022)** | (44) |
| Net change in non-cash investing working capital (Note 13) | **14,918** | 7,642 | **(16,733)** | 5,904 |
| | **(54,426)** | (63,718) | **(159,773)** | (120,658) |
| **FINANCING ACTIVITIES** | | | | |
| Proceeds from (repayment of) bank indebtedness | **(9,000)** | 52,955 | **71,630** | 46,210 |
| Common shares issued (Note 8(e)) | **-** | - | **2,900** | 40,401 |
| Exercise of warrants (Note 8(e)) | **(261)** | - | **(21,112)** | - |
| Share issue costs | **-** | (11) | **(30)** | (2,191) |
| Deferred share issue costs | **-** | (1,030) | **-** | (1,030) |
| | **(9,261)** | 51,914 | **53,388** | 83,390 |
| Increase (decrease) in cash | **(17,912)** | (561) | **20,627** | (5,191) |
| Cash, beginning of period | **39,769** | 592 | **1,230** | 5,222 |
| Cash, end of period | **$21,857** | $31 | **$21,857** | $31 |

See Note 13 for supplemental disclosure

See accompanying notes to the unaudited interim consolidated financial statements

# Iteration Energy Ltd.

## Notes to the Unaudited Interim Consolidated Financial Statements
## For the Three and Nine Months Ended September 30, 2008 and 2007

(Tabular amounts in thousands of dollars, unless otherwise noted)

### 1. NATURE OF OPERATIONS

Iteration Energy Ltd. ("Iteration" or the "Company") is a public company that trades on the Toronto Stock Exchange and is incorporated under the Business Corporations Act (Alberta). Iteration is engaged in the exploration, development and production of petroleum and natural gas in Canada.

### 2. SIGNIFICANT ACCOUNTING POLICIES

The unaudited interim consolidated financial statements of Iteration Energy Ltd. have been prepared in accordance with Canadian generally accepted accounting principles and are consistent with those policies set out in the audited consolidated financial statements for the year ended December 31, 2007, except as disclosed below. These interim consolidated financial statements do not include all disclosures provided in the December 31 financial statements and should be read in conjunction with those financial statements.

Principles of Consolidation

These consolidated financial statements include the accounts of Iteration Energy Ltd., its wholly owned subsidiaries (Cyries Energy Inc, Iteration Energy Inc. and Cyries Wyoming Inc.) and its wholly owned partnerships (Iteration Energy and Iteration Energy Partnership 2007). All inter-company transactions are eliminated on consolidation.

Changes in Accounting Policies

The CICA has issued several new accounting standards. Section 1400 *General Standards of Financial Statement Presentation*, Section 1535 *Capital Disclosures*, Section 3031 *Inventories*, Section 3862 *Financial Instruments – Disclosures*, and Section 3863 *Financial Instruments – Presentation*. These standards became effective January 1, 2008.

CICA 1400 *General Standards of Financial Statement Presentation* was amended to include requirements to assess and disclose an entity's ability to continue as a going concern. The adoption of this standard did not have an impact on the Company's financial statements.

Section 1535 *Capital Disclosures,* establishes standards for disclosing information regarding an entity's capital and how it is managed. The section specifies the disclosure of i) an entity's 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 new disclosures are provided in Note 14.

Section 3031 *Inventories,* requires inventories to be measured at the lower of cost or net realizable value; disallows the use of a last-in first-out inventory-costing methodology; and requires that, when circumstances which previously caused inventories to be written down below cost or net realizable value no longer exist, the amount of the write-down is to be reversed. This section is the Canadian equivalent to International Reporting Standards IAS-2, *Inventories.* The adoption of this standard had no material impact on the Company's consolidated financial statements.

Sections 3862 *Financial Instruments – Disclosures,* and section 3863 *Financial Instruments – Presentation,* replace section 3861 *Financial Instruments – Disclosure and Presentation*, which revises and enhances financial instruments disclosure requirements and leaves unchanged its presentation requirements. The objective of section 3862 is to provide financial statement disclosure to enable users to evaluate the significance of financial instruments for the Company's financial position and performance. The section also requires increased disclosure on the nature and extent of risks arising from financial instruments that the Company is exposed to during the reporting period and the balance sheet date and how the company is managing those risks. The purpose of section 3863 is to enhance the financial statement users' understanding of the significance of financial instruments to the Company's financial position, performance and cash flows.

Future Accounting Policies

The Canadian Accounting Standards Board has now confirmed that the use of International Financial Reporting Standards ("IFRS") will be required in 2011 for publicly accountable, profit-oriented enterprises. IFRS will replace current Canadian GAAP followed by the Company. The Company will be required to begin reporting under IFRS effective January 1, 2011 and will be required to provide information following IFRS for the comparative period. The Company is currently evaluating the impact of adopting IFRS.

Effective January 1, 2009, the Company will be adopting the new CICA Handbook Section 3064, *Goodwill and Intangible Assets,* which converges Canadian GAAP for goodwill and intangible assets with IFRS. The new standard provides more comprehensive guidance on intangible assets, particularly for internally developed intangible assets. The Company is still assessing the financial reporting impact of this standard.

## 3. ACQUISITIONS AND DISPOSITIONS

**Cyries Acquisition**

On March 7, 2008, Iteration acquired Cyries Energy Inc. ("Cyries"), by Plan of Arrangement (the "Arrangement"). Under the Arrangement, Iteration issued 93,990,604 Iteration common shares to acquire the issued and outstanding common shares, warrants and performance shares of Cyries. The value attributed to each Iteration common share was $5.99 per share, representing the volume weighted average trading price on the Toronto Stock Exchange for an Iteration common share for the period from February 27, 2008 to March 6, 2008. This period includes the three trading days before and after Iteration's announcement on March 3, 2008 of the increase in the exchange ratio for the acquisition.

Upon completion of the Arrangement, Cyries became a wholly owned subsidiary of Iteration with the existing Iteration shareholders, option holders and warrant holders holding approximately 47% of the combined entity. Although Cyries shareholders held 53% of the Iteration Common Shares on a diluted basis following the arrangement, the transaction has been accounted for as an acquisition of Cyries by Iteration, recognizing that Iteration is the surviving legal entity, Iteration paid a premium to acquire Cyries and Iteration's existing management and Board of Directors retained their positions. The financial statements for the nine month period ended September 30, 2008 incorporate the operations of Iteration Energy Ltd., Iteration Energy Inc., Iteration Energy and Iteration Energy 2007 Partnership for the period from January 1, 2008 to September 30, 2008 and the operations of Cyries Energy Inc. for the period from March 8, 2008 to September 30, 2008.

The acquisition is being accounted for using the purchase method and, the purchase price was allocated on a preliminary basis as follows:

| ($000's) | |
|---|---|
| Furniture and equipment | $821 |
| Property, plant and equipment | 599,448 |
| Goodwill | 207,259 |
| Bank Debt | (111,045) |
| Working capital deficiency | (28,325) |
| Future income tax liability | (79,563) |
| Asset retirement obligation | (14,275) |
| Total purchase price | $574,350 |
| Consideration was comprised of : | |
| Common shares | $563,004 |
| Transaction costs | 11,346 |
| Total consideration | $574,350 |

**Peace River Arch Partnership**

On September 28, 2007, with an effective date of June 1, 2007, the Company purchased 100% of the partnership interests of the Peace River Arch Partnership from an arms length third party for $50,501,000. The partnership owns producing properties located in the Peace River Arch area of North West Alberta and the Manyberries area in South East Alberta. The results of operations for the Peace River Arch Partnership have been included in the consolidated financial statements from the September 28, 2007 acquisition date.

The acquisition was accounted for by the purchase method and the purchase price was allocated as follows:

| ($000's) | |
|---|---|
| Property, plant and equipment | $55,937 |
| Goodwill | 13,758 |
| Future income tax liability | (11,863) |
| Asset retirement obligation | (6,775) |
| Total purchase price | $51,057 |
| Consideration was comprised of : | |
| Cash | $51,057 |
| Total consideration | $51,057 |

## 4. PROPERTY PLANT AND EQUIPMENT

| | **September 30, 2008 ($000's)** | December 31, 2007 ($000's) |
|---|---|---|
| Oil and gas properties | **$ 1,215,026** | $ 467,281 |
| Other | **2,817** | 753 |
| | **1,217,843** | 468,034 |
| Less accumulated depletion and depreciation | **282,242** | 182,680 |
| | **$ 935,601** | $ 285,354 |

At September 30, 2008, unproved properties and seismic expenditures amounting to $147,788,000 (September 30, 2007: $46,361,000) have been excluded from the depletion calculation. Future development costs on proven undeveloped reserves of $33,025,000 (September 30, 2007: $5,945,000) are included in the depletion calculation.

For the three and nine months ended September 30, 2008, the Company capitalized $1,045,000 and $2,895,000 respectively, (three and nine months ended September 30, 2007: $585,000 and $1,673,000 respectively) of overhead directly related to exploration and development activities.

## 5. BANK INDEBTEDNESS

Bank Indebtedness represents the drawn portion of a syndicated facility. The syndicated facility provides for maximum borrowings of $275 million. There are two components to the syndicated facility. The first is a $260 million term facility which can be used to fund the Company's capital program and matures on April 30, 2009. The maturity date of the facility may be extended for a period of 364 days, if requested by the borrower and accepted by the lender. The second component is a $15 million working capital revolving facility, which is payable on demand. Under the terms of the term facility, the Company may borrow by way of:

i) Bankers acceptances in Canadian dollars bearing interest at the bankers acceptance rate plus a margin, ranging from 90 to 150 basis points, depending on the ratio of funded debt to trailing cashflow;

ii) LIBOR based loans in United States dollars bearing interest at the LIBOR rate plus a margin, ranging from 90 to 150 basis points, depending on the ratio of funded debt to trailing cashflow;

iii) Prime rate loans in Canadian dollars bearing interest at the Royal Bank of Canada prime rate should the ratio of funded debt to trailing cashflow be less than 2.5 to 1 and at Royal Bank of Canada prime plus 25 basis points should the ratio of funded debt to trailing cashflow be greater than 2.5 to 1; and

iv) US Base Rate loans in Unites States dollars bearing interest at the Royal Bank of Canada US base rate should the ratio of funded debt to trailing cashflow be less than 2.5 to 1 and at Royal Bank of Canada prime plus 25 basis points should the ratio of funded debt to trailing cashflow be greater than 2.5 to 1.

The facility is secured by a $500 million fixed and floating charge debenture.

As at September 30, 2008, $234 million of indebtedness was in the form of 30 day bankers acceptances.

As more fully discussed in note 16, subsequent to quarter end, the Company's credit facility was increased by the existing syndicate of lenders by $ 25 million to $300 million.

## 6. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

The accounts payable and accrued liabilities consist of the following:

| | **September 30, 2008 ($000's)** | December 31, 2007 ($000's) |
|---|---|---|
| Trade accounts payable | **$57,143** | $22,023 |
| Joint venture accounts payable | **4,680** | 1,944 |
| Royalties payable | **17,531** | 6,487 |
| Total | **$79,354** | $30,454 |

## 7. ASSET RETIREMENT OBLIGATION

The total future asset retirement obligations were estimated by management based on the Company's net working interest in all wells and facilities, estimated costs to reclaim and abandon wells and facilities and the estimated timing of the costs to be incurred in future periods. The Company estimates the undiscounted cash flows related to asset retirement obligations, adjusted for inflation, to be incurred over the estimated reserve life of the underlying assets (from 2008 through 2036) will total approximately $90,002,240 (December 31, 2007: $39,281,000). The estimated fair value of the obligation at September 30, 2008 is $41,553,000 (December 31, 2007: $18,897,000) using a discount rate of six and one half percent and an inflation rate of two percent. As at September 30, 2008, no funds have been set aside to settle this obligation.

| | **September 30, 2008 ($000's)** | December 31, 2007 ($000's) |
|---|---|---|
| Balance, beginning of period | **$18,897** | $9,198 |
| Liabilities incurred on acquisition of properties | **19,041** | 6,775 |
| Increase in liabilities from drilling activity | **2,291** | 2,262 |
| Accretion expense | **1,581** | 833 |
| Settlement of liabilities | **(257)** | (171) |
| Balance, end of period | **$41,553** | $18,897 |

## 8. SHARE CAPITAL

### (a) Authorized

Unlimited number of voting common shares without par value.
Unlimited number of preferred shares issuable in series

### (b) Common Shares Issued

| | **Nine months ended September 30, 2008** | | Year ended December 31, 2007 | |
|---|---|---|---|---|
| | Number of Shares | Amount ($000's) | Number of Shares | Amount ($000's) |
| Balance, beginning of period | **71,029,780** | **$238,586** | 57,429,847 | $175,195 |
| Shares issued on public offerings | **-** | **-** | 12,977,400 | 67,892 |
| Shares issued on corporate acquisition | **93,990,607** | **563,004** | - | - |
| Shares issued on exercise of warrants | **1,000,000** | **3,733** | 278,333 | 1,039 |
| Shares issued on exercise of stock options | **-** | **-** | 344,200 | 998 |
| Share issue costs, net of tax effect of $9,000 (2007: $686,000) | **-** | **(21)** | - | (2,795) |
| Tax benefits renounced on prior year flow through share offering | **-** | **-** | - | (3,743) |
| Balance, end of period | **166,020,387** | **$ 805,302** | 71,029,780 | $238,586 |

### (c) Flow Through Shares

During 2006, the Company issued common shares on a flow-through basis for gross proceeds of $12,075,000 to finance certain oil and gas expenditures to be incurred in 2007. The renouncement of these expenditures was made to the purchasers of these shares in 2007 and accordingly, share capital was reduced by the amount of the tax benefits associated with these expenditures ($3,743,000).

### (d) Stock Options

The Company has a stock option plan, which was amended with shareholder approval on June 20, 2008 that provides for the issuance of options to its officers, employees and consultants allowing for the acquisition of up to a fixed maximum of 16,000,000 common shares. This represents less than 10% of the currently issued and outstanding common shares. The dates on which options vest are set by the Board of Directors at the time of grant. The exercise price of an option granted is the closing price of the Company's stock on the last trading date prior to the grant date. The dates on which options expire are also set by the Board of Directors at the time of grant and cannot exceed ten years. Outstanding stock options to acquire common shares through the stock option plan are as follows:

| | **Nine months ended September 30, 2008** | | Year ended December 31, 2007 | |
|---|---|---|---|---|
| | **Number of Options** | **Weighted average exercise price $** | Number of Options | Weighted average exercise price $ |
| Outstanding, beginning of period | **6,568,789** | **3.49** | 5,884,222 | 3.22 |
| Granted | **4,086,166** | **5.81** | 1,079,500 | 4.76 |
| Exercised for shares | **-** | **-** | (344,200) | (2.90) |
| Exercised for cash | **(1,642,409)** | **(2.94)** | (667) | (4.90) |
| Forfeited | **(377,500)** | **(5.90)** | (50,066) | (4.49) |
| Outstanding, end of period | **8,635,045** | **4.75** | 6,568,789 | 3.49 |
| Options exercisable, end of period | **3,473,455** | **3.27** | 3,236,062 | 3.11 |

The following table summarizes information about the stock options outstanding at September 30, 2008:

| Range of exercise prices | Number outstanding September 30, 2008 | Weighted average remaining contractual life (years) | Weighted average exercise price $ | Number exercisable September 30, 2008 | Weighted average exercise price $ |
|---|---|---|---|---|---|
| $2.90 to $4.00 | 2,729,637 | 1.43 | 2.93 | 2,754,635 | 2.96 |
| $4.01 to $5.00 | 1,987,867 | 2.61 | 4.55 | 634,545 | 4.34 |
| $5.01 to $9.00 | 3,917,541 | 3.42 | 6.12 | 84,275 | 5.19 |
| | 8,635,045 | 2.60 | 4.75 | 3,473,455 | 3.27 |

The Company's stock option plan provides stock option holders the choice, upon exercise, to receive a cash payment in exchange for surrendering the option. The cash payment is equal to the appreciated value of the stock option as determined based on the difference between the option's exercise price and the Company's share price at the time of exercise. For the three and nine month periods ended September 30, 2008, stock based compensation recovery of $16,496,000 and expense of $4,412,000 respectively (2007 recovery of $1,486,000 and expense of $3,722,000 respectively), was recognized based on the change in value of the outstanding stock options. Future fluctuations in the stock based compensation expense or recoveries are dependent on the movement of the Company's share price and the number of options outstanding. Based on the September 30, 2008 share price of $3.75, had all of the outstanding stock options to acquire 8,635,045 common shares been vested, aggregate stock based compensation expense and a corresponding liability of $2,252,000 (December 31, 2007: $8,424,300) would have been recognized. Of this amount, $2,252,000 has been recognized as stock based compensation payable at September 30, 2008 (December 31, 2007: $7,520,000).

### (e) Warrants

On March 21, 2005, warrants to purchase 5,000,000 common shares at $2.90 were issued to Iteration Energy Inc. shareholders. The warrants vested the first day after the common shares of the Company had traded at a weighted average price of not less than $4.50 per common share for any 45 consecutive calendar days within a 42-month period and expired on September 21, 2008. On May 7, 2005, all of the warrants vested. Warrant capital of $4.1 million, calculated using the Black –Scholes option pricing methodology, was ascribe to the warrants issued.

During the second quarter of 2008, 1,000,000 warrants were exercised for common shares of the Company, on the payment by the warrant holder of $2.90 per warrant exercised. The $2.9 million of cash received, plus the associated $883,000 of warrant capital ascribed has been recorded as share capital.

At the Annual General Meeting of the Company held on May 22, 2008, shareholders approved an amendment to the warrants which allowed holders of the then remaining warrants to receive a cash payment in exchange for the surrender of the warrants. The cash payment is equal to the difference between the warrant exercise price and the Company's share price at the time of the exercise. As a result of that change, the Company calculated the cash in lieu amount on the 3,722,000 warrants then outstanding, based on the difference between the fair market value of the Company's common shares at that time of $7.70 and the exercise price of $2.90. This amount of $17.9 million was recorded as stock based compensation payable with an offsetting charge to the deficit. A future income tax benefit associated with the obligation of $4.7 million, based on the Company's future tax rate of 26.5% was also recorded and warrant capital previously recorded in the financial statements at the time of $3.1 million was reclassified as a credit to the deficit.

Later in the second quarter, 3,605,000 warrants were exercised for cash, which resulted in a cash payment of $20.9 million. Of this amount, $3.5 million was recorded as an expense, representing the difference between the market value of the Company's shares at the date of exercise and the obligation recorded related to the market value of shares on May 22, 2008, as outlined above. The balance has been recorded as a reduction of stock based compensation payable.

During the third quarter, the remaining 116,667 warrants were exercised for cash, using an exercise price of $5.05 per warrant. As this amount was less than the value of the common shares at the time the conversion rights for the warrants changed of $7.70, the difference of $310,000 has been applied to reduce the initial charge to retained earnings.

### (f) Per Share Amounts

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2008** | 2007 | **2008** | 2007 |
| Weighted average common shares outstanding | **166,020,387** | 64,844,047 | **141,606,728** | 61,654,018 |
| Weighted average diluted common shares outstanding | **168,045,908** | 64,844,047 | **144,693,253** | 61,654,018 |

## 9. INCOME TAXES

The provision for future income taxes recorded in the financial statements differs from the amount that would be obtained by applying the statutory income tax rate to the loss before tax as follows:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| **($000's)** | **2008** | 2007 | **2008** | 2007 |
| Earnings (loss) before tax | **$35,383** | $(2,950) | **$44,030** | $(9,011) |
| Statutory Canadian corporate tax rate | **29.50%** | 32.12% | **29.50%** | 32.12 % |
| Anticipated tax (recovery) | **$10,438** | $(948) | **$12,989** | $(2,894) |
| Rate adjustment | **$(1,061)** | 33 | **(1,321)** | 101 |
| Other | **(690)** | (50) | **2,633** | (122) |
| Future income tax expense (recovery) | **$8,687** | $(965) | **$14,301** | $(2,915) |

The Company's future income tax liability at September 30, 2008 and December 31, 2007 is comprised of the following:

| **($000's)** | **September 30, 2008** | December 31, 2007 |
|---|---|---|
| Income tax rate (%) | **26.50** | 29.50 |
| Property plant and equipment, having different income tax and accounting basis | **$84,166** | $10,228 |
| Deferred partnership income | **28,225** | 13,082 |
| Scientific research pools | **-** | (5,301) |
| Non capital loss carry forwards | **(2,926)** | (730) |
| Share issue costs | **(4,525)** | (1,568) |
| Accrued stock based compensation | **(597)** | (2,218) |
| Asset retirement obligation | **(11,012)** | (5,575) |
| Unamortized leasehold inducements | **(61)** | (59) |
| Other | **1,355** | (349) |
| Future income tax liability | **$94,625** | $7,510 |

The current tax expense of $671,000 for the nine months ended September 30, 2008 (September 30, 2007: $197,000) relates to a provincial part 1 tax assessment.

## 10. OPERATING LEASES

The Company has entered into various operating leases with respect to its premises. The leases have various expiration dates between September 30, 2012 and June 30, 2014 and require the following future minimum lease payments, by calendar year;

| | **Gross Commitment ($000's)** | **Sublet Recovery ($000's)** | **Net Commitment ($000's)** |
|---|---|---|---|
| 2008 | $660 | ($317) | $343 |
| 2009 | $3,005 | ($1,268) | $1,738 |
| 2010 | $3,537 | ($1,268) | $2,269 |
| 2011 | $3,537 | ($1,268) | $2,269 |
| 2012 | $3,220 | ($951) | $2,269 |
| 2013 | $2,269 | - | $2,269 |
| 2014 | $1,135 | - | $1,135 |

The lease costs associated with office space previously occupied by Cyries has been sublet on a full recovery flow through basis commencing June 1, 2008 through until September 30, 2012. As a result of the sublet, starting in June 2008 the Company will expects to recover lease payments of approximately $1,268,000 per annum.

The existing lease on the Company's office space expires June 30, 2009. During the quarter, the Company renewed the lease on the existing premises, plus additional expansion space, for a further five year term commencing July 1, 2009 on the existing premises and October 1, 2009 on the expansion premises.

## 11. FINANCIAL INSTRUMENTS

The Company is exposed to a number of different financial risks arising from normal course business exposures, as well as the Company's use of financial instruments. These risk factors include market risks relating to commodity prices and interest rate risk, as well as liquidity risk and credit risk.

a) Market Risk

Market risk is the risk or uncertainty arising from possible market price movements and their impact on the future performance of the business. The market price movements that could adversely affect the value of the Company's financial assets, liabilities and expected future cash flows include commodity price risk and interest rate risk.

b) Commodity Price Risk

The Company's financial performance is closely linked to oil and natural gas prices. A change of $1.00 Cdn/GJ in natural gas prices at the wellhead would have the effect of changing earnings for the remainder of the year by approximately $5 million. A $5.00/bbl change in WTI for oil would have the effect of changing earnings for the remainder of the year by approximately $1 million.

From time to time, the Company employs the use of various financial instruments to manage these price exposures, and at this time, has entered into the following forward option for the future physical delivery of crude oil:

| **Term** | **Volume (bbl/d)** | **Contract Price (US $ /bbl)** | **Price Basis** |
|---|---|---|---|
| Dec 1, 2007 – Nov 30, 2008 | 200 | $75.00 floor, $90.20 ceiling | WTI |

The Company considers the contract to be a future sales contract in the normal course of business at prices within a predetermined range with our current oil marketer, which will be satisfied by the future delivery of crude oil. The loss realized during the three months and nine months ended September 30, 2008 with respect to this contract was approximately US $514,000 and US $1,270,000 respectively. As at September 30, 2008, the estimated value of the remaining contract was a loss of US $154,000.

c) Interest Rate Risk

The Company is exposed to interest rate risk as changes in interest rates may affect future cash flows and the fair value of its financial instruments. The Company's primary debt facility has a floating interest rate that will fluctuate based on prevailing market conditions and the Company’s ratio of funded debt to trailing cashflow. Cash flows are sensitive to changes in interest rates on this instrument. Given the amount of debt employed, the Company's strategy is to manage interest rate risk within the current economic environment framework. If interest rates on the floating instrument were to change by 1.0% for the remainder of the year it is estimated that earnings for the remainder of the year would change by approximately $0.6 million.

d) Liquidity Risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. The Company believes that it has access to sufficient capital through internally generated cashflows and external equity sources, as well as undrawn committed borrowing facilities to meet current spending forecasts. All of the trade liabilities mature in 2008 and the Company's bank loan is due on demand.

e) Foreign Exchange Risk

Foreign exchange risk is the risk that the fair value of the future cash flows will fluctuate because of changes in foreign exchange rates. The benchmark pricing for most natural gas and crude oil is based on US Dollars. Changes in the exchange rate of the Canadian dollar relative to the US dollar will directly impact the Canadian dollar commodity price realized by the Company and, as a result, cash flow. If foreign

exchange rates were to change by 1% for the remainder of the year, it is estimated that earnings for the remainder of the year would change by approximately $ 0.8 million.

f) Counterparty Credit Risk

Counterparty credit risk is the risk that a customer or counterparty will fail to perform an obligation or fail to pay amounts due causing a financial loss. The Company's accounts receivable are with customers and joint venture partners in the oil and gas industry and are subject to normal credit risks. A small portion of the Company's production is currently sold through a joint venture partner to purchasers under normal industry sale and payment terms; the balance is sold to twenty five marketers also under normal industry terms. The Company generally grants unsecured credit but routinely assesses the financial strength of its customers and joint venture partners.

As at September 30, 2008 the Company has an allowance for doubtful accounts of $11,621,000, (including a provision of $11.0 million relating to the filing for Company Creditors Arrangement Act protection by two of the Company's marketers of crude oil and natural gas), of trade accounts receivable that in the estimation of the Company may be impaired.

As at September 30, 2008, the aging analysis of trade receivables, net of the allowance for doubtful accounts, is as follows:

| | **($000's)** |
|---|---:|
| Current | $42,936 |
| 30 – 60 days | 262 |
| 60 – 90 days | 411 |
| Greater than 90 days | 6,089 |
| Total | $49,698 |

SemCAMS ULC and SemCanada Crude Company CCAA Filing

During the quarter, SemCanada Crude Company ("SemCanada") and SemCAMS ULC (SemCAMS) filed for protection under the Company Creditors Arrangement Act ("CCAA") in association with the filing for Chapter 11 protection in the State of Delaware by their US parent SemGroup, LP ("SemGroup"). The Company has marketing arrangements with SemCAMS for a portion of its natural gas production and with SemCanada for a portion of its crude oil production. As a result of the filing for CCAA protection, producers were advised that they would not be receiving payment for production supplied for the period from June 1 to July 21, 2008 within the previously agreed payment terms. The Company estimates that the value of this production is approximately $17 million, of which $9.3 million represents production for the month of June and $7.7 million represents production for the period from July 1 to July 21. Given the uncertainty, as at September 30, 2008, with respect to the ultimate timing and collection, the Company has established a provision for bad debts of $11.0 million with respect to this receivable.

## 12. CONTINGENCIES

The Company is party to various lawsuits as at September 30, 2008. It is management's opinion that, based on the best currently available information, the amount of any potential exposure and the outcome of these law suits is not determinable at this time. As a result, no provisions for these items have been recorded in these financial statements.

Pursuant to a purchase and sale agreement, the Company has indemnified the purchaser of a former subsidiary company for up to $1,000,000 of income tax and legal expenses incurred with respect to specifically identified income tax returns. The Company accrued this obligation in the first quarter of 2008 and correspondingly increased the purchase price of related property, plant and equipment acquired as part of a series of transactions which occurred in conjunction with the disposition of the former subsidiary.

The Company indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their service to the Company to the extent permitted by law. The Company has acquired and maintains liability insurance for its directors and officers.

## 13. SUPPLEMENTAL DISCLOSURE ON CONSOLIDATED STATEMENTS OF CASH FLOWS

Changes in non-cash working capital were comprised of the following:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| **($000's)** | **2008** | 2007 | **2008** | 2007 |
| Accounts receivable | **$(4,456)** | $1,834 | **$5,795** | $247 |
| Prepaids and other current assets | **(508)** | (41) | **(1,253)** | (490) |
| Accounts payable and accrued liabilities | **6,303** | 6,531 | **(34,939)** | 821 |
| Net change | **$1,355** | $8,324 | **$(30,397)** | $578 |

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| **($000's)** | **2008** | 2007 | **2008** | 2007 |
| Net change by activity: | | | | |
| Operating | **$(13,563)** | $682 | **($13,664)** | $(5,326) |
| Investing | **14,918** | 7,642 | **(16,733)** | 5,904 |
| Net change | **$1,355** | $8,324 | **$(30,397)** | $578 |

Additional information:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| **($000's)** | **2008** | 2007 | **2008** | 2007 |
| Cash interest paid | **$2,526** | $ 398 | **$6,705** | $ 1,259 |
| Cash taxes paid | **-** | - | **671** | 197 |

Included in cash interest paid during the nine month period ended September 30, 2008 are initial commitment fees of $448,000 related to the syndicated facility.

## 14. CAPITAL MANAGEMENT

The Company's principal business of the exploration, exploitation and development of oil and gas requires ongoing access to capital in order to allow the Company to successfully implement its growth strategy; and to provide adequate returns for shareholders and benefits for other stakeholders.

The Company defines capital as share capital and bank indebtedness, net of cash and cash equivalents. The consolidated capital structure of the Company is as follows

| | **As at September 30, 2008** | | As At December 31, 2007 | |
|---|---|---|---|---|
| | **($000's)** | **%** | ($000's) | % |
| Cash | **$(21,857)** | **(2.1)** | $(1,230) | (0.4) |
| Bank indebtedness | **234,000** | **23.0** | 50,370 | 17.2 |
| Share capital | **805,302** | **79.1** | 238,586 | 81.8 |
| Warrants outstanding | **-** | **-** | 3,934 | 1.4 |
| Total | **$1,017,445** | **100.0** | $291,660 | 100.0 |

As at September 30, 2008, the Company had a borrowing base bank credit facility that contained covenants which limit the amount of debt that can be incurred by the Company. Throughout the periods presented, the Company has met those covenants.

## 15. FINANCIAL INSTRUMENTS

Section 3855 of the CICA Handbook requires the initial measurement of all financial instruments at fair value with classification into one of five categories; loans and receivables; assets held to maturity; assets available for sale; other financial liabilities; and held for trading.

The Company has elected to classify its financial instruments as follows:

| | **September 30, 2008** | | December 31, 2007 | |
|---|---|---|---|---|
| **($000's)** | **Carrying Value** | **Estimated Fair Value** | Carrying Value | Estimated Fair Value |
| **Loans and receivables** | | | | |
| Accounts receivable[(1)] | **$49,698** | **$49,698** | $15,942 | $15,942 |
| **Other financial liabilities** | | | | |
| Bank indebtedness[(1)] | **234,000** | **234,000** | 50,370 | 50,370 |
| Accounts payable and accrued liabilities[(1)] | **79,354** | **79,354** | 30,454 | 30,454 |
| Stock based compensation payable[(1)] | **2,252** | **2,252** | 7,520 | 7,520 |

(1) Due to the nature and/or short term maturity of these financial instruments, carrying value approximates fair value.

The carrying values of financial instruments included in current assets and current liabilities approximates their fair value, reflecting the short term maturity, normal trade credit terms, and/or the nature of these instruments.

## 16. SUBSEQUENT EVENTS

Subsequent to quarter end, the Company increased its credit facility with its syndicate of lenders to $300 million. As a result of this increase, the margins charged by the lending syndicate on the facility were adjusted as follows:

For $275 million of the facility:

i) For borrowings by way of bankers acceptances in Canadian dollars and LIBOR based loans in United States dollars, the margin increased by 75 to 125 basis points to 165 to 275 basis points, depending on the ratio of funded debt to trailing cashflow;

ii) For borrowings by way of prime rate loans in Canadian or United States dollars, the borrowing rate in excess of prime increased by 65 to 150 basis points to 65 to 175 basis points, depending on the ratio of funded debt to trailing cashflow

For the remaining $25 million of the facility, the Company may borrow by way of Canadian or United States prime rate loans, bankers acceptances or LIBOR loans. The margin charged by the syndicate, over and above the base rates are as follows:

i) For borrowings by way of bankers acceptances in Canadian dollars, the bankers acceptance rate plus a margin, ranging from 275 to 400 basis points, depending on the ratio of funded debt to trailing cashflow;

ii) For borrowings by way of LIBOR based loans in United States dollars, the LIBOR rate plus a margin, ranging from 275 to 400 basis points, depending on the ratio of funded debt to trailing cashflow;

iii) For borrowings by way of prime rate loans in Canadian dollars, the Royal Bank of Canada prime rate plus a margin ranging from 175 to 300 basis points, depending on the ratio of funded debt to trailing cashflow; and

iv) For borrowings by way of US Base Rate loans in Unites States dollars, the US base rate plus a margin ranging from 175 to 300 basis points, depending on the ratio of funded debt to trailing cashflow.