

# MANAGEMENT'S DISCUSSION AND ANALYSIS

March 23, 2009

The following is Management's Discussion and Analysis ("MD&A") of Iteration Energy Ltd. (the "Company" or "Iteration") operating and financial results as at and for the three months and year ended December 31, 2008 as well as information and estimates concerning the Company's future outlook based on currently available information. This discussion should be read in conjunction with Iteration's audited consolidated financial statements as at and for the years ended December 31, 2008 and 2007, together with accompanying notes. Readers should also refer to Iteration's Annual Information Form for the year ended December 31, 2008 ("AIF"). All financial information is reported in Canadian dollars, unless noted otherwise, and in accordance with Canadian generally accepted accounting principles ("GAAP").

Certain amounts in prior periods have been reclassified to enable comparison with the current period's presentation.

Natural gas is converted to crude oil equivalent at a ratio of six thousand cubic feet to one barrel of oil equivalent ("boe"). Boe's may be misleading, particularly if used in isolation. A boe conversion ratio of 6 mcf: 1 bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

Additional information about Iteration filed with Canadian securities commissions, including periodic quarterly and annual reports and the AIF, is available on-line at [www.iterationenergy.com](http://www.iterationenergy.com) and at [www.sedar.com](http://www.sedar.com).

## ADVISORY – FORWARD-LOOKING INFORMATION

This MD&A was prepared on March 23, 2009 and is management's assessment of Iteration's historical financial and operating results. The reader should be aware that historical results are not necessarily indicative of future performance. This MD&A contains certain forward-looking statements and forward-looking information (collectively referred to herein as "forward-looking statements") within the meaning of Canadian securities laws. All statements other than statements of historical fact are forward-looking statements. In some cases, forward-looking statements can be identified by terminology such as "may", "will", "should", "expects", "projects", "plans", "anticipates" and similar expressions. In particular, this discussion contains forward-looking statements pertaining to the following:

- the timing and amount of production;
- natural gas, natural gas liquids and crude oil production levels;
- commodity prices for natural gas, natural gas liquids and crude oil;
- royalties payable and future royalty rates under the New Alberta Royalty Regime;
- production expenses;
- transportation expenses;
- operating netbacks;
- general and administrative expenses;
- interest expenses and interest rates;
- Canadian dollar exchange rates
- capital expenditures;
- capital and liquidity;
- funds from operations;
- debt levels;
- ratio of debt to funds from operations;
- number of net wells; and
- outlook for 2009.

Certain forward-looking statements may constitute "financial outlooks" as contemplated by National Instrument 52-102 – *Disclosure Obligations*, which are provided for the purpose of forecasting Iteration's

financial position for the first six months of 2009. Please note that the financial outlook in this MD&A may not be appropriate for purposes other than as stated above.

Forward-looking statements and information are based on the Company's current beliefs as well as assumptions made by, and information currently available to, the Company concerning anticipated financial performance, business prospects, strategies, regulatory developments, future natural gas, natural gas liquids and crude commodity prices, future natural gas, natural gas liquids and crude oil production levels, the ability to obtain equipment in a timely manner to carry out development activities, the ability to market natural gas successfully to current and new customers, the impact of increasing competition, the ability to obtain financing on acceptable terms, and the ability to add production and reserves through development and exploration activities. Although management considers these assumptions to be reasonable based on information currently available to it, they may prove to be incorrect.

Undue reliance should not be placed on these forward-looking statements, which are based upon management's assumptions and are subject to known and unknown risks and uncertainties, including the business risks discussed below, which may cause actual performance and financial results in future periods to differ materially from any projections of future performance or results expressed or implied by such forward-looking statements. Iteration's actual results could differ materially from those anticipated in our forward-looking statements as a result of the risk factors set forth below and noted elsewhere in this MD&A which include but are not limited to:

- volatility in market prices for oil and natural gas;
- risks inherent in Iteration's operations;
- uncertainties associated with estimating reserves;
- competition for, among other things: capital, acquisitions of reserves, undeveloped lands and skilled personnel;
- incorrect assessments of the value of acquisitions;
- geological, technical, drilling and process problems;
- general economic conditions including fluctuations in the price of oil and natural gas;
- royalties payable in respect of Iteration's production;
- governmental regulation of the oil and gas industry, including environmental regulation;
- fluctuation in foreign exchange or interest rates;
- unanticipated operational events that can reduce production or cause production to be shut-in or delayed;
- stock market volatility and market valuations;
- counterparty credit risk
- the need to obtain required approvals from regulatory authorities;
- environmental risks;
- insurance limitations risks;
- risks inherent in replacing reserves;
- reliance on operators and key employees;
- access to funding and issuance of debt;
- aboriginal claims; and
- availability of drilling equipment, access restrictions and cost inflation.

Readers are cautioned that this list of risk factors is not exhaustive.

The Company undertakes no obligation, except as required by applicable securities legislation, to update publicly or to revise any of the included forward looking statements, whether as a result of new information, future events or otherwise. The forward looking statements contained herein are expressly qualified by this cautionary statement.

## **NON-GAAP MEASURES**

This MD&A refers to "funds from operations" and "funds from operations per share" which do not have any standardized meaning prescribed by Canadian GAAP and therefore they may not be comparable with the calculation of similar measures for other entities. Management of Iteration uses "funds from operations" and "funds from operations per share" to analyze operating performance and leverage.

## **ITERATION OVERVIEW**

Iteration is a Canadian oil and gas company with focus areas in Northeast British Columbia/Northwest Alberta, East Central Alberta and Southern Alberta. The most significant currently producing properties are Boundary Lake and Umbach in Northeast British Columbia and Gold Creek, Knopcik and Manyberries in Alberta.

The Company strives to operate its properties whenever possible and to maintain high working interests. Iteration believes this high level of operatorship can translate to controlling costs, timing of capital outlays and projects as well as providing competitive advantages for future opportunities.

## **FINANCIAL AND OPERATIONAL HIGHLIGHTS**

The highlights for the year ended December 31, 2008 include:

- On March 7, 2008, acquired Cyries Energy Inc. ("Cyries"), via a plan of arrangement. The audited consolidated financial statements incorporate the results of operations for Cyries for the period from March 8, 2008 to December 31, 2008.
- Average production for the year was 16,400 boed, representing a 148% increase over the average production for the year ended December 31, 2007. This represents to a 6% increase in production per share.
- Drilled 68 net wells with a 92% success record.
- Funds from operations for the year of \$171.8 million, representing a 254% increase over the year ended December 31, 2007.
- As a result of the annual impairment assessment of goodwill, a charge of \$239.1 million was taken to write off the Company's goodwill due to current market conditions and uncertainties arising from overall economic conditions and commodity prices. This charge increased the loss per basic and diluted share for the year by \$1.62. Had this charge not been taken, the Company would have reported basic and diluted earnings of \$23.3 million, equivalent to \$0.16 per share. The goodwill impairment charge is non-cash in nature and does not affect our liquidity, funds from operations, debt covenants or future operations.
- Total proved reserves increased by 211% to 39.3 mmboe, an increase in reserves per share of 33% and total proved plus probable reserves increased by 201% to 57.4 mmboe, an increase in reserves per share of 29%, at December 31, 2008 in comparison to December 31, 2007.
- Total undeveloped land increased by 242% to 913,000 net acres at December 31, 2008.
- Production averaged 18,300 boed for the final week of December, 2008.

The highlights of the three months ended December 31, 2008 include:

- Average fourth quarter 2008 production of 18,000 boed which is 125% higher than the fourth quarter of 2007.
- Drilled 14.4 net wells with a 93.1% success record in the fourth quarter of 2008.
- Total capital program in the fourth quarter of 2008 was \$74.0 million, which includes \$18.4 million for property acquisitions.

- Funds from operations of \$31.2 million increased 181% compared to the fourth quarter of 2007.
- Net debt on December 31, 2008 was \$276 million resulting in a debt to annualized fourth quarter funds from operations ratio of 2.2:1.

The following is a summary of Iteration's reserves for the years ended December 31, 2008 and 2007, as set forth in the reserves evaluations of McDaniel and Associates Consultants Ltd. effective December 31, 2008 and December 31, 2008. The December 31, 2007 reserve information does not include reserve estimates in respect of Cyries' reserves.

	<b>Dec 31, 2008</b>	<b>Dec 31, 2007</b>	<b>% Change</b>	<b>% Change per share</b>
Total Proved Reserves (mboe)	39,318	12,654	211	33
Proved plus Probable Reserves (mboe)	57,447	19,064	201	29
NAV PV <sub>10</sub> Proved plus Probable Reserves (\$million)	1,113	345	223	38

### Financial Highlights

	<b>Three months ended December 31,</b>		<b>Year ended December 31,</b>	
	<b>2008</b>	2007	<b>2008</b>	2007
	<b>(unaudited)</b>		<b>(Audited)</b>	
<b>Financial</b>				
(\$thousands, except as noted)				
Production revenue before royalties	<b>\$70,656</b>	\$29,265	<b>\$361,840</b>	\$101,976
Funds from operations <sup>(1)</sup>	<b>\$31,152</b>	\$11,103	<b>\$171,830</b>	\$48,506
Per Share (\$)				
- basic	<b>0.19</b>	0.16	<b>1.16</b>	0.76
- diluted	<b>0.19</b>	0.16	<b>1.16</b>	0.76
Net loss	<b>\$(244,894)</b>	(\$3,149)	<b>\$(215,834)</b>	(\$9,442)
Per Share (\$)				
- basic	<b>(1.48)</b>	(0.05)	<b>(1.46)</b>	(0.15)
- diluted	<b>(1.48)</b>	(0.05)	<b>(1.46)</b>	(0.15)
Royalties	<b>\$12,480</b>	\$5,966	<b>\$74,473</b>	\$20,772
Production expense	<b>\$18,067</b>	\$8,801	<b>\$67,089</b>	\$21,685
Transportation expense	<b>\$1,161</b>	\$804	<b>\$5,902</b>	\$3,128
General and administrative	<b>\$1,964</b>	\$1,740	<b>\$10,188</b>	\$5,460
Stock based compensation expense (recovery)	<b>(\$2,252)</b>	(\$310)	<b>\$2,159</b>	\$3,412
Depletion, depreciation, and accretion expense	<b>\$38,090</b>	\$17,816	<b>\$139,329</b>	\$60,925
Total assets	<b>\$1,035,203</b>	\$339,065	<b>\$1,035,203</b>	\$339,065
Bank Indebtedness				
Bank loans	<b>\$266,800</b>	\$50,370	<b>\$266,800</b>	\$50,370

Working capital deficiency <sup>(2)</sup>	<b>\$9,330</b>	\$10,642	<b>\$9,330</b>	\$10,642
Net bank indebtedness	<b>\$276,130</b>	\$61,012	<b>\$276,130</b>	\$61,012
Net debt to annualized quarter funds from operations	<b>2.2 : 1</b>	1.4 : 1	<b>2.2 : 1</b>	1.4 : 1
Capital expenditures:				
Property acquisitions, net of dispositions	<b>\$18,398</b>	\$602	<b>\$59,742</b>	\$55,670
Exploration and development	<b>\$55,645</b>	\$17,008	<b>\$156,187</b>	\$88,580
<b>Shares outstanding (thousands)</b>				
Common shares	<b>166,020</b>	71,030	<b>166,020</b>	71,030
Weighted average – basic	<b>166,020</b>	69,686	<b>147,743</b>	63,678
Weighted average – diluted	<b>166,020</b>	69,686	<b>147,743</b>	63,678
Warrants (thousands)	-	4,722	-	4,722
Stock options (thousands)	<b>9,782</b>	6,569	<b>9,782</b>	6,569

Notes:

- (1) Management uses “funds from operations” and “funds from operations per share” (before changes in non-cash working capital and asset retirement expenditures) to analyze operating performance and leverage. Funds from operations and funds from operations per share as presented do not have any standardized meaning prescribed by Canadian GAAP and therefore they may not be comparable with the calculation of similar measures for other entities. Funds from operations as presented is not intended to represent operating cash flow or income from operations for the period nor should it be viewed as an alternative to cash flow from operating activities, net earnings or other measures of financial performance calculated in accordance with Canadian GAAP. All references to funds from operations and funds from operations per share throughout this Management’s Discussion and Analysis are based on cash flow from operating activities before changes in non-cash working capital.
- (2) Working capital deficiency (surplus), which is the difference between current assets and current liabilities, does not include stock based compensation payable.

## 2008 Operating Highlights

	Three months ended December 31,		Year ended December 31,	
	2008	2007	2008	2007
<b>Operating</b>				
Gas:				
Daily production (mcf/d)	<b>75,486</b>	37,885	<b>68,909</b>	35,448
Average price (\$/mcf)	<b>6.81</b>	6.11	<b>8.44</b>	6.76
Light Oil:				
Daily production (bbls/d)	<b>3,873</b>	753	<b>3,323</b>	293
Average price (\$/bbl)	<b>50.63</b>	66.21	<b>95.67</b>	68.77
Heavy Oil:				

Daily production (bbls/d)	<b>187</b>	214	<b>209</b>	108
Average price (\$/bbl)	<b>47.57</b>	40.35	<b>76.22</b>	42.68
Natural Gas Liquids (NGLs):				
Daily production (bbls/d)	<b>1,360</b>	708	<b>1,379</b>	311
Average price (\$/bbl)	<b>46.36</b>	40.12	<b>57.96</b>	48.55
Total Production (boed)	<b>18,001</b>	7,989	<b>16,396</b>	6,620
<b>Land</b>				
Net undeveloped land holdings (thousand net acres)	<b>913</b>	267	<b>913</b>	267
<b>Drilling</b>				
Wells drilled (net)				
Gas	<b>8.4</b>	1.0	<b>42.0</b>	33.4
Oil	<b>5.0</b>	4.0	<b>19.0</b>	9.0
Injector	-	-	<b>2.0</b>	-
Dry	<b>1.0</b>	1.0	<b>5.0</b>	2.0
Total	<b>14.4</b>	6.0	<b>68.0</b>	44.4
Success rate (%)	<b>93.1</b>	83.3	<b>92.4</b>	95.5

### Quarterly Financial Data

*(\$ thousands except per share data)*

Quarter ended	2008				2007			
	Dec 31	Sept 30	June 30	Mar 31	Dec 31	Sept 30	June 30	Mar 31
Revenues	\$70,656	\$108,444	\$127,175	\$55,564	\$29,265	\$22,161	\$26,806	\$23,744
Net Earnings (loss)	\$(244,894)	\$26,696	\$672	\$1,690	\$(3,149)	\$(1,985)	\$(639)	(3,669)
Net earnings (loss) per common share – basic and diluted (\$)	\$(1.48)	\$0.16	\$0.00	\$0.02	\$(0.05)	\$(0.03)	\$(0.01)	\$(0.06)

### OPERATING RESULTS

#### Net Loss

Iteration's net loss for the three months ended December 31, 2008 was \$244.9 million, as compared to a net loss of \$3.1 million for the three months ended December 31, 2007. During the quarter ended December 31, 2008, the Company recorded a charge of \$239.1 million relating to goodwill impairment. During the quarter, a stock based compensation recovery of \$2.3 million arising from the decline in our share price was recognized, as compared to a recovery of \$0.3 million for the corresponding quarter in 2007. The net loss for the year ended December 31, 2008 was \$215.8 million as compared to a net loss of \$9.4 million for the year ended December 31, 2007. The loss for the year includes the charge for goodwill impairment. Had this charge not been recorded, the Company would have reported net earnings for the year ended December 31, 2008 of \$23.3 million due to higher average commodity prices realized during the year, combined with significantly higher production volumes.

## Production

Average daily production for the three months ended December 31, 2008 was 18,001 boed, an increase of 10,012 boed from production for the three months ended December 31, 2007. This 125% increase is primarily due to the inclusion of production from the Cyries acquisition that closed March 7, 2008, and also property acquisitions that closed prior to December 31, 2008 and the results of the 2008 drilling program. For the year ended December 31, 2008, average production was 16,396 boed, an increase of 9,776 boed, or 148%, as compared to the prior year. In the calculation of average production for the year ended December 31, 2008, the operations of Cyries are included for the period from March 8<sup>th</sup> to December 31, 2008. Fourth quarter and annual average production for 2008 was in line with the Company's previous guidance dated December 10, 2008 of 18,000 boed for the quarter and 16,400 boed for the year.

Daily production <i>Average for the period</i>	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Natural gas (mcf/d)	<b>75,486</b>	37,885	99	<b>68,909</b>	35,448	94
Natural gas liquids (bbls/d)	<b>1,360</b>	708	92	<b>1,379</b>	311	343
Light oil (bbls/d)	<b>3,873</b>	753	414	<b>3,323</b>	293	1034
Heavy oil (bbls/d)	<b>187</b>	214	(13)	<b>209</b>	108	97
Total production (boed)	<b>18,001</b>	7,989	125	<b>16,396</b>	6,620	148

Approximately 60 net wells were deferred in the second half of 2008 due to falling commodity prices. As a result of the deferral of exploration and development capital, the Company expects average production for the quarter ended March 31, 2009 of 18,300 boed and for the quarter ended June 30, 2009 of 17,300 boed. The forecast reduction in average production between the first and second quarter is as a result of normal production decline combined with expected downtime on several wells due to reduced surface access during to breakup. The reduction also includes the impact of shutting in approximately 450 boed of production which is uneconomic at current commodity prices. The Company will continue to monitor commodity price and service costs to determine when to bring these wells back on production.

## Commodity Prices

Industry benchmarks <i>Average for the period</i>	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Natural gas (Alberta spot-daily) Cdn \$/GJ at AECO	<b>\$6.27</b>	\$5.83	8	<b>\$7.58</b>	\$6.02	26
Natural gas (BC Westcoast Station 2) Cdn \$/GJ	<b>\$6.23</b>	\$5.94	5	<b>\$7.46</b>	\$6.04	24
Iteration NGL basket Cdn \$/bbl <sup>(1)</sup>	<b>\$42.29</b>	\$52.65	(20)	<b>\$56.83</b>	\$59.56	(5)
Edmonton Light crude Cdn \$/bbl	<b>\$63.94</b>	\$87.18	(27)	<b>\$102.85</b>	\$76.74	34
Hardisty Lloyd blend Cdn \$/bbl	<b>\$47.36</b>	\$55.48	(15)	<b>\$82.58</b>	\$50.51	63

(1) At December 31, 2008, the composition of an Iteration NGL basket was approximately 28% pentane, 15% butane, 24% propane, and 33% ethane.

Realized commodity prices	Three months ended			Year ended		
	December 31,			December 31,		
Average for the period	2008	2007	% Change	2008	2007	% Change
Natural gas (\$/mcf)	\$6.81	\$6.11	11	\$8.44	\$6.76	25
Natural gas liquids (\$/bbl)	\$46.36	\$40.12	16	\$57.96	\$48.55	19
Light oil (\$/bbl)	\$50.63	\$66.21	(24)	\$95.67	\$68.77	39
Heavy oil (\$/bbl)	\$47.57	\$40.35	18	\$76.22	\$42.68	79
Total (\$/boed)	\$43.08	\$39.84	8	\$60.63	\$42.24	44

For purposes of comparing realized prices to benchmark prices, the Company's British Columbia natural gas production is primarily sold at Station 2 pricing (BC Westcoast Station 2) and the Company's Alberta natural gas production is sold at AECO spot - daily. Therefore for comparative purposes, the realized price for the commodity should be compared to the average of the benchmark prices for BC Westcoast Station 2 and Alberta spot - daily at AECO.

For natural gas, the realized price for the fourth quarter of 2008 increased by 11% as compared to 2007, which is more than the average benchmark price change of 6% during the same period. The reason for the change is that starting November 2008, 5,000 GJ per day of British Columbia gas production is no longer going through a secondary natural gas liquids extraction process. This results in a higher heating capacity for that production, increasing the realized price for the commodity. For the year ended December 31, 2008, the realized price for natural gas increased by 25% over 2007, which equates to the change in benchmark price for the period.

For light oil, the realized price for the fourth quarter of 2008 decreased by 24% as compared to the same period in 2007, which is slightly less than the 27% decrease in the benchmark for the same period. For the year ended December 31, 2008, the realized price was 39% higher than in 2007, as compared to a change in benchmark price for the year of 34%. For the 2008 year, realized pricing was positively impacted by the higher American Petroleum Institute gravity ("API") associated with the Company's oil production obtained as part of the Cyries transaction.

The heavy oil realized price increased by 18% in the fourth quarter of 2008 as compared to the same period in 2007, which was higher than the relative change in the benchmark for Hardisty Lloyd blend of a decrease of 15% for the same period. The change between realized and benchmark is in part due to Iteration's API mix being somewhat lighter than benchmark. For the year ended December 31, 2008, the realized price for the Company's heavy oil increased by 79%, as compared to a 63% change in the benchmark, consistent with the lighter API associated with Iteration's production.

Iteration's realized price on its natural gas liquids basket increased by 16% in the fourth quarter of 2008 as compared to the corresponding quarter in 2007 in comparison to the 20% decrease in the benchmark price for a natural gas liquids basket for the same period. The reason for the increase is shifting of the composition of the Company's natural gas liquids basket towards higher valued pentane production. For the year ended December 31, 2008, similar results were obtained. The realized price for NGL's increased by 19% compared to a 5% decrease in the benchmark price.

Iteration realized an average price of \$43.08 per boe during the fourth quarter, which is less than the Company's previous projection of \$44.80 per boe as disclosed in its guidance of December 10, 2008. This reflected the continuing softening of commodity prices and the unprecedented volatility in the Canadian dollar exchange rate. This volatility has continued into 2009. For guidance purposes, the Company is projecting commodity prices of \$4.75 Cdn./GJ AECO and \$51.00 Cdn./barrel for Edmonton Light oil for the first six months of 2009. However, the Company will be continually monitoring both commodity prices and exchange rates during this period to allow it to effectively react as required to commodity and exchange rate swings, both positive and negative.

## Revenue

Production revenue was \$70.7 million for the three months ended December 31, 2008, as compared to \$29.3 million for the corresponding period in 2007. For the year ended December 31, 2008, production revenue was \$361.8 million as compared with \$102.0 million for 2007. The increase was primarily due to the added production from the Cyries properties which were acquired on March 7, 2008 combined with the impact of other production gains and higher overall blended commodity prices realized by the Company, not only during the quarter, but during the year. Production increases for the fourth quarter and the year were 125% and 148% respectively. Realized commodity prices increased 8% in the fourth quarter 2008 as compared to 2007, and increased 44% for the year ended December 31, 2008, as compared to the year ended December 31, 2007.

Production revenue before royalties (\$ thousands)	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Production revenue	\$70,646	\$29,265	141	\$361,840	\$101,976	255

For the three months ended December 31, 2008, natural gas represented 70% of the Company's production and 67% of the Company's revenue. For the corresponding period in 2007, natural gas represented 79% of the Company's production and 73% of the Company's revenue. For the year ended December 31, 2008, natural gas also represents 70% of the Company's production but accounted for only 59% of the Company's revenue. In 2007, 89% of the Company's production volume was natural gas, which accounted for 86% of the Company's revenue.

During 2008, the Company had the following fixed price contract on oil in place:

Period	Volume	Type	Pricing	Price
Dec 1, 2007 – Nov 30, 2008	200 bbls/d	Collar	WTI – Nymex	\$75.00 US floor, \$90.20 US ceiling

For the quarter ended December 31, 2008, the Company realized a gain on this contract of approximately US \$110,000. For the year ended December 31, 2008, the Company realized a cumulative loss on this contract of approximately US \$1,127,000.

## Royalties

Royalty expense was \$12.5 million for the three months ended December 31, 2008, compared with \$6.0 million for the corresponding period in 2007. Royalties represent amounts paid by the Company for crown, freehold and gross overriding royalties. The 109% increase in royalty expense was primarily the result of a 125% increase in production. For the year ended December 31, 2008, royalty expense was \$74.5 million, compared with \$20.8 million for the year ended December 31, 2007. This represents an increase of 254%, and is the result of a 148% increase in production, largely due to the Cyries transaction, combined with a 44% increase in average realized price.

The allocation of the \$12.5 million of royalty expense fourth the quarter of 2008 was \$10.5 million for crown royalties, which represents a crown royalty burden of approximately 15.0%, and \$2.0 million for freehold and gross overriding royalties, which represents a rate of approximately 2.6%, giving a combined royalty burden of approximately 17.6%. For the corresponding period in 2007, the crown royalty burden was approximately 17.0%, the freehold and gross overriding royalty burden was 3.4% resulting in a combined royalty burden of 20.4%. For the year ended December 31, 2008, total royalty expense was \$74.5 million, of which \$65.1 million was crown royalties and \$9.4 million was freehold and gross overriding royalties. This represents a rate of approximately 18.0% for crown royalties and 2.5% for

freehold and gross overriding royalties. For the year ended December 31, 2007, crown royalties were approximately 18.0% and freehold and gross overriding royalties were approximately 2.4%.

Royalties <i>(\$ thousands except where noted)</i>	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Royalties	<b>12,480</b>	5,966	109	<b>74,473</b>	20,772	259
Per boe (\$/boe)	<b>7.61</b>	8.12	(6)	<b>12.51</b>	8.60	46
Percentage of revenue (%)	<b>17.55</b>	20.39	(14)	<b>20.50</b>	20.37	1

Royalties as a percentage of revenue for the fourth quarter were 17.6% as opposed to fourth quarter 2008 guidance of 21%. The reduction in royalty percentage rates for the quarter is a result of lower commodity prices realized. For the year ended December 31, 2008, the royalty percentage rate was 20.5%, which is in line with previous guidance.

On October 25, 2007, the Alberta provincial government announced changes to the Alberta royalty regime which take effect January 1, 2009. Based on our analysis of the proposed royalty rate changes that have been announced to date, the impact of the changes on the current Alberta based production of the Company indicates, on the assumption that 30% of the Company's production is oil and natural gas liquids and 80% of the Company's production is Alberta based, at the average 2009 commodity price used for Company guidance purposes for the first six months of 2009 of Cdn \$4.75/GJ for gas and a price of \$51.00/bbl for oil, the Company's total crown royalty burden for the first six months of 2009 would be approximately 18%. When combined with the burden from freehold and gross overriding royalties, the Company's total royalty burden for the first six months of 2009 is expected to be approximately 20.0%, in line with 2008 rates.

This rate is before taking into the consideration the impact of the Drilling Incentive Program announced by the Government of Alberta on March 3, 2009. Under the program, companies will be eligible for the following:

- 1) Each company will receive a royalty credit against royalties paid from April 1, 2009 to April 1, 2010. The rate of the royalty credit is \$200 per meter drilled on all new wells in Alberta during the time frame. The maximum amount of the royalties that can be offset through this credit is capped based on a sliding scale, depending on how much production the entity produced in Alberta in calendar 2008. Based on the Company's production for 2008, we expect to be eligible for a maximum credit of 50% of our 2009 Alberta crown royalties. The actual amount of the credit received is dependent on meters drilled.
- 2) New wells drilled and/or brought on stream after April 1, 2009 and before April 1, 2010, will pay the lesser of the current royalty or 5%, for the first 12 months of production or until the well has produced 500 mmcf of gas or 50 mbbls.

### Production Expenses

Production expenses were \$18.1 million for the three months ended December 31, 2008, compared with \$8.8 million for the corresponding period in 2007. This equates to a 105% increase on a gross dollar basis. The increase in expenses was due to the following:

- 1) A 125% increase in production for the quarter as compared to the previous year primarily due to the Cyries acquisition.
- 2) The shift in the weighting of the Company's sales towards oil, which typically has higher operating costs on a per boe basis. For the quarter ended December 31, 2008, 30% of the

Company's production was oil, as compared to 21% for the three months ended December 31, 2007.

Production expenses for the year ended December 31, 2008 were \$67.1 million as compared with \$21.7 million for the corresponding period in 2007. This equates to a 209% increase on a gross dollar basis. The increase in expenses was due to the following:

- 1) A 148% increase in production for the year as compared to the previous year primarily due to the Cyries acquisition.
- 2) The shift in the weighting of the Company's sales towards oil, which typically has higher operating costs on a per boe basis. For the year ended December 31, 2008, 30% of the Company's production was oil, as compared to only 11% for the year ended December 31, 2007.

Production expenses (\$ thousands)	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Field operating costs	17,672	8,604	105	65,514	20,986	212
Allocated general and administrative costs	395	197	101	1,575	699	125
Total production expenses	18,067	8,801	105	67,089	21,685	209

Production expenses (\$ per boe)	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Field operating costs	\$10.78	\$11.71	(8)	\$11.01	\$8.69	27
Allocated general and administrative costs	0.24	0.27	(10)	0.26	0.29	(9)
Total production expenses	\$11.02	\$11.97	(8)	\$11.27	\$8.97	26

Operating costs for the fourth quarter of \$11.02 per boe were in line with the December 10, 2008 guidance of \$11.00 per boe. Management expects operating costs to remain at approximately \$11.00 per boe for the first three months of 2009, and reduce by approximately 10% after break up. The Company expects to spend less money keeping lower rate wells on production at current commodity price levels and expects an overall softening in the cost of services.

### Transportation Expenses

Transportation expenses for the quarter ended December 31, 2008 were \$1.6 million as compared to \$0.8 million for the three months ended December 31, 2007, representing a 44% increase. The increase was due to the 99% increase in natural gas production for the quarter as compared to the same period in 2007 offset by a reallocation to production pipeline systems with lower transportation burdens. On a per boe basis, transportation expense decreased by 35% in the fourth quarter of 2008 as a result of the decrease in the percentage of the Company's total production represented by natural gas. For the quarter ended December 31, 2008, oil and natural gas liquids accounted for 30% of the Company's sales, as opposed to 21% for the three month period ended December 31, 2007. Trucking costs for oil are included in operating costs.

Transportation expenses for the year were \$5.9 million as compared to \$3.1 million for the year ended December 31, 2007, representing an 89% increase. The increase was due to the 94% increase in natural gas production for the year as compared to the same period in 2007 offset by a reallocation to production pipeline systems with lower transportation burdens. On a per boe basis, transportation expense decreased by 23% in 2008 as a result of the decrease in the percentage of the Company's total production represented

by natural gas. For the year ended December 31, 2008, oil and natural gas liquids accounted for 30% of the Company's sales, as opposed to 11% for the year ended December 31, 2007.

Transportation expenses <i>(\$ thousands except where noted)</i>	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Transportation expenses	1,161	804	44	5,902	3,128	89
Per boe (\$/boe daily sales)	0.71	1.09	(35)	0.99	1.29	(23)

For the fourth quarter of 2008, transportation costs were \$0.71 per boe, as compared to our December 10, 2008 guidance of \$1.00 per boe. The savings were as a result of the continued reallocation of a portion of production to pipelines that had capacity available at lower transportation rates. Management expects transportation expense to trend back towards the \$0.80 per boe range for the first six months of 2009, in part due to the loss of firm capacity on some of the current pipelines.

### Operating Netback

The operating netback (before general and administrative expenses) realized for the three months ended December 31, 2008 was \$24.31 per boe versus \$18.66 per boe for the corresponding period in 2007, an increase of 29 %. While the increase in commodity prices accounted for much of the increase in operating net back, the savings realized per boe in royalties, operating expense and transportation expense also contributed to the increase.

For the year ended December 31, 2008, the operating netback (before general and administrative expenses) realized was \$35.87 per boe versus \$23.37 per boe for the corresponding period in 2007, an increase of 53%. Higher commodity prices contributed to the increase combined with savings realized in transportation costs. These increases, however, were offset by higher royalty rates and production expenses.

Operating netback <i>(\$/boe daily sales)</i>	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Production revenue	\$43.08	\$39.84	8	\$60.63	\$42.24	44
Royalties	(7.61)	(8.12)	(6)	(12.51)	(8.60)	46
Production expenses	(11.02)	(11.97)	(8)	(11.27)	(8.97)	26
Transportation expenses	(0.71)	(1.09)	(35)	(0.99)	(1.29)	(23)
Operating netback	\$23.75	\$18.66	27	\$35.86	\$23.37	53

On December 10, 2008, the Company had given guidance of \$22.80 per boe as the expected operating netback to be realized for the fourth quarter of 2008. As noted above, the operating netback for the fourth quarter was higher at \$23.75 per boe due to savings realized from royalties and transportation expenses. Based on the commodity price strip and current guidance, as reported within this MD&A, with respect to royalties, production expenses and transportation expenses, Management anticipates an operating netback for the first six months of 2009 of approximately \$14.40 per boe. As has been the case for several months, the unprecedented volatility in commodity prices and exchange rates makes projections very difficult.

## General and Administrative Expenses

Total general and administrative costs (before taking into consideration overhead recoveries, general and administrative costs allocated to production expense and capitalized general and administrative expenses), increased by 33% to \$3.7 million for the three months ended December 31, 2008, as compared to \$2.8 million for the corresponding period in 2007. The primary reason for the increase was higher costs associated with staffing, office accommodation and administration costs following the Cyries acquisition.

For the year ended December 31, 2008, total general and administrative costs (before taking into consideration overhead recoveries, general and administrative costs allocated to production expense and capitalized general and administrative expenses), increased by 83% to \$15.1 million, as compared to \$8.8 million for the corresponding period in 2007. Again, the primary reason for the increase was higher costs which arose as a result of the Cyries acquisition.

While general and administrative costs increased during the fourth quarter of 2008 in absolute dollars, on a per boe basis, these costs decreased by 50% in the fourth quarter of 2008 as compared to the same period in 2007. Similar results were realized for the year ended December 31, 2008, where costs on a per boe basis decreased by 25%. This was the result of efficiency gains and economies of scale associated with being a larger company.

General and administrative expenses ( <i>\$ thousands except where noted</i> )	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
General and administrative costs before the following:						
Capitalized overhead	<b>3,680</b>	2,773	33	<b>15,077</b>	8,766	83
Allocation to production expenses	<b>(880)</b>	(780)	13	<b>(3,715)</b>	(2,452)	52
Overhead recoveries	<b>(395)</b>	(197)	101	<b>(1,575)</b>	(699)	125
General and administrative expense	<b>(441)</b>	(56)	688	<b>(599)</b>	(155)	286
General and administrative expense	<b>1,964</b>	1,740	13	<b>10,188</b>	5,460	87
Per boe, (\$/boe)	<b>1.19</b>	2.37	(50)	<b>1.70</b>	2.26	(25)

General and administrative expenses for the quarter were significantly less than the Company's December 10, 2008 guidance of \$1.60 per boe for the fourth quarter due to a significant reduction in performance bonuses accrued. Management projects general and administrative expenses to return to the approximately \$1.70 per boe level for first six months of 2009.

## Stock Based Compensation Expense

The Company's stock option plan provides 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 option, as determined by the difference between the option's exercise price and the Company's closing share price the day prior to surrendering the option. On June 20, 2008, with the approval of shareholders, the stock option plan was amended to limit the total number of common shares that may be issued under the stock option plan to a maximum of 16,000,000. This represented and continues to represent less than 10% of the then and currently issued and outstanding common shares of the Company. At December 31, 2008, options to purchase 9.8 million common shares were outstanding, which represents 6.0% of the outstanding common shares of the Company at that time. As of March 23, 2009, there are options outstanding to purchase 10.6 million common shares representing 6.3% of the issued common shares.

For the three months ended December 31, 2008, a stock based compensation recovery of \$2.2 million was recorded by the Company representing the impact on stock based compensation of the continued reduction in the Company's share price to \$1.37 at December 31, 2008, as compared to the share price of \$3.75 at September 30, 2008.

Future fluctuations in stock based compensation expense or recoveries are dependent on the movement of the Company's share price and the number of vested options outstanding, adjusted for any options exercised for cash during the period. Based on the December 31, 2008 share price of \$1.37, there is no current or future stock based compensation liability associated with any of the stock options that were outstanding as at December 31, 2008.

### Interest Expense

Interest expense on current debt (the Company had no long term debt) for the three months ended December 31, 2008 was \$2.6 million as compared to \$1.0 million for the three months ended December 31, 2007 and is primarily the interest expense associated with bankers acceptances utilized for financing during the quarter. The effective blended interest rate for the fourth quarter of 2008 on the outstanding debt was approximately 4.2%.

For the year ended December 31, 2008, interest expense was \$9.3 million, as compared to \$2.3 million for the year ended December 31, 2007. The effective blended interest rate for 2008 on the outstanding debt was approximately 5.3%. The increase in interest was a result of the utilization of an increased credit facility for 2008.

Interest expense <i>(\$ thousands except where noted)</i>	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Interest expense	2,622	1,005	161	9,327	2,264	312
Per boe (\$/boe production)	\$1.58	\$1.37	16	\$1.56	\$0.94	66

With the ongoing volatility in the credit market, combined with the projected increase in the incremental rate over prime on the facility, management is projecting bank commitment and stamping fees to increase in 2009. Although the prime rate and banker's acceptance base rates have declined over the past several months, which will offset some of the increase in commitment and stamping fees, the Company expects realized interest rates to increase for the first six months of 2009.

### Depletion, Depreciation, and Accretion

Depletion, depreciation, and accretion expense was \$38.1 million for the three months ended December 31, 2008 compared to \$17.8 million for the corresponding period in 2007 representing a 113% increase. As depletion, depreciation and accretion are based on production as a percentage of the Company's proved reserves, the increase is primarily due to the 125% increase in production for the fourth quarter of 2008 as compared to the same period in the prior year.

For the year ended December 31, 2008, depletion, depreciation, and accretion expense was \$139.3 million compared to \$60.9 million for the corresponding period in 2007. This represents a 129% increase. As depletion, depreciation and accretion are based on production as a percentage of the Company's proved reserves, the increase is primarily due to the 148% increase in production for 2008 as compared to the prior year.

On a per boe basis, depletion rates decreased from \$24.24 per boe for the three months ended December 31, 2007 to \$23.00 per boe for the current reporting period. This is a reflection of the increased reserves that have been achieved by the Company through its drilling, exploration and acquisition program.

Depletion, depreciation and accretion ( <i>\$ thousands except where noted</i> )	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Depletion, depreciation and accretion	<b>38,090</b>	17,816	113	<b>139,329</b>	60,925	129
Per boe (\$/boe production)	<b>\$23.00</b>	\$24.24	(5)	<b>\$23.28</b>	\$25.21	(8)

### Capital Expenditures

Property acquisitions for the fourth quarter of 2008 were \$18.4 million as compared to the \$0.6 million for the same period of 2007. The fourth quarter 2008 acquisitions were predominantly oil properties from arm's length third parties. In addition, amounts incurred on exploration and development capital spending for the three months ended December 31, 2008 were \$55.6 million, versus \$17.0 million for the three months ended December 31, 2007.

For the year ended December 31, 2008, property acquisitions were \$59.7 million as compared to the \$55.7 million for the same period of 2007. Amounts incurred on exploration and development capital spending for the year ended December 31, 2008 was \$156.2 million, versus \$88.6 million for the year ended December 31, 2007.

Capital expenditures ( <i>\$ thousands</i> )	Three months ended December 31,			Year ended December 31,		
	2008	2007	% Change	2008	2007	% Change
Acquisition of oil and gas properties, net of disposition proceeds	<b>18,398</b>	602	2,956	<b>59,742</b>	55,670	7
Exploration and development expenditures	<b>55,645</b>	17,008	227	<b>156,187</b>	88,580	76
Total	<b>74,043</b>	17,610	320	<b>215,929</b>	144,250	50

Iteration redirected some of its budgeted second half 2008 capital spending in light of the favorable environment for asset acquisitions that existed at the time. The Company deferred approximately 60 wells into 2009 and reduced capital expenditures on exploration and development activities by \$83 million. This allowed for \$56 million of property acquisitions, which closed in the third and fourth quarter of 2008. The 2008 property acquisitions totaled \$60 million and were a mixture of oil and gas with a combined production of approximately 1,570 boed. This equated to an acquisition cost of approximately \$38,000 per boed.

For the first six months of 2009, the Company is projecting capital expenditures on exploration and development of \$32 million, which approximates funds from operations for the corresponding period. The Company has a significant inventory of high grade drilling prospects and will monitor commodity prices to determine how many should be drilled in the second half of 2009.

### Capital and Liquidity

The Company's liquidity depends upon cash flow from operations, supplemented as necessary by equity and debt financings, and its existing committed credit facility.

As an oil and gas company, the Company has a declining asset base and therefore relies on ongoing development and acquisitions to replace production and add additional reserves. Future oil and natural gas production and reserves are highly dependent on the success of exploiting the Company's existing asset base and in acquiring additional reserves. To the extent the Company is successful or unsuccessful in these activities, funds from operations could be increased or reduced.

There are currently no capital commitments, other than those associated with the Company's drilling and exploration program of \$32 million, for the first and second quarter of 2009. The Company continually monitors its capital spending program in light of the recent volatility with respect to commodity prices and Canadian dollar exchange rates to ensure the Company, subject to a significant change in its borrowing base which results in a reduction in its credit facility, will be able to meet future anticipated obligations incurred from normal ongoing operations with funds from operations and draws on the Company's syndicated facility.

As at December 31, 2008, the Company had drawn \$267 million on its \$300 million syndicated credit facility. At that time, the Company had a working capital deficit of \$9 million, for a total net debt of \$276 million. As at December 31, 2008, the ratio of total net debt to annualized funds from operations for the fourth quarter was 2.2:1. Although it is believed that the credit facility is sufficient, there can be no assurance that the amount will be adequate to meet the financial obligations of the Company or, if required, that additional funds can be obtained.

The Company's credit facility is currently under review. Reviews focus on the borrowing base supporting lending limits and are influenced by the lenders' willingness to lend in general, commodity price forecasts used to determine the lending base, reserves, lenders' interest in particular business sectors, such as energy, and the relative strength of the borrower. There can be no assurance that the Company will be able to maintain its current borrowing base under its facility or that financing will be available or sufficient to meet the requirements of the Company or, if financing is available, that it will be on terms appropriate and acceptable to the Company.

In such a case, the Company may seek to supplement its cash from operations by equity or debt financings, negotiate incremental borrowings with subordinated lenders, sell certain of its oil and gas properties and assets, or reduce its planned capital expenditures.

The impact on the Company's 2008 funds from operations of a \$1.00/GJ swing in average AECO price for natural gas for 2008 would have been approximately \$20.0 million. The impact of a \$5.00/bbl swing in WTI for oil for 2008 would have been approximately \$5.3 million. The impact of a 1% swing in the Canadian Dollar exchange rate for 2008 would have been approximately \$5.0 million.

The Company is projecting funds from operations for the first six months of 2008 of approximately \$33 million, based on an average price during this period of \$4.75 Cdn/GJ for natural gas, \$51.00 Cdn/bbl for oil, and a Canadian dollar exchange rate of \$1.00 Cdn = \$0.80 US.

## **Goodwill**

In accordance with generally accepted accounting principles, on an annual basis, or more frequently if circumstances may indicate that impairment may occur, the Company conducts a goodwill impairment test. Goodwill impairment is a two-step process. In the first step, the Company compares the fair value (effectively share capital outstanding times market share price as at the date of the test) of the reporting unit (effectively the Company), to the carrying amount, including goodwill (effectively Shareholders' Equity). If the carrying value of the reporting unit exceeds its fair value, goodwill is potentially impaired and step two of the impairment test must be performed. In step two, the Company compares the estimated fair value of the goodwill of the reporting unit (again effectively the Company) to its carrying value. If it is concluded that an impairment to goodwill exists, a reduction in the carrying value of the goodwill is recorded in the consolidated balance sheet and recognized as a non-cash impairment charge in income.

The Company completed step one of the goodwill impairment test at year end. In performing the goodwill assessment, the Company used current market capitalization as the best evidence of fair value. As a result of the extreme volatility which has occurred within the capital markets over the past several months, principally due to the global impact of the sub-prime mortgage write-downs in the United States and the volatility of commodity prices, global equity markets have fallen significantly. The market value of the Company's common shares has fallen dramatically and, as of the date of these financial statements, the Company determined that goodwill was potentially impaired since the estimated fair value of the Company was less than its carrying value. As a result, the Company estimated the step two goodwill impairment by determining the implied fair value of the goodwill in the same manner as if it had acquired the reporting unit as of the date of the assessment.

In completing the second step of the goodwill impairment test, management fair valued the Company's reserves and other tangible and intangible assets. As a result of the dramatic decline in commodity prices over the past several months, combined with the extreme volatility in the Canadian dollar exchange rate, management has determined that based on the second step of the goodwill impairment test, goodwill is impaired. As of the date of these financial statements, management's best estimate of this impairment is \$239 million. This impairment has been recorded in these financial statements as a reduction in goodwill and a non-cash charge to income.

Due to the inherent uncertainty involved in making these estimates, and the management judgment required in an analysis of goodwill impairment, actual financial results could differ from those estimated. Changes in expected financial results or other underlying assumptions would have a significant impact on either the fair value of the Company or the amount of the goodwill impairment charge.

As the goodwill impairment charge is non-cash in nature, it does not affect the Company's liquidity, funds from operations or debt covenants and will not impact future operations.

### Operating Leases

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

	<b>Gross Commitment</b>	<b>Sublet Recovery</b>	<b>Net Commitment</b>
	<b>(\$000)</b>	<b>(\$000)</b>	<b>(\$000)</b>
2009	\$3,005	(\$1,268)	\$1,737
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 office space previously occupied by Cyries has been sublet on a full recovery flow through basis commencing June 1, 2008 through to September 30, 2012.

The existing lease on the Company's primary office space was to expire on June 30, 2009. During 2008, the Company renewed the lease on existing premises, plus additional expansion space, for a further five year term commencing June 1, 2009 on the existing premises and October 1, 2009 on the expansion premises.

### **Related Party Transactions**

There were no related party transactions during the three months ended December 31, 2008.

### **Outstanding Common Shares, Warrants and Options**

As at December 31, 2008, there were 166,020,387 common shares and 9.8 million options outstanding. Subsequent to year end, 936,000 options with a weighted average exercise price of \$0.95 were issued to officers and current and new employees of the Company. As at March 23, 2009, there were 10.3 million options outstanding.

### **Critical Accounting Estimates**

In the application of accounting policies, management is often required to make judgments based on underlying estimates and assumptions about future events and their effects. Underlying estimates and assumptions are based on historical experience and other factors that management believes to be reasonable under the circumstances. These estimates and assumptions are subject to change as new events occur and additional information is obtained. The Company believes the following are the most critical accounting estimates used in determining its financial results.

### **Full Cost Accounting**

The Company follows the full cost method of accounting whereby all costs relating to the acquisition of, exploration for and development of oil and gas reserves are capitalized, whether successful or not. The aggregate of these costs, net of costs of unproved properties and estimated salvage values, and estimated future development costs are depleted and depreciated by the unit of production method based on estimated gross proven reserves as determined by independent engineers. Changes in estimated gross proven reserves, salvage values, the value of unproved properties and seismic and future development costs have a direct impact on depletion and depreciation.

### **Ceiling Test**

The Company calculates the ceiling test on reserves based upon estimates of future prices for commodities, production rates, royalty rates, operating costs and inflation rates. Future prices for commodities are based on forward curve amounts. Future production rates, decline rates, royalty rates and operating costs are based on historical amounts. Inflation for commodity prices and operating costs is 2% per annum.

In the calculation of the ceiling test, the carrying value of property and equipment is compared to the sum of undiscounted cash flows expected to result from the future production of proved reserves, salvage value of equipment, the value of seismic and undeveloped land. Cash flows are based on third party quoted forward prices, adjusted for transportation and quality. Should the ceiling test result in an excess of carrying value, the Company would then measure the amount of impairment by comparing the carrying amounts of property, plant and equipment to an amount equal to the estimated net present value of future cash flows from proved plus probable reserves, salvage value of equipment, the value of seismic and undeveloped land. A credit adjusted risk-free interest rate of 6.5% (prior to January 1, 2007, 6.0%) was used to arrive at the net present value of the future cash flows. Any excess is recorded in the statement of earnings.

The carrying value of undeveloped properties (land and seismic data) is reviewed periodically and written down to net realizable value if impairment is determined.

### **Reserve Estimates**

On an annual basis, the Company engages independent petroleum consultants to evaluate 100% of its oil and gas reserves. The estimation of reserves is a subjective process. The accuracy of reserve estimates is a product of the quality and quantity of data available, interpretation and judgment. Reserve estimates are

based on engineering and geological data, projected future rates of production, commodity price forecasts and estimated timing of future expenditures, all of which are subject to interpretation and uncertainties.

Reserve estimates are used in the calculation of depletion and depreciation. A change in estimated reserves would result in a higher or lower depletion and depreciation charge to net earnings. Downward revisions to reserve estimates could also result in an impairment write-down of property, plant and equipment under the ceiling test.

### Asset Retirement Obligations

The Company recognizes the fair value of a liability for an asset retirement obligation in the period in which it is incurred and records a corresponding increase in the carrying value of the related long-lived asset. The fair value is determined through a review of engineering studies, industry guidelines, and management's estimates on a site by site basis. The liability is subsequently adjusted for the passage of time, and is recognized as an accretion expense in the statement of earnings under asset retirement obligations. The liability is also adjusted due to revisions in either the timing or the amount of the original estimated cash flows associated with the liability. Estimates of the asset retirement costs are subject to uncertainty associated with the method, timing and extent of future retirement activities.

The Company calculates the asset retirement obligation based on estimates of the date of abandonment, abandonment costs, and inflation. These amounts are then discounted to a present value amount. The estimates used are as follows:

#### Abandonment and reclamation costs:

Well bore and surface reclamation	
Less than 1,750 meters	\$18,972 per well
More than 1,750 meters	\$26,622 per well
Surface reclamation	
Natural gas wells	\$19,482 per well
Oil wells	\$26,622 per well
Pipelines	\$10,200 per pipeline segment
Roads	\$15,300 per km
Batteries	\$15,300 per battery
Compressors	\$204,000 per compressor
Inflation	2 % per annum
Discount rate	8.5% (6.5% prior to October 1, 2008) per annum

### Income Taxes

The Company records future tax assets and liabilities to account for the expected future tax consequences of events that have been recorded in its consolidated financial statements and its tax returns. These amounts are estimates; the actual tax consequences may differ from the estimates due to changing tax rates and regimes, as well as changing estimates of cash flows and capital expenditures in current and future periods. The Company periodically assesses the realizability of its future tax assets. A valuation allowance is recorded to the extent that there is uncertainty regarding utilization of future tax assets.

### Impact of New Accounting Pronouncements

On January 1, 2008, the Company adopted five new accounting standards that were issued by the Canadian Institute of Chartered Accountants: 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*. The adoption of these standards has had no material impact on the Company's equity, net income or cash flows. The effects of the implementation of the new standards are discussed below.

### General Standards of Financial Statement Presentation

CICA Section 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.

### Capital Disclosures

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.

### Inventories

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. The adoption of this standard had no material impact on the Company's consolidated financial statements.

### Financial Instruments – Disclosures and Presentation

As of January 1, 2008, the Company adopted two new CICA standards. Section 3862 *Financial Instruments – Disclosures* and Section 3863 *Financial Instruments – Presentation*. These sections replaced existing Section 3861 *Financial Instruments – Presentation and Disclosure*. The new disclosure standards increase the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed. The new presentation standard carries forward the former presentation requirements.

In addition, the Company has assessed new and revised accounting pronouncements that have been issued that are not yet effective and determined that the following may have a significant impact on the Company.

### Goodwill and Intangible Assets

Effective January 1, 2009, the Company adopted the 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.

### New Accounting Standards issued Subsequent to Year End

In January 2009, the CICA issued three new accounting standards, Section 1582 *Business Combinations*, Section 1601 *Consolidated Financial Statements* and Section 1602 *Non controlling interests* each of which are effective for fiscal years beginning on or after January 1, 2011 and further align Canadian GAAP with IFRS. Earlier adoption of these recommendations is permitted.

Section 1582 applies prospectively to the Company's business combinations on or after January 1, 2011. This section replaces Section 1581 *Business Combination* and harmonizes the Canadian accounting standards with International Financial Reporting Standards ("IFRS"). Under the new guidance, the purchase price used in a business combination will be the fair value of the shares exchanged at their market price on the date of the exchange. Currently, when shares are issued, they are valued based on the market price for a reasonable period before and after the date the acquisition is agreed upon and announced. Under the new guidelines, all acquisition costs are expensed where currently they are capitalized as part of the acquisition costs. There are also a number of other differences between the new guidelines and current GAAP.

Section 1601 and 1602 change the accounting and reporting of ownership interests in subsidiaries held by parties other than the parent. Non-controlling interests are to be presented in the consolidated statement of financial position within equity, but separately from parent's equity. The amount of consolidated net income attributable to the parent and to the non-controlling interest is to be clearly identified and presented on the face of the consolidated statement of income (loss). In addition, these pronouncements establish standards for a change in a parent's ownership interest in a subsidiary and the valuation of retained non-controlling equity investments when a subsidiary is deconsolidated. They also establish reporting requirements for providing sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interest of the non-controlling owners. The Company does not expect the adoption of these pronouncements to impact its consolidated financial statements in fiscal 2011.

#### International Financial Reporting Standards ("IFRS")

The Canadian Accounting Standards Board has now confirmed that the use of 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 developing a changeover plan to complete the transition to IFRS by January 1, 2011, including the preparation of required comparative information. The key elements of the plan include:

- determine appropriate changes to accounting policies and required amendments to financial disclosures;
- identify and implement changes in associated processes and information systems;
- comply with internal control requirements;
- educate and train internal and external stakeholders.

At December 31, 2008, the Company had completed a diagnostic study of the anticipated impact of the transition to IFRS. The Company is currently analyzing the accounting policy alternatives and identifying implementation options for the corresponding process changes. As IFRS is expected to change prior to 2011, the impact of IFRS on the Company's consolidated financial statements is not reasonably determinable at this time.

#### **Disclosure Controls and Procedures**

The Company has implemented disclosure controls and procedures, as defined in National Instrument 52-109-Certification of Disclosure in Issuer's Annual and Interim Filings, to ensure that information required to be disclosed by the Company is accumulated and communicated to the Company's management, as appropriate, to allow timely decisions regarding required disclosures. The Company's Chief Executive Officer and Chief Financial Officer, together with management, have concluded, based on their evaluation of the effectiveness of the Company's disclosure controls and procedures as of the year-end, the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company is (i) recorded, processed, summarized and reported within the time periods specified in Canadian securities law and (ii) accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

It should be noted that while the Company's Chief Executive Officer and Chief Financial Officer believe that the Company's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures will necessarily prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

## Disclosure Controls and Procedures and Internal Controls over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over the Company's financial reporting. The Company's internal control system was designed to provide reasonable assurance that all transactions are accurately recorded, that transactions are recorded as necessary to permit preparation of financial statements in accordance with Generally Accepted Accounting Principles, and that the Company's assets are safeguarded. Internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedure may deteriorate.

The CEO and CFO are required to certify on the effectiveness of the internal controls over financial reporting in the 2008 annual certifications in accordance with National Instrument 52-109. To do so, they have assessed the effectiveness of the Company's internal control over financial reporting as at December 31, 2008. In making its assessment, management engaged an external third party to evaluate the operating effectiveness of the internal controls to support their certifications. This evaluation identified certain duties within the accounting and finance department that could not be properly segregated, given the Company's limited staff level. However, none of the segregation of duty deficiencies are believed to have resulted in a misstatement in the financial statements as the Company relies on certain compensating controls, including a substantive periodic review of the financial statements and other financial information by the CEO and the audit committee. This weakness is considered to be a common deficiency for many smaller listed companies in Canada.

Based on this assessment, management has concluded that the Company's internal control over financial reporting was effective as of December 31, 2008.

## Changes in Internal Control Over Financial Reporting

During the fiscal year ended December 31, 2008, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. Management, including the CEO and CFO do not expect that the Company's disclosure controls or the Company's internal controls over financial reporting will prevent or detect all errors or fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives are met.

## Outlook for 2009

The following discussion is qualified in its entirety by the caution under the heading "Advisory – Forward Looking Information" at the beginning of the MD&A.

**For the first six months of 2009, the Company is providing the following guidance, which is in line with the guidance provided on March 2, 2009:**

	First Quarter, 2009	Second Quarter, 2009
Average production (boed)	18,300	17,400
Capital program (\$ million)	26	6
Funds from operations (\$ million)	19	14
Quarter end net debt (\$ million)	283	275
Net wells	6	1
Projected commodity prices:		
Natural gas (\$ Cdn/GJ)	5.15	4.35
Light crude oil (\$ Cdn/bbl)	47.00	55.00

Projected operating netback \$/boe	15.40	13.40
Projected general and administrative \$/boe	1.70	1.70

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As a result of the global credit crisis and deteriorating expectations for global economic growth, commodity prices have fallen sharply over the last several months. If the volatility in commodity prices continues, or softens further, the Company can expect to experience decreased earnings and funds from operations in comparison to previous quarters. While these factors may be mitigated to a certain extent from a weakening of the Canadian dollar, the unprecedented volatility of the exchange rate makes it difficult to project where the rate will ultimately settle and, therefore what prices and funds from operations will be realized.

Should realized prices strengthen, the Company has an inventory of high grade exploration opportunities that can be undertaken. However, should realized prices further weaken, the Company intends to scale back operations to ensure that the projected annual capital program remains in line with projected funds from operations.

Despite the challenges that have arisen in recent months, the Company continues to manage its business with prudence and a commitment to creating long term shareholder value.

## **Directors, Officers and Auditors**

### **Current Officers and Directors of the Company are as follows;**

#### Officers

Brian Illing	President and CEO
Mark Ariss	VP Exploration East
Sean Johnson	CFO
Jane Mactaggart	VP Exploitation
Carmen McKay-Illing	VP Corporate Affairs
Myron Rak	VP Production
Tony Sabelli	VP Drilling & Completions
Kevin Stromquist	VP Exploration West

#### Directors

Don Archibald (Chairman)	Independent Businessman (former Chairman & CEO – Cyries)
Pat Breen P. Eng.	President - Foremost Income Fund
Howard Crone P. Eng.	Independent Businessman (former director – Cyries)
Dallas Droppo Q.C.	Partner - Blake, Cassels and Graydon LLP
Jim Grenon	President - TOM Capital Associates
Michael Hibberd	President - MJH Services Inc.
Brian Illing P. Geol	President and CEO- Iteration Energy Ltd.
Garry Peddle	Independent Businessman (former VP Corporate – Cyries)
Robert Waters CA	Senior VP and CFO - Enerplus Resources Fund

#### Corporate Secretary

Tony Grenon	Managing Director - TOM Capital Associates
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#### Auditors

Ernst & Young LLP
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#### Corporate Counsel

Bennett Jones LLP
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**Additional Information on the Company**

Other information about the Company, including the Annual Information Form for the year ended December 31, 2008, is available through the internet on the Company's website at [www.iterationenergy.com](http://www.iterationenergy.com) and on the Company's SEDAR profile at [www.sedar.com](http://www.sedar.com). For further information, please contact Mr. Brian Illing, President and CEO, or Mr. Sean Johnson, CFO, at 403-261-6883.