

# Iteration Energy Ltd.

## Second Quarter 2009 Report

### CORPORATE SUMMARY

Financial Highlights (\$thousands, except as noted)	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Production revenue before royalties	<b>\$44,936</b>	\$127,175	<b>\$103,629</b>	\$182,739
Funds from operations <sup>(1)</sup>	<b>\$5,378</b>	\$52,824	<b>\$20,278</b>	\$81,337
Per share (\$) - basic	<b>\$0.03</b>	\$0.32	<b>\$0.11</b>	\$0.63
- diluted	<b>\$0.03</b>	\$0.31	<b>\$0.11</b>	\$0.62
Net earnings (loss)	<b>(\$22,978)</b>	\$672	<b>(\$37,253)</b>	\$2,362
Per share (\$) – basic	<b>(\$0.12)</b>	\$0.00	<b>(\$0.21)</b>	\$0.02
- diluted	<b>(\$0.12)</b>	\$0.00	<b>(\$0.21)</b>	\$0.02
Net capital expenditures	<b>\$4,196</b>	\$31,408	<b>\$39,556</b>	\$73,181
			As at June 30,	
			<b>2009</b>	2008
Total assets			<b>\$986,421</b>	\$1,236,662
Bank debt and working capital deficiency			<b>\$241,371</b>	\$241,519
Common shares outstanding			<b>210,985,384</b>	166,020,387
Stock options outstanding			<b>9,847,708</b>	8,498,045
Warrants outstanding			-	116,667

(1) “Funds from operations” and “funds from operations per share” are financial measures that are not determined in accordance with GAAP. See “Non-GAAP Measures” in the Company’s Management Discussion and Analysis.

Operating Highlights	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Production				
Natural gas (mcf/d)	<b>74,650</b>	76,563	<b>76,934</b>	62,180
Light oil (bbls/d)	<b>3,017</b>	3,840	<b>3,196</b>	2,725
Heavy oil (bbls/d)	<b>203</b>	168	<b>190</b>	192
Natural gas liquids (bbls/d)	<b>1,474</b>	1,377	<b>1,431</b>	1,237
Total production (boe/d)	<b>17,137</b>	18,146	<b>17,640</b>	14,517
Prices				
Natural gas (\$/mcf)	<b>\$3.46</b>	\$10.50	<b>\$4.45</b>	\$9.62
Light oil (\$/bbl)	<b>\$59.41</b>	\$129.54	<b>\$54.55</b>	\$119.31
Heavy oil (\$/bbl)	<b>\$49.32</b>	\$89.54	<b>\$44.80</b>	\$77.47
Natural gas liquids (\$/bbl)	<b>\$31.13</b>	\$58.68	<b>\$33.11</b>	\$53.09
Average price (\$/boe)	<b>\$28.82</b>	\$77.02	<b>\$32.46</b>	\$69.16
Operating Netback (\$/boe)	<b>\$8.58</b>	\$47.06	<b>\$10.53</b>	\$41.60
Net Undeveloped Land (‘000acres as at June 30)			<b>851</b>	748

## **PRESIDENT'S MESSAGE**

The second quarter of 2009 included some positive milestones for Iteration; we successfully completed a \$57.5 million equity offering, our bank credit facilities were refinanced and a non-core property disposition program was initiated with the majority of the transactions closed by the end of July 2009. The operating environment continued to be a challenge in the quarter as gas prices weakened, while stronger oil prices provided some benefit, and production expenses increased.

Capital expenditures were curtailed in the quarter in response to weak gas prices and limited activity due to spring break-up. Net capital expenditures were \$4.2 million for the quarter, a 90% decrease from the first quarter of 2009. Approximately \$2.2 million of dispositions were completed in the second quarter.

Average production for the quarter was 17,137 boed, down six percent from the first quarter of 2009 as a result of facility maintenance turnarounds, particularly at Gold Creek in northwest Alberta, and natural declines due to lack of activity. In addition, approximately 750 boed of production was shut-in due to low commodity prices in the second quarter of 2009. Of this amount approximately 300 boed was oil, most of which we expect to bring back on stream in the last half of the year. However given current gas prices we are expecting to shut-in an additional 350 boed of gas production.

Funds from operations for the quarter were \$5.4 million (\$0.03 per basic and diluted share), 64% lower than in the first quarter of 2009 primarily due to a decrease in average commodity prices and a decrease in production. Production expenses continue to be a concern as prior period costs have exceeded previous estimates and the fixed cost components of shut-in production are increasing per unit costs. Initiatives are underway on two fronts; one is improving the estimation process, and two is pursuing cost savings with our various service providers in light of the economic environment. In addition, the SemGroup receivable was written down by a further \$1.8 million to bring the total provision to \$15.7 million, which anticipates a recovery of 4% or \$0.7 million of the initial receivable. Without the additional SemGroup provision, funds from operations would have been \$7.2 million. The net loss for the quarter of \$23.0 million (\$0.12 per basic and diluted share) is up from the \$14.3 million net loss in the first quarter and is consistent with the lower funds from operations.

Progress was made during the quarter to improve the Company's financial position even though funds from operations decreased. During the second quarter, Iteration completed a \$57.5 million equity financing at \$1.28 per share issuing approximately 45.0 million common shares, the net proceeds of which were used to repay debt. In May 2009 a new \$265 million credit facility was also put in place to replace the previous \$260 million facility. In July 2009 we completed \$39.8 million in property dispositions with proceeds used to reduce bank debt. The dispositions resulted in a \$12.5 million reduction to the borrowing base, which is now \$252.5 million. Pro forma the dispositions, total debt outstanding would have been approximately \$200 million at the end of the second quarter of 2009.

Total proceeds from the Company's 2009 non-core property disposition program are approximately \$42 million (prior to closing adjustments; \$2.2 million completed in the second quarter of 2009 and \$39.8 million completed in July 2009). Approximately 1,000 boed of production and 3.2 million boe of proved plus probable reserves were disposed of through this initiative.

Looking forward we have updated our guidance to reflect the property dispositions, shut-in production, lower capital expenditures, higher production expenses and changes to commodity prices. These changes result in forecasted funds from operations for 2009 of approximately \$40 million (\$0.20 per basic share) based on annual capital expenditures of \$65 million (net of drilling incentive credits) and an average production range for the year of 15,600 to 16,100 boed. Economic parameters used for the last six months of 2009 in this forecast are; AECO gas price of \$3.75/mcf, WTI oil price of US\$65.00/bbl and foreign exchange rate of Cdn\$0.90 to US\$1.00.

Annual capital expenditures of \$65 million have been reduced from our previous guidance of \$75 million due to lower funds from operations. Given the increase in oil prices and the extension of the Alberta royalty and drilling credit program we are altering our spending profile on oil prospects and have cut spending on

our remaining gas prospects. The extension of the Alberta royalty and drilling credit program has allowed us to develop our Manyberries (southeast Alberta) program in a more efficient manner by delaying part of the capital program to 2010. This will permit us to drill wells after several of the waterflood pools have been properly pressured up and still earn the drilling credits. The higher oil prices have also made the economics on several other areas more attractive, particularly at Rainbow (northwest Alberta). Given the limited access to this area we will now shift part of our capital spending from Manyberries to this area and expect drilling to commence in October/November 2009. As activities for both Manyberries and Rainbow don't begin until later in this year, we do not expect to see new production until the first quarter of 2010.

Previously we had forecasted funds from operations to exceed capital expenditures in the second half of the year so that on an annual basis they would be about equal. However given we have disposed of non-core properties, we are directing additional capital to our oil prospects in core areas. We now expect capital expenditures to be slightly higher than funds from operations for the last half of the year, and as a result, exceed them by \$25 million on a full year basis.

Our Company possesses a large inventory of gas prospects and a solid inventory of oil prospects, some of which we are pursuing in the last half of the year. While gas prices are currently too low to warrant capital investment; a significant part of our gas inventory does make economic sense at prices as low as \$5.00/mcf at AECO. The forward commodity market currently gives us the opportunity to establish prices at or in excess of this level. The majority of our oil inventory is economic at today's prices and similar to gas, the forward market allows us to lock in these prices. Given the volatility we have experienced in commodity prices we expect to implement a hedging program shortly to secure prices by way of either fixed price swaps or options that meet or exceed our economic criteria. On average we expect to ultimately hedge up to one third of our base production up to two years forward. Ideally we will build this hedge portfolio over time and continue to roll it forward.

Effective August 12, 2009 Mr. Howard Crone resigned from the Board of Directors in order to pursue other interests. On behalf of the Company I would like to thank Howie for his valuable contribution to the Board and wish him all the best in his future endeavors.

The current gas operating environment is challenging and we expect it to continue until a more robust economic recovery increases demand and the effect of spending cuts starts to have a meaningful impact on supply. The oil operating environment is more promising and we look forward to developing these prospects in the second half of the year. We have been active in improving our financial position and look to further secure that position through some hedging activities. Our plans for the remainder of the year provide a balance of capital spending to projected funds from operations.

On behalf of the Board of Directors,

(Signed) Brian Illing  
President & CEO  
August 12, 2009

# MANAGEMENT'S DISCUSSION AND ANALYSIS

August 12, 2009

The following is Management's Discussion and Analysis ("MD&A") of Iteration Energy Ltd.'s (the "Company" or "Iteration") operating and financial results as at and for the three and six months ended June 30, 2009 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 unaudited interim consolidated financial statements as at and for the three and six months ended June 30, 2009 and the 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 ("AIF") for the year ended December 31, 2008. All financial information is reported in Canadian dollars, unless noted otherwise, and in accordance with Canadian generally accepted accounting principles ("GAAP").

Natural gas is converted to crude oil equivalent at a ratio of six thousand cubic feet of natural gas 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 boe 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).

The following MD&A contains forward looking information and statements. We refer you to the end of the MD&A for our discussion on forward looking information and statements in the section "ADVISORY – FORWARD LOOKING INFORMATION".

## 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 in Northeast British Columbia and Gold Creek, Knopcik and Manyberries in Alberta.

## 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 uses "funds from operations" and "funds from operations per share" (before changes in non-cash working capital) to analyze operating performance and leverage. 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 MD&A are based on cash flow from operating activities before changes in non-cash working capital. The table below provides a reconciliation between cash flow from operations and funds from operations.

(\$ thousands)	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Funds from operations	\$5,378	\$52,824	\$20,278	\$81,337
Changes in non-cash working capital	3,286	(16,114)	9,195	(101)
Cash flow from operations	\$8,664	\$36,710	\$29,473	\$81,236

## OUTLOOK FOR 2009

Iteration is updating its guidance for 2009 results issued on May 14, 2009 due to property dispositions of approximately 1,000 boed of production, additional shut-in gas production of approximately 350 boed, changes in commodity prices and reduced capital expenditures. The information below presents the Company's expected results for the full year of 2009 (which incorporates the actual results for the first six months of 2009, and the forecast for the balance of the year), the May 14, 2009 guidance and the difference between the two.

	2009 Forecast	2009 Previous May 14 Forecast	Change
<b>Production (boe/d) <sup>(1)</sup></b>			
Annual average	15,600 – 16,100	17,000 – 17,500	(8%)
<b>Capital program <sup>(2)</sup></b>			
Expenditures (\$ million)	65	75	(13%)
Net wells drilled	24	25	(4%)
<b>Funds from operations <sup>(2)</sup></b>			
Annual (\$ million)	40	80	(50%)
Annual per basic share (\$)	0.20	0.41	(51%)
Year end net debt (\$ million)	205	220	(7%)
<b>Average Pricing:</b>			
	(July – Dec 2009)	(April – Dec 2009)	
Natural gas – AECO (Cdn\$/mcf)	3.75	4.65	(19%)
Oil – WTI (US\$/bbl)	65.00	60.00	8%
Foreign exchange rate (Cdn\$/US\$)	0.90	0.82	10%

### Notes:

- (1) Production guidance reduced by 500 boed or 3% due to property dispositions and 175 boed or 1% due to expected additional shut-in gas production.
- (2) Previous guidance included Alberta drilling credits as a reduction of royalties. This guidance has applied the Alberta drilling credits to reduce capital expenditures. The amount of drilling credits included in this forecast is \$4.7 million (\$4.6 million in the previous guidance). Funds from operations include a \$1.8 million additional provision for bad debts related to SemGroup's trade receivables in connection with its Companies' Creditors Arrangement Act ("CCAA") proceedings.

Gas prices have continued to weaken from our previous forecast and although WTI crude prices are projected to be higher, the stronger Canadian dollar has left crude realizations slightly lower. A non-core disposition program was initiated in the second quarter with the majority of the transactions occurring in July resulting in approximately \$42 million of dispositions (prior to closing adjustments) consisting of approximately 1,000 boed of production (80% gas) with the proceeds used to repay debt. In addition the Company expects to shut-in an additional 350 boed of gas production in the second half of 2009 if current pricing persists.

Funds from operations are expected to be lower mainly due to lower production and commodity prices, partially offset by lower interest costs. As a result, planned capital expenditures have been reduced with cuts to gas drilling and delaying of some oil drilling at Manyberries in southern Alberta to 2010. The extension of the Alberta drilling incentives allows Iteration to follow a more efficient capital plan for this area. The recently announced B.C. drilling incentives are not expected to affect capital spending plans for the balance of the year based on our projection for gas prices.

Royalty rates are forecasted to be approximately 19% for the year (versus previous guidance of 18%) primarily due to lower commodity prices offset by removing the Alberta drilling credits and which are now shown as a reduction of capital expenditures. Production expenses continue to be affected by non-operated

prior period costs and are expected to average approximately \$14.25 per boe for 2009, about 13% higher than the previous forecast. Production expenses for the last six months of 2009 are expected to average approximately \$13.00 per boe.

General and Administrative (“G&A”) expense is expected to average \$2.20 per boe in 2009 versus previous guidance of \$1.95 per boe primarily due to lower production volumes. Interest expense is expected to be based on an average interest rate of about 6% to reflect increased borrowing costs and financing charges.

Year-end debt is expected to decline to about \$205 million as the proceeds from the property dispositions have been applied to debt repayment and funds from operations are expected to be slightly below capital expenditures for the last six months of 2009.

Should realized gas prices strengthen, the Company has an inventory of drilling opportunities that can be undertaken. However, should realized prices further weaken, the Company intends to scale back operations to ensure that the projected capital program remains in line with projected funds from operations for the last half of the year.

The impact on the Company’s 2009 funds from operations of a \$1.00/mcf increase in average AECO price for natural gas for the last six months of 2009 would be approximately \$8.1 million. The impact of a US\$5.00/bbl increase in WTI for oil for the last six months of 2009 would be approximately \$2.8 million. The impact of a one cent weakening of the Canadian Dollar versus the U.S. dollar for the last six months of 2009 would be approximately \$0.8 million. Using forward market pricing of \$3.90/mcf for AECO gas, US\$72.50 for WTI oil and Canadian/US dollar exchange rate of 0.93, funds from operations would be \$5 million higher or \$45 million.

## OPERATING RESULTS

### Production

Daily production	Three months ended			Six months ended		
	June 30,			June 30,		
<i>Average for the period</i>	2009	2008	% Change	2009	2008	% Change
Natural gas (mcf/d)	<b>74,650</b>	76,563	(2)	<b>76,934</b>	62,180	24
Natural gas liquids (bbls/d)	<b>1,474</b>	1,377	7	<b>1,431</b>	1,237	16
Light oil (bbls/d)	<b>3,017</b>	3,840	(21)	<b>3,196</b>	2,725	17
Heavy oil (bbls/d)	<b>203</b>	168	21	<b>190</b>	192	(1)
Total production (boed)	<b>17,137</b>	18,146	(6)	<b>17,640</b>	14,517	25

Average daily production for the three months ended June 30, 2009 was 6% below the same period in 2008 primarily due to lower drilling activity over the past six months and natural production declines. Shut-in production due to low commodity prices averaged approximately 750 boed for the second quarter of 2009. Both periods were impacted by facility maintenance turnarounds.

Average daily production for the six months ended June 30, 2009 was 25% higher than the prior year period primarily due to the acquisition of Cyries Energy Inc. (“Cyries”) which was completed March 7, 2008. As a result, the prior year period only includes approximately 4 months of Cyries production.

## Commodity Prices

Industry benchmarks	Three months ended			Six months ended		
	June 30,			June 30,		
<i>Average for the period</i>	2009	2008	% Change	2009	2008	% Change
Natural gas (AECO \$/mcf)	\$3.46	\$10.22	(66)	\$4.21	\$9.10	(54)
Edmonton Light crude (\$/bbl)	\$65.90	\$126.07	(48)	\$57.78	\$111.79	(48)
Hardisty Lloyd blend (\$/bbl)	\$60.29	\$103.05	(41)	\$51.27	\$89.66	(43)

Realized commodity prices	Three months ended			Six months ended		
	June 30,			June 30,		
<i>Average for the period</i>	2009	2008	% Change	2009	2008	% Change
Natural gas (\$/mcf)	\$3.46	\$10.50	(67)	\$4.45	\$9.62	(54)
Natural gas liquids (\$/bbl)	\$31.13	\$58.68	(47)	\$33.11	\$53.09	(38)
Light oil (\$/bbl)	\$59.41	\$129.54	(54)	\$54.55	\$119.31	(54)
Heavy oil (\$/bbl)	\$49.32	\$89.54	(45)	\$44.80	\$77.47	(42)
Total (\$/boe)	\$28.82	\$77.02	(63)	\$32.46	\$69.16	(53)

Natural gas prices realized for the three and six months ended June 30, 2009 decreased 67% and 54% respectively from the same periods in the prior year, which is consistent with the average benchmark price decreases. Similarly the light oil realized price for the second quarter and first half of 2009 decreased by 54% as compared to the same periods of 2008, which is slightly higher than the 48% decrease in average benchmark prices.

## Revenue

Production revenue before royalties (\$ thousands)	Three months ended			Six months ended		
	June 30,			June 30,		
	2009	2008	% Change	2009	2008	% Change
Production revenue	\$44,936	\$127,175	(65)	\$103,629	\$182,739	(43)

Production revenue for the three months ended June 30, 2009 decreased 65% compared to the corresponding period in 2008 primarily due to the 63% decrease in realized commodity prices. For the six months ended June 30, 2009 production revenue decreased 43% compared to the same period in 2008 as the reduction in commodity prices was partially offset by an increase in production.

For the three months and six months ended June 30, 2009 and 2008 gas represented a little over 70% of the Company's production and ranged between 52% and 60% of the Company's revenue.

## Royalties

(\$ thousands except where noted)	Three months ended			Six months ended		
	June 30,			June 30,		
	2009	2008	% Change	2009	2008	% Change
Royalties	\$6,517	\$27,199	(76)	\$18,659	\$38,878	(52)
Per boe (\$/boe)	\$4.18	\$16.47	(75)	\$5.84	\$14.71	(60)
Percentage of revenue (%)	14.5	21.4	(32)	18.0	21.3	(15)

Royalty expenses on an absolute, per boe and percentage of revenue basis all decreased in 2009 compared to the corresponding periods in 2008 primarily due to lower commodity prices, particularly gas prices, and the new Alberta Royalty Framework which was enacted in 2009. The new royalty framework is more sensitive to prices; the average rate dropped from 20.7% in the first quarter of 2009 to 14.5% in the second quarter of 2009. Royalties represent amounts paid by the Company for crown, freehold and gross overriding royalties. The vast majority of the Company's royalty expenses are for crown royalties.

### Production Expenses

Production expenses (\$ thousands)	Three months ended June 30,			Six months ended June 30,		
	2009	2008	% Change	2009	2008	% Change
Total production expenses	\$23,752	\$20,291	17	\$48,633	\$30,488	60
Per boe (\$/boe)	\$15.23	\$12.29	24	\$15.23	\$11.54	32

Production expenses have increased in 2009 over the 2008 periods due to higher per unit costs and for the first half of 2009 due to a 25% increase in production compared to the first half of 2008. Per unit production costs have increased in the 2009 periods compared to the previous year largely due to the inclusion of revisions of estimates of prior period costs and the fixed cost component associated with shut-in production volumes. The Company continues to experience late charges from vendors and partners particularly for processing, workover and labour costs. Excluding these costs, operating costs for the first half of 2009 would have been \$12.54 per boe. The implementation of processes and systems that began earlier this year to improve the timeliness of data and analysis relating to operating costs is progressing and is expected to be fully operational by the end of 2009.

### Transportation Expenses

(\$ thousands except where noted)	Three months ended June 30,			Six months ended June 30,		
	2009	2008	% Change	2009	2008	% Change
Transportation expenses	\$1,301	\$1,982	(34)	\$2,735	\$3,451	(21)
Per boe (\$/boe)	\$0.83	\$1.20	(31)	\$0.86	\$1.31	(34)

Transportation expenses for the quarter and six months ended June 30, 2009 were lower compared to the prior year periods on an absolute and per boe basis primarily as a result of a better allocation of the Company's production between firm and interruptible transportation contracts.

### Operating Netback

(\$/boe)	Three months ended June 30,			Six months ended June 30,		
	2009	2008	% Change	2009	2008	% Change
Production revenue	\$28.82	\$77.02	(63)	\$32.46	\$69.16	(53)
Royalties	(4.18)	(16.47)	(75)	(5.84)	(14.71)	(60)
Production expenses	(15.23)	(12.29)	24	(15.23)	(11.54)	32
Transportation expenses	(0.83)	(1.20)	(31)	(0.86)	(1.31)	(34)
Operating netback	\$8.58	\$47.06	(82)	\$10.53	\$41.60	(75)

The operating netback per boe (before general and administrative expenses) realized for the three and six months ended June 30, 2009 has decreased significantly compared to the same periods in 2008 largely due to the drop in commodity prices. Increased production expenses were more than offset by lower royalties and transportation expenses.

### General and Administrative Expenses

(\$ thousands except where noted)	Three months ended June 30,			Six months ended June 30,		
	2009	2008	% Change	2009	2008	% Change
General and administrative costs before the following:	\$4,145	\$4,285	(3)	\$9,001	\$7,390	22
Capitalized overhead	(1,047)	(1,020)	3	(2,707)	(1,790)	51
Overhead recoveries	(35)	(70)	(50)	(105)	(128)	(18)
General and administrative expense	\$3,063	\$3,195	(4)	\$6,189	\$5,472	13
Per boe (\$/boe)	\$1.96	\$1.93	2	\$1.94	\$2.07	(17)

G&A expenses for the three months ended June 30, 2009 decreased compared to the corresponding period in 2008 due to the absence of initially higher costs included in the 2008 period immediately following the acquisition of Cyries. On a per boe basis the costs are relatively similar between the two periods.

For the six months ended June 30, 2009 the absolute G&A costs are higher; however per boe costs are lower than the prior year period. Costs are higher because the first quarter of 2008 includes less than one month of Cyries operations while the entire 2009 period has costs for the combined entity. However per boe costs are lower in 2009 due to a higher production base.

### SemGroup Receivable

During the second quarter of 2009 the Company increased the provision for the un-collectability of the SemCanada and SemCams trade receivables by \$1.8 million reflecting an ultimate recovery of 4% or \$0.6 million. A provision of \$15.7 million (\$13.9 million at December 31, 2008) had been provided for as a result of these companies filing for CCAA protection.

### Stock Based Compensation Expense

The Company's stock option plan provides option holders the right to request, upon exercise, to receive a cash payment in exchange for surrendering the option, provided the request is accepted by the Company. 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 on the Toronto Stock Exchange the day prior to surrendering the option. On June 20, 2008, with the approval of shareholders, the stock option plan was amended and restated 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. In June of 2009 the Company provided employees (excluding officers and directors) the option to surrender options they held with a strike price above \$3.50 per share and in turn receive 40% of their surrendered number of options with a strike price at the then prevailing share price of \$1.40. As a result 3.4 million options were surrendered and 1.3 million options were issued. At June 30, 2009 and August 12, 2009, options to purchase 9.8 million common shares were outstanding, which represents 4.6% of the outstanding common shares of the Company at that time.

For the three and six months ended June 30, 2009, \$35,000 of stock based compensation expense was recorded by the Company compared to \$13.8 million and \$20.9 million respectively for the corresponding periods in 2008.

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 vested and outstanding. Based on the June 30, 2008 share price of \$1.17, had all of the 9,847,708 stock options outstanding been vested, aggregate stock-based compensation expense and a corresponding liability of \$276,000 would have been recognized.

### Interest and Financing Expense

(\$ thousands except where noted)	Three months ended June 30,			Six months ended June 30,		
	2009	2008	% Change	2009	2008	% Change
Interest and financing expense	\$3,215	\$3,067	5	\$4,833	\$4,179	16
Per boe (\$/boe)	\$2.06	\$1.86	11	\$1.51	\$1.58	(4)

Interest and financing expense primarily represents interest on bank debt but also includes financing charges and expenses related to bank debt. Interest and financing expense has increased in the 2009 periods compared to 2008 due to overall higher debt levels, partially offset by lower interest costs. Debt levels have increased as capital expenditures have exceeded funds from operations, equity financings and property disposition proceeds. The majority of the Company's bank debt is borrowed by way of Bankers' Acceptances. The second quarter of 2009 also includes costs related to the refinancing of the Company's bank debt facility.

### Depletion, Depreciation, and Accretion

(\$ thousands except where noted)	Three months ended June 30,			Six months ended June 30,		
	2009	2008	% Change	2009	2008	% Change
Depletion, depreciation and accretion	\$36,800	\$39,045	(6)	\$72,500	\$60,600	19
Per boe (\$/boe)	\$23.60	\$23.65	(0)	\$22.71	\$22.94	(1)

Depletion, depreciation, and accretion ("DD&A") expense is lower for the second quarter of 2009 compared to the prior year period primarily due to lower production. For the first half of 2009 higher production is increasing DD&A expense compared to the prior year period. On a per boe basis DD&A expense is within 1% of each other between the 2009 and 2008 periods.

### Funds from Operations and Net Income/(Loss)

(\$ thousands except where noted)	Three months ended June 30,			Six months ended June 30,		
	2009	2008	% Change	2009	2008	% Change
Funds from operations	<b>\$5,378</b>	\$52,824	(90)	<b>\$20,278</b>	\$81,337	(75)
per share – basic (\$)	<b>\$0.03</b>	\$0.32	(91)	<b>\$0.11</b>	\$0.63	(83)
per share – diluted (\$)	<b>\$0.03</b>	\$0.31	(90)	<b>\$0.11</b>	\$0.62	(82)
per boe (\$/boe)	<b>\$3.45</b>	\$31.99	(89)	<b>\$6.35</b>	\$30.79	(79)
Net (Loss)/income	<b>(\$22,978)</b>	\$672	(3,319)	<b>(\$37,253)</b>	\$2,362	(1,677)
per share – basic (\$)	<b>(\$0.12)</b>	\$0.00	-	<b>(\$0.21)</b>	\$0.02	(1,150)
per share – diluted (\$)	<b>(\$0.12)</b>	\$0.00	-	<b>(\$0.21)</b>	\$0.02	(1,150)
per boe (\$/boe)	<b>(\$14.73)</b>	\$0.41	(3,692)	<b>(\$11.66)</b>	\$0.89	(1,410)
Weighted average shares outstanding						
basic ('000)	<b>193,197</b>	165,812	17	<b>179,684</b>	129,266	39
diluted ('000)	<b>193,197</b>	168,413	15	<b>179,684</b>	131,242	37

Iteration's funds from operations for the three months ended June 30, 2009 was \$5.4 million compared to \$52.8 million for the same period in 2008. For the six months ended June 30, 2009 the Company's funds from operations of \$20.3 million compares to \$81.3 million for the prior year period. The reduction was primarily a result of significantly weaker commodity prices combined with higher production expense and the additional provision for the SemGroup receivable partially offset by lower royalties.

Iteration's net loss for the three months ended June 30, 2009 was \$23.0 million, as compared to a net income of \$0.7 million for the three months ended June 30, 2008. For the six months ended June 30, 2009 the Company's net loss of \$37.3 million compares to net income of \$2.4 million for the prior year period. The losses primarily arise as a result of lower funds from operations and, higher DD&A expense for the six months ended June 30, 2009, partially offset by a recovery of future income taxes.

Weighted average shares outstanding in the second quarter of 2009 increased approximately 17% over the prior year period primarily due to the 45.0 million common share equity issue completed in May 2009. For the six months ended June 30, 2009 weighted average shares outstanding increased over the prior year period due to the equity issue completed in May 2009 and the 94.0 million shares issued in conjunction with the Cyriac acquisition in March 2008 being outstanding for the entire period.

## Selected Quarterly Data

Quarter ended	2009				2008			2007	
	June 30	Mar 31	Dec 31	Sept 30	June 30	Mar 31	Dec 31	Sept 30	
Production (boe/d)	17,137	18,165	18,001	18,507	18,146	10,890	7,989	6,304	
Revenues (\$000)	\$44,936	\$58,693	\$70,656	\$108,444	\$127,175	\$55,564	\$29,265	\$22,161	
Average realized prices (\$/boe)	\$28.82	\$35.93	\$43.08	\$64.32	\$77.02	\$56.08	\$39.84	\$38.21	
Royalties (\$/boe)	\$4.18	\$7.43	\$7.61	\$13.71	\$16.47	\$11.79	\$8.12	\$9.29	
Production expense (\$/boe)	\$15.23	\$15.23	\$11.02	\$10.99	\$12.29	\$10.29	\$11.97	\$6.53	
Transportation expense (\$/boe)	\$0.83	\$0.88	\$0.71	\$0.77	\$1.20	\$1.48	\$1.09	\$1.29	
Operating netback (\$/boe)	\$8.58	\$12.39	\$23.75	\$38.85	\$47.06	\$32.52	\$18.66	\$21.10	
Net G&A expense (\$/boe)	\$1.96	\$1.92	\$1.19	\$1.62	\$1.93	\$2.30	\$2.37	\$2.19	
Net interest expense (\$/boe)	\$2.06	\$0.99	\$1.58	\$1.48	\$1.86	\$1.12	\$1.37	\$0.69	
Funds from operations (\$000)	\$5,378	\$14,900	\$31,152	\$59,338	\$52,824	\$28,511	\$11,103	\$10,561	
per boe (\$/boe)	\$3.45	\$9.11	\$18.81	\$34.85	\$31.99	\$28.77	\$15.11	\$18.21	
per share – basic (\$)	\$0.03	\$0.09	\$0.19	\$0.36	\$0.32	\$0.31	\$0.16	\$0.16	
per share – diluted (\$)	\$0.03	\$0.09	\$0.19	\$0.35	\$0.31	\$0.31	\$0.16	\$0.16	
Net income (loss)	(\$22,978)	(\$14,275)	(\$244,894)	\$26,696	\$672	\$1,689	(\$3,149)	(\$1,985)	
per boe (\$/boe)	(\$14.73)	(\$8.73)	(\$147.87)	\$15.68	\$0.41	\$1.70	(\$4.28)	(\$3.42)	
per share – basic (\$)	(\$0.12)	(\$0.09)	(\$1.48)	\$0.16	\$0.00	\$0.02	(\$0.05)	(\$0.03)	
per share – diluted (\$)	(\$0.12)	(\$0.09)	(\$1.48)	\$0.16	\$0.00	\$0.02	(\$0.05)	(\$0.03)	
Net capital expenditures (\$000)	\$4,196	\$35,360	\$74,043	\$68,837	\$31,408	\$41,774	\$17,610	\$71,316	
Bank debt and working capital deficiency (\$000) as at	\$241,652	\$296,726	\$276,130	\$232,467	\$222,129	\$216,959	\$61,012	\$82,938	

Compared to the immediately preceding quarter Iteration's second quarter 2009 production declined 6% primarily due to facility maintenance turnarounds and natural declines. Revenues have decreased 23% as commodity prices continue to fall (down 20% from the preceding quarter) and lower production. With lower commodity prices, royalties decreased 44% on a per boe basis and fell to 14.5% from 20.7% on a percentage of revenue basis compared to the first quarter of 2009. Production and transportation expense were relatively flat on a per boe basis between the first and second quarter of 2009 as prior period costs are included in both quarters. Operating netback on a per boe basis in the second quarter of 2009 has fallen 31% compared to the first quarter of 2009 primarily due to lower commodity prices partially offset by lower royalties. Between the first and second quarters of 2009 net G&A expense on a per boe basis is relatively unchanged while net interest expense per boe has increased due to overall higher borrowing costs and financing charges related to the new borrowing facility. Funds from operations for the second quarter of 2009 is 64% lower than the first quarter of 2009 due to lower operating netback, higher net interest expense and an additional \$1.8 million provision for the SemGroup receivable. Similarly the net loss between the periods increased 61%. Capital expenditures decreased 88% from the first quarter to the second quarter of 2009 as spring breakup reduced capital activities (traditionally the second quarter is a slower capital activity period absent acquisitions) and the Company curtailed expenditures due to lower funds from operations. Total debt fell \$55 million or 19% between the first and second quarters of 2009 as the Company completed an equity issue for net proceeds of approximately \$54 million in the second quarter and funds from operations exceeded capital expenditures for the quarter.

## Capital Expenditures

(\$ thousands)	Three months ended			Six months ended		
	June 30,			June 30,		
	2009	2008	% Change	2009	2008	% Change
Acquisition/(dispositions)	<b>(\$2,151)</b>	\$2,929	(227)	<b>(\$2,378)</b>	\$4,546	(248)
Land	<b>874</b>	18,622	(95)	<b>3,798</b>	21,129	(82)
Seismic	<b>967</b>	1,478	(35)	<b>2,222</b>	4,014	(45)
Drill, complete & facilities	<b>3,459</b>	7,359	(53)	<b>33,207</b>	41,702	(19)
Capitalized G&A	<b>1,047</b>	1,020	3	<b>2,707</b>	1,790	22
Total	<b>\$4,196</b>	\$31,408	(87)	<b>\$39,556</b>	\$73,181	(46)

Wells drilled (net)	Three months ended			Six months ended		
	June 30,			June 30,		
	2009	2008	% Change	2009	2008	% Change
Gas	-	2.1	n/a	<b>4.8</b>	21.6	(78)
Oil	-	4.0	n/a	<b>1.1</b>	6.9	(84)
Injector	-	-	n/a	-	1.0	n/a
Dry	-	-	n/a	-	1.7	n/a
Total	-	6.1	n/a	<b>5.9</b>	31.2	(81)
Success rate (%)	-	100.0	n/a	<b>100.0</b>	94.6	(46)

The Company completed \$2.2 million of property dispositions in the second quarter of 2009 compared to \$2.9 million of property acquisitions in the same period of 2008. Land expenditures have decreased significantly in 2009 from the prior year periods in 2008 as the second quarter of 2008 included successful land sales in the BC and West Alberta core areas. Lower overall activity levels have reduced seismic expenditures approximately 20% in 2009 from the prior year periods in 2008. Similarly drill, complete, equip and facility expenditures were significantly reduced in the second quarter of 2009 compared to the prior year period as the Company did not participate in any wells in the second quarter compared to 6.1 net wells in the prior year period. Costs for the second quarter of 2009 primarily relate to complete and equipping activities from first quarter 2009 activities.

## CAPITAL AND LIQUIDITY RESOURCES

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

As an oil and gas company, the Company has a declining asset base and therefore relies on ongoing exploration, 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.

The Company currently has budgeted for a drilling and exploration program of \$65 million for 2009. Of this amount approximately \$40 million has been spent in the first half of 2009. For the balance of the year the Company is forecasting funds from operations of approximately \$20 million versus capital expenditures of \$25 million. The \$5 million of capital expenditures in excess of funds from operations for the last half of the year is expected to be funded through the Company's credit facility. 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 expects to be able to meet future anticipated obligations incurred from normal ongoing operations with funds from operations and draws on the Company's syndicated facility.

The Company's financial position improved during the quarter due to a \$57.5 million common share equity financing and the establishment of a new credit facility. As at June 30, 2009, the Company had drawn \$246.0 million on its \$265 million credit facility. At that time, the Company had a working capital surplus of \$4.6 million, for a total net debt of \$241.3 million.

Subsequent to the quarter end the Company closed \$40 million of non-core property dispositions, the proceeds of which were used to repay the credit facility. As a result of the dispositions the Company's borrowing base was reduced by \$12.5 million to \$252.5 million. On a pro forma basis total net debt at the end of the second quarter would have been approximately \$200 million including the net proceeds from the dispositions.

### 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	\$1,769	(\$634)	\$1,135
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. Currently the subtenant has been awarded CCAA protection, however the Company continues to receive rent payments on time.

### Related Party Transactions

There were no related party transactions during the three months ended June 30, 2009.

### Outstanding Common Shares, Warrants and Options

As at June 30, 2009 and August 12, 2009, there were 210,985,384 common shares and 9,847,708 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. Reference should be made to the MD&A for the year ended December 31, 2008 for a description of the Company's most critical accounting estimates used in determining its financial results.

### Impact of New Accounting Pronouncements

#### 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 but had no current impact on the Company's financial reporting.

### 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.

### 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 June 30, 2009, 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 and Internal Controls over Financial Reporting**

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* (“NI52-109”), 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.

Management is also 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 GAAP, 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 Company’s disclosure controls and procedures concurrent with filing its interim financial statements to the first half of 2009 in accordance with NI 52-109. The Company’s CEO and CFO, together with management, have concluded, based on their evaluation of the effectiveness of the Company’s disclosure controls and procedures as of June 30, 2009, that information required to be disclosed by the Company is (i) recorded, processed, summarized and reported within the time periods specified in Canadian securities legislation and (ii) accumulated and communicated to the Company’s management, including its CEO and CFO, to allow timely decisions regarding required disclosure.

The CEO and CFO have also 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.

During the three months ended June 30, 2009, there were no material changes in the Company's disclosure controls and procedures or internal control over financial reporting, other than the addition of senior accounting personnel, including a Controller and Manager of Financial Accounting, which will aid the Company in improving its segregation of duties. In addition a new information management system is being implemented which, once fully functional, will allow management to obtain financial and operational information in a more timely manner. This system is expected to be fully functional prior to the end of 2009.

It should be noted that while the Company's CEO and CFO believe that the Company's disclosure controls and procedures and internal controls over financial reporting provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures or internal controls over financial reporting 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.

#### **ADVISORY – FORWARD-LOOKING INFORMATION**

This MD&A was prepared on August 12, 2009 and is management's assessment of Iteration's historical operating and financial results for the three and six months ended June 30, 2009. 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;
- royalties payable and future royalty rates under the Transitional Alberta Royalty program;
- the Alberta royalty incentive program including drilling credits announced on March 3, 2009;
- 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 51-102 – *Disclosure Obligations*, which are provided for the purpose of forecasting Iteration's financial position for the last six months of 2009 and as at December 31, 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.

Further information regarding these factors may be found under the heading "Risk Factors" in the AIF. 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.

**Iteration Energy Ltd.**  
**Consolidated Balance Sheets (unaudited)**

<b>As at</b> <i>(in thousands of dollars)</i>	<b>June 30,</b> <b>2009</b>	December 31, 2008
<b>ASSETS</b>		
Current		
Cash	\$ 139	\$ 6,832
Accounts receivable (Note 9(f))	32,422	43,996
Prepays and other current assets	12,100	10,846
	<b>44,661</b>	<b>61,674</b>
Property, plant and equipment (Note 4)	941,760	973,529
	<b>\$ 986,421</b>	<b>\$ 1,035,203</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current		
Bank indebtedness (Note 5)	\$ 246,000	\$ 266,800
Accounts payable and accrued liabilities (Note 6)	39,997	71,004
Stock based compensation payable (Note 8(c))	35	-
	<b>286,032</b>	<b>337,804</b>
Future income taxes	77,395	92,539
Leasehold inducements	127	193
Asset retirement obligation (Note 7)	43,532	43,323
	<b>407,086</b>	<b>473,859</b>
Commitments and contingencies (Note 10)		
Shareholders' equity		
Share capital (Note 8 (b))	860,545	805,301
Deficit	(281,210)	(243,957)
	<b>579,335</b>	<b>561,344</b>
	<b>\$ 986,421</b>	<b>\$ 1,035,203</b>

See accompanying notes to the unaudited interim consolidated financial statements.

## Iteration Energy Ltd.

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

	Three months ended June 30,		Six months ended June 30,	
<i>(in thousands of dollars, except per share amounts)</i>	<b>2009</b>	2008	<b>2009</b>	2008
<b>Revenue</b>				
Production revenue	\$ <b>44,936</b>	\$ 127,175	\$ <b>103,629</b>	\$ 182,739
Royalties	<b>(6,517)</b>	(27,199)	<b>(18,659)</b>	(38,878)
Other production revenue	<b>222</b>	629	<b>217</b>	958
	<b>38,641</b>	100,605	<b>85,187</b>	144,819
<b>Expenses</b>				
Production	<b>23,752</b>	20,291	<b>48,633</b>	30,488
Transportation	<b>1,301</b>	1,982	<b>2,735</b>	3,451
General and administrative	<b>3,063</b>	3,195	<b>6,189</b>	5,472
Stock based compensation (Note 8(c))	<b>35</b>	13,799	<b>35</b>	20,908
Interest on debt	<b>3,215</b>	3,067	<b>4,833</b>	4,179
Depletion, depreciation and accretion	<b>36,800</b>	39,045	<b>72,500</b>	60,600
	<b>68,166</b>	81,379	<b>134,925</b>	125,098
Income (loss) before the following	<b>(29,525)</b>	19,226	<b>(49,738)</b>	19,721
Non-cash charge related to warrants	-	(3,546)	-	(3,546)
Provision for bankruptcy: SemGroup LP (Note 9 (f))	<b>(1,812)</b>	(9,348)	<b>(1,812)</b>	(9,348)
Recovery of investment tax credits	-	-	-	1,820
Earnings (loss) before income taxes	<b>(31,337)</b>	6,332	<b>(51,550)</b>	8,647
<b>Income taxes</b>				
Current income tax expense	<b>1</b>	171	<b>13</b>	671
Future income tax expense (recovery)	<b>(8,360)</b>	5,489	<b>(14,310)</b>	5,614
	<b>(8,359)</b>	5,660	<b>(14,297)</b>	<b>6,285</b>
Net earnings (loss) and comprehensive earnings (loss)	<b>(22,978)</b>	672	<b>(37,253)</b>	2,362
Deficit, beginning of period	\$ <b>(258,232)</b>	\$ (16,716)	\$ <b>(243,957)</b>	\$ (18,406)
Charge on modification of warrant terms	-	(10,029)	-	(10,029)
Deficit, end of period	\$ <b>(281,210)</b>	\$ (26,073)	\$ <b>(281,210)</b>	\$ (26,073)
Basic and diluted earnings (loss) per common share (Note	\$ <b>(0.12)</b>	\$ -	\$ <b>(0.21)</b>	\$ 0.02

See accompanying notes to the unaudited interim consolidated financial statements

## Iteration Energy Ltd.

### Consolidated Statements of Cash Flows (unaudited)

	Three months ended		Six months ended	
	June 30,		June 30,	
<i>(in thousands of dollars)</i>	2009	2008	2009	2008
<b>OPERATING ACTIVITIES</b>				
Net earnings (loss)	\$ (22,978)	\$ 672	\$ (37,253)	\$ 2,362
Add (deduct) non-cash items:				
Depletion, depreciation and accretion	36,800	39,045	72,500	60,600
Recovery of investment tax credits	-	-	-	(1,820)
Future income tax expense (recovery)	(8,360)	5,489	(14,310)	5,614
Amortization of leasehold inducements	(33)	(41)	(66)	(95)
Stock-based compensation expense (Note 8 (c))	35	4,130	35	11,240
Non-cash charge related to warrants	-	3,546	-	3,546
Asset retirement expenditures	(86)	(17)	(628)	(110)
	5,378	52,824	20,278	81,337
Net change in non-cash operating working capital (Note 11)	3,286	(16,114)	9,195	(101)
	8,664	36,710	29,473	81,236
<b>INVESTING ACTIVITIES</b>				
Proceeds on sale of property plant and equipment	2,151	105	2,378	646
Acquisition of subsidiary	-	(176)	-	(778)
Acquisition of oil and gas properties	-	(2,858)	-	(4,414)
Additions to oil and gas properties	(6,347)	(28,479)	(41,934)	(68,635)
Additions to other capital assets	(200)	(475)	(335)	(515)
Net change in non-cash investing working capital (Note 11)	(19,125)	(27,286)	(29,746)	(31,650)
	(23,521)	(59,169)	(69,637)	(105,346)
<b>FINANCING ACTIVITIES</b>				
Proceeds from (repayment of) bank indebtedness	(39,545)	78,960	(20,800)	80,630
Common shares issued	57,555	2,900	57,555	2,900
Exercise of warrants	-	(20,851)	-	(20,851)
Share issue costs	(3,146)	(4)	(3,146)	(30)
Net change in non-cash financing working capital (Note 11)	(146)	-	(138)	-
	14,718	61,005	33,471	62,649
Increase (decrease) in cash	(139)	38,546	(6,693)	38,539
Cash, beginning of period	278	1,223	6,832	1,230
Cash, end of period	139	39,769	139	39,769

See Note 11 for supplemental disclosure

See accompanying notes to the unaudited interim consolidated financial statements

## **Iteration Energy Ltd.**

### *Notes to the Unaudited Interim Consolidated Financial Statements*

#### *As at and for the Three and Six Months Ended June 30, 2009 and 2008*

(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, 2008, except as disclosed below. These interim consolidated financial statements do not include all disclosures provided in the December 31, 2008 financial statements and should be read in conjunction with those financial statements. The timely preparation of financial statements requires that management make estimates and assumptions, and use judgment regarding assets, liabilities, revenues and expenses. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, actual results may differ from estimated amounts. In the three and six months ended June 30, 2009 the Company recorded additional production expenses for 2008 as costs accrued at year-end 2008 did not reflect late invoices from vendors and higher than expected recent charges from partners relating to 2008. In the opinion of management, these unaudited interim consolidated financial statements have been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

### **Basis of Consolidation**

These unaudited interim 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**

Effective January 1, 2009, the Company adopted the new CICA Handbook Section 3064, *Goodwill and Intangible Assets*, which converges Canadian GAAP for goodwill and intangible assets with International Financial Reporting Standards (“IFRS”). The new standard provides more comprehensive guidance on intangible assets, particularly for internally developed intangible assets. This new standard has no impact on the Company’s current financial reporting.

### **Future Accounting Policies**

The Canadian Accounting Standards Board (“AcSB”) 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 June 30, 2009, 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. Until this analysis is complete and 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. The Company will continue to monitor standards development as issued by the International Accounting Standards Board ("IASB") and AcSB as well as regulatory developments as issued by the Canadian Security Administrators, which may affect the timing, nature or disclosure of its adoption of IFRS.

### 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.

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 six month period ended June 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 June 30, 2008 and the operations of Cyries Energy Inc. for the period from March 8, 2008 to June 30, 2008.

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

	(\$000's)
Furniture and equipment	\$969
Property, plant and equipment	599,448
Goodwill	205,208
Bank Debt	(111,223)
Working capital deficiency	(29,827)
Future income tax liability	(75,950)
Asset retirement obligation	(14,275)
<b>Total purchase price</b>	<b>\$574,350</b>
Consideration was comprised of :	
Common shares	\$563,004
Transaction costs	11,346
<b>Total consideration</b>	<b>\$574,350</b>

Note: Goodwill was written off at December 31, 2008.

#### 4. PROPERTY PLANT AND EQUIPMENT

	<b>June 30, 2009</b>	December 31, 2008
	<b>(\$000's)</b>	(\$000's)
Oil and gas properties	\$ 1,329,193	\$ 1,290,246
Other	3,260	2,925
	<b>1,332,453</b>	1,293,171
Less accumulated depletion and depreciation	<b>390,693</b>	319,642
	<b>\$ 941,760</b>	<b>\$ 973,529</b>

At June 30, 2009, unproved properties and seismic expenditures amounting to \$122,032,000 (June 30, 2008: \$129,876,000) have been excluded from the depletion calculation. Future development costs on proven undeveloped reserves of \$84,800,000 (June 30, 2008: \$33,695,000) are included in the depletion calculation.

For the three and six months ended June 30, 2009, the Company capitalized \$1,047,000 and \$2,182,000 (three and six months ended June 30, 2008: \$1,020,000 and \$1,790,000) of overhead directly related to exploration and development activities.

#### 5. BANK INDEBTEDNESS

Bank Indebtedness represents the drawn portion of a syndicated facility, net of any actual cash balances on hand. The credit facility is with a syndicate of lenders, consisting of Canadian Imperial Bank of Commerce, Bank of Nova Scotia, Bank of Montreal and Alberta Treasury Branch. The borrowing base on this facility was established at \$265 million and consists of a \$12.5 million operating facility and a \$252.5 million extendible revolving term facility. Subsequent to June 30 the Company sold properties and the borrowing base was reduced by \$12.5 million (See Note 13 for details). This facility is secured by a \$500 million floating charge demand debenture. This facility will mature April 30, 2010, and, at the Company's request, such Credit Facilities may be renewed for a period of not more than 364 days on agreement of the lenders. The pricing on this facility is as follows:

- a) For Canadian prime based loans or US base rate loans, at applicable prime plus a margin ranging from 175 to 325 basis points, depending on the ratio of consolidated debt to annualized earnings before interest, taxes and depletion/depreciation/accretion for the preceding four quarters;
- b) For borrowings by way of Bankers' Acceptances or LIBOR loans, at the Bankers' Acceptance or LIBOR rate plus a stamping fee ranging from 275 to 425 basis points, depending on the ratio of consolidated debt to annualized earnings before interest, taxes and depletion/depreciation/accretion for the preceding four quarters, and
- c) A standby fee on the unutilized portion of the facility of between 82.5 and 127.5 basis points depending on the ratio of consolidated debt to annualized earnings before interest, taxes and depletion/depreciation/accretion for the preceding four quarters.

As at June 30, 2009, bank indebtedness was \$246 million. The effective interest rate for the six month period ended June 30, 2009 is 3.6%.

## 6. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

The accounts payable and accrued liabilities consist of the following:

	<b>June 30, 2009</b>	December 31, 2008
	(\$000's)	(\$000's)
Trade accounts payable	\$ 32,329	\$ 57,474
Joint venture accounts payable	3,892	3,790
Royalties payable	3,776	9,740
<b>Total</b>	<b>\$ 39,997</b>	<b>\$ 71,004</b>

## 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 (which is estimated to be from 2009 through 2036) will total approximately \$97,073,000 (December 31, 2008: \$98,079,000). The book value of the obligation at June 30, 2009 is 43,532,000 (December 31, 2008: \$43,323,000) using a discount rate of eight and one half percent for obligations incurred subsequent to September 30, 2008 (six and one half percent prior thereto) and an inflation rate of two percent. As at June 30, 2009, no funds have been set aside to settle this obligation.

	<b>June 30, 2009</b>	December 31, 2008
	(\$000's)	(\$000's)
Balance, beginning of period	\$ 43,323	\$ 18,897
Liabilities incurred on acquisition of properties (note 3)	-	19,854
Change in estimate	(712)	-
Increase in liabilities from drilling activity	100	2,848
Accretion expense	1,449	2,271
Settlement of liabilities	(628)	(547)
<b>Balance, end of period</b>	<b>\$ 43,532</b>	<b>\$ 43,323</b>

## 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

	Six months ended		Year ended	
	June 30,2009		December 31,2008	
	Number of	Amount	Number of	Amount
	Shares	(\$000's)	Shares	(\$000's)
Balance, beginning of period	166,020,384	\$ 805,301	71,029,780	\$ 238,586
Shares issued on public offerings	44,965,000	57,555	-	-
Shares issued on corporate acquisition (note 3)	-	-	93,990,604	563,004
Shares issued on exercise of warrants	-	-	1,000,000	3,733
Share issue costs, net of tax effect of \$834 (2008: \$9)	-	(2,311)	-	(22)
Balance, end of period	210,985,384	\$ 860,545	166,020,384	\$ 805,301

### (c) Stock Options

The Company has a stock option plan which 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. The dates on which options vest are set by the Compensation Committee of 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 Compensation Committee of 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:

	Six months ended June 30, 2009		Year ended December 31, 2008	
	Number of Options	Weighted average exercise price \$	Number of Options	Weighted average exercise price \$
Outstanding, beginning of period	9,782,445	\$4.55	6,568,789	\$3.49
Granted	3,126,291	1.19	5,343,065	5.47
Granted in conjunction with surrender	1,306,707	1.40	-	-
Exercised for cash	-	-	(1,642,409)	(2.94)
Forfeited or cancelled	(4,367,735)	(4.00)	(487,000)	(5.70)
Outstanding, end of period	9,847,708	\$2.82	9,782,445	\$4.55
Options exercisable, end of period	3,487,430	\$3.56	3,759,285	\$3.36

In June of 2009 the Company provided employees (excluding officers and directors) the option to surrender options they held with a strike price above \$3.50 per share and in turn receive 40% of their surrendered number of options with a strike price at the then prevailing share price of \$1.40. As a result 3.4 million options were surrendered and 1.3 million options were issued

The following table summarizes information about the stock options outstanding at June 30, 2009:

Range of exercise prices	Number outstanding June 30, 2009	Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number exercisable June 30, 2009	Weighted average exercise price \$
\$0.70 to \$2.89	4,650,277	3.80	1.31	-	-
\$2.90 to \$4.00	2,977,638	1.02	2.99	2,728,637	2.96
\$4.01 to \$5.00	422,334	1.88	4.68	141,445	4.57
\$5.01 to \$9.00	1,797,459	2.74	6.02	617,348	5.99
	9,847,708	2.68	2.82	3,487,430	3.56

The Company's stock option plan provides stock option holders the right to request, upon exercise, to receive a cash payment in exchange for surrendering the option provided the request is accepted by the Company. 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 six month periods ended June 30, 2009, stock based compensation expense of \$35,000 (2008: \$4,065,000 and \$11,175,000 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 vested and outstanding. Based on the June 30, 2008 share price of \$1.17, had all of the 9,847,708 stock options outstanding been vested, aggregate stock-based compensation expense and a corresponding liability of \$276,000 (December 31, 2008: \$nil) would have been recognized. Of this amount, \$35,000 has been recognized as stock-based compensation payable at June 30, 2009 (December 31, 2008: \$nil).

(d) **Per Share Amounts**

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Weighted average common shares outstanding	<b>193,197,035</b>	<b>165,811,596</b>	<b>179,683,785</b>	<b>129,265,758</b>
Weighted average diluted common shares outstanding	<b>193,197,035</b>	<b>168,412,603</b>	<b>179,683,785</b>	<b>131,241,651</b>

The options outstanding for the quarter and six months ended June 30, 2009 are not included in the computation of diluted common shares outstanding as the Company realized a net loss during these periods.

**9. 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/mcf in natural gas prices at the wellhead would have changed the net loss for the six months ended June 30, 2009 by approximately \$8.2 million. A \$5.00/bbl change in WTI for oil would have the effect of changing the net loss for the six months ended June 30, 2009 by approximately \$1.8 million.

From time to time, the Company employs the use of various financial instruments to manage these price exposures, and at this time, has not entered into any financial instruments.

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 earnings before interest, taxes, and depletion/depreciation/accretion. 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% it is estimated that net loss for the six months ended June 30, 2009 would change by approximately \$0.8 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 2009 and the Company's bank loan is due on April 30, 2010.

Scheduled reviews of the credit facility 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, lenders interest in particular business sectors, such as energy and the relative strength of the borrower. Given these constraints, there is no assurance that Iteration will be able to sustain its current borrowing base and may be required to reduce its outstanding loans. Should there be a requirement of the Company to reduce its outstanding loans, there are a number of options available including, but not limited to:

- 1) Issuance of additional equity;
- 2) Negotiation of incremental borrowings with subordinated lenders;
- 3) Divestiture of assets: and
- 4) Dedication of funds from operations.

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 indirectly 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% over the course of the quarter, it is estimated that net loss for the quarter would change by approximately \$0.6 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. Of these twenty five marketers, sales to four account for approximately 80% of the Company's production revenue.

As at June 30, 2009, the Company had an allowance for doubtful accounts of \$17.3 million (December 31, 2008 \$15.4 million) including a provision of \$15.7 million relating to the filing for CCAA protection by SemCanada and SemCAMS), on trade accounts receivable that in the estimation of the Company may be impaired.

As at June 30, 2009, the aging analysis of trade receivables, net of the allowance for doubtful accounts, is as follows:

	(\$000's)
Current	\$ 18,690
30 – 60 days	2,579
60 – 90 days	797
Greater than 90 days	27,687
Total	49,753
Less allowance for doubtful accounts	(17,331)
Total	\$ 32,422

Note: Greater than 90 days includes amounts receivable from for SemCanada and SemCAMS.

g) Fair Value of 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:

(\$000's)	June 30, 2009		December 31, 2008	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Loans and receivables</b>				
Accounts receivable	32,422	32,422	43,996	43,996
<b>Other financial liabilities</b>				
Bank indebtedness	246,000	246,000	266,800	266,800
Accounts payable and accrued liabilities	39,997	39,997	71,004	71,004

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

## 10. CONTINGENCIES

The Company is party to various lawsuits as at June 30, 2009. 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.

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

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

(\$000's)	Three months ended		Six months ended	
	June 30,		June 30,	
	2009	2008	2009	2008
Accounts receivable	\$ 6,488	\$ 15,849	\$ 11,553	\$ 9,792
Prepays and other current assets	(2,213)	(1,748)	(1,245)	(761)
Accounts payable and accrued liabilities	(20,260)	(57,671)	(30,996)	(41,240)
Income taxes payable	-	170	-	458
Net change	\$ (15,985)	\$ (43,400)	\$ (20,688)	\$ (31,751)

(\$000's)	Three months ended		Six months ended	
	June 30,		June 30,	
	2009	2008	2009	2008
Net change by activity:				
Operating	\$ 3,286	\$ (16,114)	\$ 9,195	\$ (101)
Investing	(19,125)	(27,286)	(29,746)	(31,650)
Financing	(146)	-	(138)	-
Net change	\$ (15,985)	\$ (43,400)	\$ (20,690)	\$ (31,751)

Additional information:

(\$000's)	Three months ended		Six months ended	
	June 30,		June 30,	
	2009	2008	2009	2008
Cash interest paid	\$3,215	\$3,067	\$4,833	\$4,179
Cash taxes paid	1	171	13	671

Included in cash interest paid during the three month period ended June 30, 2009 are initial commitment fees of \$347,000 related to the syndicated facility.

## 12. 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 June 30, 2009		As At December 31, 2008	
	(\$000's)	%	(\$000's)	%
Bank indebtedness	\$ 245,861	22.2	259,968	24.4
Share capital	860,545	77.8	805,301	75.6
Total	\$ 1,106,406	100.0	\$1,065,269	100.0

As at June 30, 2009, the Company had a 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.

The Company actively manages its capital structure with the objective of maintaining sufficient flexibility to allow it to execute on its capital investment program, including investing in oil and gas acquisitions, exploration and development, which may or may not be successful. For this objective to be achieved, the Company continually strives to balance the proportion of debt to equity in its capital structure to take into account the level of risk being incurred through capital expenditures.

In order to maintain or adjust the capital structure, the Company considers various factors including, but not limited to:

- a) projected debt to projected funds from operations ratio while attempting to finance an acceptable investment program, including incremental investment and acquisition opportunities;
- b) the current level of bank credit available from the banking syndicate;
- c) the level of bank credit that may be available from the banking syndicate as a result of anticipated changes in reserves;
- d) the availability of other sources of debt with different characteristics from the existing bank debt;
- e) the sale of assets;
- f) limiting the size of the investment or capital program; and
- g) issuing new common equity if available on favorable terms.

## 13. SUBSEQUENT EVENTS

In July 2009, the Company disposed of oil and gas properties for proceeds of \$39.8 million, prior to closing adjustments. These proceeds were applied against bank debt. Accordingly, the bank borrowing base was decreased by \$12.5 million to \$252.5 million.

## **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
Jane Mactaggart	VP Exploitation
Carmen McKay-Illing	VP Corporate Affairs
Myron Rak	VP Production
Tony Sabelli	VP Drilling & Completions
Peter Scott	VP Finance and CFO
Kevin Stromquist	VP Exploration West

#### Directors

Don Archibald (Chairman)	Independent Businessman (former Chairman & CEO – Cyries)
Pat Breen P. Eng.	President - Foremost Income Fund
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 AIF, 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. Peter Scott, VP Finance and CFO, at 403-261-6883.