Management's Discussion and Analysis ("MD&A")

For the Year Ended December 31, 2008

Dated April 1, 2009

Epsilon Energy Ltd.
150 Jardin Drive, Suite 9
Concord, ON, Canada L4K 3P9

(866) 384-8774
www.epsilonenergyltd.com

EPSILON ENERGY LTD.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Overview

This Management's Discussion and Analysis ("**MD&A**") is intended to assist in the understanding of trends and significant changes in or results of operations and the financial condition for the years presented. The MD&A has been prepared by management as at April 1, 2009 in accordance with GAAP and should be read in conjunction with the audited consolidated financial statements as at December 31, 2008 and 2007, respectively, together with accompanying notes, the Annual Information Form dated April 1, 2009 and Form 51-101 F3 "*Report of Management and Directors on Reserves Data and Other Information*" dated April 1, 2009. These documents and additional information about Epsilon Energy Ltd. (the "**Corporation**") are available on SEDAR at www.sedar.com. Unless stated otherwise, all references to monetary values are in United States dollars.

Cautionary Statement Regarding Forward Looking Information and Statements

Certain statements contained in this report constitute forward-looking statements. The use of any of the words "anticipate", "continue", "estimate", "expect", "may", "will", "project", "should", "believe" and similar expressions and statements relating to matters that are not historical facts constitute "forward looking information" within the meaning of applicable Canadian securities legislation. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated. Such forward-looking statements are based on reasonable assumptions but no assurance can be given that these expectations will prove to be correct and the forward-looking statements included in this report should not be unduly relied upon. These statements are made only as of the date of this report.

In particular, this report contains forward-looking statements including, but not limited to, the following:

- oil and natural gas production rates;
- commodity prices for crude oil or natural gas;
- supply and demand for oil and natural gas;
- the estimated quantity of oil and natural gas reserves, including reserve life;
- capital expenditure programs;
- future exploration, development and production costs;
- timing of drilling plans;
- planned construction and expansion of facilities;
- plans for and results of exploration and development activities;
- expectations regarding the Corporation's ability to raise capital and to continually add to oil and natural gas reserves through acquisitions, exploration and development; and
- treatment under governmental regulatory regimes and tax laws.

The Corporation's actual results could differ materially from those anticipated in these forward-looking statements as a result of the risk factors set forth below and elsewhere in this report:

- general economic, political, market and business conditions;
- risks inherent in oil and natural gas operations;
- uncertainties associated with estimating oil and natural gas reserves;
- competition for capital, acquisitions of reserves, undeveloped lands, drilling equipment and skilled personnel;
- geological, technical, drilling and processing problems;
- incorrect assessments of the value of acquisitions;

- the availability of capital on acceptable terms;
- volatility in market prices for oil and natural gas;
- reliance on key operational and management personnel;
- actions by governmental authorities, including regulatory, environmental and taxation policies;
- fluctuations in foreign exchange, interest rates and stock market volatility; and
- other risk factors discussed under "*Risk Factors*" within the Corporation's Annual Information Form dated April 1, 2009.

These factors are not all inclusive. Except as required under applicable securities laws, the Corporation undertakes no obligation to update or revise any forward-looking statements.

Corporate Overview

The Corporation is engaged in the acquisition, exploration, development and production of oil and natural gas reserves in North America, the Middle East and Africa. The Corporation's strategy involves exploiting a well-balanced inventory of oil and natural gas projects with the goal of converting its leasehold interests into proven oil and natural gas reserves, followed by production that optimizes cash flow and return on investment. Also refer to "*Risk Factors*" in the Corporation's Annual Information Form dated April 1, 2009.

Overall Performance

During 2008, the Corporation continued to explore, develop and expand its oil and gas interests. For the year ended December 31, 2008, the Corporation generated a net loss of $33,688,000, as compared to a $2,224,000 net loss for the same period of 2007. The increased net loss was principally due to impairing $34,099,000 of unproved properties in the Middle East during 2008. At December 31, 2008, the Corporation continued to have adequate funds for its ongoing operations with working capital (inclusive of restricted cash) of $15,862,000, as compared to $39,584,000 of working capital at December 31, 2007. The $23,722,000 decrease in working capital at December 31, 2008, as compared to December 31, 2007 was partially comprised of the following cash flow related items: (1) $6,596,000 of cash used in operations; (2) $47,265,000 spent on oil and gas properties; (3) $6,768,000 received from the sale of unproved properties; (4) $9,069,000 in negative changes to cash and cash equivalents due to currency rates; and (5) $31,256,000 of net proceeds from the issuance of 5,600,000 Common Shares and 17,000 warrants. Key developments during 2008 and through the date of this report by country include:

> *United States* – The Corporation has drilled eight wells as of the date of this report (six during 2008) on its Highway 706 project in Pennsylvania. Of those wells, the Corporation has completed hydraulic fracture stimulation ("**fracing**") and testing operations on one vertical well and two horizontal wells, resulting in a combined test rate of approximately 8.5 Mmcf/d from those three wells. The Corporation anticipates commencing natural gas production from its 100% owned Highway 706 project during the second quarter of 2009. Also during 2008, the Corporation participated in drilling 36 gross (13.47 net) wells within other areas of the Appalachian basin, which contributed to increasing the average daily natural gas production from 1,312 Mcf/d at December 31, 2007 to 2,502 Mcf/d at December 31, 2008, an increase of 191%.
>
> *Canada* – During 2008, the Corporation's exploration was focused on the Bakken Shale in the Province of Saskatchewan, where the Corporation entered into an agreement to earn a 50% interest in an Area of Mutual Interest ("**AMI**") covering approximately 63,360 gross acres in the Bakken shale by incurring 100% of the cost to drill two horizontal wells. The Corporation expects to commence drilling its first horizontal well in the Bakken shale during late 2009.
>
> *Republic of Yemen* ("**Yemen**") – From mid 2008 to early 2009, the Corporation participated in drilling 4 gross (2.29 net) wells in Yemen, all of which were non-commercial. The Corporation is currently evaluating the data gathered from operations to date to determine future exploration plans in Yemen, if any.

Sultanate of Oman ("**Oman**") – In January 2009, the Corporation acquired a 100% working interest in Block 55 in Oman. The initial exploration period includes a commitment to spend $25,500,000 over a three year period. The Corporation does not anticipate incurring any significant capital expenditures in Oman during 2009 and most of 2010, and is currently evaluating whether to bring in an industry partner, obtain third party financing, or a combination of both to fully fund its commitment.

Federal Democratic Republic of Ethiopia ("**Ethiopia**") – During 2008, the Corporation entered into a study agreement with the Ministry of Mines and Energy in Ethiopia, whereby the Corporation has the exclusive right to evaluate for prospective oil and natural gas exploration 154,871.53 square kilometers (96,232.7 miles) of land in the northwestern sector of the country. The term of the agreement is for one year and includes the exclusive right to enter into concession agreement(s) covering any or all of the lands studied. The Corporation has identified several areas of interest and plans to apply for concession(s) covering some or all of the study agreement area during 2009.

Going Concern

The financial statements of the Corporation have been prepared on a going concern basis, which presumes that the Corporation will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. The Corporation is relying upon its ability to continue to achieve profitable oil and natural gas production from its projects to continue as a going concern. Given the lead time associated with the many of its exploration and development activities, the Corporation's ability to continue as a going concern is dependent on many factors. Those factors include the results of future exploration, development and production activities, the timing, scope and pace of such activities, and events outside of the Corporation's direct control, such as the global credit market crisis and oil and gas commodity price volatility.

The Company has experienced net operating losses every year since its inception in 2005. Factors that will affect the Corporation's ability to continue as a going concern include:

- Continued commercial production from its existing producing properties;
- Commencement of commercial natural gas production from its Highway 706 project during 2009;
- Managing future international exploratory activities in a cost effective manner;
- Effectively managing the timing, pace, scope and the allocation of funds for capital expenditures within currently available capital resources; and
- Raising additional capital, as warranted, to accelerate or supplement the Corporation's capital expenditures by bringing in industry partners, additional debt financing, equity financing, sale of a full or partial property interests, or a combination thereof.

Reportable Geographical Operating Segments

As of December 31, 2008, the Corporation held interests in the following geographical areas: Block 41 in Yemen, the Appalachian basin in the United States, Quebec & Saskatchewan provinces in Canada, and Ethiopia. Through the end of 2008, the Corporation's oil and natural gas revenues were derived solely from the Appalachian basin in the United States.

A summary of reportable segment activity for the years ended December 31, 2008 and 2007, respectively, follows:

	Year Ended December 31,	
	2008 [1]	2007
Reportable Segments:		
United States:		
Revenues	$ 8,300,000	$ 3,670,000
Operating costs	$ 1,792,000	$ 539,000
Capital expenditures	$ 34,484,000	$ 22,819,000
Deferred pre-operating costs	$ -	$ -
Canada:		
Revenues	$ -	$ -
Operating costs	$ -	$ -
Capital expenditures	$ 535,000	$ 66,000
Deferred pre-operating costs	$ -	$ -
Yemen:		
Revenues	$ -	$ -
Operating costs	$ -	$ -
Capital expenditures	$ 15,126,000	$ 32,190,000
Deferred pre-operating costs	$ -	$ 510,000
Ethiopia:		
Revenues	$ -	$ -
Operating costs	$ -	$ -
Capital expenditures	$ 1,851,000	$ -
Deferred pre-operating costs	$ -	$ -

Notes:

(1) Excludes $451,000 of miscellaneous capital expenditures pertaining to other countries within the Middle East for which there were no associated revenues, operating costs or deferred pre-operating costs.

Selected Annual Information

Selected financial data covering the years ended December 31, 2008 and 2007, respectively, is as follows (amounts rounded to thousands, except per share amounts):

	Year Ended December 31,	
	2008	2007
Statement of operations:		
Revenues	$ 8,300,000	$ 3,670,000
Cost of operations	45,482,000	6,745,000
Operating loss	(37,182,000)	(3,075,000)
Other income	6,094,000	851,000
Net loss before income taxes	(31,088,000)	(2,224,000)
Future income tax expense	2,600,000	-
Net loss	$ (33,688,000)	$ (2,224,000)
Per Common Share data:		
Basic and diluted net loss share	$ (0.71)	$ (0.08)
Basic weighted average number of shares outstanding	47,504,000	27,148,000
Dividends per share	$ -	$ -
Cash Flows:		
Net cash provided by or (used in) operating activities	$ (6,596,000)	$ 1,116,000
Net cash used in investing activities	$ (72,945,000)	$ (44,017,000)
Net cash provided by financing activities	$ 49,768,000	$ 83,408,000
Effect of currency rates on cash and cash equivalents	$ (9,069,000)	$ (728,000)

	As At December 31,	
	2008	2007
Balance Sheet:		
Total assets	$ 134,070,000	$ 117,323,000
Current liabilities	$ 33,836,000	$ 9,502,000
Long-term debt	$ 19,000	$ -
Other liabilities	$ 2,920,000	$ 181,000
Total liabilities	$ 36,775,000	$ 9,683,000
Shareholders' equity	$ 97,295,000	$ 107,640,000

Summary of Quarterly Results

Summary quarterly information for the years ended December 31, 2008 and 2007, respectively, is below (amounts rounded to thousands of dollars, except for per share amounts):

	Quarter Ended				Year Ended
	March 31	June 30	September 30	December 31	December 31
2008:					
Total revenues	$ 1,537,000	$ 2,374,000	$ 2,476,000	$ 1,913,000	$ 8,300,000
Net income or (loss)	$ (284,000)	$ 4,158,000	$ (148,000)	$ (37,414,000)	$ (33,688,000)
Net income per share	$ (0.01)	$ 0.09	$ 0.00	$ (0.79)	$ (0.71)
Total assets	$ 116,969,000	$ 124,061,000	$ 154,013,000	$ 134,070,000	$ 134,070,000
Long-term debt	$ -	$ 30,000	$ 24,000	$ 19,000	$ 19,000
Shareholders' equity	$ 106,064,000	$ 111,434,000	$ 142,079,000	$ 97,295,000	$ 97,295,000
Dividends paid	$ -	$ -	$ -	$ -	$ -
2007:					
Total revenues	$ 883,000	$ 1,085,000	$ 678,000	$ 1,024,000	$ 3,670,000
Net income or (loss)	$ 285,000	$ (98,000)	$ (337,000)	$ (2,074,000)	$ (2,224,000)
Net income per share	$ 0.01	$ 0.00	$ (0.01)	$ (0.08)	$ (0.08)
Total assets	$ 21,812,000	$ 35,522,000	$ 65,937,000	$ 117,323,000	$ 117,323,000
Long-term debt	$ -	$ -	$ -	$ -	$ -
Shareholders' equity	$ 20,058,000	$ 33,512,000	$ 34,614,000	$ 107,640,000	$ 107,640,000
Dividends paid	$ -	$ -	$ -	$ -	$ -

Operational Outlook and Property Overview

A summary of Epsilon's projects by country are as follows:

United States

Appalachian basin - Overview

In the United States, the Corporation is focused on the Appalachian basin, where it is developing its Marcellus shale acreage in Pennsylvania and New York and has built a solid production base comprised of unconventional natural gas production in West Virginia from Devonian-aged shale gas zones and conventional natural gas production in New York from the Trenton-Black River formation. During 2008, the Corporation began to focus the majority of its Appalachian basin exploration and development efforts on its Marcellus shale acreage holdings and expects to continue to do so during 2009 and beyond.

The Marcellus Shale stretches from southern New York through western Pennsylvania into eastern Ohio and across West Virginia, where the Corporation has approximately 125,000 gross (65,000 net) leasehold acres, including approximately 48,000 gross (31,000 net) leasehold acres in highly prospective areas within Pennsylvania and New York. Industry publications, such as the January 2009 issue of the *Oil & Gas Investor*, continue to be very bullish on the Marcellus Shale, including recently published estimates of an average of 3.30 Bcf of gross natural gas reserves per well, average finding and development costs of $1.42/Mcfe and average internal rates of return of 86% based on average capital costs of $2,500 per mineral acre and average drilling costs of $3.75 million per well. Based on the Corporation's operations to date, the Corporation expects to achieve results within the range of the aforementioned metrics.

Pennsylvania

As of December 31, 2008 the Corporation has acquired approximately 15,403 gross (15,184 net) leasehold acres in Pennsylvania where the Corporation is operator, holds a 100% working interest and is focused on the Marcellus shale, an unconventional Devonian-aged shale gas zone. The Corporation's Marcellus shale

acreage appears to be in an over-pressured environment with upper (Purcell) and lower (Onondaga) limestone frac barriers present. As such, hydraulic frac stimulations are generally very effective in this geological environment.

As of December 31, 2008, the Corporation had drilled seven wells (four horizontal and three vertical) on its Highway 706 project in Susquehanna County, which is located in northeastern Pennsylvania. As of the date of this MD&A, the Corporation had completed and tested three of the wells for natural gas production. A summary of the test results follows:

- 1.1 MMcf/d = Larue #1A (drilled vertically and tested in 4Q 2008)
- 3.2 MMcf/d – Larue #1H (drilled horizontally - 3 stage frac, tested in 4Q 2008)
- 4.2 MMcf/d – Larue #2H (drilled horizontally - 5 stage frac; tested in 1Q 2009)

As a result of the above, the Corporation currently has approximately 8.5 MMcf/d of natural gas production shut in and waiting on natural gas gathering and pipeline infrastructure.

The Corporation currently is installing a natural gas gathering and pipeline system and anticipates natural gas production to commence during the later part of the first half of 2009. Initial production may be limited to current existing compressor capacity, which is approximately 6.0 - 7.1 MMcf/d. The Corporation expects to obtain additional compression capacity during the second half of 2009, if warranted.

During 2009, the Corporation expects to drill at least two additional horizontal wells, complete six wells and hook-up all nine wells drilled for natural gas production at an estimated overall cost of approximately $21,000,000.

New York

Within New York, the Corporation is focused on exploration and development of the Trenton-Black River formation (conventional gas) and the Marcellus shale (unconventional gas). The Corporation's acreage position covers primarily Schuyler, Steuben, Chemung and Tioga counties, consisting of approximately 32,618 gross (15,947 net) leasehold acres. The Corporation has a 50% working interest in its New York acreage, with two privately held companies each holding a 25% working interest. See *"Related Party Transactions – Director and former President and Chief Executive Officer*".

Marcellus Shale

In New York, competitor companies are actively permitting Marcellus shale wells in and around the Corporation's leasehold acreage. The Corporation continues to evaluate potential exploration, development and production opportunities in the Marcellus shale, including but not limited to, participating in competitor wells, developing its existing leasehold acreage and/or entering in joint ventures with other companies. During 2008, the Corporation acquired 10,200 gross (5,100 net) prospective Marcellus shale leasehold acres in Chemung and Tioga counties in New York from a privately held company for approximately $3.7 million.

During 2008, the Corporation participated in drilling one non-operated well (.03 net) in the Marcellus shale, which had a favorable production test and is currently shut in waiting on production infrastructure. Based on the positive test results from that well, the Corporation has commenced staking its first four company-operated Marcellus shale test wells within its Park Place project. Drilling operations on those wells are expected to commence during late 2009.

Trenton-Black River

The Corporation is also focused on exploration of the prolific Trenton-Black River formation, a conventional natural gas reservoir target. The Corporation holds various non-operated working interests with multiple operators in well units from less than 1%, up to approximately 12%. The Corporation has

leveraged the expertise of local area operators, including utilizing 3D seismic and horizontal drilling techniques. Production rates from the Trenton-Black River can range from 3.0 MMcf/d to 40.0 MMcf/d on a gross basis.

Within the Trenton-Black River formation, 9 gross (0.34 net) wells were producing and 4 gross (0.08 net) wells were shut in waiting on pipeline connection at December 31, 2008. In addition, 4 gross (0.03 net) non-participating wells had not paid out and the Corporation had drilled 14 gross (0.42 net) exploratory dry holes since its inception. At December 31, 2008, net production from Trenton-Black River formation was approximately 957 Mcf/d.

2009 Outlook

Due to its current focus on the Marcellus shale in Pennsylvania and New York, the Corporation is not allocating a significant amount of capital to fund participation in drilling future wells targeting the Trenton-Black River formation in New York. During 2009, the Corporation expects to selectively participate in two or more Trenton-Black River wells with a small working interest and drill four Marcellus shale wells with a 50% working interest at an overall net cost of approximately $1,300,000.

West Virginia

The Corporation currently has two medium-to-low risk Devonian-aged shale gas project areas in West Virginia; Amber Bank and Blue Jacket. Hard Rock Exploration Inc., a local operator, is the operator of each of these projects.

The Amber Bank project is located in Jackson and Roane counties and consists of approximately 25,957 gross (8,435 net) leasehold acres, in which the Corporation holds working interests ranging from 30% to 60%. In the Amber Bank project, the Corporation is focused on targets in three shallow unconventional Devonian-aged shale gas zones; the Lower Huron, Rhinestreet, and Marcellus. Collectively, these Devonian-aged shale gas zones represent approximately 850 feet of prospective gas bearing shale.

The Blue Jacket project is located in Cabell county and consists of approximately 10,197 gross (6,021 net) leasehold acres, in which the Corporation holds a 63% working interest. In the Blue Jacket project, the Corporation is focused on two shallow unconventional Devonian-aged shale gas zones; the Lower Huron and Rhinestreet. Collectively, these Devonian-aged shale gas zone represent approximately 400 feet of prospective gas bearing shale.

As of December 31, 2008, the Corporation had participated in drilling 111 gross (58.96 net) wells in West Virginia with a 100% success rate, including 108 gross (57.56 net) producing wells and 3 gross (1.40 net) wells that were shut in awaiting hook-up. Natural gas production from West Virginia was approximately 1,545 Mcfe/d net to the Corporation as of December 31, 2008. Due to its current focus on the Marcellus shale in Pennsylvania and New York, the Corporation does not anticipate allocating a significant amount of funds to continue participating in drilling wells on its West Virginia projects during 2009.

Ohio

The Bailey's Mill project is located in Belmont and Monroe counties and consists of approximately 40,155 gross (8,840 net) leasehold acres, in which the Corporation holds a 25% working interest. PC Exploration Inc. is the operator and also holds a 75% working interest in the Bailey's Mill project. The Corporation is focused on the Marcellus, a shallow unconventional Devonian-aged shale gas zone. The Marcellus Devonian-aged shale gas zone represents approximately 80 feet of prospective gas bearing shale. As of December 31, 2008, the Corporation had drilled three gross (0.75 net) wells, all of which were producing gas on an intermittent basis at the rate of approximately 15-25 Mcf/d net to the Corporation. Due to its current focus on the Marcellus shale in Pennsylvania and New York, the Corporation does not anticipate allocating a significant amount of funds to continue participating in drilling future wells on its Bailey's Mill project.

Canada

Saskatchewan

On August 28, 2008, the Corporation entered into an agreement with a private Canadian company covering joint oil and natural gas exploration and development activities in a 63,360 gross acre AMI covering the Bakken oil play in southeast Saskatchewan province.

Under the terms of the agreement the Company has the ability to earn a 50% interest in approximately 8,960 gross (7,806 net) acres within the AMI. The private Canadian company is the operator of the AMI and drilling operations on the first well are expected to commence during the last half of 2009. The Company estimates it will spend a minimum amount of $5.0 million on this project. The project lies within the favorable Saskatchewan province royalty area.

On October 9, 2008, the Corporation acquired additional prospective Bakken oil play interests in approximately 31,370 gross (13,775 net) acres for approximately $439,000 via a competitive bid at the Saskatchewan crown lease sale with the same private company.

Quebec

The Corporation has an elective participating interest of up to 25% in Gastem, Inc.'s (TSXV: GMR) holdings in approximately 1,185,000 gross (249,000 net) leasehold acres. The leasehold acreage includes 452,000 gross (66,000 net) leasehold acres in the St. Lawrence Lowlands covering Utica shale, and Trenton-Black River targets and 733,000 (183,000 net) leasehold acres in the Gaspe Peninsula covering Silurian and Devonian targets. Within the St. Lawrence Lowlands leasehold acreage, Forest Oil Corporation has committed to spend CDN$10 million to earn a 60% interest in approximately 112,000 gross acres held by Gastem Inc, which is referred to as the Yamaska project. The Corporation elected to not participate in the first two wells drilled on the Yamaska project. However, the Corporation has elected to participate in future operations with a 5% working interest and does not expect to spend a significant amount of capital.

Yemen – Block 41

During 2007, the Corporation acquired a 57.14% paying interest and 50% undivided percentage interest in the rights, duties, interests and obligations under the Block 41 Production Sharing Agreement ("**Block 41PSA**") covering approximately 5,600 square kilometers (1.4 million acres), which is located onshore in Yemen. The Corporation is the operator of Block 41. As of the date of this report, the Corporation had fulfilled all obligations pertaining to the Farm-in Agreement except for the $3.0 million due upon the Declaration of Commerciality, an event that has yet to occur. There is one field discovery, the Al Waya 1, which was drilled by the prior operator in 2002 and tested at 473 barrels per day ("**bbls/d**") of 34° API gravity oil from the Naifa formation and had significant shows in lower formations.

During 2008, the Corporation drilled three wells on Block 41:

Al Waya 2

On October 21, 2008, the Corporation announced that the Al Waya 2 will be abandoned after encountering mechanical issues (multiple losses of circulation and damaged bottom hole assembly) while attempting to drill through a faulted and/or fractured zone during side-tracking operations. The side-track was drilled to a depth of approximately 1,478 meters and did not test the targeted Naifa zone. The initial well bore in the Al Waya 2 was also abandoned after testing revealed the zones of interest to be wet, despite having encouraging oil and natural gas shows while drilling. Total costs for this well as of December 31, 2008 was $4,615,000 gross ($2,637,000 net).

Kaninah #1

On January 9, 2009, the Corporation announced that the Kaninah #1 will be plugged and abandoned after testing operations failed to yield commercial results. The complex geology that was encountered while drilling caused difficulty during both the completion and testing phases of this well. Although drilling logs showed zones with an extensive presence of hydrocarbons, actual testing results failed to confirm commercial flows. Despite these inconclusive results, potential still exists for future exploration on this prospect. The Corporation, along with its partners, will use the data collected to formulate future exploration plans for the Kaninah prospect. Total costs for this well as of December 31, 2008 was $4,553,000 gross ($2,601,000 net).

West Mahrawa #2

On January 9, 2009, the Corporation announced that drilling logs and subsequent initial testing have indicated the presence of hydrocarbons in the West Mahrawa #2. Initial test results yielded uneconomic results due to heavy oil with an API gravity of 4.62. Oil samples have been sent for analysis to assist in further evaluation of this well. Additional testing operations, if warranted, are expected to continue after the evaluation is completed and necessary testing equipment is obtained. Total costs for this well as of December 31, 2008 was $6,419,000 gross ($3,668,000 net).

Mukulla #1

In early 2009, the Corporation drilled the Mukulla #1 at a location approximately 15 kilometers east of the Al Waya discovery. On February 26, 2009, the Corporation announced that the Mukulla #1 was an exploratory dry hole after testing results failed to yield commercial quantities of oil or natural gas. The Mukulla #1 is the final obligation well under the approved 2008 drilling program with the Ministry of Minerals. The Mukulla #1 is expected to cost approximately $3,500,000 gross ($2,000,000 net).

*Oil and Gas Mine Company ("**OGMC**") Default*

As of December 31, 2008, the Corporation had outstanding receivables from OGMC of $5,590,881 for their pro-rata share of costs pertaining to Block 41. On March 3, 2009, the Corporation sent OGMC a notice of default for failure to pay such amount. Under terms of the Block 41 PSA, OGMC has thirty days from the date of default to pay such amount. In the event that OGMC fails to cure the default, the remaining working interest partners may assume OGMC's interest in proportion to their working interest.

2009 Outlook

The Corporation is currently evaluating the data obtained to date from its operations on Block 41 to determine the most effective way to proceed with its future exploration activities on Block 41, if any.

As of the date of this report, substantially all seismic activity has been focused on the western half of the middle portion of Block 41 where the Al Waya field discovery is located, which represents approximately one-third of the concession. There has been little or no exploratory activity conducted on the other portions of Block 41. As such, management believes there may be potential for substantial oil and natural gas resources yet to be exploited on Block 41 beyond the prospects identified on 2D seismic to date.

Oman - Block 55

On January 26, 2009, the Corporation was awarded a 100% working interest in Block 55, an onshore oil and natural gas concession in Oman that covers approximately 7,564 square kilometers (1,869,105 acres). In management's opinion, Block 55 is prospective for commercial oil and natural gas exploitation. Exploration plans during the initial three year exploration program include acquiring 800 kilometers of seismic data, reprocessing 4,133 kilometers of existing seismic data and a drilling program covering a minimum of four initial exploratory wells designed to exploit Block 55's oil and natural gas potential.

Within Block 55 four exploratory wells have been previously drilled, including the Ameeq-1, which is a discovery well that may contain crude oil reserves in the range of one to ten Mbbls. Two of the three remaining exploratory wells previously drilled on Block 55 encountered oil and natural gas shows but failed to yield commercial quantities of oil. Adjacent to and within 20 kilometers of Block 55, there are approximately 27 discoveries, including 12 fields comprising approximately 158 wells that are currently productive. In addition, OilEx, who operates an adjacent block, has reported a significant oil discovery near the southern border of Block 55. Other oil and natural gas operators in Oman include PDO, EnCana, Hunt Oil, Reliance Industries, MOL, Sinopec and Occidental.

Terms of the Exploration and Production Sharing Agreement ("**EPSA**") include an initial bonus payment of $2,000,000 and a commitment to spend a minimum of $25,500,000 over an initial three-year exploration period comprising the following items:

- 3D seismic: acquire 300 square kilometers; reprocess 133 square kilometers
- 2D seismic: acquire 500 square kilometers, reprocess 4,000 square kilometers
- Drill four wells

At the Corporation's option, the initial exploration period can be extended for an additional three year period provided the Corporation commits to spend $28,500,000, comprising the following items:

- Acquire 600 square kilometers of 3D seismic or 500 square kilometers of 2D seismic
- Drill three wells

Commercial crude oil production carries a contractual term of 20 years and will be allocated as follows:

- 40% of crude oil production is designated for cost recovery.
- 60% of crude oil production is designated as profit oil and will be allocated as follows:
  - Up to 10,000 bbls/d - 80% government of Oman; 20% Operator
  - 10,000 to 20,000 bbls/d - 82.5% government of Oman; 17.5% Operator
  - Over 20,000 bbls/d - 83.5% government of Oman; 16.5% Operator

The Corporation is obligated to pay income taxes to the government of Oman. However, under terms of the Block 55 EPSA, the government of Oman undertakes to pay such taxes on behalf of the Corporation from the government of Oman's share of crude oil and/or gas.

The Corporation is the official operator of Block 55 and is considering bringing in industry partners, raising additional capital, or a combination of both to fund the exploitation of this concession. Leaving aside the $2,000,000 bonus payment, the Corporation does not expect to spend a significant amount of capital towards this concession until 2010 or later.

Ethiopia – Northwest Area Study Agreement

On June 12, 2008, the Corporation entered into an exclusive Study Agreement, referred to as the Northwest Area Study Agreement, with the Ministry of Mines and Energy in Ethiopia. The Northwest Area Study Agreement covers 154,871.53 square kilometers (96,232.7 square miles) in the northwestern sector of the country for an initial one year term and includes an exclusive right to negotiate an agreement or agreements to further explore for oil and natural gas on any or all of the land covered by the Northwest Area Study Agreement by obtaining an oil and natural gas concession or concessions from the Ministry of Mines.

Since signing the Northwest Study Agreement, the Corporation has acquired detailed stream drainage maps and Landsat imagery over the study area. Based on that data, 13 large surface high areas have been identified. During 2009, the Corporation plans to apply for concession(s) covering some or all of the prospective areas identified thus far. The Corporation expects to spend approximately $1 million during the term of the Northwest Area Study Agreement.

Critical Accounting Estimates

The preparation of the consolidated financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates that affect reported amounts of assets and liabilities, the disclosure of any contingent assets and liabilities as of the date of the consolidated financial statements, as well as the reported amounts of revenues and expenses during the reported periods. By their nature, these estimates, including those related to future cash flows are subject to measurement uncertainty and the impact on the current and future consolidated financial statements resulting from changes in such estimates could be significant. Due to the use of estimates, actual results could differ significantly from those reported. Management believes the estimates used within the consolidated financial statements are reasonable as of the date of these consolidated financial statements.

The amounts recorded for depletion and amortization of property and equipment, stock based compensation, stock options, warrants, income taxes, asset retirement obligations, and other accruals are based on estimates. The Ceiling Test is based on estimates of oil and natural gas reserves, production rates, oil and natural gas prices, future costs and other relevant assumptions. Stock compensation, stock options, and warrants are valued using the Black-Scholes option pricing model which includes volatility assumptions that contain measurement uncertainty. The valuation allowance for income taxes is subject to measurement uncertainty pertaining to projected future production levels, future capital expenditures, future commodity prices and future operating costs, all of which could vary significantly from actual results. Asset retirement obligations contain plugging and abandonment estimates, productive well life estimates, and other factors for which actual results may vary significantly from original estimates. Also see Note 3 – "*Accounting Pronouncements*" within the annual consolidated financial statements for the year ended December 31, 2008.

Full Cost Accounting

The Corporation utilizes the full cost method of accounting for its crude oil and natural gas properties. Accordingly, all costs related to the exploration for and development of crude oil and natural gas reserves, whether successful or not, are capitalized. The capitalized costs and future capital costs are depleted on the unit-of-production method based on estimated proved reserves. Costs of significant unproved properties, net of impairments, are excluded from the amortization, depletion and accretion calculation. Properties excluded from the depletion calculation are assessed periodically to ascertain whether impairment has occurred.

The carrying amount of crude oil and natural gas properties may not exceed their recoverable amount (the "**Ceiling Test**"). The costs are assessed to be recoverable if the sum of the undiscounted cash flows expected from the production of proved reserves and the lower of cost or market of unproved properties exceeds the carrying value of the crude oil and natural gas assets. If the carrying value of the crude oil and natural gas assets is assessed to not be recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost or market of unproved properties. The cash flows are estimated using future product prices and costs, which are discounted using a risk-free rate of interest. At December 31, 2008, the Ceiling Test for the Corporation's Yemen oil and natural gas properties failed, resulting in an impairment of $34,099,000.

The alternative method of accounting for crude oil and natural gas properties is the successful efforts method. The major difference in applying the successful efforts method is that exploratory dry holes and geological and geophysical exploration costs are charged against net earnings in the year they are incurred rather than being capitalized. The use of the full cost method usually results in higher capitalized costs and higher DD&A rates than the successful efforts method.

Crude Oil and Natural Gas Reserves

The Corporation retains qualified independent reserves evaluators to estimate the Corporation's proved and probable crude oil and natural gas reserves. The estimation of reserves involves the exercise of judgment.

Forecasts are based on engineering data, expected rates of production and the timing of future capital expenditures, all of which are subject to major uncertainties and interpretations. The Corporation expects that over time its reserve estimates will be revised upward or downward based on updated information such as the results of future drilling, testing and production levels. Reserve estimates can have a significant impact on net earnings, as they are a key component in the calculation of DD&A and for determining potential asset impairment. For example, a revision to the reserve estimate would result in a higher or lower DD&A charge to net earnings. Downward revisions to reserve estimates could also result in a write-down of crude oil and natural gas properties.

When estimating oil and natural gas reserves and their associated net cash flows, there are numerous factors that contain significant measurement uncertainties that are beyond the Corporation's control. Those factors include, but are not limited to, volumetric reserve estimates, future commodity pricing, future operating costs and the timing of and amount of future capital costs. When assessing the fair market value of reserves, additional factors must be considered such as current market conditions, credit markets, location of reserves, classification of reserves based on risk of recovery, political risk and other factors, all of which may contribute to significant measurement uncertainty. Due to the complexity involved, reserve estimates and fair market value estimates will vary greatly from one party to another.

Asset Retirement Obligations ("ARO")

The Corporation is required to recognize a liability for future abandonment and site restoration costs associated with the Corporation's crude oil and natural gas properties in accordance with existing laws, contracts or other policies. The fair value of the estimated ARO is recorded as a long-term liability, with a corresponding increase in the carrying amount of the related asset known as the asset retirement cost, which is depleted on a unit-of-production basis over the life of the reserves. The liability is adjusted each reporting period to reflect the passage of time, with the accretion charged to earnings, and for revisions to the estimated future cash flows, if any. Actual costs incurred upon settlement of the obligations are charged against the liability. The ARO is based on estimated costs, taking into account the anticipated method and extent of restoration consistent with legal requirements, technological advances, industry practices and the possible use of the site. Since these estimates are specific to the sites involved, there are many individual assumptions underlying the Corporation's total ARO amount. These individual assumptions can be subject to change based on experience. Restoration technologies and costs are constantly changing, as are regulatory, political, environmental, safety and public relations considerations. The Corporation estimates future retirement costs based on current estimates adjusted for inflation and credit risk. These estimates for inflation and credit risk are also subject to measurement uncertainty.

The Corporation has estimated the net present value of its total ARO for wells drilled on its projects in the Appalachian basin to be $334,757 and $194,777 at December 31, 2008 and December 31, 2007, respectively, based on estimated total undiscounted future liabilities of $1,075,126 and $524,558 at December 31, 2008 and 2007, respectively. These payments are expected to be made at the end of the associated properties economic life, which is estimated to be approximately 65 years. The Corporation assumed an estimated credit adjusted risk-free rate of 4.25% and an estimated inflation rate of 2% to calculate the net present value of the asset retirement obligations. The total future ARO was estimated based on the Corporation's net ownership interest in all wells and facilities in the Appalachian basin in the U.S, and includes estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods.

No provision was made for asset retirement obligations with respect to the Corporation's Yemen properties, where the Block 41 PSA provides that all property and equipment will be transferred to the government of Yemen prior to the end of the Block 41 PSA term. Asset retirement activities during the term of the Block 41 PSA, if any, are fully recoverable from the proceeds of cost oil under the terms of the Block 41 PSA.

Stock-Based Compensation

The Corporation records stock-based compensation expense using the fair value method. The fair value of an option is calculated at the grant date using the Black-Scholes option pricing model and expensed over

the vesting term of the option. The Corporation records the cumulative stock-based compensation as a contributed surplus. When options are exercised, contributed surplus is reduced and share capital is increased by the amount of accumulated stock-based compensation for the exercised option. Any consideration received on the exercise of stock options is credited to share capital. The determination of stock-based compensation expense is based on assumptions regarding stock volatility, risk-free interest rates and the term of the options. These assumptions, by their nature, are subject to measurement uncertainty. An increase in volatility, the risk-free rate or the term would increase the calculated expense.

Income Taxes

The determination of the Corporation's income and other tax liabilities requires the interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ from that estimated and recorded by the Corporation's management. The valuation allowance for income taxes, if any, is subject to measurement uncertainty pertaining to projected future production levels, future capital expenditures, future commodity prices and future operating costs, all of which could vary significantly from actual results.

Fair Value of Financial Instruments

The Corporation's carrying value of cash and cash equivalents, accounts receivable, investment in convertible debentures, accounts payable and accrued liabilities approximate their fair value due to the immediate or short-term maturity of these instruments. The Corporation's investment in a convertible debenture, which is currently in default, earns interest at a fixed rate which is subject to interest rate risk, as the value will fluctuate as a result of changes in market rates. The entire carrying value of the convertible debenture, including accrued interest, was written off in its entirety during 2007. See Note 6 *"Investments"* in the annual consolidated financial statements for the year ended December 31, 2008.

International Financial Reporting Standards

In March 2007, the Canadian Institute of Chartered Accountants ("**CICA**") announced that Canadian publicly accountable enterprises will adopt International Financial Reporting Standards ("**IFRS**") as issued by the International Accounting Standards Board ("**IASB**") effective January 1, 2011. IFRS will require increased financial statement disclosure. Although IFRS uses conceptual framework similar to GAAP, differences in accounting policies will need to be addressed. One issue of primary concern is that under IFRS, oil and natural gas companies must use the Successful Efforts Method of accounting, as compared to the Full Cost Method of accounting currently utilized by the Corporation. If adoption to the Successful Effort Method is required, a conversion from the Full Cost Method of accounting to the Successful Efforts Method of accounting will likely have a material impact on the Corporation's consolidated financial statements. The Corporation is currently assessing the impact this and other IFRS related issues will have on its consolidated financial statements in future periods.

Changes in Accounting Policies, including Initial Adoption

The Corporation has reviewed all recently issued, but not yet adopted, accounting standards by CICA in order to determine their effects, if any, on the Corporation's results of operations or financial position. Based on that review, the Corporation believes none of the pronouncements, except for the conversion to IFRS that is scheduled to be effective January 1, 2011, will have a significant effect on current or future earnings or operations. As part of IFRS disclosure in 2011, the Corporation must show comparative information for 2010 in the basis of IFRS.

Results of Operations

(Dollar amounts are rounded to thousands of U.S. dollars, unless stated otherwise)

The following discussion encompasses the Corporation's revenues and costs of operations. Unless noted otherwise, the discussion pertains to the Corporation's Appalachian basin segment, as all other identified geographical operating segments were essentially in the start-up phase during 2008 and 2007 and had no reportable revenues or operating costs during those years.

Revenues

Since the commencement of the Corporation's first natural gas production during 2006 through December 31, 2008, the Corporation's oil and natural gas revenues have been derived primarily from its West Virginia and New York projects, both of which are in the Appalachian business segment. Historically, the operator in each of the Corporation's projects has marketed the Corporation's pro-rata share of oil and natural gas produced, primarily at index prices applicable to each area of production. In West Virginia, the Corporation receives, on average, a premium of approximately 15% over the posted natural gas prices due to the high Btu content in the natural gas the Corporation produces. Summary data follows:

	Year Ended December 31,	
	2008	**2007**
Summary Revenue Data:		
Natural Gas:		
Net gas production (Mcf)	749,167	470,446
Realized average natural gas price per MCF	$ 9.30	$ 7.80
Net natural gas revenues	$ 6,969,000	$ 3,670,000
End of period net production exit rate (Mcf/d)	2,502	1,312
Crude oil:		
Net oil production (Bbls)	11,992	-
Realized average oil price per Bbl	$ 86.98	$ -
Net oil revenues	$ 1,043,000	$ -
End of period net production exit rate (Mcf/d)	-	-
Net natural gas gathering fees	288,000	-
Total oil and natural gas revenues	$ 8,300,000	$ 3,670,000

Natural Gas Revenues

During 2008, natural gas revenues were $6,969,000, an increase of 90%, and natural gas production was 749,167 Mcf, an increase of 59%, as compared to 2007. The increase in natural gas revenues was principally due to a 19% increase in natural gas prices, a full year of production from the Blue Jacket project (initial production in August 2007) in West Virginia and new wells brought on line during 2008 as a result of the Corporation's ongoing drilling program in West Virginia and New York.

Crude Oil Revenues

During 2008, the Corporation's crude oil production resulted from three new wells that were brought on line in West Virginia. The oil production from those wells appears to have been related to an isolated fracture system. Oil production peaked at approximately 100 bbls/d in July 2008 and declined to less than five bbls/d at the end of 2008. There was no crude oil production during 2007.

Producing Well Counts

At December 31, 2008, the Corporation had 117 gross (58.59 net) producing wells, including 108 gross (57.56 net) wells in West Virginia, 6 gross (0.28 net) wells in New York, and 3 gross (0.75 net) in Ohio. In addition, the Corporation had 15 gross (8.51 net) shut-in wells waiting on tie-in to facilities, including 7 gross/net wells in Pennsylvania, 3 gross (1.41 net) wells in West Virginia and 5 gross (0.10 net) wells in New York. In comparison, at December 31, 2007, the Corporation had 75 gross (36.1 net) producing wells, including 69 gross (35.4 net) wells in West Virginia, 4 gross (0.2 net) wells in New York, and 2 gross (0.5 net) in Ohio. Also, at December 31, 2007, the Corporation had 23 gross (11.1 net) shut-in wells waiting on tie-in to facilities, including 1 gross/net well in Pennsylvania, 18 gross (10.06 net) wells in West Virginia and 4 gross (0.04 net) wells in New York.

Other Revenue

Other revenue consists of net natural gas gathering fees from the Corporation's Blue Jacket project in West Virginia The Corporation owns a 63% working interest in the gathering system that serves the Blue Jacket project. During the year ended December 31, 2008, net natural gas gathering fees were $288,000. There were no net natural gas gathering fees recorded during 2007.

Cost of Operations

The Corporation's cost of operations has progressively increased as the Corporation continues to expand its business. Cost of operations includes project operating costs, amortization and depletion, and general and administrative expenses. For the years ended December 31, 2008 and 2007, all project operating costs pertained to the Corporation's Appalachian basin business segment. A summary of the components of the costs of operations for each indicated period follows:

	Year Ended December 31,	
	2008	**2007**
Project operating costs:		
Production taxes	$ 376,000	$ 100,000
Lease operating expenses	1,414,000	364,000
Royalties	2,000	75,000
Total project operating costs	1,792,000	539,000
Impairment of unproved properties	34,099,000	-
Impairment of investment in convertible debenture	-	1,115,000
*Amortization, Depletion and Accretion ("**DD&A**"):*		
Amortization	106,000	24,000
Depletion	1,953,000	1,325,000
Accretion	13,000	5,000
Total DD&A	2,072,000	1,354,000
*General & Administrative ("**G&A**"):*		
General G&A	5,672,000	2,347,000
Non-monetary compensation	1,847,000	1,390,000
Total G&A	7,519,000	3,737,000
Total operating costs	$45,482,000	$ 6,745,000

Project Operating Costs

Project operating costs consist of production taxes, lease operating expenses, and royalties. Project operating costs were $1,792,000 and $539,000 for the years ended December 31, 2008 and 2007, respectively. A description of each category comprising project operating costs follows:

- Production taxes were $376,000 for the year ended December 31, 2008, an increase of $276,000, as compared to $100,000 for the year ended December 31, 2007. The increase was due primarily from increased natural gas production during 2008. Production taxes are assessed by the state in which production occurs. In West Virginia, the production tax rate is approximately 4% of gross revenues. In New York, the Corporation's wells are exempt from production taxes. Production taxes will vary from period-to-period based on production levels by state and/or oil and natural gas prices.

- Lease operating costs were $1,414,000 or $1.72/Mcfe and $364,000 or $0.77/Mcfe for the years ended December 31, 2008 and 2007, respectively. Lease operating expenses include the operating costs necessary to extract oil and natural gas and transport it to a sales point. The increase of $1,050,000 or $0.95/Mcfe for the year ended December 31, 2008, as compared to the year ended December 31, 2007, was the result of a full year of production during 2008 coupled with higher initial production costs associated with the start-up of new wells. Lease operating expenses per Mcf or Bbl will vary from period-to-period based on the level of oil and or natural gas production and related expenses. As the Corporation increases its operations, lease operating expenses are expected to increase accordingly in future periods.

- Royalties were $2,000 for the year ended December 31, 2008, a decrease of $73,000 as compared to $75,000 for the year ended December 31, 2007. Royalties reflect amounts paid to New York royalty owners for natural gas production from wells in which the Corporation is not yet classified as an integrated participating owner, but the Corporation is required to pay its share of royalties applicable to integrated royalty owners. During 2008, the Corporation did not participate in any wells for which it was classified as an integrated participating owner. See Note 12 - "*Contractual Obligations – Trenton-Black River*" in the annual consolidated financial statements for the year ended December 31, 2008.

Impairment of Unproved Properties

During the year ended December 31, 2008, the Corporation recorded unproved property impairments of $34,099,000, as compared to no unproved property impairments during the same period of 2007. Effective December 31, 2008, the Corporation assessed the carrying value of is unproved properties on Block 41 in Yemen and determined that such costs were partially impaired. The Corporation recorded an impairment of $34,071,000, which reflects a write-down to the estimated fair value of the Corporation's unproved property costs for Block 41 in Yemen of approximately $12.5 million at December 31, 2008. See Note 2 (k) "*Measurement Uncertainty*" in the consolidated financial statements for the year ended December 31, 2008. In addition, the Corporation impaired $28,000 of costs pertaining primarily to Qatar, where it has no further exploration plans. For further information about the Corporation's oil and natural gas reserves, see the Corporation's Form 51-101F as at December 31, 2008 on www.sedar.com.

Impairment of Investment in Convertible Debenture

During the year ended December 31, 2008, the Corporation did not have any impairment losses on its investments. At December 31, 2007, the Corporation recognized an impairment loss of $1,115,000 on its investment in a convertible debenture of Peace River Oil Inc. The Corporation impaired its entire investment in the Peace River Oil Inc. convertible debenture, including $1,019,000 of principal and $96,000 of accrued interest after Peace River Oil Inc. defaulted on the principal and interest payments, failed to obtain third party financing that would have provided funds to pay the amounts due, failed to sell certain property interests that would have provided funds to repay the amounts due in whole or in part, and failed to renegotiate the convertible debenture at terms acceptable to the Corporation.

Amortization, Depletion and Accretion

Amortization, depletion and accretion consists of amortization of office equipment, depletion applicable to the Corporation's capitalized proved oil and natural gas properties utilizing the full cost method, and accretion applicable to the Corporation's asset retirement obligations. Substantially all of the Corporation's amortization, depletion and accretion expenses since inception were comprised of depletion expense attributable to the Corporation's producing natural gas properties in the Appalachian basin. Amortization and accretion costs were an immaterial component of DD&A during the reported periods.

Depletion expense was $1,953,000 or $2.38/Mcfe, and $1,325,000 or $2.82/Mcfe, for the years ended December 31, 2008 and 2007, respectively. Depletion expense was progressively higher due to natural gas production volumes, which increased period over period. During 2008 and 2007, the Corporation's depletion expense applied solely to its United States properties. In accordance with the full cost method for depletion, the Corporation excluded unproved property costs of $11,182,000 and $10,571,000 from its United States depletable cost center for the years ended December 31, 2008 and 2007, respectively. The Corporation included $240,000 and $232,000 of impaired unproved leasehold costs in its United States depletable cost center for the years ended December 31, 2008 and 2007, respectively. Depletion expense will fluctuate from period to period depending upon production levels, the amount of proved reserves, depletable costs, and the level of capital expenditures, among other factors.

General and Administrative

G&A was $7,519,000 for the year ended December 31, 2008, an increase of $3,782,000 over $3,737,000 for the year ended December 31, 2007. G&A consists of general corporate expenses applicable to all reportable segments, which are comprised primarily of compensation, outside legal, professional and other consulting services, travel and other related corporate costs. Staffing levels increased in 2008 from 2007 levels and there was a full year of direct costs (approximately $2,700,000) associated with the Corporation's international operations, while a minimal amount was spent during 2007 for international operations. As the Corporation expands its business, G&A expenses are expected to increase accordingly in future periods.

Non-monetary compensation included as a G&A component was $1,847,000 for the year ended December 31, 2008, an increase of $457,000, as compared to $1,390,000 for the year ended December 31, 2007. The increase in 2008 was directly associated with higher staffing levels during 2008. Non-monetary compensation comprises stock options and Common Shares granted to certain employees, consultants and directors of the Corporation. For stock option awards, the Corporation estimated the fair value of such stock options on the date of grant using the Black-Scholes option pricing model and amortized the fair value to G&A expense over the respective vesting periods. For Common Shares granted for services rendered, the fair value is determined based on the average sales price per Common Share on the date of grant, resulting in a charge to compensation expense in the period granted.

Other Income or (Expense)

Other income was $6,094,000 for the year ended December 31, 2008, an increase of $5,243,000, as compared to $851,000 for the year ended December 31, 2007. During 2008, the Corporation earned $1,205,000 of interest income on its cash and cash equivalents, received $24,000 pertaining to purchase discounts, incurred $85,000 of interest expense, wrote off $140,000 pertaining to unsuccessful start-up costs for a commodity trading company in the Middle East, received $77,000 of operator overhead fees from the Block 41 joint venture, and recorded a $5,013,000 gain from the sale of unproved leasehold interests in the Appalachian basin (see Note 9 *"Property and Equipment – Unproved Property Divestitures"* in the annual consolidated financial statements for the year ended December 31, 2008). Other income for the year ended December 31, 2007 of $851,000 consisted solely of interest income. In future periods, the amount of interest earned or interest expense incurred will vary due to the future levels of the Corporation's cash, cash equivalents, restricted cash and/or debt.

Income Taxes

Future income tax expense was $2,600,000 for the year ended December 31, 2008 as compared to none for the same period of 2007. The determination of the Corporation's current and future income tax expense and liabilities requires the interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ from that estimated and recorded by the Corporation's management.

Comprehensive Income (Loss)

The Corporation's results of operations may vary significantly from period to period based on the factors discussed in "*Risk Factors*" within the Corporation's Annual Information Form dated as of April 1, 2009 and on other factors such as the Corporation's exploratory and development drilling success. Therefore, the results of any one period may not be indicative of future results.

The Corporation's comprehensive income (loss) consists of its reported net income (loss) plus unrealized foreign currency gains and losses. The Corporation's comprehensive income (loss) for each indicated period follows:

	Year Ended December 31,	
	2008	**2007**
Comprehensive loss:		
Net loss	$ (33,688,000)	$ (2,224,000)
Unrealized foreign currency losses	(9,069,000)	(728,000)
Comprehensive loss	$ (42,757,000)	$ (2,952,000)

Fourth Quarter Results – 2008 and 2007

Net loss for the fourth quarter of 2008 was $37,414,000, an increase of $35,340,000, as compared to a $2,074,000 net loss, for the same period of 2007. The increase in the net loss was principally due to an impairment of unproved properties of $34,099,000. Revenues were $889,000 higher during the fourth quarter of 2008, resulting from higher natural gas production volumes and higher average natural gas prices, as compared to the same period of 2007. A discussion of each component of the net loss for the fourth quarter of 2008 and 2007, respectively, follows:

Oil and natural gas revenues were $1,913,000 for the fourth quarter of 2008, an increase of $889,000 as compared to $1,024,000 for the same period of 2007. Revenues were substantially higher due to more wells on line as a result of the Corporation's drilling programs in West Virginia and New York. Natural gas production was 217,105 Mcf for the fourth quarter of 2008, an increase of 94,957 Mcf, as compared to 122,148 Mcf for the same period of 2007. The average natural gas price for the fourth quarter of 2008 was $8.54 per Mcf, an increase of $0.16 Mcf, as compared to $8.38 for the same period of 2007.

Project operating costs were $453,000 for the fourth quarter of 2008, an increase of $245,000, as compared to $208,000 for the same period of 2007. Operating costs in the fourth quarter of 2008 increased due to more wells on line as a direct result of the Corporation's drilling programs in West Virginia and New York. At December 31, 2008, the Corporation had 117 gross (58.59 net) producing wells, as compared to 73 gross (35.5 net) producing wells at December 31, 2007.

During the fourth quarter of 2008, the Corporation recorded unproved property impairments of $34,099,000, as compared to no unproved property impairments during the same period of 2007. Effective December 31, 2008, the Corporation assessed the carrying value of is unproved properties on Block 41 in Yemen and determined that the costs were partially impaired. The Corporation recorded an impairment of $34,071,000, which reflects a write-down to the estimated fair value of the Corporation's unproved property costs for Block 41 in Yemen of approximately $12.5 million at December 31, 2008. See Note 2 (k) "*Measurement Uncertainty*" in the consolidated financial statements for the year ended December 31,

2008. In addition, the Corporation impaired $28,000 of costs pertaining primarily to Qatar, where it has no further exploration plans.

There was no impairment of investment in convertible debenture during the fourth quarter of 2008, as compared to $1,115,000 during the same period of 2007. During the fourth quarter of 2007, the Corporation impaired its entire investment in the Peace River Oil Inc. convertible debenture, including $1,019,000 of principal and $96,000 of accrued interest after Peace River Oil Inc. defaulted on the principal and interest payments, failed to obtain third party financing that would have provided funds to pay the amounts due, failed to sell certain property interests that would have provided funds to repay the amounts due in whole or in part, and failed to renegotiate the convertible debenture at terms acceptable to the Corporation.

Amortization, depletion and accretion were $327,000 for the fourth quarter of 2008, a decrease of $409,000, as compared to $736,000 for the same period of 2007. During the fourth quarter of 2008, less depletion expense was recorded as result of adjustments made to reflect a lower than anticipated final annual depletion rate per Mcfe for the entire year of 2008. During the fourth quarter of 2007, additional depletion expense was recorded to reflect a higher than anticipated final annual depletion rate per Mcfe for the entire year of 2007.

G&A was $1,820,000 for the fourth quarter of 2008, an increase of $228,000, as compared to $1,592,000 for the same period of 2007. G&A expenses such as legal, consulting, and travel were higher during the fourth quarter of 2008 due to an increased level of business activity in North America and the Middle East, as compared to the same period of 2007.

Other income was $43,000 for the fourth quarter of 2008, a decrease of $511,000, as compared to $554,000 for the same period of 2007. Net interest income was $82,000 during the fourth quarter of 2008, a decrease of $472,000 was as compared to $511,000 in the same period of 2007, due to lower average cash, cash equivalent and restricted cash balances during the fourth quarter of 2008. In addition, during the fourth quarter of 2008, the Corporation wrote off $140,000 pertaining to unsuccessful start-up costs for a commodity trading company in the Middle East, received $77,000 of operator overhead fees from the Block 41 joint venture, and received $24,000 from purchase discounts.

Future income tax expense was $2,600,000 for the fourth quarter of, 2008 as compared to none for the same period of 2007. The determination of the Corporation's current and future income tax expense and liabilities requires the interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ from that estimated and recorded by the Corporation's management.

Liquidity and Capital Resources

Working Capital

At December 31, 2008 and 2007, the Corporation had working capital of $(17,841,000) and $38,484,000, respectively. The Corporation's working capital as of December 31, 2008 and 2007 did not take into account $33,703,000 and $1,100,000, respectively, of restricted cash that was classified as "other assets" on the Balance Sheet. Had restricted cash been included in the working capital computation, working capital at December 31, 2008 and 2007 would have been $15,862,000 and $39,584,000, respectively. The Corporation's working capital will fluctuate from period-to-period, depending on the timing of cash receipts and payments, the pace of its operations, investing and financing activities, among other factors.

Loan Facilities and Letter of Credit

At December 31, 2008, the Corporation had two credit lines in place totaling $26,000,000 and had utilized $19,184,134 of credit that was then available, including $9,204,500 at Northwestern Bank and $9,979,634 at TD Bank. A discussion of each loan facility follows:

- *Northwestern Bank, Traverse City, Michigan:* USD$11,000,000, secured by a lien on the Corporation's New York assets in the amount of $10,000,000 and a $1,000,000 minimum deposit at Northwestern Bank. Terms of the credit line include an interest rate of prime less 1/4 percent. As at December 31, 2008, the Corporation had an outstanding amount of $9,204,500 under the terms of this credit line, leaving $1,795,500 of available unused credit.

- *TD Bank, Toronto, Canada:* USD$15,000,000, secured by Canadian dollar equivalent of 115% of the borrowed amount. Terms of the credit line include an interest rate of prime plus 0.5%. As at December 31, 2008, the Corporation had an outstanding amount of $9,979,634 under the terms of this credit line, leaving $5,020,366 of available unused credit.

During 2008, the Corporation utilized its credit lines primarily to manage foreign currency translation volatility resulting from the United States financial crisis that developed during the latter half of 2008. During that time, the foreign currency translation rate changed from approximately 1.0 per Canadian dollar to U.S. dollar to approximately 0.80 per Canadian dollar to U.S. dollar. Prior to the United States financial crisis, the Corporation held a substantial amount of its cash, cash equivalents and short term investments in Canadian dollars.

Letter of Credit - Yemen

Under terms of the Block 41 PSA, as operator the Corporation must post a letter of credit in favor of the Ministry of Minerals covering the gross amount of expected expenditures during each calendar year. During 2008, the Corporation initially posted a $16,000,000 letter of credit secured by $17,600,000 of restricted cash deposits at TD Bank. The letter of credit was subsequently reduced as documented details pertaining to the work program on Block 41 were presented to the Ministry of Minerals by the Corporation. At December 31, 2008, the balance of that letter of credit had been reduced to $8,000,000, which was secured by restricted cash of $11,375,064. On March 11, 2009, the letter of credit was further reduced from $8,000,000 to $4,500,000.

OGMC Default

As of December 31, 2008, the Corporation had outstanding receivables from Oil and Gas Mine Company ("OGMC") of $5,590,881 for their pro-rata share of costs pertaining to Block 41. On March 3, 2009, the Corporation sent OGMC a notice of default for failure to pay such amount. Under terms of the Block 41 PSA, OGMC has thirty days from the date of default to pay such amount. In the event that OGMC fails to cure the default, the remaining working interest partners may assume OGMC's interest in proportion to their working interest. In the event OGMC does not fully cure its default, the Corporation may have to adjust its spending plans or obtain capital from a third party sources to make up the cash shortfall.

Cash Flow from Operations

During 2008, the Corporation used $6,596,000 in its operating activities, an increase of $7,712,000 as compared to receiving $1,116,000 from its operating activities in 2007. During 2008, the Corporation generated a net loss of $33,688,000 before adjusting for a $5,013,000 net gain on the sale of assets. Cash used in operations during 2008 was further adjusted by a $8,512,000 negative adjustment pertaining to changes in the Corporation's non-cash balances related to operations and by a positive $40,617,000 of non-cash add-backs covering impairments, amortization, depletion and accretion and stock based compensation.

During 2007, the Corporation received $1,116,000 from its operating activities, a decrease of $994,000, as compared to $2,110,000 during 2006. During 2007, the Corporation incurred a net loss of $2,224,000 and a $357,000 negative adjustment pertaining to the Corporation's non-cash balances related to operations, both of which were partially offset by $3,697,000 pertaining to non-cash add-backs covering amortization, depletion and accretion and stock based compensation.

Cash Flow from Investing Activities

Since inception, the Corporation has invested substantially all of its capital into its oil and natural gas properties. At December 31, 2008, the Corporation had invested approximately 87% of its share capital into its oil and natural gas properties.

During 2008, the Corporation spent $72,945,000 on its investing activities, an increase of $28,928,000, as compared to 44,017,000 in 2007. During 2008, the Corporation spent $47,265,000 on its oil and natural gas properties, including $14,155,000 in Yemen, $1,306,000 in Ethiopia, $30,818,000 in the United States, $535,000 in Canada and $451,000 in other countries. In addition, the Corporation spent $345,000 on office equipment, received $6,768,000 in gross proceeds from the sale of unproved properties in the United States, re-classified $32,603,000 of cash and cash equivalents to restricted cash, and received $501,000 pertaining to other assets.

During 2007, the Corporation spent $44,017,000 on its investing activities, an increase of $30,510,000 over the amount of $13,507,000 reported for 2006. During 2007, the Corporation spent $42,268,000 on its oil and natural gas properties, including $19,543,000 in Yemen, $22,659,000 in the United States and $66,000 in Canada. In addition, during 2007 the Corporation invested $111,000 on office equipment and spent $538,000 on deferred pre-operating costs in Yemen. Also during 2007, cash flows used in investing activities included $1,100,000 as a result of re-classifying certain amounts of the Corporation's available cash and cash equivalents as restricted in nature as at December 31, 2007.

Cash Flow from Financing Activities

Since its inception through December 31, 2008, the Corporation has raised $138,259,000 of capital from the net issuance of 50,315,323 Common Shares.

The Corporation received $49,768,000 during 2008 from its financing activities, a decrease of $33,640,000 as compared to $83,408,000 for 2007. During 2008, the Corporation sold 5,600,000 Common Shares at a price of CDN$6.25 per Common Share and received a net amount of $31,213,000 after deducting issuance costs. Also during 2008, the Corporation re-purchased and cancelled 1,000,000 Common Shares for $691,000 at an average price of $0.69 per Common Share, received $43,000 from the exercise of 17,000 warrants at $2.50 per Common Share, received $19,184,000 from utilizing its lines of credit, and received a net amount of $19,000 from the issuance of long-term debt.

During 2007, the Corporation received $83,408,000 from its financing activities, an increase of $69,433,000 over the amount of $13,975,000 reported for 2006. During 2007, the Corporation received a net amount of $83,408,000 from the issuance of 24,067,688 of Common Stock at an overall average price of $3.42 per common share.

A summary of cash flows from financing activities involving the issuance or cancellation of the Corporation's Common Shares during 2008 and 2007 follows:

	Average Price per Common Share	Common Shares [2]	Net Proceeds
Cash flows from issuance of Common Stock:			
2008:			
Bought deal, net of issuance costs	CDN$6.25	5,600,000	$ 31,213,000
Warrants exercised	US$2.50	17,000	43,000
Common share re-purchase	US$0.69	(1,000,000)	(691,000)
Totals	US$6.62	4,617,000	30,565,000
2007:			
Private placements [1]	US$2.50	5,388,700	13,112,000
Initial public offering	CDN$4.00	18,000,000	69,355,000
Stock option exercise	US$1.39	678,988	941,000
Totals	US$3.42	24,067,688	$ 83,408,000

Notes:

(1) Net proceeds exclude non-cash commissions of 80,000 Common Shares at a price of $2.50 per Common Share.
(2) Excludes 1,586,735 Common Shares issued for consideration other than cash, including 50,000 Common Shares issued to an officer who paid for such shares during 2006, 80,000 Common Shares issued for commissions pertaining to private placements, and 1,456,735 Common Shares pertaining to the Block 41 PSA acquisition.

Effect of Currency Rates on Cash and Cash Equivalents

The effect of currency rates on cash and cash equivalents comprised a net unrealized foreign currency exchange loss of $9,069,000 for the year ended December 31, 2008 and a net unrealized foreign currency exchange gain of $171,000 for the year ended December 31, 2007. The exchange rate for Canadian to US dollar was 0.8183 and 1.0194 at December 31, 2008 and 2007, respectively. Net unrealized gains and losses arising from changes in foreign currency rates on cash, cash equivalents and restricted cash will vary from period to period due to the level of the Corporation's cash, cash equivalents and restricted cash.

Capitalization

At December 31, 2008, the Corporation's share capital was $138,259,000, consisting of 50,315,323 Common Shares issued and outstanding. Also at December 31, 2008, the Corporation had outstanding unexercised options covering 3,317,449 Common Shares at a weighted average exercise price of approximately $2.60 per Common Share and a weighted average contractual term of 8.7 years. Of those options, 1,836,166 were fully vested and 1,481,283 were unvested.

At December 31, 2007, the Corporation's share capital was $109,726,000, consisting of 45,698,323 Common Shares issued and outstanding. Also at December 31, 2007, the Corporation had outstanding unexercised options covering 2,565,632 Common Shares at a weighted average exercise price of approximately $2.31 per Common Share and weighted average contractual term of 8.4 years, and unexercised warrants covering 17,000 Common Shares with an exercise price of $2.50 per Common Share and a term of 18 months from the closing of the first private placement, which occurred during the second quarter of 2007.

2009 Capital Budget

For 2009, the Corporation's Board of Directors approved a capital budget of $28,800,000. Highlights include:

- Marcellus Shale - $21,600,000; includes drilling at least two wells in Highway 706, hooking up wells in Highway 706 for production, constructing production infrastructure in Highway 706, and drilling four wells within the Park Place project in New York.
- Yemen - $3,400,000; includes drilling one exploratory well.
- Oman - $2,900,000; includes a $2,000,000 signing bonus pertaining to Block 55.

The amount of capital to be spent in 2009 is mostly discretionary. As such, the Corporation's capital budget is a "fluid" amount and may increase or decrease due to factors such as available capital, operational success or failure, commodity prices and the actual pace of operations. In order to fully fund its planned operations during 2009, it is likely that the Corporation may need additional capital to obtain its capital expenditure goals.

Future Capital Requirements

2008 resulted in one of the most volatile years in the oil and natural gas industry. Commodity prices for oil and natural gas reached all time highs and then dipped to multi-year lows. In the last half of 2008, global capital markets tightened and retrenched dramatically. The downward trend in the capital and commodity markets resulted in many oil and natural gas companies reducing their capital budgets substantially due to the reduced availability of capital and reduced economic returns resulting from lower commodity prices. Accordingly, there can be no assurance that the Corporation can successfully raise enough capital to fund its future capital needs outside of its existing available capital at terms acceptable to the Corporation.

Historically, the Corporation has relied on proceeds from the sale of its Common Shares to fund its operations. In order to fully fund or accelerate the Corporation's current planned acquisition, exploration and development activities beyond 2009, the Corporation will need additional capital. The timing, pace, scope and amount of the Corporation's capital expenditures is largely dependent on the availability of capital. The Corporation may obtain funds for future capital investments from strategic alliances with other energy or financial partners, the issuance of additional Common Shares, Preferred Shares, or debt securities, project financing, sale of partial property interests, or other arrangements, all of which may dilute the interest of the Corporation's existing shareholders or the Corporation's interest in the specific project financed. The Corporation may change the allocation of capital among the categories of anticipated expenditures depending upon future events that the Corporation cannot predict. For example, the Corporation may change the allocation of its expenditures based on the actual results and costs of future exploration, appraisal, development, production, property acquisition and other activities. In addition, the Corporation may change its anticipated expenditures if costs of placing any particular discovery into production are higher, if the field is smaller, or if the commencement of production takes longer than expected.

The Corporation regularly forecasts its capital needs on an annual, quarterly and monthly basis. The Corporation's current internally generated cash flows do not provide sufficient capital for the Corporation's current long-range exploration and development plans. However, by prioritizing and adjusting the timing of capital expenditures, management anticipates its 2009 capital expenditures will be fully funded through most or possibly all of 2009 with its capital resources on hand at December 31, 2008, including the use of its existing $11.0 million line of credit with Northwestern Bank, which is secured by a $1.0 million minimum cash deposit and a $10.0 million lien on the Corporation's New York properties. Accordingly, the Corporation anticipates raising additional capital to fully fund its capital needs beyond 2009, including fulfilling its obligations on Block 55 in Oman and to further develop its Marcellus shale properties in the Appalachian basin. Upon commencement of natural gas production from its Highway 706 project in Pennsylvania during mid 2009, the Corporation believes it will have sufficient oil and natural gas reserves required to obtain additional reserve based debt financing. However, tight credit markets, operational delays, or poor project performance could adversely affect the Corporation's ability to obtain such financing. The Corporation has a number of additional options available to it if cash flow does not cover future capital expenditure plans including, but not limited to, i) revising the scope and/or timing of its capital expenditure plans, ii) selling a partial or 100% interest in a property to a third party, iii) obtaining project specific financing from a third party, iv) obtaining additional debt financing, and v) issuing Common Shares, or a combination of these options. Beyond 2009, the Corporation's capital needs are expected to be met through a combination of cash flow and debt. Future debt levels are forecasted to remain within acceptable ratios for conforming reserve based debt.

Outstanding Share Data

As at December 31, 2008 and as of the date of this report, the Corporation's capitalization consisted of 50,315,323 Common Shares issued and outstanding. In addition, as at December 31, 2008 and as of the date of this report, the Corporation 3,317,449 outstanding options at an average exercise price of CDN$2.60 per Common Share with a weighted average life of 8.7 years.

Commitments and Contingencies

Bakken Shale Drilling Commitment

The Corporation entered into an agreement with a privately held Canadian company on August 28, 2008, whereby the Corporation agreed to pay 100% of the costs to drill a minimum of two horizontal wells in the Bakken shale in order to earn a 50% working interest in acreage controlled by the private company. The agreement was further amended on December 19, 2008, whereby the Corporation agreed to advance to the private company CDN$2,712,000 prior to September 1, 2009 to drill the first earning well. Should the Corporation fail to do so, the Corporation must pay the private company liquidating damages of CDN$2,000,000 and forfeit the Corporation's rights under the agreement. In addition, the private company shall then acquire the Corporation's other Bakken shale leasehold (purchased at the October 6, 2008 Saskatchewan Crown land sale and from Spartan on November 9, 2008) for CDN$563,832.08. Furthermore, the private company is indebted to the Corporation in the amount of CDN $439,205, as evidenced by a promissory note dated October, 6, 2008. The private company shall be entitled to offset the full amount that it may owe the Corporation should the Corporation fail to fund the first earning well and pay the liquidated damage amount outlined above.

Yemen- Block 41 PSA

In accordance with the Farm-in Agreement with the Oil and Gas Mine Company dated September 10, 2007, the Corporation is obligated to pay the Oil and Gas Mine Company $3,000,000 upon a Declaration of Commerciality, which is defined as "*the act of approval by the Ministry of Minerals on the behalf of the Republic of Yemen for an operator to develop a Commercial Discovery under an existing production sharing agreement.*" The $3,000,000 payment will only be incurred in the event the Corporation makes a commercial oil or natural gas discovery on Block 41 and the Ministry of Minerals grants a license to commercially produce such discovery. Due to the contingent nature of this item, it is not reflected in the Corporation's Balance Sheet at December 31, 2008.

Oman – Block 55 EPSA

On January 26, 2009, the Corporation was awarded Block 55, an onshore oil and natural gas concession in Oman that covers approximately 7,564 square kilometers (1,869,105 acres). Terms of the EPSA include an initial payment of $2,000,000 and an initial three-year exploration period with a commitment to spend a minimum of $25,500,000 during that period to drill four exploratory wells, acquire 300 square kilometers of new 3D seismic, reprocess 133 square kilometers of 3D seismic, acquire 500 square kilometers of 2D seismic, and reprocess 4,000 square kilometers of 2D seismic. The Corporation is the official operator of Block 55 and is considering bringing in industry partners, raising additional capital, or a combination of both to fully fund the exploitation of this concession. The Corporation does not expect to spend a significant amount of capital towards this concession until 2010 or later.

New York – Trenton-Black River Well Units

In June 2005, a new integration statute was enacted by the State of New York whereby leasehold interest owners could elect to participate in the drilling of a well by choosing one of the following options:

> 1) Integrated non-participating owner – leasehold owner elects to not pay their proportionate share of costs up-front. The leasehold owner participates in their proportionate share after payout of a non-consent penalty plus costs.

2) Integrated participating owner – leasehold owner elects to pay their proportionate share of costs up-front.

3) Integrated royalty owner – leasehold interest owner elects to receive a proportionate 12.5% royalty interest.

During 2006, the Department of Environmental Conservation classified the Corporation's interest in several wells drilled, prior to the statute change and by way of public hearing, as an integrated non-participating owner. As a result, the Corporation was charged a non-consent penalty on its pro-rata share of costs to drill and complete various wells by Fortuna, the operator. The Corporation believes its interest in the subject wells should have been classified as an integrated participating owner upon payment of its pro-rata share of costs, effectively negating the non-consent penalty the operator could charge prior to dispersing the Corporation's pro-rata share of profits. The Corporation formally appealed the Department of Environmental Conservation's ruling, and, if successful, will require the non-consent penalty withheld by the operator to be dispersed to the Corporation. As a result there is no anticipated effect on the Corporation's established working interest. As at December 31, 2008, the outcome of the Corporation's appeal was not determinable.

As at December 31, 2008, the Corporation was classified as an integrated non-participating owner in 7 gross (0.10 net) wells, including 3 gross (0.06 net) for which the non-consent penalty had paid out.

Arbitration – Pinpoint Drilling and Directional Services LLC

On November 5, 2008, the Corporation was notified by its contract operator that Pinpoint had served a Notice of Arbitration covering invoices totaling $1,158,550 for drilling services performed by Pinpoint on the Corporation's Highway 706 project in Pennsylvania during 2008. At December 31, 2008, the Corporation had capitalized the entire disputed amount, including $545,909 paid near the time the Notice of Arbitration was filed and the $612,641 for which the Corporation has asserted is invalid due to negligent performance by Pinpoint and, which remained unpaid at year-end. The arbitration will take place in 2009.

Drilling services performed by Pinpoint on Highway 706 to date has been in accordance with a drilling contract dated May 16, 2008 between Pinpoint and the Corporation's contract operator for a term of one year. Under terms of the Contract, the Corporation is subject to a stand-by day rate of $14,800 per day. On February 17, 2009, the Corporation, through its contract operator, informed Pinpoint that the Corporation's Board of Directors had approved terminating the drilling contract upon completion of drilling the Hardic 2H. Pinpoint completed drilling the Hardic 2H on March 18, 2009.

Office Leases

At December 31, 2008, the Corporation had the following offices:

- Traverse City, Michigan – office lease agreement effective April 1, 2007 with a two year term and monthly lease payments of $4,375.
- Houston, Texas – office lease agreement effective November 26, 2008 with a five year term and monthly lease payments of $6,347.
- Sana, Yemen - office lease agreement effective November 1, 2007 with a two year term and monthly lease payments of $5,900.
- Abu Dhabi, United Arab Emirates: office lease agreement effective December 15, 2008 with a one year term and annual lease payment of $57,183.

- Toronto, Canada - The Corporation's office in Toronto, Canada is owned by the Executive Chairman and is utilized at no charge to the Corporation. See Note 17 *"Related Party Transactions"* in the annual consolidated financial statements for the year ended December 31, 2008.

The future commitments and obligations are summarized in the following table:

	Payments Due by Period				
	Total	Less than 1 Year	1 – 3 Years	4 – 5 Years	After 5 Years
Future Commitments:					
Long-term debt	$ 35,000	$ 16,000	$ 19,000	$ -	$ -
Operating leases	500,000	201,000	229,000	70,000	
Purchase obligations	2,712,000	2,712,000	-	-	-
Other long-term obligations	25,500,000	-	25,500,000	-	
Total	$ 28,747,000	$ 2,929,000	$ 25,748,000	$ 70,000	$ -

Other long-term obligations in the above table reflect the initial three-year work commitment associated Block 55 in Oman, which the Corporation was awarded on January 26, 2009.

Disclosure Controls and Procedures

The Corporation has evaluated the effectiveness of its disclosure controls and procedures and has concluded based on the Corporation's evaluation that they are sufficiently effective to provide reasonable assurance that material information relating to the Company is made known to management and disclosed in accordance with applicable securities regulations.

The Chief Executive Officer and Chief Financial Officer, together with other members of management, after having designed Internal Controls Over Financial Reporting ("ICFR") to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial reporting in accordance with GAAP, have not identified any changes to the Corporation's internal control over financial reporting which would materially affect, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

During 2008, the Corporation documented and tested its entity level and process level controls covering ICFR reporting and concluded that such controls were effective.

Recent Changes in Accounting Standards

The Corporation has reviewed all recent changes in Accounting Standards, including the following sections of the CICA Handbook: Section 1506 "*Accounting Changes*", Section 1530 "*Comprehensive Income*", Section 3855 "*Financial Instruments – Recognition and Measurement*", Section 3861 "*Financial Instruments – Disclosure and Presentation*", Section 3862 " *Financial Instruments Presentation*", Section 3865 "*Hedges*", Section 1535 "*Capital Disclosures*", Section 3064 "*Goodwill and Intangible Assets",* Section 1582 "*Business Combinations*", Section 1601 "*Consolidated Financial Statements*", and Section 1602 "*Non-Controlling Interests*". None of these Accounting Standard changes had a material effect on the Corporation's 2008 or 2007 financial results.

Internal Controls over Financial Reporting

The Chief Financial Officer, together with other members of management, have designed and documented internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial reporting in accordance with GAAP. During 2008, the Corporation's internal controls were tested for compliance by an independent consultant and no material weaknesses were found.

Environmental Issues

Compliance with Environmental and Safety Regulations

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of federal, provincial and local laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills and releases or emissions of various substances produced in association with oil and natural gas operations. The legislation also requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liabilities, and potentially increased capital expenditures and operating costs. The discharge of oil, natural gas or other pollutants into the air, soil or water may give rise to liabilities to governments and third parties and may require the Corporation to incur costs to remedy such discharge. Although the Corporation believes that it is in material compliance with current applicable environmental regulations, no assurance can be given that environmental laws will not result in a curtailment of production or a material increase in the costs of production, development or exploration activities or otherwise adversely affect the Corporation's financial condition, results of operations or prospects. The Corporation must also conduct its operations in accordance with various laws and regulations concerning occupational safety and health. Currently, the Corporation does not foresee expending material amounts to comply with these occupational safety and health laws and regulations. However, since such laws and regulations are frequently changed, the Corporation is unable to predict the future effect of these laws and regulations.

Middle East and Africa

In emerging nations, such as Yemen, Oman and Ethiopia, where environmental regulations and legislation are evolving, many oil and natural gas exploration and production companies operate in accordance with standards prevailing in established oil and natural gas producing jurisdictions, such as Canada and the United States. The Corporation has yet to conduct any significant on the ground operations in Ethiopia, but intends to adhere to established industry practice standards upon the commencement of such operations.

The Corporation's activities in the Middle East and Africa are in predominately arid desert areas. As such, the environmental impact associated with exploration and production activity in these areas are significantly less than is typical for similar oil and natural gas exploration, development and production activities located in more temperate or tropical environments. The Corporation is committed to conducting its operations in the Middle East and Africa in accordance with environmental standards used by other major international oil and natural gas exploration and production companies. Generally, such standards meet or exceed those imposed by legislation and regulations in Yemen, Oman and Ethiopia.

North America

The Corporation's activities are subject to numerous federal, provincial and state laws and regulations concerning the storage, use and discharge of materials into the environment, the remediation of environmental impacts and other matters relating to environmental protection, all of which may adversely affect the Corporation's operations and the costs of doing business. Federal, provincial and state regulatory authorities also have established rules and regulations requiring permits for drilling, drilling bonds and reports concerning drilling and producing activities. Such regulations also cover the location of wells, the method of drilling and casing wells, the surface use and restoration of well locations, the plugging and abandoning of wells, and other matters. There can be no assurance that future legislation or administrative regulations or interpretations will not impose stricter requirements that could have an adverse impact on the operating costs of the Corporation and the oil and natural gas industry in general. The Corporation believes it is in material compliance with existing environmental laws and regulations and does not currently believe that it will be required to expend material amounts to comply with existing environmental laws and regulations in the future.

Related Party Transactions

The Corporation reports its related party transactions on an exchange amount basis. A summary of such transactions follows:

Executive Chairman

The Corporation utilizes administrative services provided by 706147 Ontario Inc., a company owned by the Executive Chairman and his spouse to assist in managing the Corporations daily operations. In addition, the Corporation shares office space with Capital Z Corporation, a company owned by the Executive Chairman, at no charge. Related party transactions with the Corporation's Executive Chairman were conducted in Canadian dollars and the exchange rate differences were immaterial. A summary of related party transactions between the Corporation and its Executive Chairman follows:

	Year Ended December 31,	
	2008	**2007**
706147 Ontario, Inc.:		
Administrative services	$ 56,859	$ 26,139
Accounts payable	$ -	$ 2,341
Capital Z Corp:		
Office space	$ -	$ -

During the year ended December 31, 2006, the Corporation invested in a convertible debenture with Peace River Oil Inc. for CDN$1.0 million. It was a condition of the agreement between the Corporation and Peace River Oil Inc. that the Executive Chairman of the Corporation would also become a director of Peace River Oil Inc. The Executive Chairman resigned his directorship of Peace River Oil Inc. on January 30, 2007. In addition, as part of the agreement covering the convertible debenture, the Corporation acquired the right to explore for natural gas on approximately 9,000 (gross and net) unproved acres in the Peace River area. In management's opinion, this acreage has nominal value and there are no current exploration plans regarding such acreage. On December 12, 2007, Peace River Oil Inc. defaulted on the principal and the 9% interest due pertaining to the convertible debenture. As such, the Corporation recorded an impairment charge for the convertible debenture for the period ended December 31, 2007. See Note 6 "*Investments*" in the annual consolidated financial statements for the year ended December 31, 2008.

Director

On February 7, 2007, the Corporation obtained a 25% undivided participating interest in Gastem Inc.'s undeveloped oil and natural gas interests covering approximately 313,524 hectares (757,788 acres) in the St. Lawrence Lowlands and in the Gaspe Peninsula of Quebec. Under terms of the agreement, the Corporation may elect to participate on a well-by-well basis with a 25% working interest in any current or future properties Gastem Inc. may acquire in Quebec. In return, the Corporation granted Gastem Inc. the right to participate for 25% of the Corporation's interest in future wells to be drilled in the Corporation's Amber Bank project in West Virginia by spending up to $1.05 million. The Corporation's carrying value of the portion of its Amber Bank project's leasehold attributable to Gastem Inc.'s participation was nominal. The agreement was consummated with the expectation that Raymond Savoie, Gastem Inc.'s President, would become a director of the Corporation. Mr. Savoie became a director of the Corporation on July 16, 2007. See Note 7 "*Property and Equipment*" in the annual consolidated financial statements for the year ended December 31, 2008. Related party transactions with Gastem Inc. were conducted in US dollars. A summary of related party transactions between the Corporation and Gastem Inc. follows:

	Year Ended December 31,	
	2008	2007
Gastem Inc.:		
Accounts receivable	$ 21	$ -
Joint venture costs	$ 76,876	$ 1,133,067
Joint venture revenues	$ 309,917	$ 120,803
Accounts payable	$ 14,995	$ 66,051

Director and former President and Chief Executive Officer

Austin Exploration LLC, a company owned by the Director and former President and CEO of the Corporation, is also a participant in the Corporation's New York acreage. Western Land Services Inc., a company owned by the same individual, provides oil and natural gas lease brokerage services to the Corporation in accordance with a Project Services Agreement between Western Land Services and the Corporation. Under terms of the Project Services Agreement, Western Land Services agreed to provide services to the Corporation at its lowest corporate rates less 10%. Substantially all of the services provided by Western Land Services are capitalized in oil and natural gas properties. In addition, Western Land Services provided the Corporation with office space free of charge from its inception in 2005 through March 31, 2007, at which time the Corporation began leasing office space from a third party in Traverse City, Michigan. Related party transactions with the Corporation's current director and former President and CEO were conducted in US dollars. A summary of related party transactions between the Corporation and its current director and former President and CEO follows:

	Year Ended December 31,	
	2008	2007
Austin Exploration LLC:		
Accounts receivable	$ 109,562	$ 55,693
Joint venture costs	$ 2,654,594	$ 826,020
Joint venture revenues	$ 902,291	$ 1,132,939
Accounts payable	$ 75,115	$ 10
Western Land Services:		
Lease brokerage services	$ 1,667,898	$ 3,188,360
Accounts payable	$ 138,819	$ 365,860
Office space	$ -	$ -